ABSTRACT

The scope of this work is to present some of the problems related to the application on the OECD Model Convention to the so-called “hybrid entities” and “hybrid instruments” under the OECD Model Convention which, as widely known, is the most used model convention for countries when it comes to draft international tax treaties.

The main issue regarding the hybrid entities and the hybrid instruments is to verify if they are really covered by the current text of the OCDE Model Convention, or if there is any problem of application and interpretation concerning such entities and instruments, that may be an obstacle to treaties’ entitlement.

In order to analyze this issue, we will initiate this work by making a brief introduction related to the OCDE Model Convention as well as giving an overview to the readers about the application of the tax treaties based in such Model. In this topic, it is important to have in mind the distinction between the state of source of the income, and the state of residence of the person that obtained such income.

Afterwards, we will expose what can be understood as “hybrid entities”, its concept and the problem related to such theme. As a few examples we can mention the partnerships, trusts, foundations and investment funds. Then, we will show the possible application of tax treaties to investment funds is particularly related to the perspective of the state of source of the income, as well as the relevant terms to determine if it is possible to apply tax treaties to such entities.

Particularly in this regard, some important concepts will be interpreted, such as definition of beneficial owner. The same chapter also focuses on the possible application of the OECD Partnership Report to investment funds.

Moreover, we will demonstrate the difficulty to classify the most common “hybrid entities” in the scope of OCDE Model Convention, specifically regarding its art. 3, which establishes the definition of persons covered by the scope of the Convention.

Then, it will be examined the definition of hybrid instruments and the difficulty to qualify the type of income derived from those instruments, mainly regarding financial instruments. Therefore, it is essential to analyze art. 10, 11 and 21 of OECD Model Convention to conclude if amendments are considered necessary. Basically, this issue relates to know the correct treatment of income distributed from an investment fund, according to the OECD Model Convention.

Finally, we will express our conclusion about such matter, therefore, if we understand that the hybrid entities and the hybrid instruments, specially the financial ones, are duly covered in the current OCDE Model Convention text, and it is possible to apply such convention to such entities and instruments, without help of any other doctrine or international taxation source.
I. OCDE MODEL CONVENTION AND HYBRID ENTITIES: ANALYSIS OF ITS APPLICABLE ARTICLES

In this chapter we will analyze the application of the OECD Model Tax Convention (“OECD MC”) as well as its Commentaries (“Commentaries”) to “hybrid entities.” The term “hybrid entity” can be understood as any entity that is treated, for income tax purposes, as a flow-through vehicle. Normally, they are considered as a transparent entity under the domestic law of one country and as a separate taxable entity (non-transparent entity) under the domestic law of another country. One of the most common examples is the partnership, an entity that can be treated as transparent on non-transparent in one or in both countries and therefore gives rise to a classification conflict.

Additionally, entities can also be considered as hybrids in the sense that they combine private law features conventionally associated with a corporation or a partnership. In this sense, the application of treaty provisions to partnerships has proven to be very difficult and debatable, because often it can be generated irreconcilable results depending on the treatment of a partnership under the domestic law of a Contracting State of the treaty as either a taxable entity separate from the partners or a flow-through vehicle with no individual taxable capacity.

In order to try to clarify more such matter, the OECD created a Partnership Report to approach the application of the OECD model tax convention to partnerships, and suggest possible solutions to these problems.

According to VAN RAAD¹, the OECD Partnership report also provides some important recommendations for the amendment of certain articles of the model convention and some of the related commentary. Being that said, it clearly demonstrates that the existing text of OCDE Model Convention is far from resolving the conflicts of application, interpretation and qualification of hybrid entities such as partnerships.

Other very used form of hybrid entity is the investment fund. There are many forms under which an investment fund may be organized, and they are crucially linked to its possible entitlement to the benefits of tax treaties, specially those that adopt the OCDE Model Convention.

In order to having granted such benefits, an investment fund must be considered both a “person” and a “resident” in accordance with the definitions of such terms as laid down in the relevant provision of the Model Convention. In this respect, an investment fund organized under corporate law is considered to fall within the meaning of “company” as defined in art. 3(1)(a), or whether the entity lacks of the requirements of a company it may still be encompassed in the definition of “body corporate” provided that is treated as a company for tax purposes.

Hence, the meaning of the term “body of persons” is extremely crucial for the application of OECD MC to all hybrid entities. Nevertheless, there is another requirement to enable the treaties’ benefits entitlement to entities like the investment funds or partnerships, specially concerning the possibility of their inclusion in the term “resident”.

In order to be considered as a resident for treaty purposes there is a doubt emerging from the interpretation of the term “liable to tax”, that may be understood either as a “potential taxation” of “the actual taxation” by incomes received by the hybrid entities. Though, making such interpretation even more complicated, there are some cases that aggravate this interpretation and definition problem. One of these examples is when the hybrid entity

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is considered as fiscally transparent, since the issues to be solved, in order to consider it as a resident for treaty purposes, are more intricate.

Nonetheless, after deep analysis of the OECD Commentaries regarding such matter, we agree with PALLESI\textsuperscript{2} when the author states that a transparent entity may be entitled to treaty benefits and, therefore, be considered as resident for treaty purposes, even though it may appear that such wide interpretation goes beyond the literal and technical meaning of the wording of art. 4 of the OECD MC.

Unfortunately, there is no explicit mention of this understanding, what makes it difficult to apply the treaties to partnerships, investment funds, trusts and others. In this sense, we believe that a written express inclusion of such understanding would be an important starting point to achieve the scope of eliminating the practices that discourages cross-border activities with all those hybrid entities, specially to partnerships and investment funds.

To summarize all the requirements above described to verify if hybrid entities are entitled to treaty benefits, we can affirm that the following questions shall be answered:

(i) does the term “person” and “body of persons”, by the current wording of the OECD MC, include the hybrid entities such as partnerships, investment funds, trusts, foundations and other?
(ii) Are such entities considered as “liable to tax”;
(iii) may they be considered as the beneficial owners of the income received according to art. 10, 11 and 12 of OECD MC? And
(iv) Can the income received by such entities be considered as “paid to” such vehicles?

I.A APPLICATION OF REQUIREMENTS TO THE TREATY ENTITLEMENT FOR HYBRID ENTITIES

Firstly, the OECD MC definition of “persons” and “resident” are very important to define if the treaty can be applied to such entities. On the subject of the concept of persons, as defined in art. 3(1)(a) of the OECD MC, when such entity is organized under a contractual arrangement it may not be included in such definition of “body of persons”.

Moreover, “person” is then defined by art. 3(1)(a) “as including an individual, a company and any other body of persons”. Partnerships and foundations are, according to the Commentary, also included in such definition. The Commentary defined “body corporate” as: “any other taxable unit, although not incorporated, that is treated as a body corporate according to the tax law of the Contracting State in which it is organized”.

in view of that, hybrid entities may not be considered as individuals, but may better be assimilated to companies or body of persons. Still, in which definition such entities fall in depends on the legal structure they have adopted under their domestic law. For this reason, it may be concluded that if a hybrid entity is, under its domestic law, considered as a corporation it definitely fits in the definition of “company” mentioned in the OCDE MC

it should be underlined that the Commentary to art 3, in its paragraph 2 specifies, for partnerships, that “where it is not the case (they have to be considered as persons) because they constitute other body of persons”.

\textsuperscript{2} PALLESI, Niccolo. “The application of tax treaties to investment funds”. University of California, Berkley, 2007. Available at Berkley Eletronic Press (bepress) in 12.07.08
Additionally, due to the wide definition of “body corporate” given in the Commentary, also an entity, “although not incorporated”, may fit in the above definition, and thus be treated as a company, provided that is treated as such for tax purposes

In conclusion, the condition for qualifying any hybrid entity as a person, according to OECD MC, will depend if the entity is treated in its country of establishment as a body or person (company), since this term is defined neither in the Model Convention nor in the Commentary.

Conversely, it is commonly accepted that some hybrid entities like investment funds may constitute an “association of person”; not a “body of person” because they lack of independent identity (i.e. legal personality) from the participants-members. While the OCDE MC does not amend the text of the Model Convention, there will remain doubts when it comes to such issue. However, if the entity is not a company but is treated as such for tax purpose it may be included of the definition of body corporate according to the wording of paragraph 2 of the Commentary on art. 3.

In order to reach this conclusion both paragraph 2 of the Commentary on art.3, which expressly mentions that the terms “persons is to be used in a wide sense”, and the General Report on the IFA Congress in 1997 according to which, if specific requirements are met, such funds are regarded as persons for treaty purposes.

As per definition of resident in art. 4(1) of OECD MC, it does not say when an investment fund or a partnership is considered as a taxable entity that they necessarily are considered as a resident for treaty purposes. But, as above mentioned, if the entity is treated as such for tax purpose it may be included of the definition of body corporate, and, might be considered, therefore, as resident for tax purposes too.

Considered that all hybrid entities such as investment funds, partnerships and trusts may be considered as a “person” for treaty purposes, it is necessary to check whether those entities may be assessed as a “resident” in the meaning of art. 4(1) of the OECD MC. The problems concerning the interpretation of this article regards the different definition that may be given to the term “liable to tax”. The definition of “resident” of a Contracting State expressed by the Model Convention means that the person has to be subject to worldwide taxation in at least one of the two Contracting States.

Nevertheless, another issues arise in defining the term “liable to tax”. According to a wide interpretation, the term “liable to tax” would imply that a “potential taxation” would be sufficient in order to be eligible for treaty benefits. By contrast, according to a narrower interpretation, the term “liable to tax” would imply that an “actual taxation” is the “condition sine qua non” for treaty entitlement. Additionally, we believe that such term should be interpreted in a wide sense bearing in mind the “objective and purpose of the Convention”.

In addition, the meaning of “liable to tax” has to be also analyzed. Entities that are potentially liable to tax (but actually are not) such as tax-exempt entities should not be assessed as resident for treaty purposes. On the other hand, when an entity is disregarded for tax purposes, therefore considered as transparent, it will never become potentially taxable. As a result, according to PALLESI, the only way through which transparent vehicles may be entitled to treaty benefits is by the insertion of a specific provision dealing with the matter in the OECD MC or in its Commentary.

In this respect, it should be mentioned that the OECD Commentary in its paragraph 8.2 on art. 4 allows “pension fund, charities entities and other organizations” to be considered as resident for treaty purpose.

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Furthermore when it comes to the term “beneficial owner”, it is not defined either in the Model Convention itself, or in its Commentary. In the latter, it is instead expressly mentioned that the term “has not to be used in a narrow technical sense”. In addition, the Commentary also specified that “agent or nominee may not be considered as the beneficial owner” of the income as well as “conduit companies the powers of which are so narrow that, as a practical matter, they amount to be as mere fiduciary or administrator acting on account of the interested parties”. According to 1996 US Technical Explanation of art. 10(2), the beneficial owner is defined as: “any person resident in Contracting State to whom that State attributes the dividend for purpose of its tax.”

Since the term “beneficial owner” was introduced in the 1977 version of the OECD Model Convention with the scope of fighting the phenomenon commonly known as “treaty shopping”, we understand that, according to current wording of OECD MC, there is no prohibition that a hybrid entities could be considered as the “beneficial owners” of the income they receive. If the hybrid entity is not considered as a conduit company (that according to the Commentary is excluded from being considered as the beneficial owner), there is no prohibition to such application.

As per the possible application of the term “paid to”, since such definition is not provided in the OECD MC, according art. 3 of such Model Convention when a term is not defined therein reference has to be made to the domestic law of the state applying the Treaty. On this grounds, the application of the principle stated in the Partnership Report (i.e. an item of income is paid to a resident of a Contracting State if the latter exercises its taxing power over the income) has shown that the latter result is able to avoid conflicts of qualification that otherwise would lead to double taxation of the income.

Finally, concerning the definition of the term “paid to” in regards of hybrid entities we understand that the appropriate meaning of the term “paid to” is the one developed by the Partnership Report, and the state of source must follow the residence state in case of conflicts of qualifications concerning the tax status of a partnership, may also be applied to other hybrid entities, such as investment funds, trusts and foundations.

As a result, it is evident that the OECD will dedicate further consideration to this matter.
II. HYBRID INSTRUMENTS AND THE QUALIFICATION IN OECD MODEL CONVENTION OF INCOME GENERATED BY THEM

Nowadays, the financial instruments used in the globalize markets are getting more and more complex, leading to problems of qualification of the income generated by those. Normally, the income obtained by use of financial instruments can be classified as equity (dividends), established in art. 10 of OECD MC, or debt (interest), established in art. 11 of OECD MC.

However, the recent financial instruments cannot be clearly attributed to either equity or debt remuneration since they consist in hybrid-instruments or miscellaneous finance products. In addition to such qualification issue, the tax classification of the remuneration made by the investment funds or companies to its participants can also suffer an “income’s transformation”, occurring when the type of the income received by the investor is re-characterized when distributed by the investment fund or the company.

Since the hybrid instruments have a wide range of classification, from corporate shares and typical of loans to jouissance rights, convertible bonds and profit participation loans, it is not that simple to determine if such instrument is considered equity or debt.

In general, the classification of income’s distribution used to depend significantly from the classification of the entity making such remuneration. Nevertheless, when cumulating hybrid entities distributing income from hybrid instruments, the issue starts to become more and more complex.

Fiscally speaking, the classification as equity or debt is very important for two points of view. The first one concerns the payable entity and the deductibility of the income paid. This means that the entity that pays any income qualified as interest to another, can consider such amounts paid as tax-deductible, reducing its tax base.

Secondly, from the investor’s point of view, the classification determines whether the payments received from the respective instrument will be treated as a dividend or as interest and, therefore, if such amounts will be taxed after distributed. This may happen because in some cases, the dividends are not taxed after the distribution, therefore, the investor do not have to pay any income tax on such dividend like amounts, while if such amounts are considered as interest, they might be taxed.

The so called “tailor-made” finance instruments can lead either to double non-taxation or double taxation of remuneration received by the investor. The double non-taxation of the profits happens since the payment could be deductible as interest in the source state and may be exempt as a dividend in the investor’s state of residence.

On the other hand, if the hybrid instrument is treated as equity in the source state and as debt in the state of residence of the parent company, it might lead to double taxation, when the payment is subject to withholding tax in the source state and to income tax in the investor’s state of residence.

As described above, it is clear that hybrid instruments arise several important issues that directly affects the taxation not only to the party that receives the income (investor) but to the party that pays such income (investment fund, corporation, partnership etc).

As a result, the question that emerges is: is there any sufficient criteria on the OECD MC qualifying the yield paid on hybrid financial instruments?

Firstly, with the purpose of answering such question, one premise can be taken: the yield on hybrid instruments in the majority of cases either qualifies as dividend or interest in
terms of the OECD-MC. Hence, the analysis is focused on Art 10 (Dividends) and Art 11 (Interest) of the OECD-MC, or even in Art. 21 (Other Income).

Another important issue concerning the qualification of the hybrid entity that immediately reflects on the qualification of the income is the characterization of such entity as transparent or non-transparent, regarding the classification of the entity making the income payment or distribution.

Given that investment funds may be either considered as a separate taxable entity or as a transparent entity, the payment of an income previously classified as interest or dividend may be, conversely, re-classified when the investment funds are assessed as transparent entities. This happens since the income “flows through” the fund directly to the investors without any transformation at the fund level. For this purpose, the income could be re-qualified either as interest or dividend, depending on the nature of the payment and/or the financial instrument.

For a better understanding of this intricate theme, it is necessary to specifically examine Articles 10 and 11 of OECD MC.

Article 10 (3) OECD-MC defines the term dividends as follows:

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.

As it can be proved form the mere reading of such paragraph of article 10, in the last sentence it explicitly refers to the national law of the source state and thereby considers the internal law of both contracting states as a part of the treaty’s interpretation.

From the wording of Art 10 (3) one can conclude that only income from other corporate rights is affected by the reference to the national law of the source state, which only relates to the taxation treatment as income from shares but not to the meaning of the term corporate rights as used in the treaty. In this sense, all the examples of income enumerated in the Art 10 (3) OECD-MC have to be corporate rights, in order for them to qualify under the definition in Art 10 (2) OECD MC. They will only qualify as dividend according to Art 10 (3) OECD MC, if the underlying hybrid instrument constitutes a corporate right in terms of the OECD MC.

Some authors defend that an investment only qualifies as equity and therefore as dividend generating, if the investor must accept the possible risk of the loss of the investment similarly to the risk assumed by a shareholder. It is also considered that a profit-participating right is an essential characteristic for equity classification, but it alone clearly does not change the nature of debt to equity.

Nevertheless, the specific wording of Art 10 OECD-MC does not explicitly list these criteria. The wide scope of possible characteristics of hybrid instruments (e.g. conversion rights, fixed repayment by a definite date, fixed minimum interest rates) consequently makes it difficult to decide, whether the two criteria mentioned above are fulfilled.

In matters of qualification the income generated by hybrid instruments as equity (Art. 10) or interest (Art. 11), it is necessary to examine Art 11 (3) of the OECD MC, which provides the definition of the term interest, as follows:
The term "interest" as used in this Article means 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. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

It is important to mention that Art. 11 (3) OECD MC, in contrary of Art. 10, contains no reference to the national law of the Contracting States and therefore is recognized as the final and only definition of the term interest in OECD MC, being interpreted independently from any national law.

In accordance with Art 11, paragraph 21 of the OECD Commentary to the OECD MC this is justified because “the definition covers practically all the kinds of income which are regarded as interest in the various domestic laws; – the formula employed offers greater security from the legal point of view and ensures that conventions would be unaffected by future changes in any country's domestic laws; – in the Model Convention references to domestic laws should as far as possible be avoided.

The problem with hybrid finance instruments is that on one hand dividends in terms of Art 10 constitute remunerations for making capital available as well and on the other hand debt claims which carry a right to participate in the debtor's profits are explicitly covered by the definition of interest in Art 11 (3)4. For that reason the problem concerns the conflict on the application of Art 10 (3) and Art 11 (3) of OECD MC.

In this specific point, the OECD Commentary in its Art 11 comment 19 implicitly acknowledges that any kind of income can only be qualify under one of the distributive rules of the OECD MC, by a mutual exclusion, as can be confirmed from the mentioning that the term “interest” as used in Article 11 does not include items of income which are dealt with under Article 10. Therefore, it can be said that the terms income from corporate rights and income from debt claims in context of the tax treaties are mutually exclusive.

Moreover, according to SIX5 the hybrid instruments with a profit-participating right as well as a right to participate in the liquidation proceeds of the issuing company from a tax treaty perspective are not qualified as yield related to income from debt claims in terms of Art 11 (3) OECD MC, but rather income from corporate rights in terms of Art 10 (3) OECD MC.

As a result, the yield in such cases qualifies as dividend in terms of Art 10 OECD MC. On the other hand the yield of hybrid financial instruments which impart a participation in the entrepreneurial risk solely through a profit-participating right, e.g. if the payment of interest on a debt claim depends on profits being made, does not qualify as dividend but rather as interest in terms of Art 11 (3) OECD MC.

Evidently, as it can be seen from the issue above described, this matter is particularly thorny, and the current wording of OECD MC as well as its Commentaries are not entirely and sufficient helpful to resolve the problems that may arise from the use of hybrid financial instruments in the capital markets reality.

4 VOGEL, Klaus. "Klaus Vogel on Double Taxation Convention". Kluwer. 1991
III. CONCLUSION

Tax treaty application has always been a very complex issue to International Tax Law specialists and professionals. However, nowadays, many other issues have been arising from such area, especially because the globalization phenomena.

Actually, with the increase of the use of hybrid entities and also hybrid financial instruments by all kind of business worldwide, a substantial part of the income is being generated by those entities and instruments, mainly derived from cross-border transactions. As a consequence, the owners of such relevant income wish to have granted the treaty benefits to those entities and instruments, in order to adequately compete in the international market.

The analysis of the possible treaty entitlement to hybrid entities concerns the interpretation of several specific terms in the OECD MC, such as “body of person”, “resident”, “liable to tax”, “beneficial owner” and “paid to”. By the solely reading of the OECD MC or its Commentaries, it is our opinion that one cannot conclude about this issue and, therefore, it is impossible to solve this problem.

As per the second issue that has been examined herein concerns the problems arising from the qualification of the income generated by hybrid instruments, mainly the financial ones. Since those hybrid instruments often produces income that may be either qualified as dividends (Art. 10) or interests (Art. 11), and in some cases as in both of such income types, it has been proved to be very thorny a ultimate rule to solve all of this cases.

Consequently, one possible solution to classify the yield originated from hybrid instruments which is analyze if such yield can be qualified as corporate rights in terms of Art 10 OECD-MC: if so, it would be classified as Dividend in terms of Art 10, whereas in all other cases the yield consequently classifies as Interest in terms of Art 11 OECD-MC.

Nevertheless, one other requirement considered by the doctrine to solve this problem is to see if the investment at least incorporates a participation in the profits as well as a participation in the liquidation proceeds of the issuing company, therefore, is considered as dividend too.

Adversely, those criteria are not expressed neither in the OECD MC nor in its Commentaries, which makes it very complicated to be taken as the applicable rule to solve such matter. Since the OECD-MC itself however does not explicitly list these criteria, in the case of hybrid instruments the wide scope of possible characteristics as regards the participation in the entrepreneurial risk contributes to a very difficult qualification.

In conclusion, the problem regarding the application of tax treaties to both hybrid entities as well as to hybrid instruments, with respect to the OECD MC is very thorny and difficult. Until this moment, we believe that the current wording of the Model Convention does not solves the problems generated by hybrid entities entitlement to treaty benefits and is definition as “body of persons resident in a Contracting State”. Also, the OECD MC text does not clearly helps the application and qualification on income generated by hybrid instruments, mainly financial ones, in article 10, article 11 or even art. 21 of it.

Being that said, we are very convinced that the hybrid entities and the hybrid instruments are not adequately covered in the OECD Model Convention, not either in its Commentaries. Therefore, it is unmistakable that the OECD should dedicate further consideration to these matters.


OECD MODEL CONVENTION, 2005 version.


