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BEPS Action 2: Missing Proposals on Hybrid Financial Instruments – Part 1

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With the declared aim of curbing cross-border tax arbitrage practiced with hybrid financial instruments, the OECD recommended, in Action 2 of the BEPS project, the adoption of anti-hybrid rules, designed to establish a link between the tax treatments applicable to the remuneration derived from financial instruments with characteristics of both equity and debt in the source state and in the residence state, in order to reach a final tax outcome that does not lead to double taxation or double non-taxation (OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20).

To align the tax treatment in both tax jurisdictions, the OECD considers that the first anti-hybrid rule should be applied the source state ("primary response"), whereby the payment made under a hybrid financial instrument should not be deducted from the taxable profits of the payer if the corresponding amount is not taxed at the level of the payee in the residence State.

However, if the source State does not restrict the deduction of such expense, the OECD recommends that the residence State apply a defensive rule ("defensive rule"), whereby the income received by the payee will be included in the tax base of the income tax. Thus, the participation exemption regime provided for in domestic law no longer applies, because the beneficiary is required to tax the income.

At this point, the first question that may arise concerns the compatibility of the "primary response" proposed by the OECD in Action 2 of the BEPS project, which restricts the right to deduct the remuneration derived from hybrid instruments, with the non-discrimination clause contained in article 24 (4) of tax treaties patterned on OECD MC, which reads as follows:

> *"Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. (…)"*

As can be seen, article 24(4) of the OECD MC provides that interest, royalties and other

disbursements paid by an enterprise in the source state to a beneficiary in the residence state must be deductible under the same conditions as they would be if they had been paid to a resident of the source state. The exceptions concerning article 9, article 11 (7), or article 12 (6) of the OECD MC, which preserve the right to adjust the remuneration in accordance with arm's length principle, are irrelevant when the remuneration of the hybrid financial instrument reflects the financial conditions found in transactions between unrelated parties in a market setting.

Also, the fact that the non-resident is not subject to full tax liability in the source state should not be used as a justification to argue that residents and non-resident are not in comparable situations for the purposes of article 24(4) of the OECD MC. In fact, unlike other provisions of the non-discrimination clause, article 24 (4) only mentions that certain payments must be deductible under the same conditions, without requiring a comparison between taxpayers. In any event, even if it is assumed that a comparison test is inherent in the non-discrimination clause, the absence of full tax liability in the source State does not constitute a valid criterion to restrict the deduction of such expense, unless a payment made in the same condition to a resident without full tax liability (e.g. tax exempt entity) is also non-deductible for tax purposes.

Thus, if it were assumed that the remuneration derived from the hybrid financial instrument would be deductible in the source State if the payment was made to a resident company, then article 24(4) of the OECD MC would prevent the application of a domestic anti-hybrid rule based on Action 2 of the BEPS Project.

An additional difficulty that may arise is whether the classification of the remuneration of the hybrid financial instrument as interest or as dividends may affect the protection granted by the non-discrimination clause.

If the remuneration of the hybrid financial instrument is classified as interest under article 11(3) of a tax treaty based on the OECD MC, it follows that, for the sake of consistency, the income should also be considered as interest under article 24(4).

What may be debatable is whether the interest definition contained in article 11(3) may be used for the purposes of applying article 24(4) of the OECD MC, mainly because the wording of the former distributive rule states that "the term 'interest' as used in this Article means income from debt - claims of every kind". The expression "as used in this article" seems to indicate that the term "interest", when used in other articles of the OECD MC, does not necessarily refer the interpreter back to article 11(3).

Given the wording of the treaty provision, two different interpretations can be drawn:

1. the interpreter should use the explicit definition found in article 11(3), through a systematic interpretation of the tax treaty in its context; or
2. the interpreter should use the domestic law definition of interest based on article 3(2), which allows the recourse to the domestic law of the state applying the treaty "unless the context otherwise requires".

Strictly speaking, the interest definition in article 11(3) of the OECD MC should be used for the interpretation of the non-discrimination provision, since its definition has a broad meaning ("income from debt-claims of every kind") and represents the closest reference for contextual interpretation. Thus, if the remuneration derived from a hybrid financial instrument is classified as interest under article 11(3), it should also be considered as interest when interpreting article 24(4).

That stems from the fact that tax treaties must be interpreted in a systematic and logical manner, which implies that, whenever possible, the terms expressly defined must keep the same meaning in the interpretation of the tax treaty as a whole.

Moreover, by using the expression "the term 'interest' as used in this Article ", article 11(3) of the OECD MC simply indicates that its meaning and content should be reached by the autonomous interpretation, irrespective of meaning given to the term in the domestic laws of the relevant contracting states. Thus, this expression does not prevent a systematic interpretation of the OECD MC.

In addition, given that the term "interest" is expressly defined in the OECD MC, it will have priority over the general reference to domestic law based on article 3 (2), despite the presence of undefined terms within its definition.

The domestic law definition of the term interest should not be used in this case, because, according to the wording of article 3(2) of the OECD MC, the domestic law of the contracting states should only be used to determine the meaning of a term not defined in the tax treaty when the context does not require another solution. In this case, it is possible to acknowledge that the "context otherwise requires", due to the fact the application of the concept of interest found in the domestic law may deprive the taxpayer of the protection assured by the non-discrimination provision. In fact, the use of domestic law definition of interest may significantly reduce the protection granted by the non-discrimination provision, as the source state, in order to restrict the deduction of certain payments, could alter the legal nature of the income through a legal fiction just to disregard the application of the non-discrimination provision.

In this regard, article 31(1) of the Vienna Convention on the Law of Treaties states that treaty provisions should be interpreted in good faith in accordance with the ordinary meaning to be given to the terms in their context and in the light of its object and purpose. Consequently, the definition found in domestic law should not be used when it can lead to results inconsistent with the teleological interpretation of the tax treaty, in a way that renders part of its provisions superfluous or less effective. In this case, the use of a domestic law definition may render the non-discrimination provision ineffective, diminishing its practical effects, because the source state would amend the meaning attributed to the term in the same law that restricts the right to deduct the payment from the income tax base. That is precisely what the drafters of the non-discrimination clause intended to avoid, which reflects its object and purpose.

Therefore, if the remuneration derived from the hybrid financial instrument is categorized as interest in the tax treaty, the non-discrimination provision will prevent the application of the anti-hybrid rule proposed by the OECD in Action 2 ("primary response"), which restricts the right to deduct the corresponding expenses.

On the other hand, if the remuneration of the hybrid financial instrument is characterized as dividend under article 10(3) of the tax treaty, the question that arises concerns whether it can fall within the concept of "other disbursements" for the purposes of applying the non-discrimination provision.

The concept of "other disbursements" is not defined in the OECD MC, and the Commentaries on article 24(4) do not provide any further clarification in relation to its content. However, the term "disbursement" will rarely be expressly defined or have a proper meaning in the domestic law of

most countries for its interpretation based on article 3(2) of the OECD MC. But even if there is a definition in the domestic law, it will probably not be different from the ordinary meaning of the term “disbursement”, which encompasses any kind of payments. Thus, the expression “other disbursements” must be interpreted broadly to reach any payments made as consideration for the supply of goods or services, as well as any other monetary payments.

By embracing a broad interpretation of the term “disbursement”, it may be argued that the remuneration derived from the hybrid financial instrument, although classified as dividend under article 10(3) by the source state, remains protected by the non-discrimination provision, which would prevent, once again, the application of the anti-hybrid rule proposed by the OECD in Action 2 of the BEPS project.

Based on the above, it can be concluded that regardless of the classification of the remuneration derived from the hybrid financial instrument as interest or as dividends by the source state, the anti-hybrid rules proposed by the OECD to restrict the right to deduct the payments made to non-residents may breach the non-discrimination provision found in article 24(4) of tax treaties patterned on the OECD MC.

In order to overcome this issue, the OECD could have recommended the inclusion of a specific provision stating that the non-discrimination provision does not prevent the application of anti-hybrid rules, even when the asymmetry in the tax treatment, which is a prerequisite for the hybrid mismatch, occurs only in cross-border transactions, leading to a discriminatory treatment of non-residents. This kind of provision is commonly used in tax treaties to ensure the compatibility of thin capitalization rules with the non-discrimination provision, and it would be inserted in existing tax treaties through the multilateral tax treaty to be developed under Action 15 of the BEPS project.

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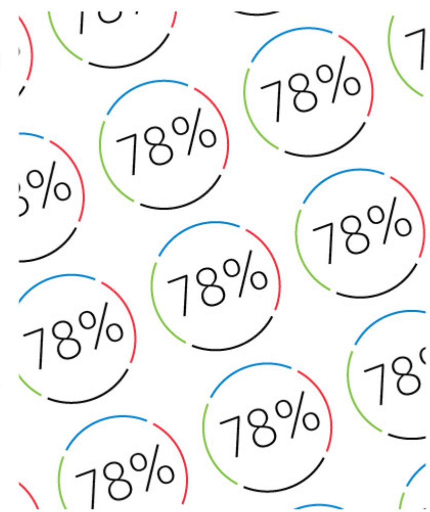

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