Qualification of Hybrid Financial Instruments in Tax Treaties

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I. Introduction

The use of hybrid financial instruments has gained significance in international finance and their tax treatment concerns need of accurate study and precision. Hybrid financial instruments play an important role in today's economy as recent studies show [1]. They serve to raising capital in a cost efficient manner, accommodating to the investors demands, hedging risks, uprising capital flows and investment opportunities, favoring investments that would not had been made otherwise. The also allow to monetize assets and, due to their flexibility, may be used to accommodate to the different regulation requirements of different countries taking advantage of the regulation differences.

On the other hand, hybrid financial instruments have been blamed as one cause of the actual financial and debt international crisis, as a result of its ability to hidden risks. As Warren Buffet famously stated in 2003, talking about OTC derivatives, "… derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal" [2]. As a result, many reforms have been adopted or are in the process of being adopted that may have certain

[1] The literature is extensive and vast. See Copeland, Weston, Shastri. *Financial Theory and Corporate Policy*. 4th ed. Pearson. 2005. McDonald, R. Derivatives markets. Pearson.3rd ed. 2009. Barton, T.L, Shenkir, W.G. Walker, P.L. *Making enterprise risk management pay off Ft Press. 2002.*

[2] Buffet, W. Chairman's letter to the shareholders of Berkshire Hataway. Feb., 21, 2003.

influence in the qualification and use of the diversity of HFI and, and so is the tax treatment of some instruments, resulting in higher complexity of the subject.

The complexity of the matter derives from various reasons: diversity and flexible use of the instruments, different legal, accounting and regulatory frameworks, and cross border implications.

On the one hand, the extreme complexity is due to the flexible tools and formulas that can be used to create a hybrid financial instrument in order to accommodate to any specific need and circumstances both of the investors and the companies in need of capital supply or risk protection. The variety of elements composing the instrument, and the continuous development and financial creativity makes most of the cases difficult to understand the components of the instrument and, therefore, to precise its qualification for legal, regulatory and tax purposes. This opacity makes in some cases difficult to ascertain the proper qualification of the outcomes of the instrument.

Secondly, hybrid financial instruments are subject to a legal and regulatory framework that has been subject in recent years to some important changes, mainly as a result of the financial crisis, resulting in a changing environment that, in some cases, may diversify the qualification of the instrument and the outcomes for different purposes and in different jurisdictions; both making it difficult to verify it, and creating risks and opportunities.

The variety of regulatory, accounting and tax treatment both domestically and at a comparative level may lead to differences, inconsistencies, opportunities and risks. On the one hand, the regulatory framework of financial institutions has been subject to recent changes. At an international level, the Basel Committee on Banking Supervision has issued a new proposal of reform measures (Basel III) devoted to strengthen the regulation, supervision and risk management of the banking sector redefining the capital of the financial institutions and, thus, affecting the qualification of different hybrid instruments. In the EU, the Capital Requirements Directive 2006/48/EC has been subject to different amendments (Directive 2006/49/EC, Directive 2009/111/EC) and some proposals (Proposal of 12 July 2011 presented by the Commission[3]), and some adaptations and different national implementations and interpretation in the different EU Member Countries [4]. In the US, the approval of the Dod-Frank Act on 21st July 2010, overruled the Gramm Leach Bliley Act of 1999 [5] and established a new framework with important implications in the consideration of hybrid financial instruments. However, it is to be noted that the use of HFI is not privative of financial institutions, since their use has been profoundly and generally accepted for capital expansion demands of MNEs, business restructurings and other financial and risk transactions.

On the other, the accounting system of these instruments and their outcomes greatly varies from country to country, with some important changes regarding the recognition, the

[3] http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

[4] See among others the RD 771/2011 of 3 June, amending the RD 210/2008 of 15 February on own resources and the RD 2606/1996 of 20 December in Spain as an example.

[5] See Goldberg, S.P. Cooney, J. "OTC Derivatives: Their role in the Financial Crisis, the Impact of Financial Reform, and the Outlook for the Future" 24 Journal of Taxation of Financial Institutions 13. 2010. (taken from LexisNexis Database).

characterization of stock ownership and the determination of the time of accrual or realization of the income. Relationship between accounting and tax treatment also vary from country to country.

Finally, the tax treatment of HFI and income generated by them also varies not only from country to country, but in a single country, depending on the different qualification and consideration –deconstruction, joint treatment, unitary techniques being used in the tax rules [6]-, with the result that very similar economic instruments may have different tax treatment. This leads to the use of HFI not only as an important finance mechanism but also as an important tax planning tool giving rise to some tax arbitrage possibilities.

The use of HFI in a cross-border situation, often linked with the use of hybrid entities, gives rise to more flexibility, considering the possibility of using different regulatory frameworks, open new tax arbitrage and tax planning possibilities, but also generate new tax risks, derived from the effects of the potential counteracting measures that have been enacted by some countries and the uncertainties that may arise from the effects of the application of tax treaties on the flows of income and capital generated by the use of cross-border HFI and, especially, from the qualification to give to these flows of income under tax treaties [7]. As a result, possible double taxation and double non-taxation situations may arise. This will be the main object of the present analysis.

II. Concept of Hybrid Financial Instrument.

Among the many concepts that have been used, it can be considered that Hybrid Financial Instruments (hereinafter, HFI) are instruments that incorporate elements both of equity and

[6] See for a general view CDFI. Tax treatment of hybrid financial instruments in cross-border transactions. Volume LXXXVa. 2000. Kluwer. The Netherlands.

[7] The tax treaty treatment and qualification of hybrid financial instruments has been previously dealt in different specific studies. See, among all, Rotondaro, C. "Tax Treaty Characterization Issues of Credit Derivatives" DFI. Marh-April. 2000. P. 79-99. Helminen, M. "Classification of Cross-Border Payments on Hybrid Instruments". BIFD. February 2004. p. 56-61. Six, M. "Hybrid Finance and Double Taxation Treaties". BIT January 2009. P. 22-25. IFA. Tax treatyment of Hybrid Financial Instruments in Cross-Border Transactions. 54th IFA Congress. Munich. 2000. Pistone, P. Romano, C. "Short Report on the Proceedings of the 54th IFA Congress, Munich 2000" BIFD. January 2001. P. 35-42. Gammie, M. "The Source Taxation of Derivative Financial Instruments, 'Synthetic Securities', Financial Hedging Transactions and Similar Innovative Financial Transactions". DFI September-October. 1999. P. 231-236. Jorion, P. "Derivative Markets. Economic implications for taxation" Ad Hoc Group of Experts on International Cooperation in Tax Matters. UN. Tenth Meeting. 2001.OECD. Innovative Financial Transactions. Tax Policy Implications. Ad Hoc Group of Experts on International Cooperation in Tax Matters. UN. Eigth Meeting. 1997. Wijnen, W. "The Right to Redemption as a Key Characterization Factor in the OECD Model Convention Passive Income Taxation System: The Case of Reverse Convertibles" Ad Hoc Group of Experts on International Cooperation in Tax Matters. UN. Tenth Meeting. 2001. Thuronyi, V. "Taxation of New Financial Instruments2. Ad Hoc Group of Experts on International Cooperation in Tax Matters. UN. Tenth Meeting. 2001. Ragusa, M. Corneli, A. "Tax Appeal of Hybrid Capital Instruments in Italy through Tremonti Bonds and Basel III Anticipations" DFI (Derivatives & Financial Instruments" May-June. 2010. P. 68-72.

debt, and sometimes are also called mezzanine finance.[8] HFI, then, use mature characteristics both of debt and equity.

Traditionally, debt and equity were considered to have separate and well defined trends, despite the fact that the definition and elements vary from country to country and depending on the evolution of case law and legislation. In general terms, the following structure can be used to generally distinguish debt and equity

EQUITY TRENDS	DEBT TRENDS
No assured investment return	Right to claim return
Full business risk	Credit risk
Voting right	Lack of voting right
Liquidation right	Fixed/predetermined return
Subordinated payment	Repayment preference if default

However, the distinction is more and more overcome by the use and profusion of HFI that may adapt the needs and position of investors and capital claimants, to the extent that it has open the debate of the legal basis for distinction between debt and equity. However, from a tax treaty perspective, the debate necessarily needs to be reconciled with the parameters of qualification of income under the treaty as provided in it. Therefore, there is a need to find a proper characterization for tax treaty purposes.

Considering the ability of using HFI to adapt to the specific demands and needs of each particular circumstance, there is a great variety and typology of HFI which, as said, turns the matter into difficulty, especially on qualification grounds. For illustrative purposes, authors classify the basic HFI 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.

III. Key issues

As has been said before, the use of HFI gives rise to a reconsideration of the distinction between debt and equity income and therefore, also of their tax treatment, both from a domestic and a tax treaty perspective, originating different alternatives of taxation. Even more, in some cases the question of the classification under treaty concerns releases the issue of whether the tax treaty classification leads to source state taxation (normally through a withholding tax) or to a lack of source state taxation due to the application of the allocation

[8] In IFA, CDFI 2000, cit. HFI are defined as a financial instrument that has economic characteristics that are inconsistent in whole or in part with the classifications implied by its legal forms 8or his characteristics consistent with more than one classification) that may be issued for a variety of reasons.

rules resulting from the tax treaty classification of the income. But before the consideration of the tax treaty classification there is a need to consider whether in each particular case HFI give rise to the obtaining of income for the participants or to a simple cash flow.

A second important aspect of cross-border taxation of HFI income results in the consideration of the use of HFI as abusive for tax purposes and whether general consideration of specific considerations need to be made in that regard. Related to it, there is the issue of the possible consideration of tax arbitrage schemes as abusive by some legislation, some tax authorities or case law practices and whether it is possible to counteract tax arbitrage schemes through tax treaty measures –related to qualification or not- or not, or whether tax treaties may or may not prevent the use of domestic counteracting measures. Obviously, one of the consequences of using HFI schemes under a tax treaty coverage is whether and how double non-taxation that may result can be counteracted through the use of tax treaties, but other also are what type of reaction and consequences can be assumed from a tax treaty when the result is the opposite, that is, that double taxation arises, either as a result of a lack of homogeneous tax treaty classification of the income or, even possibly, when this is the result of a homogeneous tax treaty classification of the income.

IV. Previous Remarks on Tax Treaty Qualification

When dealing with tax treaty qualification of income it has to be beard in mind the purposes on this qualification exercise. It is to be noted that some of the relevant articles for HFI, in particular articles 10 and 11, refer the qualification limited to the application of this article. Both articles 10 and 11 refer the definition of the term … 'as used in this Article'. Therefore, the qualification given in those articles is not 'for the purposes of the convention' and has, thus, a much more limited scope.

As a result of such limitation of scope, the qualification of the income derived from HFI –when it is considered to be either dividend or interest- does not in principle affects the application of article 23 by the State of Residence of the investor in the HFI, as the Commentary on article 23 clarifies –paragraphs 32.1 to 32.6-.

Moreover, in general terms, articles 10 and 11 do not affect –apart from the top amount limitation of the collectible tax established in article 10.2 and 11.2 and other aspects that for the purposes of the present article do not seem relevant- the domestic tax regime is not necessarily affected by the application of the tax treaty and the tax treaty qualification. Tax treaty qualification serves a purpose –as regards articles 10 and 11- which is more limited that it may seem. Therefore, 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 qualification of the income under the treaty model standards. Common treaty qualification under treaty standards both in the source and the residence States may result in incoherent tax results, and diverse treaty qualification may, in some cases, derive in consistent application of integrated tax mechanisms at source and at residence. Without forgetting that, consideration of coherence and consistency may vary from the point of view of the investors and the States concerned.

In principle, the tax treaty qualification is mainly and only valid for the determination of the allocation rule that will be applicable, the conditions that concrete it, and the consequences enshrined there.

However, such treaty qualification does not cover and does not necessarily impacts several issues of the domestic tax regime applicable to the income derived from the HFI and from its payment.

- The tax regime is generally driven by domestic tax, which in turn, especially in case affecting non-resident investors, may be linked to the domestic tax characterization of the income. Therefore, it is necessary to consider that a certain income from HFI may have a double and distinct characterization for domestic and for tax treaty purposes, which may turn in combination in a variety of legal tax situations and consequences in both contracting States.
- Therefore, timing issues and criteria being used for realization of income (accrual, payment,…) depend on the criteria set up by domestic tax laws.
- Double tax treaties do not normally contain rules for allocation of expenses between the contracting States.
- The same is true for the determination of the deductibility or the non-deductibility of certain payments as cost –both of interest and equity returns- or the possible compensation of negative income and losses, and for the possible monetization and depreciation of certain assets.

Therefore, some of the assumptions regarding the cross-border treatment of dividend and interest payments are derived from certain generalized patterns which, in no case, can be considered to be binding international rules, despite the fact that the allocation rules for interest and dividend income in tax treaties are based on these patterns. As a general standard, interest income is considered to be taxed at the Residence State, while dividend income is to be taxed at source; that is, at the State of residence of the company paying them. Deductibility of interest income is not necessarily granted by tax treaties, despite the fact that some Commentaries of the OECD MC seem to suggest the opposite –paragraph 11.20-, although if source State restricts that deductibility, the non-discrimination clauses may play a limited role.

On the other hand, double-non taxation is becoming an issue at a tax treaty level, despite the fact that it has not been specifically, systematically and consistently dealt with up to now.

Finally, it has to be considered that the effects of integration between tax treaties and domestic tax rules highly depends on constitutional law concerns of every contracting State, although some international consensus has been reached, that the criteria enshrined in the Vienna Convention of the Law of Treaties should be respected –especially the prohibition of unilateral override and the bona fide application and to some extent the interpretation criteria-; even if the contracting State is not a signatory Member State of the VCLT or if the VCLT has not been ratified by that State. Nevertheless, it is also true that the Vienna Convention of the Law of Treaties offers insufficient and unsatisfactory solutions in case of a tax treaty being unilaterally overridden by a contracting State.

V. OECD MC Guidelines for Tax Treaty Qualification of HFI.

The OECD MC has no specific guidance on the tax treaty qualification of HFI, generally speaking, neither a specific and single mention to them. Only in specific treaties it is possible to find some direct reference to them. Therefore, as said before, there is a need to stick to classical types of income as derived from the treaty classification sources of income enshrined in the OECD MC, mainly interest and dividends, but also capital gains, business income or other income.

Despite that legal fact that is reproduced in tax treaties, there are some minor references to specific HFI in the Commentaries of the OECD MC. For example, Commentary 21.1 on article 11 refers to 'non traditional financial instruments', but this seems little guidance considering the actual development of the derivatives market. This reference is the result of the 1995 amendment of the Commentaries after the OECD 1994 Report, and only covers interest rate swaps, financial futures options to buy shares and deep discount bonds.

A second example refers to specific HFI mentioned along the Commentaries, which may serve as guidance for the treaty qualification, considering the relevance that Commentaries may play in tax treaty interpretation in different tax jurisdictions.

-Paragraph 25 of the Commentaries on article 10 establishes some criteria as to when interest on loans can be treated as dividends for treaty purposes.

-Paragraph 20 of the Commentaries on article 11 refers to premiums, prizes attached to bonds and debentures, as defined in the text of the Model.

-Paragraph 19 of the Commentaries on article 11 refers to participating bonds and convertible bonds qualifying them as interest income, but can be considered dividends if the loan effectively shares the risks run by the debtor company, or in case of a thin capitalization rule requalification.

A third type of mention is found in the observations, reservations and positions of non-member States. For instance, Reservation to Article 10.3 in paragraph 81.1 made by 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'. However, Portugal in its domestic tax law has move in the opposite direction. Law 67-a/2007 of 31 December considers that all gains from interest rate swaps, currency swaps and other forward contracts will be considered interest income *also for double tax treaty purposes*, despite the fact that, apparently, article 11 contains a closed treaty definition of interest income.

Finally, as a result of the considerations made in the Report on Harmful Tax Competition prepared by the OECD (1996, p. 170) synthetic instruments may be challenged as a result of the anti abuse rules being applicable at a domestic tax level of the contracting States. (paragraph 25 of the Commentaries on article 11).

VI. Relationship between Article 10 and 11 of the OECD MC and in Tax Treaties.

Considering that one of the most prevalent issues facing HFI treaty qualification is the possible qualification of the resulting income either as interest or as a dividend, one of the main issues to discuss is, in case of potential qualification conflict, which qualification takes precedence.

The OECD Model does neither provide a definite, nor clear, nor specific answer on that, despite the fact that some arguments and considerations can be made considering the clarifications and analysis made by the Commentary.

The first indication about the relationship between article 10 and article 11 of the OECD MC as regards income tax treaty classification appears in paragraph 19 of the Commentaries on article 11. Interest does not include items of income which are dealt with in article 10. Therefore, from this *clarification* dividend income classification takes precedence over interest income classification for –limited or not- tax treaty purposes.

However, this indication is not necessarily followed by the logic of the treaty definitions of interest and dividend income. Interest income –for the purposes of article 11- is a closed tax treaty definition. Only income expressly identified as interest income in article 11.3 can be considered interest income for the purposes of the application of article 11. On the contrary, dividend income may be considered to be any income that, according to the source State domestic tax legislation, 'is subjected to the same taxation treatment as income from shares' by the *source* State. As interest income is a *closed* tax treaty definition and dividend income is an *open* tax treaty definition, there may be situations where income may be treated as interest *and* as dividend for tax treaty purposes, or situations where none the treaty definitions of interest and dividend may be relevant or applicable.

From that divergence in qualification of the income for treaty purposes, positive and negative conflicts of qualification may arise. In one situation, what qualification takes precedence if, according to domestic law a certain type of income from HFI is treated as a dividend in the tax law of the source contracting state, while it is possible to consider it as an interest under the closed interest treaty definition? In the other situation, what qualification would be relevant if neither the closed interest treaty definition can be extended to the HFI income nor the domestic law of the source contracting State does neither provide a tax treatment similar to a dividend? Other situations may arise when the treaty income classification of interest and dividends does not follow OECD MC standards and are not considered in this article.

In the second case, it seems that other classification under the treaty should be applicable, probably that of capital gains –if this is relevant under the laws of the contracting State- or that of 'other income'.

In the first case, according to the Commentary, the dividend qualification should take precedence. However, some tax literature considers that, giving relevance to the tax treaty

concept and the formulation of uniform qualifications for treaty purposes, closed treaty definitions should be given precedence over open treaty definitions in order to favor homogeneous and international tax treaty definitions of income. Nevertheless, the distinction between closed and open treaty definition may be a tricky one. There are neither fully closed treaty definitions nor fully open treaty definitions – or qualifications of income-, since a closed treaty definition is made of concepts that are not defined in the treaty and, therefore, there is a need to verify the relevance of the context of the treaty in the situation. In other words, closed treaty definitions are made of open not defined terms in the treaty itself, which turns the reference to domestic law of the Contracting States almost necessary in each and every case, upon variation, depending on the conditions of the referral, and the validity and priority of the contextual interpretation in every single case.

The reference is also valid for open treaty definitions which in no case should lead to unilateral treaty override and, therefore, the verification of the relevance of the context of the treaty may play a role. In that respect, the determination of the validity of the Commentaries in the verification of the context, the significance of the context in a treaty interpretation environment –whether it requires or not a different interpretation- and the integration of tax treaty interpretation mechanisms into the mechanisms foreseen in the Vienna Convention of the Law of treaties may lead to different conclusions, since there are significant variations regarding the conclusions of these issues among the tax literature and in different tax jurisdictions. Moreover, the preference is relative –and to a certain extent circular- since the treaty concept of dividends excludes income arising from 'debt claims', which, in this case, may be considered to have preference for qualification purposes.

Another issue is whether there is a need to find a common and similar qualification in both contracting States.

Some authors, from a logical perspective, take the consideration that this should be the most straightforward solution to avoid problems of double taxation arising as a result of the application of a tax treaty and its interaction with domestic tax law of both Contracting States. In my view, there must not necessarily be the case; 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.

The first assumption derives from the different wording of the tax treaty definitions: had the tax treaty negotiators –and the OECD when dealing with the issue- wanted to give a single and common use of a concept throughout the treaty, they would not have used different wordings referring to the scope of treaty definitions –'for the purposes of this convention', as opposed to 'the term… as used in this Article'-. But the fact of using terms with a limited scope of application denotes that the qualification may not have a general scope, although qualification problems as a result of that in the residence state for the application of article 23 need to be dealt separately.

The second assumption cannot be accepted either. As I mentioned before, the tax treaty qualification of the income needs to live with the domestic tax qualification of the income –both at the source and the residence States-; as the concrete tax regime applicable to the cross-border income covered/entitled to the treaty mainly depends on the domestic tax qualification –with the limitations derived from the application of the treaty, uniform treaty qualification may not solve all conflicts arising from the interaction between the tax regimes of both contracting States plus the requirements of the treaty upon each of them. Double taxation may not necessarily arise as a result of different qualification of the income in both contracting states, but as a result of the interaction of the domestic tax regimes of the contracting states with the effects of the treaty. Moreover there is also the possibility of giving rise to a double non-taxation situation and in such a case, it is to be seen whether and what type of counteracting measures Contracting States are allowed to use under the requirements of the treaty (respecting the treaty requirements).

VII. Dividend Income Classification of HFI under Tax Treaties.

Article 10.3 of the OECD Model Convention contains a limited treaty classification of income as dividends –for the purposes of the application of article 10 only-.

'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'.

From the treaty model definition the following ideas can be ascertained.

There are, three types of income that can be considered dividend income for 'article 10 of the treaty' purposes: (1) those enumerated as *examples* –income from shares, founders's shares-; (2) other rights participating in profits not being debt claims,…-; and (3) those *other* corporate rights 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. The reference to 'other corporate rights' has been interpreted as meaning that in any case dividend income requires the presence of a *corporate right generating the income* in any case. Therefore, even the possibility to enjoy for a 'dividend taxation treatment' in the state of source limits the tax treaty classification of the income as dividend to income from corporate rights (Helminen, Vogel, Rotondaro) This conclusion is confirmed by the reservations made by some countries to the Commentary (Belgium, paragraph 78, and Luxembourg and Chile, paragraph 81.2). For instance, if as a result of the amendment of Section 541HR 4213 US Tax Act of 2009, dividend equivalent payments are considered to be dividends, only in the case that the payment is linked to a corporate right can this domestic requalification and assimilation of tax treatment can be acceptable for tax qualification purposes.

For the open treaty definition of dividends the following requirements must be met:

From this definition there appears to be a clear indication of qualification for treaty purposes: income from debt claims should be treated as interest, and income from corporate rights should be considered as dividend for –limited- treaty purposes. The commentary provides a guideline on the consideration of a corporate right, as a 'right to benefit from a possible increase in the value of the company's assets as remuneration for sharing the risk taken by the enterprise'. The entrepreneurial risk, confronted or not to the credit risk appears to be one of the key definitional elements for the income to be considered dividend for the purposes of application of article 10 of the treaty.

Other elements may play a role but there are no necessary key factors, such as giving rise to a participating right, the entitlement in the liquidation proceeds or control right over capital (Sixt, p. 24). The holding position (ownership of capital) is also difficult to ascertain whether it constitutes a necessary element in the definition of the dividend income for article 10 purposes. From a literal interpretation, it appears that the reduced top maximum rate applicable by the source State only applies to the holder of the shares, and not necessarily to the beneficiary of the income. Paragraph 24 of the Commentaries on article 10 of the OECD MC also seems to refer to the holding of the shares as a requirement. But that does not necessarily mean that the beneficiary of the dividend payment does not satisfy the requirements for the application of other clauses in article 10. Otherwise, the income should be classified under article 21 for tax treaty purposes. The answer, in any case, depends on the special drafting of the provision in every tax treaty and its interaction with the domestic tax treatment of income obtained as (stripped) dividend coupons, as they are distributed from profits out of which dividends are paid. However, consistent treatment derived from the interaction between the treaty and the domestic tax treatment of the Contracting States is not always possible, unless specific and different qualifications arise in both contracting States, as the analysis of the tax treaty between Germany and US suggests.

A third element of the concept refers to the possible requalification of interest loans as dividends for treaty purposes. There is no explicit mention in the tax treaty and in the Model Convention Commentaries a reference included as a result of the outcome of the report on Harmful Tax Competition. The Commentaries on Article 10 clarify the conditions for doing so:

-The lender effectively shares the risks run by the company (Comm, paragraph 25); This conclusion must be taken after examination of the circumstances of the case. Among these circumstances, the outweight between capital and debt, the right to profits, the subordination in the repayment of the loan, or the dependence of the level of payment on the profits of the company, or lack of definite day for repayment.

-The loan is assimilated to capital under the basis of 'internal law or practice' (Comm paragraph 15.d);

-If the domestic tax law so provides.

VIII. Hybrid Financial Instruments Income as Interest Income for Treaty Purposes

Apparently, interest income is a closed tax treaty definition. Article 11.3 of the OECD MC contains no reference to source state income classification. The authors of the Model Convention tried to formulate a comprehensive definition in order to avoid treaty override practices through the amendment of domestic tax qualification of income through or from interest.

This comprehension is not, however, undoubtedly effective. For various reasons. First, due to the lack of comprehension in other treaty definitions for income qualification purposes, which render possible to have a double treaty classification or a lack of treaty classification. Second, because the comprehension is not total, since there is always a need to refer to domestic (tax) law and practices to ascertain certain meanings of words and references used in the treaty definition (closed definition made of open definition terms).Third, because the practice of some countries does not seem to respect the consequences of such a closed tax treaty concept, as some examples with HFI show. Portugal, for instance, through Law 67-A/2007 of December 31 considered as interest income all gains from certain swaps and forwards, also for tax treaty purposes. In the opposite side, some treaties reinforce the interest treaty definition by opening the reference to source state domestic tax qualification (Spain-Brazil DTC), or by enlarging the treaty definition (UK-Germany DTC, by considering profits from participating loans as interest and not dividends). On the other hand, it has to be beard in mind that not all hybrid financial instruments are specifically dealt in the Commentary on article 11.

From the analysis of article 11.3 of the OECD MC, the tax literature (Vogel, Rotondaro) has identified certain basic elements that conform the treaty definition of interest income for the purposes of article 11 of the treaty:

-There must be a debt-claim, of every kind, allowing any type of remuneration.

-The remuneration has to be made for making capital available, as a result of the underlying claim.

-The remuneration cannot be made as a price payment.

-There must be an actual exchange of a principal.

According to these criteria, guarantees remuneration cannot automatically be considered as a remuneration in the form of interest. The same can be said as for credit default swaps (CDS), as there is no actual exchange of principal and capital is not made available. Substitution payments are not normally covered by article 11 of the OECD MC, since there is only a cash flow, not interest income. A similar conclusion can be reached as regards TRORs (total rate of return swaps) since there is no exchange of principals and no principals are made available under the contract, but not in the case of credit-linked notes, since an actual transfer of the principal occurs.

IX. Negative Delimitation.

As a result, some hybrid financial products may obtain, in principle, unless a requalification appears under the anti-abuse legislation of the source State –we do not analyze here whether this requalification is in conformity or not with the requirements of the treaty-, a qualification different from interest or dividend income under an applicable tax treaty and therefore lack of withholding tax at source.

Hybrid financial instruments (through the use of derivatives) are sometimes used to avoid any tax treaty qualification allowing the source contracting state to apply a withholding or other alternative source taxation. However, the put-call parity theorem allows to transform the nature of the return into the desired one by the parties [9]. The put-call parity theorem states that given any three of the following four financial instruments –a zero-coupon bond, a share of stock, a call option on the stock and a put option – the fourth instrument can be synthesized from the other three; which means that any position containing one of these instruments can be constructed in at least two different ways. Specialized tax literature show how some derivatives may be implemented for these purposes, such as credit default swaps (CDS), currency swaps, total rate of return swaps or credit-linked notes [10].

In front of that array of possibilities, many states tend to react through the establishment of certain anti-abuse legislation that prevents certain requalification, or mandatorily provides for a specific qualification and legal regime for tax purposes, such as the previous reference made to the Portuguese legislation or the treatment under the US domestic legislation of certain dividend equivalent income. The application of these counteracting measures is made without any type of coordination among the tax authorities and may lead to very different results considering at the same time the parallel application of counteracting anti-abusive measures by the residence or other intermediate States. The lack of coordination at an international level determines the lack of consistency necessary to tackle the taxation of income from cross-border HFI from a neutral perspective, thus leading to interesting –but sometimes risky- tax planning opportunities, open to the possible counteracting reaction of the States affected by the transaction.

X. Reaction by the Residence State.

As we have mentioned in the previous paragraphs, the qualification of the income under article 10 and 11 only affects the determination of the maximum tax applicable by the source State. From a literal wording and understanding of articles 10 and 11 only the source State is bound by a qualification whose sole effects are constrained to limit the tax jurisdiction of the State where the income originates.

As a result of that, and considering the reaction of the State of residence of the investor obtaining the income, the interaction between the domestic tax laws of the source and the

[9] Norstad, J. "The Put-Call Parity Theorem". http://homepage.mac.com/j.norstad Knoll, M.S. "Put-Call Parity and the Law" Cardozo Law Review 24 May 2002. P.61-91.

[10] The US reporter of the 2000 IFA report on hybrid financial instruments explains how there are thirteen different ways of creating a cash flow identical to a fixed rate obligation, with obvious different tax treatment.

residence State and the application of the tax treaty may result in the elimination of international double taxation. But in some cases, due either to the use of tax arbitrage mechanisms, to the use of schemes that may be considered abusive by one or both contracting States, or by the application of counteracting measures by one or both contracting states, the result may either be double taxation or double non-taxation. But on the consideration that this result is not necessarily linked to the application of a common or a distinct qualification for tax treaty purposes by both contracting States, either as a result of the application of the tax treaty clauses or as a result of the application of domestic tax law by both States.

Double taxation may arise as a result of many different situations: (a) on the one hand the source (payor) state does not grant deductibility of certain payments, either because the payment deserves the qualification of dividend under domestic-tax treaty concerns, or because the domestic tax regime applicable to the payment does not allow for deductibility, as a result of a requalification clause, or an anti-abuse provision or technique; (b) on the other, the residence State does not grant the mechanism for alleviation of double taxation, either denying exemption or credit under the applicable treaty.

However, in some instances hybrid financial instruments can also be used to generate a foreign tax credit in the residence state, despite the fact that the foreign tax credit has not actually been economically supported by the taxpayer claiming the credit Hybrid financial instruments can be used in schemes devoted to generate foreign tax credits without a corresponding income being taxed in the residence State or without a foreign tax being effectively paid. These *fictitious* foreign credits through the use of hybrid financial instruments (through the use of structured passive investment arrangements) have been counteracted by some countries, for example in the United States (Final Regulations Reg 156779-06 US, July 18, 2011).

Double non-taxation emerges on the contrary in the opposite situation. The outcome/yield of a hybrid financial instrument is classified as debt in the source State, allowing at the same time for deductibility of such payment, while the same yield is considered as equity for tax treaty and domestic tax purposes in the residence state, while applying the exemption to the recipient of that income.

Binding treaty qualification for the residence State would neither solve the problems nor be a requirement derived from the Model Treaty. Under article 23 of the OECD MC, the residence State is only bound to eliminate double taxation when, according to the treaty, the source State is enable to exercise its tax jurisdiction, giving relief according to the terms of that article (paragraph 32.1 of the Commentary on Article 23). However, application of article 23 does not necessarily imply that in order to eliminate double taxation the residence State has to mandatorily follow the income treaty classification given by the other contracting State.

Because the State of residence is not bound to follow source State qualification of the yield of the hybrid financial instrument, the OECD Model Convention establishes different patterns to solve the possible conflicts that may arise:

- If the conflict of qualification derives from interpretation issues of the treaty, for instance when the residence and the source State consider that a different provision becomes

applicable to the item of income, the conflict of qualification needs to be resolved through the mutual agreement procedure established in article 25 of the Model (in particular, paragraph 3).

- If the conflict of qualification derives from differences of domestic tax law of both contracting states but, in any case, both States act in accordance with the Treaty, State of residence must nevertheless grant alleviation of double taxation (paragraph 32.3).

- If the conflict of qualification is the result of different appreciation of the facts by both Contracting States, the conflict must be solved through the mutual agreement procedure as well (paragraph 32.5).

However, the reconstruction is not an easy task as, according to the put-call parity theorem, it is possible to create different cash-flows similar in substance but different in form and, therefore, to decide which is the 'qualitative' substance behind may lead to confusing and different results.

A possible double non-taxation may also be the outcome of the use of cross-border hybrid financial instruments. In such a case, the Model Convention does neither clearly state what is the position of the Model itself, nor contains specific measures to counteract or prevent the situation to happen. Until recently, tax treaties mainly dealt with the alleviation of international (juridical) double taxation, and very few remarks and provisions were devoted to tackle with the issue of double non-taxation. In the actual version of the Model Convention, there are only a few general indications on how to deal with this situation by the residence State, despite the fact that also the source State may indeed also apply measures to counteract double non-taxation.

In that case, the Commentary of the OECD MC, not the Model itself, not any specific provision in a treaty, considers that in case the source State interprets the treaty so as to preclude its right to tax under the treaty, the State of residence may consider that the item of income may not be taxed by the State of source in accordance with the provisions of the convention and, thus, does not become required by paragraph 23A.1 to exempt the item of income under the requirements of the treaty. In that case, the OECD MC Commentary considers that the residence State is not bound by the treaty classification of the income made by the source State, but by the result of such a classification made by the source State preventing it to exercise its tax jurisdiction.

In such event, there are other measures that may be established in order to avoid duplicate tax benefits in both States, eliminating the double dipping. Some treaties contain switch over clauses that deny the exemption method and apply the credit method instead in order to avoid a double exemption of the income at source and at residence States. In other situations, States feel legitimized and compelled to apply counteracting measures, either combating directly the cross-border tax arbitrage situations or considering them as abusive and allowing the proper *reconstruction* of the transactions and the corresponding qualification of the income being obtained.

This is not the proper place to deeply consider the validity and lawfulness of tax arbitrage, especially at a cross-border level. This is an ongoing discussion with clear positions and arguments in favor or against [11]. Lacking a general common position in the international tax literature, there is also a variety of reactions in different jurisdictions in front of the consequences derived from the use of tax arbitrage possibilities thanks to the intervention of hybrid financial instruments. While in some jurisdictions, the use of HFI leading to tax arbitrage possibilities in favor of the taxpayer have been considered as abusive (for instance, in New Zealand, see decision of the High Court, BNZ Limited Investments and Ors v. Commissioner of Inland Revenue, Civ 2004-485-1059, p. 265, decision of 15th July 2009), in other jurisdictions the use of tax arbitrage schemes was not put at discussion despite the fact that the Court found other arguments to dismiss certain tax advantages that were sought by the taxpayer (for instance, the UK Court of Appeal decision in the Bayfine case, Bayfine UK vs. Commissioners of HMRC [2011] EWCA Civ 304, decision of the Court of Appeal of 23rd March 2011). However, as said before, the Model Convention has not taken a clear position in that regard, and only the Commentaries contain certain indications on certain counteracting measures that could be considered to be in line (compatible) with the treaty. In front of that situation, certain recent tax treaties adopt specific measures. For instance, the United States-United Kingdom tax treaty in its recent amended protocol include a new article 24.4.c) in order to prevent the application of domestic legislation counteracting certain HFI schemes.

Another approach taken by the residence State which is mostly followed is to amend domestic tax provisions accordingly in order to, either:

-limiting the scope of the participation exemption regime if the payments on hybrid financial instruments are deductible at the level of the issuing company;

-restricting interest deductibility at the level of the issuing company if the instrument is treated as equity in the state of residence of the investor. [12]

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[11] Among the scholars that consider tax arbitrage as being lawful, see Rosenbloom, D. "International Tax Arbitrage and the International Tax System" David Tillinghast Lecture. 53 Tax Law Review 2000, p. 37 at 53. Krahmal, 'International hybrid instruments: jurisdiction dependent characterisation' Houston Business and Tax Law Journal. 2005. P. 127. A position against international tax arbitrage is defended by Rosembuj, T. *La crisis financier y el arbitraje fiscal internacional. Los productos híbridos y las entidades* híbridas. Ed. El Fisco. Barcelona. 2011. A more cautious position is taken by Avi-Yonah, R. " Tax Competition, Tax Arbitrage and the International Regime" Michigan Law School. Working Paper. 73-5-2007, defending the existence of the 'one taxation principle'. In a more balanced position Ring, D.M. "One Nation among Many: Policy Implications of Cross-Border Tax Arbitrage" B.C.L.Rev. 79 (2002-2003), p. 79-176.

[12] Examples of what is said can be found in the United Kingdom: Finance (No.2) Act 2005, Secs. 24 to 31 and Schedule 3, plus the HRMC Guidance Notes FA 96/S91A-G, under the heading 'Taxing loan relationships: anti-avoidance: shares as debt' and under 'Avoidance involving tax arbitrage'. Germany also modified its domestic participation exemption in the 2007 German Annual Tax Act narrowing its scope. In Denmark, similar provisions were introduced by Act No. 98 of 10 February 2009 (based on Bill L23). In Spain, a similar result has been obtained through the administrative interpretation of the domestic participation exemption without a specific legislative amendment concerning certain payments received by Spanish parent companies from their Brazilian subsidiary companies in the form of *juros sobre capital propio*. Resolution of the Central Economic-Administrative Court (TEAC) of 13th April 2011.

XI. Final Considerations.

From what has been said, tax treaty qualification cannot be considered a key decisive element to solve risks, uncertainties and inconsistencies of tax treatment of cross-border hybrid financial income. Tax treaties affect its tax regime only to a very limited extend, despite the fact that HFI can use the effects of tax treaties to overcome certain undesired results derived from the simple interaction between the domestic tax systems of two said States.

On the other hand, it is clearly a lack of development of an international consensus approach to the tax treatment and identification of the cross-border tax key issues related to them. Despite the fact of the limited extent of tax treaties, it would be advisable that the OECD would further develop international standards on the mater.

In the meantime, greater coordination of unilateral taxation measures and counteracting tax measures seems to be needed in order to avoid undesired results, most of them as a result of the application of domestic tax measures devoted to counteract tax benefits obtained through the use of HFI which in turn (at the end) result in double taxation for taxpayers.

In that sense, and 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.