CHAPTER 1

Introduction

§1.01 General Frame
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§1.01 GENERAL FRAME

In the hodiernal world, in particular from the taxation standpoint, financial instruments owe their surmountable importance[1] to their specific flexibility. In this regard, derivative[2,3] financial instruments are some of the most flexible structures available, the conceivable features and combinations of which tend to be unlimited.

Therefore, through a careful assembly process giving rise to complex financial instruments unique tax benefits can be attained in a cross-border context.[4,5] Though,

1. *Cf.* '*This is because derivative financial instruments challenge some of the fundamental assumptions that underlie income tax systems*'. In Gammie, M., *The Source Taxation of Derivative Financial Instruments, 'Synthetic Securities', Financial Hedging Transactions and Similar Innovative Financial Transactions*, Derivatives & Financial Instruments, IBFD, September/October 1999, p. 232.
2. *Cf.* '*In Derivatives: The Wild Beast of Finance, 1998, Alfred Steinherr illustrates how a merchant in Venice in 1470* [could use] *many of the techniques of modern derivative financial instruments to manage the risks associated with fifteenth century commerce. What has happened particularly over the last 25 years has been a spectacular growth in the markets for – and therefore access to and availability of – the products for managing modern day commercial and financial risks.*' In *id.*, p. 231.
3. *Cf.* It is a well-publicized fact that the world's GDP amounts to around 50 trillion USD, while the notional amount of the outstanding derivatives is presently worth 441 trillion USD.
4. *Cf.* '*Hybrids enhance the performance of financial instruments by customizing them to the different needs of investors and issuers on the globalized market. The taxpayer may exploit the differences in their characterization, source, timing and amount for tax arbitrage purposes, though the General*

uncertainty is a reality in some jurisdictions on behalf of taxpayers who pursue the most sophisticated financial options to their undertakings.

Accordingly, the initial quote – '*Hitting the right balance between greed and fear*'[6] – reports, in our view, to the need to equitably consider the reservations and the corresponding disproportionate actions from both taxpayers and tax administrations, pertaining with particular accuracy to this field of international taxation.

In this sense, tax administrations nurture a natural zeal over the revenue from unfamiliar dynamics that may constitute potential threats[7] and so countries may follow the course of over-taxing certain dealings ultimately resulting in their interdiction. Similarly, taxpayers can be subject to multiple-taxation, or to unlawfully enjoy tax benefits in several jurisdictions.

For instance, at the midst of the present financial crisis Governments strive to find new ways to collect revenue. Regarding the context of the scope of this study, a proposal was made for a Financial Transaction Tax within the European Union, even though the catastrophic effects of the Swedish experience in this respect are well known.

Yet, financial instruments and derivatives are generally recognized by experts as playing a fair and advantageous role in the economy, e.g., by promoting liquidity as well as an efficient allocation of resources.

Nevertheless, many countries worldwide already have similar transaction taxes which have not altogether destroyed the said market.

In fact, the proposed Financial Transaction Tax within the European Union is expected to privilege the geographical areas that are already financial centres, by providing an incentive to taxpayers of the countries adhering to the proposal, to finance elsewhere.

To continue to set the frame of the present essay, it is relevant to take into account that the technological[8] advances that triggered the globalization process are at the origin both of the massive use of financial instruments and of other problematic concepts for international tax law.

Reporter concluded that this is normally not their main goal.' In Pistone, P. & Romano, C., *Short Report on the Proceedings of the 54th IFA Congress, Munich 2000*, IBFD Bulletin, January 2001, p. 36.

5. *Cf.* '*The general principal against tax evasion establishes the restriction of any abusive practice in tax arbitrage.*' In Rosembuj, T., *International Tax Arbitrage*, Intertax, Vol. 39, Issue 4, 2011, p. 158.
6. In Plambeck, C. & Crowe, D., *Taxation of Financial Instruments*, Tax Notes International, 1995.
7. *Cf.* '*Several countries have so far adopted administrative procedures to limit tax arbitrage, such as the UK equity notes rules, the no-ruling policy by the Netherlands or the US corporate tax shelters rules.*' In Pistone, P. & Romano, C., *Short Report on the Proceedings of the 54th IFA Congress, Munich 2000*, IBFD Bulletin, January 2001, p. 36.
8. *Cf.* '*...it is the increase in computing power needed to perform the complex mathematical computations which underlie derivative financial instruments and which has contributed to their growth.*' In Gammie, M., *The Source Taxation of Derivative Financial Instruments*, '*Synthetic Securities*', *Financial Hedging Transactions and Similar Innovative Financial Transactions*, Derivatives & Financial Instruments, IBFD, September/October 1999, p. 232. This field may therefore continue to quickly evolve in pace with technological innovation, for example with the development of cryptocurrencies or high frequency trading.

Effectively, we are convinced that the cornerstone elements of the discussion on the taxation of cross-border financial instruments, namely in connection to the principles of residence and source, mostly apply to other areas of international taxation, in particular, where income is derived from intangibles or through electronic commerce.[9]

In our approach, there is not one specific instrument which is to be globally analysed throughout the present desideratum, although numerous instruments are mentioned with the view to illustrate certain points.

It is our hopeful prospect that along with an academic value, the work here undertaken could serve taxpayers by evidencing the potential features and difficulties of complex financial instruments such as hybrids, synthetics, and non-traditional financial instruments and consequently, the most appropriate course for each particular operation and setting.

Furthermore, the conclusions here taken could also aid governments and tax administrations, by categorizing inconsistencies and weighting the tax consequences of the legislative options nowadays in place with view to an increased neutrality of taxation.

§1.02 SCOPE AND DELIMITATION

The present book highlights the tax arbitrage opportunities in a cross-border context ensuing from financial engineering, which '*is the process of combining and/or stripping financial instruments in order to attain a specific, desired financial position.*'[10,11]

As overtly known, there are basic building blocks to which financial instruments can deconstructed or built from,[12] so that a financial structure meets the requirements and qualifies for the tax benefits provided by the legal regimes applicable, in multiple jurisdictions.[13]

Therefore, in our study, the relevant concepts and their interrelations are clarified, as well as the cross-border hindrances of their usage from a tax planning

9. *Cf.* Ring, D.M., *Commentary: Exploring the Challenges of Electronic Commerce Taxation Through the Experience of Financial Instruments*, SelectedWorks, NYU Tax Law Review, January 1996, pp. 663-676, available at http://works.bepress.com/diane_ring/23/.
10. In Hilling, A., *Income Taxation of Derivatives and Other Financial Instruments – Economic Substance versus Legal Form*, Jönköping University, JIBS Dissertation Series No. 042, 2007, Note 56 on p. 12.
11. The emphasis is ours, since obtaining a certain financial position is the essence of structured finance.
12. *Cf.* e.g., Neftci, S.N., *Principles of Financial Engineering*, Elsevier Academic Press, 2004.
13. *Cf.* '*It has become a truism that any financial instrument can be expressed as the combination of a series of separate smaller components*', in Duncan, J.A., *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume LXXXVa, Kluwer Law International, 2000, p. 30. In the note to this statement, the general reporter refers to KAU, *Carving Up Assets and Liabilities – Integration or Bifurcation of Financial Products*, 1990, which describes '*13 alternative ways of replicating the cash-flow of a fixed-rate debt obligation*', adding that, '*the commentator stopped not because he had run out of alternatives* [...], *but because he had made his point.*'

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perspective, in the presence or in the absence of a tax treaty and in light of other international laws such as EU Directives.

Additionally, there is a discussion on the international meaning and application of tax principles to this reality,[14] considering the implications of alternative policies in order to address the question, – how should, given the immense global financial assortment, complex financial instruments be assessed so that each substantive reality is taxed consistently?[15,16]

To an extent tax arbitrage may be unintended[17] by certain jurisdictions, or in certain cases is resultant, for the most part, from the fact that the various kinds of instruments and the blending thereof are characterized by an economic substance that does not always meet the legal qualification.[18]

Though this may be true within a single legal system, there are unique tax opportunities resulting from cross-border dealings, known as mismatches.

Nevertheless, as many factors potentiate tax advantages for the taxpayer from the use of cross-border financial instruments, it is relevant to stress that the mismatch of the legal treatments applied to certain instruments by several jurisdictions does not comprehend the whole universe of issues giving rise to tax arbitrage in this area.

Even if the tax treatment of financial instruments was universally harmonized, cross-border tax arbitrage opportunities would be far from eradicated.[19]

14. *Cf.* '*The refinement of techniques to tailor financial instruments to meet the needs of particular issuers and investors, and to include within a single integral instrument economic characteristics that in prior year might have been documented separately, has placed stress on traditional tax classification rules* [...]. *The wide spread recognition that it is possible to construct economically identical instruments out of disparate building blocks also contributed to the sense that the application of traditional classification principles may no longer be sufficient to produce coherent and administrable results.*' In *id.*, p. 21.
15. Where consistency is a requirement of the application of the tax neutrality principle rendered, in turn, as an efficiency promoting criteria.
16. *Cf.* Similar questions were raised yet left unanswered at Pistone, P. & Romano, C., *Short Report on the Proceedings of the 54th IFA Congress, Munich 2000*, IBFD Bulletin, January 2001, p. 36.
17. *Cf.* '*In many cases,* [...] *determining whether a particular benefit was intended will raise difficult metaphysical questions.*' In Duncan, J.A., *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume LXXXVa, Kluwer Law International, 2000, p. 34.
18. *Cf.* Pistone, P. & Romano, C., *Short Report on the Proceedings of the 54th IFA Congress, Munich 2000*, IBFD Bulletin, January 2001, pp. 35-36. See also AA.VV., *54th IFA Congress, Munich 2000, Summaries of Discussion on Subjects I and II*, Prepared by the Summary of Discussion Committee of IFA, IBFD Bulletin, February 2001, pp. 81-82.
19. *Cf.* '*Even in purely domestic situations, symmetry of treatment (in the sense that the tax treatment of payments made by the issuer and received by the holder of a financial instrument is reciprocal) would appear to be the exception and not the rule. Financial instruments are frequently used in domestic markets to transfer tax benefits. For example, a company that is a position to make effective use of interest deductions may prefer to issue conventional debt obligations. Those obligations typically will be purchased by an investor base that consists largely of tax exempt institutions (for example, because it is in a loss position) may prefer to issue preferred stock, in which event the investor base will consist of entities that qualify for an exemption or reduced rate of tax on dividend income.*' In Duncan, J.A., *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume LXXXVa, Kluwer Law International, 2000, p. 32.

In concrete, hybrid, synthetic or non-traditional financial instruments are the distinct categories of complex instruments that pose the most challenging problems to their assessment, often being at the genesis of white income.[20]

This could occur as a result of the application of different criteria under accounting, regulatory, and tax law or as consequence of different rules to ascertain the timing or measurement[21] of the payoff from financial instruments, or through the generation of multiple foreign tax credits or multiple deductions and by combinations of favourable treatments in several countries, resulting in the erosion of the tax base and in the shifting of income.[22]

In spite of the aforementioned, '*the issuance of hybrid instruments, particularly in the public markets, is motivated to a very substantial extent by considerations unrelated to taxes.*[23] [...] [Such as, to] *raise funds on attractive terms, to hedge risks or to monetize assets*'.[24]

Therefore, '...*a line should be drawn between acceptable and unacceptable arbitrage.* [...] *unacceptable tax arbitrage would exist only where the transaction is a sham or is entered into exclusively for tax purposes.* [...] *otherwise it is necessary to enquire into the <u>motivation</u> of entering into the transaction, which is a purely <u>subjective judgment</u>.*'[25]

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Consequently, as previously mentioned,[26] the line should not be drawn between intended and unintended arbitrage, as this would be just as subjective as trying to ascertain the actual weight of the tax motivation in relation to other advantages accruing from a certain operation.[27]

20. White income refers to income that, in a lawful way, is not taxed in any jurisdiction.
21. *Cf.* '*The measurement of income over time is the Achilles heel of all income tax systems. ...financial instruments* [...] *target this weakness in a most fundamental way.*' In Gammie, M., *The Source Taxation of Derivative Financial Instruments, 'Synthetic Securities', Financial Hedging Transactions and Similar Innovative Financial Transactions*, Derivatives & Financial Instruments, IBFD, September/October 1999, p. 232.
22. *Cf.* '*For example, an instrument may be structured to qualify for favorable capital regulatory or accounting treatment while preserving the issuer's ability to deduct interest payments for tax purposes or to make payments free of withholding tax.*' In Duncan, J.A., *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume LXXXVa, Kluwer Law International, 2000, p. 23.
23. In *id.*, p. 22.
24. In Duncan, J.A., *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume LXXXVa, Kluwer Law International, 2000, p. 23. The same idea is expressed in AA.VV., *54th IFA Congress, Munich 2000, Summaries of Discussion on Subjects I and II*, Prepared by the Summary of Discussion Committee of IFA, IBFD Bulletin, February 2001, p. 81.
25. Emphasis added. Quotation from AA.VV., *54th IFA Congress, Munich 2000, Summaries of Discussion on Subjects I and II*, Prepared by the Summary of Discussion Committee of IFA, IBFD Bulletin, February 2001, p. 82.
26. *Cf.* see *supra* note 17.
27. *Cf.* '*If a commentary published before a law was enacted describes a planning opportunity that the proposed law would make available, should the drafters of the law be presumed to have intended to facilitate that opportunity?*' Duncan, J.A., *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume LXXXVa, Kluwer Law International, 2000, p. 34.

Hence, we are left with the question, as hurled by the general reporter of the 54th IFA meeting, of '*whether and in what respects the fact that a payment crosses the border makes a difference?*'[28]

This question has been answered by most commentators[29] by suggesting that '*...a government should not be concerned that value passes outside its jurisdiction if that value properly reflect risks assumed elsewhere. Nor in such cases should it necessarily concern one jurisdiction that another jurisdiction fails to recognize and tax the value associated with the risk assumed or chooses to tax it in a different manner or at a different time.*'[30]

Nevertheless, countries should be concerned with the idea of effecting tax neutrality in order not to create artificial encouragements in the market.

In accordance, all alternative forms of financial instruments should be taxed in a consistent manner.[31] Certainly, this is not easy to attain and absolute neutrality is an unobtainable goal, even in an exclusively domestic setting.[32]

However, there are valid options to achieve greater neutrality, even though these options do not come without shortcomings and downsides.

At this point, in these introductory remarks, we have enounced and related the topics as well as previously laid questions, so to set the framework for the following analysis.

§1.03 METHODOLOGY

The approach taken here is in line with the common methodology used in legal studies, interpreting the relevant elements constituting an expression of the legal sources.[33]

This is achieved by employing doctrinal literature debating the questions raised in the field, the OECD-, the UN- and the US-Income Tax Model Conventions, the respective Commentaries and Technical Explanations,[34] other OECD reports, case law with international relevance and the conclusions therefrom, two EU Directives[35] that

28. In *id.*, p. 22.
29. *Cf.* Rosembuj, T., *Abusive Transactions on Financial Hybrids*, Intertax, Vol. 39, Issue 5, 2011, p. 247.
30. In Gammie, M., *The Source Taxation of Derivative Financial Instruments, 'Synthetic Securities', Financial Hedging Transactions and Similar Innovative Financial Transactions*, Derivatives & Financial Instruments, IBFD, September/October 1999, p. 233.
31. *Cf.* '*...different forms of instruments tend to be extremely close substitutes. If the tax system taxes different instruments differently, the system will be particularly distortive. For this reason neutrality is an important objective.*' In *id.*, p. 234.
32. *Cf.* see *supra* note 19.
33. The expression 'legal sources' has a limited scope, here taking the meaning of the prevailing rules of society when enforceable and combined, corresponding to what is in practice considered to be legitimate, as described by A.M. Hespanha and J. Habermas.
34. *Cf.* OECD, Model Tax Convention on Income and on Capital and Commentary, 2010; UN Model Tax Convention and Commentary, 2011; US Model Income Tax Convention and the respective Technical Explanation, 2006.
35. *Cf. Interest and Royalties Directive* – Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, published in the Official Journal of the European Union, L 157, 26 June 2003, 0049–0054. *Parent-Subsidiary Directive* – Council Directive 90/435/EEC of

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constitute important ways of mitigating double taxation in the common market of the European Union, and also tax accounting rules derived from the International Financial Reporting Standards (IFRS), namely IAS 32 (*Financial Instruments: Presentation*), IFRS 7 (*Financial Instruments: Disclosures*), and most significantly IAS 39 (*Financial Instruments: Recognition and Measurement*) replaced by IFRS 9, together with US GAAP solutions.

The present work is not intended as a comprehensive comparative study, rather it is focused on the substantial questions that can be raised as a consequence of the legal approaches that are in force, and that can be classified in types, which do result in entirely different answers to these tax questions arising in the international context.

In effect, this study takes a multidisciplinary approach, as it requires the combination of elements from tax law, accounting, and finance.

The financial references here included have taken an essential part in the outline, as well as in the author's understanding, of the economic substrate of the instruments and related concepts, which subsequently take a key role in shaping the tax law outcome.

The previous statement stays true, even though the definitions for the same concepts differ under tax law, accounting rules, and financial theory.

Overall, through a critic cross-analysis of the positions enforced to this date, regarding the issues under the scope of this book, it is our aim to give a fair picture of the identified problems and solutions that have been asserted in order to draw conclusions and formulate sound contributions to the ongoing debate.

On the citing method, the conventional approach has been adopted.[36]

§1.04 MOTIVATION

The motivation to write this book, on cross-border tax arbitrage through the use of financial engineering giving rise to innovative instruments, roots to the enthusiasm in understanding the nature, and the consequences in the international tax arena, of the mechanisms and boundaries of this unceasingly adaptable financial reality. As well as to comprehend how the interpretation of the established legal concepts develops to comprise such reality when confronted with the paradoxes brought by it.

In that sense, the self-development of the author and the desire to be familiar with the fine subtleties of this field of international tax law can be said to be the main motivation for the research leading to this book.

23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, as amended by Directive 2003/123/EC, published in the Official Journal of the European Union, L 007, 13 January 2004, 0041–0044.

36. According to which, once a full reference has been made in a certain page it is after only cited by the surname of the author and the first word of the title, unless the subsequent references follow immediately after, in which case the citation is made by the Latin expression, *id.*, in case the page is different, and *ibid.*, in case the reference is made to the same page. In the same sense, case law is fully referenced the first time it is mentioned and in the jurisprudence list on page -X-, afterwards each case is alluded to by its abbreviate designation.

However, it is our strong wish that the outcome of this effort could be viewed as a consistent approach to the problems therein discussed, so that the cross-border tax arbitrage framework here established may serve as a practical tool, and that the propounded considerations on the international assessment of financial instruments prove to be well-based and time resistant.

Essentially, the international questions tackled within the study of the taxation of financial instruments are very much at the centre of the problems dealt with in other areas of international tax law and not, as sometimes it is presented, a world of its own.

Therefore, we are convinced that the awareness of financial instruments' tax dynamics is of great relevance to other topics of international taxation, for instance, those that deal with technological innovations that challenge the principles of source and residence, and that are precisely among those that pose the most blurred perplexities to their tax assessment.

§1.05 RESEARCH QUESTION

The research question, being the object of the present book, has been formulated as an endeavour – *to establish patterns of tax arbitrage opportunities through the use of financial engineering with cross-border financial instruments, identifying the problems and proposing solutions for the dilemmas of employing innovative and complex financial instruments such as hybrids, synthetics, and non-traditional financial instruments.*

Additionally, we aim to ascertain how to adequately tax cross-border financial instruments in accordance with a benchmark established to achieve greater international tax neutrality.

Accordingly, in order to efficiently develop the topic, the research question is dissected and reformulated in two sets of sub questions.

Hence, we have rephrased the first part of the research question as follows:

1. Which elements giving rise to different kinds of tax arbitrage opportunities should be wholly considered when structuring complex cross-border financial instruments?
Within the context of these elements:

a. *What are the key factors that determine the characterization of income from hybrid financial instruments under tax treaties?*
b. *What are the criteria for the entitlement of the yield from hybrid instruments to the beneficial treatment under EU Directives endeavouring to address international double taxation?*

A research question may also be phrased as a statement to be attested. The second part of the research question has been reformulated in this manner:

2.1 *Additionally, we intend to demonstrate that, the most adequate benchmark to tax financial instruments in accordance with an international understanding of the principle of tax neutrality, should be the economic substance of the instruments.*

2.2 *Furthermore, that this proposed view does not conceptually deter cross-border tax arbitrage.*
2.3 *Lastly, we intend to show the potential of expected return taxation as a method to mirror the economic substance of financial instruments, in order to tax them and to allocate taxing rights between States over their proceeds in a consistent manner.*

It is undeniable that the different approaches to these vital issues have resulted in ambiguity on how complex financial instruments in cross-border situations should be addressed.

§1.06 STRUCTURE OF THE BOOK

After the introductory remarks of Chapter 1, the following Chapters 2 and 3 are deeply intertwined, since the conceptual explanations done in the first cannot be achieved without including elements that are an integrant component of the discussion taking place on the second. Namely, the concept of expected return or the problematization of the debt and equity division, comprise already arguments with impact in the ensuing conclusions of Chapter 3.

Chapter 2 has the purpose of clarifying the terminology used and the inter relations between the presented concepts. Thus, Chapter 2, §2.01 deals with the notion of financial instrument, of derivative, and with the notion of basic building blocks in light of the expected return paradigm. Chapter 2, §2.02 clarifies the concept and relevance for the scope of the study of the three kinds of complex financial instruments, – hybrid, synthetic, and non-traditional.

Chapter 3 discusses what should be the most adequate tax treatment of the mentioned three kinds of complex financial instruments in cross-border situations, considering an objective benchmark for the international application of the principle of tax neutrality.

In order to do so, in Chapter 3, §3.01 the economic substance of the financial instruments is identified as the benchmark that assures greater international tax neutrality, and a proposal is made for the inclusion of expected return taxation in the International Financial Reporting Standards.

Chapter 3, §3.02 considers whether cross-border tax arbitrage, particularly in the case of financial instruments, is deterred by the proposed views on international tax neutrality; subsequently, the particular problems of circularly linked rules are commented, illustrating the dilemmas States are confronted with when tackling tax arbitrage situations perceived as being harmful; lastly, other closely related kinds of international arbitrage that in all instances must be considered are covered: intra-group finance of multinational enterprises, rating and regulatory aspects, the application of the methods of integration and bifurcation to the assessment of financial instruments in accordance with their substance is discussed and, concerning the timing of income taxation, the principles of realization and accrual giving rise to tax arbitrage opportunities are examined.

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In Chapter 3, §3.03, a comparative analysis is made between the Belgian and Brazilian regimes of deductions for net equity; the tax qualification of hybrid financial instruments is compared under Australian and US rules, and the approaches on the taxation of cross-border hybrid financial instruments, focussing on repurchase agreement transactions, are highlighted under UK and US provisions, exemplifying concrete patterns of cross-border tax arbitrage. Finally, a case of a cross-border derivative, - a total return swap, - between entities located in Luxembourg and Portugal, evidencing both the high flexibility of these sorts of arrangements as well as the entirely different tax consequences attracted as a result thereof.

Accordingly, these comparisons denote how different systems can be typified in gradation, - from a more formalistic legal approach to one more in line with the economic substance of the instruments.

Chapter 4 analyses patterns of international tax arbitrage that should be taken into account when structuring cross-border financial instruments.

Therefore, Chapter 4, §4.01 deals with tax treaty characterization of income from hybrid instruments under the OECD-, the UN- and the US- Income Tax Model Conventions, considering which should be the key tie-breaking factor for the application of the interest or the dividend article. In the ambit of tax treaty law, several cases from national Courts with international relevance in the interpretation of tax treaties are mentioned and some are scrutinized. In addition, these aspects are integrated into an analysis of the non-discrimination principle under paragraphs 4 and 5 of Article 24 of the OECD Model Convention (hereafter, OECD MC).

Chapter 4, §4.02 concerns the entitlement of income from hybrid instruments to the benefits of the relevant EU tax Directives, in the background of related jurisprudence from the Court of Justice of the European Union (CJEU).

Chapter 5 hubs the intersection of all the explored kinds of international tax arbitrage that could be used as a tax planning engine, and contains the global conclusions directly addressing the research question.

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CHAPTER 2

Locating the Main Concepts

§2.01 Definitions
[A] The Concepts of Financial Instrument and Derivative
[B] Risk-Based Rules and Expected Return
§2.02 Financial Engineering Giving Rise to Complex Instruments
[A] The Use of Synthetics and the Hedging Relationship
[B] Non-traditional Financial Instruments
[C] Hybrid Financial Instruments: The Debt and Equity Quandrum
[1] When the Sweeter Equity Is Really Debt
[2] The Case for the International Alchemy of Financing

§2.01 DEFINITIONS

[A] The Concepts of Financial Instrument and Derivative

The definitions of the concepts employed in this field often differ under legal/accounting and financial standards.

Therefore, in order to relate the relevant concepts and develop the arguments leading to our findings it is most convenient to previously clarify the meaning of the terminology utilized for the purposes of the present book.

Without, however, the intention to provide an all-embracing glossary, the following lines are dedicated to conceptual explanations, permitting an increasing complexity of the ideas presented.

In this framework, tax arbitrage in a cross-border context is identified with the tax optimization opportunities ensuing from the tax advantages available in several jurisdictions, some of which result from inconsistencies of the legal treatment of a certain economic reality.

While, financial engineering explores these advantages, resultant or not from cross-border inconsistencies, by creating instruments that take them into account. In this sense, from a tax perspective, financial engineering is a form of tax planning.

Under the accounting definition, in accordance with IFRS,[37] a financial instrument is '*...any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.*'[38]

Accordingly, it is considered to be a financial asset any asset that is cash, an equity instrument of another entity or a legally enforceable right to receive cash or another financial asset from another entity.[39] Whereas, a financial liability is a legally enforceable obligation to transfer away a financial asset to a different entity, under conditions that are potentially favourable to the transferring entity.[40,41]

These definitions were chosen considering that the fundamental concepts described in IFRS are widely used around the world. For instance, – '*the origins of IAS 39*[42] *can be found in US GAAP, and at a high level there are only limited differences between IAS 39 and the equivalent US standard.*'[43]

An additional reason for the choice is that the accounting methods adopted determine to a very significant extent how income from financial instruments is taxed and when.

Within the above referred definition of financial instruments lies the concept of derivative financial instrument.[44]

Derivative financial instruments are defined as *(i)* having little or no initial value, as *(ii)* being settled at a future date, and *(iii)* having their value determined by reference to an underlying item, usually securities, commodities, currencies or indexes.[45]

Derivatives are essentially volatility management tools which redistribute the risk in the market. In order to effectively allow parties to control their risk exposure, – through hedging, speculation, and arbitrage,[46] – derivatives provide for the exchange of a financial position, in other words, the exchange of specified cash flows at determined moments in time.

37. IFRS – International Financial Reporting Standards.
38. In para. 1 of IAS 32 (Financial Instruments: Presentation).
39. *Cf.* Lof, M. van der & Laan, P., *Accounting for Financial Instruments in Accordance with IFRS*, Derivatives & Financial Instruments, IFRS Special Issue, IBFD, March/April 2010, p. 3.
40. *Cf. ibid.*
41. Although the concepts of 'financial asset' and 'financial liability' are defined in IAS 39, the term 'asset' itself is not defined therein. Yet, in IASB Framework, an 'asset' is a resource of an entity resultant from a past event, linked to economic advantages. Moreover, the IASB interpretations are included as an integrant part of IFRS, *cf.* para. 11 of IAS 1.
42. IAS 39 (Financial Instruments: Recognition and Measurement).
43. In Lof, M. van der & Laan, P., *Accounting for Financial Instruments in Accordance with IFRS*, Derivatives & Financial Instruments, IFRS Special Issue, IBFD, March/April 2010, p. 3.
44. The derivatives market ramifies into exchange-traded derivatives and those with no formal organization, the over-the-counter derivatives. Nevertheless, the contracting parties of OTC derivatives normally follow the regulations established by market associations, such as the International Swaps and Derivatives Association, in particular the documentation in the ISDA Master Agreement. *Cf.* Usher, G., *ISDA Documentation*, in Denton, J. (ed.), *Practical Derivatives, A Transactional Approach*, Globe Business Publishing, 2006, pp. 25-39.
45. *Cf.* e.g., Southern, David, *The Taxation of Derivatives*, British Tax Review, 1998. See also Henderson, Schuyler K., *Henderson on Derivatives*, 2nd edition, LexisNexis, 2010.
46. *Cf.* e.g., Hull, J.C., *Options, Futures, and Other Derivatives*, Prentice Hall, 2006, p. 8.

Through the use of derivative financial instruments, it is possible to transfer the intrinsic risks of a specific financial operation among the parties involved, without transferring the underlying[47] itself.[48] Thus, it is generally recognized that the taxation of derivatives should be distinct from the tax treatment of the underlying asset.

Three approaches have been compiled[49] to address the taxation of derivative financial instruments, the *(a)* decomposition approach, according to which the derivative's cash flows are separately valued; the *(b)* separate transaction approach, which establishes that each derivative contract is quarantined and taxed on its net result; and the *(c)* linked approach, under which correlated transactions are jointly considered, and taxed on the result of the entire operation.

[B] Risk-Based Rules and Expected Return

It was previously mentioned[50] that financial engineering implies the structure of financial instruments by way of assembling certain basic building blocks, to which the economic substance of all financial instruments can be decomposed, whether to reproduce the return of existent instruments or for purposes of financial innovation.

In this section, it is explained what these building blocks are, based on the pure pattern of their returns, as a risk-free investment or a fully risk-dependent investment.

It is important to clarify that the total risk of an investment, also designated as business risk, is characterized by a positive or negative departure from the expected return of the investment. Whereas the downside risk, concept frequently used in insurance, only refers to such deviation when it is negative, – the risk of loss.[51]

Thus, expected income[52] arises in investments with no risk, while windfall gains or losses occur as a result of risk exposure.[53,54]

47. In this context, the term 'underlying' is used as a noun.
48. *Cf.* Lof, M. van der & Laan, P., *Accounting for Financial Instruments in Accordance with IFRS*, Derivatives & Financial Instruments, IFRS Special Issue, IBFD, March/April 2010, p. 4.
49. *Cf.* Plambeck, C.T., Rosenbloom, H.D. & Ring, D.M., *Tax Aspects of Derivative Financial Instruments*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume LXXXb, Kluwer Law International, 1995.
50. On section §1.02, p. 3, paras 1 and 2.
51. *Cf.* Shaviro, D., *Risk-Based Rules and the Taxation of Capital Income*, Tax Law Review, Vol. 50, 1995, pp. 643-724. Wood, O.G., *Evolution of the Concept of Risk*, The Journal of Risk and Insurance, Vol. 31, Issue 1, 1964, pp. 83-91. Athearn, J.L., *What Is Risk?*, The Journal of Risk and Insurance, Vol. 38, Issue 4, 1971, pp. 639-645. Brooks, J., *Taxation, Risk, and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax*, Georgetown Law Faculty Publications, No. 1248, 2013.
52. The *rate of expected return* can be mathematically given by the product of the *net return* multiplied by the *risk*, which is, in this context, the rate of likelihood of the occurrence of windfall gains or losses. *i.e.*, Expected Return = (Net Return.Risk) or (Return.Risk)/Cost.
53. *Cf.* Hilling, A., *Income Taxation of Derivatives and Other Financial Instruments – Economic Substance versus Legal Form*, Jönköping University, JIBS Dissertation Series No. 042, 2007, pp. 23-40.
54. The described financial theories assume a market in equilibrium, where instruments with the same substance would have the same value. See Modigliani, M., *The Cost of Capital, Corporation Finance and the Theory of Investment*, American Economic Review, Vol. 48, Issue 3, 1958, pp. 261-297.

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Actually, in the market, risk is a zero-sum game, although it may be reallocated at a premium, risk is never eliminated as such.

Effectively, the return on debt, – i.e., from making capital available, – is typically expected income, yet the return from derivatives is exclusively windfall gains or losses.[55]

Therefore, debt instruments and derivatives are the basic building blocks to which the economic substance of all other financial instruments can be redirect to.

This is so as a result of the fact that the return of all other financial instruments may be reproduced by precise arrangements of expected income and windfall gains and losses, that is, of debt and derivatives.[56]

§2.02 FINANCIAL ENGINEERING GIVING RISE TO COMPLEX INSTRUMENTS

In order to establish the framework of tax arbitrage opportunities that can be attained through financial engineering, we have proposed to broach the cross-border tax aspects of three types of complex financial instruments, – hybrids, synthetics, and non-traditional financial instruments, – which are those that pose the most perplexities to their tax assessment, particularly in a cross-border context.

In the next sections of this chapter, the nature, purpose, and hindrances of these concepts is explored from an income tax perspective in light of financial theory and IFRS interpretations.

[A] The Use of Synthetics and the Hedging Relationship

The basic building blocks, – derivatives and debt, – may reproduce the return of any financial arrangement, giving rise to a *synthetic* financial instrument.

The reproduction of an instrument consists in the replication of the net return of that instrument.[57] For instance, a synthetic share is an instrument that yields the net return of that share, which is to say, the net return of the incorporated assets and business activities.

55. Derivative financial instruments can be divided into price-fixing or price-insurance derivatives, as a consequence of the way they transfer risk. For instance, since an option typically has a value at inception it is acquired at a premium. Derivatives may also transfer the total risk on an investment or only a partial risk. For example, an option may be used to transfer the downside risk of the underlying, whereas a forward transfers the exposure to the total risk of the underlying.
56. *Cf.* Smithson, C.W., *A LEGO® Approach to Financial Engineering: An Introduction to Forwards, Futures, Swaps, and Options*, Midland Corporate Finance Journal, 1987.
57. In essence, Islamic Finance resources to these same financial engineering techniques to construe financial operations that replicate the return on the desired investments, while in accordance with certain religious determinations that exclude various dealings. One of the most characteristic aspects is the prohibition of interest payments.

By the same token, considering that the yield on debt is expected return, synthetic debt[58] is attained by reducing the total risk exposure connected to a certain income stream. For example, a share and a derivative fixing the future price of such share at a given moment.

Effectively, synthetic financial instruments are formed by financial positions exposed to the same risk, so that they partially offset each other's return, replicating the return from another distinct financial instrument.[59]

Hence, from this structure two conclusions can be drawn.[60] First, the synthetic instrument wholly considered comprises necessarily an inferior risk exposure than any of its elements independently considered. Second, the return from synthetics necessarily matches the return from other existent financial instruments; that is to say, synthetics do not create new financial instruments,[61] albeit, these may be perceived as legally innovate.

Synthetic financial instruments may essentially be utilized for two purposes,[62] *(a)* to take advantage of tax arbitrage opportunities, and *(b)* hedging, – managing the risk exposure of investments. In fact, synthetics and hedging operations are identically structured.[63]

Whenever a financial instrument and a corresponding synthetic of that instrument are not subject to a consistent tax treatment, then tax arbitrage opportunities arise in several ways.

For instance, if the return is differently classified when it is resultant from a given financial instrument and from the building blocks of an analogous synthetic instrument, then tax benefits can be attained through arbitrage.

In other words, tax arbitrage ensues, in the ambit of synthetics, from the inconsistent tax treatment of the return from different combinations of offsetting

58. It is relevant to highlight that, debt and derivatives are not the basic building blocks because their financial positions cannot be replicated, that is not the case. Debt and derivatives are the basic building blocks because through these instruments any other financial position may be reproduced, and therefore, all other financial instruments may be reconducted to combinations of debt and derivatives, *i.e.*, expected return from risk-free investments and windfall gains and losses from the assumption of risk. Accordingly, synthetic financial instruments may be synthetic debt, synthetic equity or synthetic derivatives.
59. *Cf.* Edgar, T., *The Income Tax Treatment of Financial Instruments, Theory and Practice*, Canadian Tax Foundation, 2000, pp. 313 *et seq*. See also, Edgar, T., *Response: A Defensible and Workable Approach to the Income Tax Treatment of Financial Instruments*, Canadian Tax Journal, Vol. 50, Issue 1, 2002, pp. 249-260.
60. *Cf.* AA.VV., *The Use of Derivatives in Tax Planning*, Fabozzi, F.J. (ed.), 1998. See also Smithson, C.W., *Managing Financial Risk: A Guide to Derivative Products, Financial Engineering, and Value Maximization*, McGraw-Hill, 1998.
61. Contrasting with composite contracts, see next section §2.02[B].
62. *Cf.* Hilling, A., *Income Taxation of Derivatives and Other Financial Instruments – Economic Substance versus Legal Form*, Jönköping University, JIBS Dissertation Series No. 042, 2007, pp. 145-170. '*...a hedge relationship and a synthetic are equal*' in *id.*, p. 159.
63. *Cf.* Trombley, M.A., *Accounting for Derivatives and Hedging*, McGraw-Hill Higher Education, 2003. See also Pirchegger, B., *Hedge Accounting Incentives for Cash Flow Hedges of Forecast Transactions*, European Accounting Review, Vol. 15, Issue 1, 2006, pp. 115-135.

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financial positions, all of which accomplish the same economic substance, that is, – the same return pattern.[64]

This reality needs to be considered when structuring cross-border financial instruments, particularly, since the combination of an asymmetric tax treatment of synthetics in different jurisdictions creates possibilities that would not be otherwise available, providing for similar mismatch opportunities as hybrid financial instruments.[65]

However, in a domestic context, debt is typically taxed on accrual basis, while synthetic debt constituted by an asset and a derivative fixing the future price of the sale of the asset may provide timing arbitrage opportunities, since the return on such synthetic position is usually taxed upon realization.

This kind of tax advantages may be achieved in a parallel way through the use of a straddle.[66] A straddle is an investment formed in the same way as a synthetic. However, the yields from the financial instruments integrating the straddle exactly offset each other, giving rise to an investment with no net return, and thus, with no economic substance.

Therefore, straddles provide a deferral by the strategic sale of the synthetic's component comprising a loss. In any case, the instrument can be reacquired to maintain the investment.

[B] Non-traditional Financial Instruments

Non-traditional financial instruments can be formed in two ways, by *(a)* 'bringing together' or by *(b)* 'setting apart'.

That is, by means of reassembling financial instrument's building blocks or by isolating the components of current financial instruments, it is possible to achieve a distinctive ensuing return, with no correspondence with pre-existing instruments.

Contrarily to the synthetic structure, the income streams from the elements integrating a composite contract are not interdependent and do no offset each other. The reason for this is that the components of composite contracts are subject to different risks, resulting in a unique return pattern.[67]

For the purposes of identifying cross-border tax arbitrage opportunities, composite contracts that aggregate pre-existing financial positions are the ones that cause most difficulties to their assessment.[68] This is so, since akin to synthetics, composite

64. Put-call parity is a theorem that can be used for purposes of pricing options, yet it can also be used to create a synthetic bond, in order to achieve tax benefits. *Cf.* Hilling, A., *Income Taxation of Derivatives and Other Financial Instruments – Economic Substance versus Legal Form*, Jönköping University, JIBS Dissertation Series No. 042, 2007, p. 153.
65. See Sections §3.01[C] and §3.02[E], and the conclusions from Chapter 5 in Section §5.01.
66. *Cf.* Hilling, A., *Income Taxation of Derivatives and Other Financial Instruments – Economic Substance versus Legal Form*, Jönköping University, JIBS Dissertation Series No. 042, 2007, p.169.
67. *Cf. id.*, p. 47 *et seq.*
68. *Cf.* '*...the financial engineering, product innovation processes, and the jurisdiction dependent stage of progression of these processes, additionally contribute to the tax diversity in the treatment of the hybrid instruments. The tax jurisdictions drastically differ in their attitude towards an*

contracts achieve tax advantages whenever the tax treatment given to the combined whole differs from the one given to its components.[69]

From a legal standpoint both synthetics and non-traditional financial instruments are jointly acknowledged to be financial innovative categories of instruments, although only the later are so substantially, since synthetics reproduce the return pattern of existing instruments.[70]

[C] Hybrid Financial Instruments: The Debt and Equity Quandrum

[1] When the Sweeter Equity Is Really Debt

Before all else, the word '*quandrum*' is a creation that has been employed to the discussion on hybrid financial instruments for the reason that the word itself is a hybrid or a blending between the terms 'quandary' and 'conundrum', respectively meaning *perplexity* and *riddle*.

Therefore we have adhered to this terminology as it reflects with a certain wit the both complex and dilemmatic nature of the subject.

In section §2.02[C][1], from a conceptual perspective, the background discussions on hybrid financial instruments are explored, considering the notion and the disparate treatment given to debt and equity. Section §2.02[C][2] focuses on the justification for the underlying division as well as the proposed alternatives for the paradox.

Effectively, all investments must be financed through debt, equity or a combination of the two.[71] However, the definition of debt and equity varies both, *(a)* in several jurisdictions and *(b)* for different purposes. For example, the debt and equity definitions under regulatory rules, namely when derived from the Basel Accords applicable in the banking sector, often differ from the definitions for tax and for tax accounting purposes in a single jurisdiction.[72]

Nevertheless, it is possible to typify the general characteristics commonly attributed to debt and to equity finance in the way expressed by the next table. (The words in bold highlight the most advantageous aspects of either financing option).

understanding of the innovative financial products that allow complete separability and manipulability of the classic instruments' component parts and make the risk profile and tax efficient characterization of such instruments effectively elective. The resulting diversity in tax treatment unsurprisingly provides numerous opportunities for tax arbitrage.' In Krahmal, A., *International Hybrid Instruments: Jurisdiction Dependent Characterization*, Houston Business and Tax Law Journal, 2005, p. 116.

69. For accounting purposes, non-traditional FI comprise compound FI, which are non-derivative instruments entailing an equity and a liability element. IAS 32 establishes that such components should be separately presented as financial liabilities, assets or equity. For example, a convertible bond is a compound FI.
70. *Cf.* e.g., Neftci, S.N., *Principles of Financial Engineering*, Elsevier Academic Press, 2004.
71. *Cf.* e.g., Johannesen, N., *Cross-Border Hybrid Instruments*, Department of Economics, University of Copenhagen, 2010.
72. *Cf.* Cottani, G. & Liebentritt, M., *Tire 1 Capital Instruments: Regulatory and Tax Issues*, Derivatives & Financial Instruments, IBFD, May/June 2008, p. 65.

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Table 2.1 General Features of Debt and Equity

	Maturity	*Seniority*	*Control*[73]	*Return on Investment*	*Risk*	*Rating*	*Legal Position*
Debt	**Fixed**. Nominal right to claim the capital made available	**Senior/ Preference**	No voting rights	**Fixed**, independent from the business	**Limited to credit default risk**	No or negative impact	Creditor
Equity	Residual right, no assurance of repayment. Only upon liquidation	Junior/ Subordinated	**Voting rights**	Contingent, sharing profits and losses	Business/ total risk, up to the invested capital	**Positive impact**	**Owner**

In this framework, hybrid financial instruments are defined as instruments containing debt and equity features, that is, with '*economic characteristics that are inconsistent, in whole or in part, with the classification implied by their legal form.*'[74] Thus, hybrid financial instruments are also referred to as mezzanine finance.[75]

In fact, the above mentioned distinctive attributes are indicators commonly related to the pure characteristics of an ordinary share on one end, and a plain vanilla short-term bond on the other. Hence, instruments can be classified in degrees being

73. Parties holding a long position on debt instruments may have no legal right to access information or to exercise any type of control. However, this is true in practice to the extent all credit obligations are fulfilled, if a payment is missed (default event) or if the credit rating decreases, this assumption may not stand, since the debt holders may be able to foreclose assets that compromise the business activity.
74. This definition has been widely accepted and reproduced by other commentators, as proposed by Duncan, J.A., *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume LXXXVa, Kluwer Law International, 2000, p. 22.
75. *Cf. 'For illustrative purposes, authors classify* [hybrid financial instruments] *into preferred or preference shares, redeemable preference shares, participation loans, jouissance rights, silent partnerships – typical or atypical –, participation bonds, convertible bonds, warrant bonds, subordinated long term and perpetual indebtedness, and subordinated debt. Most common instruments are convertible debts, debentures and obligations, redeemable shares or participating debentures, loans and certificates, and preference shares. But in recent years there has been a considerable development of other more "exotic" derivatives, through the combined use of options, forwards and swaps, such as credit default swaps or credit default options.'* In Prats, F.A.G., *Qualification of Hybrid Financial Instruments in Tax Treaties*, Diritto e Pratica Tributaria Internazionale, Vol. 3, Issue 3, CEDAM, Milan, September/December 2011, p. 980 *et seq.*

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either closer to debt or equity. The more debt or equity features a certain instrument displays, the more likely it is that it will be classified accordingly.[76]

The following table represents the most common tax treatment given to the return on debt and equity investments.

Table 2.2 General Taxation of Debt and Equity

Type of Finance	*Type of Payment*	*Outbound Taxation*	*Inbound Taxation*
Debt	Interest	(Generally) Deductible	Includible; and (generally) subject to a lower withholding tax at source
Equity	Dividend	(Generally) Non-deductible	Includible, often subject to a substantial shareholder's relief; and subject to a withholding tax at source

The return on an equity investment, – a dividend distribution, – is typically non-deductible, i.e., it is an after-tax payment, and it is subject to a withholding tax at source, pursuant from the territoriality principle. Yet, frequently the receiver detaining a substantial shareholding qualifies for a relief.[77] Whereas, the return on a debt investment, – an interest payment, – is generally deductible[78] to the tax base of the borrower and included in the tax base of the lender while eventually subject to a lower[79] withholding tax in the source State.

In this background, payments are subject to juridical double taxation[80] if no relief is provided for the tax withheld at source, – domestically or ensuing from a tax treaty.

76. *Cf. 'As a result of financial innovation, contemporary instruments possess both debt and equity characteristics of varying magnitude and thus are more easily placed on a "debt-equity continuum" rather than pigeonholed into pure debt or equity categories.'* In *Krahmal, A., International Hybrid Instruments: Jurisdiction Dependent Characterization*, Houston Business and Tax Law Journal, 2005, p. 103.
77. In Europe such relief often takes the name of participation exemption, while in the US it is known as qualified dividend distributions, taxed at the long-term capital gains rate.
78. Besides, '*countries may provide for the deduction of interest far in advance of any cash payment, such as original issue discount (OID), over the life of the instrument.*' In Blessing, P.H., *The Debt-Equity Conundrum – A Prequel*, Bulletin for International Taxation, IBFD, April/May, 2012, p. 199.
79. The rates of withholding taxes vary considerably, some countries have higher withholding taxes on interest payments than on dividend payments, and some do not levy them at all.
80. *Cf. 'In juridical double taxation two or more states levy their respective taxes on the same entity or person on the same income and for identical periods.'* In Rohatgi, R., *Basic International Taxation*, 2nd edition, Vol. 1, Principles, Richmond Law & Tax, 2005, p. 2, para. 4.

Additionally, payments made between related parties are subject to economic double taxation[81] at the level of the paying entity and at the level of the receiving entity, unless the payment is either deductible at source or exempt in the residence State. This is necessarily the case for dividend payments as these are by definition effectuated between related parties, though it may not be the case for interest payments.

Table 2.3 Taxation of Cross-Border Payments

Taxation of Cross-Border Payments[82]	*Residence: Exempt –*	*Residence: Includible +*
Source: Deductible –	**Source – / Residence -**	Source – / Residence +
Source: Non-deductible +	Source + / Residence -	**Source + / Residence +**

Excluding the possibility of a partial exemption or deduction, there are four possible intersections, as expressed in the preceding table.

The most advantageous of these combinations is the double non-taxation resulting from the junction of the deduction of the payment in the source State together with the granting of an exemption in the residence State. Conversely, economical double taxation takes place whenever a payment is non-deductible in the source State and fully taxed in the residence State. Whereas, the other two arrangements provide for single taxation.

Moreover, the absence or the existence of a withholding tax levied at source, on outbound dividends or interest payments, conjugated with the presented frame, gives rise to triple non-taxation or, as mentioned *supra*, to both juridical *and* economical double taxation.[83]

From the above mentioned, it can be concluded that debt and equity are taxed differently in a single country, and even more so in cross-border dealings.

The return on equity is taxed at two levels, – at the levels of the paying and receiving entities, – while the return on debt is commonly only taxed at the level of the receiving entity.[84]

Cross-border investments in shares are hampered by the income tax at the corporate level at source, whereas cross-border investments in debt of a foreign company are not.[85,86]

81. *Cf. 'Economic double taxation arises in international taxation when the same economic transaction, item or income is taxed in two or more States during the same period, but in the hands of different taxpayers.'* In *ibid.*
82. The plus (+) signs imply that the income payment is added to the tax base, and correspondingly, the minus (-) signs indicate that the income is excluded from the tax base.
83. *Cf.* Eberhartinger, E. & Six, M., *Taxation of Cross-Border Hybrid Finance. A Legal Analysis*, Intertax, 2009, p. 6.
84. *Cf.* Schön, W., *The Distinct Equity of the Debt-Equity Distinction*, Bulletin for International Taxation, IBFD, September 2012, p. 490.
85. *Cf. id.*, p. 493.
86. For instance, the repatriation of the debt principal, unlike equity, is typically made free of a withholding tax at source or taxation as a result of the domestic law of the residence State.

Furthermore, corporate entities, members of a partnership or individuals, deriving cross-border income may be deemed to have a permanent establishment in the source State and taxed accordingly. Yet, the same taxpayers holding a long position in a cross-border debt instrument do not give rise to a permanent establishment in the source State.[87,88]

Hence, the way taxing powers are shared among jurisdictions is significantly conditioned by the distinctive tax treatment given to debt and equity under domestic laws, comprising a source basis of taxation for the return on equity investments and a residence basis for the taxation of the return on debt investments.[89]

Consequently, there is typically a tax incentive towards debt finance as a result of two differing traits: *(a)* the withholding tax rates applied to interest payments are lower in relation to those applied to dividend payments; even under tax treaties, portfolio dividends, i.e., not arising in the context of a substantial shareholding,[90] are commonly subject to higher withholding tax rates than interest payments;[91] and *(b)* in most countries interest payments are deductible while the return on equity investments is not, with a few exceptions, i.e., Belgium, Brazil, Italy and Liechtenstein.[92]

From an international taxation point of view, the main reason[93] for this distinctive treatment is that while equity tends to be a stationary investment *sine die* in the source State, debt can be promptly retrieved and reallocated to other investments. Thus, this reality explains the existing tax competition[94] regarding the attractiveness of debt investments.[95,96]

87. *Cf. ibid.* See also Schön, W., et al., *Debt and Equity: What's the Difference? A Comparative View*, Max Planck Institute for Intellectual Property, Competition & Tax Law, Research Paper Series No. 09-09, July 2009, pp. 98-99.
88. Though, alternative means of equity financing can attain these benefits through, e.g., derivatives or renting property, which provides deductions and does not constitute a PE in light of the OECD MC.
89. *Cf.* Schön, W., *The Distinct Equity of the Debt-Equity Distinction*, Bulletin for International Taxation, IBFD, September 2012, p. 490.
90. A substantial shareholding is considered to be 10% of the capital under the UN MC, 25% of the capital under the OECD MC and 10% of the voting rights under the US MC. Both the OECD MC and the US MC establish that the withholding tax rate in such cases should not exceed 5% of the gross profit.
91. Interest payments are subject to a withholding tax rate at source not exceeding 10% of the gross profits under the OECD MC, while the US MC generally provides for no withholding tax at source for interest payments. However, both the OECD MC and the US MC provide for a maximum withholding tax rate of 15% for portfolio dividend payments. The UN MC does not include numeric values for these rates.
92. *Cf.* Brown, P., *Debt-Equity Conundrum*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume XCVIIb, Kluwer Law International, 2012, p. 41. Austria and Croatia had and abolished akin rules.
93. See *Infra*, section §2.02[C][2], analyses in detail the rationale and the alternatives for the distinct tax treatment of debt and equity.
94. Elasticity to select a tax setting has increased by 50% from 1992-2011, cf. Blessing, P.H., *The Debt-Equity Conundrum – A Prequel*, Bulletin for International Taxation, IBFD, April/May, 2012, p. 205.
95. *Cf.* Schön, W., *International Tax Coordination for a Second-Best World (Part II)*, World Tax Journal, February 2010, p. 84.
96. Therefore, equity investments may increase the incidence of a *lock-in effect*, – term that refers to the situation where a comparatively worse investment is kept as a result of the high cost of changing.

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[5] *Conclusion: Abridged Highlights*

(1) In sum, the flexibility of the total return swap accounts for its economic advantages, although, deviation from the standard form may raise several legal issues such as, the existence of an agent permanent establishment, beneficial ownership questions, or even of income classification under domestic law as well as under the applicable tax treaty, particularly if the reference asset itself is exchanged.
(2) In a standard total return swap, the income under the contract should normally be classified as *other income*, under Article 21 of the OECD MC,[497] thus allocating exclusive taxing powers to the residence State of the TR Receiver. As withholding taxes at source would be levied if such income was to be classified as either dividends or interest. Though, the notion that income under a swap contract is not per se interest is currently well established.
(3) It is relevant to emphasize that in a swap agreement what is actually exchanged is the availability of certain cash flows in specified moments in time, fitting the desired income pattern sought by the parties, and not an amount or asset as such.
(4) From the above discussed it can be retrieved that a total return swap between entities located in Luxembourg and in Portugal enjoys several advantages and a broad freedom to structure creative operations.

497. *Cf.* Art. 21 of the current OECD MC corresponds to Art. 22 of the DTC Lux-Pt.

CHAPTER 4

International Tax Arbitrage

§4.01 Tax Treaties on Income from Hybrid Instruments
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[3] Article 24(5) of the OECD MC: Non-discrimination of Shareholders
§4.02 EU Law on Income of Hybrid Instruments
[A] The Interaction of the Interest and Royalties and the Parent-Subsidiary Directives regarding the Yield from Hybrid Instruments
[B] EU Law on Cross-Border Tax Arbitrage in Relation to Hybrid Instruments

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§4.01 TAX TREATIES ON INCOME FROM HYBRID INSTRUMENTS

[A] Model Tax Conventions on the Characterization of Income

The analysis taken in this and the next sections is centred on the comparison between the OECD-, the UN- and the US Income Tax Model Conventions, considering the respective Commentaries and Technical Explanation,[498] with particular emphasis to the dividends and interest articles.

Nonetheless, emphasis is channelled to the analysis of the OECD MC, given the great number of double tax conventions based on it,[499] with minimal overall digression.[500]

It is adequate to start by referring that taxing rights are not created by tax treaties; rather the role of tax treaties is to allocate taxing rights between countries, in order to mitigate double taxation,[501] which arises as a result of the intersection of the internal laws of States.

Therefore, it is necessary to primarily inquire whether a given State can tax a certain dealing under its domestic laws and in the presence of a sufficient connecting factor with the taxable event and taxpayer.[502]

When a tax treaty is applicable, the characterization of income from cross-border financial instruments influences the final tax liability by determining, between the source and residence States, which should waive its tax claim and to what extent.[503]

Moreover, taxpayers benefit from the more favourable treatment, either under the applicable tax treaty or under the domestic law.[504]

For the purposes of the examination of tax treaties, the Vienna Convention on the Law of Treaties constitutes a consensual international basis, in particular, regarding

498. *Cf.* OECD, Model Tax Convention on Income and on Capital and Commentary, 2010; UN Model Tax Convention and Commentary, 2011; US Model Income Tax Convention and the respective Technical Explanation, 2006.

499. *Cf.* Vogel, K., *Problems of the Interpretation of Tax Treaties*, Steuer und Wirtschaft International, 2000, p. 106.

500. *Cf.* Eberhartinger, E. & Six, M., *Taxation of Cross-Border Hybrid Finance. A Legal Analysis*, Intertax, 2009, p. 7.

501. Tax treaties are designed to address juridical double taxation, see *supra* note 80.

502. *Cf.* e.g., Vogel, K., *Double Tax Treaties and Their Interpretation*, International Tax & Business Law, Vol. 4, Issue 1, 1986, pp. 7-8.

503. *Cf.* '*it has been argued that the intention of the negotiators of the treaty* […] *was to avoid double taxation and not to facilitate duplicative claims to the same benefits. Thus, it has been argued, the tax authorities of a treaty jurisdiction have the power to construe treaties in accordance with their underlying purpose, and not to extent treaty benefits to transactions that fall outside that purpose.*' In Duncan, J.A., *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume LXXXVa, Kluwer Law International, 2000, p. 33.

504. *Cf.* Prats, F.A.G., *Qualification of Hybrid Financial Instruments in Tax Treaties*, Diritto e Pratica Tributaria Internazionale, Vol. 3, Issue 3, CEDAM, Milan, September/December 2011, p. 979.

the rejection of a unilateral override,[505] on the acceptance of the principle of *bona fide*[506] as well as, for the most part, of the principles of interpretation.[507,508]

The interpretation of treaties, regarding our subject matter, operates by subsuming the substantive features of a given financial instrument to an applicable rule of the treaty, the scope of which has been previously ascertained.

In this respect, predominant doctrine has taken the view that tax treaties must be interpreted autonomously, that is, in accordance with the specific meaning derived from their particular rules, regardless of the domestic laws of the Contracting States, unless a direct reference is made.[509,510]

In essence, considering that the application of a given income article of a treaty determines which State and to what extent may tax the income from a financial arrangement, the ensuing analysis is focussed on the underlining basis of the criteria for such characterization.

To begin, under the OECD-, the UN- and the US Model Conventions, Article 7 *(Business Profits)* is of subsidiary nature for purposes of characterization of income from financial instruments arising in the course of business, given that this article[511] remits to other applicable articles of the Convention, provided no permanent establishment is deemed to exist.

Article 7 (*Business Profits)* grants exclusive taxing rights to the State of residence, which operates the tax on a net basis, as opposed to withholding taxes which are applied to gross profits, as before deductions.

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505. *Cf.* Vienna Convention on the Law of Treaties, 1969, Art. 27.

506. *Cf.* VCLT, 1969, Articles 26 and 31(1).

507. *Cf.* VCLT, 1969, Articles 31-33. In particular, Art. 31(1) requires that, '*a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.*' While, Art. 31(2) stresses the inclusion of additions to the text.

508. These aspects of the VCLT are applicable even for non-signatory States and States that did not ratified the Convention. Although, the VCLT lacks mechanisms to curtail actual cases of unilateral override.

509. *Cf.* Lang, M., *Interpretation of Double Taxation Conventions*, Country Chapter Austria, IFA *Cahiers De Droit Fiscal International*, Volume LXXVIIIa, Kluwer, 1993, p. 202. see also, Lang, M., *Hybride Finanzierungen im Internationalen Steuerrecht*, Vienna Orac, 1991.

510. *Cf.* Czech Republic: Supreme Administrative Court, 10 February 2005, *AAA v. Financial Directoratej*, Case 2Afs 108/2004–106, translation published in International Tax Law Reports (2005), No. 8, pp. 178-205, Tax Treaty Case Law IBFD. In this case, the Commentary was not found to be part of the context of the treaty in the sense of Art. 31(3) of the Vienna Convention on the Law of Treaties, as the tax authorities did not prove that the Commentary was a '*subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions, nor a subsequent practice in the application of the treaty.*' The Supreme Administrative Court considered the Commentary as a supplementary means of interpretation, but did not consider the relevant provisions. Since, in the view of the Court, the meaning of the terms '*dividend*' and '*interest*' was not ambiguous under the tax treaty.

511. *Cf.* OECD MC, 2010, Art 7(4); UN MC, 2011, Art 7(6); US MC, 2006, Art 7(6).

[B] *Dividend* and *Interest* Articles

[1] Introduction

In this section, the dividend and interest articles of the referred Model Conventions[512] are scrutinized for the purpose of treaty characterization of the income from cross-border financial instruments.

In particular, Articles 10 and 11 correspond directly to the dichotomy of hybrid financial instruments characterization, between the tax treatment given to the return on equity and debt investments, respectively.

In tax treaties, both the dividend and interest articles grant limited taxing rights to the State of source, typically yet not necessarily exercised by means of a withholding tax, while providing for an unrestricted right to tax to the residence State.

In order to mitigate double taxation, tax treaties require the State of residence to provide a relief for the withholding tax levied in the source State, through the exemption or credit method.[513,514]

In this background, portfolio dividends i.e., not arising in the context of a substantial shareholding, are commonly subject to higher withholding tax rates than interest payments.

A substantial shareholding is considered to be 10% of the capital under the UN MC, 25% of the capital under the OECD MC and 10% of the voting rights under the US MC.

In addition, both the OECD MC and the US MC establish that the withholding tax rate in the framework of a substantial shareholding should not surpass 5% of the gross profit, and provide for a maximum withholding tax rate of 15% for portfolio dividend payments, while the UN MC does not include numeric values for these rates.[515]

Interest payments are subject to a withholding tax rate at source not exceeding 10% of the gross profits under the OECD MC, while the US MC generally provides for no withholding tax at source for interest payments.[516]

[2] Treaty Concepts: Dividend

In this setting, the US Model defines dividends as follows, – '*income from shares or other rights, not being debt-claims, participating in profits, as well as income that is*

512. See *supra* note 291.
513. *Cf.* OECD MC, 2010, Art. 23 A and B; UN MC, 2011, Art. 23 A and B; US MC, 2006, Art. 23.
514. *Cf.* OECD Commentary, 2010, on Art. 23 A and B, para. 47, naturally commends that the credit method be applied instead of the exemption method if the residence State chooses to tax the income.
515. *Cf.* Articles 10(2) and 11(2) of the OECD- and UN MC and Articles 10(2) and 11(1) of the US MC, require the recipient of the income to be its beneficial owner in order to enjoy treaty benefits.
516. *Cf.* '*these limits are an important subject of treaty negotiations* [...] *it is also possible for a specific DTC to deny the source state the right to levy withholding tax, more frequently in the case of interest payments.*' In Eberhartinger, E. & Six, M., *Taxation of Cross-Border Hybrid Finance. A Legal Analysis*, Intertax, 2009, pp. 7-8. In addition, see Annex I, on p. 113.

subject to the same taxation treatment as income from shares under the law of the State of which the payer is a resident'.[517]

Whereas, the OECD- and the UN Model Conventions provide for the ensuing definition of dividends, – '*the term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights not being debt-claims, participating in profits, as well as income from other corporate rights, which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.*'[518]

The term dividend is not defined exhaustively and both definitions refer to the domestic law of the source State.

In particular, under Article 3(2) of the OECD MC, the expression '*income from other corporate rights*' is not defined in the Convention, and its meaning should in this case be derived from the domestic law of the source State, unless the context otherwise requires.[519,520]

However, it is essential to clarify the extent of this referral.

In this frame, the dividend article encompasses, (a) the listed elements, – '*shares, 'jouissance' shares or 'jouissance' rights, mining shares, founders' shares*'; it further includes (b) '*other rights*' which are defined in the article as (i) participating in the profits, and (ii) not being a debt-claim; and (c) '*other corporate rights*', subject to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

Firstly, the addition of the term '*other*' to '*corporate rights*' confirms that all the items specified in Article 10(3) are corporate rights.

Secondly, from the wording of Article 10 it can be clearly understood that the term '*corporate rights*' must be interpreted independently from the domestic law of the

517. *Cf.* US MC, 2006, Art. 10(5).
518. *Cf.* OECD – (2010) and UN MC (2011), Art. 10(3) on both Model Conventions.
519. *Cf.* '*the use of the ambiguous expression 'income from other corporate rights' should be avoided, as was recommended in the OECD Thin Capitalization Report.* [...] *So far as the potential overlap between the dividend and interest definitions is concerned we support the Thin Capitalization Report's recommendation that it should be made clear that Art. 11 does not include anything dealt with in Art. 10.* [...] *In addition, the Commentary should state that there can be no conflict between the Model's interest definition and limbs 1 and 2 of the dividend definition, so that the only case where the priority rule would be necessary is in the case of limb 3 of the dividend definition amended as we have suggested.*' In Jones, J.A., et al., *The Definitions of Dividends and Interest in the OECD Model: Something Lost in Translation?*, British Tax Review and IBFD, Vol. 1, Issue 1, October 2009, p. 45. In the same course, '*The definition of Dividends under Article 10.3 OECD MC raises complex issues, mainly due* [...] [to the fact that] *this provision endorses the qualification under domestic law for treaty purposes*' In Tenore, M., *Taxation of Dividends: A Comparison of Selected Issues under Article 10 OECD MC and the Parent-Subsidiary Directive*, Intertax, Vol. 38, Issue 4, 2010, p. 226.
520. *Cf.* see *infra*, section §4.01[C] on p. 68, further clarifies when the definitions found in the source State's domestic law prevail for treaty purposes. Furthermore, the OECD Comm., 2010, Art. 3, para. 11, refers to the domestic law '*in force when the Convention is being applied.*' Also, Art. 31 of VCLT by obliging an interpretation in good faith precludes, within Art. 3(2), domestic laws violating a treaty provision.

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source State, – *'the term 'dividends' as used in this Article means income from* [...] *or other rights not being debt-claims, participating in profits'*.

Finally, the term *'other corporate rights'* cannot be interpreted as imposing whatever definition of dividends the source State applies, since to qualify as a dividend under Article 10 such definitions need to be in accordance with the concept of *'corporate rights'* as autonomously interpreted in the treaty.[521,522]

Thus, the referral to the domestic law of the source State relates only to the *'taxation treatment as income from shares'*, and not to the meaning of the term *'corporate rights.'*[523]

On the contrary, the US MC's definition of dividends does not require an autonomous interpretation instead accepting the source State's definition, unrestrained by the concept of *'corporate rights'* under the treaty.[524] To the domestic definition the US MC only adds that, specifically, *'income from shares or other rights, not being debt-claims, participating in profits'*, fall under Article 10.

[3] Treaty Concepts: Interest

Interest is defined in a similar way by the Model Income Tax Conventions, as *'income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures'*.

521. *Cf.* '[Some States] *seem to be of the opinion that as long as they, as the source state, tax an item of income as a dividend, the income also qualifies as a dividend under the tax treaties following the OECD Model and the residence state should accept the dividend classification. This way of applying a tax treaty, however, cannot be correct if the payment was not made on a corporate right.*' In Helminen, M., *Classification of Cross-Border Payments on Hybrid Instruments*, IBFD Bulletin, February 2004, p. 58. In addition, *'the OECD Commentary clearly means not only rights in the form of equity, but also rights in the form of debt-claims which, in their true nature, are actually equity.'* In *id.*, p. 59 and in the OECD Comm., 2010, on Art. 10(2), para. 15(d).

522. *Cf.* This position is widely acknowledged by doctrine, e.g., *'this means that the source state's classification is relevant only if, from the perspective of an autonomous interpretation, it is qualified as a corporate right.'* In Six, Martin, *Hybrid Finance and Double Taxation Treaties*, Bulletin for International Taxation, IBFD, January 2009, p. 23. See also, Vogel, K., *Klaus Vogel on Double Taxation Conventions*, Kluwer, 1997, p. 649.

523. The OECD view is that the term – *'other corporate rights'* – should be strictly interpreted as referring to 'disguised profit distributions'. See, e.g., *'"other corporate rights" through a limited interpretation of paragraph 25 of the Commentary on Article 10 of the OECD Model, which, in their view, would only apply if the holder of the debt claim is at the same time the shareholder (so that the interest flows through the shares, instead of through the debt claim).'* In Pijl, H., *Interest from Hybrid Debts in Tax Treaties*, Bulletin for International Taxation, IBFD, September 2001, p. 492. See also Bammens, N., *Articles 24(4) and 24(5) of the OECD Model Applied to Domestic Thin Capitalization Rules*, World Tax Journal, June 2013, p. 152, para. 5.

524. *Cf. 'The definition* [of dividends] *is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the state of source, as well as arrangements that might be developed in the future.'* In US Model Tech. Explanations, 2006, para. 165.

This is an exhaustive or a closed definition, that is, no reference is made to the domestic law of the Contracting States. As a consequence, the definition is to be autonomously interpreted.[525,526]

The OECD Commentary[527] reads that the exhaustive and autonomous nature of the definition of interest in Article 11 is warranted by the fact that (i) it encompasses the essence of most domestic law definitions of interest; in addition, (ii) a closed definition enhances both legal certainty and the longevity of the rule; lastly, (iii) referrals to the domestic law of Contracting States should, as much as possible, be avoided.

While, in the US Model, the following is added to the abovementioned definition providing for a reference to the source State's domestic law, – *'and all other income that is subjected to the same taxation treatment as income from money lent by the taxation law of the Contracting State in which the income arises.'*[528,529]

As stated, Article 11(3) of the OECD MC reads that *'the term interest as used in this Article means income from debt-claim of every kind.'* In the same direction, the Commentary[530] holds that *'the definition of interest* [...] *does not normally apply to payments made under certain kind of nontraditional financial instruments where there is no underlying debt (for example interest rate swaps).'* Provided there is no abuse.

It can be retrieved, from the examination of Article 11 of the OECD MC and the respective Commentary as well as of doctrinal contributes evidencing logical repercussions of the concepts, that the characterization of a given return as interest income requires, (i) the existence of a legally enforceable *'debt-claim'* that may be *'of every*

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525. *Cf.* Bundgaard, J., *Perpetual and Super-Maturity Debt Instruments in International Tax Law*, Derivatives & Financial Instruments, IBFD, July/August 2008, p. 139; Bundgaard, J. & Dyppel, K.J., *Profit-Participating Loans in International Tax Law*, Intertax, Vol. 38, Issue 12, 2010, p. 658.

526. *Cf.* OECD Comm., 2010, on Art. 11, para. 21.

527. *Cf. ibid.*

528. *Cf.* US MC, 2006, Art. 11(3). In addition, para. 186 of the US Model Technical Explanations, 2006, further clarifies the referral to the source State's domestic law by including the US definition of interest.

529. *Cf.* OECD, 2010, Reservations on Art 10(3), para. 81.1, (added in 1994) *'Portugal reserves the right to amplify the definition of dividends in paragraph 3 so as to cover certain payments, made under profit participation arrangements, which are treated as distributions under its domestic law'*. Nevertheless, Law 67-a/2007, of 31 December determines that income from interest rate swaps, currency swaps and exchange forwards is interest income domestically and for tax treaty purposes. Even though Art. 11 comprises a closed definition of interest, the new law will impact the tax treaties negotiated by Portugal, in which the definition of interest included the wording *'other income assimilated to income from money lent by the taxation law of the State in which the income arises'*, as was stated in the 1963 Draft Income Tax Treaty. In these cases, income from derivatives will be subject to withholding taxes as if it was interest. As we see it, this does not constitute treaty override, since the treaties following the 1963 Draft allocated taxing rights providing for this possibility that Portugal chose not to exercise, until 2008. Recent treaties remain unaltered by this change in the internal law.

530. *Cf.* OECD Comm., 2010, on Art. 11, para. 21.1. The reference to non-traditional financial instruments only mentions, – interest rate swaps, financial futures, options to buy shares and deep discount bonds.

kind', (ii) providing remuneration (iii) for making capital available, rather than paid as a price,[531] (iv) implying the actual exchange of the face value.[532]

Nevertheless, the term '*debt-claim*' is not defined in the OECD MC or in the Commentary, instead some examples are provided.

In accordance with the provided criteria e.g., credit default swaps or total return swaps do not generally yield interest income since there is no actual exchange of the face value of the contract and capital is not made available.

In the case of payments made under a guarantee the same conclusion can be reached, given that there is no underlying debt-claim unless the credit event for which the guarantee is provided does take place, in which case the payments under the guarantee cease.

Although, since under a credit-linked note capital is actually exchanged, payments made under this instrument may be characterized as interest for treaty purposes.[533]

Moreover, the OECD Commentary[534] refers to participating bonds and convertible bonds as giving rise to income falling under the interest article until the moment of actual conversion occurs, unless the instrument shares the business risk or in case of reclassification by thin capitalization rules.

The OECD 1994 Report on the Taxation of new financial instruments states that, '*even payments on interest rate swaps, which may be a stream of payments calculated on an interest basis, are not income from a debt-claim. They are income from an interest rate swap agreement*'.[535]

Furthermore, the interest article should in most situations comprehend an original issue discount (OID).[536]

However, in situations where the accrued interest yet not paid is withheld at source tax arbitrage opportunities arise if the unpaid interest can be deducted in the source State.[537]

Overall, the OECD- and the UN Model Conventions provide for autonomous definitions of the concepts of dividends and interest, with the exception of the term '*other corporate rights*' in the referred manner.

Diverging from this approach, the US MC establishes that both the dividend and interest treaty concepts comprehend their definition under the source State's domestic law.

531. *Cf.* Vogel, K., *Klaus Vogel on Double Taxation Conventions*, Kluwer, 1997, pp. 646 et seq.
532. *Cf.* Eberhartinger, E. & Six, M., *Taxation of Cross-Border Hybrid Finance. A Legal Analysis*, Intertax, 2009, p. 9.
533. *Cf.* Thuronyi, V., *Taxation of New Financial Instruments*, United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters, September 2001, p. 9, para. 28.
534. *Cf.* OECD Comm., 2010, on Art. 11, para. 19.
535. *Cf.* OECD, *Taxation of New Financial Instruments*, 1994. See, Thuronyi, V., *Taxation of New Financial Instruments*, United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters, September 2001, p. 9, paras 26-28.
536. *Cf.* OECD Comm., 2010, on Art. 11, para. 20, '*...what constitutes interest yielded by a loan security, and may properly be taxed as such in the State of source, is all that the institution issuing the loan pays over and above the amount paid by the subscriber, that is to say, the interest accruing plus any premium paid at redemption or at issue.*'
537. *Cf.* OECD, *Taxation of New Financial Instruments*, 1994, para. 108.

[C] Conflicts of Qualification

Conflicts of qualification between Contracting States are a significant predicament in the application of tax treaties, possibly leading to the refusal of the residence State to grant relief for the taxes paid at source in accordance with the treaty.[538]

The OECD MC and Commentary prescribe the mutual agreement procedure[539] to resolve conflicts of qualification materializing due to the Contracting States' divergence on matters of (i) interpretation, that is, in determining the meaning and scope of the provisions of a particular double tax convention;[540] or if (ii) Contracting States hold a disparate understanding of the facts.[541]

However, the State of residence is required to provide relief for the taxes paid at source in cases where (iii) the conflict of qualification is a product of discrepant and conflicting domestic laws leading to the application of distinct provisions of the treaty.[542]

A different approach if followed by the US MC, which requires the residence State to provide relief for the taxes paid in accordance with an applicable tax treaty following the qualification of the source State.[543,544]

On another approach to cross-border interactions and possible inconsistencies, tax treaties may encase '*subject-to-tax*' clauses or '*switch over*' provisions disapplying a normally granted exemption, and enforcing a credit method instead to promote single taxation.[545,546,547]

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538. *Cf.* e.g., in Switzerland: Federal Tax Appeal Commission, 7 June 2004, *Case SRK 2002-032*, Tax Treaty Case Law IBFD. The Court noted that the dividend concept was not defined in the tax treaty, and in accordance with the treaty's Art. 2(2), undefined terms have the meaning found in the tax law of the Contracting States, unless the context otherwise requires. Therefore, the recharacterization of the payment in question as dividend income under the treaty must be determined in light of the domestic law of the source State. Yet, in another case, France: *Conseil d'Etat*, 10 June 1983, *Case 27,391*, published in 36 Droit Fiscal 10 (1984) at 402, Tax Treaty Case Law IBFD, the Court concluded that in the context of the treaty in question, the term dividend was clearly defined, and did not constitute a disguised profit distribution.
539. *Cf.* OECD MC, 2010, Art. 25.
540. *Cf.* OECD MC, 2010, Art. 25(3) and OECD Comm., 2010, on Art. 23 A and B, para. 32.2.
541. *Cf.* OECD Comm., 2010, on Art. 23 A and B, para. 32.5.
542. *Cf.* OECD Comm., 2010, on Art. 23 A and B, para. 32.3.
543. Naturally, the same result may be attained under the OECD- or the UN MC's by the introduction of such modifications. For instance, the tax treaty between Austria and Germany though being based on the OECD MC makes the entire definition of corporate rights giving rise to dividend payments dependent on the source State's domestic law.
544. *Cf.* '*under the treaties following the US Model, interest on profit-participating loans always qualifies as a dividend if the source state treats the interest as a dividend because it treats the investment as equity.* [...] *Solely the fact that the taxation of profit-participating interest in the source state is thus limited to the same tax rate as applies to dividends does not, however, make profit-based interest qualify as a dividend.*' In Helminen, M., *Classification of Cross-Border Payments on Hybrid Instruments*, IBFD Bulletin, February 2004, note 7 on p. 59.
545. At the domestic level States may deny benefits e.g., refuse the exemption or deny deductions, in relation to cross-border income that is not taxed by the other State. See *supra*, section §3.02[B].
546. *Cf.* OECD MC, 2010, Art. 23A(4) and OECD Commentary, 2010, on Art. 23 A and B, para. 32.6 – States are not required to provide relief originating white income, as such result is inconsistent with the purpose of mitigating double taxation. (As mentioned *supra* at note 206).
547. *Cf.* '*coherence or lack of coherence of the cross-border tax treatment of a certain piece of income are not necessarily achieved or avoided by simply establishing a mandatory and universal*

In addition, a well known legal study[548] has concluded that even though tax treaties may efficiently restrain the rate of withholding in the State of source, (i) dividend characterization under a tax treaty typically curbs some, yet not all, double and triple taxation cases; while in cases where the income stream is (ii) characterized as interest, such income often would escape double taxation regardless of the existence of an applicable treaty; whereas (iii) tax treaties have no bearing on situations where white income arises.[549,550]

Given this setting, for what it concerns the function of tax treaties[551] i.e., provided double taxation is significantly narrowed, it is irrelevant that a consistent criteria for tax treaty characterization of income is not sufficient to ensure an overall consistent treatment of cross-border financial instruments, or even that the tax treaty characterization is not in conformance with the qualification under the domestic law's of the Contracting States.[552]

In this regard, it can be asserted that the current conjuncture comprising inconsistent classification criteria at the tax treaty level accounts for most of the insufficiencies appointed to bilateral agreements in order to mitigate double taxation.[553]

qualification of the income under the treaty model standards.' In Prats, F.A.G., *Qualification of Hybrid Financial Instruments in Tax Treaties*, Diritto e Pratica Tributaria Internazionale, Vol. 3, Issue 3, CEDAM, Milan, September/December 2011, p. 983.

548. *Cf.* Eberhartinger, E. & Six, M., *Taxation of Cross-Border Hybrid Finance. A Legal Analysis*, Intertax, 2009, pp. 10-11. Also available at, http://ssrn.com/abstract=1080549.
549. Furthermore, according to a probability analysis based on a binomial model comprising economic and legal elements, *ceteris paribus*, in the presence of conflicts of qualification the outcome of which is uncertain intra-group cross-border hybrid finance is, in the large majority of cases, more advantageous in relation to straightforward classic finance. See Eberhartinger, E., Pummerer, E. & Göritzer, A.F., *Cross-Border Intra-Group Hybrid Finance and International Taxation*, Vienna U. Research Paper Series No. 2012-01, July, 2010, pp. 30-33. Available at, http://ssrn.com/abstract=2171635.
550. *Cf.* '*double taxation can result in* [approximately] *50% (439 of 870) of all relations* [between OECD States].' In Zielke, R., *Shareholder Debt Financing and Double Taxation in the OECD: An Empirical Survey with Recommendations for the Further Development of the OECD Model and International Tax Planning*, Intertax, Vol. 38, Issue 2, 2010, p. 91.
551. The role of tax treaties is to allocate taxing rights in order to avoid double taxation, in this context the relevance of tax treaty characterization of income correlates, from a policy perspective, to an idea of international tax neutrality, i.e., international capital mobility irrespectively of taxation, as one of the elements on the basis of global efficiency and wealth.
552. *Cf.* '*neither that the qualification of the income needs to be symmetric in both Contracting States for treaty purposes; nor that assuming the symmetrical qualification approach problems of double taxation would automatically be solved.*' In Prats, F.A.G., *Qualification of Hybrid Financial Instruments in Tax Treaties*, Diritto e Pratica Tributaria Internazionale, Vol. 3, Issue 3, CEDAM, Milan, September/December 2011, p. 987.
553. *Cf.* '*considering that one of the relevant tax treaty factors for distinguishing equity from debt returns for tax treaty purposes is the identification of the risks involved, there is a clear need to improve the risk identification and the risk measurement techniques of hybrid financial instruments.*' In *id.*, p. 997.

[D] Key Tie-Breaking Factors on the Characterization of Income

This section discusses the criteria to resolve the overlap between the tax treaty definitions of '*Dividends*' and '*Interest*'. For the sake of simplicity it focuses on the OECD MC.

To that end, the present section is divided into three subsections, – in §4.01[D][1] the classical formulation of the '*corporate rights test*' is examined, in §4.01[D][2] the '*debt-claim test*' is explored, and in §4.01[D][3] overall conclusions are drawn on the interpretation of the tax treaty law in order to, (a) identify the common legal practice, (b) provide arguments for the criteria which in our view logically dictates the characterization of income, and, from a tax policy perspective, (c) elaborate on the adequate basis for the adoption of a consistent rule.

As a starting point, the characterization of an item of income as '*Dividends*' or '*Interest*' under Articles 10(3) and 11(3) of the OECD MC has in common the reliance on the features of the financial arrangement under which the payments are made.

[1] Treaty Interpretation: 'Corporate Rights Test'

The meaning of the treaty concept of '*corporate rights*' yielding dividend income is far from consensual among the doctrine.

According to the widely cited interpretation advanced by Professor VOGEL, a corporate right implies a right to benefit from the potential increase in value of the enterprise as remuneration for sharing the business risk, which also comprises the potential loss of the invested capital in the image of a regular shareholder.[554]

Therefore, the '*shareholder's test*' or '*corporate rights test*' establishes the scope of the dividend article to depend on the existence of remuneration from an investment catering both a right to (i) participate in the profits ***and*** (ii) in the liquidation proceeds.[555]

Each of these requisites is a condition to qualify as a dividend, thought not per se sufficient.[556] Hence, it must be understood that an item of income comprising only one of these features may be characterized under any other applicable article of the treaty.[557]

Moreover, entitlement to the liquidation proceeds of an entity is identified with a share in the hidden reserves, entailing that the reimbursement of the invested capital is necessarily subordinated to the claims of other stakeholders.[558]

554. *Cf.* Vogel, K., *Klaus Vogel on Double Taxation Conventions*, Kluwer, 1997, p. 651.
555. *Cf. ibid.*
556. *Cf.* The wording of the OECD MC, 2010, Art. 10, '*participating in profits*' referring to '*other rights*', *i.e.*, to the meaning of corporate rights.
557. E.g., a share category without participation in the profits, yet entitled to the liquidation proceeds.
558. *Cf.* Vogel, K., *Klaus Vogel on Double Taxation Conventions*, Kluwer, 1997, p. 646.

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The twofold criteria is to be found through a subsequent test in view of all facts and circumstances.[559]

However, such analogy *vis-à-vis* with the position of the shareholder refers exclusively to aspects impacting the assumption of business risks and not, for instance, to voting and control rights.[560]

Wholly considered, the vital fault of this test as acknowledged by its supporters is that, in light of all the possible features of a given instrument under which payments are made, it is far from overt when such instrument can be said to be sufficiently participating in the profits and in the liquidation proceeds in order to render a dividend characterization under the treaty.[561]

[2] Treaty Interpretation: 'Debt-Claim Test'

In general, interest is defined as remuneration for making capital available **on a temporary basis**, thus requiring repayment.[562]

The OECD MC's income characterization as interest finds the core of its meaning by reference to the expression – *'debt-claims of every kind'*, – itself not defined in the Model Convention.[563]

Ergo, the treaty notion of interest relies on a *'debt-claim test'* which, autonomously interpreted, requires the existence of a legally enforceable right[564] of the

559. *Cf. 'Examples: (1) the loan very heavily outweighs any other contribution to the enterprise's capital (or was taken out to replace a substantial portion of capital which has been lost) and is substantially unmatched by redeemable assets; (2) the creditor will share in any profits of the company; (3) repayment of the loan is subordinated to claims of other creditors or to the payment of dividends; (4) the level of payment of interest would depend on the profits of the company; and (5) the loan contract contains no fixed provisions for repayment by a definite date.'* In Helminen, M., *The Dividend Concept in International Tax Law*, Kluwer, 1999, p. 272. In another example, income from perpetual debt cannot per se be regarded as dividends. *Cf.*, *id.*, p. 283; See also, Bundgaard, J., *Perpetual and Super-Maturity Debt Instruments in International Tax Law*, Derivatives & Financial Instruments, IBFD, July/August 2008, p. 140.
560. *Cf. ibid.* See also, *'the extent of the control rights connected with a financial instrument, however, should have no influence on the nature of the instrument as equity or debt because limitations on a shareholder's control rights do not directly increase or decrease the risk component.'* In *Cf.* Six, Martin, *Hybrid Finance and Double Taxation Treaties*, Bulletin for International Taxation, IBFD, January 2009, p. 24.
561. *Cf.* Eberhartinger, E. & Six, M., *Taxation of Cross-Border Hybrid Finance. A Legal Analysis*, Intertax, 2009, p. 9.
562. *Cf.* Vogel, K., *Klaus Vogel on Double Taxation Conventions*, Kluwer, 1997, p. 731.
563. *Cf.* OECD MC, 2010, Art. 11(3). The OECD Comm., 2010, on Art. 11, para. 18, provides further clarification on the concept of 'debt-claim' by listing some examples.
564. Rotondaro used the expression – *'absolute and unconditional'*; while Fehér employed the term – *'legally enforceable.'* In Fehér, T., *Conflicts of Qualification in Tax Treaty Law*, Eva Burgstaller, Katharina Haslinger and Prof. Lang (eds), Wien, 2007, p. 242. See, Rotondaro, C., *The Right to Redemption as a Key Characterization Factor in the OECD Model Convention Passive Income Taxation System – The Case of Reverse Convertibles*, Derivatives & Financial Instruments, IBFD, September/October 2000, p. 264.

provider of capital to its redemption, that is, to reclaim the repayment[565] of the face value[566] of the advanced sum.[567]

This interpretation as brought forward by Doctor Rotondaro constitutes, in his view,[568] the only reliable criterion to distinguish between income falling under the dividend or interest articles of the treaty.[569,570,571]

It could be sustained in aid to this view that, since the interest article as any other exhaustive treaty definition favours an autonomous and thus homogeneous treaty interpretation, it should take precedence over other income articles.[572]

Nevertheless, regardless of whether an autonomous interpretation should, merely by that fact, take precedence, treaty definitions themselves resourcing to terms not defined in the treaty ultimately refer their meaning to the internal law of the Contracting States, thus compromising the desired hermeneutical homogeneity.[573]

565. *Cf.* This concept controversially relies on the OECD Comm., 2010, on Art. 11, para. 19.
566. The face value may not coincide with the principal, as debt may be issued at a premium, which would constitute interest under the OECD MC and Comm., 2010, on Art. 11, para. 20, *'when a bond or debenture has been issued at a premium, the excess of the amount paid by the subscriber over that repaid to him may constitute negative interest which should be deducted from the interest that is taxable'*. (Emphasis added).
567. *Cf.* In a hallmark case, interest under the Canada–Germany double tax convention was seen as remuneration received by the lender for making the principal available to be used by the borrower on a temporary basis. Thus, such interest compensation necessarily entails, *(i)* an actual exchange of a principal *(ii)* with the corresponding right to the repayment thereof; in other words, an underlying debt-claim. In Canada: Federal Court of Appeal, 15 January 1981, *Melford v. Her Majesty the Queen*, Case A-147-80, published in CarswellNat 194, [1981] C.T.C. 30, [1981] 2 F.C. 627, 36 N.R. 9, 81 D.T.C. 5020, Tax Treaty Case Law IBFD.
568. *Cf.* The next section §4.01[D][3] scrutinizes the grounds for the acceptance or otherwise of the *'debt-claim test'* as the only reliable criterion to operate the treaty characterization of the income.
569. *Cf. 'the existence/non-existence of an unconditional and certain right to redemption is the only effective and correct criterion available in order to distinguish between interest and dividend under the treaty.'* In Rotondaro, C., *The Right to Redemption as a Key Characterization Factor in the OECD Model Convention Passive Income Taxation System – The Case of Reverse Convertibles*, Derivatives & Financial Instruments, IBFD, September/October 2000, p. 265. This interpretation also finds its roots on the presence of the word 'repayment' in para. 25 to Art. 10 and in the text of para. 19 to Art. 11 of the OECD Comm., 2010.
570. In another case with the same sense as the *Melford* case, the sentence read, – *'the boundary* [between dividends and interest under the treaty], *does not accommodate a distinction between interest in form only and interest in substance (but not in form); the* **only relevant criterion** *for the application of Art. 11 [...], rather than Art 10, is whether the income is subjected to the same taxation treatment as income from money lent by the law of Australia.'* (The emphasis is ours). In Australia: Federal Court of Australia, 22 October 2008, *Deutsche Asia Pacific Finance Inc v. Federal Commissioner of Taxation*, published in [2008] FCA 1570, Tax Treaty Case Law IBFD, para. 82 last part.
571. *Cf.* In agreement with Rotondaro on the scope of the interest Article, – '[the] *touchstone for whether an instrument will be treated as debt is whether the holder of the instrument has the right to be paid back its investment regardless of the profitability of the issuer.'* In Brown, P., *Debt-Equity Conundrum*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume XCVIIb, Kluwer Law International, 2012, p. 40.
572. *Cf.* Prats, F.A.G., *Qualification of Hybrid Financial Instruments in Tax Treaties*, Diritto e Pratica Tributaria Internazionale, Vol. 3, Issue 3, CEDAM, Milan, September/December 2011, p. 986.
573. *Cf. ibid.*, p. 987.

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