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

Ramon Tomazela (Mariz de Oliveira e Siqueira Campos Advogados) · Monday, August 17th, 2015

The first part of this blog post addressed the incompatibility of the anti-hybrid rule proposed by the OECD to the source state ("primary response"), which restricts the right to deduct the payments made to non-residents, with the non-discrimination provision found in article 24(4) of tax treaties patterned on the OECD MC.

In this second part of the post, attention will be given to the secondary response ("defensive rule") suggested by the OECD to the residence state, according to which the payment received by the payee should be included in the tax base of the income tax to the extent that it is deductible by the payer in the source state.

Indeed, in order to establish a link between the tax treatments applicable to the remuneration derived from financial instruments with characteristics of both equity and debt, the OECD recommended, in Action 2 of the BEPS project, that the residence state should apply a "defensive rule" and tax the payment as an ordinary income, in the event the payer is located in a jurisdiction that does not apply the "primary response". Therefore, participation exemption regimes provided for in domestic law, as part of the tax policy followed by some countries to alleviate double taxation, should no longer apply to deductible payments.

However, the OECD should have considered that some tax treaties entered into by countries adopt the exemption method to avoid economic double taxation of dividends, which can significantly reduce the effectiveness of the anti-hybrid rule suggested by the OECD, which focuses exclusively on the domestic law.

As an example, article 23(3) of tax treaty signed by Brazil and Spain grants an exemption to dividends distributed by companies resident in Brazil, without making its application dependent on conditions established in Spanish domestic law. This treaty provision reads as follows:

> *"Where a resident of Spain derives dividends which, in accordance with the provisions of this Convention, may be taxed in Brazil, Spain shall exempt such dividends from tax, but may, in calculating the tax on the remaining income of that resident, apply the rate of tax which would have been applicable if the exempted dividends had not been so exempted".*

Considering that the treaty provision transcribed above expressly provides that Spain must exempt dividends received from Brazilian companies, it is certain that any requirements placed on domestic laws, even if in line with the OECD's recommendations under BEPS Action 2, cannot restrict the scope the obligations assumed by the countries in the international sphere.

Indeed, if a tax treaty does not make the application of the exemption method dependent on the fulfillment of specific conditions provided for in domestic law, the enactment of subsequent domestic law restricting its scope will result in violation of the commitment assumed at the international level ("treaty override"). For comparison purposes, see article 22(1)(b) of the tax treaty signed between the United Kingdom and Liechtenstein, in which the application of the exemption method is subject to the requirements provided for in the domestic law of the United Kingdom.

> *"Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom or, as the case may be, regarding the exemption from United Kingdom tax of a dividend arising in a territory outside the United Kingdom or of the profits of a permanent establishment situated in a territory outside the United Kingdom (which shall not affect the general principle hereof):*
>
> *[…]*
>
> *b) a dividend which is paid by a company which is a resident of Liechtenstein to a company which is a resident of the United Kingdom shall be exempted from United Kingdom tax when the exemption is applicable and the conditions for exemption under the law of the United Kingdom are met."*

As can be seen from the comparison of these two treaty provisions, the tax treaty signed between the United Kingdom and Liechtenstein clearly states that the exemption method adopted by the former is subject to the fulfillment of the requirements established in its domestic laws. In turn, the tax treaty concluded between Brazil and Spain does not establish any conditions, which implies that the exemption method is a self-enforcing rule that cannot be restricted by subsequent law. If Spain deems appropriate, it may renegotiate the terms of its tax treaty Brazil, but it cannot override it unilaterally without violating its international commitments.

Therefore, the anti-hybrid rules proposed by the OECD in Action 2 may be incompatible with tax treaties that adopt the exemption method to dividends, without making its application dependent on the fulfillment of the criteria laid down in domestic law.

For these reasons, the OECD lost an excellent opportunity to recommend specific measures against the use of financial instruments hybrid instruments in a tax treaty context, in order to reduce tax planning opportunities commonly exploited by taxpayers through differences in the distributive rules ("rule shopping") and in the methods to avoid double taxation, based on the results arising from the interaction between the treaty provision and the domestic law of both contracting states.

Indeed, instead of just suggesting tax measures to be implemented into the domestic law of the countries concerned, the OECD could have proposed changes not only in the OECD MC, but also in existing tax treaties, by means of the multilateral tax treaty to be developed under Action 15 of the BEPS project.

Regarding the source state, as commented in the previous blog post, 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.

With regard to the residence state, the OECD could have recommended, for countries that use the exemption method to relieve double taxation, the adoption of a provision similar to Article 22 of the tax treaty concluded between Germany and Luxembourg, according to which Germany will only grant exemption to dividends received from companies in Luxemburg when, in addition to all the other requirements, the corresponding amount has not been recognized as a deductible expense in Luxembourg The wording of the treaty provision, in its relevant part, reads as follows:

> *"In the case of items of income from dividends the preceding provision shall apply only to such dividends…which were not deducted when determining the profits of the company distributing these dividends".*

Finally, within the OECD MC, the OECD could have proposed specific amendments to avoid conflicts in the classification of remuneration derived from hybrid financial instruments in articles 10 and 11 of the OECD MC, given the fact that the "new approach" proposed by the OECD since 1999, based on the Partnership Report, is insufficient to solve most of the difficulties encountered in concrete cases.

In fact, the "new approach" only solves qualification conflicts in the strict sense, which are caused by differences in the domestic law of both contracting states. Conversely, the residence is not obliged to follow the distributive rule applied by the source state when the origin of the divergence stems from the facts of the concrete case or from the interpretation of the treaty provisions. This may lead to "derived qualification conflicts", whereby the contracting states do not agree in relation to the motives that gave rise to the application of different distributive rules. For example, "derived qualification conflicts" may arise when the residence state considers that the reason for the application of different distributive rules by both contracting states relies on the facts of the case or on the interpretation of the treaty provisions, while the source state understands that there is an authentic conflict of qualification caused by differences in the domestic law, and vice versa.

In addition, the residence state must agree that the source state has correctly applied its domestic law, pursuant to the "general renvoi clause" of article 3(2) or to the specific reference to domestic law found in the dividend definition (third limb) and in the interest definition of tax treaties based on the 1963 OECD MC. This may give rise to additional issues, because the definitions of dividends and interest in the OECD MC contain in their wording terms not defined (for example, "corporate rights" and "debt-claims"), for which reason one contracting state may understand that it requires an autonomous interpretation, whereas the other contracting state may considerer that the non-defined term has to be interpreted based on its domestic law meaning.

In conclusion, the OECD could have taken advantage of the BEPS project to discuss specific solutions for the use of hybrid financial instruments in a tax treaty context, such as: (i) the elimination of the reference to domestic law in the third limb of article 10(3) of the OECD, which creates an overlap between the definitions of dividends and interest, so that the treaty concept of dividend would be regarded as closed and exhaustive; (ii) the harmonization of the tax treatment applicable to dividends and interest, in order to avoid tax arbitrage and rule shopping, which was the original approach adopted in article IX of the 1943 Mexico Model; (iii) the inclusion of a new distributive rule to deal with hybrid financial instruments and derivatives contracts, as previously discussed by the OECD in its report "Taxation of New Financial Instruments" of 1994; (iv) inclusion of tie breaker tests to decide whether the remuneration should qualify as dividend or interest; (v) introduction of criteria to bifurcate the remuneration of hybrid financial instruments into article 10 and article 11.

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