

Financial Instruments in the OECD Model Tax Convention

Jan Weissbrodt

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Financial Instruments in the OECD Model Tax Convention

DISSERTATION

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by

Jan Weissbrodt

born in Berlin, Germany

in 1979

Supervisor: Prof. dr. Rainer G. Prokisch

Co-supervisors: Prof. dr. Hans van den Hurk

Assessment Committee: Prof. dr. Raymond Luja (Chair)
Dr. Marcel Schaper
Prof. dr. Alexander Brüggem
Prof. dr. Marjaana Helminen
Prof. dr. Madeleine Simonek

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Abbreviations

A.A.R.	Authority for Advance Rulings
Art.	Article(s)
AS	Aksjeselskap
BEPS	Base Erosion and Profit Shifting
BC	(IAS / IFRS) Basis for Conclusions
BNB	Beslissingen in belastingzaken / Nederlandse Belastingrechtspraak
BStBl	Bundessteuerblatt
BV	Besloten vennootschap met beperkte aansprakelijkheid
CDO	Collateralised debt obligation(s)
Chap.	Chapter(s)
CLN	Credit-linked note(s)
CoCo	Contingent convertible bond(s)
C.T.C.	Canada Tax Cases
CPEC	Convertible preferred equity certificate(s)
D.C.	District of Columbia
DECS	Dividend enhanced convertible securities
DO	Dissenting Opinion
DStR	Deutsches Steuerrecht
DTC	Double Tax Convention(s) on Income and on Capital
EBIT	Earnings before Interest and Taxes
EBITDA	Earnings before Interest, Taxes, Depreciation and Amortisation
EC	European Community
ECJ	European Court of Justice
EEC	European Economic Community
e.g.	exempli grātia
EMIR	European Market Infrastructure Regulation
et al.	et alii / et aliae / et alia
etc.	et cetera
et seq.	et sequens
et seqq.	et sequentia
EU	European Union
FCA	Federal Court of Australia
HCA	High Court of Australia
IAS	International Accounting Standards
IBFD	International Bureau of Fiscal Documentation
ICJ	International Court of Justice
i.e.	id est
IE	(IAS / IFRS) Illustrative Examples
IFA	International Fiscal Association
IFRIC	(IFRS) International Financial Reporting Interpretations Committee

IFRS	International Financial Reporting Standards
IG	(IAS / IFRS) Guidance on Implementing
ILS	Insurance-linked security(s)
Inc.	Incorporated
IWB	Internationale Wirtschaftsbriefe
Jr.	Junior
KPMG	Klynveld, Peat, Marwick & Goerdeler
Ltd.	Limited
MTC	Model Tax Convention on Income and on Capital
n/a	Not applicable
No.	Number(s)
NWB	Neue Wirtschaftsbriefe
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
p.	Page(s)
Par.	Paragraph(s)
PERCS	Preferred equity redemption cumulative stock
PT	Perseroan Terbatas
Ref.	Reference(s)
SCRIP	Substitute Cash Redeem in Person
SFAS	Statement(s) of (US) Financial Accounting Standards
Sec.	Section(s)
SIC	(IAS) Standing Interpretations Committee
TARN	Targeted accrual redemption note(s)
TFEU	Treaty on the Functioning of the European Union, Lisbon, 13 December 2007, available online at http://eur-lex.europa.eu (last retrieved on 15 September 2017)
UN	United Nations
US / USA	United States of America
VCLT	Vienna Convention on the Law of Treaties, Vienna, 23 May 1969, available online at http://treaties.un.org (last retrieved on 15 September 2017)
Vol.	Volume(s)
vs.	versus

Chapter 1

Introduction

1.1 Subject

1.1.1 Problem

- 1 Financial instruments are legal contracts evidencing financial transactions. Financial transactions can be understood in a narrow purposive sense of particularly providing finance capital (e.g. equity yielding dividends and debt yielding interest) or in a broader, objective sense of generally dealing with cash and/or cash-equivalents (e.g. also including capital gains). While the OECD MTC deals with income from both forms of financial transactions, it requires them to be classified into its various distributive articles. Obviously the aspect of applying a legal framework to contracts is not a particular issue of financial instruments but rather of any tax case. The peculiarity of financial instruments is, however, that they extract or separate economic attributes such as cash flows or risks from any real asset. In other words: it is this economic purity which allows financial instruments, as opposed to physical transactions, to transform those economic attributes from the underlying assets into a “piece of paper” and to market and transact them between taxpayers under considerably low frictions (e.g. transaction costs, timing, legal restrictions, etc.). And it is this very reason which makes finance capital an extraordinarily mobile economic factor. Even facing the specific complexity of the OECD MTC as what is called in this study a collective tax law, it is therefore not so much the legal but rather the economic aspect of financial instruments that is detached from that legal aspect in such an exceptional manner that it challenges the traditional real-economic fundamentals of any legal framework dealing with economic situations. Thinking this to its end raised quite early doubts towards the principal capability and expedience of an income tax law system to tackle these challenges¹.

¹ *David Hasen*, p. 399 et seq. and 481; *Duncan, James A.*, Tax Treatment of hybrid Financial Instruments in cross-border Transactions – General Report, Series IFA Cahiers 2000, Vol. 85a, p. 21; *Achim Pross*, p. 172 and 181; *Anthony Polito*, p. 762; *Shaviro, Daniel*, Risk-Based Rules and the Taxation of Capital Income, *Tax Law Review* 1995, Vol. 50, Issue 4, p. 645, 690, 704 and 708; *David Weisbach*, p. 492 and 495; *Warren, Alvin C. Jr.*, Financial Contract Innovation and Income Tax Policy, *Harvard Law Review* 1993, Vol. 107, Issue 2, p. 461, 482 and 491 et seq.; *Edward Kleinbard*, financial innovations, p. 1361 et seqq.; *Edward Kleinbard*, debt, p. 946.

- 2 These challenges include, for instance²:
- Financial transactions, both in the narrow and the broader sense mentioned above³ are flexible and can be tailor-made in the sense that they can be replicated by each other and/or artificially synthesised.
 - As a result, the basic principles of realisation, its methods (e.g. accrual versus cash flow basis) and its date are placed at disposal, as are, consequently, the general rules of attribution.
 - In addition, financial transactions are capable of compensating or synergising compound effects (e.g. hedges), so that the amounts of income are not necessarily predetermined.
 - Furthermore, the source of income is highly flexible in terms of replaceability and mobility.
 - In transferring or exchanging not only cash-equivalents as positive assets but also risks as negative assets, financial instruments present unique issues with respect to “in lieu of” payments.
- 3 Due to the strong dualism between the legal form and the economic substance in tax law, many financial instruments or transactions appear to be ambiguous and impervious to a distinct classification. These ambiguities, which already emerge in domestic tax laws, become even more critical in the law of DTC. Domestic laws often try to constitute a closed and cohesive system that may resolve or alleviate these conflicts, for instance by subsidiarity rules, fall-back provisions or tests⁴. Due to their segregated structure of income types or schedules, DTC, however, provide only the four possible Art. 10, 11, 13 and 21 OECD MTC, which lead to considerably different legal consequences. In addition, the question of which level of law is relevant and decisive (e.g. DTC itself, protocol, domestic law, treaty override, binding or non-binding memorandum of consultations, etc.) for each and every single criterion leads to another level of complexity when interpreting and applying DTC. For these reasons, qualification conflicts must be acknowledged as very likely to occur in the field of financial tax law, fostering entire repeals (e.g. the OECD Multilateral Convention⁵) or at least secondary law and derivative concepts (e.g. “abuse”). Such derivative concepts, however, presuppose genuine concepts (e.g. definitions) as their precondition instead of creating them as their result. In casuistically alleviating the cursory symptoms rather than dealing with the actual root causes in an abstract manner, those responses eventually erode primary law and thus subvert legal certainty as a whole.

1.1.2 Objective

- 4 The intention and objective of this study is to develop a tie-breaking test in order to distinguish:
- (1) *Shares* yielding *dividends* pursuant to Art. 10(3) OECD MTC and *debt-claims* yielding *interest* pursuant to Art. 11(3) OECD MTC from each other;
 - (2) The group of these finance transactions in the narrow sense from those in the broader sense⁶, i.e. capital *gains* pursuant to Art. 13(5) OECD MTC; and
 - (3) The group of these specific financial transactions from the general residual of *other income* pursuant to Art. 21(1) OECD MTC.

² OECD, ST/SG/AC.8/2001/CRP.8, p. 17 et seqq., par. 47 et seqq.

³ See par. 1.

⁴ Similarly: *Michael Lang*, hybrids, p. 128.

⁵ OECD, Multilateral Convention to implement Tax Treaty related Measures to prevent BEPS, Paris, 2017.

⁶ See par. 1.

- 5 Closed-end tax law systems such as domestic tax laws typically adhere to other and/or additional purposes than tax treaties and thus apply other and/or additional principles⁷. In contrast, the aspired OECD MTC tie-breaking test shall – as much as possible – have the following properties or characteristics⁸:

Logical requirements to the tie-breaking test

- *Coherence*: The test criteria or differentiators form a logical and systematic structure.
- *Consistency*: Equal or comparable inputs (i.e. cases of financial instruments or transactions) harmonically and consequently result in equal or comparable outputs (i.e. legal classifications) respectively.
- *Universality*: The test is capable of processing the greatest possible diversity of inputs.
- *Completeness*: The test is gapless in the sense that it is capable of always resulting in an output (i.e. legal classification).
- *Mutual exclusivity*: The output from the test is unique or otherwise clearly and distinctly determined without any overlap or ambiguity.

Legal requirements to the tie-breaking test

- *Justifiability*: The test criteria or differentiators shall each be supported by the current state and findings of jurisprudential research and discourse. In addition, they shall also integrate dissenting opinions wherever possible.
- *Autonomy*: All test criteria or differentiators and consequently also the outputs from the test are independent from domestic laws.
- *Objectivity*: All test criteria or differentiators and consequently also the outputs from the test are also independent from domestic terminology.

Technical requirements to the tie-breaking test

- *Resilience*: All test criteria or differentiators and, consequently, also the outputs from the test are robust and stable, even when viewed from different perspectives.
- *Operationalisability*: The test shall be easy to apply, as it will use publicly available or otherwise easily identifiable information wherever possible.

1.1.3 Relevance

- 6 It has been estimated that presently there exist around 3,000 DTC worldwide⁹. This represents an estimated coverage of nominal ca. 7%¹⁰ of all possible combinations of jurisdictions under international law, but of real ca. 80% in terms of their accumulated share of the global economic power¹¹. Given the economic significance of

⁷ Illustrative: Brunson, Samuel D., Elective Taxation of Risk-Based Financial Instruments: A Proposal, Houston Business and Tax Law Journal 2007, Vol. 8, Issue 1, p. 15 et seqq.

⁸ Illustrative: OECD, ST/SG/AC.8/2001/CRP.8, p. 25 et seq., par. 89 et seqq.

⁹ Institute of Chartered Accountants in England and Wales, www.icaew.com/en/library/key-resources/double-tax-treaties (last retrieved on 15 September 2017).

¹⁰ Calculation based on a maximum of 208 jurisdictions under international law (Auswärtiges Amt der Bundesrepublik Deutschland, Länderverzeichnis für den amtlichen Gebrauch in der Bundesrepublik Deutschland, 23 February 2017, Auswärtiges Amt der Bundesrepublik Deutschland, Berlin, 2017).

¹¹ Calculation based on International Monetary Fund, World Economic Outlook Database (Gross Domestic Product) 2016, International Monetary Fund, Washington D.C., 2016, and World Bank, World Bank national Accounts Data and OECD National Accounts Data Files (Gross Domestic Product) 2016, World Bank, Washington D.C., 2016.

the OECD member jurisdictions, the OECD MTC's longstanding history¹² and its significant international acceptance and conformity¹³, the OECD MTC may safely be recognised as the world's leading and most influential standard template for the negotiation of DTC. As such, it has extended its impact far beyond the OECD area¹⁴.

- 7 This importance of the OECD MTC has grown gradually over decades. For instance, as recently as 1955 only 70 DTC had been signed¹⁵. It is nevertheless remarkable that its originators and their successors seem to have taken comparatively little effort into systematically (re-)defining the key terms in the relevant distributive articles and/or into conceptually developing respective tie-breaking tests¹⁶. In particular, the widely cited original documents of OEEC/OECD Working Parties No. 1, 11, 12 and 14 dating between 1957 and 1974 do not contain abstract bottom-up considerations with respect to those fundamental terms. Instead, they provide first of all casuistic top-down analyses of the various domestic tax law systems and financial instruments encountered at that time. In addition, they provide the corresponding effects of the tax burden and tax revenue allocation. It must be taken seriously that the OECD MTC's international acceptance strongly depends on such effects¹⁷. However, it appears that the key terms and their remarkably rudimentary definitions were considered to be clear and proven, and were derived¹⁸ or even taken from other DTC already present at that time¹⁹. This is even more evident as many of today's financial instruments were invented later²⁰. In this historical context the important doctrine must be seen²¹ that:
- (1) "In view of the great differences between the laws of OECD Member countries, it is impossible to define 'dividends' fully and exhaustively."²²
 - (2) "In the course of the revision of the 1963 Draft Convention, a thorough study has been undertaken to find a solution which does not refer to domestic laws. This study has led to the conclusion that, in view of the still remaining dissimilarities between Member countries in the field of company law and taxation law, it did not appear to be possible to work out a definition of the concept of dividends that would be independent of domestic laws."²³
- 8 For one thing, these occurrences and developments are the historical root cause for the consequent legal uncertainties we face at present. On the other hand, the understanding of the abstract grounds and interdependencies in terms of economic and financial theory has grown significantly in recent years. This has

¹² For a comprehensive overview see *May, Nicolás* in *Thomas Ecker*, p. 419 et seqq.

¹³ OECD Commentaries 2014, introduction, p. I-4, par. 13.

¹⁴ OECD Commentaries 2014, introduction, p. I-4, par. 14.

¹⁵ OECD Commentaries 2014, introduction, p. I-1, par. 4.

¹⁶ See par. 4.

¹⁷ OEEC Council, Fourth Report of the Fiscal Committee, ref. C(61)97, Paris, 1961, p. 12 et seqq.

¹⁸ Exemplary also *Anthony Polito*, p. 778.

¹⁹ *May, Nicolás* in *Thomas Ecker*, p. 425 et seq.; OEEC (Working Party No. 12 of the Fiscal Committee), Second Report on the Taxation of Dividends, ref. FC/WP12(60)4, Paris, 1960, p. 12.

²⁰ *Harris, Peter A.* in *IBFD Commentaries on Art. 10 OECD MTC*, sec. 5.1.2.4.2.

²¹ OECD, CFA/WP1(73)2, p. 6, par. 9, p. 10, par. 19, and p. 14, sec. A.

²² OEEC (Working Party No. 12 of the Fiscal Committee), Second Report on the Taxation of Dividends, ref. FC/WP12(60)4, Paris, 1960, p. 15.

²³ OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-9 et seq., par. 23, tracing back to OECD Commentaries 1977 on Art. 10 OECD MTC, par. 23. The author has been unable to locate this study (equally: *Hans Pijl*, hybrid debts, sec. 2.2.2.), even on request to the OECD.

given rise to a pervasive and increasing innovation and sophistication of modern financial instruments²⁴. In other words: On the one hand, the traditional legal income tax framework is limited per se in its capabilities to tackle the specific economic challenges of financial instruments²⁵. On the other hand, these have been simultaneously elaborated to very adept standards. As a consequence, these two developments finally led to today's significant divergence in the dualism between the rule of law and its economic subject. In addition, the technique of financial engineering has not only professionalised but also internationalised. Accordingly, the OECD MTC has to cope with a vast diversity of financial instruments²⁶ and transactions arising from and thus embodying the peculiarities of a large number of unprecedentedly transparent and accessible jurisdictions. Lastly, the specific character of the OECD MTC as a collective and increasingly global but basically not yet multilateral tax law makes its adaptations and enhancements comparably inertial and causes its leverage and implementation to be time-consuming. These conditions have contributed – and will continue to do so – to the fairly acute situation into which the cross-border taxation of financial instruments and transactions has evolved.

1.2 Scope

- 9 The exclusive subject of this study is the OECD MTC. Particular DTC as parts of their respective domestic tax laws and their supplementary agreements (e.g. protocols, memorandum of consultations, etc.) as well as similar tax-related treaties under international law (e.g. those on exchange of information, judicial or administrative assistance, etc.) are not its focus. Other collective tax laws are not the subject of this study. However, they may be consulted as sources of inspiration in the sense of comparative law depending on specific criteria for relevance and appropriateness. These criteria are outlined in section 1.4.
- 10 More specifically, this study concentrates on the constitutive²⁷ paragraphs within those distributive articles of chap. III, which are relevant for the income from financial instruments and transactions in the broader sense. These are Art. 10(3), 11(3), 13(5) and 21(1) OECD MTC²⁸. Transactions such as letting and leasing, royalties and annuities, betting and gambling or those in the context of (“framed” or “wrapped”) activities to be classified into other schedules of the OECD MTC taxonomy (e.g. business or employment) shall not be considered to be financial instruments in this sense. Notably, any justification for such exclusion of these legal transactions from the economic nature and context of financial instruments²⁹ would actually require an equally thorough and in-depth analysis. This was, however, far too extensive for the envisaged volume of this study and therefore dispensed with. Within those constitutive paragraphs, this study concentrates only on the substantive core of genuine concepts within the object of taxation (definitions). Any precedent matter (e.g. taxpayer, tax domicile, etc.) as well as any derivative concept (e.g. “abuse”) or otherwise situative aspect (e.g. related parties) or subsequent consideration (e.g. legal consequences, appropriateness, procedural law, etc.) are

²⁴ OECD, ST/SG/AC.8/2001/CRP.8, p. 8, par. 1 et seqq.

²⁵ See par. 1.

²⁶ *Duncan, James A.*, Tax Treatment of hybrid Financial Instruments in cross-border Transactions – General Report, Series IFA Cahiers 2000, Vol. 85a, p. 31.

²⁷ *Marjaana Helminen*, dividend concept, p. 55.

²⁸ See par. 4.

²⁹ See par. 1.

entirely left aside. This implies the working assumption that the subjective intention of the involved parties coincides with the objective observables, i.e. the arm's length principle.

- 11 This study takes the perspective of the investor as the relevant recipient of the income. However, the classification of financial instruments and transactions may also be seen as depending in some way on the classification of the issuer (e.g. company versus partnership). As stated before, this study focusses on the general object of taxation and not on subjective aspects (e.g. hybrid entities, collective investment schemes)³⁰, which are outside the scope of this work. This may be especially relevant where these subjective aspects preselect or narrow that object of taxation. The following topics are not the primary subject of this study but appear to be closely connected with it. Hence, they turn out to be either indispensable for avoiding the actual constriction of this study's subject towards meaninglessness or at least helpful for its understanding. These topics are:
- the category of *capital* pursuant to chap. IV of the OECD MTC;
 - questions of subjective attribution, particularly *beneficial ownership*³¹;
 - matters relating to the nature, recognition and determination of income;
 - time aspects.
- 12 Finally, this study takes the English language version of the OECD MTC and the OECD Commentaries as its basis.

1.3 Approach

- 13 As stated before, previous developments led to the current impasse in the interpretation and application of the OECD MTC with respect to financial instruments and transactions.³² In this context, the history and analysis of previous studies gives the impression that the literal or textual element of interpretation is close to having reached its limitations of capability. It nevertheless leaves a number of essential issues open or ambiguous. In order to gain additional jurisprudential insights, the methodology in this study is therefore to put the focus more on the systematic element of interpretation. Owing to the specific nature of financial instruments and transactions, this approach promises to lead comparably deeper into their economic conceptual grounds. In other words: from the author's point of view, the aforementioned peculiarities of financial instruments³³ provide an adequate justification for the conclusion that the disentanglement of their structural mechanisms must play a significant role in the interpretation and application of the said provisions. Nevertheless, the results will be carefully embedded in the findings made so far by also integrating dissenting opinions wherever possible. In this sense, this study shall therefore represent a complementary rather than an alternative approach.

³⁰ See par. 10.

³¹ Comprehensively: *Joanna Wheeler*, missing keystone, sec. 2.4., 2.5. and 3.

³² See par. 7 et seq.

³³ See par. 1.

- 14 Facing that more or less exhausted literal or textual interpretability and applicability³⁴, especially of autonomous terms, the history and analysis of relevant case law also conveys the impression that the competent courts tend to seek salvation in methodologically referring to their respective domestic tax laws quite early. In particular, they seem to neglect first considering all possibilities to resolve the issue on the treaty level itself. In other words: Art. 3(2) OECD MTC is actually given extensive prevalence by undervaluing its important exception of “*unless the context otherwise requires*”. In doing so, however, the purpose, intention and function of the OECD MTC are frustrated. In fact, they foster selective repeals and thus eventually exacerbate the problem of potential qualification conflicts. This study is an attempt to tap the full potential of an autonomous interpretation of those terms, to the extent that it is in line with methodological requirements and jurisprudential appropriateness. Within this scope, it is consequently an important part of its approach to distinctly identify the limitations of the autonomous towards the domestic interpretation, by strictly focussing on the former and not on the latter (e.g. including the question which of the involved domestic tax laws applies).
- 15 This study strictly follows a descriptive purpose in the sense that it attempts to respect and interpret the OECD MTC as it actually is (*de lege lata*). This means in particular that it does not follow a normative purpose in the sense that it indicates any evaluative suggestion beyond the OECD MTC as it actually is (*de lege ferenda*). Nevertheless, some sections employ findings from the normative field of tax policy making. It is important to note that the use of these findings remains however confined to their descriptive discoveries and concepts regarding inherent structural rationales and interrelationships within collective tax law systems in general. In particular, it also does not encompass their specific normative conclusions regarding needs and recommendations for action. Admittedly, those conceptual insights are also taken into account for the systematic way of interpretation in this study, in so far as any interpretation results should naturally be able to solve the present and ideally also potential legal conflicts actually identified by the research area of tax policy making. However, this consideration is strictly limited to the extent that it is in line with methodological admissibility and jurisprudential justifiability. It is also carefully embedded in the descriptive findings made so far. In this sense, the methodological way and spirit of interpretation in this study may be said to take a progressive approach.
- 16 That said, it turns out that a meaningful discussion and treatment of financial instruments and transactions under the OECD MTC may not be constricted to the narrow delimitation between the isolated terms of *dividends* pursuant to Art. 10(3) OECD MTC, *interest* pursuant to Art. 11(3) OECD MTC, capital *gains* pursuant to Art. 13(5) OECD MTC and/or *other income* pursuant to Art. 21(1) OECD MTC. Instead, additional aspect in the context between these terms must be taken into account in this discussion³⁵. This is caused by the many systematic connections and conceptual interdependencies between all these legal aspects³⁶ on the one side and the specific economic detachment of financial instruments and transactions³⁷ on the other, and, consequently, to their exceptional capability to arbitrarily convert and address these aspects. In other words: it could be said that financial instruments and transactions are in a sense an “organic topic”, which cannot be reasonably described by individually picking out certain isolated aspects. Rather than following

³⁴ See par. 13.

³⁵ See par. 11.

³⁶ See par. 14.

³⁷ See par. 1.

such a classical, analytical approach, this study attempts to make a compromise between these two techniques. It starts with a holistic or synthetic view that considers the relevant “shades” between the pure concepts. Only subsequently does it take the reductive or analytical view that dives into the details of these concepts.

- 17 Interpreting such a comprehensive as well as strongly entangled and interdependent system from the fairly few words in Art. 10(3), 11(3), 13(5) and 21(1) OECD MTC may also present a formidable challenge. In order to improve legibility and comprehensibility, this study takes a “funnel approach”: it starts with the general and fundamental aspects and basic principles³⁸, which are embedded in the systematic legal setting afterwards³⁹. In the course of the study, the findings are condensed or broken down to potential differentiators⁴⁰ and only then are they interpretatively tested against the concrete legal texts⁴¹. Finally, the study ends with a practice section applying the abstract-theoretical findings to a number of specific groups of financial instruments and transactions⁴². The order of the sub-sections therein follows the logical dependencies found among them.

1.4 Sources of law and their relevance

1.4.1 Preliminary remarks

- 18 The purpose of this section is to give a brief overview of the selection of legal sources being worth of consideration and their potential relevance for this study. These legal sources may generally be categorised into two groups. On the one hand, those being either legally binding or at least admissible for the purpose of legally interpreting the OECD MTC (interpretational legal sources). On the other hand those without such more or less binding character but rather representing a source of inspiration (inspirational legal sources). These two categories have in common that they must be of a collective character in the sense of a multinational or multi-jurisdictional compromise across, and must be beyond the heterogeneous peculiarities of individual (domestic) or cultural (regional) tax laws or even entire tax systems. *Multi-jurisdictional* in this sense is independent of and may not be confused with the term *multilateral*, which merely describes the formal organisational mode of constituting and maintaining a collective law. A multi-jurisdictional law can be multilateral (e.g. the OECD Multilateral Convention⁴³) or bilateral (e.g. OECD MTC/DTC). Obviously, the borderline between collective and non-collective tax laws is fluid. There might be domestic tax laws with a collective character that is stronger than a homogeneous multi-jurisdictional tax law. Even the OECD MTC itself may be seen as being “locally biased” in that it embodies and represents the peculiarities of the developed countries, i.e. their capital-exporting national economics. In that, collective tax laws – as opposed to domestic tax laws – are no closed-end systems: they reach a new generic quality by sharing a number of similar conceptual problems. The objective of this section is therefore to briefly analyse some collective tax laws by quality and scope of their comparability criteria. This would require a more comprehensive and detailed comparability analysis, but such an analysis would be far too extensive to be given here. Instead, the crucial aspect and the added scientific value of the respective collective tax law – even though it is not being legally

³⁸ See sec. 2.2.

³⁹ See sec. 2.3.

⁴⁰ See sec. 2.4.

⁴¹ See sec. 3.

⁴² See sec. 5.

⁴³ OECD, Multilateral Convention to implement Tax Treaty related Measures to prevent BEPS, Paris, 2017.

binding – is to what extent its fundamental principles are compatible and fit into those of the OECD MTC. These coincidences are the fixation points, on which the conceptual framework built in this study is pinned. For these reasons, the following legal sources have been excluded from the analysis and are not consulted in this study:

- Domestic tax laws, except where these have an extraordinary collective character;
- Particular DTC as part of just two domestic tax laws;
- MTC of individual jurisdictions as being “locally biased” (e.g. US MTC);
- MTC of multiple jurisdictions with a homogeneous tax law culture (e.g. Nordic MTC).

19 The practice of international taxation is an allocation conflict between the jurisdictions over the tax revenues available for distribution. In this conflict it can be observed that it is naturally the jurisdiction of residence that is urged to avoid double taxation by crediting the tax that has already been withheld by the source jurisdiction. Therefore, the main purpose and function of DTC pursuant to Art. 31(1) VCLT is to strike a balance between the two contracting jurisdictions by limiting the allocation of taxation rights to the source jurisdictions (limiting effect or function of DTC). To serve this function, the terms used in the treaty need to be associated with a unique and common meaning pursuant to Art. 31(4) VCLT in order to avoid qualification conflicts, which would necessarily occur where the contracting jurisdictions interpreted the DTC from their domestic perspectives⁴⁴. Being in line with the international law principles of interpretation pursuant to Art. 31 et seqq. VCLT, this is the reason why DTC in particular and the OECD MTC in general are basically to be interpreted autonomously (primacy of the autonomous interpretation), especially as regards parts serving its tax-limiting function. In other words: the treaty purpose, intention and function require a restrained or cautious invocation of domestic tax law⁴⁵.

20 The autonomous interpretation leads to the problem that each of its attempts to define a term or figure may tend to exacerbate the interpretation problem in the triangle between the treaty and the two domestic tax laws by creating more and more terms with the need of interpretation⁴⁶. This was one practical reason why there is an exception to the primacy of the autonomous interpretation in Art. 3(2) OECD MTC that gives prevalence to domestic tax law for the interpretation of terms not being defined in the OECD MTC therein (“*lex fori*”)⁴⁷. However, pursuant to the express wording of Art. 3(2) OECD MTC this exception applies only “*unless the context otherwise requires*”⁴⁸. Due to this limiting insertion, the significance or relevance of Art. 3(2) OECD MTC is controversial⁴⁹. Nevertheless, pursuant to the international law principles of interpretation⁵⁰

⁴⁴ Wassermeyer, Franz in Wassermeyer Commentaries, p. 284, par. 86; Michael Lang, interpretation, p. 288 et seq.; Huerta, Adalberto Ramos in Eva Burgstaller, p. 21, 28 and 31; Michael Lang, hybrids, p. 22 et seq.; Klaus Vogel Commentaries 1997, p. 208 et seq., par. 60; Rainer Prokisch, interpretation, p. 52; OECD, Consolidated List of outstanding Points concerning the OECD Draft Convention on Income and Capital, ref. TFD/FC/218, Paris, 1967, p. 29, sec. A. In other words: the autonomous interpretation prevents misconceptions where the two contracting jurisdictions use the same term but each with a different understanding of its content.

⁴⁵ Peter Hongler, p. 207.

⁴⁶ Similarly: Caroline Poirer, sec. 2.7.

⁴⁷ Wassermeyer, Franz in Wassermeyer Commentaries, p. 271, par. 71 et seq.; Vogel, Klaus / Prokisch, Rainer, Interpretation of Double Taxation Conventions – General Report, Series IFA Cahiers 1993, Vol. 78a, p. 72.

⁴⁸ The additional exception of separate authorities’ agreements inserted by the OECD MTC Draft Update, p. 11, par. 8, is not relevant for the scope of this study (see par. 14).

⁴⁹ For an overview see Michael Lang, hybrids, p. 24 et seqq.; Dürschmitt, Daniel in Vogel / Lehner, p. 549 et seqq., par. 116a et seqq.; Wassermeyer, Franz in Wassermeyer Commentaries, p. 271, par. 71, and p. 281, par. 82. The relation between the autonomous and the domestic interpretation was much more controversial prior to the 1995 update to OECD MTC, adopted on 21 September 1995.

⁵⁰ See par. 19.

the majority of commentators⁵¹ came to the consensus view that this *context* is to be understood in a broad sense. In particular, the domestic interpretation is not permissible where the OECD MTC provides a closed or exhaustive definition⁵², where domestic tax law would make parts of the OECD MTC inapplicable⁵³ or where the *term* in question has a general meaning (i.e. is no *terminus technicus*)⁵⁴. This conclusion of the majority opinion is in line with the aforementioned purpose, intention and function of the OECD MTC outbalancing the aforementioned possible problem of exacerbation by the autonomous interpretation. Anything else would only relegate the interpretation and application problem of qualification conflicts to the mutual agreement procedure⁵⁵.

- 21 However, in order to “regulate the interface between the tax law systems of two states”⁵⁶, a DTC must – instead of being detached or distant – necessarily be linked with the domestic tax law by certain “connecting factors”⁵⁷. These are references to items which represent facts or precursory matters from the treaty perspective.⁵⁸ In other words: the domestic tax law first needs to constitute a taxable event. Only afterwards is this taxable event subject to the treaty’s subsequent function of assessing and – where necessary – limiting the taxation.⁵⁹ Those connecting factors, which are regularly interpreted domestically rather than autonomously, are typically references to the taxpayer and the tax base (e.g. *company, profit, income, assets, etc.*).⁶⁰
- 22 Having set their general scope and role in this section, the potential international sources of tax law, be they legally binding or interpretational or inspirational⁶¹, shall now be introduced in a nutshell.

⁵¹ *Avery Jones, John F.* in *IBFD Commentaries on The Scope of Art. 3(2) of the OECD Model*, sec. 8.1.; *Reimer, Ekkehart / Rust, Alexander* in *Klaus Vogel Commentaries* 2015, p. 207, par. 111, and p. 212, par. 123; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 271, par. 71, and p. 282, par. 82; *Michael Lang*, introduction, p. 45, par. 74, p. 57, par. 117, and p. 57, par. 119; *Peter Hongler*, p. 210; *Michael Lang*, interpretation, p. 288 et seq.; *Huerta, Adalberto Ramos* in *Eva Burgstaller*, p. 31; *Klaus Vogel Commentaries* 1997, p. 214, par. 72.

⁵² *Dürschmitt, Daniel* in *Vogel / Lehner*, p. 546, par. 101 and 107; *Reimer, Ekkehart / Rust, Alexander* in *Klaus Vogel Commentaries* 2015, p. 208, par. 114, and p. 213, par. 126; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 271, par. 71 et seq., and p. 280 et seq., par. 81; *Fehér, Tamás* in *Eva Burgstaller*, p. 235; *Klaus Vogel Commentaries* 1997, p. 211, par. 63; all with explicit references to Art. 10(3) and 11(3) OECD MTC.

⁵³ *Reimer, Ekkehart / Rust, Alexander* in *Klaus Vogel Commentaries* 2015, p. 218, par. 124; *Dürschmitt, Daniel* in *Vogel / Lehner*, p. 551, par. 116c.

⁵⁴ *Avery Jones, John F.* in *IBFD Commentaries on The Scope of Art. 3(2) of the OECD Model*, sec. 7.2.2.; *Dürschmitt, Daniel* in *Vogel / Lehner*, p. 544, par. 98; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 272, par. 71, and p. 282, par. 82; *Huerta, Adalberto Ramos* in *Eva Burgstaller*, p. 23 et seq.; Dutch Hoge Raad der Nederlanden, judgement ref. 33267, 1999; *Klaus Vogel Commentaries* 1997, p. 210, par. 62.

⁵⁵ OECD, Consolidated List of outstanding Points concerning the OECD Draft Convention on Income and Capital, ref. TFD/FC/218, Paris, 1967, p. 29, sec. A.

⁵⁶ *Joanna Wheeler*, attribution, p. 487.

⁵⁷ *Michael Lang*, introduction, p. 46, par. 76.

⁵⁸ *Michael Lang*, hybrids, p. 26.

⁵⁹ OECD Commentaries 2014 on Art. 1 OECD MTC, p. C(1)-20, par. 9.2, and p. C(1)-32, par. 22.1.

⁶⁰ *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 271, par. 71, and p. 282, par. 82; *Michael Lang*, introduction, p. 46, par. 77; *Michael Lang*, interpretation, p. 289; *Michael Lang*, hybrids, p. 31 et seq.; *Klaus Vogel Commentaries* 1997, p. 215, par. 73.

⁶¹ See par. 18.

1.4.2 OECD Commentaries on the OECD MTC

- 23 The legal character of the OECD Commentaries⁶² evolved into a complex matter while being identified by OECD in the mid 1990s⁶³ and was increasingly disputed during the 2000s decade. Apart from contradictory provisions in the OECD materials⁶⁴, the following points in the field of general international law emerged as the key questions⁶⁵.

How can jurisdictions passively enter into legal obligations?

- 24 Pursuant to Art. 31(2)(a) VCLT, the context for the interpretation of an international treaty comprises any relating agreement – including tacit ones – which were made between the parties in connection with the conclusion of that treaty. In earlier boundary dispute judgements, the ICJ⁶⁶ had established and developed the concepts of acquiescence and estoppel (“speak or act”⁶⁷). Acquiescence means the tacit or implied consent by silence, especially when called for reaction. In contrast, estoppel means the tacit or implied consent by continuously practicing the status quo, especially when benefitting from it. This raised the question as to whether a jurisdiction might implicitly accept the OECD Commentaries as a tacit agreement with legally binding effect⁶⁸, especially where this jurisdiction did not make any reservation⁶⁹ or observation⁷⁰ to the Commentaries, as is the common practice⁷¹.

When does a treaty negotiation start to touch international law?

- 25 As the general rule pursuant to Art. 31(1) VCLT, a treaty shall also be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context. Even if acquiescence and estoppel would not bind the jurisdiction to the OECD Commentaries as a tacit agreement (hard law)⁷², in a particular DTC negotiation this jurisdiction may still appear to its counterparty as being committed to the OECD Commentaries (soft law). The reason is that the OECD Commentaries are part of the OECD’s institutional framework. This appearance was in question to create such context or good faith, either entirely by legitimate expectations of the counterparty or selectively to the extent that the wording of the OECD MTC has been used – at least where a different understanding has not been *established* pursuant to Art. 31(4) VCLT⁷³. This appearance may be even more crucial where this jurisdiction is an OECD member and depends on that jurisdiction’s role within the OECD’s institutional framework (e.g. voting policy, initiatives, membership in working groups or statutory bodies, reservations and/or observations, etc.).

⁶² The role of the OECD Reports will not be dealt with further. For this study the authors follows the view that the OECD Reports do not have a legally binding character (*Provodová, Kateřina* in *Thomas Ecker*, p. 158).

⁶³ *Rainer Prokisch*, OECD Commentaries; *Rainer Prokisch*, interpretation, p. 52 et seq.

⁶⁴ For an overview see *Gómez-Ballina, Rodrigo* in *Schilcher / Weninger*, p. 98 – 102.

⁶⁵ Conference Position Paper: The Quest of the Holy Grail in International Tax Law – The legal Status of the Commentaries on the OECD MTC in *Frank Engelen*, p. 262.

⁶⁶ In particular: Fisheries case; Temple of Preah Vihear; North Sea Continental Shelf; Gulf of Maine; Maritime Frontier Dispute.

⁶⁷ *Engelen, Frank* in *Frank Engelen*, p. 70.

⁶⁸ *Engelen, Frank* in *Frank Engelen*, p. 65.

⁶⁹ OECD Commentaries 2014, introduction, p. I-10, par. 31.

⁷⁰ OECD Commentaries 2014, introduction, p. I-9 et seq., par. 30. On the legal effects of observations see, *Guglielmo Maisto*, observations.

⁷¹ *Engelen, Frank* in *Frank Engelen*, p. 61.

⁷² See par. 24.

⁷³ *Rainer Prokisch*, interpretation, p. 54.

Do the OECD Commentaries represent international customary law?

- 26 The ICJ shall apply international conventions, which establish rules and international custom, as evidence of a general practice accepted as law.⁷⁴ Irrespective of the international treaty law governed by the VCLT, the question was raised whether the OECD Commentaries may represent another source of international law (i.e. customary law).

Who is the addressee of the OECD Commentaries?

- 27 Primarily, a DTC is an international treaty between two jurisdictions. However, at least one of its purposes and functions was also the protection of the rights of the taxpayer, who is in so far the object of the treaty and its interested third party.⁷⁵ In this respect, a DTC was a “hybrid system” inducing the jurisdiction to act ambiguously while balancing its own interests against those of the taxpayer.⁷⁶ But even though a DTC granted those protection rights directly to the taxpayer⁷⁷, he was allowed to claim the OECD Commentaries only for the application of a particular DTC as the subject to the jurisdictions’ legislative procedure and its courts’ interpretation. This dual purpose⁷⁸ made it unclear whether the addressee of the OECD Commentaries is either the jurisdiction’s government in its negotiator and executor role, the legislator in its approver role, the courts in their interpreters role, or the taxpayer in his role as an interested stakeholder.
- 28 The majority of commentators⁷⁹ came nevertheless to the consensus view that the OECD Commentaries have no legally binding effect. Their arguments were primarily the following:
- The concepts of acquiescence and estoppel applied only “where there is a duty or a need to speak”.⁸⁰ Since recommendations⁸¹ were legally not binding⁸² regardless of their subject, they were not accessible to constitute a tacit agreement.
 - But even if acquiescence and estoppel applied, a positive intention to enter into a legally binding agreement would be further required in any case.⁸³ However, all OECD members themselves proclaimed their common understanding and intention not to do so.⁸⁴ This intention was established objectively and not merely subjectively,⁸⁵ and it was supported by the fact that the OECD Commentaries have never been

⁷⁴ Art. 38(1)(a) and (b) of the ICJ Statutes, The Hague, 18 April 1946, available online at www.icj-cij.org (last retrieved on 15 September 2017).

⁷⁵ Ward, David A. in Frank Engelen, p. 89; Pijl, Hans in Frank Engelen, p. 108; David Ward, interpretation, p. 53.

⁷⁶ Pijl, Hans in Frank Engelen, p. 109 and 128.

⁷⁷ Pijl, Hans in Frank Engelen, p. 107; Rainer Prokisch, OECD Commentaries, p. 6.

⁷⁸ Rainer Prokisch, interpretation, p. 57.

⁷⁹ Among others: Mellinghoff, Rudolf in Franz Wassermeyer, *Festgabe*, p. 35 et seq.; Michael Lang, introduction, p. 48, par. 83; Sven-Eric Bärsch, p. 98; Peter Hongler, p. 220; Ward, David A. in Frank Engelen, p. 73; Pijl, Hans in Frank Engelen, p. 97, 112, 124 and 129; Gómez-Ballina, Rodrigo in Schilber / Weninger, p. 109, and Schmitt, Marcus in Schilber / Weninger, p. 121; Weiss, Friedl in Erasmus-Koen, Monica / Douma, Sjoerd, Legal status of the OECD Commentaries – in search of the holy grail of international tax law, *Bulletin for International Taxation* 2007, Vol. 61, No. 8, p. 347; David A. Ward, The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process, in *Bulletin for International Taxation* 2006, Vol. 60, No. 3, p. 100; David Ward, interpretation, p. 113; Wattel / Marres, interpretation, p. 234; Michael Lang, hybrids, p. 26 and 54.

⁸⁰ Ward, David A. in Frank Engelen, p. 74; Pijl, Hans in Frank Engelen, p. 125.

⁸¹ In particular, the Recommendations 1997, sec. I.2.

⁸² Ward, David A. in Frank Engelen, p. 74; Pijl, Hans in Frank Engelen, p. 112.

⁸³ Ward, David A. in Frank Engelen, p. 81 and 87, with reference to North Sea Continental Shelf; Pijl, Hans in Frank Engelen, p. 112.

⁸⁴ Ward, David A. in Frank Engelen, p. 74.

⁸⁵ Ward, David A. in Frank Engelen, p. 80, with reference to Qatar vs. Bahrain.

registered pursuant to Art. 102 of the UN Charter.⁸⁶ In addition, none of the OECD members applying the dualistic concept has ever deemed it necessary to transform the OECD Commentaries into their domestic tax laws.⁸⁷

- The assumption that the OECD members were committed to the OECD Commentaries was prejudicial⁸⁸ and could be observed neither theoretically nor practically.⁸⁹ In addition, the OECD Commentaries as a general framework could not be subject of the context or good faith, as they were not made between the parties in connection with the conclusion of a particular DTC⁹⁰. Finally, the concept of good faith as such was a mere interpretation aid and did not transmute something non-binding into binding international law⁹¹.
- In the absence of the two constituent or qualifying elements of a consistent practice and a common conviction and acceptance on its legally binding nature (“*opinio iuris sive necessitatis*”), the OECD Commentaries did not represent international customary law either.⁹² Instead, they rather represent a supplementary means of interpretation pursuant to Art. 32 VCLT.
- Finally, there were also good practical reasons such as flexible adaptations to new developments why OECD chose the Commentaries not to be legally binding.⁹³

29 Accordingly, the OECD Commentaries formed the legal context to a particular DTC in the sense of an aid or assistance in interpreting and applying it at the point in time when it was negotiated.⁹⁴ They did not represent a legal but rather a political commitment (“*comply or explain*”), encouraged by political measures (such as peer review, peer pressure, etc.).⁹⁵ As such, they were primarily addressed to the jurisdiction’s government in its role as the negotiator and executor.

30 The author shares this view. In the sense of a contextual element of interpretation, the OECD Commentaries are linked as a logical subset to the OECD MTC, which itself undisputedly represents a legally unbinding recommendation. As such, the OECD Commentaries cannot go beyond the OECD MTC in the sense of being stronger. This remains true even if the OECD MTC as a recommendation has been followed in a particular DTC negotiation, no matter how closely the two are linked. In other words: no matter how

⁸⁶ UN, Charter of the UN, New York, 26 June 1945, available online at www.un.org (last retrieved on 15 September 2017); *Ward, David A.* in *Frank Engelen*, p. 75.

⁸⁷ *Ward, David A.* in *Frank Engelen*, p. 81.

⁸⁸ *Ward, David A.* in *Frank Engelen*, p. 76; *Pijl, Hans* in *Frank Engelen*, p. 125, *David Ward*, interpretation, p. 51.

⁸⁹ *Ward, David A.* in *Frank Engelen*, p. 76, 82 and 87; *Pijl, Hans* in *Frank Engelen*, p. 119; *David Ward*, interpretation, p. 41 and 48.

⁹⁰ *Mellinghoff, Rudolf* in *Franz Wassermeyer, Festgabe*, p. 36, par. 4, and p. 47, par. 39; *Michael Lang*, introduction, p. 48, par. 84; *Ward, David A.* in *Frank Engelen*, p. 82; *Ellis, Maarten J.*, The Influence of the OECD Commentaries on Treaty Interpretation – Response to *Prof. Dr. Klaus Vogel*, *Bulletin for International Taxation* 2000, Vol. 54, No. 12, p. 618; *Rainer Prokisch*, interpretation, p. 53.

⁹¹ *David Ward*, interpretation, p. 48.

⁹² *Avery Jones, John F.* in *IBFD Commentaries on Issues in the Application of International Law Interpretation Principles to Tax Treaties*, sec. 5.2.5.; *Mellinghoff, Rudolf* in *Franz Wassermeyer, Festgabe*, p. 37, par. 10 et seq.; *Pijl, Hans* in *Frank Engelen*, p. 98; *Gómez-Ballina, Rodrigo* in *Schilber / Weninger*, p. 109; *Weiss, Friedl* in *Erasmus-Koen, Monica / Douma, Sjoerd*, Legal status of the OECD Commentaries – in search of the holy grail of international tax law, *Bulletin for International Taxation* 2007, Vol. 61, No. 8, p. 347; *David Ward*, interpretation, p. 41 and 51; *Czech Nejvyšší Správní Soud*, judgement ref. 2Afs 108/2004–106, 2005; Supreme Court of Canada, judgement ref. 23940, 1995, par. 44; High Court of Australia, judgement ref. [1990] HCA 37, 1990.

⁹³ *Ward, David A.* in *Frank Engelen*, p. 83; *Pijl, Hans* in *Frank Engelen*, p. 103.

⁹⁴ *Mellinghoff, Rudolf* in *Franz Wassermeyer, Festgabe*, p. 36, par. 5, p. 42, par. 24 et seq., and p. 47, par. 39; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 277, par. 78; *Michael Lang*, introduction, p. 51, par. 95; *Peter Hongler*, p. 222; *Michael Lang*, interpretation, p. 285 et seq.; *Hans Pijl*, hybrid debts, introduction; *Ward, David A.* in *Frank Engelen*, p. 85 and 93; *David Ward*, commentaries, p. 101; *David Ward*, interpretation, p. 42, 80 and 110. On the particular question regarding the static or dynamic interpretation see par. 33 et seq.

⁹⁵ *Pijl, Hans* in *Frank Engelen*, p. 96, 120 and 124.

often the recipient (i.e. OECD member) follows a recommendation (i.e. OECD MTC for the purpose of a particular DTC), it remains a recommendation with all its supplements (i.e. OECD Commentaries). As such, it shares the same fate (i.e. it is unbinding) and leaves the ultimate decision with that recipient at all times without ever turning into any kind of obligation.

- 31 Beyond these arguments, the question to what extent a mere involvement or engagement of a member within the OECD's institutional framework may prejudice a particular DTC negotiation leads to the subsequent problem of the OECD's institutional framework as being more of a bilateral or multilateral nature.

Example 1: Art. 6(2) of the OECD Convention⁹⁶ allows a majority's resolution to not apply to a member that abstained from voting. This possibility to evade the organisational power in the same way as such abstention from voting was an "escape from democracy" is exceptional for multilateral frameworks. It actually leads to a state of "rights without obligations", making it typically difficult or perhaps even impossible for the multilateral framework to exist.

Bilateral in this sense means a clear separation between the OECD and its members, with no soft legal obligations between them. *Multilateral* means the OECD and its members to be incorporated into one municipal entity imposing hard legal obligations to its members. This point becomes even more crucial, as a second aspect of ambiguity relates to the fact that the OECD appears to coalesce both the "legislative" and the executive function in itself (and maybe even the "judicative" function as well)⁹⁷. The two aspects combined show the possible spectrum between a non-committal network acting as a neutral counsellor on the one hand and a community of duties acting as "judge and hangman" on the other, in which the OECD as a standard setter to legal tax developments may be reflected. This could be seen as the institutional background why the OECD Commentaries form the legal context only to those DTCs negotiated at that respective point in time. In fact, only for those DTCs the OECD could be said to have acted in its "legislative" role. And perhaps it was this aspect that *Maarten J. Ellis* meant when he said: "The fact that the Commentary is now changed so frequently [...] makes it less valuable and certainly less authoritative"⁹⁸.

- 32 Accordingly, today's majority of commentators explicitly or implicitly take the position that the OECD's institutional framework is basically of a bilateral nature, at least as regards its recommendations.⁹⁹ In fact, this was also the original intention of the OECD MTC¹⁰⁰. However, it seems that the remarkable dynamic of international tax developments nowadays and the consequential authority of the OECD in this field may change that actual view, and that this might have even been one driver for the OECD's BEPS action item

⁹⁶ OECD, Convention on the OECD, Paris, 14 December 1960, available online at www.oecd.org (last retrieved on 15 September 2017).

⁹⁷ OECD, Peer Review – An OECD Tool for Co-operation and Change, 2003, p. 15; similarly: *Schmitt, Marcus* in *Schilcher / Weninger*, p. 120; *David Ward*, commentaries, p. 101.

⁹⁸ *Ellis, Maarten J.*, The Influence of the OECD Commentaries on Treaty Interpretation – Response to *Prof. Dr. Klaus Vogel*, Bulletin for International Taxation 2000, Vol. 54, No. 12, p. 618.

⁹⁹ See footnote 79.

¹⁰⁰ League of Nations, Document C.216.M.85, ref. C.216.M.85, London, 1927, p. 8; Report presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, ref. C.562.M.178.1928.II., Geneva, 1928, p. 5.

No. 15, according to which the OECD Multilateral Convention¹⁰¹ has been introduced in order “to modify existing bilateral tax treaties”¹⁰².

- 33 In sum, this generally means that the historical interpretation, the conflict between static and dynamic interpretation and the dependencies between these two aspects deserve careful consideration when consulting the OECD Commentaries. Above all, there must be a clear and strict separation between the interpretation of the OECD MTC as such and the interpretation of a particular DTC.
- 34 Being subject to the domestic practice of interpretation and unless otherwise agreed in that particular DTC¹⁰³, the academic literature¹⁰⁴ de facto tends to support a static approach:
- Amplifications to existing provisions (e.g. by adding new examples or new arguments) shall be treated similarly to the opinions of other well-regarded commentators.
 - Interpretations and further developments, especially those that fill gaps, shall also be treated similarly to the opinions of other well-regarded commentators. But they shall be treated with special attention and great care to the independent consideration of whether they represent a fair and legitimate interpretation.
 - Reversions of existing provisions shall be ignored or discarded for the purpose of the interpretation of that particular DTC, the reason being that they would otherwise not enjoy democratic legitimacy. In addition, they infringe the principle of non-retroactivity pursuant to Art. 28 VCLT.
- 35 In contrast to this interpretation of a particular DTC, the working material for the interpretation of the OECD MTC is, however, the latest available version of the OECD Commentaries. It is obvious and clear in itself that the OECD Commentaries represent a dynamic interpretation of the OECD MTC, i.e. the latest available version of the OECD Commentaries applies as the end point of a dynamic interpretation of the OECD MTC. Given that each version of the OECD Commentaries forms the legal context to a particular DTC at the point in time it was negotiated, a renewal of an assumed DTC identical to the OECD MTC has ceteris paribus no space for being anything other than the result from a change of the OECD Commentaries. But even if the OECD Commentaries represented a static interpretation of the OECD MTC, this would lead to the same methodological approach for this study: it implied the case of a particular DTC following the OECD MTC that was negotiated *as per today*, i.e. the latest available version of the OECD Commentaries applied again but now as the starting point of a static interpretation of the OECD MTC. As a conclusion for the further course of this study, the latest available version of the OECD Commentaries is relevant for the dynamic interpretation of the actual OECD MTC¹⁰⁵. Complementary to the interpretation of a particular

¹⁰¹ OECD, Multilateral Convention to implement Tax Treaty related Measures to prevent BEPS, Paris, 2017.

¹⁰² OECD, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 – 2015 Final Report, Paris, 5 October 2015, p. 11.

¹⁰³ Some DTCs contain specific rules which explicitly allow the dynamic interpretation by referring to the OECD Commentaries and their later changes.

¹⁰⁴ Among others: *Avery Jones, John F.* in IBFD Commentaries on Issues in the Application of International Law Interpretation Principles to Tax Treaties, sec. 5.1.; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 277, par. 78; *Mellinghoff, Rudolf* in *Franz Wassermeyer, Festgabe*, p. 42, par. 24 et seqq.; *Michael Lang*, introduction, p. 53, par. 102; *Peter Hongler*, p. 222; *Hans Pijl*, hybrid debts, introduction; *Ward, David A.* in *Frank Engelen*, p. 86; *Schmitt, Marcus* in *Schilcher / Weninger*, p. 137; *David Ward*, commentaries, p. 101; *David Ward*, interpretation, p. 110; *Wattel / Marres*, interpretation, p. 224, 229 and 232; *Klaus Vogel*, interpretation, p. 616; *Michael Lang*, later commentaries, p. 9; *Ault, Hugh J.*, The Role of the OECD Commentaries in the Interpretation of Tax Treaties, *Intertax* 1994, Vol. 22, No. 4, p. 148.

¹⁰⁵ OECD MTC Draft Update; Paris, 11 July 2017; OECD, MTC (full version), Paris, 15 July 2014.

DTC, older versions of the OECD Commentaries may serve the historical interpretation of the OECD MTC in so far as existing provisions had been amplified.

1.4.3 UN Commentaries on the UN MTC

- 36 While not being legally binding to the OECD MTC, the UN Commentaries¹⁰⁶ and the UN MTC¹⁰⁷ as a collective tax law are undoubtedly inspirational sources of law¹⁰⁸. In fact, Art. 10(3)¹⁰⁹, 11(3)¹¹⁰, 13(6)¹¹¹ and 21(1)¹¹² UN MTC reproduce their equivalents of Art. 10(3), 11(3) and 13(5) OECD MTC in an identical wording. Accordingly, the UN Commentaries explicitly refer directly to the respective passages within the OECD Commentaries. The reason is that “the similarities between these two leading Models reflect the importance of achieving consistency where possible.”¹¹³ Insofar, the added value of the UN Commentaries on the UN MTC for the interpretation and application of the OECD MTC appears to be fairly limited. By derogation from this basic principle, only the UN Commentaries on Art. 11(3) UN MTC provide some additions and amendments with respect to Islamic financial instruments. These are consulted later in this study in the context of interpreting the term *interest* pursuant to Art. 11(3) OECD MTC¹¹⁴.

1.4.4 US tax law

- 37 The US federal tax law is an exception from the general principle of this study to exclude domestic tax laws as typically closed-end systems¹¹⁵ from being a source of interpretation or inspiration. The reason for this is that the legal development in the US has historically taken a different route than in most other countries, in that the private and corporate law is a matter of the particular member states rather than of the federal state¹¹⁶. The federal tax law, for which the private and corporate law principally is a precursory field of law, has to cope with a large number of varying tax law rules and systems among these particular member states, making the need for tax law concepts evident. From this perspective, the varying legal systems of the particular member states are themselves closed-end systems, making it conceptually pointless to graft another legal system onto them in a conventional and satisfactory manner. In order to still ensure compatibility and consistency, the US federal tax law instead took the unconventional approach of developing independent universal standards to evaluate the material outcome of these varying legal systems of the particular member states, rather than to attach to its formal ways and means. In the absence of any other material reference, these standards – known as “tests” – are predominantly based on economic criteria. In other words: the US federal tax law works in a way that it legally goes beyond its precursory fields of law. It employs tests to evaluate their material economic

¹⁰⁶ UN, Commentaries on the Articles of the UN MTC, UN Department of Economic & Social Affairs, New York, 2011, available online at www.un.org (last retrieved on 15 September 2017).

¹⁰⁷ UN, Model Double Taxation Convention between Developed and Developing Countries, UN Department of Economic & Social Affairs, New York, 2011, available online at www.un.org (last retrieved on 15 September 2017).

¹⁰⁸ See par. 18.

¹⁰⁹ UN Commentaries on Art. 10 UN MTC, p. 176, par. 1, and p. 184, par. 14.

¹¹⁰ UN Commentaries on Art. 11 UN MTC, p. 192, par. 1, and p. 198, par. 19.

¹¹¹ UN Commentaries on Art. 13 UN MTC, p. 225, par. 1, and p. 236, par. 17.

¹¹² UN Commentaries on Art. 21 UN MTC, p. 299, par. 1 and 3.

¹¹³ Introduction to the UN MTC, p. vi, par. 2.

¹¹⁴ See par. 292.

¹¹⁵ *Duncan, James A.*, Tax Treatment of hybrid Financial Instruments in cross-border Transactions – General Report, Series IFA Cahiers 2000, Vol. 85a, p. 21 et seq. See also par. 18.

¹¹⁶ *Zimmer, Frederik*, Form and Substance in Tax Law – General Report, Series IFA Cahiers 2002, Vol. 87a, p. 25.

substance for a legal transaction, which is then legally codified back into the federal tax law. By doing so, it tackles the same conceptual difficulties and therefore is of the same collective nature as the OECD MTC.

- 38 As a consequence, the US federal tax law has evolved to a jurisdiction with exceptionally strong doctrines for dealing with a large variety of legal concepts¹¹⁷. Accordingly, there has also emerged a natural convergence between the concepts of the US federal tax law and the US accounting law, which is known as one of the most significant influencing factor of the IAS/IFRS¹¹⁸.
- 39 Undoubtedly, the US federal tax law is an inspirational source of law¹¹⁹ and in this study no attempts shall be made to create or advocate a legally binding character to the OECD MTC. Having accepted this, the US federal tax law might nevertheless allow valuable insights into its subjacent concepts in order to establish a maximum of inherent consistency and systematology in the treatment of financial instruments and transactions under the OECD MTC with a minimum of assumptions or preconditions.

1.4.5 EU tax law

- 40 Sources of EU tax law, which might potentially be of interest for this study, are:
- (1) the Parent-Subsidiary Directive, originally introduced in 1990¹²⁰ but replaced in 2011¹²¹ and last amended in 2015¹²². It governs the elimination of double taxation on European inter-company profit distributions.
 - (2) the Interest and Royalties Directive, introduced in 2003¹²³ and currently in discussion for being replaced¹²⁴. It governs the elimination of double taxation on European inter-company interest payments and royalties.
 - (3) the Anti Tax Avoidance Directive, introduced in 2016¹²⁵ and currently in discussion for being amended¹²⁶. It governs measures against tax avoidance (e.g. thin capitalisation rules, exit taxation, controlled foreign company rules and hybrid mismatches).
 - (4) the Savings Directive, introduced in 2003¹²⁷ but de facto repealed in 2015¹²⁸. It governed an exchange of information among the EU member states on received interest income. As this directive has already expired, it is out of scope for this study.
- 41 At these respective times, the EU had 12 (1990), 15 (2003) and 28 (2016) member states with multiple diverse legal cultures and tax law systems. Without pre-empting a comparability analysis¹²⁹, the EU tax law

¹¹⁷ Zimmer, *Frederik*, Form and Substance in Tax Law – General Report, Series IFA Cahiers 2002, Vol. 87a, p. 38.

¹¹⁸ <http://archive.ifrs.org/Use-around-the-world/Global-convergence/Convergence-with-US-GAAP/Pages/Convergence-with-US-GAAP.aspx> (last retrieved on 15 September 2017).

¹¹⁹ See par. 18.

¹²⁰ Directive 90/435/EEC.

¹²¹ Art. 9 of Directive 2011/96/EU.

¹²² Directive 2015/121/EU.

¹²³ Directive 2003/49/EC.

¹²⁴ Directive Proposal 2011/0314(CNS). For the current procedural status see <http://eur-lex.europa.eu/procedure/EN/201020> (last retrieved on 15 September 2017).

¹²⁵ Directive 2016/1164/EU.

¹²⁶ Directive Proposal 2016/0339(CNS). For the current procedural status see http://eur-lex.europa.eu/procedure/EN/2016_339 (last retrieved on 15 September 2017).

¹²⁷ Directive 2003/48/EC.

¹²⁸ Art. 1(2)(b) of Directive 2014/107/EU.

¹²⁹ See par. 18.

could be seen in this light as not “locally biased” and thus as a collective tax law. This particularly applies to the non-harmonised tax matters at those times, which gave the very reason for such integration initiatives. On the one hand, the EU tax law is no direct interpretational source of law¹³⁰ for this study and no attempts shall be made in this study to create or advocate a legally binding character towards the OECD MTC. On the other hand, neither is it an inspirational source of law for this study, for the following reasons:

- 42 The Parent-Subsidiary Directive¹³¹ applies its relevant term of a *profit distribution* only to qualified minimum holdings of 10%¹³², which corresponds with the qualified minimum holding concept of 25% in Art. 10(2) (a) OECD MTC. However, the 10% qualified minimum holdings criterion reflects the tax-wise borderline between the EU rights¹³³ in regards to the freedom of establishment pursuant to Art. 49 TFEU et seqq. and the free movement of capital pursuant to Art. 63 TFEU et seqq. In contrast, the 25% qualified minimum holdings criterion is intended as a compromise between the source jurisdiction’s right to tax the profits of the company as the source and the residence jurisdiction’s right to tax those of its holder¹³⁴. Apart from this intentional and functional difference, the two concepts have in common that they eventually include – and even particularly focus on – dual-character investors (e.g. related parties), which can provide equity and debt capital simultaneously. In that, their subjective scope, however, is narrower. Their objective scope or understanding of what a *dividend* or *profit distribution* shall be must necessarily be broader than those of Art. 10(3) OECD MTC¹³⁵. This is made obvious for instance by the fact that the two concepts also incorporate aspects of tax groups (e.g. profit-transfer agreements) and anti-abuse considerations¹³⁶ (e.g. hidden profit distributions). As the further analysis in this study will show, Art. 10(2) OECD MTC is open in so far as it refers to parts of Art. 10(3) OECD MTC being explicitly interpreted domestically.¹³⁷ In contrast, the Parent-Subsidiary Directive employs an integrated and cohesive term *profit distribution*. Consequently, it incorporates also derivative dividend concepts¹³⁸ – be it domestic ones or autonomous ones or both – rather than solely the genuine one as the exclusive focus of this study¹³⁹. In addition, the replacement of the Parent-Subsidiary Directive in 2011¹⁴⁰ was also intended to implement the OECD’s BEPS action item No. 2 on what is considered

¹³⁰ Equally: *Offermanns, René H. M. J.*, Restrictions on Treaty Override Resulting from EU Law, European Taxation 2013, Vol. 53, No. 9 / Special Issue, sec. 2; *Kemmeren, Eric C. C. M.*, Double Tax Conventions on Income and Capital and the EU: Past, Present and Future, EC Tax Review 2012, Vol. 21, Issue 3, p. 160; *Fernandes, Sandra Martinho* et al., A comprehensive Analysis of Proposals to amend the Interest and Royalties Directive, European Taxation 2011, Vol. 51, No. 9 / 10 / 11, sec. 3.3.2.3.; similarly: *Jakob Bundgaard*, hybrids, p. 192; *Jakob Bundgaard*, EU Tax Directives, sec. 2.2.; ECJ, judgement ref. C-101/05, 2007, par. 37; ECJ, judgement ref. C-446/04, 2006, par. 170; ECJ, judgement ref. C-336/96, 1998.

¹³¹ See par. 40(1).

¹³² Art. 3(1) of Directive 2011/96/EU.

¹³³ ECJ, judgement ref. C-282/04 and C-283/04, 2006; ECJ, judgement ref. C-492/04, 2007.

¹³⁴ OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-2 et seq., par. 10, and p. C(23)-21, par. 50.

¹³⁵ Equally: *Jakob Bundgaard*, hybrids, p. 190; *Sven-Eric Bärsch*, p. 115 et seqq.; *Terra, Ben J. M. / Wattel, Peter Jacob*, European Tax Law, 6th edition, Wolters Kluwer (Law & Business), Alphen aan den Rijn, 2012, p. 631 et seqq.; *Jakob Bundgaard*, EU Tax Directives, sec. 3.1.2.1.; *Marjaana Helminen*, dividend concept, p. 171; *Bell, Susan*, Cross-border Repatriation of Dividends: tax neutral in the European Union?, Derivatives & Financial Instruments 2005, Vol. 7, No. 1, p. 22 et seqq.; *Guglielmo Maisto*, Parent-Subsidiary Directive, p. 177; *Marjaana Helminen*, Parent-Subsidiary Directive, p. 162 and 166; *de Hosson, Fred C.*, The Parent-Subsidiary Directive, Intertax 1990, Vol. 18, Issue 10, p. 433 et seqq.

¹³⁶ For instance, Art. 1(3) of Directive 2015/121/EU.

¹³⁷ See par. 271.

¹³⁸ See par. 3.

¹³⁹ See par. 10.

¹⁴⁰ See par. 40(1).

“hybrid mismatch arrangements”¹⁴¹. The result is that its scope of application¹⁴² was actually limited by being selectively suspended, which makes particularly “hybrid” loans, as one of the very key subjects of this study,¹⁴³ eventually its “blind spot”. For these reasons, the Parent-Subsidiary Directive cannot expediently be used as an inspirational source of law for the interpretation of the genuine *dividend* concept pursuant to Art. 10(3) OECD MTC, which must instead be resilient to stand also against non-dual character investors.

43 Furthermore, the Interest and Royalties Directive¹⁴⁴ applies its relevant term of *interest* only to qualified minimum holdings of 25%¹⁴⁵, which is in discussion to be reduced to 10%¹⁴⁶ in order to correspond to the Parent-Subsidiary Directive¹⁴⁷. Basically, the term *interest* “is based on that used in Article 11 of the 1996 OECD Model Tax Convention on income and on capital, with the exception of income from government securities which is not relevant to this Directive”¹⁴⁸. However, “the Directive applies not only to the payments of interest or royalties as defined under paragraph 1 but also to all payments regarded by Member States as such, either under a Double Taxation Convention in force between the Member State where the interest or royalties arise and the Member State of the beneficial owner or, in the absence of such a Convention, on the basis of the national tax legislation of the Member State where the interest or royalties arise.”¹⁴⁹ Apart from likewise focussing on dual-character investors¹⁵⁰, the term *interest* employed by the Interest and Royalties Directive is thus eventually broader than that of Art. 11(3) OECD MTC¹⁵¹. It actually incorporates at least also domestic concepts¹⁵² – be they genuine ones or derivative ones or both – instead of solely an autonomous one as the exclusive focus of this study¹⁵³. For this reason, the Interest and Royalties Directive is equally not used as an inspirational source of law for the interpretation of the genuine *interest* concept pursuant to Art. 11(3) OECD MTC, which is exclusively to be interpreted autonomously¹⁵⁴.

44 Apart from likewise incorporating the above-mentioned derivative concepts, the Anti Tax Avoidance Directive¹⁵⁵ particularly defines its potentially relevant term of *hybrid mismatches* explicitly as “*situations [... with ...] any of the following outcomes*”¹⁵⁶. Obviously, the Directive refers thus to the legal consequences of

¹⁴¹ OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report, Paris, 5 October 2015, p. 11.

¹⁴² *van den Hurk, Hans*, Proposed Amended Parent-Subsidiary Directive reveals the European Commission’s Lack of Vision, Bulletin for International Taxation 2014, Vol. 68, No. 9, sec. 2.2.3.

¹⁴³ See par. 4(1).

¹⁴⁴ See par. 40(2).

¹⁴⁵ Art. 3(b) of Directive 2003/49/EC.

¹⁴⁶ Art. 2(d) of Directive Proposal 2011/0314(CNS). See also par. 42.

¹⁴⁷ Explanatory Memorandum COM(2011)714, “definition of associated company”.

¹⁴⁸ Explanatory Memorandum COM(1998)67, p. 6, par. 1(a).

¹⁴⁹ Explanatory Memorandum COM(1998)67, p. 6, par. 2; Explanatory Memorandum COM(2011)714, “Exclusion of payments as interest and royalties”, explicitly leaving the term *interest* unchanged.

¹⁵⁰ *Terra, Ben J. M. / Wattel, Peter Jacob*, European Tax Law, 6th edition, Wolters Kluwer (Law & Business), Alphen aan den Rijn, 2012, p. 773.

¹⁵¹ Equally: Jakob Bundgaard, hybrids, p. 183; Jakob Bundgaard, EU Tax Directives, sec. 2.1.

¹⁵² Report COM/2009/0179, sec. 3.3.4., consequently holding that “the survey did not reveal any significant discrepancies between the Article 2(a) definition of ‘interest’ and those relied on in the context of national legislation transposing the Directive. Nor do there appear to be any obvious differences between the Article 2(a) definition and that of Article 11 of the OECD Model Tax Convention (MTC) that might be of relevance for the application of the Directive.”

¹⁵³ See par. 14.

¹⁵⁴ See footnote 153.

¹⁵⁵ See par. 40(3).

¹⁵⁶ Art. 1(1)(b) of Directive Proposal 2016/0339(CNS); Art. 2(9) of Directive 2016/1164/EU. The explanatory insertions in brackets as well as the *Italic* emphases have been added by the author.

financial instruments or transactions instead of to their legal grounds as the exclusive focus of this study¹⁵⁷. In other words: the Directive leaves the fundamental schedule or box structure and the respective classification of income from financial instruments actually untouched, and merely suspends, rather than amends, the general rules selectively. In that, it actually limits their scopes of application in the same way the Parent-Subsidiary Directive was enriched by derivative anti-abuse measures in 2011,¹⁵⁸ and leaves particularly debt-equity “hybrids”¹⁵⁹ as one of the very key subjects of this study eventually a “blind spot”. Insofar, it takes a top-down approach and therefore represents secondary law. For these reasons, the Anti Tax Avoidance Directive can also not expediently be used as an inspirational source of law for the interpretation of the genuine concepts of *dividends* pursuant to Art. 10(3) OECD MTC, *interest* pursuant to Art. 11(3) OECD MTC and capital *gains* pursuant to Art. 13(5) OECD MTC as sources of primary law, which instead require a bottom-up approach.

1.4.6 IAS / IFRS

- 45 The IAS/IFRS are undoubtedly an inspirational source of law¹⁶⁰ and no attempts shall be made in this study to create or advocate a legally binding character to the OECD MTC¹⁶¹. True, some jurisdiction apply the IAS/IFRS as their mandatory accounting standard by simultaneously grafting their domestic tax law onto the accounting law¹⁶². However, in the universal context of the OECD MTC as a collective tax law, this may not lead to generalisations¹⁶³ (e.g. to taxpayers such as private individuals, which are not subject of those accounting laws). Having accepted this, the IAS/IFRS might nevertheless allow valuable insights by drawing constructive analogies or by investigating some perceptions on universal or hidden structural rationales, which may to a certain extent be transferable to the OECD MTC¹⁶⁴. The reason is not only that the IAS/IFRS are a collective law as well that necessitates to ignore the domestic peculiarities of precursory fields of law. In other words: the IAS/IFRS do likewise need to “make themselves a generic opinion on what has happened” without recurring to the domestic laws¹⁶⁵. The peculiarity essentially is that this legal assessment by the IAS/IFRS is – by its material nature – economically driven due to their specific purpose, function and intention. Hence, where it comes to economic aspects or concepts (such as *substance over form*, risk, correlations, etc.), the IAS/IFRS are considerably closer to the problem¹⁶⁶ allowing to draw insightful parallels to the interpretation of the OECD MTC.
- 46 Among others, the IAS/IFRS particularly address the following fields relevant for this study:
- (1) IAS 39 deals with the special aspect of the recognition of financial instruments. In 2001 the IAS Board adopted IAS 39 that had originally been issued by its predecessor organisation, the IAS Committee,

¹⁵⁷ See par. 10.

¹⁵⁸ See par. 42.

¹⁵⁹ Art. 1(3) of Directive Proposal 2016/0339(CNS); Art. 9 of Directive 2016/1164/EU.

¹⁶⁰ See par. 18.

¹⁶¹ OECD, Taxation of new Financial Instruments, OECD, Paris, 1994, p. 27 et seqq.

¹⁶² OECD, BEPS Action No. 2 – Neutralising the Effects of Hybrid Mismatch Arrangements (Final Report), 5 October 2015, OECD, Paris, 2015, p. 35, par. 63.

¹⁶³ OECD, ST/SG/AC.8/2001/CRP.8, p. 27 et seq., par. 99 et seqq.

¹⁶⁴ Similarly: *Laukkanen, Antti*, Taxation of Investment Derivatives, IBFD, Amsterdam, 2007, p. 416; OECD, ST/SG/AC.8/2001/CRP.8, p. 28, par. 102.

¹⁶⁵ See par. 18.

¹⁶⁶ *Kaeser, Christian / Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1308, par. 112; *Peters, M.J.*, IFRS, Tax Accounting and Derivatives, Derivatives & Financial Instruments 2010, Vol. 12, No. 2a / Special Issue; OECD, ST/SG/AC.8/2001/CRP.8, p. 28, par. 102.

in 1999 with the intention to replace IAS 39 in its entirety by IFRS 9¹⁶⁷. In 2006 the IAS Board had joined¹⁶⁸ a long-term project of the US Financial Accounting Standards Board on “financial instruments with characteristics of equity” (formerly “liabilities and equity”)¹⁶⁹ and pursued it independently since 2012¹⁷⁰. This long-term project¹⁷¹ was divided into the three successive phases of (1) classification and measurement, (2) impairment and (3) *hedge accounting*. The first two of these topics are complete to-date by being entirely carved-out and relocated from IAS 39 to IFRS 9. The third one becomes effective as per 2018, i.e. the topic of *hedge accounting* is still provided in both IAS 39 providing the old and IFRS 9 the new rules. In the meantime, the transition rules basically provide the right to elect between the *hedge accounting* rules of IAS 39 and IFRS 9¹⁷², particularly in regards to portfolio hedging¹⁷³ that is not yet included in IFRS 9 but rather subject of a research project¹⁷⁴. At the same time, IFRS 9 also incorporated IFRIC 9, which dealt with *embedded derivatives*. As IAS 39 will expire soon, this study focuses on the new *hedge accounting* rules pursuant to IFRS 9 only. Therefore, IAS 39 is out of scope and IFRS 9 in scope of this study¹⁷⁵. IFRS 9 deals with the holder’s perspective¹⁷⁶ on financial instruments in general. Its most relevant features are the classification of financial instruments into *financial assets* and *financial liabilities* as well as the provisions in terms of *embedded derivatives* and *hedge accounting*.

- (2) IAS 32¹⁷⁷, though from the issuer’s perspective¹⁷⁸, deals with the special aspect of the presentation of financial instruments. In 2005 IAS 32 also incorporated SIC-5, which dealt with the classification of financial instruments, and SIC draft interpretation D34, which dealt with financial instruments and rights redeemable by the holder. The most relevant feature of IAS 32 is the classification of financial instruments into *equity* and *liability*.
- (3) IFRS 7¹⁷⁹ deals with the special aspect of the disclosure of financial instruments and also incorporates some of the requirements allocated from IAS 32 and IAS 39 when released in 2005. Its most relevant features are the provisions in terms of risks, *embedded derivatives* and *hedge accounting*.
- (4) IFRS 4¹⁸⁰, though from the issuer’s perspective¹⁸¹, deals with the special aspect of *insurance contracts*. Although not the primary focus for this study, the classification of risks and the provisions in terms of *unbundling* insurance and deposit components are relevant features.

¹⁶⁷ IAS 32, introduction.

¹⁶⁸ IAS Board, Financial Instruments with Characteristics of Equity – Discussion Paper, IAS Board, London, 2008, p. 4, par. 3 et seqq.

¹⁶⁹ For an overview see www.fasb.org/project/fi_with_characteristics_of_equity.shtml (last retrieved on 15 September 2017).

¹⁷⁰ www.iasplus.com/en/projects/research/short-term/fice (last retrieved on 15 September 2017).

¹⁷¹ For an overview see <http://archive.ifrs.org/current-projects/iasb-projects/financial-instruments-a-replacement-of-ias-39-financial-instruments-recognition> (last retrieved on 15 September 2017) and www.iasplus.com/en/projects/major/financial-instruments (last retrieved on 15 September 2017).

¹⁷² IFRS 9.7.2.21.

¹⁷³ IFRS 9.6.1.3.

¹⁷⁴ IFRS 9.IN10 and 9.BC6.87 et seqq. See also par. 47.

¹⁷⁵ Legal status as per 1 January 2018 (IFRS 9.7.1.1).

¹⁷⁶ IAS 32.AG30; IFRS 9.2.1(d).

¹⁷⁷ Legal status as per 1 January 2017.

¹⁷⁸ IAS 32.2.

¹⁷⁹ Legal status as per 1 January 2017.

¹⁸⁰ Legal status as per 1 January 2017.

¹⁸¹ IFRS 4.1.

(5) IFRIC 2¹⁸² interprets IAS 32 and IFRS 9 by applying their principles to members' shares in co-operative entities and similar instruments. Its most relevant feature is the provision of generic similarity or comparability criteria for certain features and circumstances, in which they affect the classification as *liabilities* or *equity*.

47 In addition, there are two research projects by the IAS Board on-going to date, which address further fields relevant for this study:

- Macro *hedge accounting*¹⁸³ in the context of a comprehensive financial instruments project, dealing with dynamic risk management and *portfolio hedging*; and
- Financial instruments with characteristics of *equity*¹⁸⁴ in the context of a comprehensive conceptual framework project.

48 By their structure, the IAS/IFRS typically comprise the *Standard* itself, including one or more Appendixes, a *Basis for Conclusion* (BC) outlining the backgrounds and considerations behind the *Standards* and a *Guidance on Implementing* (IG) suggesting possible ways to apply the *Standards* and accompanying *Illustrative Examples* (IE). In contrast to the OECD MTC, all of these auxiliary materials state individually whether or not they are an integral part of the *Standard*. Only materials being an integral part of the *Standards* have the mandatory or legally binding character of constitutive "law"¹⁸⁵. However, the other auxiliary materials are – even though they are regarded to have the same interpretative value as the opinions of other well-regarded commentators – nevertheless de facto requirements¹⁸⁶.

¹⁸² Legal status as per 1 January 2017.

¹⁸³ For an overview see www.iasplus.com/en/projects/major/macro-hedge-accounting (last retrieved on 15 September 2017). See also par. 46(1).

¹⁸⁴ For an overview see www.iasplus.com/en/projects/research/short-term/fice (last retrieved on 15 September 2017).

¹⁸⁵ IAS 8.9.

¹⁸⁶ Diana Doege, p. 39, with further citations.

Chapter 2

Basic principles, systematic context and potential differentiators of financial instruments

2.1 Preliminary remarks

- 49 The purpose of this section is to explore and discuss the abstract-theoretical mechanisms of financial instruments and transactions. Its intention is to prepare their various implications and aspects¹⁸⁷ for the subsequent analysis of the relevant distributive articles, which follows in section 3.¹⁸⁸ On the one hand, this examination in particular is necessarily characterised by leading comparably deeper into the economic grounds¹⁸⁹. On the other hand, this is compensated by correspondingly shedding light on their structural links to the relevant legal concepts. According to the “funnel approach” taken in this study and in order to improve its legibility and comprehensibility¹⁹⁰, this section starts with the basic principles¹⁹¹, which are embedded into the systematic legal context afterwards¹⁹². In the further course of the section, the findings will eventually be condensed and broken down to potential differentiators¹⁹³ as the final objective of this section.

2.2 Analysis and discussion of basic principles

2.2.1 Preliminary remarks

- 50 The purpose of this section is to outline a clear and distinct understanding of selected fundamental principles or concepts and their various aspects and implications on the classification of the income types of financial instruments and transactions. One objective is to present the author’s view of these principles. Another objective is to further concretise these principles in order to derive and identify some general guidelines, which indicate their principal applicability and scope as well as their intensity to potential fields of differentiators.

¹⁸⁷ See par. 16.

¹⁸⁸ See par. 10.

¹⁸⁹ See par. 13.

¹⁹⁰ See par. 17.

¹⁹¹ See sec. 2.2.

¹⁹² See sec. 2.3.

¹⁹³ See sec. 2.4.

- 51 In the absence of any express wording, most of these principles or concepts cannot methodologically be interpreted literally or textually, but only indirectly from inherent and implicit interdependencies within the OECD MTC. That is also the reason why the following considerations take the liberty of transferring some structural findings and parallels from other inspirational disciplines to the OECD MTC. While the methodological justification of such transfer might in certain cases be subject of legitimate debates, the author's intention to put them up for discussion is primarily to draw additional insights or conclusions and to establish a maximum of inherent consistency and systematology in the treatment of financial instruments and transactions with a minimum of assumptions or preconditions. Like the inspirational source of law, the crucial aspect and the scientific value added by those disciplines is, even though not legally binding, to see to what extent their structural findings and parallels are compatible and fit into those of the OECD MTC. These coincidences are those fixation points on which the conceptual framework built in this section of this study is pinned¹⁹⁴.

2.2.2 Asset versus transaction

- 52 In the context of a systematic interpretation, the income types of financial instruments can generally be approached by either the asset or the transaction. Generally speaking, transactions are economically reciprocal arrangements or exchanges of benefits described by an economic operation and an economic return. Financial transactions are transactions of monetary benefits¹⁹⁵. On the other hand, financial assets are the result of financial transactions¹⁹⁶. While the asset-based approach derives the income classification indirectly from its source or origin, the transaction-based approach derives it directly from the effective operation:

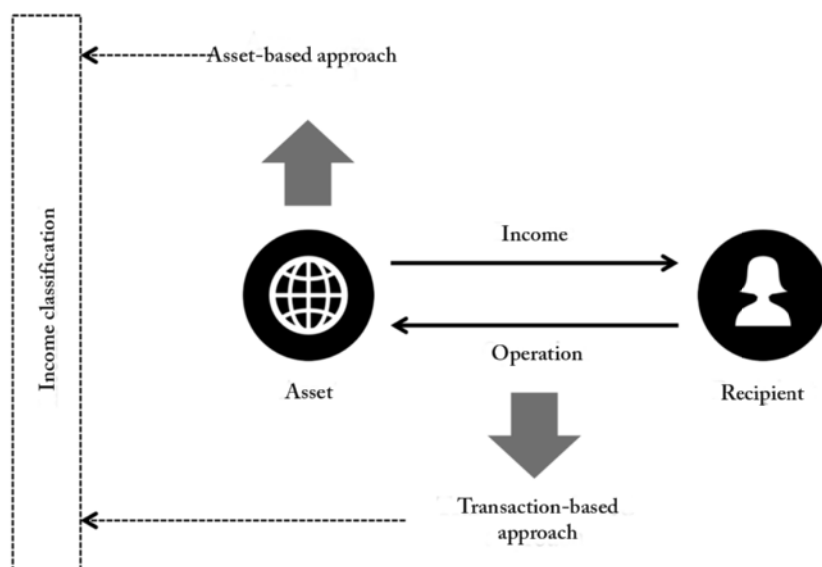


Illustration 1: Asset-based approach versus transaction-based approach

¹⁹⁴ See par. 18.

¹⁹⁵ See par. 1.

¹⁹⁶ IAS 32.11 and 32.AG3 et seqq., defining certain financial assets as rights as a class of specific monetary financial objects.

As a demonstration, a *dividend* may be defined either asset-based as *income from shares* or transaction-based as *income from the provision or contribution of equity*. An *interest* may be defined either asset-based as *income from bonds* or transaction-based as *income from the provision or contribution of debt capital*.

- 53 As a starting point, assets and transactions are principally independent of each other, since assets can be subject of various transactions. That is why the asset-based approach apparently leads to the literal imprecision that also income types other than *dividends* may be seen as being obtained from *shares* (e.g. the capital *gain* when selling them) and income types other than *interest* may be seen as being obtained from *bonds* (e.g. the compensation when lending them). Consequently, the asset-based approach requires and implies as additional information an assignment or reconciliation of transactions, which are admissible or accessible to the asset in order to make the income classification clear and meaningful.¹⁹⁷ As an illustration, whether a hammer is a tool or turns into a weapon depends solely on its usage or the action. In other words: it could be said that the asset-based approach is not cohesive in that it merely indicates the transaction implicitly but not addresses it explicitly. Continuing with the previous demonstration¹⁹⁸, the phrase *income from shares* actually means *income from the provision or contribution of equity in the form of shares* and the phrase *income from bonds* actually means *income from the provision or contribution of debt capital in the form of bonds*. This literal or textual interpretation is methodically solved by gap filling: those other income types from transactions not admissible or accessible to the asset in order to yield *dividends* or *interest* are said to be not genuinely obtained *from* the asset itself but derivatively *from* that other transaction¹⁹⁹. For instance, a capital *gain* is said not to have been obtained *from the share* but *from the sale* of the share or *with* the share, and a compensation is said not to have been obtained *from the bond* but *from the lending* of the bond or *with* the bond.
- 54 In other words: the asset-based approach turns the principal independence of assets and transactions into a one-way predetermination or dependency of the transaction by or from the asset, but not vice versa. Not only does the asset-based approach thus imply and require the transaction-based approach by way of that textual but also systematic interpretation; another difference between the two is that the latter makes it possible to analyse the income types of financial instruments in a more consistent way: the concepts of *dividends* and *interest* can actually be examined by using both approaches. But the asset-based approach is not practicable when it comes to the concept of capital *gains*, which already is a transaction itself (i.e. the sale).²⁰⁰ Hence, following the asset-based approach would lead to a dualism of methods.
- 55 The reason for this is that the asset is a static reference²⁰¹ in the sense of a particular state. In contrast, the transaction is a dynamic reference in the sense of a change of that state²⁰², which is closer to the nature and object of an income tax²⁰³. In this sense, the said assignment or reconciliation²⁰⁴ could be seen as an

¹⁹⁷ Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.3.2.4., touching this point in the context of OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-10 et seq., par. 25.

¹⁹⁸ See par. 52.

¹⁹⁹ See examples at Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.2.5.6, and Reimer, Ekkehart in Klaus Vogel Commentaries 2015, p. 1050, par. 6.

²⁰⁰ Equally: Ismer, Roland / Blank, Alexander in Klaus Vogel Commentaries 2015, p. 161, par. 44. See also examples in par. 53.

²⁰¹ Similarly: David Hariton, equity and debt, p. 502.

²⁰² See Illustration 1 on p. 24.

²⁰³ Ismer, Roland in Vogel / Lehner, p. 474, par. 38.

²⁰⁴ See par. 53.

“adapter” between the static reference *asset* and the dynamic reference *transaction* to make the two approaches compatible with each other. Although it should be kept in mind that the OECD MTC not only applies to *taxes on income* but also to those on *capital*, for the purpose of an income tax the asset is an impracticable reference.

- 56 As stated before²⁰⁵, financing of any kind is economically a reciprocal arrangement or an exchange of benefits described by an economic operation (i.e. the provision or contribution of capital) and an economic return (i.e. the income). In this respect, the difference between dividends and interest is less an economic one than an aspect of the legal or organisational form.²⁰⁶ For tax purposes, the substance of a transaction is determined by the operation (condition) and assessed by the return (amount). This is why the main advantage of the transaction-based approach is its straight or more direct access to the substance of the income types.

Side note: Apart from practical means²⁰⁷, the economic substitutability of debt and equity was the reason why Art. 9 of the Mexico Draft MTC covered both *dividends* and *interest* as one *income from movable capital*²⁰⁸. The background of splitting the *income from movable capital* into *dividends* and *interest* and of taxing them differently was the idea that “dividends were to be taxed in the country where the capital from which they were derived was invested – i.e., put into productive use”²⁰⁹. In contrast, “interest [was to be taxed in] the country from which capital originated had a prior right to tax such interest wherever the capital was invested”²¹⁰. Although this is an economic consideration as well, it is no micro-economic one referring to the substance of the transaction but a macro-economic one referring to the tax burden and tax revenue allocation.

- 57 Admittedly, following the pure transaction-based approach would be insufficient for the analysis of the income types of financial instruments. The reason for this is that there is obviously more than one provision in the OECD MTC dealing with income from financial transactions. Ergo, the transaction-based approach requires an object to which it refers (i.e. the asset) as well. However, it shall be emphasised that the reason and purpose for that object in the asset-based approach is a different one than in the transaction-based approach. In the asset-based approach this purpose, apart from the matter of course that, first and foremost, the location of the source or situs of the asset constitutes a cross-border situation, is to derive the income classification from the object. In the transaction-based approach, however, the purpose is to identify and classify the object itself according to the system of the OECD MTC²¹¹. For instance, there is a difference in the system of the

²⁰⁵ See par. 52.

²⁰⁶ Jieyin Tang, substance vs. form, sec. 5.1.; Wolfgang Schön, comparative analysis, p. 163 et seq.; Sven-Eric Bärsch, p. 76; Peter Hongler, p. 269; Marjaana Helminen, dividend concept, p. 163 et seq. and p. 167; David Weisbach, p. 494; Emmerich, Adam O., Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation, University of Chicago Law Review 1985, Vol. 52, Issue 1, p. 122 et seq.; League of Nations (Economic and Financial Commission), Report on Double Taxation submitted to the Financial Committee – Economic and Financial Commission Report by the Experts on Double Taxation, ref. E.F.S.73. F.19, Vol. 4, sec. 1, Geneva, 1923, p. 37, sec. II, par. V(c).

²⁰⁷ Fuentes Hernandez, Daniel in Thomas Ecker, p. 447.

²⁰⁸ League of Nations, Annex to London and Mexico Model Tax Conventions Commentary and Text, Geneva, November 1946, available online at <http://adc.library.usyd.edu.au> (last retrieved on 15 September 2017), p. 24.

²⁰⁹ League of Nations, Annex to London and Mexico Model Tax Conventions Commentary and Text, Geneva, November 1946, available online at <http://adc.library.usyd.edu.au> (last retrieved on 15 September 2017), p. 25.

²¹⁰ League of Nations, Annex to London and Mexico Model Tax Conventions Commentary and Text, Geneva, November 1946, available online at <http://adc.library.usyd.edu.au> (last retrieved on 15 September 2017), p. 26.

²¹¹ Marjaana Helminen, dividend concept, p. 72.

OECD MTC between the incomes from financing a *company* or a *partnership* depending on whether or not the corporate level has already been taxed.²¹² The illustration that both *company* and *partnership* can be financed by equity and debt makes plain that the purpose of classifying the income using the asset-based approach is independent of the purpose of classifying the object using the transactions-based approach²¹³. Or in other words: the object (i.e. the asset) carries one single bit of information in the transaction-based approach (i.e. on itself for tax-systematic purposes) but two bits of information in the asset-based approach (i.e. on itself for tax-systematic purposes and on the income classification).

- 58 In summary, the transaction-based approach decomposes the object into the asset-related and the transaction-related bit of information. This transaction-related bit, which determines the substance of the transaction, is the underlying operation. Contrarily, the asset-related bit of information is important for tax-systematic purposes. Both components are required for the income classification, but the asset-based approach separates source and transaction only implicitly, requiring additional information, while the transaction-based approach does so explicitly, without requiring such additional information²¹⁴. In contrast to the transaction-based approach for capital *gains*, the OECD MTC has obviously taken the asset-based approach (arising rule)²¹⁵ for *dividends* and *interest*²¹⁶. For *other income* the approach is not relevant due to its character as a residuary provision, which covers the remainder of any further income – be it from an asset or a transaction – and therefore does not need to be decomposed. However, while both approaches lead to the same results, the transaction-based approach provides more information, a deeper understanding and maybe new perspectives going beyond the asset-based approach. It opens or disentangles the implied dependencies between asset (source) and transaction (operation), and eventually provides more transparency. In this sense, the transaction-based approach is no substitute for the asset-based approach but rather an enlargement and breakdown. For these systematic reasons, as an interim conclusion the transaction-based approach emerges as the more practicable one for the further course of this study.

²¹² Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 1.1.2.2.

²¹³ In result equally: Joanna Wheeler, attribution, p. 478.

²¹⁴ The OEEC (Working Party No. 12 of the Fiscal Committee), Report on the Taxation of Dividends, ref. FC-WP12(58)1part1, Paris, 1958, p. 18, already mentions the two components explicitly: “The essential condition is that there must be on the one hand an independent legal entity (payments by partnerships of individuals are thus excluded), and on the other hand a relationship founded on a contract of association and giving a right to participate in the profits.” Similarly: Kaeser, Christian / Wassermeyer, Franz in Wassermeyer Commentaries, p. 1307, par. 110.

²¹⁵ Laukkanen, Antti, Taxation of Investment Derivatives, IBFD, Amsterdam, 2007, p. 236; Carmine Rotondaro, redemption, p. 266; Klaus Vogel Commentaries 1997, p. 1072, par. 11; analogously: IAS 32.36; IFRIC 2.11.

²¹⁶ As regards to *interest*, the OECD Commentaries 2014 on Art. 11 OECD MTC seem to modify the asset-based approach taken by the OECD MTC: unlike *dividends*, the OECD Commentaries 2014 on Art. 11 OECD MTC also refer to the creditor as an object additional to debt-claims as the source of *income*. The reason is probably given in OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-1, par. 1: “Unlike dividends, interest does not suffer economic double taxation that is, it is not taxed both in the hands of the debtor and in the hands of the creditor.” In other words: *shares*, which represent the legal but not the economic source of *income*, are logically set between the *recipient or beneficial owner* and the issuer as an additional level of taxation. In contrast, *debt-claims*, which represent both the legal and the economic source of *income*, induce a more direct relationship between the two. In this respect, the OECD Commentaries 2014 deduce the object of the income types of financial transactions from the tax subjectivity of the issuer by applying an economic perspective. Although this appears to be consistent and may open new perspectives in other respects, for the discussion here it still remains an asset-based approach (i.e. it makes no difference whether the static reference is the asset or its issuer) and therefore has no further impact on the question of which approach this study will purposively take.

2.2.3 Risk

The nature and role of risk

- 59 Financial instruments “can be and are used to allocate among the contracting parties various risks relating to changes in market value”²¹⁷. In other words: risk as such cannot be resolved but only transferred or re-allocated (e.g. by way of hedging). On the one hand, this gives rise to the reasonable assumption that the concept of risk plays an important role in the tax treatment of financial instruments. On the other hand, risk is linked to and is naturally limited by the question of aggregation and disaggregation²¹⁸, as diversification is a portfolio-based concept²¹⁹. Hence, assuming rational taxpayers means, as a final consequence, to consider any asset and transaction as being part of their net risk mitigation strategy, and calls for a total consolidation²²⁰. However, this potential significance of the risk concept with regard to financial instruments conflicts with and is limited by the fact that the OECD MTC is generally based on a classification of asset and income types or schedules (position-by-position or item-by-item approach)²²¹.
- 60 Risk is typically understood as a potential loss (positive risk, i.e. a hazard) or gain (negative risk, i.e. a chance). The economical difference between the two is that the latter is a positive asset calling for compensation from the buyer (e.g. the option holder) to the seller. In contrast, the former is a negative asset calling for reverse compensation from the seller (e.g. the option writer) to the buyer. According to economical understanding, the so-called *value at risk* as the standard measure for financial instruments²²² is the result of two aspects: (1) uncertainty of information on the existence (probability) and/or the interdependencies (effect) of factors or determinants influencing a specific event and (2) an objective value of that event.²²³ The first aspect implies that risk is an ex-ante or forward-looking heuristic concept in the stochastic sense, as opposed to ex-post or backward-looking concepts in the statistical or empirical sense, so that later changes never affect the past but only the future. This is why, in particular, the actual occurrence of that ex-post event does not *change* the ex-ante nature of the risk as such²²⁴ but merely lets it *materialise*.

Example 2: A credit risk from a *debt-claim* does not retroactively turn into a business risk only because it has become dependent on it due to a sudden business crisis, i.e. the actual frustration of the forward-looking going-concern assumption²²⁵.

²¹⁷ *Shaviro, Daniel*, Risk-Based Rules and the Taxation of Capital Income, *Tax Law Review* 1995, Vol. 50, Issue 4, p. 659; similarly: IAS 32.AG16; *Steinberg, Lewis R.*, Colloquium on Financial Instruments: Commentary, *Tax Law Review* 1995, Vol. 50, Issue 4, New York University School of Law, New York, 1995, p. 725.

²¹⁸ See sec. 2.2.5.

²¹⁹ As will be shown in more detail later (see par. 102). Similarly: IFRS 9.BC6.178.

²²⁰ *Steinberg, Lewis R.*, Colloquium on Financial Instruments: Commentary, *Tax Law Review* 1995, Vol. 50, Issue 4, New York University School of Law, New York, 1995, p. 726; critically: *Brooks, John R. II*, Taxation, Risk, and Portfolio Choice: The Treatment of Returns to Risk under a Normative Income Tax, *Tax Law Review* 2013, Vol. 66, Issue 3, p. 269 et seqq.

²²¹ See par. 58.

²²² KPMG Deutsche TreuhandGesellschaft Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, *Offenlegung von Finanzinstrumenten und Risikoberichterstattung nach IFRS 7: Analyse der Offenlegungsvorschriften für Finanzinstrumente nach IFRS 7 sowie zum Kapital nach IAS 1*, Schäffer-Poeschel, Stuttgart, 2007, p. 156 et seqq.

²²³ *Brooks, John R. II*, Taxation, Risk, and Portfolio Choice: The Treatment of Returns to Risk under a Normative Income Tax, *Tax Law Review* 2013, Vol. 66, Issue 3, p. 281.

²²⁴ In this sense, however: *Sven-Eric Bärsch*, p. 233; *Ceryak, David V.*, Using Risk Analysis to Classify Junk Bonds as Equity for Federal Income Tax Purposes, *Indiana Law Journal* 1990, Vol. 66, Issue 1, p. 289.

²²⁵ IAS 32.30, IFRS 9.B5.5.27.

In contrast to those qualitative changes of the financial instrument (e.g. modifications or re-negotiations) giving rise to its re-classification²²⁶, such quantitative changes are rather subject of its re-evaluation²²⁷. The second aspect makes clear that it is the quantitative value itself, or its changes, which is at risk. Namely, it comprises no other uncertainties such as the timing or value changes, which are – to a certain extent – predictable or expectable²²⁸. Further, the objective value has to be distinguished from its subjective assessment. For instance, an objective value at risk can be assessed differently by taxpayers with higher and lower risk tolerances.

- 61 This very general understanding of risk can naturally be interpreted and (de-)composed in countless varieties. The purpose and objective of this section is therefore to set a terminological base and to structure these various terms in order to hold a stringent vocabulary for the further course of this study.

Absolute versus relative risk

- 62 Theoretically, risk can be either equal or not equal to zero. However, in fact there is no absolutely riskless state (e.g. market risk, systematic risk, etc.), which is why finance theory operates with relative risk. In the absence of a better alternative, the state with the lowest absolute risk (e.g. deposit at the central bank) is relatively “riskless” compared to any other available state. However, such a comparative approach is necessarily impacted by environmental influences, making the determination of the relatively riskless state fluent and the attribution or allocation of the root cause for a change of absolute risks impossible.

Example 3: The interest-change risk is the hazard that the absolute market (i.e. environmental) interest rate changes, so that the absolute interest rate of a particular interest-bearing financial instrument (e.g. a straight bond) changes relatively²²⁹. However, the market interest rate risk is also affected by the expected inflation risk. Consequently, an inflation-linked note may be considered as “riskless” where the ex-ante inflation expectations have ex-post been met or underestimated. And it may be considered “risky” where these expectations have been overestimated or where there is a significant time lag between the coupon payment and the underlying²³⁰.

Objective versus subjective risk

- 63 Subjective risks are those affecting only one individual taxpayer or contracting legal party (i.e. gross risk from an isolated view). In contrast, inter-subjective or objective risks are those affecting more than one taxpayer or contracting legal party (i.e. net risk from a consolidated view).

Example 4: Where two parties are contracting in a win-lose situation (i.e. a conflict of interests, e.g. a bet against each other), the subjective risk is positive and the objective risk is zero (zero-sum wagers). Where, however, the two parties are contracting in a win-win situation (i.e. an incorporation of interests, e.g. a bet of both against a third party), both the

²²⁶ IFRS 9.5.5.12 and 9.B5.5.25).

²²⁷ IFRS 9.5.5.9.

²²⁸ David Hasen, p. 406.

²²⁹ IFRS 9.BC6.503

²³⁰ Haufe, IFRS, p. 1712, par. 166 et seqq.

subjective and the objective risks are positive. Hence, the risk profile of one or all contracting parties allows conclusions to the incentives of the transaction and therefore indications to its legal character.

Although likewise subjective, this relational aspect must however be separated from the evaluative aspect of risk assessment²³¹. For instance, an individual taxpayer may assess a positive subjective risk as negative due to his risk-aversion.

Symmetric versus asymmetric risk

- 64 Objective risks can be either symmetric or asymmetric²³². The value of a symmetric risk is always zero (e.g. forward), whereas the value of an asymmetric risk is always positive²³³ (e.g. option). The zero value of symmetric risks does not, however, mean that it is riskless²³⁴ but only that the positive risk goes equally in both directions of the contract.

Formal versus material risk

- 65 At first glance, it seems inconceivable to understand an economical or mathematical parameter such as risk in a formal way, which is why “law” is not even listed as a practice area for the term *risk* in most encyclopaedias. However, special fields of private law show that risk may be defined formally, perhaps as an occurrence where the contracting parties agree it to be by convention (e.g. insurance contract law). This raises, for instance, the question as to whether a hazard which is contractually agreed as but is virtually possible or impossible to materialise can be considered a risk.

Example 5: A “deep-in-the-money option” or “deep-out-of-the-money option” (also referred to as “low exercise price option”) has a strike price set in a way that the risk is close to zero and the success is de facto certain. As a consequence, the price of the underlying is virtually carved-out or substituted by that strike price.

Legal versus non-legal risks

- 66 Legal risks “are hazards that arise when the confidence in a certain legal situation is frustrated”²³⁵. Or in other words: legal risks are mainly rooted in the legal relationships as such. In particular, they comprise uncertainties with regard to laws and their tools (especially contracts), including their enforceability.²³⁶ Non-legal risks are any other hazards. Where a risk cannot be attributed to any legally contracting party²³⁷, it cannot possibly be a legal risk. For instance, market risk is the residual objective risk after a total consolidation of all market

²³¹ See par. 60.

²³² Dana Doege, p. 18.

²³³ IFRS 9.B4.3.3; *Kuhn / Hachmeister*, p. 61, par. 47 et seq., and p. 708, par. 29.

²³⁴ See par. 62.

²³⁵ *Fuchs, Florian*, Close-out Netting, Collateral und systemisches Risiko: Rechtsansätze zur Minderung der Systemgefahr im außerbörslichen Derivatehandel, *Schriften zum Unternehmens- und Kapitalmarktrecht* No. 6, 2013, p. 22 (translated by the author), with further citations.

²³⁶ *Kolbrenner, Scott Marc*, *Derivatives Design and Taxation*, *Virginia Tax Review* 1995, Vol. 15, Issue 2, p. 237.

²³⁷ See par. 62.

participants²³⁸ (i.e. a total diversification of all investments on the market) and therefore cannot possibly represent a legal risk.

Underwriting versus timing risk

- 67 Underwriting risk – also referred to as “intrinsic risk”²³⁹ or “underlying risk” – is a hazard that refers to ex-ante unpredictable changes in the substance of a present value (if-at-all probability)²⁴⁰. Elements such as assets or transactions bearing also underwriting risk are called *risk-based*.

Side note: Underwriting risk must not be identical with *insurance risk*²⁴¹, which might be more comprehensive by also encompassing some timing risks²⁴². In addition, the key differentiator of *insurance risk* – as opposed to underwriting risk – is that it is (1) specific to the insured²⁴³ in the sense of a physical adverse effect beyond a mere uncertain event²⁴⁴ and (2) limited to insurable interests as specific events only²⁴⁵. In other words: although both bear underwriting risks, an insurance is a specific type of a guarantee²⁴⁶ and pays only in case of a material adverse effect. Hence, it is not an asset, whereas a financial instrument pays in any case²⁴⁷ and is therefore an asset²⁴⁸.

- 68 In contrast, timing risk is a hazard that merely refers to changes in the ex-ante predictable or expectable²⁴⁹ timing of value changes (accrual or dissipate uncertainty)²⁵⁰. Elements such as assets or transactions bearing only timing risk are called *time-based*.

Side note: Timing risk must not be identical with *financial risk*²⁵¹, which is the complement to *insurance risk* and might therefore be more comprehensive by also encompassing some underlying risks.

- 69 The borderline between underlying and timing risk is fluid. On the one hand, there is a nexus between risk and timing, in that the risk or probability that the event occurs²⁵² is the higher the longer the respective time period is. The reason behind is the law of large numbers, according to which the relative frequency of

²³⁸ Ceryak, David V., Using Risk Analysis to Classify Junk Bonds as Equity for Federal Income Tax Purposes, Indiana Law Journal 1990, Vol. 66, Issue 1, p. 286.

²³⁹ IFRS 9.6.2.4(a), 9.6.5.15 and 9.B6.5.29.

²⁴⁰ Appendix C to SFAS 113, par. 121 (IFRS 4.BC19); IFRS 4.BC35 and 4.BC37 may be understood to the contrary but draws upon practical considerations only.

²⁴¹ Appendix A of IFRS 4.

²⁴² IFRS 4.B2(b).

²⁴³ IFRS 4.B9.

²⁴⁴ IFRS 4.B14 and 4.BC56.

²⁴⁵ IFRS BC.29.

²⁴⁶ IFRS 9.B2.5(a) and 4.BC67.

²⁴⁷ IFRS 32.AG8, 4.BC60, 9.B2.5(b) and 9.BC6.519.

²⁴⁸ Haufe, IFRS, p. 1736 et seq., par. 232; Kuhn / Hachmeister, p. 21, par. 138.

²⁴⁹ See par. 60.

²⁵⁰ IFRS 4.BC19; David Miller, p. 516 et seq.; Appendix C to SFAS 113, par. 121.

²⁵¹ Appendix A of IFRS 4.

²⁵² IAS Board, portfolio hedging, p. 87, par. 8.6(b).

uncertain events stabilises around a constant value that is virtually certain to occur. On the other hand, there is a strong subjective aspect with regard to the predictability, as the following example illustrates²⁵³.

Example 6: There is a difference between the cases of a retroactive insurance, in which the parties are (1) ignorant or (2) aware of the fact that the insured event has already occurred²⁵⁴. In the first case (1) the insurer takes the risk as his own by only calculating the event's value at risk into his premium (i.e. probability of less than 100%), keeping the insurance a shift of underwriting risk. In the second case (2) the insurer will calculate the value of the entire event into his premium (i.e. probability equal to 100%), diminishing the transaction to a mere shift of money (timing risk).

In addition, the underwriting risk necessarily also implies the timing risk (but not vice versa)²⁵⁵. Where the occurrence of the event is at all uncertain, this obviously includes its timing as well. That is why underwriting risk can replicate and be converted into timing risk (but not vice versa), as the following example illustrates²⁵⁶:

Example 7: Where the value paid out from an excess insurance is higher than the value of the adverse effect from the entire event itself and thus overcompensates its prospected probability, the value at risk is re-equalised to the value of the entire event, leaving eventually only timing risk as a remainder.

Consequently, it is either a question of whether to disaggregate²⁵⁷ the risk²⁵⁸ or a matter of degree, how much timing risk is critical to turn it entirely from underwriting into timing risk²⁵⁹.

- 70 The difference between underwriting and timing risk is however key for the axiomatic delimitation of financing, for instance from insurances or bets. Insurance is first of all the taking of underwriting risk as own risk²⁶⁰ in order to pool and distribute it according to the law of large numbers²⁶¹. This means that any transfer or conduit of underwriting risk, such as by way of hedges, reinsurances or securitisations, diminishes the transaction to a mere shift of money (timing risk).

Side note: From the IAS/IFRS insurance perspective, this axiom²⁶² appears to be problematic. As pooling merely helps to ensure a greater predictability, in the long run there are no uncertain risks but only certain events. Consequently, it could even be said that there is actually no such thing as an "insurance" but only financing. A "distribution" of risk is nothing else than transfer

²⁵³ IFRS 4.B3 et seq.

²⁵⁴ *David Miller*, p. 517; IFRS 4.B12.

²⁵⁵ IFRS 9.B6.5.34; IAS Board, December 2016, 5B, p. 8, par. 28.

²⁵⁶ IFRS 4.B13; *David Miller*, p. 521.

²⁵⁷ See sec. 2.2.5.

²⁵⁸ IFRS 4.DO10.

²⁵⁹ Analogously for insurance risk versus financial risk: IFRS 4.B10.

²⁶⁰ IFRS 4.B8 and 4.B11.

²⁶¹ *Frank Angermann*, p. 10; *Dana Doege*, p. 21; *David Miller*, p. 530.

²⁶² IFRS 4.BC29.

of risk, at least back to the insured party by way of calculating it into the premium. This is why there are considerable overlaps between *insurance contracts* pursuant to IFRS 4 and financial instruments pursuant to IFRS 9²⁶³.

To this extent, a bet is a negative insurance in the sense of granting a chance (i.e. taking a negative underwriting risk²⁶⁴)²⁶⁵. In contrast, financing is to take timing risk as own risk in order to pool and distribute it by way of transforming lots and maturities.

Side note: From the IAS/IFRS perspective, this axiom appears to be problematic as well, in that it is only theoretically possible to separate timing risk (i.e. financing) from underwriting risk (i.e. insurance). In practice, however, there is no absolutely riskless state²⁶⁶ in the sense of a pure timing risk, so that financing actually bears underwriting risk²⁶⁷ (e.g. business risk, credit risk, etc.) as well. This underwriting risk from a financial transaction may even resemble the underwriting risk from an insurance transaction²⁶⁸. For instance, the shareholder of an insurance company bears in fact the underwriting risk from the insurance business. This is why there are considerable overlaps between financial instruments pursuant to IFRS 9 and *insurance contracts* pursuant to IFRS 4²⁶⁹.

2.2.4 Substance versus form

2.2.4.1 *Genuine versus derivative concepts*

- 71 As stated earlier²⁷⁰, DTC are “hybrid systems” with the dual purpose of representing international agreements between two jurisdictions (horizontal binding effect) and fields of the public tax law governing the relation between these jurisdictions and its taxpayers (vertical binding effect). As regards the latter, on the one hand, a DTC has to integrate itself as a coherent element into the whole legal system of its jurisdiction. It basically respects the instruments and legal relations granted by other fields of that legal system (“form”), in particular the private and corporate law but also to other fields of the public law (e.g. accounting law). Although these precursory fields of law may themselves adhere more to substantive than to formal concepts, the legal form is nevertheless bound by these fields of the law. On the other hand, it has to reassess and – where necessary – subordinate these instruments and legal relations under its own normative purposes and auxiliary conditions. One of these is the equal or neutral treatment of comparable patterns (“substance”) in order to avoid distortions and to find public acceptance owed to the expropriative character of tax law. That is why tax law is actually a legal model of economic facts: while its material content is economically induced or driven, its formal application and procedural requirements are subject to legal methodologies. In this inherent conflict,

²⁶³ IFRS 4.4(d).

²⁶⁴ See par. 60.

²⁶⁵ Equally: IFRS 4.BC26; contrary: *Kuhn / Hachmeister*, p. 20, par. 111, classifying bets into the IAS/IFRS category of derivatives (see par. 96 et seq.).

²⁶⁶ See par. 62.

²⁶⁷ IFRS 9.BC6.524 et seq.

²⁶⁸ IFRS 9.B5.7.14 and 9.B5.7.15(b).

²⁶⁹ IFRS 9.2.1(c) and 9.BC6.390 et seqq.

²⁷⁰ See par. 27.

tax law has “to balance the rule of law and the legality principle on the one hand and the equality of taxpayers and the efficiency of the tax collection on the other.”²⁷¹

- 72 In this context, the purpose and objective of this section is to identify general guidelines indicating the principal applicability and the scope of when, where and to what extent the aspect of substance prevails over the aspect of form for particular fields of attributes. As a starting point, *substance over form* is a general and implicit principle of interpretation (bottom-up induction) rather than an explicit legal directive (top-down deduction). It can only be derived indirectly from particular terms or provisions within the OECD MTC. It applies methodologically to both steps of applying the tax law: the case-by-case assessment or subsumption of facts or attributes from precursory fields of law (“look-through”) and the abstract interpretation of the OECD MTC as the tax law itself.²⁷² In both ways it can be considered as certain that the legal form is the baseline.²⁷³ This is not only a result of Art. 31(1) VCLT²⁷⁴ and the general policy that tax law has to respect the instruments and legal relations granted by other fields of the legal system²⁷⁵. It was also the original intention of the OECD MTC²⁷⁶. The form is the determination or construct of a relationship (path), whereas the substance is an evaluation of its result (destination). This is why concepts of substance are subsequent matters arising from the tax law itself. Their application requires additional qualifying elements or measures within the tax law going beyond the determining or constructive attributes from precursory fields of law²⁷⁷. In this sense it could be said that the conflict between substance and form is not acted out on the same logical level. A solution through the form actually represents a transparency of the tax law in that it lets the legal result from the precursory fields of law “pass”. In contrast, a solution through the substance actually represents an opacity of the tax law, in that it replaces the legal result from the precursory fields of law by its own.

2.2.4.2 *Abuse as a derivative concept*

- 73 The most prominent and omnipresent example or use case of the general *substance over form* principle is the concept of treaty abuse as a construct to prevent taxpayers from actually “writing their own tax ticket”²⁷⁸. However, the *substance over form* principle goes far beyond this, as it touches “the viability of the fundamental rules and classifications on which income tax systems and international tax agreements are currently based”²⁷⁹. In particular, this includes the object of taxation, aspects of ownership or questions of character and source as well as of timing and amount of the income. Accordingly, the scope of the general *substance over form* principle must be split up into its specific use case of abuse and the remainder²⁸⁰. This necessity predominantly follows from systematic considerations: even allowing or applying both approaches in the

²⁷¹ Zimmer, Frederik, Form and Substance in Tax Law – General Report, Series IFA Cahiers 2002, Vol. 87a, p. 21.

²⁷² Wheatcraft, George Shorrocks Ashcombe, The Interpretation of Tax Laws with special Reference to Form and Substance – General Report, Series IFA Cahiers 1965, Vol. 50a, p. 8, 10 et seq. and 14.

²⁷³ Equally: Jieyin Tang, substance vs. form, sec. 5.2.; Marjaana Helminen, dividend concept, p. 166; IFA, 54th IFA Congress, Munich 2000 Summaries of Discussion on Subjects I and II, Bulletin for International Taxation 2001, Vol. 55, No. 2, p. 81.

²⁷⁴ Hans Pijl, interest, sec. 6.2.3.

²⁷⁵ See par. 71.

²⁷⁶ Among others: League of Nations, Document C.216.M.85, ref. C.216.M.85, London, 1927, p. 14.

²⁷⁷ Hensel, Albert in Paul Krüger, calling the tax law an “unavoidable extension to the fact of the private law” (p. 235, translated by the author) and “a special field grafted onto the private law” (p. 242, translated by the author).

²⁷⁸ William Plumb, p. 455; similarly: Harris, Peter A., Corporate Tax Law: Structure, Policy and Practice, Cambridge University Press, Cambridge, 2013, p. 191.

²⁷⁹ OECD, ST/SG/AC.8/2001/CRP.8, p. 31, p. 4.

²⁸⁰ See par. 10.

OECD MTC simultaneously (i.e. *substance over form* and form over substance) may resolve the problem of qualification conflicts but it would raise the new one of determining the applicable distributive provision. Equally important is that, to the author's understanding, there must be a difference between genuine legal concepts on the one hand (e.g. a definition) and derivative or situative legal concepts on the other (e.g. abuse). Any confusion of the two types may result in methodological and/or logical errors (e.g. circular reasoning, *cum hoc ergo propter hoc*, etc.). Pursuant to the laws of logic, treating a derivative legal concept *like* a genuine legal concept presupposes that the latter already exists. Or in other words: the exception is determined by the general principle. The difference between the two types is that genuine legal concepts are exogenous, whereas derivative or situative legal concepts are endogenous in that they are derived from genuine legal concepts. While both types typically trigger the same legal consequences, they are nevertheless different from each other.

Example 8: A shareholder loan can only be treated *like* a *dividend*, if the understanding of what a *dividend* is already exists. The shareholder loan may be treated *like* a *dividend* but still remains a loan.

For these reasons it must be clear whether a particular criterion of a provision or term either affects the genuine legal concept itself (fact) or merely employs its legal consequence analogously (notion). The following illustration visualises this understanding:

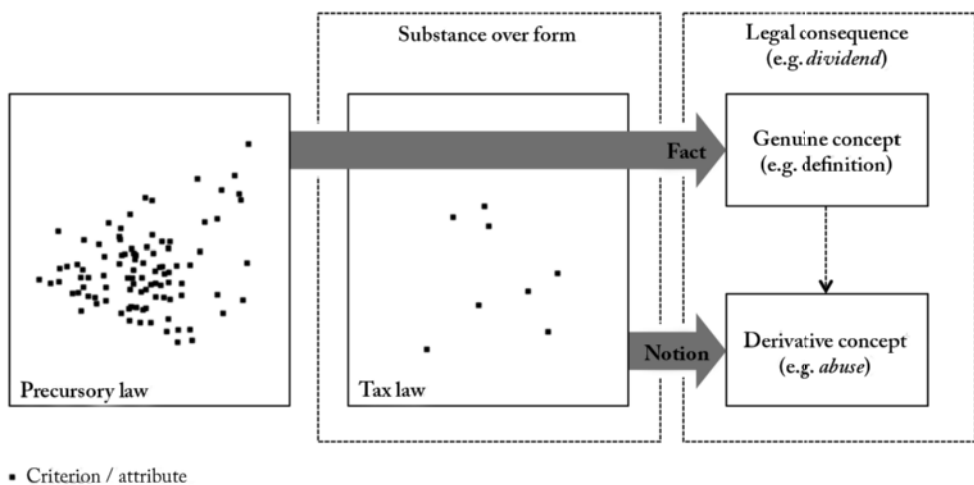


Illustration 2: Genuine and derivative legal concepts under the *substance over form* principle

- 74 More challenging than the abstract need to distinguish abusive and non-abusive concepts is, however, the identification or location of the concrete point or reference at which a particular legal criterion of a provision or term is clustered into the one concept or the other. The assessment reference to draw this red line can often not be the purpose, intention or function of the respective provision or term. While it should be possible to grasp the purpose, intention and function of each legal provision or term in the OECD MTC by way of

interpretation, it seldom reveals whether it is intended to impact a genuine legal concept as such or to merely trigger its legal consequence²⁸¹. The answer may be easy in cases where a provision or term recurs to another one or is explicitly worded as a notion. But it can be challenging in cases where the reason for the provision or term is to complement another one, especially where both terms are embedded into the same provision.

Example 8 (continued): It may be ambiguous whether the reclassification of the shareholder loan into “functional equity” is intended to impact the genuine legal definition of a *dividend* as such or to merely trigger its legal consequence.

Example 9: It may be ambiguous whether *penalty charges for late payment* pursuant to Art. 11(2) OECD MTC are not considered *interest* by excluding them from its genuine legal definition or whether they are considered *interest* but merely excluded from its legal consequence²⁸².

The selection of an appropriate assessment reference to draw a common line in the sense of “one size fits all” is even more difficult in the treaty context. As stated before, a particular provision or term of the OECD MTC must be capable of dealing with terms and meanings in multiple jurisdictions²⁸³ which employ diverse genuine and derivative legal concepts themselves. A particular criterion in the OECD MTC may be regarded as part of a genuine legal concept (e.g. a definition) by one jurisdiction but as part of a derivative or situative legal concept (e.g. abuse) by another jurisdiction, because they are different closed-end systems²⁸⁴.

Example 9 (continued): Pursuant to their respective domestic tax law systems, one jurisdiction may consider *penalty charges for late payment* still a part of the genuine *interest* definition, while another may see such charges as an anti-abusive provision.

75 This problem leads to the philosophical issue of what, at a global scale, is considered as “normal”. This question is far too general and its answer so extensive that a satisfactory answer cannot be given here. With respect to the scope of this study, according to which the concept of treaty abuse shall not be analysed in more detail²⁸⁵, it is sufficient to hold the following key points:

- (1) It follows from the legality principle²⁸⁶ that any concept of abuse must be made explicitly and in written form²⁸⁷, i.e. may not be deduced by way of interpretation and particularly not by analogy. The reason is that “abuse begins exactly where the art of interpretation starts to fail”²⁸⁸.
- (2) From the fact that concepts of substance are subsequent matters requiring additional qualifying elements within the OECD MTC itself²⁸⁹ it can further be concluded that there is no space for any treaty abuse where the OECD MTC adopts terms from precursory fields of law. This also includes abusive concepts

²⁸¹ Similarly: *Hensel, Albert* in *Paul Krüger*, p. 242.

²⁸² French Conseil d’État, judgement ref. 215124, 2001.

²⁸³ See par. 19 et seqq.

²⁸⁴ See par. 18.

²⁸⁵ See par. 10.

²⁸⁶ See par. 71.

²⁸⁷ *Hensel, Albert* in *Paul Krüger*, p. 223 – 247 and 262 et seq., comprehensively and in detail deducing and justifying this aspect as well as systematically distinguishing and explaining the other legal principles and their incapability of constituting anti-abuse concepts.

²⁸⁸ *Hensel, Albert* in *Paul Krüger*, p. 244 et seq. (translated by the author).

²⁸⁹ See par. 72.

pursuant to domestic tax laws as the only precursory fields of law for a DTC²⁹⁰. In other words: only terms which are exclusively created by the OECD MTC or which are also employed by domestic tax law but interpreted autonomously, come potentially into question for representing an abusive concept.

- (3) When breaking these terms into their particular attributes, another separation line is the distinction between misuses of legal options from misuses of economic options. Abuse is defined only as the misuse of legal options in the absence of economic reasons²⁹¹. In turn, there is no space for any abuse where there is at least also a minimum of economic reasons as a falsifier²⁹². It follows further that if the abusive concept, which is a specific and more restrictive use case, already fails due to economic reasons, the general and less restrictive *substance over form* principle must fail even more.²⁹³ That is why the two concepts are necessarily related in such a way that the specific use case of abuse replaces the general *substance over form* principle instead of subordinating to it. The general *substance over form* principle is no “fall-back” for the specific concept of treaty abuse in the sense of a residuary provision. Or in other words: abuse is constituted by distinct qualifiers going beyond the general *substance over form* principle. As a consequence, attributes of a term with a multi-purpose or ambiguity of serving both the abusive and the non-abusive function nevertheless belong only to the latter. Where a mixed case does not – in its entirety – outweigh the attributes of a term towards abuse, it is typically split up quantitatively into an abusive part and a non-abusive part.

Example 8 (continued): The shareholder loan may be quantitatively disaggregated into a non-abusive part to the extent that it is still at arm’s length (i.e. *interest*) and the remainder as an abusive part (i.e. *dividend*).

As a consequence, attributes of terms not unambiguously belonging to the abuse concept require a cautious invocation of the *substance over form* principle. Or in other words: in cases of doubt, in favour of the legal form.

2.2.4.3 Limitations of the genuine substance over principle

- 76 The previous analyses have explained the principal necessity of delimitating and carving-out the specific aspect of treaty abuse from the general concept of *substance over form*. In the following chapters the remaining genuine legal concept of *substance over form* will be analysed in order to identify those general guidelines indicating the weighting of substance or form for particular attributes of financial instruments. In this context, some comments²⁹⁴ may initially be suggest applying the *substance over form* principle in a particularly progressive manner to financial instruments as a specific pattern or box of transactions. The argument behind this is that they are exceptionally flexible by allowing constructions and combinations in a way that any specified set of discrete economic attributes can be replicated or separated in a variety of legal forms at the free disposition of the contracting counterparties.²⁹⁵ That is why financial instruments in particular were suspected of eliciting to tax planning and tax avoidance. However, not only would it in practice be prejudicial

²⁹⁰ See par. 21.

²⁹¹ Jieyin Tang, substance vs. form, sec. 3.1.; Hensel, Albert in Paul Krüger, p. 277.

²⁹² Argumentum e contrario.

²⁹³ Argumentum a minori ad maius.

²⁹⁴ Warren, Alvin C. Jr., Financial Contract Innovation and Income Tax Policy, Harvard Law Review 1993, Vol. 107, Issue 2, p. 465.

²⁹⁵ Sven-Eric Bårsh, p. 82; OECD, ST/SG/AC.8/2001/CRP.8, p. 2 and 25, par. 89; Duncan, James A., Tax Treatment of hybrid Financial Instruments in cross-border Transactions – General Report, Series IFA Cahiers 2000, Vol. 85a, p. 21.

at worst and impossible at best to find financial instruments which do not at least have economic (non-tax) purposes as well²⁹⁶. But also in theory, such a progressive approach was flawed: it is the legal form which gives a financial instrument certain attributes (e.g. default or credit or solvency or liquidity risk, hereafter referred to as “default risk” in general and “credit risk” for debts) and therefore significant features of its individual economic substance or profile²⁹⁷. In addition, even more important than these technical arguments is it to hold that no indications can be found in the OECD MTC for such a specific pattern or box for financial instruments. Instead, the OECD MTC is generally based on a classification of asset and income types or schedules (vertical position-by-position approach)²⁹⁸, regardless of whether or not they arise from financial instruments²⁹⁹ (horizontal pattern approach). That is why those comments in favour of a progressive application of the *substance over form* principle to financial instruments are intended to be understood in a normative or tax-political rather than a descriptive or interpretative way. In other words: any normative need for future action or abstract considerations on tax policies, which may be motivated by the comparatively low frictions of financial instruments, is not the same as and incompatible with the descriptive interpretation and application of the existing OECD MTC³⁰⁰.

- 77 Instead, the position could be taken that financial instruments, including “classic” financial instruments such as shares or straight bonds³⁰¹, are based on or derived from the value of something else³⁰² and therefore are predominantly evidence of relative legal claims³⁰³. In other words: “It is these contractual rights, not the economic substance that make financial instruments differ from each other”³⁰⁴, so that “an effort to apply the economic substance principle to ‘everything’ will in effect cause it to apply to nothing”³⁰⁵. It appears that this difference has also been recognised by the IAS/IFRS. Although applying *substance over form* as the general principle for all assets³⁰⁶ including financial instruments³⁰⁷, the IAS/IFRS nevertheless require a *contract*³⁰⁸ as a necessary minimum condition (*conditio sine qua non*)³⁰⁹. Statutory or otherwise public financial assets and

²⁹⁶ Jieyin Tang, substance vs. form, sec. 3.1., with further citations; OECD, ST/SG/AC.8/2001/CRP.8, p. 31, par. 116; Duncan, James A., Tax Treatment of hybrid Financial Instruments in cross-border Transactions – General Report, Series IFA Cahiers 2000, Vol. 85a, p. 22 et seq.; Ferguson, Bradford L., The Rationales for the Rules: How to think about Derivatives in the Tax World, Taxes: The Tax Magazine 1994, Vol. 72, Issue 12, p. 998.

²⁹⁷ Circular reasoning. David Hasen, p. 408 et seq., 445 and 469; Ceryak, David V., Using Risk Analysis to Classify Junk Bonds as Equity for Federal Income Tax Purposes, Indiana Law Journal 1990, Vol. 66, Issue 1, p. 282.

²⁹⁸ See par. 59.

²⁹⁹ Jieyin Tang, substance vs. form, sec. 5.2.; IFA, 54th IFA Congress, Munich 2000 Summaries of Discussion on Subjects I and II, Bulletin for International Taxation 2001, Vol. 55, No. 2, p. 82.

³⁰⁰ See par. 15.

³⁰¹ See par. 56.

³⁰² Huang, Peter H., A Normative Analysis of New Financially Engineered Derivatives, Southern California Law Review 2000, Vol. 73, Issue 3, p. 503 et seq.; Plambeck, Charles T. / Rosenbloom, H. David / Ring, Diane M., Tax aspects of derivative Financial Instruments – General Report, Series IFA Cahiers 1995, Vol. 80b, p. 661; Baer, Robert, Understanding Derivatives and Financial Instruments, Taxes: The Tax Magazine 1994, Vol. 72, Issue 12, p. 930.

³⁰³ OECD, ST/SG/AC.8/2001/CRP.8, p. 14, par. 31 et seq.; Anthony Polito, p. 772 et seq.; Plambeck, Charles T. / Rosenbloom, H. David / Ring, Diane M., Tax aspects of derivative Financial Instruments – General Report, Series IFA Cahiers 1995, Vol. 80b, p. 660; Shaviro, Daniel, Risk-Based Rules and the Taxation of Capital Income, Tax Law Review 1995, Vol. 50, Issue 4, p. 657 et seq.

³⁰⁴ Jieyin Tang, substance vs. form, sec. 5.1.

³⁰⁵ David Hariton, substance, p. 34.

³⁰⁶ IAS / IFRS Framework 4.44.

³⁰⁷ IAS 32.15 and 32.18.

³⁰⁸ IAS 32.11 and 32.13.

³⁰⁹ Haufe, IFRS, p. 1647, par. 3, and p. 1665, par. 48; Nguyen, Tristan, Bilanzielle Abbildung von Finanzderivaten und Sicherungsgeschäften: Hedge Accounting nach HGB und IAS / IFRS, Munich, 2007, p. 23.

liabilities are not considered a *contract* in this sense³¹⁰, which might give rise to differences between IAS/IFRS and the OECD MTC. However, the explicit reference to a *contract* is nevertheless an unmistakable indication of the legal form as the baseline for financial instruments. The author shares this view, which is why a first interim conclusion for the further course of this study is that the existence of financial instruments as an asset or transaction requires a cautious invocation of the *substance over form* principle³¹¹.

78 As regards aspects of risk, it was stated on the one hand that even such economical or mathematical parameter as risk could principally be interpreted in a legal way³¹², on the other hand it could be the legal form which gives a financial instrument certain risk attributes³¹³. Although such legal risk attributes may be subject of another financial instrument (e.g. an insurance or credit “derivative”), this other financial instrument in itself bears *new* legal risks³¹⁴. As risks cannot be resolved but only transferred or re-allocated³¹⁵, it is this legal transfer that is causing new legal risks and makes the idea of “resolving legal risks” even more doubtful (i.e. both self-contradiction and circular reasoning). This is why transferring legal hazards is methodologically not a matter of risk but rather of aggregation and disaggregation³¹⁶. According to the author’s point of view, the question to which extent the substance prevails over the form must therefore depend to a considerable extent on the source or origin of the risk. The more a risk is rooted in the relationship to the contracting counterparty as the subject, which the taxpayer is legally related with (i.e. the existence of financial instruments as an asset or transaction³¹⁷), the more the focus must naturally tend to the legal form. This should not be misunderstood prejudicially, in that the internal risk from the financial instrument is to be split up into its separate components or aspects (e.g. multiple credit risks of serial contracting parties), which is the subject of section 2.4.5. It only means that the external risks are to be typified or allocated (e.g. credit risk versus market risk). Apart from that, the focus must naturally tend more to the economic substance. As a consequence, an occurrence contractually agreed as uncertain but in actuality either almost certain or virtually impossible to materialise cannot be considered a risk³¹⁸.

79 Within the scope of this study³¹⁹, aspects with regard to the payment profile of financial instruments lead first of all to realisation issues and to subjacent questions on the nature of an income tax. In the context of the OECD MTC, which does not only apply to *taxes on income* but also to those on *capital*³²⁰, this materialises in the systematic distinction between *income* pursuant to chap. III of the OECD MTC and *capital* pursuant to chap. IV of the OECD MTC. This fundamental question touches the theory of tax types and cannot be examined in more detail here. Instead, it is sufficient to hold: while the former “fruit and tree doctrine”³²¹

³¹⁰ IAS 32.AG12; Haufe, IFRS, p. 1669, par. 59.

³¹¹ See also par. 75(3).

³¹² See par. 65.

³¹³ See par. 76.

³¹⁴ Equally: Dominik Dettenrieder, p. 210.

³¹⁵ See par. 59.

³¹⁶ See sec. 2.2.5.

³¹⁷ See par. 77.

³¹⁸ Equally: IAS 32.AG28; Christoph Berentzen, p. 87; Andriessen, Floris, Accounting for Derivatives under IFRS, Derivatives & Financial Instruments 2006, Vol. 8, No. 6, p. 258. See also par. 65.

³¹⁹ See sec. 1.2.

³²⁰ See par. 55.

³²¹ For a summary see Stefano Simontacchi, p. 124 et seq. and OECD, The Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals: Report of the OECD Committee on Fiscal Affairs, Paris, 1979, p. 93 et seqq.

revolved around the axiomatic distinction between *income* and capital *gains* (i.e. the asset as the source of that *income*), the actual Schanz-Haig-Simons concept³²² rather calls for common grounds between the two. If the existence of financial instruments as an asset already requires a cautious invocation of the *substance over form* principle³²³, this must be even more true for the existence of the income or transaction itself³²⁴. The reason is that the asset as the source requires and implies the income or transaction³²⁵. Accordingly it is the law which splits economic capital or wealth into legal *capital* and legal *income*. That is why for the initial determination of whether or not there is a payment, the legal form must play a decisive role. For the subsequent question of what may be considered a payment or not (e.g. payments in kind), however, the economic substance is of higher importance.

- 80 In terms of rights and obligations from financial instruments as another field of possible criteria for the classification of financial instruments, it is beyond question that the legal form is of essential importance for the way of interpretation. This follows directly from the preceding findings³²⁶ that the *substance over form* principle can methodologically only apply in an evaluative way to the abstract interpretation of the OECD MTC as the tax law itself and to the case-by-case subsumption of facts or attributes *as the results* from precursory fields of law, but can never touch these facts or attributes themselves. This is why a provision or term in the context of tax law, which picks up a wording from a precursory field of non-tax law, may be understood synonymously as long as there are clear indications that its economic interpretation demands another meaning. For this, the mere purpose, intention and function of the tax law are not sufficient³²⁷. Or in other words: "Considering [...] a 'factual obligation' is close to nonsense"³²⁸.
- 81 Finally, as regards aspects of time, at a first glance it seems impossible to interpret such physical parameters in different ways. However, some financial instruments (e.g. demand deposits, short-term call money, netting agreements, perpetuations, etc.) illustrate that time may also be defined formally, perhaps as a potential or theoretical feasibility to legally terminate the transaction at any time. This raises, for instance, the question as to whether or not a period being contractually agreed but which virtually never comes into effect can be considered a duration. The issue bears a nexus with the aspect of temporal aggregation and disaggregation³²⁹: it strongly depends on the question whether such novation by way of expiry or renunciation of the formal termination right constitutes a new financial instrument (substitution)³³⁰. In other words: aspects of time are interdependent with the financial instrument's existence as such, bearing an inextricable nexus with each other in a reciprocal relationship. From the finding³³¹ that the existence of financial instruments tends to

³²² "Income is the money value of the net accretion to one's economic power between two points of time." (Haig, *Robert Murray*, The Federal Income Tax, Columbia University Press, New York, 1921, p. 7)

³²³ See par. 77.

³²⁴ Argumentum a maiore ad minus.

³²⁵ See par. 53 et seq.

³²⁶ See par. 72.

³²⁷ Hensel, *Albert* in *Paul Krüger*, on p. 241 et seq. accurately denying a concept of "fiscal economic terms" (translated by the author), and on p. 242 and 264 summarising that tax law cannot be triggered by economic but only by legal facts, in that the former must be transformed into the latter.

³²⁸ Gutmann, *Daniel* in *Michael Lang*, beneficial ownership, p. 343. See however the term constructive obligation in IAS 37.10, which remarkably does not apply to financial instruments (Haufe, IFRS, p. 1649, par. 9).

³²⁹ See sec. 2.2.5.

³³⁰ Similarly: IFRS 9.BC6.334.

³³¹ See par. 77.

follow the form rather than the substance, it follows in the author's view that aspects of time had to be basically interpreted pursuant to domestic tax law as well. Ergo, the principle of *substance over form* does not apply to this extent³³². However, aspects of time become particularly important in interaction with other aspects³³³. That is why these other aspects, including their relative importance and intensity, are to be taken into particular consideration for the question to what extent the substance may eventually still prevail over the form³³⁴.

Example 10: The time lag between the legal commitment and the effective settlement might be relevant for distinguishing spot and forward transactions³³⁵. The time period for transferring assets or partial rights temporarily might be relevant for determining or allocating ownership. The timing characteristics between two or more transactions or components might be relevant for aggregating or disaggregating them. The duration of a transaction might be relevant for its classification.

2.2.4.4 Conclusions

- 82 The purpose and objective of this section was to identify general guidelines indicating the applicability and scope of when, where and to what extent the aspect of substance prevails over the aspect of form for particular fields of attributes of financial instruments.³³⁶ The findings have, on the one hand, validated the natural intuition that fields of attributes determining legal states as the legal building blocks of financial instruments (e.g. rights and obligations) mainly follow the form. In contrast, fields of attributes economically assessing the results from these legal states (e.g. risk) mainly follow the substance. On the other hand, there are fields interacting with both aspects (e.g. time). A particular criterion of a provision or term from such a field must be interpreted on an individual basis. Finally, this section has disentangled the interdependency between the legal form and the economic substance in both methodological ways of applying the tax law: the case-by-case assessment or subsumption of facts or attributes from precursory fields of law (e.g. risk profile by legal form) and the abstract interpretation of the OECD MTC as the tax law itself (e.g. "fiscal economic terms").

2.2.5 Aggregation versus disaggregation

2.2.5.1 Preliminary remarks

- 83 The purpose and objective of this section is to identify general guidelines indicating the principal applicability and to determine when, where and to what extent financial instruments which imply the transactions³³⁷ shall be either aggregated or disaggregated under the OECD MTC, or neither. Starting with the circumscription of the terminological understanding and scope of the two schemes, the section proceeds with the introduction of a theoretical base model for this study of a total disaggregation into options. Then, some first conclusions are drawn from this base model with regard to the specific aspect of aggregation. This done, the section

³³² Contrary: IFRS 9.B5.5.39, applying in so far a more progressive substance over form principle at least to some particular types of undrawn commitments, which is however due to the IAS/IFRS-specific and thus non-transferrable purposes.

³³³ Similarly: *Wheeler, Joanna* in IBFD Commentaries on Time in Tax Treaties, sec. 5.

³³⁴ See also par. 75(3).

³³⁵ Appendix to IFRS 9, regular way purchase or sale.

³³⁶ See par. 72.

³³⁷ See par. 53 et seq.

continues with an in-depth analysis of both the IAS/IFRS and finance theory in order to draw further conclusions from them in regards to disaggregation. The final conclusions bring all these aspects together.

2.2.5.2 Definition and scope

- 84 Aggregation – also referred to as “integration”, “amalgamation” or “bundling” – means the conjoined or pooled treatment of more than one financial instrument or transaction as one consolidated unit according to its economic substance (i.e. typically the predominant component³³⁸). As the logical complement, disaggregation – also referred to as “bifurcation”, “fragmentation” or “unbundling” – means the breaking or deconstruction of one financial instrument or transaction into its qualitative components and separate treatment according to their economic substance. Alternatively, disaggregation can also be understood in the quantitative sense of a proportion or layer of the entire financial instrument³³⁹ (i.e. a proportion or layer of *all* its qualitative components³⁴⁰), which is however not the primary focus of this study.
- 85 On the one hand, both schemes of aggregation and disaggregation are expressions of, and therefore apply only to, the extent of the *substance over form* principle. As such, they actually ignore the legal form³⁴¹ and can be dealt with only on the treaty level. Especially the disaggregation scheme finds its systematic justification in treating a combination of financial instruments or transactions similarly as if these were held or realised separately³⁴². On the other hand, the approach of aggregation and disaggregation can be understood in two ways: in a narrow sense it means the composition or decomposition of “derivative” financial instruments (e.g. structured products) or transactions (e.g. composite options strategies) and their separate or consolidated treatment. In the broader sense it refers to the interpretation of particular legal characteristics of “classic” financial instruments such as *shares* or *debt-claims*. The former is a methodology for the case-by-case assessment or subsumption of factual attributes in order to concretely apply the law (i.e. refers to the object of the legal issue). In contrast, the latter is a methodology for identifying the legal attributes in order to abstractly interpret the law (i.e. refers to the target of the legal issue)³⁴³. These boundaries are blurred, since another objective of the interpretation is to determine the legal object. Illustrated by an example, “hybrid” financial instruments coalesce both the applicative and the interpretative aspect in themselves. However, for the further course of this study it is sufficient to hold, but also important to emphasise, the principal different ways of understanding the general approach of aggregation and disaggregation: aggregation and disaggregation in the narrow sense are best practices and pre-steps in order to prepare the case for the subsequent interpretation by way of aggregation and disaggregation in the broader sense³⁴⁴. The IFRS seem to make this distinction as well: the applicative aspect is subject of IFRS 7 and 9³⁴⁵, whereas the interpretative aspect is subject of a

³³⁸ *Duncan, James A.*, Tax Treatment of hybrid Financial Instruments in cross-border Transactions – General Report, Series IFA Cahiers 2000, Vol. 85a, p. 30.

³³⁹ IFRS 9.B6.3.16.

³⁴⁰ For an overview see *Dominik Dettenrieder*, p. 132 et seqq.

³⁴¹ Equally: IAS 32.BC22; *Diana Doege*, p. 48. See also par. 77 et seqq.

³⁴² *David Weisbach*, p. 507 et seqq.; IAS 32.BC29; critically: *Jieyin Tang*, bifurcation or integration, sec. 5.1.

³⁴³ See par. 72.

³⁴⁴ “Although the debate has been framed in theoretical terms, it generally has turned on practical considerations. The case has not been made on normative grounds for the theoretical superiority of either a complete bifurcation or integration approach.” (*Deborah Huffman Schenk*, equity derivatives, p. 580).

³⁴⁵ See par. 46(1) and 46(3).

fundamental research project in the context of the IFRS framework³⁴⁶. While the latter methodologically applies in any case, the predominant question here is whether or not the financial instrument as the legal object is to be composed or decomposed. The difference is clarified by the example of a straightforward share and a structured product or hedge, which are all objects of the legal problem of classifying them into the distributive articles of the OECD MTC. Interpreting these provisions abstractly raises the same questions of analytically and/or contextually identifying their legal attributes (i.e. the aggregation and disaggregation in the broader sense). However, applying these provisions concretely to the structured product and the hedge seems – in contrast to the straightforward *share* – to raise the particular question of whether or not it has to be composed (hedge) or decomposed (structured product) and treated respectively.

- 86 In this study, aggregation and disaggregation are understood in the narrow sense. For the further course the applicative or preparatory aspect of aggregation and disaggregation in this narrow sense is analysed in this section, whereas the interpretative aspect of aggregation and disaggregation in the broader sense is subject of sections 2.4 and 3. The following illustration visualises this understanding:

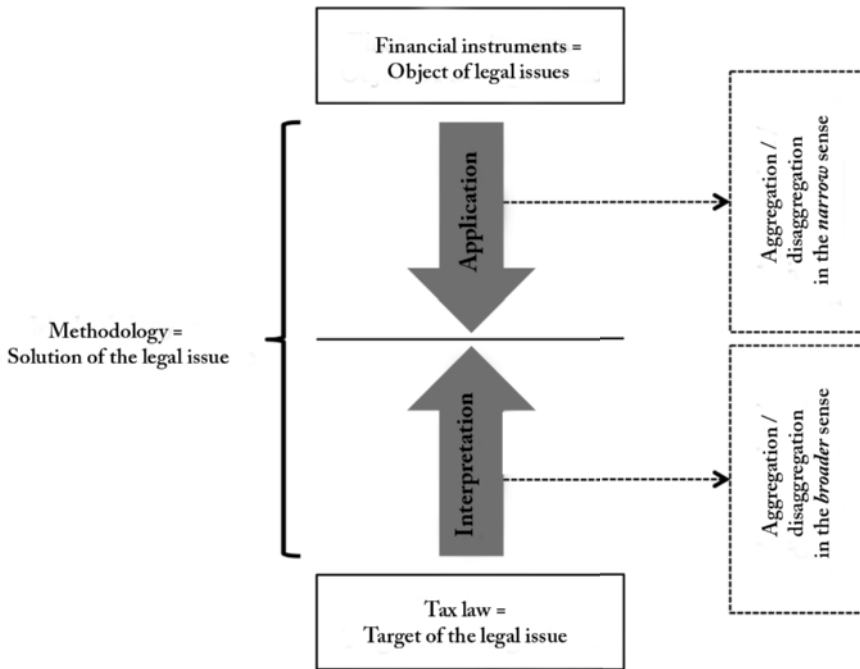


Illustration 3: Aggregation and disaggregation in the narrow versus in the broader sense

- 87 The common method of aggregation and disaggregation (in the narrow sense) is drawing analogies. This is why their scopes are naturally limited: as a matter of principle, analogies always require and presume

³⁴⁶ See par. 47.

benchmarks, which can themselves not likewise be derived by analogies. This leads to the problem what such benchmark shall be. Aggregation and disaggregation are best practices³⁴⁷, but in practice any financial instrument is likewise object of the same legal question that still needs to be answered by drawing that analogy. That is why the distinction between genuine and derivative legal concepts³⁴⁸, which refer only to the target of the legal issue, may not lead to the conclusion that there are also genuine and derivative objects of that legal issue. By the example of a straightforward *share* and a structured product or hedge³⁴⁹, the pre-classification of the former into some kind of benchmark (“genuine financial instrument”) and of the latter into something other (“derivative financial instrument”) would be a circular reasoning. Starting from the same legal problem of classifying both into Art. 10(3), 11(3), 13(5) or 21(1) OECD MTC, the one does not differ in any way from the other. In other words: while the distinction of the income types of financial instruments is real, the distinction of “classic”, “hybrid”³⁵⁰ and “derivative”³⁵¹ financial instruments is an illusion. Nevertheless, this classification into “classic”, “hybrid” and “derivative” financial instruments is an established part of the common technical terminology and shall therefore also be used in this study. It is, however, important to keep in mind that the benchmark for drawing analogies from “derivative” and “hybrid” to “classic” financial instruments is not more than an interpretational imagination. Rather, aggregation and disaggregation as a special matter of applying the law is equally relevant for all three classes.

- 88 The schemes of aggregation and disaggregation are controversial³⁵². Apart from practical complications, this is because the specific nature of financial instruments has given rise to fundamental conceptual difficulties³⁵³:
- (1) Due to their methodological limitations, aggregation and disaggregation are incapable of substituting or even going beyond the interpretation of the tax law in order to alleviate its structural weaknesses³⁵⁴. For this reason, they would add no value to the actual problems.
 - (2) The flexibility and multiplicity of financial instruments allowed the replication and (re-)combination of an infinite or at least non-unique number of not only legal but also economic attributes. This made it impossible to find an equivalent in order to draw an analogy for a given financial instrument.³⁵⁵
 - (3) These economic attributes could even be different for one and the same financial instrument, depending on the context. For instance, the position in a particular financial instrument might be a speculative investment by one taxpayer or point in time but part of a hedge strategy by another³⁵⁶. While there are no

³⁴⁷ See par. 85.

³⁴⁸ See par. 73.

³⁴⁹ See par. 85.

³⁵⁰ In contrast, IFRS 32.28.

³⁵¹ In contrast, IFRS 32.AG15, Appendix A to IFRS 9 and IFRS 9.BA1 – 9.BA5.

³⁵² For a comprehensive overview see *David Weisbach*, p. 512 et seqq.

³⁵³ See par. 1 et seqq.

³⁵⁴ *Warren, Alvin C. Jr.*, Financial Contract Innovation and Income Tax Policy, Harvard Law Review 1993, Vol. 107, Issue 2, p. 477; *Edward Kleinbard*, financial innovations, p. 1355.

³⁵⁵ *Brunson, Samuel D.*, Elective Taxation of Risk-Based Financial Instruments: A Proposal, Houston Business and Tax Law Journal 2007, Vol. 8, Issue 1, p. 11 et seq.; OECD, ST/SG/AC.8/2001/CRP.8, p. 29 et seq., par. 108; *Duncan, James A.*, Tax Treatment of hybrid Financial Instruments in cross-border Transactions – General Report, Series IFA Cahiers 2000, Vol. 85a, p. 30; *David Weisbach*, p. 512; *Kau, Randall Koon Chuck*, Carving up Assets and Liabilities – Integration or Bifurcation of Financial Products, Taxes: The Tax Magazine 1990, Vol. 68, Issue 12, p. 1007.

³⁵⁶ *Haufe*, IFRS, p. 1653, par. 20.

general tools available to cope with context-specific analyses (aggregation), the available analytical tools (disaggregation) are insensitive to that context.³⁵⁷

- (4) Both schemes created results, which are not economically comparable with the original financial instruments³⁵⁸. They ignored the fact that, pursuant to economic organisation theory, the mere existence of the original financial instrument is proof enough that it cannot be replicated more efficiently (synergetic effects)³⁵⁹.
- (5) The disaggregation scheme was principally infinite in that there is no limit at which it ought to be stopped.³⁶⁰ The same may be true in the opposite way, in that the highest level of aggregation is eventually the taxpayer.
- (6) Despite the components or consolidated units in which the financial instruments are to be transformed by the two schemes, in finance theory there were also various methods or techniques taking different assumptions and therefore leading to different results.³⁶¹ In addition, practical considerations with regard to the operational complexity beg the question whether the benefits actually exceed the costs.³⁶²

2.2.5.3 Options as building blocks

89 As stated above, these issues occur due to the fact that financial instruments can be converted or replicated in multiple ways without changing their economic and potentially also their legal features³⁶³. Apparently, taxpayers are driven economically, also in tax matters. That is why emphasising that the taxpayer might also be interested in the legal profile of a financial instrument, was an overstatement (which is why, for instance, anti-abuse rules exist). From the taxpayer's view, law is subject and therefore subordinate to economic considerations, in that the legal features are only relevant to the extent that they impact the economic features. Economically, any position is fully and conclusively described by only two parameters: risk and return.³⁶⁴ Economic equivalence is therefore typically visualised by a risk-return matrix. Finance theory has shown³⁶⁵ that the risk-return profile of any financial instrument (i.e. a data point in that risk-return matrix) can basically be replicated or synthesised by options. In fact, there is nothing more granular than options, as they are the smallest available transactions or units containing all economic attributes to fully describe a risk-return profile. In this sense, they could indeed be called the "quarks" of finance theory³⁶⁶. True, on the one hand, options are themselves legal transactions and financial instruments, which can be replicated by other options (put-call parity), so that the problem of aggregation and disaggregation returns to its origin. On the other hand, risks

³⁵⁷ Edward Kleinbard, financial innovations, p. 1355 et seq., noticing on p. 1358 et seq. that also "the substance-over-form doctrine can be applied to financial innovation [only (author's note)] to determine whether each component of a complex financial strategy is real but once the reality of those components has been confirmed, the substance-over-form doctrine has not been invoked to merge these separate and real components into a different synthetic financial instrument."

³⁵⁸ Kuhn / Hachmeister, p. 317 et seq., par. 49; IFRS 7.BC31; Edward Kleinbard, debt, p. 948.

³⁵⁹ Jieyin Tang, substance vs. form, sec. 3.2.1.; Achim Pross, p. 157 et seq.

³⁶⁰ Achim Pross, p. 147; Kau, Randall Koon Chuck, Carving up Assets and Liabilities – Integration or Bifurcation of Financial Products, Taxes: The Tax Magazine 1990, Vol. 68, Issue 12, p. 1007, accurately noticing that "unlike the natural world, there are no fundamental individual particles such as quarks."

³⁶¹ Achim Pross, p. 153 et seq. and 158; Jeff Strnad, conceptual framework, p. 574.

³⁶² OECD, ST/SG/AC.8/2001/CRP.8, p. 30, par. 111; Achim Pross, p. 153 and 158.

³⁶³ See par. 76.

³⁶⁴ Finance theory "can convert an infinite-dimensional erratic examination of limitless factors into a two-dimensional relationship of risk and return." (Anthony Polito, p. 790).

³⁶⁵ Gaspar Lopes Dias, tax arbitrage, p. 3; David Hasen, p. 423; Jeff Strnad, conceptual framework, p. 574 et seq.; Anthony Polito, p. 782; all with further citations.

³⁶⁶ See footnote 360.

rooted in the underlying as the object of the option must naturally follow the economic substance rather than the legal form³⁶⁷. In this light, it should be permissible to conclude that the possibility of replicating an option by another option is not of any relevance, as it does not impact the economic substance. That is why options could, in other words, be said to be the building blocks for (re-)assembling or (re-)engineering any economic risk-return profile³⁶⁸.

- 90 The basic economic principle of decomposing and recomposing financial instruments by options is used in finance theory for pricing purposes³⁶⁹ and was recovered and discussed by domestic tax academics³⁷⁰ in the mid 1990s. In the theoretical context of normative tax policy making it was found that the transition of one tax pattern or box of tax law into another by way of “atomising” them with options can be used for ensuring the consistency and robustness of newly designed (“perfect”) tax systems. The idea behind this was to take the total tax on all particular options as a checksum for the total tax on all patterns or boxes, which can be replicated or synthesised with these options³⁷¹. True, the normative context and character of those studies is different from the descriptive and interpretative objective of this study (*de lege lata*)³⁷². And obviously the OECD MTC differs considerably from domestic tax laws in many regards (e.g. purpose, system, interpretation, etc.). However, the following considerations attempt to transfer some of the findings to the OECD MTC. The intention is to draw additional insights or conclusions and to establish a maximum of inherent consistency and systematology in the treatment of financial instruments and transactions with a minimum of assumptions or preconditions.
- 91 As a starting point, any asset as the source of income may be understood as a continuum of actions. These actions can ultimately be decomposed and economically seen as a cloud or portfolio of multiple binary choices of the identical qualitative structure (i.e. only the quantitative values differ) for either taking or refraining from an action (long option).

Example 11: The acquisition of an asset as a continuum of actions may be decomposed into the two binary choices of (1) buying or not buying the asset and (2) paying or not paying the acquisition price.

Each of these choices has an expected return, which is the net consequence of prospected total proceeds (gain) and costs (option premium). A decision maker takes a choice depending on his subjective assessment of both consequences. The actual costs are typically certain and paid in advance, while the prospected proceeds are typically uncertain and paid in arrear, so that his assessment is influenced by the expected probability of occurrence (risk).

³⁶⁷ See par. 78.

³⁶⁸ *David Hasen*, p. 423.

³⁶⁹ IAS Board, July 2016, 5B, p. 7 et seq., par. 32.

³⁷⁰ See footnote 352.

³⁷¹ *Achim Pross*, p. 171 et seq., accurately illustrating that “disaggregation achieves the target if it becomes dispensable” (translated by the author).

³⁷² See par. 15.

Example 11 (continued): The costs for not paying the acquisition price might be a penalty. Depending on the decision maker's subjective assessment of the circumstances, he is in any case free and might decide to take this penalty (e.g. for some more important reasons). This subjective assessment is not only influenced by the amount of the penalty but also by its probability of occurrence.

In that the other decision makers behave in the same manner (i.e. long option from their perspective), they coincidentally shift a higher risk to that single decision maker (i.e. short option from his perspective). This is a necessary consequence from the binary character of the choices in the sense that the one person's chance is the other person's risk. As a result, the environment influences the decision maker's assessment by eliminating and narrowing his reasonable choices (hedging long by short options), whereby the unreasonable choices nevertheless remain existent (incentive compatibility). With this model in mind, the flexibility of financial instruments merely means to arbitrarily pick and extract any particular option (long or short, a single one or a specific set, etc.) from the asset³⁷³. Not only financial or legal risks might be selected in that way but genuine business risks (e.g. a portfolio might hedge the share of a company with seasonal business with a weather "derivative") as well. The following illustration visualises this understanding:

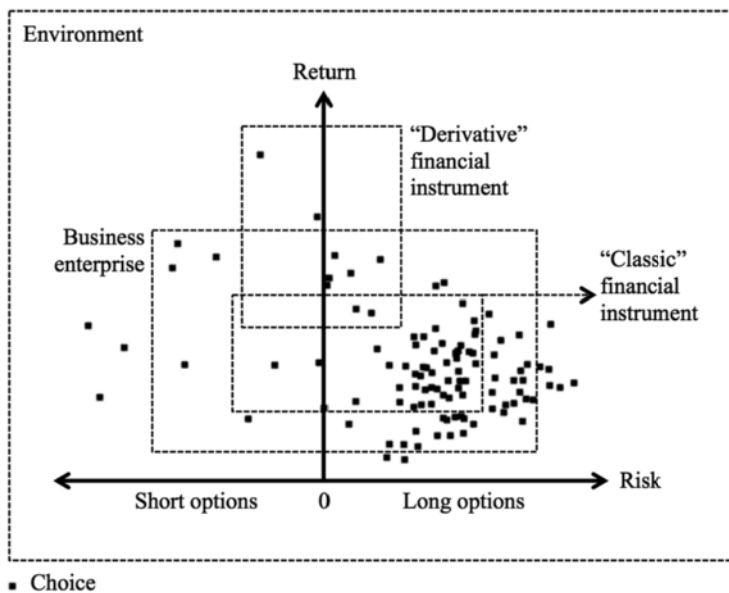


Illustration 4: Aggregation and disaggregation in a risk-return matrix

92 The original approach of taking the total tax on all options as a checksum for the total tax on all patterns or boxes in order to ensure consistency in perfect tax systems³⁷⁴ drew its binary conclusion (i.e. consistent or not

³⁷³ Similarly: IFRS 9.B3.2.14; IAS Board, December 2016, 5B, p. 5, par. 16; *Shaviro, Daniel*, Risk-Based Rules and the Taxation of Capital Income, *Tax Law Review* 1995, Vol. 50, Issue 4, p. 665.

³⁷⁴ See par. 90.

consistent) from the quantitative analysis of the options (i.e. total tax equal or not equal). Further, the question may, however, be asked which additional conclusions can be drawn from the qualitative analysis of the options themselves. The idea behind this is the other way around: a principle capable of ensuring consistency in perfect tax systems should also be capable of analysing inconsistencies in imperfect tax systems. Given the assumption (which will be discussed in the following³⁷⁵) that the OECD MTC is not a consistent tax system, the principle of economic equivalence allows financial instruments to be flexibly converted or replicated into each other by options while maintaining their risk-return profile but with different tax implications. So far the conclusion from the original approach. However, where two financial instruments are not entirely identical (e.g. *share* and *debt-claim*), in such an inconsistent tax system their replication or synthesis into each other by options is necessarily imperfect. It is incomplete in the way that it leaves a residuum of building blocks, i.e. excessive or missing options or both. The total net of such a residuum in terms of risk and return represents a position indicating unique differentiators of the respective financial instrument. The distinction between dividends and interest was said to be a legal rather than an economic question³⁷⁶, which finance theory alone cannot answer³⁷⁷. However, although such reverse deductions back to some legal differentiators can only be drawn through the coarse and blurry optics of economics (i.e. the two-dimensional risk-return profile of options), the approach might nevertheless allow some general guidelines³⁷⁸. The following illustration visualises this understanding:

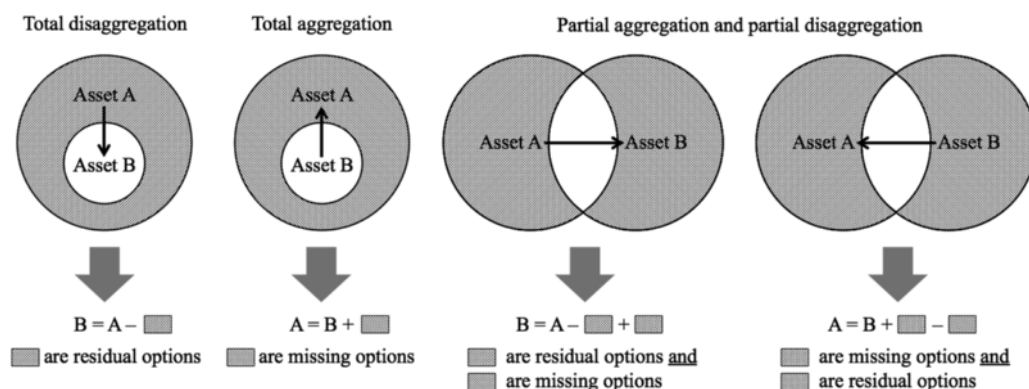


Illustration 5: Residual and / or missing options due to imperfect replication

2.2.5.4 Aggregation must be applied restrictively

- 93 The baseline for the specific aspect of aggregation and disaggregation is the same as for the general application and interpretation of the OECD MTC³⁷⁹: the legal form³⁸⁰. Starting from that point, the two schemes merely

³⁷⁵ See par. 95.

³⁷⁶ See par. 56.

³⁷⁷ Equally: *Anthony Polito*, p. 792.

³⁷⁸ Equally: *Sven-Eric Bärsch*, p. 82 et seqq.

³⁷⁹ See par. 72 and 75(3).

³⁸⁰ IFA, 54th IFA Congress, Munich 2000 Summaries of Discussion on Subjects I and II, Bulletin for International Taxation 2001, Vol. 55, No. 2, p. 81 et seq.

head in opposite logical directions (i.e. aggregation as an external financial engineering versus disaggregation as an internal financial engineering). It appears therefore that aggregation and disaggregation are qualitatively identical in that the “weaknesses [...] inherent in one of these methods also will be inherent in the other”³⁸¹. Consequently, the tools available for the analytical analyses of disaggregation would be principally the same and could also be used for the context-specific analysis of aggregation.

Side note: The IAS/IFRS know some techniques for aggregation³⁸² such as micro hedging³⁸³ (i.e. one single position), portfolio hedging³⁸⁴ (i.e. more than one position with similar risk profiles) and macro hedging³⁸⁵ (i.e. more than one position with dissimilar risk profiles) – each for both fair value³⁸⁶ (i.e. on asset level) and cash flow³⁸⁷ (i.e. on income level). In particular, they provide the concept of *economic relationship*³⁸⁸ as a possible basis for such context-specific analysis.³⁸⁹ In addition, under specific conditions there is an exception from the general prohibition of aggregation³⁹⁰ for offsetting financial assets and financial liabilities³⁹¹. The effectiveness of such right to set-off is, however, a legal matter³⁹² and would therefore necessarily have to follow the domestic interpretation³⁹³.

94 However, as a result of the original approach³⁹⁴ there is a conditional difference between the two schemes in the sense of a logical one-way dependency. This one-way dependency has implications for the applicability of aggregation only and shall be explained in the following. As a result from that study³⁹⁵,

- a tax system was called “universal” where it specifies a tax treatment for every possible transaction (comprehensive scope);
- a tax system was called “consistent” where the total tax on all patterns or boxes is always equal (horizontal view);
- a tax system was called “linear” where the total tax on all particular options is always equal to the total tax on all patterns or boxes, which can be replicated or synthesised with these options (vertical view);
- a tax system was called “continuous” where the total tax on all patterns or boxes similarly composed is similarly high (robustness);
- linearity is the strongest condition, consistency the weakest and continuity is in between: linear tax systems are thus always continuous but non-linear tax systems are not always non-continuous. Continuous tax

³⁸¹ *Jeff Strnad*, bifurcation and integration, p. 562.

³⁸² For an overview see *Dana Doege*, p. 22 et seqq.

³⁸³ IFRS 9.6.3.1.

³⁸⁴ IFRS 9.6.1.3.

³⁸⁵ IFRS 9.6.6.1(c).

³⁸⁶ IFRS 9.6.5.2(a) and 9.B6.5.1.

³⁸⁷ IFRS 9.6.5.2(b) and 9.B6.5.2.

³⁸⁸ IFRS 9.6.4.1(c)(i) and 9.B6.4.4 et seq.

³⁸⁹ For a comprehensive examination see Dominik Dettenrieder, p. 191 et seqq.

³⁹⁰ IAS 1.29; IFRS 4.BC106.

³⁹¹ IAS 32.42 et seq. and 32.45.

³⁹² *Hartenberger, Heike* in *Beck, IFRS / IAS*, p. 213, par. 259; *Lof, Michiel van der / Laan, Peter*, Accounting for Financial Instruments in Accordance with IFRS, Derivatives & Financial Instruments 2010, Vol. 12, No. 2a / Special Issue, sec. 7.

³⁹³ Equally: IAS 32.AG38B et seqq.

³⁹⁴ See par. 90.

³⁹⁵ *Jeff Strnad*, conceptual framework, p. 578, 595 and 598.

systems are always consistent but non-continuous tax systems are not always non-consistent. Consistent tax systems are not always continuous but non-consistent tax systems are always non-continuous. And continuous tax systems are not always linear but non-continuous tax systems are always non-linear.

- The following illustration visualises this understanding:

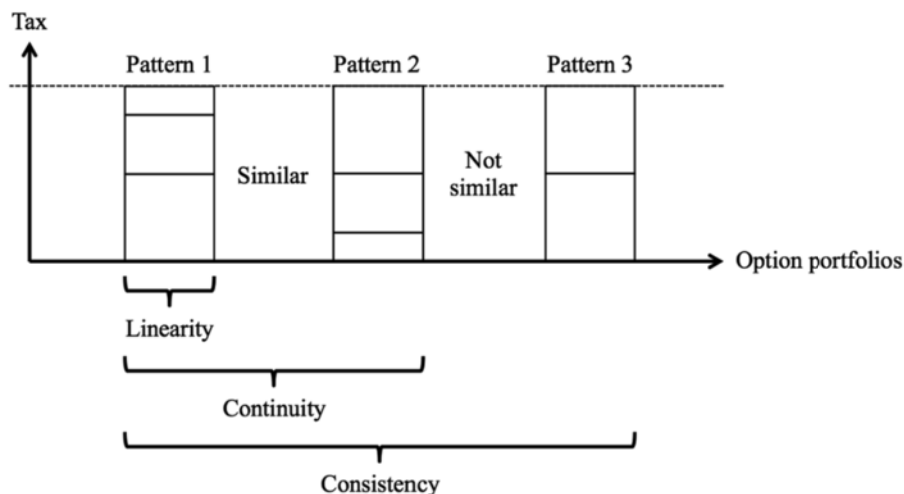


Illustration 6: Linearity, continuity and consistency of tax systems

- 95 It is apparent that pursuant to these definitions the OECD MTC may be universal but is neither linear (which is why the issue of aggregation and disaggregation even exists) nor consistent (e.g. the different allocation of taxation rights to the source jurisdiction pursuant to the patterns or boxes of the distributive articles). Hence, it cannot be a continuous tax system either. Continuity comes, however, into effect first and foremost in the context of aggregation³⁹⁶. Starting from the legal form³⁹⁷, only aggregation requires and presumes the contextual or situative information of what shall be in scope or not in scope of the consolidation³⁹⁸. In other words: only where the objects or items for such pairing of the original and the target instrument are predetermined can the missing options for replicating or synthesising the original by the target instrument be deduced by reversing the direction (i.e. conversely replicating or synthesising the target by the original instrument). Where this contextual or situative information is missing, however, an axiomatic aggregation³⁹⁹ is arbitrary, non-directional or “blind” and its coincidental result highly sensitive to the continuity of the tax system⁴⁰⁰. This is because the treatment of the respective pattern is erratic in that the consolidation of the

³⁹⁶ *Jeff Strnad*, conceptual framework, p. 602.

³⁹⁷ See par. 100.

³⁹⁸ See par. 88(3).

³⁹⁹ *Pistone, Pasquale / Romano, Carlo*, Short report on the proceedings of the 54th IFA Congress, Munich 2000, Bulletin for International Taxation 2001, Vol. 55, No. 1, p. 35, advocating that “integration should instead apply whenever the components of a hybrid are linked in a way that investors would not acquire them separately.”

⁴⁰⁰ *Jeff Strnad*, conceptual framework, p. 602.

original financial instrument with one set of options leads to a significantly different treatment than the consolidation of the same original financial instrument with another set of options⁴⁰¹.

Example 12: For the total aggregation in Illustration 5⁴⁰² the information that asset A shall be replicated or synthesised by asset B must be predetermined. Only under this condition is it possible to derive the missing options by way of conversely replicating or synthesising asset B by asset A. In contrast, the partial replication or synthesis in Illustration 4⁴⁰³ of the “classic” financial instrument by the “derivative” financial instrument consolidates also some particular options (data points) from the environment. As the aggregation scheme points upward to the taxpayer as the highest level of aggregation⁴⁰⁴, at some point the question arises whether or not income or transactions from different source jurisdictions may or shall be consolidated. The possibility to establish triangular relationships is another example of the discontinuity of treaty law.

As stated above, the conclusion from that study for tax policy making was that continuity requires a highly restrained or cautious invocation of aggregation schemes in imperfect tax systems with special attention to and great care for the risks of exacerbating the distortions from the deeper and therefore inevitable inconsistencies⁴⁰⁵. From the author’s point of view, this rationale can also be transferred to the interpretation of the OECD MTC. Since the OECD MTC is an inconsistent and therefore uncontinuous tax system, the possible benefits of aggregation would most likely be outweighed by the negative effects. As a first interim conclusion for the further course of this study, any interpretation towards aggregation is therefore subject to particularly strict requirements, which justifies going beyond the literal or textual interpretation only as an absolute exception. That is why a consolidation of an asset or transaction upwards from its legal form can not be justified by the *substance over form* principle (e.g. hedges or other composite units).

2.2.5.5 What can be learned from the IAS/IFRS

96 That said, in the following the disaggregation shall be analysed in more detail. In this respect, some commentators take the position that any splitting of financial instruments into components and their separate treatment was generally not compatible with the OECD MTC⁴⁰⁶. However, the problem is quite fundamental in that it is actually inseparable from the *substance over form* principle⁴⁰⁷. Even an option on one underlying as the most simple unit⁴⁰⁸ can be seen either legally as a bet agreement⁴⁰⁹ or economically as a present disposition

⁴⁰¹ Comprehensively: OECD, ST/SG/AC.8/2001/CRP.8, p. 31 et seqq., par. 115 et seqq.

⁴⁰² See p. 48.

⁴⁰³ See p. 47.

⁴⁰⁴ See par. 88(5).

⁴⁰⁵ Jeff Strnad, conceptual framework, p. 603 et seq.

⁴⁰⁶ Sven-Eric Bärsch, p. 107 et seq., 238 and 323, without justification; Haslechner, Werner in Klaus Vogel Commentaries 2015, p. 927, par. 91, without justification and confusing the applicative aspect of aggregation and disaggregation in the narrow sense with the interpretative aspect of aggregation and disaggregation in the broader sense (see par. 85).

⁴⁰⁷ See par. 85.

⁴⁰⁸ See par. 89.

⁴⁰⁹ David Hasen, p. 429. Dolan, Kevin / DuPuy, Carolyn, Equity Derivatives: Principles and Practice, Virginia Tax Review 1995, Vol. 15, Issue 2, p. 207 et seq. See also par. 70.

of future interests in that underlying, namely its contingent value appreciation⁴¹⁰. Although the baseline is the legal form⁴¹¹, any treatment of the option must nevertheless face the question of whether it stops at the derivative alone (form) or goes beyond towards the underlying (substance). As regards options as the building blocks of financial instruments, this dualism is reflected by the strong interdependencies between the strike price of the option, the probability of success and the gain from the underlying⁴¹². Even when following the very formal view, the determination alone of whether that option participates in profits pursuant to Art. 10(3) OECD MTC or rather represents a sale pursuant to Art. 13(5) OECD MTC made it necessary to also consider the underlying. Any deviation from the derivative level is, however, actually a disaggregation by way of look-through⁴¹³ to the underlying⁴¹⁴. And there appears no reason why and according to which criteria “more complex” financial instruments shall be treated differently (e.g. a composite strategy of two options in one legal contract). Like the *substance over form* principle in general, the author takes the view that it is not a question of whether or not financial instruments are to be disaggregated but only in which scope and to what extent. As will be shown throughout the further course of this study, disaggregation is – consciously or unconsciously – actually also applied in various respects of treaty interpretation and application.

Relevant IAS/IFRS provisions

97 In this respect, the IAS/IFRS do not take a holistic approach by way of a general principle of interpretation but, rather, a casuistic approach⁴¹⁵ by way of explicit individual regulations:

- (1) In the context of a comprehensive conceptual framework project, the IAS/IFRS tackle the question of disaggregating financial instruments with characteristics of *equity*⁴¹⁶. These are research activities with a special focus on dual-character “derivatives”. The value of such instruments is solely dependent on the equity value but their form of settlement causes them to be classified as *liabilities*. Although these questions deal with the disaggregation of “derivative” financial instruments as well, they nevertheless point to the subjacent interpretational issue of distinguishing *equity* and debt (i.e. the disaggregation in the broader sense) and are therefore subject of section 2.⁴¹⁷
- (2) IAS 32.28 provides the separation of non-“derivative” financial instruments as a general principle. This provision takes the issuer’s perspective⁴¹⁸ and must furthermore be seen in the special context of the different purposes, intentions and functions of the IAS/IFRS⁴¹⁹ as opposed to the OECD MTC. However, conclusions may nevertheless be drawn from its subjacent economic rationale as to the disaggregation of certain “hybrid” financial instruments.

⁴¹⁰ IAS 32.AG17 and IAS 32.AG20; *Huffman Schenk, Deborah / Cunningham, Noel B.*, Taxation without Realization: A Revolutionary Approach to Ownership, *Tax Law Review* 1992, Vol. 47, Issue 4, p. 775 et seq.; *David Hasen* accurately adding that “the only relevant difference from an ordinary prepaid forward contract is that the option is for a contingent part of the property” (p. 427) and “Appreciation and risk of loss are characteristics of property, not property itself. Viewing an option sale as the sale of ‘property’ consisting solely of appreciation or liability is mistaken because it treats a feature of property – that it can increase or decline in value – as itself property.” (p. 428).

⁴¹¹ See par. 93.

⁴¹² IFRS 7.BC29. See also par. 65.

⁴¹³ See par. 72.

⁴¹⁴ IAS 32.AG20.

⁴¹⁵ *Dana Doege*, p. 39.

⁴¹⁶ See par. 47.

⁴¹⁷ See par. 86.

⁴¹⁸ IAS 32.AG30. See also par. 46(2).

⁴¹⁹ See par. 45.

- (3) IFRS 9.4.3 provides the concept of *embedded derivatives*, which treats the applicative scheme of disaggregation as is understood in the narrow sense here. The provision specifies the conditions and the mode of isolating or separating “derivative” financial components from compound instruments.
- (4) IFRS 9.6 deals with the specific aspect of *hedge accounting*, i.e. the effect of mitigating risks by using financial instruments. Hedging is primarily a concept of aggregation⁴²⁰. However, it may nevertheless allow conclusions on the admissibility and structuring (including disaggregation) of *hedging instruments* and *hedging items* based on the dependencies between various risks and their influencing factors.
- (5) IFRS 4.10 provides the concept of *unbundling* (i.e. disaggregating) insurance and deposit components from compound contracts. However, the requirement⁴²¹, permission⁴²² and prohibition⁴²³ of such *unbundling* merely depend on practical considerations with regard to the clear and reliable quantifiability of these components rather than on qualitative ones⁴²⁴. Conversely, the aggregation of separated insurance and deposit contracts into one was also discussed within the scope of IFRS 4.10 but not pursued any further⁴²⁵. For these reasons, the provision does not provide further insights usable for this study.

Transfer of relevant IAS/IFRS provisions

98 Because the IAS/IFRS obviously have to face the same conceptual difficulties as the tax law⁴²⁶, they provide some general perceptions on the structural rationale. These may also be transferable to the application of the OECD MTC. I shall now attempt to do so. IAS/IFRS terminology:

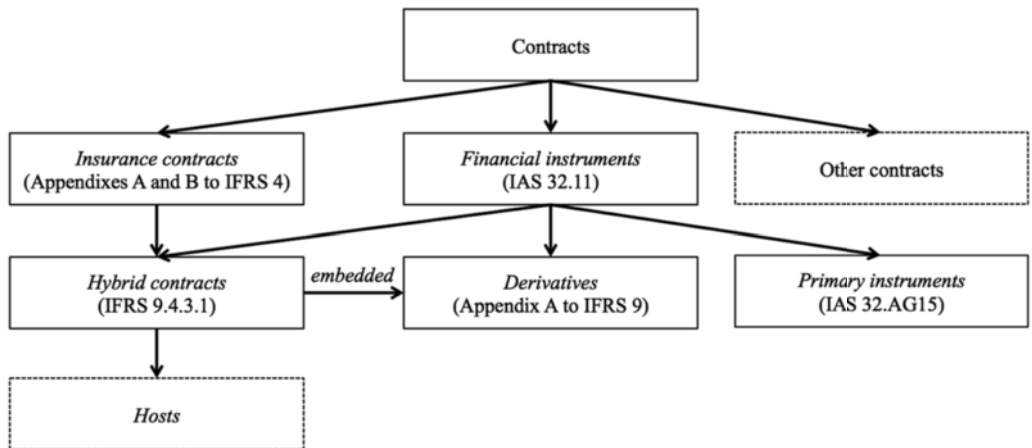


Illustration 7: IAS/IFRS terminology

⁴²⁰ See par. 59.

⁴²¹ IFRS 4.10(a).

⁴²² IFRS 4.10(b).

⁴²³ IFRS 4.10(c).

⁴²⁴ IFRS 4.BC45 et seq.

⁴²⁵ IFRS 4.BC54.

⁴²⁶ See par. 88.

The following list of findings is limited to IAS/IFRS regulations on disaggregation, which potentially allow universal statements by way of transferring their rationale to the OECD MTC. In addition, the IAS/IFRS provide a wide range of further similar requirements and prohibitions with regard to disaggregation. However, these are situative⁴²⁷ and/or IAS-/IFRS-specific (such as depending on the measurement regime, e.g. at fair value versus at amortised cost) and therefore do not allow universal statements.

- (1) The IAS/IFRS limit the scope of disaggregation to *financial instruments*⁴²⁸. Namely, contracts on *non-financial items* are excluded, even where these are similarly fashioned as financial instruments (e.g. commodity options)⁴²⁹. The subjacent rationale seems to classify the underlying actually into belonging either to real economy or financial economy⁴³⁰. The reason is that the contracting parties are, in effect, trading the *non-financial item*. Thus, the IAS/IFRS actually distinguish between primary market transactions and secondary market transactions. In the author's view, this criterion and therefore the exclusion of contracts on *non-financial items* from the disaggregation scheme cannot be transferred to the OECD MTC:
 - Though it is true that the contracting parties are economically trading the *non-financial item*, this conclusion already implies and requires disaggregation (i.e. to that non-financial underlying item)⁴³¹.
 - This is also the reason why it is inconsistent to say that, on the one hand, an option was a participation in future interests in its underlying (i.e. its contingent value appreciation)⁴³² but was, on the other hand, distinct from it⁴³³. Instead, it is correct to hold that an option is legally distinct from its underlying (form) but economically inseparable from it (substance)⁴³⁴. This principle is generally valid for all kinds of underlyings and therefore demands application of the disaggregation scheme, irrespective of the nature of the underlying.
 - As stated before, it is illusory to draw a dividing line between “financial” and “non-financial” contracts, as it is one of their conceptual features and specific peculiarities to blur these boundaries⁴³⁵. That is why their distinction – such as between a gross physical settlement and delivery of the underlying and a non-physical net settlement in cash or substitutes⁴³⁶ – is basically ineffective, as it does not touch the fundamental economic character of the transaction.
- (2) Among the *financial instruments*, the disaggregation is further prohibited where the *host* of a *hybrid* – taken separately – is a *financial instrument* itself⁴³⁷ (non-qualified host). However, this restriction is mainly rooted in considerations of practical simplification that outweigh the original intention of the disaggregation scheme to prevent abuse⁴³⁸. Further, the possibility of reutilising separated *embedded derivatives* for the purpose of *hedge accounting* finally did not convince the IAS Board. The IAS-/IFRS-specific reason is that

⁴²⁷ Among others: IFRS 9.B4.3.5 or 9.B4.3.8.

⁴²⁸ IAS 32.28, IFRS 9.4.3.

⁴²⁹ *Kuhn / Hachmeister*, p. 771 et seqq., par. 5 et seqq.; *Dana Doege*, p. 18.

⁴³⁰ IAS 32.AG20. Except where they are net settled (IAS 32.AG22).

⁴³¹ Circular reasoning. See also par. 96.

⁴³² IAS 32.AG17 and 32.AG20.

⁴³³ IAS 32.AG17.

⁴³⁴ See par. 91.

⁴³⁵ See par. 87. Equally: IFRS 9.BC6.179.

⁴³⁶ IAS 32.AG20 et seq.; Anna Verena Matthies, p. 51.

⁴³⁷ IFRS 9.4.3.2 and 9.BC6.117. This was a change when transitioning from IAS 39, according to which the disaggregation of *embedded derivatives* was required for all assets (IFRS 9.BC4.83 et seqq.).

⁴³⁸ IFRS 9.BC4.88 et seqq.

an enhanced accuracy of the risk management reporting was considered an even less important priority of the disaggregation scheme⁴³⁹. After all, this is even more illusory than drawing a dividing line between “financial” and “non-financial” contracts⁴⁴⁰. For these reasons, the exclusion of *hybrids* with non-qualified *hosts* from the disaggregation scheme can, in the author’s view, not be transferred to the OECD MTC.

- (3) An *embedded derivative* is subject of a mandatory⁴⁴¹ separation from its *host* only if it has, among other conditions, the following cumulative key characteristics:
- It is a component of a *financial instrument* that also includes a non-“derivative” *host*, and neither is contractually transferable independently of that instrument nor has a different counterparty.⁴⁴²
 - In delimitating the “derivative” from *insurance contracts*⁴⁴³, its underlying may not be a variable specific to one of the contracting parties⁴⁴⁴.
 - Some of the cash flows of the *financial instrument* vary in a similar way to a stand-alone *derivative*.

Example 13: SFAS 133.21(a)(i) admitted by IAS 8.12⁴⁴⁵ provides that value changes of the compound position between 9% and 11% are considered as similar where the value of the stand-alone position changes by 10%.⁴⁴⁶

- The *embedded derivative* earmarks some or all of the cash flows that would otherwise be required by the underlying.⁴⁴⁷
- The economic characteristics and risks of the *embedded derivative* are not closely related to the economic characteristics and risks of the *host*.⁴⁴⁸ The reason behind this is the axiomatic assumption that closely related *embedded derivatives* are unlikely to being employed for abusive purposes.⁴⁴⁹
- A separate *financial instrument* with the same terms as the *embedded derivative* would meet the definition of a *derivative*.⁴⁵⁰

These conditions show, for one thing, that also the IAS/IFRS take the legal form as the baseline for the above question⁴⁵¹ of where the disaggregation starts⁴⁵². They further emphasise and concretise this finding in that the “derivative” component may not be transferable independently. By doing so, they also give indications on the integrity of financial instruments⁴⁵³.

⁴³⁹ IFRS 9.BC6.120 et seq.

⁴⁴⁰ See par. 98(1). Argumentum a maiore ad minus.

⁴⁴¹ Hartenberger, Heike in Beck, IFRS / IAS, p. 173, par. 141 and 143; Kuhn / Hachmeister, p. 705, par. 11.

⁴⁴² IFRS 9.4.3.1. et seq.

⁴⁴³ See par. 67.

⁴⁴⁴ IFRS 9.4.3.1 and 9.BA.5.

⁴⁴⁵ IFRS 4.BC18.

⁴⁴⁶ Equally: Dominik Dettenrieder, p. 137.

⁴⁴⁷ IFRS 9.4.3.1.

⁴⁴⁸ IFRS 9.4.3.3(a).

⁴⁴⁹ IFRS 9.BCZ.4.92.

⁴⁵⁰ IFRS 9.4.3.3(b) and Appendix A of IFRS 9.

⁴⁵¹ See par. 93.

⁴⁵² Hartenberger, Heike in Beck, IFRS / IAS, p. 172, par. 137; Oldeweme, Daniel Johannes, Die Bilanzierung von Commodity-Hedges nach International Financial Reporting Standards (IFRS), Dissertation No. 3523, University of Sankt Gallen, Sankt Gallen, 2008, p. 137, accurately observing that also IFRS 9.6.2.6 appears to implicitly stipulate a distinction between individually contracted financial instruments incorporating multiple (embedded) “derivatives” (i.e. aggregation) and financial instruments generated by multiply contracted “derivatives” (i.e. disaggregation).

⁴⁵³ Similarly: Kuhn / Hachmeister, p. 62, par. 51. See also par. 85 and 91.

Example 14: A simple termination right or option in a loan agreement is not to be separated (i.e. it is not a financial instrument), whereas complex financial covenants may be.

In addition, the IAS/IFRS are also in line with the above understanding⁴⁵⁴ that legal risks cannot be “resolved” but only transferred, in that *derivatives* with different contracting counterparties are to be separated, even if otherwise combined. Consequently, the IAS/IFRS further support the view that the existence of financial instruments is predominantly a matter of the legal form⁴⁵⁵.

- (4) An aggregate of multiple *embedded derivatives* may not be further disaggregated to the extent that they relate to the same risk type or factor.⁴⁵⁶ In other words: the risk type or factor represents the limit at which the disaggregation is to be stopped⁴⁵⁷. In addition, non-optional *embedded derivatives* (e.g. forwards) may generally not be further disaggregated into optional *embedded derivatives* (i.e. options)⁴⁵⁸, as otherwise a symmetric risk with a value of zero⁴⁵⁹ could be arbitrarily replicated by an asymmetric risk with a positive value⁴⁶⁰.⁴⁶¹
- (5) Under certain IAS-/IFRS-specific conditions, the currency risk⁴⁶² component (from the reporting currency perspective) may be separated. This possibility is limited to specific non-“derivative” *financial instruments*.⁴⁶³ A further disaggregation beyond the currency risk (e.g. into the particular market risk components) is not permitted. This specific restriction reflects the difficulties in reliably and predictably attributing or allocating value changes to such other risks (especially the market risk components).⁴⁶⁴ It may therefore be assumed in turn that the limitation to non-“derivative” *financial instruments* is likely to have its reason in the fact that the currency risk component of *derivatives* is particularly difficult to separate from their other risk components (e.g. where the underlying is traded in a different currency).⁴⁶⁵ Accordingly, a counter-exception are embedded currency *derivatives*, which obviously bear no other risks than their singular currency risk, and may therefore be separated from their *host*. This possibility is limited to transactions not denominated in currencies, which are norm or custom pursuant to common market practice (functional currency), as in these cases a close relation to the *host*⁴⁶⁶ is assumed.

Side note: A further requirement for a close relation to the *host* is that the embedded currency “derivative” is non-leveraged and non-optional.⁴⁶⁷ In the author’s view, this additional requirement is however owed to and must therefore be seen in the IAS-IFRS-specific context

⁴⁵⁴ See par. 78.

⁴⁵⁵ See par. 77.

⁴⁵⁶ IFRS 9.B4.3.4; *Hartenberger, Heike in Beck, IFRS / IAS*, p. 175, par. 147; *Kubn / Hachmeister*, p. 712, par. 47 et seq.

⁴⁵⁷ See par. 88(5).

⁴⁵⁸ IFRS 9.B4.3.3.

⁴⁵⁹ See par. 64.

⁴⁶⁰ See par. 67.

⁴⁶¹ *Kubn / Hachmeister*, p. 707 et seq., par. 25.

⁴⁶² Appendix to IFRS 7.

⁴⁶³ IFRS 9.6.2.2 and 9.B6.2.5.

⁴⁶⁴ IFRS 9.BC6.191; *Oldeweme, Daniel Johannes*, Die Bilanzierung von Commodity-Hedges nach International Financial Reporting Standards (IFRS), Dissertation No. 3523, University of Sankt Gallen, Sankt Gallen, 2008, p. 128 et seq.

⁴⁶⁵ Argumentum e contrario.

⁴⁶⁶ IFRS 9.BCZ4.93 et seq., exempting hybrids with a host that is no financial instrument from the obligation to separate embedded derivatives.

⁴⁶⁷ IFRS 9.BCZ4.100.

of reassessing *embedded derivatives*⁴⁶⁸, which are not featured to adapt themselves to changes in external circumstances (e.g. market developments)⁴⁶⁹. As a result, this specific context and, consequently, this additional requirement is not transferable to the OECD MTC.

Transferred to the broader understanding of financial instruments in this study as opposed to the narrower understanding by the IAS/IFRS⁴⁷⁰, this condition is however always fulfilled. For securitised *financial instruments* in particular, their trading currency is per se such custom pursuant to common market practice. But also as regards non-securitised *financial instruments* in general, in the context of international tax law the functional currency is always the tax currency, the reason being is that the tax payment as the fulfilment of the legal obligation necessarily requires a realised transaction⁴⁷¹. Consequently, there is no other way than to determine the functional currency pursuant to domestic tax law, which is per se such norm pursuant to common market practice. It may therefore be systematically permissible and technically feasible to separate the currency component from financial instruments on the OECD MTC level by way of disaggregation. However, following the IAS/IFRS rationale it is economically unnecessary. In addition, the only reasonable alternative for classifying a currency component separated from any other income type was capital *gains*, for which it was equivalent to sales proceeds. Since income is a split-off from capital⁴⁷², it was, however, impossible to determine the corresponding acquisition transaction, as the following example demonstrates:

Example 15: A dividend payment in another currency might be considered an “acquisition” of that currency. However, the dividend as a legal split-off of economical substance from the share is already contained in the economical value of the share at the time of its acquisition. Consequently, it is principally not the dividend payment itself but the acquisition of the share that could represent an “acquisition” of the currency. However, the dividend entitlement is not only unknown or even unexpected at the time of acquiring the share. In case it exceeds the market expectations it can even be itself a constituting value driver of the share. This makes a viable determination of any acquisition transaction eventually impossible, even retrospectively.

- (6) Under certain IAS-/IFRS-specific conditions, the underwriting spot element and the time-based forward element may⁴⁷³ be separated from specific options⁴⁷⁴ or aggregates thereof⁴⁷⁵ and from forwards⁴⁷⁶. Consequently, this equally applies to currency basis spreads⁴⁷⁷, as these bear no other risks than their singular currency risk (i.e. the underwriting element)⁴⁷⁸ and interest rate risk (i.e. the time-based element).

⁴⁶⁸ IFRS 9.B4.3.11.

⁴⁶⁹ IFRS 9.BCZ4.100 et seqq.

⁴⁷⁰ See par. 98(1).

⁴⁷¹ Similarly: Haufe, IFRS, p. 1867, par. 35.

⁴⁷² See par. 79.

⁴⁷³ Critically: *Dominik Dettenrieder*, p. 165 et seqq.

⁴⁷⁴ IFRS 9.6.2.4(a).

⁴⁷⁵ IFRS 9.B6.5.31.

⁴⁷⁶ IFRS 9.6.2.4(b).

⁴⁷⁷ IFRS 9.6.2.4(b).

⁴⁷⁸ See par. 98(5).

Side note: A currency basis spread is the difference between the market interest rates of two currency areas. In contrast to exchange swaps, currency basis spreads also swap the principal amount and therefore contain a time-based element⁴⁷⁹.

However, there is a general exception in analogy to the prohibited disaggregation of non-optional into optional *embedded derivatives*⁴⁸⁰: written (short) options or aggregates thereof representing a net short position do not qualify for this separation, unless and to the extent that they are designated as an offset to an individual purchased (long) option or an aggregate thereof representing a net long position⁴⁸¹. This is because options represent an asymmetric risk⁴⁸². Due to the net short position, such asymmetric risk is, however, to the detriment of the taxpayer in that its potential loss could be significantly greater than its potential gain. Assuming a rational taxpayer, short options are therefore considered as ineffective for hedging purposes⁴⁸³. In that regard, there is no economic substance justifying a disaggregation into short options⁴⁸⁴. Conversely, purchased (long) options or aggregates thereof always qualify for this separation: the asymmetric risk from net long positions is advantageous for the taxpayer in that its potential gain could be significantly greater than its potential loss. Again, assuming a rational taxpayer, long options are therefore considered as effective for hedging purposes⁴⁸⁵. There is, therefore, a strong economic substance justifying a disaggregation into long options.

- (7) In contrast to the temporal aggregation as a designation of parts of the duration for hedging purposes⁴⁸⁶, the corresponding temporal disaggregation of the time-based element is not permitted (e.g. swaps into a series of forwards)⁴⁸⁷. However, an exception is formed by the time-based elements of long options⁴⁸⁸ as well as of forwards and currency basis spreads⁴⁸⁹ which are to be further separated into *transaction related* and *time-period related* components⁴⁹⁰. As regards options, the reason is that economically they represent a protection or insurance⁴⁹¹ against asymmetric (downside) risks⁴⁹² and still allow the participation in favourable changes.⁴⁹³ These one-sided risks can relate to capitalised transactions (i.e. *transaction related*, e.g. capital gains) or to non-capitalised transactions (i.e. *time-period related*, e.g. dividends, interest)⁴⁹⁴. As regards forwards and currency basis spreads, the reason is that they are considered economical insurances⁴⁹⁵,

⁴⁷⁹ Kuhn / Hachmeister, p. 326, par. 86.

⁴⁸⁰ See par. 98(4).

⁴⁸¹ IFRS 9.6.2.1, 9.6.2.6 and B6.2.4.

⁴⁸² See par. 64.

⁴⁸³ IAS 39.AG94; Haufe, IFRS, p. 1857, par. 12; Dominik Dettenrieder, p. 181 et seq.; Diana Doege, p. 50.

⁴⁸⁴ Equally: Kuhn / Hachmeister, p. 318, par. 50.

⁴⁸⁵ IFRS 9.BC6.195.

⁴⁸⁶ Haufe, IFRS, p. 1860, par. 19, and p. 1866, par. 34; Kuhn / Hachmeister, p. 335, par. 140; Dominik Dettenrieder, p. 160 et seq.

⁴⁸⁷ IFRS 9.6.2.4(c); Haufe, IFRS, p. 1860, par. 19; Kuhn / Hachmeister, p. 318, par. 52, and p. 367 et seq., par. 315. Critically: Dominik Dettenrieder, p. 131 et seq., generally questioning the transferability of the IAS/IFRS disaggregation scheme to the IAS/IFRS hedging technique due to their different and perhaps incompatible purposes.

⁴⁸⁸ IFRS 9.6.5.15(a).

⁴⁸⁹ IFRS 9.6.5.16.

⁴⁹⁰ Critically: Dominik Dettenrieder, p. 173 et seq., arguing that such distinction was not always clearly and reliably determinable.

⁴⁹¹ See par. 70.

⁴⁹² See par. 64.

⁴⁹³ IAS Board, portfolio hedging, p. 29, par. 3.5.6.

⁴⁹⁴ IFRS 9.B6.5.29 and 9.BC6.391 et seqq.

⁴⁹⁵ IFRS 9.BC6.418.

even though they do not represent an asymmetric risk. This is demonstrated by the observation that they are typically used where a risk of depreciation of the *hedged item* will in any case be protected at a specific value, even by accepting a potential loss in the *hedging instrument* itself. Consequently, their time-based elements (i.e. their forward components)⁴⁹⁶ can be *transaction related* and/or *time-period related* as well⁴⁹⁷. The *transaction related* component is represented by that part of the option, forward or currency basis spread, which would be attributed to a hypothetical perfect hedge of that transaction⁴⁹⁸. The hypothetical remainder represents the *time-period related* component⁴⁹⁹. In the author's understanding, this view provides an important redline for the distinction of capital *gains* from the other income types of financial instruments in that it qualitatively decomposes the time-based element and systematically allocates its components depending on their economic context.

- (8) Correspondingly, the interest rate risk may be separated as well⁵⁰⁰; where the time-based element (interest rate) is clearly and reliably determinable⁵⁰¹, this must necessarily also apply to potential changes of that time-based element (interest rate risk)⁵⁰².
- (9) The restrictive disaggregation scheme under IAS/IFRS, not allowing its voluntary or optional application beyond the permissions and mandatory obligations, is axiomatic and therefore controversial⁵⁰³. In the absence of any explicit provision, undoubtedly there are no option rights with regard to disaggregation in the OECD MTC either. The discussion shows, however, that the IAS/IFRS approach would, in principle, be transferable to other circumstances as well.

2.2.5.6 What can be learned from finance theory

- 99 Having discussed its admissibility, scope and granularity, the disaggregation scheme shall now be examined content-wise. All finance theories cited in the aforementioned tax studies⁵⁰⁴ describe a positive relation between risk and return, in that a higher venture demands a higher compensation and vice versa. On the other hand, risky and riskless positions have in common that the capital or principal is not at the disposal of the investor, for which he will in any case demand a time-dependent compensation (opportunity costs). This relation can most generally be expressed by the following equation⁵⁰⁵:

Return from risk-based positions = return from time-based positions + risk premium

This means that the return from risk-based positions always includes the return from time-based positions, since underwriting risk implies timing risk⁵⁰⁶. Conversely, however, the return from time-based positions can, except for credit risk⁵⁰⁷, never *include* the return from risk-based positions, since timing risk does not in turn

⁴⁹⁶ IFRS 9.BC6.416 and 9.BC6.424.

⁴⁹⁷ IFRS 9.B6.5.34.

⁴⁹⁸ IFRS 9.B6.5.32, 9.B6.5.33(a), 9.B6.5.37, 9.B6.5.38(a) and 9.B6.5.39; IFRS 9.BC6.396.

⁴⁹⁹ IFRS 9.B6.5.32, 9.B6.5.33(a), 9.B6.5.37, 9.B6.5.38(a) and 9.B6.5.39; IFRS 9.BC6.397.

⁵⁰⁰ IFRS 9.5.3.2.

⁵⁰¹ See par. 98(6).

⁵⁰² Argumentum a minori ad maius.

⁵⁰³ Dominik Dettenrieder, p. 160, 168 et seqq. and 190 et seq.; Oldeweme, Daniel Johannes, Die Bilanzierung von Commodity-Hedges nach International Financial Reporting Standards (IFRS), Dissertation No. 3523, University of Sankt Gallen, Sankt Gallen, 2008, p. 138 et seq.; Nguyen, Tristan, Bilanzuelle Abbildung von Finanzderivaten und Sicherungsgeschäften: Hedge Accounting nach HGB und IAS / IFRS, Munich, 2007, p. 188 et seq. with further citations.

⁵⁰⁴ See footnote 365.

⁵⁰⁵ Equally: Kuhn / Hachmeister, p. 706, par. 17.

⁵⁰⁶ See par. 69.

⁵⁰⁷ IFRS 9.BC6.503.

imply underwriting risk. In other words: while the return from time-based positions compensates timing risk only, the return from risk-based positions compensates both underwriting risk and timing risk.

The role and limitations of finance theory

100 As stated above⁵⁰⁸, there are, however, no absolutely riskless positions but only relatively riskless ones. That is why finance theory draws its implications exclusively from the *levels* of risk and does not say anything about the *types* of risk. Consequently, risk-based and time-based positions are economically fluid and situative categories (e.g. a debtor's credit risk can be higher than an equity's business risk)⁵⁰⁹. Tax law in general and the position-by-position approach of the OECD MTC⁵¹⁰ in particular call, however, for a clear and universal separation line between the income types of financial instruments⁵¹¹. Indeed, any attempt to bring these two heterogeneous dimensions perfectly in line is illusory, which is another reason why finance theory alone cannot distinguish between *dividends* and *interest*⁵¹². However, the implied suggestion that this was necessary at all was an overrun and may not lead to giving up the entire interpretation and application of law in favour of economy⁵¹³. The mere existence of law in general and tax law in particular is proof enough that there are obviously more and conflicting interests and objectives than just the *substance over form* principle (e.g. legal certainty, coherence, operational practicability, etc.)⁵¹⁴. The material object of tax law may not be mixed up with the formal methodology of law making. From this perspective it can be accepted that the formal construct of tax law is materially no more than an approximate model of economic facts⁵¹⁵. Even turning law into economy would still cause other legal distortions (e.g. a tax bias of financial accounting legally bound to tax classifications). Instead, it remains the interpretational question, which relative importance or priority the *substance over form* principle shall be given. The key of knowledge lies hidden where finance theory still contributes to legal interpretation and not where legal interpretation already fails at finance theory. In this regard, the glass is half full rather than half empty. On the other hand, any further mismatch and distortion between form and substance beyond having exhausted the general principles of interpretation then has to be accepted in favour of the other conflicting interests of the law.

101 That said, the mere *level* of risk can never be a priority and even less the sole differentiator between the income types of financial instruments. In order to apply the general guidelines pursuant to the *substance over form* principle⁵¹⁶ under the OECD MTC, the level of risk nevertheless appears to be the crucial assessment factor for qualifying the relative importance of the particular fields of legal attributes of financial instruments, since, where this relative importance of legal criteria shall be evaluated in terms of their economic results (i.e. the *substance over form* principle)⁵¹⁷, the assessment factor as the measurement reference must necessarily be

⁵⁰⁸ See par. 62.

⁵⁰⁹ Similarly: Harris, Peter A., *Corporate Tax Law: Structure, Policy and Practice*, Cambridge University Press, Cambridge, 2013, p. 192.

⁵¹⁰ See par. 59 and 76.

⁵¹¹ Marjaana Helminen, dividend concept, p. 167, accurately calling it an "imaginary line".

⁵¹² See par. 92.

⁵¹³ OECD, ST/SG/AC.8/2001/CRP.8, p. 30, par. 109; Anthony Polito, p. 762, calling those attempts "fruitless" and "mindless".

⁵¹⁴ Similarly: Peter Hongler, p. 270 and 272.

⁵¹⁵ "Taxable income is not economic income, it is at best a transaction-based approximation to economic income, which is itself only a proxy for some more fundamental policy goal." (Anthony Polito, p. 765 et seq., and on p. 774 et seq., calling the distinction between equity and debt a legal fiction).

⁵¹⁶ See par. 78.

⁵¹⁷ See par. 72.

an economic parameter as well. Due to the fact that economics has only two dimensions⁵¹⁸, risk is, however, the only permissible qualifier for such evaluation. The return as the only other economic qualifier left is no qualitative parameter that allows universal statements, but rather a quantitative one that depends on individual circumstances. The approach for analysing financial instruments must therefore be a multi-stage process of risk identification, risk disaggregation and risk elimination, before such risk evaluation may reveal the relative importance of those particular fields of criteria:

- (1) As the first methodological step, any particular risk must be disaggregated and its components classified by *type* (i.e. by its source or origin) into legal and non-legal risks⁵¹⁹. However, legal risks were said to be not “resolvable” but only convertible by transfer or re-allocation⁵²⁰ and therefore by accepting new legal risks⁵²¹. This entire first step of identifying legal risks must therefore necessarily be subject to form over substance (i.e. by its formal source or origin). In contrast to the infinite-dimensional legal form, the economic *substance over form* approach would not be able to qualitatively identify and separate different types of risk (such as legal risk⁵²²), since risk as a whole is its sole qualitative dimension⁵²³. As I have said earlier, in the absence of any explicit provision or implicit principle within the OECD MTC, the aggregation scheme can typically not be justified positively⁵²⁴. Consequently, any subsequent step is to be performed regularly based on the disaggregation scheme only. Ergo, disaggregation is de facto a one-way downward. The consequent tax planning possibilities and distortions by discretionarily choosing or structuring the legal (contractual) form of the financial instrument⁵²⁵ are the lesser of the two evil alternatives⁵²⁶ and therefore acceptable in favour of the other conflicting interests of the law⁵²⁷.
- (2) Once the legal risk has been identified by way of that form over substance analysis, the *substance over form* principle can then be applied as a subsequent logical step in order to reveal the relative importance of those particular fields of criteria. However, another interim conclusion can be drawn from the fact that legal risks cannot be “resolved” but only converted by transferring or re-allocating them and therefore accepting new legal risks⁵²⁸. Any relative level of risk found as a result of having disaggregated a financial instrument can imperceptibly be of two principal kinds: it could represent either an economic gross risk or a “managed” or “engineered” (hedged) net risk in the sense of being replicated or synthesised.

Example 16: Where a structured product has been disaggregated, a currency risk may stem gross from the trade currency of the underlying straightforward *share* or net from a hedge strategy synthetically embedded into the structured product itself (e.g. physically-settled compo or quanto equity swaps⁵²⁹). Methodologically the underlying straightforward *share* and the structured product do not differ from the perspective of legally classifying them into

⁵¹⁸ See par. 89 and 92.

⁵¹⁹ IFRS 9.B5.7.14 and 9.BC6.473 as well as analogously for aggregation: IFRS 9.6.4.1(c)(ii) and 9.B6.4.7 et seq. See also par. 78 and 62.

⁵²⁰ *Gaspar Lopes Dias*, tax arbitrage, p. 14.

⁵²¹ See par. 78.

⁵²² Equally: IFRS 9.BC6.470 and 9.BC6.504.

⁵²³ Similarly: *Anna Verena Matthies*, p. 80.

⁵²⁴ See par. 95.

⁵²⁵ *Harris, Peter A.*, *Corporate Tax Law: Structure, Policy and Practice*, Cambridge University Press, Cambridge, 2013, p. 205.

⁵²⁶ See par. 95.

⁵²⁷ See par. 100.

⁵²⁸ See par. 101(1).

⁵²⁹ *Juan Ramirez*, p. 21 et seq.

the distributive articles of the OECD MTC. As a consequence, the conceptual features and specific peculiarities of financial instruments make it impossible to see to which of those two categories that currency risk belongs⁵³⁰.

However, as regards legal risks, any replication or synthesis would finally lead to the same results (i.e. gross and net legal risks are always equal). Legal risks therefore appear to be of no superior importance for the further distinction between non-legal risks. Where the additional assumption is taken that legal risks do not significantly differ across the different jurisdictions and types of financial instruments, they even become irrelevant. Consequently, the level of legal risks can only be exploited by quantitatively comparing it with the level of non-legal risks rather than qualitatively draw further conclusions from it. As another finding for the further course of this study, legal risks must therefore be eliminated from the successive disaggregation.

- (3) In contrast to the legal risks, the gross and net of non-legal risks is not always equal, which is why non-legal risks merit further disaggregation. The revolving process of risk disaggregation, risk elimination and risk assessment in order to pick out the non-legal risks and put them in relation to each other stops where the relative risk levels of the components from a next iteration's disaggregation would not significantly change any more. This is the point where unrelated risks are close to being "pure" or where related risks fall into the same category. For instance, the sub-risk of a duration extension might increase the default risk and therefore falls into the same category.
- (4) The result of such multi-stage process is a selection of non-legal risk types, each represented by a closed and homogeneous portfolio of replicating options⁵³¹. A particular risk type can now be merged into a specified reference portfolio (e.g. a straightforward *share* or bond) by mixing their replicating options. From the response or behaviour of that consolidated option portfolio it should be possible to draw qualitative reverse deductions towards some general or universal guidelines for its legal classification.

Portfolio theory as a reference model

- 102 Without going too deep into finance theory, this approach shall be very briefly introduced in the following, before the conclusions are drawn. The said reference option portfolio must be designed in order to meet two conditions: (1) it must allow objective or universal statements independent of individual circumstances, which (2) are as close as possible to the legal distinction between the income types of financial instruments. Namely, it must be as close as possible to the distinction between *dividends* pursuant to Art. 10(3) OECD MTC and *interest* pursuant to Art. 11(3) OECD MTC, as the *other income* pursuant to Art. 21(1) OECD MTC can then be negatively distinguished as the residual. As modern portfolio theory has shown⁵³², such reference portfolio contains one risky (risk-based) and one riskless (time-based) position⁵³³. The risk-return relation of such a reference portfolio and its complement of two risk-based positions can be visualised as follows:

⁵³⁰ See par. 87.

⁵³¹ See par. 91.

⁵³² Markowitz, Harry Max, Portfolio Selection, The Journal of Finance 1952, Vol. 7, Issue 1, p. 77 et seqq.

⁵³³ See par. 96.

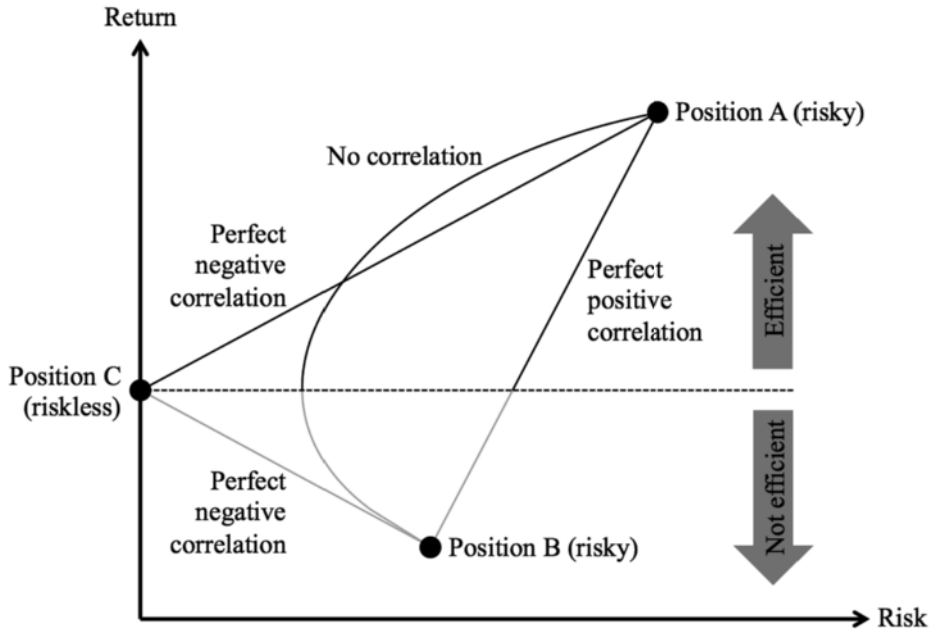


Illustration 8: Option portfolio of non-legal risks (B) and reference portfolio (A, C)

103 Position B represents the particular option portfolio of non-legal risks as the experimental object of the respective sub-analysis. C represents the riskless position in the above sense of the one with the lowest relative risk⁵³⁴. Though not absolutely riskless, position C as the deemed purely time-based position is nevertheless the theoretical ideal-type of a *debt-claim*⁵³⁵ implying an *interest*⁵³⁶. As such, it does not only meet the second above condition of being as close as possible to its legal intention⁵³⁷. It is also easy to distinguish from *other income*, which must thus necessarily be a risk-based income type. In addition, position C also meets the first above condition of allowing universal statements independent of individual circumstances, as it can be objectively determined by publicly available information. Unlike position C, position A represents the theoretical ideal-type of a *share* implying a *dividend*⁵³⁸. As such, position A is, however, more difficult to determine, as it must also be distinguished from *other income* and is not available as publicly available information. Nevertheless, it should be permissible to assume that any company has a minimum of regulatory core equity. Bringing everything together results in three use cases:

- (1) The financial instrument to be analysed refers to *one single* share as its underlying, regardless of how that underlying is further modified (e.g. by adding or subtracting certain effects). In this case, position A is the regulatory core equity of that share.

⁵³⁴ See par. 62 and 100.

⁵³⁵ IFRS 9.4.1.3(b); *Christoph Berentzen*, p. 82.

⁵³⁶ See par. 53 et seq.

⁵³⁷ See par. 102.

⁵³⁸ See par. 53 et seq.

- (2) The financial instrument to be analysed refers to *more than one* share as its underlying, regardless of how these underlyings are further modified. In this case, position A is the weighted regulatory core equity of these shares.
- (3) The financial instrument to be analysed refers *not to a* share. In this case, it can not bear any genuine equity-related risk. Instead, it can only be designed to replicate each and every particular non-legal risk or option portfolio of a certain share synthetically with the same or a similar non-legal risk-return profile. However, not only can such identical risk-return profile not be the only differentiator⁵³⁹. More important is that such synthetic replication was possible only at the price of higher legal risks⁵⁴⁰. And this was economically unreasonable, as the mere existence of that share was said to be *ceteris paribus* proof enough that the underlying business enterprise cannot be replicated more efficiently⁵⁴¹. This means as another conclusion for the further course of this study that financial instruments not formally referring to a *share* as their underlying can by themselves not be *shares* pursuant to Art. 10(3) OECD MTC or profit-participating *debt-claims* pursuant to Art. 11(3) OECD MTC (form over substance).

104 Thus, also position A is determinable in that it meets the two above conditions of allowing universal statements independent of individual circumstances and of being as close as possible to its legal intention⁵⁴². We can now come to the analysis of the response or behaviour of that consolidated portfolio between one risk-based and one time-based position by mixing their replicating options with those representing the particular non-legal risk type to be analysed.

Applying the model

- 105 The two positions A (*share*) and C (*debt-claim*) are mutually exclusive. Therefore, position B as the option portfolio representing the particular non-legal risk can correlate
- (1) positively with the option portfolio representing position A (*share*), which coincidentally means a negative correlation with the option portfolio representing position C (*debt-claim*). It is the hyperbolic line between A and B that morphs into the form of the straight line between A and B, the more the positive correlation between A and B approximates perfection. That a riskless position (C) can positively or negatively correlate with a risky position (B) is no principal contradiction. The reason is that C is not absolutely riskless but merely represents the position with the lowest relative risk⁵⁴³.
 - (2) negatively with the option portfolio representing position A (*share*), which coincidentally means a positive correlation with the option portfolio representing position C (*debt-claim*). It is the hyperbolic line between A and B that morphs into the form of the straight line between A and C, the more the negative correlation between A and B approximates perfection. Where the negative correlation between A and B is perfect, C is perfectly replicated synthetically by A and B.
 - (3) with neither position A (*share*) nor position C (*debt-claim*). It is the hyperbolic line between A and B that does not morph at all.

⁵³⁹ See par. 92.

⁵⁴⁰ Jieyin Tang, bifurcation or integration, sec. 5.1.; Jieyin Tang, substance vs. form, sec. 3.2.1. See also par. 78.

⁵⁴¹ See par. 88(4).

⁵⁴² See par. 102.

⁵⁴³ See par. 62 and 100.

- 106 These use cases demonstrate that any particular non-legal risk type can be clearly classified into either “equity-like” or “debt-like”, depending on its relatively higher correlation to the one or the other.

Example 17: The US federal tax law takes the correlation coefficient between a financial instrument and its underlying („delta“) to determine its tax classification (sec. 871m US tax code). In contrast, the correlation approach in this study is, however, not applied to a financial instrument in its entirety, as finance theory alone cannot classify it⁵⁴⁴. Instead, it is applied to particular risk types in order to draw qualitative reverse deductions towards some general or universal guidelines for its legal classification.

Moreover, the smaller or higher correlation to the one or the other can indicate their relative weight to other risk types. These relative weights can then be used as the said assessment factors for qualifying the relative importance of those particular fields of legal criteria of financial instruments under the OECD MTC⁵⁴⁵. In this respect, the income types of financial instruments are somewhat successively pulled apart, until their overlap is reduced to a minimum⁵⁴⁶. In a subsequent step, the findings can then be applied to the disaggregation of “more complex” instruments.

2.2.5.7 Conclusions

- 107 Taking this approach, it should therefore be permissible to draw, for example, the following preliminary conclusions towards the income types of financial instruments, which form the subject of a further detailed examination in the following sections:
- (1) One of the most important differentiators between *shares* pursuant to Art. 10(3) OECD MTC and *debt-claims* pursuant to Art. 11(3) OECD MTC appears to be the effective subordination. The reason for this is that subordinated principal, especially equity, primarily absorbs all risks by participating in losses first and in profits last⁵⁴⁷. In other words: the more subordinated a *debt-claim* is, the more it approximates, *ceteris paribus*, to a *share* in this respect.
 - (2) The effective duration or maturity of financial instruments in the sense of when the control over the disposal of the capital or principal returns to the investor considerably influences their risk-return profiles. While the short-term volatility typically decreases, the long-term default risks necessarily increase⁵⁴⁸.
 - (3) For the same reason, there appears to be a significant difference between financial instruments with notional or floating capital or principal and those with actual principal. While the former limits the risks to the return, the latter puts also the capital or principal itself at risk. Since the basic ideal-type of both *shares* and *debt-claims* has an actual capital or principal respectively, a notional capital or principal might be an indicator to *other income* pursuant to Art. 21(1) OECD MTC.
 - (4) On the other hand, the temporal payment profile does not seem to be a differentiator of major importance. In the sense that any payment profile is economically capitalised or discounted, it is independent of the timing⁵⁴⁹. In other words: it is the underwriting element rather than the time-based element of payments

⁵⁴⁴ See par. 92.

⁵⁴⁵ See par. 101.

⁵⁴⁶ See Illustration 5 on p.48.

⁵⁴⁷ Equally: *William Plumb*, p. 422; for IAS / IFRS: *Anna Verena Matthies*, p. 151 et seq.

⁵⁴⁸ Equally: IFRS 9.5.5.19 et seq. and 9.B5.5.10 et seq.; *William Plumb*, p. 416; *David Hariton*, equity and debt, p. 506; See also par. 69.

⁵⁴⁹ Equally: *Haufe*, IFRS, p. 1711, par. 165.

which significantly affects the risk-return profile. Admittedly, just as the effective duration or maturity of the capital or principal affects its own default risk, the effective payment date of the remuneration affects its own default risk⁵⁵⁰.

Example 18: The risk-return profile of a long-term zero bond with notional principal depends exclusively on the remuneration.

However, considering the typical value ratio between the remuneration on the one hand and the capital or principal on the other illustrates that the former is of minor importance compared to the latter⁵⁵¹. Nevertheless, the significance of the time-based element increases as a consequence of a longer duration or maturity of the financial instrument⁵⁵².

- (5) The origin of the capital or principal, i.e. injection from the outside or accumulation from the inside, appears to be a matter of no vital importance as regards the risk-return-profile. Subject of the economic assessment is the asset as a whole, regardless of where its funds originate from, since the risk-return-profile is basically a concept of pre-tax considerations. Admittedly, reinvested gains are at the same risk as the capital or principal itself⁵⁵³. However, considering the typical value ratio between gains on the one hand and the capital or principal on the other illustrates that the former is regularly of minor importance compared to the latter⁵⁵⁴.
- (6) Membership rights (e.g. voting, management, etc.) represent legal risks and do therefore not need to be disaggregated. Even in a special particular case, where they, exceptionally, represented non-legal risks, they would typically not have a material impact on the total risk-return profile. For these reasons, membership rights are of subordinate importance compared to proprietary rights⁵⁵⁵.
- (7) Risk considerations also support the above conclusions of not separating options from their underlyings but instead treating the two as one logical concept or mechanism⁵⁵⁶. The reason for this is that already upon contracting in the option the underlying's risk burden as one of its most important economic interests changes between the contracting parties. Just like selling the underlying, writing an option on that underlying transfers its impairment risk to the option holder in the way that the owner's (i.e. the option writer's) interest changes from value appreciation into the opposite of value depreciation⁵⁵⁷. This transfer of risks is independent of the option's later execution, by which that risk is merely materialised. In other words: it is the actual signing of the option which transfers the underwriting risk⁵⁵⁸ from the underlying. In contrast, the execution of the option actually represents the redemption of a contingent debt transaction, i.e. of financing the underwriting risk from the underling⁵⁵⁹, and therefore timing risk.

⁵⁵⁰ Equally: *David Hariton*, equity and debt, p. 507.

⁵⁵¹ Similarly: *Kolbrenner, Scott Marc*, Derivatives Design and Taxation, Virginia Tax Review 1995, Vol. 15, Issue 2, p. 242 et seq.

⁵⁵² See par. 107(2).

⁵⁵³ Equally for IAS/IFRS: IAS Board, June 2015, 5A, p. 17, par. 64.

⁵⁵⁴ Equally for IAS/IFRS: IAS Board, June 2015, 5A, p. 16, par. 59(b).

⁵⁵⁵ Equally: *Sven-Eric Bärtsch*, p. 238; for IAS / IFRS: IAS Board, June 2015, 5A, p. 16, par. 59(a); *Anna Verena Matthies*, p. 149.

⁵⁵⁶ See par. 96 and 98(1).

⁵⁵⁷ *David Hasen*, p. 429.

⁵⁵⁸ See par. 67.

⁵⁵⁹ *David Hasen*, p. 429.

108 However, the methodological restrictions and limitations of the approach substantially re-narrow its broad possibilities and therefore must be kept well in mind when drawing such conclusions:

- (1) As stated before⁵⁶⁰, the approach should allow objective or universal statements. While the positions A (*share*)⁵⁶¹ and B (*debt-claim*)⁵⁶² meet this condition, position B (non-legal risk type) strongly depends on the context. Although the approach is independent of the absolute level of risk⁵⁶³, it may nevertheless vary between different business enterprises and might therefore cause distortions⁵⁶⁴. For instance, a specific risk type may correlate stronger with equity of one business enterprise, while simultaneously correlating stronger with debt of another. This effect may appear particularly in win-lose situations⁵⁶⁵, which are a typical characteristic of financial transactions⁵⁶⁶ (e.g. where the profit from equity or *other income* of one party is the debt from a loss of the other).
- (2) Another aspect of the requisite objectivity and universality is that the implications must also be independent of domestic law. As stated above, the domestic tax law constitutes a taxable event first, before becoming the subject of treaty law.⁵⁶⁷ The domestic tax law presumes and therefore implies the legal facts from non-tax fields of domestic law⁵⁶⁸. All these legal facts from tax and non-tax fields of domestic laws are in principle infinite⁵⁶⁹, which is why they themselves can't serve as differentiators in the OECD MTC. Instead, they must be grouped or abstracted to some higher-level treaty types of differentiators⁵⁷⁰. In other words: the implications from the approach must begin and end with some "generic" types of legal criteria, which represent the limitations of the legal form and the autonomous interpretation of the OECD MTC⁵⁷¹.
- (3) In addition, due to the fundamental incompatibilities and conflicts⁵⁷² between the economic equivalence of financial instruments⁵⁷³ and the schedule-based system of the OECD MTC⁵⁷⁴, the implications gained from the approach can be consistent only to a certain extent. No approach based on legal criteria can overcome the conceptual deficiencies of the OECD MTC. This also explains why the disaggregation scheme can only be as good as its components⁵⁷⁵.
- (4) Disaggregation in practice requires considerably detailed price or value information⁵⁷⁶ (complete market requirement⁵⁷⁷), limiting its applicability to marketable and liquid components.

⁵⁶⁰ See par. 102.

⁵⁶¹ See par. 104.

⁵⁶² See par. 103.

⁵⁶³ See par. 101.

⁵⁶⁴ *Anthony Polito*, p. 793 et seq.

⁵⁶⁵ See Example 4 on p. 29.

⁵⁶⁶ IAS 32.11; *Gaspar Lopes Dias*, tax arbitrage, p. 14; *David Hasen*, p. 402, 406 and 408; *Huang, Peter H.*, A Normative Analysis of New Financially Engineered Derivatives, Southern California Law Review 2000, Vol. 73, Issue 3, p. 503.

⁵⁶⁷ See par. 21.

⁵⁶⁸ See par. 80.

⁵⁶⁹ *Anthony Polito*, p. 781 et seq.

⁵⁷⁰ See sec. 2.4.

⁵⁷¹ See par. 85 et seq.

⁵⁷² See par. 100.

⁵⁷³ See par. 89.

⁵⁷⁴ See par. 76.

⁵⁷⁵ *David Hasen*, p. 469; *Anthony Polito*, p. 782.

⁵⁷⁶ *Jieyin Tang*, bifurcation or integration, sec. 4.1.

⁵⁷⁷ *Jeff Strnad*, conceptual framework, p. 578.

- (5) Finally, the implications from the approach back to some “generic” differentiators can only be drawn from the two dimensions of the economic risk-return profile⁵⁷⁸.

That is why the approach will not be understood and cannot be used as a best practice or technique for classifying financial instruments on daily case-by-case basis. Rather, it represents an attempt to draw some general guidelines for a classification into the income types of financial instruments⁵⁷⁹. Instead of any direct top-down approach as to what extent the *substance over form* principle justifies the disaggregation scheme to apply in the OECD MTC, it seems to the author more promising and more robust to indirectly work out these distinction criteria in order to make the inherent and implicit systematic interdependencies between them clearer and more transparent. In other words: a strong and logical system combining a certain degree of disaggregation with some clear and flexible distinction criteria, by simultaneously resting on a minimum of pre-conditions⁵⁸⁰, suggests itself more easily and enjoys more acceptance than any axiom. These would necessarily give rise to significant qualification conflicts and could at worst exclude a significant number of jurisdictions from the scope or application of the OECD MTC⁵⁸¹.

2.3 Analysis and discussion of the systematic context

2.3.1 Preliminary remarks

- 109 The purpose of this section is to outline a clear and distinct understanding of selected systematic aspects of the distributive articles themselves, as far as relevant for this study. Like the analysis and discussion of basic principles before⁵⁸², a first the objective is to present the author’s view of these aspects. Another objective is to concretise these aspects in order to set a clear scope and to identify specific key differentiators for classifying the income types of financial instruments. Finally, this section has also the objective to provide a comprehensive discussion, comparison and integration of the different opinions, which have already been expressed elsewhere.
- 110 In contrast to the preceding analysis and discussion of basic principles, most of the aspects discussed in this section are already concrete enough to be taken from the explicit or at least be derived from the implicit wording of the OECD MTC by way of legal interpretation. However, in order to ensure a maximum of consistency, all this is carried out by carefully embedding the systematic aspects into those general guidelines found in the preceding sections. That is why the way of interpretation in this section is significantly influenced by the above findings. Where it is considered reasonable and appropriate, the following considerations also take the liberty of transferring some structural findings and parallels from other legal sources to the OECD MTC.

⁵⁷⁸ See par. 92.

⁵⁷⁹ See par. 101.

⁵⁸⁰ See par. 90.

⁵⁸¹ “There was a general consensus that there are insuperable practical or technical obstacles to the adoption of a bifurcation regime” (IFA, 54th IFA Congress, Munich 2000 Summaries of Discussion on Subjects I and II, Bulletin for International Taxation 2001, Vol. 55, No. 2, p. 82.

⁵⁸² See sec. 2.2.

2.3.2 Relations between the distributive articles

- 111 As stated earlier⁵⁸³, the main function of the distributive Art. 10, 11, 13 and 21 OECD MTC is to restrict or limit the allocation of taxation rights to the source jurisdiction⁵⁸⁴. Just as for all distributive articles in the OECD MTC, this function is served best by covering as much income as possible taxed by domestic tax laws⁵⁸⁵. In fact, it means that the scope of the distributive articles has to be as broad or comprehensive as possible⁵⁸⁶. However, their scope is limited to what the contracting jurisdictions jointly intended to regulate at all⁵⁸⁷. In other words: gaps within, between or around the distributive articles may be considered only where there is certain indication that the contracting jurisdictions did explicitly not intend to regulate that respective point at all.
- 112 In this intentional context, it is the consensus view⁵⁸⁸ that the entire set of all distributive articles shall completely and comprehensively cover all income considered or treated as taxable by the jurisdictions. In other words: there are no gaps either among Art. 10, 11, 13(5) and 21(1) OECD MTC or between these and any other distributive provision.
- 113 Further, there is consensus⁵⁸⁹ on the point that Art. 10, 11, 13(5) and 21(1) OECD MTC generally do not overlap, i.e. they are mutually exclusive:
- (1) As regards to Art. 10 and 11 OECD MTC, the contrary position⁵⁹⁰ is rejected predominantly as it
 - is based on parts of Art. 10(3) OECD MTC which are not only to be interpreted domestically but also subsidiary to other parts being interpreted autonomously⁵⁹¹;
 - also conflicts with the clear wording in (limb 2 of) Art. 10(3) OECD MTC, which explicitly and distinctly negates *debt-claims* as exclusively employed by Art. 11(3) OECD MTC.
 The subsequent question as to whether that mutual exclusivity between Art. 10 and 11 OECD MTC may be a result of either a subordinate relationship⁵⁹² or of their equal position on the same level or rank⁵⁹³

⁵⁸³ See par. 19.

⁵⁸⁴ Equally: *Harris, Peter A.* in IBFD Commentaries on Art. 10 OECD MTC, sec. 1.1.2.1.; OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-1 et seq., par. 5; *Harun Ogutu, Andrew* in *Schilcher / Weninger*, p. 277; *Kragen, Adrian A.*, Double Income Taxation Treaties: The O.E.C.D. Draft, California Law Review 1964, Vol. 52, No. 2, p. 323.

⁵⁸⁵ *Klaus Vogel* Commentaries 1997, p. 358, par. 2.

⁵⁸⁶ See par. 19 et seqq.

⁵⁸⁷ *Rainer Prokisch*, interpretation, p. 56 et seq.

⁵⁸⁸ *Gaspar Lopes Dias*, debt-claims, sec. 3.1.; *Dürschmitt, Daniel* in *Vogel / Lehner*, p. 781, par. 2; *Cui, Shanshan* in *Thomas Ecker*, p. 638; *Febér, Tamás* in *Eva Burgstaller*, p. 238; *Wattel / Marres*, fictitious income, p. 69.

⁵⁸⁹ *Harris, Peter A.* in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.2.4.1.; *Gaspar Lopes Dias*, debt-claims, sec. 3.1.; *Pöllath, Reinhard / Lohbeck, Allit* in *Vogel / Lehner*, p. 1291, par. 5b; *Kopp, Karin E.M.* in *Wolfgang Schön*, equity and debt, p. 850; *Santos, Ramon Tomazela*, Tax Treaty Qualification of Income Derived from Hybrid Financial Instruments, Bulletin for International Taxation 2013, Vol. 67, No. 10, sec. 4.3.; *Peter Hongler*, p. 262; *Avery Jones* Commentaries, sec. 5; *Eberhartinger / Six*, p. 10; *Martin Six*, hybrid finance, sec. 3.; *Jakob Bundgaard*, perpetuals, p. 140; *Febér, Tamás* in *Eva Burgstaller*, p. 238 and 244; *Carmine Rotondaro*, redemption, p. 266; *Michael Lang*, hybrids, p. 90, p. 104, 111 and 121; OECD, Report on Thin Capitalization, Issues in International Taxation 1987, No. 2, p. 25, par. 60; OECD, CFA/WP1(73)2, p. 8, par. 13.

⁵⁹⁰ *Tischbirek, Wolfgang / Specker, Gerhard* in *Vogel / Lehner*, p. 1219, par. 201, and *Klaus Vogel* Commentaries 1997, p. 657, par. 200a, both explicitly giving precedence (*lex specialis*) only to the extent that the provisions refer to the domestic tax laws; perhaps: *Helminen, Marjaana* in IBFD Commentaries on Art. 10 OECD MTC, sec. 6.2.2., without taking clear position.

⁵⁹¹ *Michael Lang*, hybrids, p. 39 et seq. See also par. 268 et seqq.; Federal Court of Australia, judgement ref. [2008] FCA 1570, 2008.

⁵⁹² *Kaesler, Christian / Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1325, par. 136, and p. 1407, par. 10; *Hans Pijl*, interest, sec. 6.2.; perhaps: *Martin Six*, hybrid finance, sec. 3.

⁵⁹³ *Peter Hongler*, p. 262.

will be addressed later⁵⁹⁴, but is not of vital importance for the further course of this study⁵⁹⁵. As a result of their mutual exclusivity, the consistent and coherent system of Art. 10 and 11 OECD MTC demands that their autonomous parts must basically lead to equivalent results⁵⁹⁶.

- (2) As regards Art. 13(5) OECD MTC, the provision is subsidiary to Art. 11 OECD MTC and therefore also to Art. 10 OECD MTC⁵⁹⁷.

As regards Art. 21(1) OECD MTC, the provision is also subsidiary to Art. 10, 11 and 13(5) OECD MTC. This is a result of its character as a residuary clause for all other distributive articles⁵⁹⁸, which may, however, not extend the scope of the OECD MTC as a whole⁵⁹⁹. It means that any gap within or among Art. 10, 11 and 13(5) OECD MTC or between these and any other distributive provision necessarily fall under Art. 21(1) OECD MTC.⁶⁰⁰

2.3.3 Beneficial ownership

2.3.3.1 Preliminary remarks

- 114 Although *beneficial ownership* is primarily a concept of subjective (re-)attribution rather than of objective income classification, it nevertheless appears to bear a close and strong nexus with a number of subject areas in this study. Accordingly, it is important to have a clear understanding and distinction of *beneficial ownership* in mind when analysing the tax treatment of financial instruments under the OECD MTC in order to avoid false conclusions. Considering the vital importance of this for the current way of making financial transactions, it proved to be insufficient and possibly misleading to exclude it from the scope of this study⁶⁰¹. The purpose and objective of this section is therefore to analyse the concept of *beneficial ownership* in order to provide the author's understanding of its various aspects and implications on the classification of the income types of financial instruments.

2.3.3.2 Definition and scope

- 115 Financial transactions are often made indirectly by inserting a third party into the legal relationship between the investor and the investment, i.e. a financial intermediary. This intermediary (e.g. bank, broker, agent, issuer, fiduciary, nominee, administrator, etc.) may act on behalf of the investor or on his own behalf. In any case, such intermediation is typically arranged in a way that there is a legal or contractual obligation for the intermediary to pass any proceeds or income from the asset to the investor. As this pass-through normally includes any tax levied on that income, the intermediary as the formal taxpayer and the investor as the effective taxpayer

⁵⁹⁴ See par. 204 et seq. and 221.

⁵⁹⁵ Equally: *Gaspar Lopes Dias*, tax arbitrage, p. 132. See also sec. 1.1.2.

⁵⁹⁶ *Kaesler, Christian / Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1427, par. 71.

⁵⁹⁷ Equally: *Harris, Peter A.* in *IBFD Commentaries on Art. 10 OECD MTC*, sec. 5.1.2.5.6., and *Li, Jinyan / Avella, Francesco* on Art. 13 OECD MTC, sec. 6.2.2.; *OECD Commentaries 2014 on Art. 10 OECD MTC*, p. C(10)-11, par. 28, on Art. 11 OECD MTC, p. C(11)-12, par. 20 et seq. and on Art. 13 OECD MTC, p. C(13)-13, par. 31; *Dutch Hoge Raad der Nederlanden*, judgement ref. 28.959, 1994.

⁵⁹⁸ *Eduardo Orellana*, sec. 1; *Alexander Bosman*, p. 98 et seq. and 245; *Rust, Alexander* in *Klaus Vogel Commentaries 2015*, p. 1541, par. 27, and in *Vogel / Lechner*, p. 1922, par. 11; *Wassermeyer, Franz / Kaesler, Christian* in *Wassermeyer Commentaries*, p. 2053, par. 1; *OECD Commentaries 2014 on Art. 21 OECD MTC*, p. C(21)-1, par. 1; *Kopp, Karin E.M.* in *Wolfgang Schön*, equity and debt, p. 846; *Cui, Shanshan* in *Thomas Ecker*, p. 631; *Peter Hongler*, p. 273; *Michael Lang*, hybrids, p. 106; *Klaus Vogel Commentaries 1997*, p. 1071, par. 7.

⁵⁹⁹ *Alexander Bosman*, p. 79; *Rust, Alexander* in *Klaus Vogel Commentaries 2015*, p. 1541, par. 25; *Ismer, Roland* in *Vogel / Lechner*, p. 464 et seq., par. 7; *Cui, Shanshan* in *Thomas Ecker*, p. 638; *Michael Lang*, hybrids, p. 106; *Klaus Vogel Commentaries 1997*, p. 1072, par. 12.

⁶⁰⁰ *Wattel / Marres*, fictitious income, p. 69; *Michael Lang*, hybrids, p. 106; *Klaus Vogel Commentaries 1997*, p. 1072, par. 12.

⁶⁰¹ See par. 11 and 16.

become separate. In such cases, the purpose, intention and function of the treaty⁶⁰² can be reached only by making it available to the effective taxpayer. Ergo, there must be some sort of concept beyond the pure legal circumstances in order to include the effective taxpayer to the treaty benefits and simultaneously exclude the formal taxpayer from them. The legal effect of the concept is a deemed (re-)attribution to the *beneficial owner* instead of to the formal *recipient*.

- 116 This original problem of identifying those mismatches between the legal and the economic enjoyment of the income from the asset is addressed by the concept of the *beneficial owner* as a specific (re-)attribution rule⁶⁰³ within the scope of Art. 10(2) and 11(2) OECD MTC under the general *substance over form* principle⁶⁰⁴. Meanwhile, corresponding to the current secondary objective of the OECD MTC to also prevent double non-taxation⁶⁰⁵, the concept of *beneficial ownership* has the dual purpose⁶⁰⁶ of being also a specific anti-abuse provision⁶⁰⁷ within Art. 10(2) and 11(2) OECD MTC, applicable also to equivalent forms of those mismatches. With respect to the scope of this study⁶⁰⁸, the following analyses primarily focus on the (re-)attributional aspect of the *beneficial owner* concept. In contrast, the anti-abuse aspect shall only be touched where it serves the better understanding of that (re-)attributional aspect. For instance, from the anti-abuse aspect it may be concluded that there must be at least one *beneficial owner*. In order to ensure the application of the OECD MTC, it may also be concluded from the word *the* in Art. 10(2) and 11(2) OECD MTC that there isn't more than one single *beneficial owner* on the same asset or income (i.e. vertical or serial, e.g. a pass-through). An exception to this basic principle may be where there is a group of persons sharing the same legal and economic situation (i.e. horizontal or parallel, e.g. a partnership).⁶⁰⁹
- 117 As regards the interpretation of the term *beneficial owner*, it may legitimately be brought forward that the concept also implies an attribution rule and therefore a certain domestic nexus to a resident person⁶¹⁰, in that any assignment to someone other than the taxpayer could actually frustrate its purpose, intention and function⁶¹¹. However, the mere fact that not all jurisdictions know it in their domestic tax laws⁶¹² makes plain that the concept of *beneficial ownership* is necessarily created by, and therefore can only be dealt with, on the treaty level⁶¹³. This becomes especially clear when considering the OECD MTC as a collective law

⁶⁰² See par. 19.

⁶⁰³ Robert Danon, sec. 3.3.; Adolfo Martín Jiménez, sec. 3.4., with a detailed justification and sec. 4.; Verdoner, Louan / Offermanns, René / Huibregtse, Steef, A Cross-Country Perspective on Beneficial Ownership, European Taxation 2010, Vol. 50, No. 9 / 10, sec. 2.

⁶⁰⁴ Robert Danon, sec. 3.2. See also sec. 2.2.4.

⁶⁰⁵ OECD MTC Draft Update, p. 8, par. 15.2, 15.6 and 16 et seq.; OECD Commentaries 2014, introduction, p. I-5, par. 16.

⁶⁰⁶ Kemmeren, Eric C.C.M. in Klaus Vogel Commentaries 2015, p. 710, par. 6, and p. 716 et seqq., par. 20 et seqq.; OECD Commentaries 2014, p. C(10)-3, par. 12.1, and p. C(11)-7, par. 9.1; Duff, David G. / Reimer, Ekkehart in Michael Lang, beneficial ownership, p. 16 and 258.; Michael Lang, introduction, p. 101, par. 284; Verdoner, Louan / Offermanns, René / Huibregtse, Steef, A Cross-Country Perspective on Beneficial Ownership, European Taxation 2010, Vol. 50, No. 9 / 10, sec. 2.

⁶⁰⁷ See par. 73.

⁶⁰⁸ See sec. 1.2.

⁶⁰⁹ Reimer, Ekkehart in Michael Lang, beneficial ownership, p. 256; Joanna Wheeler, attribution, p. 482.

⁶¹⁰ See par. 21.

⁶¹¹ Duff, David G. in Michael Lang, beneficial ownership, p. 16; similarly: Indonesian Pengadilan Pajak, judgement ref. Put-13602/PP/MLI/13/2008, 2008.

⁶¹² Tischbirek, Wolfgang in Vogel / Lechner, p. 1107, par. 15; Joanna Wheeler, attribution, p. 480.

⁶¹³ Oliver, J. David B., Beneficial Ownership and the OECD Model, British Tax Review 2001, No. 1, p. 85 and 68; OECD, Double Taxation Conventions and the Use of Conduit Companies, Paris, 1986, p. R(6)-4, par. 6.

in the sense of a multinational or multi-jurisdictional compromise⁶¹⁴. True, *beneficial ownership* was said to be indeed a concept of subjective (re-)attribution⁶¹⁵. However, it is the further conclusion that this aspect necessarily also bears a domestic nexus. Given this, it appears an impermissible generalisation to transfer such an aspect from a specific DTC between two jurisdictions, which know a *beneficial ownership* concept in their domestic tax laws, to the OECD MTC in general. Accordingly, the majority of commentators came to the consensus view that the term *beneficial owner* falls under the exception rule *unless the context otherwise requires* in Art. 3(2) OECD MTC⁶¹⁶ and therefore to be interpreted autonomously⁶¹⁷. In addition, the concept of *beneficial ownership* for *dividends* in Art. 10(2) OECD MTC is identical to the one for *interest* in Art. 11(2) OECD MTC.⁶¹⁸

118 Obviously, the purpose of *beneficial ownership* is to go beyond the purely legal relationships. This “quest for the unknown” has led to some uncertainty on the role of the law⁶¹⁹. Accordingly, the questions raised are, for instance:

- What is meant by “non-legal” relations (e.g. illegal)?
- What is the role of economic or purely factual power structures (e.g. between parent and subsidiary entities)?
- Which are their principles and how can these be operationalised for applying the OECD MTC (e.g. what is an “economic interpretation”)?

These ambiguities and questions fall into the two methodological categories of applying the tax law⁶²⁰: (1) the case-by-case assessment or subsumption of concrete facts or attributes from precursory fields of law and (2) the abstract interpretation of the OECD MTC as the tax law itself.

119 As regards the first question of what is meant with “non-legal” relations, it is the author’s understanding that this uncertainty is a result from the confusion of two separate aspects. On the one hand, the concept of *beneficial ownership* can be used to describe a relationship between two persons or subjects (i.e. the *recipient* and the *beneficial owner*). According to the purpose of *beneficial ownership* of going beyond the law, there is no space for this relationship to be anything other than a non-legal one. It is this subject-related aspect,

⁶¹⁴ See par. 18.

⁶¹⁵ See par. 114 et seq.

⁶¹⁶ See par. 20.

⁶¹⁷ *Caroline Poirer*, sec. 2.6., and *Kemmeren, Eric C.C.M.* in *Klaus Vogel Commentaries* 2015, p. 718 et seq., par. 25, and p. 720 et seq., par. 31, both with reference to OECD, *Beneficial Owner*, 2012, p. 3, 18 and 20, deleting the earlier reference to the domestic tax law in OECD, *Beneficial Owner*, 2011, p. 3 and 5; *Tischbirek, Wolfgang* in *Vogel / Lehner*, p. 1107, par. 15; *Raber, Hans Georg* in *Franz Wassermeyer, Festgabe*, p. 304, par. 4; *Katja Dyppel Weber*, sec. 4.1.; OECD Commentaries 2014, p. C(10)-3, par. 12.1, and p. C(11)-7, par. 9.1; OECD, *Beneficial Owner*, 2012, p. 3, par. 2 et seq.; UN, Committee of Experts on International Cooperation in Tax Matters – Report on the sixth Session (18 – 22 October 2010), Economic and Social Council, Official Records 2010, Supplement No. 25, UN, New York, 2011, p. 17 et seq., par. 86 et seq.; *Robert Danon*, sec. 2.1. et seq. and 6.; *Arnold, Brian J.* in *Michael Lang*, *beneficial ownership*, p. 49; Court of Appeal of England and Wales, judgement ref. A3/2005/2497, 2006; *Joanna Wheeler*, attribution, p. 481 et seq.; *Philip Baker*, p. 10-7, par. 10-B13; *du Toit, Charl Petrus*, royalties, p. 237; *Klaus Vogel Commentaries* 1997, p. 562, par. 8; unclear: *Adolfo Martín Jiménez*, in favour in sec. 3.2. but then contrary in sec. 3.4.; perhaps contrary: *Kaesen, Christian / Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1285, par. 69, referring however to the particular protocol amending the specific German-US DTC, and p. 1413, par. 31a, without justification; OECD, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*, OECD, Paris, 2010, p. 9, par. 31, remaining vague on whether or not the exception rule unless the context otherwise requires in Art. 3(2) OECD MTC shall actually apply to the specific case of collective investment vehicles (see par. 11).

⁶¹⁸ OECD, *Beneficial Owner*, 2012, p. 16.

⁶¹⁹ *Tischbirek, Wolfgang* in *Vogel / Lehner*, p. 1106, par. 13, and p. 1108 et seq., par. 17 et seq.; *Kemmeren, Eric C.C.M.* in *Klaus Vogel Commentaries* 2015, p. 723, par. 37; OECD Commentaries 2014, p. C(10)-4, par. 12.4, and p. C(11)-8, par. 10.2; *Adolfo Martín Jiménez*, sec. 3.3., 3.5. and 4; *Charl du Toit*, evolution, sec. 3.2.5.; *Klaus Vogel Commentaries* 1997, p. 562 et seq., par. 10.

⁶²⁰ See par. 72 and 82.

which is typically meant where economic or factual power structures are advocated. On the other hand, the concept of *beneficial ownership* can be used to describe a relationship between a person or subject and an object (e.g. income, asset). Equally, pursuant to the purpose of *beneficial ownership* of going beyond the law, there is again no space for this relationship to be anything other than a non-legal one. It is this object-related aspect, which is typically meant where the legal relationship between the two persons or subjects is advocated. Bringing both ways of interpretation together makes it important to keep and address those two aspects clearly separated. A non-legal relationship between a person or subject and an object can nevertheless be the result of a legal relationship between two or more persons or subjects. The following illustration visualises this understanding:

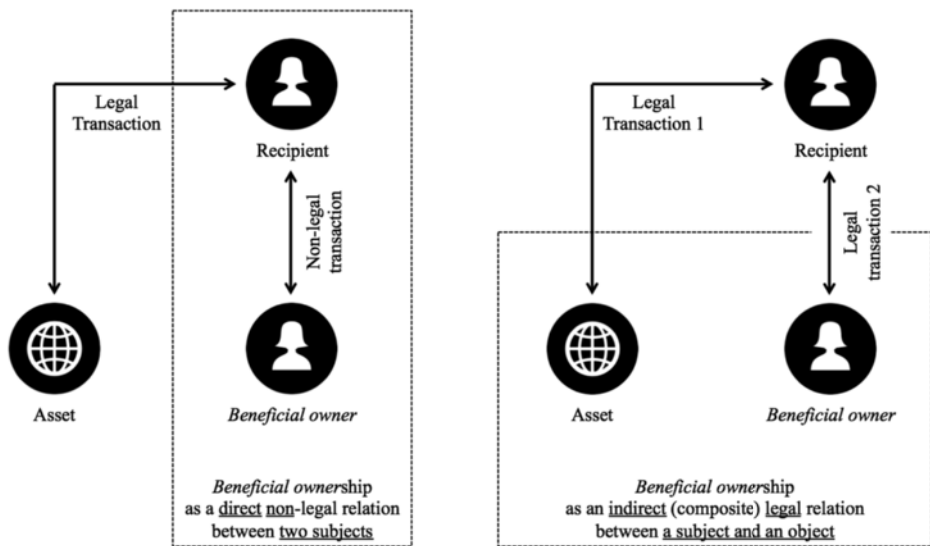


Illustration 9: Subject-related aspect and object-related aspect of *beneficial ownership*

- 120 That said, the supposed ambiguity of *beneficial ownership* seems to be rooted in the application or transfer of the economic or factual power structures from the relation between the two subjects or persons (i.e. the subject-related aspect) to the relation between the subject and the object (i.e. the object-related aspect). Accordingly, the dispute over the relation between the subject (*beneficial owner*) and the object (asset or income) revolves around an imaginary dualism between its legal or non-legal character and interpretation as a methodological approach. In other words: the misunderstanding appears to be caused by confusing the two methodological steps of applying the tax law⁶²¹. It is a consequence of actually transferring the principles of the case-by-case assessment or subsumption of concrete facts or attributes from precursory fields of law to the abstract interpretation of the OECD MTC as the tax law itself.

⁶²¹ See par. 118.

- 121 In this respect, it is in line with the above findings⁶²² and accurate according to the majority of commentators⁶²³ to say that, in the end, an “economic interpretation” or an “economic approach” in terms of *beneficial ownership* do not exist. Ultimately, economic or factual power structures are reducible to legal powers or relations⁶²⁴. However, it shall become clear that this view is limited to the object-related aspect of *beneficial ownership* and to a methodology. In practice, economic or factual power structures between two subjects (i.e. the subject-related aspect) as a matter of fact actually exist (“economic compulsion”, e.g. incentives to take a certain legal choice)⁶²⁵. Nevertheless, with respect to the scope of this study⁶²⁶, the focus here shall be limited to the object-related aspect (i.e. the relation between *beneficial owner* and asset or income). As an interim result for the further course of this study it is held that the *beneficial ownership* is understood in a narrow sense of requiring composite legal transactions between the *beneficial owner* and the asset or income. Mere economic or factual relations are not sufficient. In that sense *beneficial ownership* is a requisite and explicit exception from the finding⁶²⁷ that an aggregation of an asset or transaction upwards from its legal form (i.e. composite units of in- and outflow) basically can not be justified by the *substance over form* principle.

2.3.3.3 Asset- and transaction-related aspect

- 122 Its position between the general allocation rules in Art. 10(1) and 11(1) OECD MTC respectively and their definitions in Art. 10(3) and 11(3) OECD MTC raises the question whether, and to what extent, the concept of *beneficial ownership* affects the definitions and interpretations of the terms *dividends* and *interest*. On the one hand, Art. 10(2) and 11(2) OECD MTC may be understood as mere (re-)attribution rules, leaving the definitions themselves untouched. This view is not only supported by the fact that both provisions refer back to their general allocation rules in the precedent paragraphs by the word *however*. In doing so, they require the terms *dividends* and *interest*, introduced by Art. 10(1) and 11(1) OECD MTC respectively, as a precondition. In addition, only the specific limitation rules in Art. 10(2) and 11(2) OECD MTC depend on the concept of the *beneficial owner* but the general allocation rules in Art. 10(1) and 11(1) OECD MTC⁶²⁸ do not. In other words: the function of *beneficial ownership* is only to affect the amount of tax allocated to the source jurisdiction but not its subjacent legal grounds. These elements of purposive, intentional and functional interpretation may be complemented by the systematic consideration that the legal consequences of Art. 10(2) and 11(2) OECD MTC cannot at the same time as they depend on Art. 10(1) and 11(1) OECD MTC respectively also have any influence back on them⁶²⁹.
- 123 On the other hand, the definitions in Art. 10(3) and 11(3) OECD MTC are located subsequent to the concept of *beneficial ownership* in the precedent Art. 10(2) and 11(2) OECD MTC. From this textual position, the terms *dividends* and *interest* may be understood in that they could be influenced by the concept

⁶²² See par. 80.

⁶²³ *Tischbirek, Wolfgang* in *Vogel / Lechner*, p. 1106, par. 13, and p. 1109 et seq., par. 19; Kemmeren, *Eric C.C.M.* in *Klaus Vogel Commentaries* 2015, p. 723, par. 37; *Gutmann, Daniel* in *Michael Lang*, *beneficial ownership*, p. 343; *Adolfo Martín Jiménez*, sec. 3.5. and 4.; *Charl du Toit*, *evolution*, sec. 3.2.5.

⁶²⁴ Equally for IAS / IFRS: *Kuhn / Hachmeister*, p. 604 et seqq., par. 32 et seqq.

⁶²⁵ *Hartenberger, Heike* in *Beck, IFRS / IAS*, p. 163, par. 112; comprehensively: IAS Board, October 2016, 5B.

⁶²⁶ See sec. 1.2.

⁶²⁷ See par. 95.

⁶²⁸ *Helminen, Marjaana* in *IBFD Commentaries on Art. 11 OECD MTC*, sec. 3.2.3.3.1.1.; *OECD Commentaries* 2014, p. C(10)-3, par. 12, and p. C(11)-7, par. 9.

⁶²⁹ Circular reasoning.

of *beneficial ownership*. This view may also be supported by the systematic argument that the existence of, and the distinction between, *shares* and *debt-claims* depend on the attribution and therefore the economic ownership of the underlying capital or principal⁶³⁰. Finally, the literal interpretation of the English term *beneficial owner* is to be understood in a connotation of a static rather than a dynamic reference⁶³¹. In fact, an *ownership* typically refers to an object or right already in existence (i.e. the asset). In contrast, an alternative reading as *ownership in a transaction* or an *ownership in an income* is somehow hard to imagine. The reason is that a transaction requires the consent of the contracting counterparty and an *income* requires a realisation as a logical pre-step. Since the asset implies the transaction⁶³², any influence of the *beneficial owner* to the asset would – according to that view – necessarily also influence the transaction⁶³³.

124 In this study, the former position is, however, taken that the *beneficial ownership* does not affect the genuine legal concepts⁶³⁴ and the interpretation of the terms *dividends* and *interest*:

- As a literal element of interpretation, its static connotation appears to be a peculiarity of the English version of “beneficial owner”. This stands in contrast to the broader and thus more flexible denotation of the term in many other languages, such as – for instance – in Dutch (“uiteindelijk gerechtigde”), French (“bénéficiaire effectif”), German (“Nutzungsberechtigter”), Italian (“beneficiario effettivo”), Portuguese (“beneficiário efectivo”) or Spanish (“beneficiario efectivo”).
- The first systematic counterargument that Art. 10(3) and 11(3) OECD MTC are textually located subsequent to Art. 10(2) and 11(2) OECD MTC, is not sustainable. Justifying a logical nexus with Art. 10(1) and 11(1) OECD MTC as a precondition would require a stronger emphasis than that provided their mere textual position. In that sense this textual position is unfortunate; the definitions of *dividends* and *interest* should rather be moved upward prior to the second paragraphs (e.g. as is in Art. 12 OECD MTC).
- The second systematic counterargument that the existence of and the distinction between *shares* and *debt-claims* depend on the attribution and therefore the economic ownership of the underlying capital or principal, represents a circular reasoning. The concept of *beneficial ownership* is itself the legal consequence of Art. 10 and 11 OECD MTC and therefore cannot simultaneously be a precondition for their application. That is why matters of attribution and ownership of the underlying capital or principal must necessarily be separated from the treaty concept of *beneficial ownership*.
- The third counterargument that the term *beneficial owner* appeared closer to a static rather than to a dynamic reference, demands a deeper examination:

125 The OECD MTC uses the term *beneficial owner* only in conjunction with the income or transaction⁶³⁵. However, according to the majority of commentators⁶³⁶ there is nevertheless a *beneficial ownership* in the asset

⁶³⁰ Michael Lang, hybrids, p. 95 et seqq.

⁶³¹ See par. 55.

⁶³² See par. 53 et seq.

⁶³³ Argumentum a maiore ad minus.

⁶³⁴ See par. 73.

⁶³⁵ “However [...] but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed [...]” (Art. 10(2) OECD MTC); “However [...] but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed [...]” (Art. 11(2) OECD MTC).

⁶³⁶ Kemmeren, Eric C.C.M. in Klaus Vogel Commentaries 2015, p. 724, par. 39; Kaeser, Christian / Wassermeyer, Franz in Wassermeyer Commentaries, p. 1282 et seq., par. 68; OECD Commentaries 2014, p. C(10)-4, par. 12.4, p. C(10)-6, par. 12.6, p. C(11)-9 et seq., par. 10.2 and 10.4; Reimer, Ekkehart in Michael Lang, beneficial ownership, p. 257 and 261 et seqq.; OECD, Beneficial Owner, 2012, p. 10;

as well. In other words: the economic aspect of *beneficial ownership* does not only address the (re-)attribution of the income or transaction but also that of the asset.⁶³⁷ The two aspects are independent of each other and can lead to different results⁶³⁸.

Example 19: An asset may be legally encumbered in a way that its proceeds are entitled to one beneficiary but its principal or underlying right to another beneficiary. Although both are based on composite legal transactions, the former may be considered the *beneficial owner* of the income and the latter the *beneficial owner* of the asset itself.

It may therefore be legitimately questioned where the *beneficial ownership* in the asset stems from and/or what its purpose and justification is in the context of distributive provisions dealing only with income.

- 126 The third counterargument, according to which the term *beneficial owner* appeared closer to a static rather than to a dynamic reference⁶³⁹, may suggest that the distinction between the two aspects of *beneficial ownership* might be seen as a necessary result from the asset-based approach taken by the OECD MTC for *dividends* and *interest*.⁶⁴⁰ However, as has been shown, these definitions can alternatively be accessed and more precisely be interpreted by means of the transaction-based approach, which leads to the same results⁶⁴¹. For this same reason, the *beneficial ownership* in the asset isn't required to distinguish the sources of *dividend* income from those of *interest* income either. Ergo, a justification for the view that the concept of *beneficial ownership* had an influence on the definitions of *dividends* and *interest*, must likewise stand against the transaction-based approach. Also the transaction-based approach was said to require the asset in order to identify and tax-systematically classify the source of income⁶⁴². However, this objective classification is independent of the subjective matter of (re-)attribution or (re-)assignment (e.g. both a *company* and a *partnership* can each be attributed to a legal owner or to a *beneficial owner*). Hence, neither the asset-based approach nor the transaction-based approach provide any compelling reason for the conclusion that the concept of *beneficial ownership* had an influence on the definitions of *dividends* and *interest*.
- 127 According to the author's view, the *beneficial ownership* in the asset nevertheless follows from other intentional and purposive considerations. As stated above, it is first and foremost the location of the situs of the asset as the source of income, which constitutes a cross-border situation at all and therefore determines the applicability of the OECD MTC as a whole.⁶⁴³ From this perspective it is obvious that its purpose of being also a specific anti-abuse provision, for instance to prevent treaty shopping by inserting a legal owner between asset and investor, would fail where the *beneficial ownership* did not also include that asset. In other words: the

Collier, Richard, Clarity, Opacity and Beneficial Ownership, British Tax Review 2011, No. 6, p. 703; Michael Lang, hybrids, p. 96; Klaus Vogel Commentaries 1997, p. 562, par. 9; OECD, Double Taxation Conventions and the Use of Conduit Companies, Paris, 1986, OECD Commentaries 2014, p. R(6)-7, par. 13; contrary: Robert Danon, sec. 3.2., merely observing that OECD, Beneficial Owner, 2011, does not also refer to beneficial ownership in the asset.

⁶³⁷ OECD Commentaries 2014, p. C(10)-6, par. 12.6, and p. C(11)-9, par. 10.4.

⁶³⁸ OECD Commentaries 2014, p. C(10)-4, par. 12.4, p. C(11)-8, par. 10.2.

⁶³⁹ See par. 123.

⁶⁴⁰ See par. 58.

⁶⁴¹ See par. 52 et seqq.

⁶⁴² See par. 57 et seq.

⁶⁴³ See par. 57.

anti-abuse purpose of *beneficial ownership* necessarily requires the situs of the asset as the source of income. As an interim result for the further course of this analysis it is held in accordance with the majority's view⁶⁴⁴ that there is not only a *beneficial ownership* in the income or transaction but also a *beneficial ownership* in the asset.

2.3.3.4 *Interim conclusions*

- 128 The dual aspect of the *beneficial ownership* of referring to the asset and to the income or transaction appears to correspond with its dual purpose and function⁶⁴⁵. While the (re-)attributional purpose relates to the income, the anti-abuse purpose relates to the asset. In other words: the (re-)assignment of assets by way of *beneficial ownership* serves its anti-abuse function, whereas the (re-)assignment of income by way of *beneficial ownership* serves its (re-)attributional function. Admittedly, the anti-abuse aspect applies to forms of mismatches between formal and effective taxpayer equivalent to a financial intermediation⁶⁴⁶. It may therefore be legitimately called into question, why the anti-abuse aspect – as opposed to the (re-)attribution aspect – should exclusively refer to the asset rather than to the income as well. In other words: why the asset as the source of income shall not only be a necessary minimum condition (*conditio sine qua non*) for the anti-abuse purpose⁶⁴⁷ but also its sufficient maximum condition (*conditio per quam*) or verifier. However, in the treaty context the difference between non-abusive mismatches (e.g. financial intermediation) and abusive mismatches (e.g. conduit companies) can only be the application of the treaty itself (i.e. the misuse of its material benefits). Pursuant to Art. 1 OECD MTC this is possible only by establishing a *resident person* in the other jurisdiction, i.e. the situs of asset. It is such “creation” of an asset by establishing a *resident person* between investment and investor at which the anti-abuse aspect of *beneficial ownership* is targeting. In contrast, the (re-)assignment of income through a financial intermediary – which is a *resident person* in the other jurisdiction as well – is already covered by the (re-)attributional aspect, even where there was no anti-abuse purpose. The observation that *beneficial ownership* in the asset as a result of the anti-abuse purpose and *beneficial ownership* in the income or transaction as a result of the (re-)attributional purpose often correlate in practice⁶⁴⁸, may not lead to the conclusion that the two aspects are in any way systemically dependent on each other⁶⁴⁹. This is not to say that it was easy to distinguish abusive and non-abusive mismatches in practice. It only means that, once they have been distinguished, they address different purposes of *beneficial ownership* with different implications. The reason for this independency is that treaty abuse presupposes additional qualifying elements going beyond a mere financial intermediation.⁶⁵⁰ The asset-based approach implies the classification of the income or transaction⁶⁵¹ but not its (re-)attribution as a subsequent logical step. In other words: *beneficial ownership* is not covered by the asset-based approach. Ergo, asset and transaction are – as regards their (re-)attribution – principally independent of each other⁶⁵². Hence, following the consensus that

⁶⁴⁴ See footnote 636.

⁶⁴⁵ See par. 116.

⁶⁴⁶ See par. 115.

⁶⁴⁷ See par. 127.

⁶⁴⁸ Reimer, Ekkehart in Michael Lang, *beneficial ownership*, p. 260 et seq., confusing the anti-abuse aspect and the (re-)attributional aspect by making the reservation that an income or transaction attribution different from the asset attribution were subject to a justification under material economic reasons.

⁶⁴⁹ Cum hoc ergo propter hoc.

⁶⁵⁰ Gutmann, Daniel in Michael Lang, *beneficial ownership*, p. 342 et seq.

⁶⁵¹ See par. 54.

⁶⁵² See par. 53.

the two purposes are not one and the same⁶⁵³, the financial intermediary as a *resident person* is excluded from the treaty application by way of the (re-)attributional aspect. In contrast, any artificial structure as a *resident person* (e.g. conduit company) is excluded from the treaty application by way of the anti-abuse aspect. Apparently, there should be no doubt that the (re-)attributional aspect of *beneficial ownership* relates to the income or transaction⁶⁵⁴. However, the aforementioned considerations confirm the above hypothesis that the anti-abuse aspect of *beneficial ownership* relates only to the asset. The following illustration visualises this understanding:

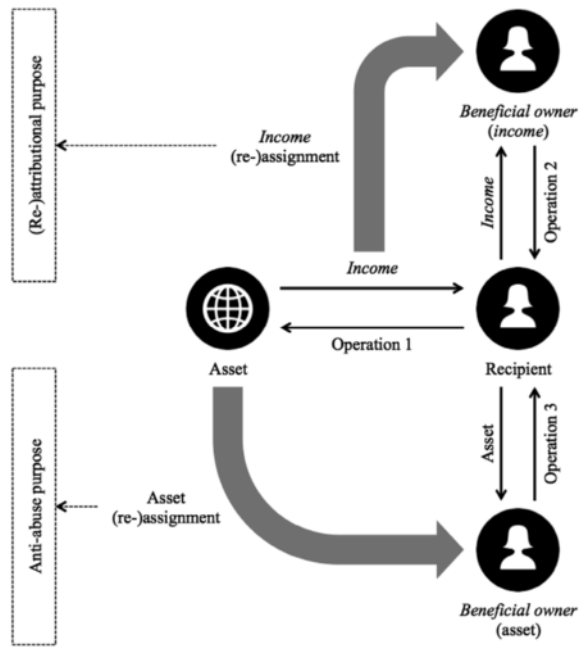


Illustration 10: (Re-)attributional aspect and anti-abuse aspect of *beneficial ownership*

- 129 This understanding demonstrates that the third counterargument, according to which the term *beneficial owner* literally is to be understood in a connotation of a static rather than to a dynamic reference⁶⁵⁵, may indeed be correct. According to the author's understanding, this argument is nevertheless biased to the single aspect of asset (re-)assignment. This asset (re-)assignment, however, does in no way – neither by subject nor by purpose – affect the income⁶⁵⁶. Therefore it does not provide any compelling reason either for the conclusion that the concept of *beneficial ownership* had any influence on the interpretation of *dividends* and *interest*. Summarising this as an interim conclusion, the concept of *beneficial ownership* in Art. 10(2) and 11(2) OECD MTC is independent of, and does not affect, the genuine legal definitions of the terms *dividends* and *interest* in Art. 10(3) and 11(3) OECD MTC. As a result, it means in particular that an income from a

⁶⁵³ See par. 116.

⁶⁵⁴ See par. 125.

⁶⁵⁵ See par. 123.

⁶⁵⁶ Contrary: Reimer, Ekkehart in Michael Lang, *beneficial ownership*, p. 261 (see footnote 648), consistently endeavouring to approach the beneficial ownership in the income or transaction via the beneficial ownership in the asset.

transaction keeps its genuine nature and is not (re-)classified into something else only because it has been (re-)attributed by way of *beneficial ownership*. For instance, a *dividend* income passed-through to a *beneficial owner* in the form of *interest* still keeps its nature of a *dividend* and is not (re-)classified into *interest*. Or methodologically spoken: the concept of *beneficial ownership* is not able to substitute the nature of *dividends* and *interest*.

- 130 Beyond this finding, the above understanding also allows additional insights. Where the *beneficial ownership* in the asset is linked to the source and the *beneficial ownership* in the transaction is linked to the income from that source⁶⁵⁷, both aspects point in opposite directions of the logical step sequence of a tax event:

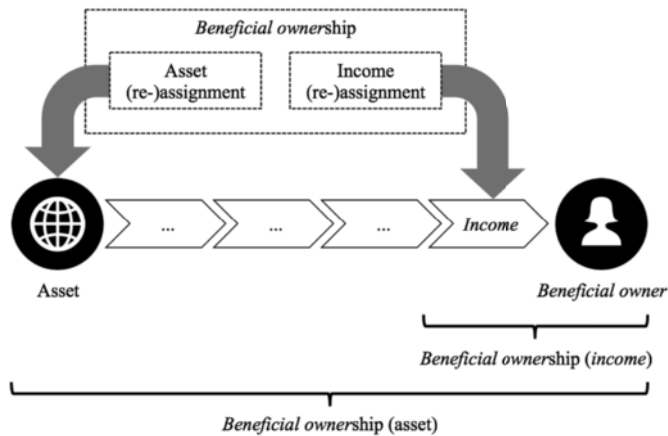


Illustration 11: Different scopes of *beneficial ownership* in the asset and in the income or transaction

All the logical steps of a tax event such as aggregation versus disaggregation, operation or realisation affect the income but not the asset. Hence, each of them must necessarily bears a nexus with the *beneficial ownership* in the income or transaction and cannot possibly bear a nexus with the *beneficial ownership* in the asset. Accordingly, the *beneficial ownership* in the asset encompasses a person's entire relation with all logical steps including the asset. In contrast, the scope of the *beneficial ownership* in the transaction is limited to a person's income only. That is not only why the subjective (re-)attribution of the income must be carefully distinguished from all the precedent logical steps, whereas the subjective (re-)attribution of the asset already implies all these logical steps. It is also the systematic reason for the observation that the (re-)attribution of the income or transaction and that of the asset are independent of each other and can lead to different results⁶⁵⁸.

- 131 Due to the fact that the asset is the source of the income, these two aspects with their different scopes apply very closely to each other and therefore tend to be confused. This may lead to false conclusions when interpreting Art. 10(3) and 11(3) OECD MTC, which shall be demonstrated by the following examples:

⁶⁵⁷ See par. 128.

⁶⁵⁸ See par. 125.

- (1) Aggregation versus disaggregation: The *beneficial ownership* in the asset already includes the information of what the asset structure is (e.g. structured product or underlying). In contrast, the *beneficial ownership* in the income or transaction does not include or provide information on what the income structure is (e.g. income from the structured product or from its underlying), which is subject to the precedent aggregation versus disaggregation test. Where the *beneficial ownership* in the asset is extrapolated to the *beneficial ownership* in the income or transaction from that asset, the structure of the asset may give rise to erroneous conclusions regarding the structure of the income or transaction.
- (2) Operation: The *beneficial ownership* in the asset already includes the information that the asset is subject of finance (e.g. borrowed share). In contrast, the *beneficial ownership* in the income or transaction does not include or provide the information that the *income* is *derived from* that finance (e.g. *dividend* or compensation), which is subject to the precedent finance operation test. Where the *beneficial ownership* in the asset is extrapolated to the *beneficial ownership* in the income or transaction from that asset, the nature of the asset may give rise to erroneous conclusions regarding the nature of the income or transaction. This may not be misunderstood to mean that the *beneficial ownership* had any influence on the income or transaction. Rather, it means that the nature of the income or transaction may in turn have an influence on its *beneficial ownership*.
- (3) Realisation: The *beneficial ownership* in the asset already includes the information that the asset “exists tax-wise”. In contrast, the *beneficial ownership* in the income or transaction does not include or provide the information that the income “exists tax-wise”, which is subject to the precedent realisation test. Where the *beneficial ownership* in the asset is extrapolated to the *beneficial ownership* in the income or transaction from that asset, the asset (re-)attribution may give rise to erroneous conclusions regarding the income realisation.

132 Having investigated its aspects and consequences as well as its context and scope, it has been found so far that the *beneficial ownership* in the asset is independent of *beneficial ownership* in the income or transaction⁶⁵⁹. Therefore, the *beneficial ownership* in the asset is basically not relevant for the further course of this study. It has also been found that the *beneficial ownership* in the income or transaction has no influence on the definitions of *dividends* and *interest*.⁶⁶⁰ However, the deemed (re-)attribution of income – keeping their genuine legal character – actually means a look-through approach.⁶⁶¹ In other words: the *beneficial owner* realises the income in the same legal character as the *recipient* before him, regardless of the form in which that income is passed through (classification chain). From the *beneficial owner's* perspective it could therefore be suggested that the concept actually did influence the classification of his *dividends* and *interest*. Or in other words: that the income (re-)classification by way of *beneficial ownership* was a necessary side effect of the income (re-)attribution. However, Art. 10(2) and 11(2) OECD MTC necessarily take the *recipient's* perspective, as the concept of *beneficial ownership* is their legal consequence. That is why Art. 10(3) and 11(3) OECD MTC cannot apply to the *beneficial owner* a priori⁶⁶² but only a posteriori.

Example 20: A *beneficial owner* resident in the same jurisdiction A as the *recipient* is a posteriori set into the treaty A position of the *recipient*, taking his income classification as a

⁶⁵⁹ See par. 128.

⁶⁶⁰ See par. 129.

⁶⁶¹ Reimer, Ekkehart in Michael Lang, *beneficial ownership*, p. 261.

⁶⁶² Circular reasoning.

legal consequence (classification chain). In contrast, a *beneficial owner resident* in a different jurisdiction B than the *recipient* does not take the income classification as a legal consequence from treaty A. Instead he is a priori *recipient* himself under treaty B (i.e. no cross-treaty classification chain).

Accordingly, the (re-)classification of the *beneficial owner's* income is not the primary purpose, intention and function of the concept. Instead, it is rather to include the *beneficial owner* and simultaneously exclude the *recipient* from the treaty benefits by entirely replacing the latter by the former.⁶⁶³ In other words: *beneficial ownership* is no (re-)classification of one object into another (i.e. the income) but a replacement of one subject by another (i.e. the *recipient* by the *beneficial owner*). This is why there are not two transactions as a result of *beneficial ownership* (i.e. the genuine income type and a re-classified income type) but only one and the same (i.e. the genuine income type). Again, it is important to emphasise that this replacement is a legal consequence of the *beneficial ownership* concept and has therefore no influence on the definitions of *dividends* and *interest*. This does not only apply to those realised by the *recipient* but also to those (re-)attributed to the *beneficial owner*. As stated before⁶⁶⁴, it would nevertheless be insufficient and possibly misleading to exclude the concept of *beneficial ownership* in the income or transaction as the primary focus⁶⁶⁵, which turns out to be of utmost importance for today's way of making financial transactions.

2.3.3.5 Operationalisation

- 133 The definition of *beneficial ownership* in the income or transaction now requires an analysis of the legal relation between the *recipient* and the *beneficial owner*. In other words: what material quality this legal relation needs to have in order to constitute *beneficial ownership*. Although the legal relation as such must be determined individually by reference to the domestic law, the material key question of when their composition turns into a mere formal attribution is a matter to be interpreted autonomously.⁶⁶⁶
- 134 In this respect, the majority of commentators adopt a control concept consisting of two critical powers⁶⁶⁷: (1) the power to control whether or not there shall be a distribution, i.e. the power to create or distribute *income*; and (2) the power to control how this distribution is to be used, i.e. the power to enjoy or apply *income*. Where a legal position is restrained in a way that one of these two critical control powers is restricted or limited, the *recipient* is not considered the *beneficial owner*. The approaches to developing a concrete test for this control concept can be isolated⁶⁶⁸ and categorised as follows:
- (1) Risk test: Some commentators⁶⁶⁹ suggest a low dependency to be sufficient by testing the default or market risk remaining with the *recipient* of the *income* in the technical sense of a mere correlation between the in- and outflows. In other words: to what extent the fulfilment of the legal obligations or commitments by the

⁶⁶³ See par. 115.

⁶⁶⁴ See par. 114.

⁶⁶⁵ See par. 116.

⁶⁶⁶ Tisbbirek, Wolfgang in Vogel / Lehner, p. 1107, par. 15; Klaus Vogel Commentaries 1997, p. 562, par. 8. See also par. 72.

⁶⁶⁷ Caroline Poirer, sec. 2.5., and Robert Danon, sec. 3.2., particularly stressing the first control power; Collier, Richard, Clarity, Opacity and Beneficial Ownership, British Tax Review 2011, p. 702; Oliver, J. David B., Beneficial Ownership and the OECD Model, British Tax Review 2001, No. 1, p. 57; Klaus Vogel Commentaries 1997, p. 562, par. 9; similarly for IAS / IFRS: Anna Verena Matthies, p. 49 et seq.

⁶⁶⁸ Among others: Canadian Federal Court of Appeal, judgement ref. A-252-08, 2009, combining several of these test criteria into one integrated approach.

⁶⁶⁹ Joanna Wheeler, attribution, p. 482 et seq. and 488.

recipient towards a creditor (outflows) depends on the fulfilment of the legal obligations or commitments by a debtor (inflows). They argue that such a quantitative approach was a practical compromise between the two extremes of an one-on-one relationship on the one hand and on the other hand the possibility of spotting fragmented or otherwise complex bundles of payments. In addition, it also was the correlation as a strong indicator of risk taken by the *recipient* which represented the key difference as opposed to financial intermediaries, who are obliged to pay their creditors independently of any other transaction.

- (2) Service fee test: Other commentators⁶⁷⁰ suggest a closer dependency between in- and outflows by way of identifying those obligations or commitments to pass-through the inflows by respective service fees. They argue that such a qualitative approach arises from the distinction between the management of own assets on the one hand and on the other hand the management on behalf of someone else.
- (3) Intended use test: instead of such objective tests focussing on the mere existence of those obligations or commitments, some commentators⁶⁷¹ suggest a stronger dependency between in- and outflows by examining their particular nature with the subjective approach of an intended use;
- (4) Individual analysis: other commentators⁶⁷² even support a narrow view suggesting that those obligations or commitments to pass-through the inflows must refer to and be verified for each and every payment individually (e.g. pertaining to the currency, settlement or default risk).

135 As discussed before⁶⁷³, the IAS/IFRS provide the concept of *economic relationship*⁶⁷⁴. It describes a general qualifying criterion for putting separate legal items into such context for the purpose of aggregation (*hedging*). It is qualitatively defined as a causal relation between in- and outflows that must be quantitatively observable by expected negative correlation depending on the same risk in the sense of a typical and systematically similar change in response to that risk.⁶⁷⁵ Such *economic relationship* must further meet the requirements of *hedge effectiveness*, which is actually close to the above risk test⁶⁷⁶. This means that credit risk may not dominate it⁶⁷⁷, for instance where in- and outflows are collateralised differently⁶⁷⁸ or where there is a significant time lag between the two⁶⁷⁹. It also means that the in- and outflows must be proportionate in approximately equal amounts or benefits⁶⁸⁰, i.e. a legal relationship providing an outflow that is significantly lower than the respective inflow cannot be considered an effective *economic relationship*. Admittedly, transferring this approach to the treaty concept of *beneficial ownership* also requires to take the limited scope of the *hedge accounting* (i.e. aggregation) rules in general and the *economic relationship* concept in particular⁶⁸¹ into account as exceptions

⁶⁷⁰ Reimer, Ekkehart in Michael Lang, beneficial ownership, p. 258 et seq.

⁶⁷¹ Without providing a methodological justification: Kemmeren, Eric C.C.M. in Klaus Vogel Commentaries 2015, p. 724, par. 38; OECD Commentaries 2014, p. C(10)-4, par. 12.4, p. C(11)-8, par. 10.2; OECD, Beneficial Owner, 2012, p. 6 et seqq., par. 12 et seqq., instead providing a casuistic and non-exhaustive list or catalogue of typical examples empirically encountered in most OECD members.

⁶⁷² Without justification: Tischbirek, Wolfgang in Vogel / Lehner, p. 1109 et seq., par. 19; Reimer, Ekkehart in Michael Lang, beneficial ownership, p. 259 et seq.

⁶⁷³ See par. 93.

⁶⁷⁴ IFRS 9.6.4.1(c)(i).

⁶⁷⁵ IFRS 9.B6.4.4 et seqq.

⁶⁷⁶ See par. 134(1), with the difference that credit risk can also be caused by a significant time lag between in- and outflows.

⁶⁷⁷ IFRS 9.6.4.1(c)(ii).

⁶⁷⁸ IFRS 9.B6.4.8.

⁶⁷⁹ IAS 32.48.

⁶⁸⁰ IFRS 9.6.4.1(c)(iii); Dominik Dettenrieder, p. 205.

⁶⁸¹ Dominik Dettenrieder, p. 194.

from the principal IAS/IFRS prohibition of aggregation⁶⁸². However, not only are these limitations subject of criticism already within the IAS/IFRS⁶⁸³; the IAS/IFRS concept of *economic relationship* also appears to be principally transferable to the OECD MTC concept of *beneficial ownership*, in that both represent a specific subset of their respective *substance over form* principles as exceptions from their general primacy of the legal form⁶⁸⁴. Nevertheless, *beneficial ownership* addresses aspects regarding the payment profile, rights and obligations as well as timing of financial instruments, which all demand a cautious invocation of the *substance over form* principle⁶⁸⁵. True, it also addresses aspects of risk, which is naturally more associated with the economic substance rather than with the legal form⁶⁸⁶. However, as was found⁶⁸⁷, this particularly does not apply to credit risk as a legal risk⁶⁸⁸. Apart from its limited scope of application, from the author's point of view there are, as a result, no compelling reasons to justify less restrictive requirements than those of the risk-based IAS/IFRS concept of *economic relationship*, if transferred to the treaty concept of *beneficial ownership*. Conversely, this result would also systematically correspond to the potential approach found above in regard to the disaggregation scheme⁶⁸⁹. Consequently, *beneficial ownership* would have to be interpreted narrowly by necessitating particular high demands to the qualitative relation and quantitative correlation between in- and outflows, to their proportionality as well as to the similarity of their causal risks.

- 136 The IAS/IFRS concept of *economic relationship* allows the aggregation and contextualisation not only of single but also of multiple transactions⁶⁹⁰. In contrast, from the author's point of view, the treaty concept of *beneficial ownership* applies to individual transactions only (i.e. one single inflow and its respective outflow). Admittedly, *beneficial ownership* is a requisite and explicit exception to the finding that an aggregation of a transaction upwards from its legal form can basically not be justified by the *substance over form* principle⁶⁹¹. However, there is a difference between the horizontal aggregation of in- and outflows for the purpose of determining their economic relationship and the vertical aggregation of multiple in- or outflows. The reason is that the former is a logical pre-step and necessary pre-condition for the latter⁶⁹². Consequently, the IAS/IFRS provide different concepts for these two independent problems, i.e. *economic relationship*⁶⁹³ for the horizontal aggregation but *hedging instruments*⁶⁹⁴ and *hedged items*⁶⁹⁵ for the vertical aggregation. So does the OECD MTC: subject of the specific rules of *beneficial ownership* is solely the horizontal aggregation, whereas the vertical aggregation is a result of the *substance over form* principle⁶⁹⁶ in general. In other words: the specific question of *what* is to be aggregated (object) is different from the general question of *when* something is to be aggregated

⁶⁸² IAS 1.29, IFRS 4.BC106.

⁶⁸³ See par. 98(9).

⁶⁸⁴ See par. 116.

⁶⁸⁵ See par. 79, 80 and 81.

⁶⁸⁶ See par. 78.

⁶⁸⁷ See par. 101(1).

⁶⁸⁸ See par. 66.

⁶⁸⁹ Argumentum e contrario. See also par. 101.

⁶⁹⁰ See par. 93.

⁶⁹¹ See par. 121.

⁶⁹² See par. 85.

⁶⁹³ IFRS 9.6.4.1(c).

⁶⁹⁴ IFRS 9.6.2.

⁶⁹⁵ IFRS 9.6.3.

⁶⁹⁶ See par. 84 and 131(1).

(condition). The exceptional concept of *beneficial ownership* (horizontal aggregation) is necessarily limited by its logical pre-step (vertical aggregation) to the relation between an individual inflow and its respective outflow, i.e. the inflow cannot be less than the outflow (maximum limit). In other words: a pass-through of multiple inflows by one single outflow of the same total amount cannot be subject of a (re-)attribution by way of *beneficial ownership* (horizontal aggregation)⁶⁹⁷. This would imply and require their prior consolidation (vertical aggregation) as a logical pre-step, which, however, cannot be justified by the general *substance over form* principle. Even more restricted for the general principles than the application of the aggregation scheme, are its specific exceptions⁶⁹⁸. The following illustration visualises this understanding:

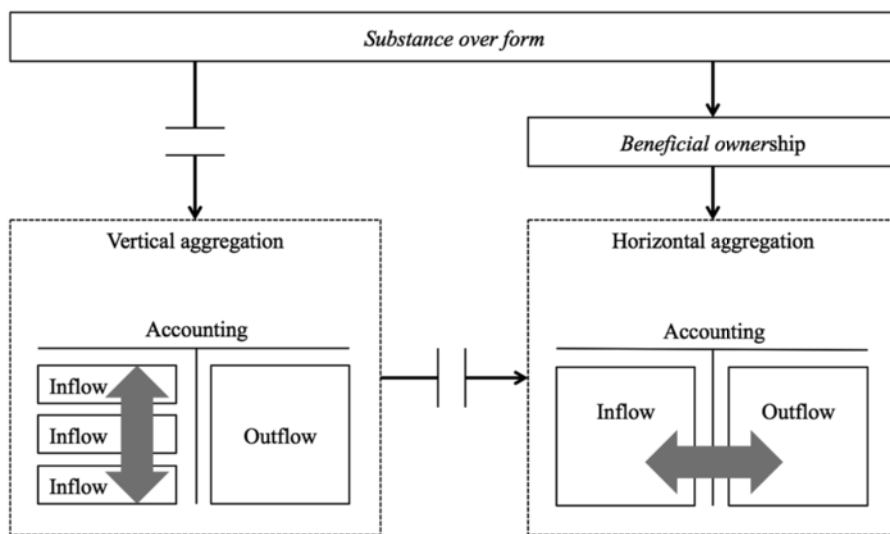


Illustration 12: The horizontal aggregation of *beneficial ownership* as opposed to the vertical aggregation

- 137 In contrast to that vertical aggregation, the concept of *beneficial ownership* is not limited to the same extent by its likewise logical pre-step of vertical disaggregation, which is much less restrictive⁶⁹⁹. In other words: depending on the less restrictive admissibility requirements of the disaggregation scheme, a pass-through of one single inflow by multiple outflows of the same total amount might principally result into (re-)attribution by way of *beneficial ownership*. However, the additional *hedge effectiveness* requirement of approximately proportional in- and outflows⁷⁰⁰ necessarily limits it as well, in that the inflow can't be more than the outflow (minimum limit) either. According to its narrow interpretation, this results in the conclusion that *beneficial ownership* is to be determined on the basis of individual transactions only. The consequent tax planning possibilities and distortions by discretionarily choosing or structuring the legal (contractual) form of the financial instrument as the baseline or starting point were said to be acceptable⁷⁰¹ also with regard to *beneficial ownership*.

⁶⁹⁷ In result equally: Tax Court of Canada, judgement ref. 2012 TCC 57, 2009, par. 43 et seq.

⁶⁹⁸ Argumentum a maiore ad minus.

⁶⁹⁹ See par. 96.

⁷⁰⁰ See par. 135.

⁷⁰¹ See par. 101(1).

- 138 The concept of *beneficial ownership* as a special subset of the general *substance over form* principle⁷⁰² must necessarily ignore the legal form of the in- and outflows. Obviously, an in- and outflow cannot be excluded from the applicability of *beneficial ownership* only because of their different income classifications (e.g. an inflow in the form of an *interest* is passed-through as an outflow in the form of a *dividend*). That is why the credit risk as an economic parameter induced by the legal form⁷⁰³ is of particular importance for indicating a relationship between in- and outflows. While it is not capable of positively verifying a qualitative relation, it is nevertheless capable of negatively falsifying it. Where there is a dominating credit risk because of any kind of gap between in- and outflow for whatever reasons, there cannot possibly be an economic relationship between them⁷⁰⁴. This is why a non-dominating credit risk in turn doesn't necessarily imply such a qualitative relation. Obviously, this qualitative relation cannot be determined on the basis of the relationship's legal terms but must instead depend on its critical economic characteristics (e.g. effective maturity structure, causal risk structure or its sources such as their underlyings or components or substitutes, etc.).

2.3.3.6 Limitations

- 139 The concept of *beneficial ownership* as a method of horizontally aggregating in- and outflows necessarily requires and implies that the general principles of the OECD MTC apply to outflows as well. However, this obviousness is neither self-evident nor trivial. The scope of chap. III of the OECD MTC is limited to *income* from transactions which are subject of a double taxation⁷⁰⁵. The subjacent question is therefore whether or not these outflows must be treated as or are even the same as negative *income* (e.g. a donation of *interest*, a pass-through of *dividends* in the form of transaction costs for capital *gains*). And, if yes, whether or not negative income can in some sense be subject of double taxation. In the context of financial instruments, the vast majority of the observations in practice may allow the assumption that any form of passed-through *income* pursuant to the distributive articles of the OECD MTC represents itself any other form of item being subject of the OECD MTC. That is why the question which qualitative criteria or requirements the pass-through must comply with in order to constitute a *beneficial ownership*, appears to be of no relevance with respect to the scope of this study⁷⁰⁶. Rather, it is sufficient to hold that the concept of *beneficial ownership* covers as a minimum any pass-through that potentially represents any form of *income* itself pursuant to the distributive articles of the OECD MTC. This is a direct result of the original purpose, intention and function, according to which first of all *income* from financial transactions being arranged through intermediaries should be (re-) attributed by way of *beneficial ownership*⁷⁰⁷. On the one hand, *income* is regularly interpreted domestically rather than autonomously⁷⁰⁸. On the other hand, this can consequently be only half the truth: the concept of *beneficial ownership* obviously represents a necessary exception from this general principle⁷⁰⁹. In other words: where the counter-position was taken that any negative amount (i.e. outflow) is considered as either subject of the domestic interpretation or incapable of being subject of double taxation, it was excluded from the applicability of the OECD MTC as a whole. As a consequence, the concept of *beneficial ownership*

⁷⁰² See par. 116.

⁷⁰³ See par. 76 and 101(1).

⁷⁰⁴ See par. 135.

⁷⁰⁵ See par. 19.

⁷⁰⁶ See sec. 1.2.

⁷⁰⁷ See par. 115.

⁷⁰⁸ See par. 21.

⁷⁰⁹ See par. 117.

would entirely fall short. Accordingly, the position must be taken that the interpretation of *income* has to be separated into an autonomous and qualitative aspect on the one hand and the domestic and quantitative determination of the tax base on the other⁷¹⁰. Or in more concrete terms: the disentanglement or separation of the causal or contextual nature of *income* from its mathematical sign. As a first result of such an approach, the initial question of whether or not negative income can be subject of double taxation would be logically independent of its mathematical sign. Having eliminated its mathematical sign in this way from the entire problem of income classification, it would be methodologically inconsistent to conclude that *income* was incapable of suffering double taxation only because its amount is negative. As a second result, the requisite double taxation of negative income must instead be determined by also reversing the mathematical sign of the tax itself. These conclusions justify applying the general principles of the OECD MTC to negative income as well⁷¹¹ by allowing it to access the concept of *beneficial ownership* and thus making it yet even clearer and more meaningful.

Example 21: Negative amounts could be classified as negative *income* or as transaction or acquisition costs. While both have their negative mathematical sign in common, this is nevertheless not their qualitative differentiator but only a quantitative attribute. The qualitative difference between costs and *income* is actually their different contextual situation caused by different transactions (e.g. *income* from a financial transactions versus costs for a service transaction). Ergo, drawing reverse deductions from the *income*'s mathematical sign back to its contextual situation is flawed and mixes two different aspects. Once their different contextual situation has been determined pursuant to the autonomous interpretation (income classification), their quantitative tax base can then be determined pursuant to domestic law as a subsequent logical step only by considering their mathematical sign. Where the negative amounts may not be deducted from that domestic tax base in both contracting jurisdictions, be it as negative *income* or as transaction or acquisition costs, they suffer double taxation and are thus admissible for or accessible to the application of the OECD MTC.

- 140 Making negative income accessible to the general principles of the OECD MTC via the specific concept of *beneficial ownership* should, however, not lead to the erroneous reverse deduction that all these general principles must actually apply to the outflows in order to trigger *beneficial ownership*. The concept of *beneficial ownership* was said to cover any *income* as a necessary minimum condition (*conditio sine qua non*)⁷¹² but not necessarily also a sufficient maximum condition (*conditio per quam*). In other words: the requirements to the outflow are weaker than those to the inflow (e.g. the outflow is not required to be realised in the same way or even at the same point in time as the inflow). The reason is that it was not in line at least with the anti-abuse purpose of *beneficial ownership*⁷¹³, if the outflow was sufficient for being identical with the inflow, which is why the problem of the legal relation between the *recipient* and the *beneficial owner* exists⁷¹⁴ at all. Conversely,

⁷¹⁰ See par. 56.

⁷¹¹ Equally: Haslechner, Werner in Klaus Vogel Commentaries 2015, p. 924 et seq., par. 86; OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-11 et seq., par. 20; unclear: Pöllath, Reinhard / Lobbeck, Allit in Vogel / Lebner, contrary on p. 473, par. 35 but then in favour on p. 1325, par. 70.

⁷¹² See par. 139.

⁷¹³ See par. 116.

⁷¹⁴ See par. 133 et seqq.

it was also methodologically flawed to draw any reverse deduction from these weaker requirements within the specific concept of *beneficial ownership* to the interpretation of *income* in general. The particular reason is that the outflow as a genuine concept⁷¹⁵ is an objective legal precondition of *beneficial ownership*, whereas the *income* (re-)attribution as a derivative concept is only its subjective legal consequence that justifies no generalisations.

Example 21 (continued): From the fact that the outflow as a negative income is, within the scope of *beneficial ownership*, not likewise required to be realised it may not be concluded that *income* in general was not required to be realised at all.

- 141 The last topic that should be addressed here is the question whether the concept of *beneficial ownership* goes beyond Art. 10 and 11 OECD MTC, in particular as regards Art. 13(5) and 21(1) OECD MTC. On the one hand, the concept of *beneficial ownership* is expressis verbis only employed by Art. 10(2) and 11(2) OECD MTC⁷¹⁶ and not also by any other distributive provision⁷¹⁷. Hence, a teleological extension in that it was nevertheless an inherent principle of Art. 13(5) and 21(1) OECD MTC⁷¹⁸ may be seen as an interpretatio contra legem. Accordingly, there seems to be consensus that the concept of *beneficial ownership* is at least not a general anti-abuse provision.⁷¹⁹ But even if it was, there was – by analogy – no reason to assume that the *beneficial ownership* in the asset was also under Art. 13(5) and 21(1) OECD MTC in any way relevant for the *beneficial ownership* in the income or transaction and therefore for the scope of this study.⁷²⁰
- 142 On the other hand, there is the (re-)attributional purpose of *beneficial ownership*, making it more difficult to take a clear position, as the initial problem of replacing the formal taxpayer (e.g. a financial intermediary) by the effective taxpayer (i.e. the investor) in order to make the treaty benefits available to him also arises under Art. 13(5) and 21(1) OECD MTC, just as it does under Art. 10 and 11 OECD MTC. True, the additional Art. 29 OECD MTC inserted by the OECD MTC Draft Update⁷²¹ does not enlarge, restrict, alter or otherwise address the specific and genuine (re-)attributional aspect of *beneficial ownership*⁷²². Instead, it is intended to act as a general and derivative limitation in benefits rule. As such it has to be seen solely in the context of the OECD MTC objective, particularly in the background of BEPS, to also limit “opportunities for non-taxation or reduced taxation through tax evasion or avoidance”⁷²³. This is why the problem is typically solved by way of teleological reduction in that the (re-)attributional aspect of *beneficial ownership* was generally dispensable⁷²⁴. Admittedly, this interpretation may also be seen as an interpretatio contra legem – even more so as the

⁷¹⁵ See par. 73 and 131(3).

⁷¹⁶ And Art. 12(3) OECD MTC, which is however out of scope of this study (see par. 10).

⁷¹⁷ Li, Jinyan / Avella, Francesco in IBFD Commentaries on Art. 13 OECD MTC, sec. 6.4.1.2.

⁷¹⁸ In this sense: Reimer, Ekkehart in Michael Lang, *beneficial ownership*, p. 265.

⁷¹⁹ Helminen, Marjaana in IBFD Commentaries on Art. 11 OECD MTC, sec. 3.2.3.3.1.2., and Li, Jinyan / Avella, Francesco on Art. 13 OECD MTC, sec. 6.4.1.2.; Caroline Poirer, sec. 4.; Tischbirek, Wolfgang in Vogel / Lebner, p. 1110, par. 19; Adolfo Martín Jiménez, sec. 3.3 with a detailed justification, sec. 3.5 and sec. 4, Collier, Richard, *Clarity, Opacity and Beneficial Ownership*, British Tax Review 2011, No. 6, p. 702 et seq.; Joanna Wheeler, attribution, p. 478.

⁷²⁰ See par. 132.

⁷²¹ OECD MTC Draft Update, p. 17 et seqq.

⁷²² OECD MTC Draft Update, p. 177, par. 8.

⁷²³ OECD MTC Draft Update, p. 10, par. 4, p. 17, footnote 1, and p. 175, par. 1.

⁷²⁴ Li, Jinyan / Avella, Francesco in IBFD Commentaries on Art. 13 OECD MTC, sec. 6.4.1.2.; Avery Jones, John F. in Michael Lang, *beneficial ownership*, p. 333 et seq.

beneficial ownership is a necessary precondition for the specific limitation rules of Art. 10(2) and 11(1) OECD MTC, which would consequently be put into question as a whole. However, according to the view represented here, a teleological extension towards an exceptional rule (i.e. anti-abuse aspect of *beneficial ownership* under Art. 13 and 21 OECD MTC) demands higher interpretation requirements than a teleological reduction towards the respective basic rule (i.e. no re-attributional aspect of *beneficial ownership* under Art. 10 and 11 OECD MTC). As a result for the further course of this study, the author therefore comes to the conclusion that the (re-)attributional aspect of *beneficial ownership* subsists explicitly in Art. 10(2) and 11(2) OECD MTC but implicitly in Art. 13(5)⁷²⁵ and 21(1) OECD MTC. In contrast, the anti-abuse aspect of *beneficial ownership* subsists in Art. 10(2) and 11(2) OECD MTC only.

- 143 Thinking this out consequently may suggest that the anti-abuse aspect of *beneficial ownership* had “squeezed out” its (re-)attributional aspect in that the latter was de facto not part of the concept of *beneficial ownership*. However, such a final conclusion would not only be still in line with all the material findings aforementioned; it would even reinforce them by accentuating the roles of the two aspects. As a consequence, the divergent application of the *beneficial ownership* concept within Art. 13(5) and 21(1) OECD MTC to the asset on the one hand and the income or transaction on the other may give rise to systematic distortions in triangular cases. For instance, the financial intermediary as the legal owner may suffer tax withheld by the source jurisdiction pursuant to his DTC with the issuer, which the investor as the *beneficial owner* might not reclaim pursuant to his DTC with the financial intermediary.

2.3.4 Realisation

2.3.4.1 Definition and legal basis

- 144 Realisation is an event defined by the tax law as a coincidence of factual, spatial and temporal circumstances, which principally triggers a tax consequence (taxable event). As it is typically the link between the subjective and objective criteria of a legal provision, it bears a strong nexus with a number of other legal issues with the effect of multiple and often conflicting aspects. For instance, the term *income* as used in Art. 10(3), 11(3) and 21(1) OECD MTC – including “other benefits in money or money’s worth”⁷²⁶ – as well as the term *gain* as used in Art. 13(5) OECD MTC are principally not to be interpreted autonomously but domestically⁷²⁷. This was said to be a necessary precondition for the purpose of a treaty to “process” the taxable events as constituted by domestic tax law as precursory matters or input information⁷²⁸. However, also relevant in this context is the common criterion that this *income* must have been realised. This requirement is reflected by the words *paid* in Art. 10(1) OECD MTC for *dividends* and Art. 11(1) OECD MTC for *interest*, by the word *alienation* in

⁷²⁵ Equally: Indian A.A.R., judgement ref. 2010 TPI 81, 2010, par. 10.

⁷²⁶ OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-11, par. 28; *Kaeser, Christian / Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1310, par. 114.

⁷²⁷ *Harris, Peter A.* in *IBFD Commentaries on Art. 10 OECD MTC*, sec. 2.1.2.2.2.2., and *Li, Jinyan / Avella, Francesco* on Art. 13 OECD MTC, sec. 5.1.2.; *Alexander Bosman*, p. 249; *Haslechner, Werner* in *Klaus Vogel Commentaries 2015*, p. 834, par. 89; *Tischbirek, Wolfgang / Specker, Gerhard* in *Vogel / Lebner*, p. 1211, par. 186; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1427, par. 72, p. 1611, par. 28, p. 1612, par. 29, p. 1613, par. 31, and p. 1648, par. 137; OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-11, par. 28, and on Art. 13 OECD MTC, p. C(13)-2, par. 6; *Michael Lang*, introduction, p. 46, par. 77; *Peter Hongler*, p. 227 et seq.; *Philip Baker*, p. 13-2, par. 13B.04; *Giuliani, Federico Maria*, Article 10(3) of the OECD Model and Borderline Cases of Corporate Distributions, *Bulletin for International Taxation* 2002, Vol. 56, No. 1, p. 11; *Klaus Vogel Commentaries 1997*, p. 649 et seq., par. 186, p. 657, par. 201, p. 818, par. 24, and p. 1072, par. 11.

⁷²⁸ See par. 21.

Art. 13(5) OECD MTC and by the word *arising* in Art. 21(1) OECD MTC⁷²⁹. The terms are considered to be equivalent⁷³⁰, which is why they are hereafter collectively referred to as *realisation*.

- 145 As regards Art. 11 OECD MTC, the realisation requirement may alternatively also be deduced from the word *arising* in Art. 11(1) OECD MTC. This does, however, not merit substantive attention and has only the purpose of making clear that the taxation right of the source jurisdiction is limited to its own geographical scope⁷³¹. With regard to Art. 13 OECD MTC, the realisation requirement may alternatively also be deduced from the word *derived* in Art. 13(1) and 13(4) OECD MTC. This may be derived by similar analogy as the word *paid* has been taken from Art. 10(1) and 11(1) OECD MTC to interpret *income* from *dividends* in Art. 10(3) OECD MTC and *interest* in Art. 11(3) OECD MTC. However, in this case the absence of *derived* in Art. 13(5) OECD MTC had no substantial meaning⁷³². Nevertheless, it is cautiously assumed that Art. 13(5) OECD MTC does not employ the word *derive* on purpose due to its character of a residuary clause for Art. 13(1) to 13(4) OECD MTC⁷³³. For these reasons, in the further course of this study the realisation requirement is interpreted from the term *alienation*.
- 146 In the context of income classification, to what extent notional or deemed income shall be regarded as being realised – especially as regards to capital *gains*⁷³⁴ – is controversial. The key issue which emerges is the unclear dependency⁷³⁵ between the transaction to be interpreted autonomously⁷³⁶ versus its *income* to be interpreted domestically⁷³⁷. It is a result from the conflict within the distributive articles between their tax limiting function on the one hand⁷³⁸ (i.e. in favour of the autonomous interpretation) and the taxable event as a requisite fact or precursory matter on the other⁷³⁹ (i.e. in favour of the domestic interpretation).
- 147 To clarify this issue, this section starts with an analysis of the terms *paid* and *from* in the context of *dividends* and *interest*. The findings from this analysis will afterwards be set in a wider context by drawing an outer line around the set of all distributive provisions, i.e. by generally distinguishing *income* pursuant to chap. III of the OECD MTC from *capital* pursuant to chap. IV of the OECD MTC). Notably, the conclusions are limited to the relevant Art. 10(3), 11(3), 13(5) and 21(1) OECD MTC and make no claim to also applying to other

⁷²⁹ Contrary: *Wattel / Marres*, fictitious income, p. 72, solely focussing on the term item of income by entirely disregarding the term arising and therefore concluding that “Article 21 does not require that something has been ‘paid’ or otherwise more or less actually enjoyed or received or benefited from but only that an ‘item of income’ of a resident be involved that is not covered by any other allocation provision in the treaty.”

⁷³⁰ *Alexander Bosman*, p. 81 et seq.

⁷³¹ *Helminen, Marjaana* in IBFD Commentaries on Art. 11 OECD MTC, sec. 2.1.1. and 2.1.2.3.

⁷³² *Alexander Bosman*, p. 81; *Reimer, Ekkehart* in *Klaus Vogel* Commentaries 2015, p. 1053, par. 23; *Wattel / Marres*, fictitious income, p. 69.

⁷³³ *Reimer, Ekkehart* in *Klaus Vogel* Commentaries 2015, p. 1077, par. 138, and in *Vogel / Lechner*, p. 1476, par. 178, and p. 1479, par. 211; OECD Commentaries 2014 on Art. 13 OECD MTC, p. C(13)-12, par. 29; *Michael Lang*, introduction, p. 109, par. 322 et seq.; *Klaus Vogel* Commentaries 1997, p. 842, par. 91.

⁷³⁴ *Reimer, Ekkehart* in *Klaus Vogel* Commentaries 2015, p. 1051, par. 10 and 12; *Li, Jinyan / Avella, Francesco* in IBFD Commentaries on Art. 13 OECD MTC, sec. 5.1.2.; *Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1609, par. 26, p. 1611, par. 28, p. 1612, par. 29, p. 1613, par. 31, and p. 1648, par. 137; *Philip Baker*, p. 13-2, par. 13B.04.

⁷³⁵ See par. 144.

⁷³⁶ Focussing on this aspect: *Helminen, Marjaana* in IBFD Commentaries on Art. 11 OECD MTC, sec. 5.1.1.2.5.2.; *Harris, Peter A.* in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.2.5.3.; *Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1270, par. 46, and p. 1415, par. 36.

⁷³⁷ Focussing on this aspect: *Wattel / Marres*, fictitious income, p. 69.

⁷³⁸ See par. 19.

⁷³⁹ See par. 21.

distributive articles. The next step then draws another line between capital *gains* and the other income types within chap. III of the OECD MTC by transferring the implications found in the previous step to capital *gains*. The final step applies the implications found in the previous steps to deemed income, including deemed capital gains.

2.3.4.2 The relevance of the terms ‘paid’ and ‘from’

- 148 As a starting point, the majority of commentators tend to the consensus view that the word *paid* is an auxiliary term that would bear a nexus with the transaction⁷⁴⁰ and therefore had to be interpreted autonomously. The term is to be understood with a broad meaning in the sense that the *income* must be transferred at the disposal of the *recipient* or *beneficial owner* in the manner required by contract or by custom⁷⁴¹. Accordingly, the OECD MTC grants a certain degree of flexibility in this respect. For instance, it considers not only payments decided by annual general meetings of the shareholders a *dividend* but also other benefits in money or money’s worth⁷⁴². Hence, the term *paid* goes beyond cash transactions and also includes surrogates⁷⁴³.
- 149 For some commentators it nevertheless appears reasonable to argue in favour of a domestic interpretation of the term *paid*, in that it would rather bear a nexus with *income*⁷⁴⁴. However, from the author’s point of view, *income* must be seen in two contextual aspects:
- On the one side, *income* has the only purpose and function in the treaty context to serve the assessment of a transaction⁷⁴⁵. In this context, the domestic interpretation of *income* and therefore its capability to contribute anything to the autonomous meaning of the distributive provisions of the OECD MTC is “reduced to zero”. Ergo, on the treaty level the question of whether something has been *paid* as such is independent of the assessment by the *income*, i.e. there is no nexus between the two in this respect.⁷⁴⁶
 - On the other hand there is the domestic context, in which the jurisdiction – while comprehensively interpreting *income* pursuant to its domestic tax law – is limited by the treaty in so far⁷⁴⁷ as *income* must be causally linked to the asset (i.e. *share* or *debt-claim*). This limitation is the weaker the more broadly *income* is interpreted by that jurisdiction. In other words: the elements of *share* and *debt-claim* as the sources of that *income* could almost entirely be marginalised where the domestic interpretation of *income* is only

⁷⁴⁰ Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lehner, p. 1156, par. 22; Kaeser, Christian / Wassermeyer, Franz in Wassermeyer Commentaries, p. 1270, par. 45, p. 1414, par. 36, and p. 1305, par. 104; Kemmeren, Eric C.C.M. in Klaus Vogel Commentaries 2015, p. 712, par. 13.

⁷⁴¹ Kemmeren, Eric C.C.M. in Klaus Vogel Commentaries 2015, p. 712, par. 11; Tischbirek, Wolfgang / Specker, Gerhard / Pöllath, Reinhard / Lobbeck, Allit in Vogel / Lehner, p. 1155, par. 22, p. 1295, par. 14, and p. 1304, par. 34; OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(10)-2, par. 7, and p. C(11)-2, par. 5; Belgian Hof van Beroep, judgement ref. 2010/AR/66, 2011; Brazilian Conselho de Administração de Recursos Fiscais, judgement ref. 106-17.142, 2008; Fuentes Hernandez, Daniel in Thomas Ecker, p. 448; Philip Baker, p. 11-3, par. 11-B06.

⁷⁴² Kaeser, Christian/Wassermeyer, Franz in Wassermeyer Commentaries, p. 1271, par. 47; OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-11, par. 28.

⁷⁴³ Tischbirek, Wolfgang/Specker, Gerhard in Vogel/Lehner, p. 1156, par. 22; Kaeser, Christian / Wassermeyer, Franz in Wassermeyer Commentaries, p. 1270, par. 46, p. 1414, par. 36, and p. 1430, par. 76, also making a connection with the beneficial owner, who – as a different person than the recipient – demands a broad meaning of paid; Klaus Vogel Commentaries 1997, p. 587, par. 22, and p. 722, par. 40.

⁷⁴⁴ In this sense: Helminen, Marjaana in IBFD Commentaries on Art. 11 OECD MTC, sec. 5.1.1.2.5.2., stating that “if a state deems that interest income exists, it most likely also deems that it is paid.”; Dutch Hoge Raad der Nederlanden, judgement ref. 13/02237, 2014, par. 3.3.3., for capital gains, and Dutch Hoge Raad der Nederlanden, judgement ref. 37651 and 37670, both par. 3.4.1., both 2003, for the term derived in the context of Art. 15 OECD MTC.

⁷⁴⁵ See par. 56.

⁷⁴⁶ Similarly: Wattel / Marres, fictitious income, p. 67, stating that “income fictions are, however, not the same thing as a method of calculating advantages that have been actually received.”

⁷⁴⁷ See par. 19.

broad enough. The reason is that the domestic tax law may impose its tax not only based on transactions but also on other trigger events wider than, or even independent of, any transaction. However, in the context of *dividends* pursuant to Art. 10(3) OECD MTC and *interest* pursuant to Art. 11(3) OECD MTC the transaction-based approach is not only implied but also required by the asset-based approach⁷⁴⁸.

- 150 The requisite link between the *income* and the asset is systematically established by the coincidence of the two words *paid* in Art. 10(1) and 11(1) OECD MTC and *from* in Art. 10(3) and 11(3) OECD MTC. The term *from* determines a causal relation between *income* and asset⁷⁴⁹. In contrast, the term *paid* validates this relation as what is considered as realised.⁷⁵⁰ In other words: the two terms act as that said “adapter” between the static reference *asset* and the dynamic reference *transaction*⁷⁵¹. The two terms are interdependent in the sense of bearing an inextricable nexus with each other in a reciprocal relationship, as no validation is possible without a determination and no determination is ascertainable without a validation.
- 151 As a consequence, both terms, *paid* and *from*, form one logical unit or concept that is to be interpreted autonomously. This is a result not only from the aforementioned literal and contextual considerations but also from the systematic structure of Art. 10(3) and 11(3) OECD MTC. The clause *income from shares* actually represents an indirect paraphrase for the transaction *income paid from the provision or contribution of equity* and the clause *income from debt-claims* actually represents an indirect paraphrase for the transaction *income paid from the provision or contribution of debt capital*. It is obvious that these logical equivalents preserve their meanings only as a whole and may therefore not be divided⁷⁵². More especially this follows also from the tax-limiting function of Art. 10 and 11 OECD MTC⁷⁵³ as an intentional and purposive argument of interpretation. These financial transactions are the constituting and indispensable elements and their very reasons for existence, which is why they may not be frustrated or marginalised⁷⁵⁴.
- 152 Admittedly, Art. 3(2) OECD MTC gives prevalence to domestic tax law for the interpretation of terms not defined in the OECD MTC therein (“*lex fori*”)⁷⁵⁵. This is the justification why some commentators do not see any specific treaty law requirement regarding the connection between the *income* and its trigger event⁷⁵⁶. However, for the aforementioned reasons the systematic structure as well as the purpose, intention and function of Art. 10 and 11 OECD MTC are of particular significance⁷⁵⁷. They justify the autonomous interpretation of the terms *paid* and *from* under the exception rule *unless the context otherwise requires* in Art. 3(2) OECD MTC. This is even more conclusive, as (1) both terms are *no termini technici*, (2) both limb 2 of Art. 10(3) OECD MTC and Art. 11(3) OECD MTC provide closed and exhaustive definitions and (3) a

⁷⁴⁸ See par. 53 et seq.

⁷⁴⁹ Equally: *Alexander Bosman*, p. 82 and 322; *Hans Pijl*, hybrid debts, introduction.

⁷⁵⁰ See par. 144.

⁷⁵¹ See par. 55.

⁷⁵² See par. 52 et seq.

⁷⁵³ See par. 112.

⁷⁵⁴ Similarly: Dutch Hoge Raad der Nederlanden, judgement ref. 39.385, 2004.

⁷⁵⁵ See par. 20.

⁷⁵⁶ *Alexander Bosman*, p. 81 et seq., p. 93, 252 and 260; *Reimer, Ekkehart* in *Klaus Vogel Commentaries* 2015, p. 1052, par. 21, and p. 1053, par. 24, as well as in *Vogel / Lechner*, p. 1443, par. 28 and 30. All without however providing further justification, particularly in regards to whether or not the exception rule unless the context otherwise requires may apply (see par. 14).

⁷⁵⁷ *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 277, par. 78; *Klaus Vogel Commentaries* 1997, p. 215 et seq., par. 73 and 74(3).

domestic interpretation could make these provisions inapplicable.⁷⁵⁸ In summary, the domestic interpretation of *income* is limited by the terms *from*⁷⁵⁹ and *paid*.

2.3.4.3 *The relevance of the term 'arising'*

- 153 While there is more or less consensus on the point that the terms *paid* and *from* in the context of *dividends* and *interest* are to be interpreted autonomously⁷⁶⁰, the discussion is more controversial with regard to *other income* pursuant to Art. 21(1) OECD MTC⁷⁶¹. This is quite remarkable, as the realisation requirements in all distributive provisions are considered equivalent to each other, in that they are not in themselves relevant for the delimitation of the distributive provisions.⁷⁶² The matter of realisation was said to point to subjacent questions on the nature of an income tax. Here, the actual Schanz-Haig-Simons concept calls for common ground between *income* pursuant to chap. III of the OECD MTC and *capital* pursuant to chap. IV of the OECD MTC⁷⁶³. According to the view represented in this study, this common ground is a legal event (form over substance). This legal event may not be triggered by the domestic *tax* law but must be triggered by any *precursory* field of law. In addition, the legal event must – by comparing the states before and after – result in a new right. This limited autonomous interpretation of the realisation principle, which may be called a “principle of autonomous legality”, is the result of the following systematic considerations:
- 154 When it comes to the determination of capital, the law becomes primarily relevant for the subjective aspect of attribution (i.e. who is and who is yet or not yet or no more considered the owner). But it is typically less relevant for the objective aspect of what capital is. As a demonstration, the legal answer to the question of what a given person’s capital is, may be something like: “Capital is the total of all his rights” (e.g. assets, entitlements, etc.). This looks like a legal definition of capital but could also be seen as somehow incomplete if looked at more closely as the following example illustrates:
- 155 The actual share’s price is not only affected by (1) the company’s substantial assets and rights represented by the share but also (2) by a prospected but uncertain dividend and (3) by the expected but uncertain development of the market interest rates⁷⁶⁴. While the first effect (1) is covered by that legal understanding of capital as the total of all rights, the last two examples (2) and (3) demonstrate that capital is actually more than legal substance: rather, it includes also uncertain future economic expectations. This fact comes into focus against the background that modern and generally accepted methodologies to determine a person’s capital are constantly based on a look-forward perspective and on probabilities. In the second example (2), the prospected dividend as the value driver is already forward-looking but still somehow connected with and therefore assignable to the right (i.e. the share). However, in the third example (3), the expected development

⁷⁵⁸ See par. 20.

⁷⁵⁹ Equally: *Harris, Peter A.* in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.2.5.1.

⁷⁶⁰ See par. 148.

⁷⁶¹ See footnote 729.

⁷⁶² See par. 144.

⁷⁶³ See par. 79.

⁷⁶⁴ Similarly: IFRS 9.3.2.8.

of the market interest rates as the value driver is also forward-looking but caused externally (i.e. it comes from the outer environment)⁷⁶⁵, being completely unrelated and unassignable to the right (i.e. the share)⁷⁶⁶.

- 156 From the legal perspective, these value drivers are aspects of the assessment of a given right. However, this assessment requires and presumes an assignment of the value drivers to that right. Although this assignment is less a legal but rather an economic discipline, it is the constituting and indispensable core element of capital. While a right assessed at a zero value is not capital, value drivers may in turn be realised in multiple legal ways or even without being attached to any right (e.g. by way of *beneficial ownership* through factual power structures⁷⁶⁷). That is why, from the economic perspective, the legal perspective appears to be limited by being attached to rights. For this reason, the economic answer to the same demonstrative question of what a given person's capital is, may be something like: "Capital is the total of all his value drivers convertible into cash." This is the economic definition of capital, which is obviously more comprehensive than the above legal understanding⁷⁶⁸. From this economic perspective, the "total of all rights" are mere containers or allocational references for the value drivers.
- 157 Bringing both together, the legal view that the assignment of value drivers to given rights is an assessment problem is nevertheless as true as the economic view that the assignment of value drivers to rights is an allocation problem.⁷⁶⁹ That is why both the legal and the economic understanding of capital are neither wrong nor incomplete. The legal understanding of capital, such as in Art. 22 OECD MTC, starts with the existence of any right leaving the allocation problem of value drivers (assessment) aside. In contrast, the economic understanding of capital starts with the existence of any value driver leaving the legal rights as allocational references aside. Both aspects form one logical concept or mechanism, being mutually interdependent and bearing an inextricable nexus with each other in a reciprocal relationship. That is why the assessment can solve allocation problems the same way the allocation can solve assessment problems. In economic science, there is even a technical term for this assignment problem: "external effects". It describes value drivers, which are excluded from the pricing mechanism in the sense that uninvolved third parties are affected as well, rather than only the involved legal parties (e.g. pollution). External effects typically result in distorted market prices. However, external effects are actually allocation problems due to the lack of marketable references or units (i.e. rights), by which the involved legal parties and the uninvolved third parties could compensate each other. Nevertheless, even in the absence of those marketable references or units, the value drivers *are* in fact assigned to rights. However, these are – by way of an "externalisation" – the rights of the uninvolved third parties (i.e. the assessment "solves" the allocation problem). It is rather the undesirable distortion effects of this "assessment solution" which can be mitigated by way of an "internalisation". "Internalisation" does nothing else than create dedicated rights (e.g. pollution certificates) or other negative assets⁷⁷⁰ as marketable references or units in order to involve the third party in the relationship (i.e. the allocation solves the assessment problem). In other words: both views eventually mean the same "coin" and only take their justification from different sides of

⁷⁶⁵ See par. 62.

⁷⁶⁶ See par. 66.

⁷⁶⁷ See par. 119 et seq.

⁷⁶⁸ See par. 154.

⁷⁶⁹ Similarly: Kemmeren, Eric C.C.M. in *Klaus Vogel Commentaries* 2015, p. 719, par. 27.

⁷⁷⁰ See par. 60.

that “coin”.⁷⁷¹ As a first conclusion, capital is here understood as the total of all value drivers, economically allocated to rights as the object, which is legally attributed to a subject⁷⁷².

- 158 This understanding also demonstrates that the law gains further relevance when it comes to the (de-) composition or structure of the capital in the sense of constituting rights, which are required and presumed for allocating value drivers to them (e.g. assets, entitlements, etc.). Taking the previous example⁷⁷³ again, the actual share's price is also affected by the prospected but uncertain dividend. It does not affect the total economic capital as a whole (i.e. share and/or *dividend* and/or sales proceeds), whether the share is held cum dividend at a higher price (*capital*) or the income is realised by either selling the share cum dividend at a higher price (*capital gain*) or by receiving the *dividend* and holding the share ex dividend at a lower price. Rather, it affects only its decomposition in what is legally considered *capital* (i.e. the right in the share) and *income* (i.e. the right in the *dividend* and/or the sales proceeds). The reason is that *income* does not *arise* from “anywhere” outside but from inside the *capital* itself. This means as another conclusion that *capital* cannot be distinguished from *income* economically but only legally. Or in other words: *income* is part of *capital*, legally split-off from it⁷⁷⁴. In this respect, one could even go so far as to say that there is no need for legal events (e.g. dividend resolution) for making someone economically richer. Accordingly, a key differentiator within the OECD MTC between *income* pursuant to chap. III of the OECD MTC and *capital* pursuant to chap. IV of the OECD MTC is that there must be as a necessary minimum condition (*conditio sine qua non*) some legal event in the sense of creating a new right. Taxable events not caused by the creation of any new right are not *income*. To this minimal extent (form over substance⁷⁷⁵), the realisation of *income* must be interpreted autonomously.⁷⁷⁶ The result of that legal event is that the *income* is legally realised and the *capital* legally decreases.

2.3.4.4. The relevance of the term ‘alienation’

- 159 Although the realisation requirements in all distributive provisions are considered equivalent, the discussion whether it shall be interpreted autonomously or domestically is the most controversial in respect of capital *gains* pursuant to Art. 13(5) OECD MTC⁷⁷⁷. Going forward drawing another line between capital *gains* and the other income types within chap. III of the OECD MTC, the implications found in the previous step shall now be transferred to capital *gains*.

⁷⁷¹ Reimer, Ekkehart in Klaus Vogel Commentaries 2015, p. 1050, par. 4, and in Vogel / Lechner, p. 1440, par. 3, falling victim to this ambiguity by saying that “the increase has to follow from the object itself, not from a change in the outer appearance of the object”, just as David Hasen, p. 405, by saying that “the fluctuations must result from secondary market effects, rather than from a change either to the property that generates the return, or in the relationship of the holder to the property itself.” The increase does actually not only follow from the object itself (i.e. internal value drivers) but inextricably also from a change in its outer appearance (i.e. external value drivers). However, in the absence of other rights as allocational references, the external value drivers will be assigned to the object (see also Example 4 on p. 29). This said externalisation by way of assessment makes those abovementioned statements not wrong but misleading. Likewise ambivalent: Wassermeyer, Franz in Wassermeyer Commentaries, p. 1609, par. 26, p. 1611, par. 28, p. 1612, par. 29, p. 1613, par. 31, and p. 1648, par. 137.

⁷⁷² See par. 120 et seqq.

⁷⁷³ See par. 155.

⁷⁷⁴ Equally: Joanna Wheeler, missing keystone, sec. 3.2.1., accurately stating that “there must be something that is already detached from the source that can be classified as income, and the ‘paid to’ terminology reflects this feature”.

⁷⁷⁵ See par. 79.

⁷⁷⁶ Equally: IFRS 9.5.7.1A(a); Reimer, Ekkehart in Klaus Vogel Commentaries 2015, p. 1051, par. 11, and p. 1052, par. 15 and 20; Wassermeyer, Franz in Wassermeyer Commentaries, p. 1609, par. 26, by also emphasising that this autonomous interpretation is precedent to Art. 3(2) OECD MTC; Michael Lang, introduction, p. 107, par. 313.

⁷⁷⁷ See footnote 734.

- 160 As stated earlier, capital is economically more than actual legal substance such as real assets and rights⁷⁷⁸. Moreover, even this actual substance is in fact determined by the income that can probably be expected from it (including the proceeds from its possible later re-sale or liquidation). Or in other words: today's capital *is* tomorrow's income.

Example 22: A strip is a split-off of specifically identified cash flows such as profit entitlements from a financial instrument. It represents income and, at the same time and in the same amount, also capital.

Taking the above example⁷⁷⁹ again, the actual share's price is also affected by the prospected but uncertain dividend. It does not affect the income as a whole, whether the income is realised by either selling the share cum dividend at a higher capital *gain* or by receiving the *dividend* and holding the share ex dividend at a lower price. Rather, it only affects its legal classification as a *dividend* or capital *gain*. This is not just another reason why *capital* cannot be distinguished from *income* economically but only legally. It also means as another conclusion that capital *gains* cannot be distinguished from the other income types economically⁷⁸⁰ but also only legally. The difference is that the distinction between *income* pursuant to chap. III of the OECD MTC and *capital* pursuant to chap. IV of the OECD MTC is the realisation by *any* legal event *at all*⁷⁸¹. In contrast, the distinction within chap. III of the OECD MTC is that the legal event must refer *to* the asset itself for capital *gains* (the "tree") and *not to* the asset for the other income types (the "fruit").

- 161 Legal events refer *to* the asset, if they affect the critical ownership rights *in* the asset⁷⁸². This is the key differentiator of capital *gains* from the other income types leading to another conclusion: in both categories there must be some legal event that restructures the capital by splitting-off income and creating new rights. Notably, in both categories this legal event does not change the total economic capital as a whole. However, the legal event for capital *gains* creates a new right (e.g. the sales proceeds) *replacing* an existing one (e.g. the ownership rights *in* the asset itself). In contrast, the legal event for the other income types creates a new right (e.g. *dividend*) *set next to* that existing one. Since neither category changes the total economic capital, the consequence is a different value allocation for the respective rights. Capital *gains* leave the *value* of the existing rights unchanged: their number decreases at the same ratio as their proportional value (vertical split-off of value substance⁷⁸³)⁷⁸⁴. On the contrary, the other income types leave the *number* of the existing rights (i.e. the ownership rights *in* the asset itself) unchanged. As a consequence, their value must be reallocated to more rights than before by "extracting" or "carving-out" value from the existing rights (horizontal split-off of value substance⁷⁸⁵)⁷⁸⁶. In other words: while capital *gains* replace one allocational reference by another, the other income types re-allocate the value to more references than before.

⁷⁷⁸ See par. 155.

⁷⁷⁹ See par. 155.

⁷⁸⁰ Similarly: Reimer, *Ekkehart in Klaus Vogel Commentaries* 2015, p. 1051, par. 11.

⁷⁸¹ See par. 158.

⁷⁸² Similarly: IFRS 9.3.2.9. For a more detailed analysis see par. 314 et seqq.

⁷⁸³ Similarly: IFRS 9.B6.3.16 et seq.

⁷⁸⁴ Equally: IFRS 9.3.2.2(a)(ii).

⁷⁸⁵ Similarly: IFRS 9.B6.3.16 and 9.B6.3.18.

⁷⁸⁶ Equally: IFRS 9.3.2.2(a)(i) and 9.3.2.2(a)(iii); similarly: *Marjaana Helminen*, dividend concept, p. 141.

- 162 On the one side, both capital *gains* and the other income types give rise to new rights. Hence, this information cannot be taken as a differentiator. On the other side, capital *gains* decrease the number of the existing rights in a way that they are no longer with the owner once the transaction is completed (i.e. the dual character of *alienation*⁷⁸⁷). This makes the *alienation* a legal right that refers to the disposal of the critical ownership rights a dual-purpose differentiator for capital *gains* in a tie-breaking test. Not only does it distinguish capital *gains* from *capital* but at the same time it also distinguishes capital *gains* from the other income types. As another conclusion for the further course of this study, this means in result: by comparing the states before and after, the legal event must – as a necessary minimum condition (*conditio sine qua non*) – impair the mathematical number of the critical ownership rights *in* the asset⁷⁸⁸. Other legal events without such an effect cannot constitute capital *gains*. Such a differentiator would also comply with the logical, legal and technical requirements to the tie-breaking test aspired to in this study⁷⁸⁹. To this minimal extent, the realisation of capital *gains* must be interpreted autonomously. An accompanying piece of information that may also be used for an even more precise tie-breaking test, is the criterion if or to what extent the ratio between the number of the critical ownership rights *in* the asset and their proportional value changes as a result of that legal event (i.e. by comparing the states before and after).
- 163 Beyond that, these considerations also give indications of an answer to the subsequent question which intensity or qualitative criteria such a legal event must have in order to be independent from the domestic interpretation of the realisation. For instance, a legal event is also a change of the tax status of an asset treated by domestic tax law as a deemed capital gain. In order to constitute any kind of *income*, from the aforementioned considerations it follows, however, that there are at least two requirements to the quality or intensity of the legal event in the sense of a necessary minimum condition (*conditio sine qua non*):
- (1) It may not be triggered by the domestic *tax* law but must necessarily be triggered by a *precursory* field of law. This follows from the fact that the domestic tax law itself builds on *precursory* fields of law⁷⁹⁰. As was stated, the domestic tax law itself cannot generate the information on the original trigger event as the cause or “input”, but can only evaluate it for the purpose of tax classification as the effect or “output”⁷⁹¹. This is why the reverse deduction that there was a realisation wherever there is a *tax*, was an erroneous conclusion from an effect to its cause⁷⁹².
 - (2) The comparison of the states before and after must result in the creation of a new right⁷⁹³. This follows from the above conclusion that the determination of *income* requires a legal event and that the legal events of both capital *gains* and the other income types create new rights⁷⁹⁴.

⁷⁸⁷ See par. 145.

⁷⁸⁸ Similarly: Reimer, *Ekkehart in Klaus Vogel Commentaries* 2015, p. 1051, par. 12.

⁷⁸⁹ See par. 5.

⁷⁹⁰ See Illustration 2 on p.35.

⁷⁹¹ See par. 80.

⁷⁹² Cum hoc ergo propter hoc.

⁷⁹³ See par. 161 et seq. Similarly: *Wattel / Marres*, fictitious income, p. 68, stating that “the terms ‘paid’ and ‘payment’ must therefore be interpreted broadly but in any case a fulfilment of an obligation is required, or at least a real shift of assets or value from one taxpayer to another. This is not the case with respect to fictitious income: in fact, it is called ‘fictitious’ precisely because it is non-existent from a civil law point of view and has not (or has not yet) led to any shift of assets or value.”

⁷⁹⁴ See par. 158 et seqq.

2.3.4.5 Deemed income

- 164 Coming back to the starting point of this section, the aforementioned considerations provide the background and influence as well as the reason for the considerable significance of the terms *paid*, *arising* and *from* – even though *income* is unquestionably to be interpreted pursuant to domestic tax law. Said terms actually concretise that requirement and word it into legal language. Applying these considerations to deemed income, the consequence is, on the one hand, that those taxable events creating a new right are clearly considered as realised in line with the above understanding⁷⁹⁵ of a limited autonomous interpretation (e.g. the dividend resolution for a *dividend* in kind or the shareholder resolution for a corporate action).
- 165 On the other hand, it follows that any other taxable event not triggered by the creation of new rights is not considered as realised in line with that above understanding of a limited autonomous interpretation. In this point the systematic distinction between *income* and *capital* coalesces with the meaning and interpretation of the term *taxes on income* pursuant to Art. 2 OECD MTC. This is of particular importance where a DTC does not contain a provision on the taxation of *capital* equivalent to Art. 22 OECD MTC.⁷⁹⁶ In those cases the aforementioned conclusions may fail, as they have been systematically deduced from the initial distinction between *income* and *capital*. Without such provision equivalent to Art. 22 OECD MTC on the taxation of *capital*, those DTC apply, however, to taxes on *income* only. This is why the problem is actually shifted to Art. 2 of that DTC. As stated, this touches on the theory of tax types, which cannot be examined in more detail here⁷⁹⁷. As a side note, some of the following considerations may, however, give indications of the treatment of deemed income and may help to understand the preceding conclusions from this perspective as well.
- 166 As an example, a source jurisdiction may be assumed to impose a notional income tax based on the absolute value or the value performance of assets held at a particular date (mark-to-market method). This example of an increment value tax shall be analysed in three versions:
- (1) the tax covers all income types except capital gains and applies irrespective of the income effectively realised, while capital gains are taxed as effectively realised;
 - (2) the tax covers all income types including capital gains and applies irrespective of the income and capital gains effectively realised;
 - (3) the tax regime grants the voluntary option to alternatively declare the income and/or capital gains effectively realised.
- 167 In all three versions the trigger event for the taxation pursuant to domestic tax law is the mere ownership in the assets held at that particular date. Transformed into the asset-based wording⁷⁹⁸, it would read: “income from the *holding* of shares/bonds”. Obviously, this trigger event is not a legal event in the sense of creating a new right. It shows that an increment value tax serves as a good illustration for the question whether such weak causal link between the asset and that deemed income⁷⁹⁹ shall legitimate the source jurisdiction to impose tax. At the same time it also demonstrates why this problem coalesces with the meaning and interpretation of the term *taxes on income* pursuant to Art. 2 OECD MTC. While the provisions on the taxation of income require

⁷⁹⁵ See par. 158.

⁷⁹⁶ Dubut, *Thomas* in *Thomas Ecker*, p. 121.

⁷⁹⁷ See par. 79 and 153.

⁷⁹⁸ See par. 52.

⁷⁹⁹ See par. 149.

a transaction as a dynamic reference in order to represent an income tax, the mere *holding* of the assets as the trigger event is a static reference⁸⁰⁰. It also demonstrates again that the asset-based approach is not cohesive. Although it is not a transaction but associated with the asset by the domestic tax law, *holding* is not admissible or accessible to the asset in order to yield *income*. In other words: the object of an increment value tax is not compatible with the object of an income tax. For this reason the problem cannot be resolved methodologically by reference to the good faith principle in Art. 31(1) VCLT⁸⁰¹.

- 168 The third version (3) is a false problem. An assumed rational taxpayer will never declare his income effectively realised where this exceeds the notional or deemed income. Consequently, such contingent notional or deemed income could be assumed to always represent *income* effectively realised. Taken this separately, the third version (3) is therefore a straightforward income tax in line with the above understanding of a limited autonomous interpretation⁸⁰². Nevertheless, the third version (3) also demonstrates that the interpretation and application of the terms *paid*, *arising* and *alienation* may not depend on the circumstances of an individual case. In particular, they may not depend on the design of an individual tax system. Instead, they must – to a certain extent – necessarily be detached from the domestic tax law.
- 169 According to the view represented in this study, the first two versions (1) and (2) are examples of taxable events not triggered by a legal event and therefore not realised in line with the above understanding of a limited autonomous interpretation⁸⁰³. The second version (2) exposes even more clearly the character of such an increment value tax. “Deemed capital gains” or “accruals” without any legal event are actually the same as *capital* and consequently a tax on these items is actually a wealth tax⁸⁰⁴.
- (1) As a first argument in favour of a literal or textual interpretation, any other conclusion would contradict the clear and explicit wording of Art. 13(5) OECD MTC. The attempt of some commentators to solve the problem of an increment value tax within the scope of Art. 13(5) OECD MTC⁸⁰⁵ would mean nothing else than actually ignoring the term *alienation*. Due to its dual character⁸⁰⁶, the term *alienation* does not only represent the realisation requirement; it also requires a transfer of the asset to another person or subject⁸⁰⁷. Therefore, the attempt of other commentators to “broaden” the interpretation⁸⁰⁸ of the term *alienation* into its exact opposite of a non-*alienation* is an interpretatio contra legem. The same would be true for the interpretation of the term *paid* into its opposite of a non-*paid*, such as effective *interest* from an inflation-linked note into nominal “interest” from a non-inflation linked note. Chap. III of the OECD MTC represents a realisation-based rather than an accretion-based tax system in that its application is

⁸⁰⁰ See par. 55.

⁸⁰¹ *Alexander Bosman*, p. 85, insofar confusing systematic with intentional elements of interpretation.

⁸⁰² See par. 164.

⁸⁰³ See par. 165.

⁸⁰⁴ Equally: *David Weisbach*, p. 510 et seq.

⁸⁰⁵ Without justification: *Reimer, Ekkehart/Ismer, Roland/Blank, Alexander* in *Klaus Vogel Commentaries* 2015, p. 160, par. 37, p. 162, par. 48, and p. 1568, par. 8 and 10 et seq.; *Ismer, Roland* in *Vogel/Lebner*, p. 474 et seq., par. 39; *Wassermeyer Commentaries*, p. 222, par. 44.

⁸⁰⁶ See par. 145.

⁸⁰⁷ See par. 162.

⁸⁰⁸ *Stefano Simontacchi*, p. 190 et seq., merely comparing the legal consequences (effect) of Art. 13(5) OECD MTC with those of Art. 7 and 21 OECD MTC. He also seems to draw the impermissible reverse deduction to the legal grounds (cause) that there was an inconsistently different tax regime unless unrealised capital gains were subsumed under Art. 13(5) OECD MTC as well. This argument also prejudices that unrealised income was even subsumable under Art. 7 and 21 OECD MTC.

deferred until a concrete trigger event occurs, i.e. the legal event⁸⁰⁹. This becomes particularly clear where the deemed capital gain, once realised later, is then not taxed. In a consistent tax system this is quite likely, as the capital gain would otherwise be double-taxed, even pursuant to the source jurisdiction's own domestic tax law. Such an interpretatio contra legem would not methodologically justify compensating a "systematic inconsistency" between realised and unrealised capital gains⁸¹⁰ either. Potential solutions such as mark-to-market, ex-post, risk-based or pattern approaches come into question only in the context of a possible future reform and fundamental change of the entire tax system⁸¹¹. A possible need for future action was, however, said to be not the same as the interpretation and application of the existing OECD MTC⁸¹². For these reasons any attempt at solving the realisation requirement by way of interpretation at all, in order to make the objects or natures of an increment value tax and an income tax compatible with each other⁸¹³, especially by applying the *substance over form* principle, is an impermissible interpretatio contra legem.

- (2) In addition, the aforementioned arguments make plain that such "systematic inconsistency" between realised and unrealised capital gains actually does not exist. The system of the OECD MTC was said to call, moreover, for a common ground between *income* and capital *gains* in order to distinguish the two from *capital*⁸¹⁴ (i.e. the realisation). Furthermore, the realisation represents the necessary link between the asset and the transaction. As such it is independent of the *income* in the treaty context⁸¹⁵, so that there is no need either for any domestic interpretation. In addition, the character of a tax determined by its object (i.e. wealth) must be distinguished from its tax base (i.e. increment value or unrealised capital gain).⁸¹⁶ And finally, the distributive articles cannot go beyond Art. 2 OECD MTC⁸¹⁷, which is intended to delineate the scope of taxes generally covered by the OECD MTC⁸¹⁸. These systematic arguments of interpretation are also in line with the consensus that the realisation requirements in all distributive provisions are equivalent⁸¹⁹. In other words: just as unrealised income is not the same as realised *income*, unrealised capital gains are not the same as realised capital *gains*.
- (3) As an intentional and purposive argument of interpretation, the financial transactions were said to be the constituting and indispensable elements of the distributive provisions and their very reasons for existence,

⁸⁰⁹ "The capital gains system relies on realization events, or triggers, such as a sale or exchange, before a person's income will be taxed, regardless of any increase in wealth in the meanwhile. This system is known as the 'wait and see' approach because, regardless of appreciation or depreciation of the asset between purchase and sale" (*Kolbrenner, Scott Marc*, *Derivatives Design and Taxation*, Virginia Tax Review 1995, Vol. 15, Issue 2, p. 245). In other words: chap. III of the OECD MTC "is able to measure the economically meaningful quantities only as closely as accounting and market-based mechanisms will allow. Taxable income is not economic income, it is at best a transaction-based approximation to economic income, which is itself only a proxy for some more fundamental policy goal." (*Anthony Polito*, p. 765 et seq.).

⁸¹⁰ *Stefano Simontacchi*, p. 191.

⁸¹¹ *Jieyin Tang*, bifurcation or integration, sec. 2; *Sven-Eric Bärsch*, p. 77; *Wood, Richard*, Financial Innovation and a Universally Applicable Distinction between Accruals and Realization Taxation, *Intertax* 2011, Vol. 39, Issue 8 / 9, p. 402 et seq.; *Laukkanen, Antti*, Taxation of Investment Derivatives, IBFD, Amsterdam, 2007, p. 408 et seq.; *David Hasen*, p. 399 – 403; *Achim Pross*, p. 172; *Deborah Huffman Schenk*, financial instruments, p. 583 et seqq.; *David Weisbach*, p. 492; *Jeff Strnad*, conceptual framework, p. 592; *Warren, Alvin C. Jr.*, Financial Contract Innovation and Income Tax Policy, *Harvard Law Review* 1993, Vol. 107, Issue 2, p. 474.

⁸¹² See par. 76.

⁸¹³ See par. 167.

⁸¹⁴ See par. 79 and 153.

⁸¹⁵ See par. 149 et seqq.

⁸¹⁶ See footnote 746.

⁸¹⁷ See par. 113.

⁸¹⁸ *Cui, Wei* in IBFD Commentaries on Art. 2 OECD MTC, sec. 6.2.1.

⁸¹⁹ See par. 144.

which is why they may not be frustrated or marginalised⁸²⁰. In addition, pursuant to the laws of logic it should be permissible to make the general assumption that the contracting jurisdictions of a DTC do not intend to regulate something that cannot actually be processed by that DTC.

Metaphorically, DTC are “converters” which receive information from the domestic tax law (i.e. the income classification as the “input”). They act in order to attach an additional piece of information (i.e. the income re-classification as the “conversion”)⁸²¹ and then to send it back to the domestic tax law (i.e. the “output”). The input must contain at least two separate pieces of information: (1) the event or matter of fact as the cause and (2) the effect to what extent that event or matter of fact is taxable pursuant to domestic tax law. Where the first piece of information (1) was missing, the input would only read: “We have taxed *something*” (effect only). Obviously, this information is incomplete and cannot actually be “processed” or converted by the DTC. What was missing was any reference of what that taxation is linked or referring to, namely the complementary input information of “what has happened”. In other words: the purpose and function of DTC require and presume an assignment of the tax to an event in the sense that the event must be the object of the tax. While the tax as the effect addresses Art. 2, the event as the cause addresses the distributive articles. The necessity to receive both pieces of information shows once more the nexus between the two aspects⁸²². The character of the tax cannot be determined without any reference or object. To a certain extent, this reference must be objectified⁸²³ in order to separate the information of “what has happened” from “there is a tax”, i.e. to separate cause and effect. The mere subjective and unilateral intention of the domestic tax law that the tax (e.g. increment value tax) shall cover certain events (e.g. capital *gains*) is not sufficient. This holds a fortiori for the eventually axiomatic notice that an increment value tax was an income tax⁸²⁴, because its object was not the total wealth⁸²⁵. This is even more crucial since Art. 2(2) OECD MTC also includes “taxes imposed on [...] elements of [...] capital”. This expression actually coalesces both in one: rights on certain assets and rights on income from assets⁸²⁶. The arbitrariness is made particularly clear by the demonstrative question, at which point or level the notional tax base shall otherwise “start to turn” from an income into a wealth tax: 5% of net wealth or 10% or maybe 15%? Obviously, the character of a tax cannot be a question of its level. Instead, that certain extent, to which the *event* must be objectified, is the interpretation of the terms *paid*, *arising* and *alienation* as the autonomous part of the realisation.

That said, a DTC can “receive” the following states or combinations of information:

- The event and the tax
- The event and no tax
- No event and the tax
- No event and no tax

⁸²⁰ See par. 151.

⁸²¹ See par. 163.

⁸²² See par. 165.

⁸²³ See par. 168.

⁸²⁴ David Weisbach, p. 509.

⁸²⁵ In this sense, however: Dutch Hoge Raad der Nederlanden, judgement ref. 42.211, 2006, and *Wattel / Marres*, fictitious income, p. 78. They argue that the Dutch increment value tax regime for notional capital income is integrated in the taxation of income from other sources, such as considering some specific deductibles and personal allowances.

⁸²⁶ See par. 158.

The third case is the only one that cannot be “processed” by the DTC in this respect due to its incompatible objects of taxation (qualification conflicts)⁸²⁷. True, the input information represent facts or precursory matters from the treaty perspective⁸²⁸, but these facts or precursory matters refer only to tax level of Art. 2 in the sense of “there is a tax” and not to the distributive articles in the sense of “what has happened”. This is another reason why at the treaty level the reverse deduction that there was a realisation (cause) wherever there is a tax (effect)⁸²⁹, leads to erroneous conclusions.

- (4) In this respect, the OECD Commentaries on Art. 13 OECD MTC are not perfectly clear. In the preliminary remarks certain statements can be found suggesting that an increment value tax is considered an income tax⁸³⁰. This would imply that a legal event would not be required at all. Then, some of the general remarks seem to (re-)narrow these statements, without however taking a clear position.⁸³¹ These paragraphs trace back to 1962⁸³², when Art. 22 OECD MTC already existed. In that sense these statements may enjoy an even greater legitimacy, as the OECD could be said to have acted in its “legislative” role⁸³³. Therefore the historical interpretation of Art. 13(5) OECD MTC does not give further indication as to whether an increment value tax is considered either an income tax or a wealth tax⁸³⁴. The fact that Art. 2(2) OECD MTC also includes taxes on capital appreciation⁸³⁵, in itself does not justify a conclusion as to whether or not that capital appreciation is eventually meant as an income tax⁸³⁶. The reason is that the OECD MTC does not only apply to *taxes on income* but also to those on *capital*⁸³⁷. Art. 13 OECD MTC was introduced later than Art. 22 OECD MTC⁸³⁸ and it might therefore be surmised that the position was chosen merely because the problem came up and is more relevant in the context of Art. 13(5) OECD MTC rather than of Art. 22 OECD MTC. Admittedly, the position of these interpretations in the context of Art. 13(5) OECD MTC in conjunction with the position of Art. 13 in chap. III of the OECD MTC (i.e. “taxation of *income*”) suggests that an increment value tax was at least historically considered an income tax rather than a wealth tax⁸³⁹. However, it seems the OECD Commentaries take a narrow final view⁸⁴⁰ only with respect to accruals on business assets⁸⁴¹. For those, Art. 13(5) OECD MTC is even more limited, namely to movable business assets not allocated to the source jurisdiction only⁸⁴². This would

⁸²⁷ See par. 167.

⁸²⁸ See par. 144.

⁸²⁹ Cum hoc ergo propter hoc.

⁸³⁰ “It is left to the domestic law of each Contracting State to decide whether capital gains should be taxed and, if they are taxable, how they are to be taxed. [...] The Article [13] does not specify to what kind of tax it applies. It is understood that the Article [13] must apply to all kinds of taxes levied by a Contracting State on capital gains.” (OECD Commentaries 2014 on Art. 13 OECD MTC, p. C(13)-1, par. 2 et seq., explicitly mentioning “increment taxes”).

⁸³¹ “Appreciation in value not associated with the alienation of a capital asset is not taxed, since, as long as the owner still holds the asset in question, the capital gain exists only on paper.” (OECD Commentaries 2014 on Art. 13 OECD MTC, p. C(13)-2, par. 7, further merely noticing some observations of special country practices).

⁸³² OECD, FC-WP19(62)1, p. 3.

⁸³³ See par. 31.

⁸³⁴ See also *Cui, Wei* in IBFD Commentaries on Art. 2 OECD MTC, sec. 3.4.

⁸³⁵ OECD Commentaries 2014 on Art. 2 OECD MTC, p. C(2)-1, par. 3; OECD, FC-WP19(62)2, p. 4, par. 8.

⁸³⁶ In this sense, however: *Ismer, Roland* in *Vogel / Lebner*, p. 474 et seq., par. 39.

⁸³⁷ Equally: *Stefano Simontacchi*, p. 187.

⁸³⁸ *Li, Jinyan / Avella, Francesco* in IBFD Commentaries on Art. 13 OECD MTC, sec. 1.2.1.; *Stefano Simontacchi*, p. 123).

⁸³⁹ *Stefano Simontacchi*, p. 139 et seqq.

⁸⁴⁰ “Where capital appreciation and revaluation of business assets are taxed, the same principle should, as a rule, apply as in the case of the alienation of such assets.” (OECD Commentaries 2014 on Art. 13 OECD MTC, p. C(13)-3, par. 9).

⁸⁴¹ Equally: *Stefano Simontacchi*, p. 191.

⁸⁴² *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1645, par. 133.

still be in line with the first requirement of the intensity or qualitative requirements of the legal event⁸⁴³, according to which it may not be triggered by the domestic tax law but must come from a precursory field of law. As regards business assets, a legal event may be seen in an obligation to recognise, appreciate or revalue the asset pursuant to the domestic accounting law⁸⁴⁴ but not pursuant to the domestic tax law⁸⁴⁵. This is regardless of the fact that the domestic accounting law itself may adhere more to substantive than to legal concepts⁸⁴⁶. However, it may not be in line with the second requirement⁸⁴⁷, according to which the legal right must eventually give rise to a new right. As regards business assets, the obligation to recognise, appreciate or revalue the asset pursuant to the domestic accounting law can only be considered as a realisation where there can be simultaneously created a new right. The OECD Commentaries give no indication whether this crucial point was either taken into account or, rather, was simply overlooked.

- 170 It may be suggested from some comments⁸⁴⁸ that the OECD MTC concept of *beneficial ownership* necessarily implied deemed income. According to this view, deemed (re-)attribution would actually mean its deemed realisation by the *beneficial owner* as a third party, especially where the deemed income is “realised” by the *recipient* only and never actually paid to the *beneficial owner*. In other words: that there was a deemed realisation wherever there is a deemed taxpayer. Apparently, this view would mix the genuine legal realisation requirement with subsequent matters of (re-)attribution and (re-)classification⁸⁴⁹. As was stated, the law has a dual function⁸⁵⁰ with regard to capital of (1) determining a right in the *capital* and (2) attributing this right to a person⁸⁵¹. Even more, the law has that same dual function also with regard to *income* of (1) determining a right in the *income* – i.e. the realisation requirement as understood here – and (2) attributing this right to a person. And just as for *capital*, these two functions must be distinguished carefully⁸⁵² for the *income* as well. The objective determination or the initial question whether a transaction is considered as realised⁸⁵³ is a different one than the subsequent question to what or whom that *income* shall subjectively be attributed⁸⁵⁴. The reason is that the former is a logical pre-step and a necessary pre-condition for the latter⁸⁵⁵. That is why the deemed attribution by the concept of *beneficial ownership* cannot vice versa have any influence back on the deemed realisation. Rather, it can necessarily only have an influence forward on a subsequent and different (re-)classification rule⁸⁵⁶. In other words, there are three instead of two legal issues in this respect logically building on each other: (1) genuine realisation, (2) genuine attribution and (3) derivative reclassifications. While the first two aspects are the general principles, the third is a specific exception rule⁸⁵⁷ not justifying

⁸⁴³ See par. 163(1) and 164.

⁸⁴⁴ Equally: OECD, FC-WP19(62)2, p. 4, par. 8).

⁸⁴⁵ See par. 163.

⁸⁴⁶ See par. 71.

⁸⁴⁷ See par. 163(2) and 164.

⁸⁴⁸ *Tischbirek, Wolfgang / Specker, Gerhard* in *Vogel / Lebner*, p. 1157, par. 25; *Robert Danon*, sec. 3.3.; *Klaus Vogel Commentaries* 1997, p. 563, par. 11, p. 588, par. 25, and par. 722, par. 41. See also footnote 743.

⁸⁴⁹ See par. 73, 131(3) and 140.

⁸⁵⁰ See par. 79.

⁸⁵¹ See par. 157.

⁸⁵² See par. 130.

⁸⁵³ See par. 148 and 151.

⁸⁵⁴ Equally: *Helminen, Marjaana* in IBFD Commentaries on Art. 11 OECD MTC, sec. 5.1.1.3.2.

⁸⁵⁵ See par. 123.

⁸⁵⁶ Equally: *Tischbirek, Wolfgang* in *Vogel / Lebner*, p. 1107, par. 15; OECD, *Beneficial Owner*, 2012, p. 10; *Adolfo Martín Jiménez*, sec. 3.4.

⁸⁵⁷ See par. 73 and 141.

reverse deductions back to the general principles⁸⁵⁸. That is why, in particular, the legal event creating a new right cannot not be suspended by reference to the specific concept of *beneficial ownership*. This rationale and result remain valid even if the realisation requirement was to be entirely interpreted autonomously. In this case the three legal issues mentioned before would still build on each other in the sense of a one-way dependency, so that the exception rule of *beneficial ownership* could still reclassify the genuine attribution without also reclassifying the genuine autonomous realisation. Instead of raising a new issue, it would simply leave the initial question of how the two realisation concepts interact (i.e. the one on the treaty level and on the level of the domestic tax law). Further, the aforementioned rationale and result remain also valid even where there was a concept in the domestic tax law equivalent to the OECD MTC concept of *beneficial ownership*. The reason is that three legal issues would still build on each other in the sense of a one-way dependency, so that the exception rule of *beneficial ownership* could still reclassify the genuine domestic attribution without also reclassifying the genuine realisation. Instead of raising a new issue, it would simply leave the subsequent question of how the two *beneficial ownership* concepts interact⁸⁵⁹ (i.e. the one on the treaty level and on the level of the domestic tax law). To sum up, the term *from* is limited to the objective and general determination of a causal relation between *income* and asset⁸⁶⁰. It does not also determine the subjective and specific attributional relation between *income* and taxpayer, which is independent and subject of the subsequent concept of *beneficial ownership*⁸⁶¹. That is why it is accurate to say that it was “highly impractical” to replace the concept of *beneficial ownership* by a formula of the type of *income derived by* or the like⁸⁶².

- 171 All these validations show that the above conclusions⁸⁶³ of a limited autonomous interpretation of the terms *paid, arising* and *alienation* are resilient. According to the view represented here, they should also be transferable to those DTC that do not contain a provision equivalent to Art. 22 OECD MTC on the taxation of capital⁸⁶⁴. They may not be deduced directly from the distinction between *income* and *capital*⁸⁶⁵, but they can, however, be deduced indirectly from the distinction between capital *gains* and the other income types⁸⁶⁶. This latter distinction is that the realisation of *income* may not, and the realisation of capital *gains* must decrease the number of critical ownership rights in the asset. However, in both cases the realisation must be triggered by some legal event in the sense of creating a new right, which is required and presumed for allocating the value drivers. In other words: the distinction between *income* and *capital* is a necessary and implicit precondition for the distinction between capital *gains* and the other income types. Where a DTC does not contain a provision equivalent to Art. 22 OECD MTC on the taxation of capital, the systematic reverse deduction of this inherent principle nevertheless suggests itself. Otherwise the requisite distinction between capital *gains* and the other income types in those DTC would not be possible⁸⁶⁷.

⁸⁵⁸ See par. 80. Equally: Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lehner, p. 1156, par. 22.

⁸⁵⁹ Equally: Avery Jones, beneficial owner, p. 5.

⁸⁶⁰ See par. 150.

⁸⁶¹ See par. 115 et seqq.

⁸⁶² Gutmann, Daniel in Michael Lang, beneficial ownership, p. 342.

⁸⁶³ See par. 164.

⁸⁶⁴ See par. 165.

⁸⁶⁵ See par. 158.

⁸⁶⁶ See par. 160 et seqq.

⁸⁶⁷ Argumentum a minori ad maius.

- 172 The term *taxes on income* in Art. 2 may be interpreted autonomously to the extent that it covers only taxes on income triggered by a legal event in the sense of creating a new right. With respect to the scope of this study⁸⁶⁸, this side note however limited to the sole question whether the aforementioned conclusions are transferable to those DTC. There may be other valid arguments in those cases eventually justifying a different result. In particular, those arguments could come to the conclusion that Art. 2 nevertheless applies for some other good reasons, especially where the increment value tax is listed in Art. 2(3) of the DTC. Otherwise an increment value tax would be generally excluded from the scope and application of those DTC. This would lead to the opposite result, i.e. the source jurisdiction was legitimated to impose such an increment value tax instead of being restricted or limited in its taxation rights.

2.3.4.6 Conclusions

- 173 The purpose and objective of this section was to analyse the nature, the scope and the influence of the realisation principle. It is reflected by the words *paid* in Art. 10(1) OECD MTC for *dividends* and Art. 11(1) OECD MTC for *interest*, by the word *alienation* in Art. 13(5) OECD MTC and by the word *arising* in Art. 21(1) OECD MTC. It was found that the realisation principle as the link between the subjective and objective criteria of the distributive articles bears a particularly strong nexus with the asset and transaction on the one hand and the *income*-related elements on the other. This was identified as the root cause of the conflict and ambiguity between its domestic and its autonomous interpretation. As a result, the author takes the view of a limited autonomous interpretation of the realisation principle. It requires at least a legal event arising from a domestic field of law that is precursory to its tax law. This conclusion draws predominantly upon systematic considerations with in regard to the requisite distinction between *income* pursuant to chap. III of the OECD MTC and *capital* pursuant to chap. IV of the OECD MTC. As a secondary result from these considerations, it was further demonstrated that the limited autonomous interpretation of the realisation principle sets the scope for the classification of income types from financial instruments, in so far as deemed or notional income is basically not accessible to the OECD MTC. Finally, it was found as a subsequent conclusion that the characteristics of this legal event may be used as differentiators in a tie-breaking test to distinguish capital *gains* from other income types.

2.4 Analysis and discussion of potential differentiators

2.4.1 Preliminary remarks

- 174 The purpose of this section is to introduce, analyse and discuss possible differentiators with the aim of developing a concrete tie-breaking test that potentially delimitates Art. 10(3), 11(3), 13(5) and 21(1) OECD MTC. In particular, “all debt and equity characterisations can be described as an effort to determine whether (at least in relation to someone else) an investor is participating in the issuer’s profits and risks.”⁸⁶⁹ As indicated earlier, these differentiators shall as much as possible comply with the logical, legal and technical requirements to the tie-breaking test aspired to in this study⁸⁷⁰. The requirements of autonomy and universality are accorded the highest priority. Like the analysis and discussion of basic principles⁸⁷¹ and aspects of the systematic

⁸⁶⁸ See par. 11.

⁸⁶⁹ David Hariton, equity and debt, p. 515.

⁸⁷⁰ See par. 5.

⁸⁷¹ See sec. 2.2.

context⁸⁷² before, the objective of this section is further to present the author's view of these differentiators. This attempt to reveal particulars of what many commentators content themselves with terming "general principles" or "typical characteristics" is nothing else than an interpretative concretisation of the legal rule in order to approximate the specific case to decide on⁸⁷³. There is indeed a difference between these two techniques. But this difference is merely a matter of precision and therefore methodological heuristics in the law as a deficient rule set rather than a clear distinction line. As the case law method of judiciary in common law jurisdictions demonstrates, the difference between abstraction and casuistry⁸⁷⁴ is fluid. As an illustration, the approach can be compared with the recognition of patterns (e.g. human faces), which are typically all unique (i.e. casuistic) but can still be formalised (e.g. automatised) in a rule-based (i.e. abstract) manner.

- 175 In the absence of any express wording, most of the differentiators discussed herein cannot, however, be methodologically interpreted literally or textually. Rather, they can be identified only indirectly from inherent and implicit systematic interdependencies within the OECD MTC. Where it is considered reasonable and appropriate, the following considerations therefore take the liberty of transferring some structural findings and parallels from other (inspirational) sources of law to the OECD MTC. Again, all this is carried out while carefully embedding these structural considerations and interpretations into the general guidelines and the systematic aspects found in the preceding sections, by which they are significantly influenced. The methodological justification of such transfer may in certain cases be subject of legitimate debates. However, the author's intention to put them up for discussion is primarily to draw additional insights or conclusions and to establish a maximum of inherent consistency and systematology in the treatment of financial instruments and transactions with a minimum of assumptions or preconditions. The concrete interpretative examination and verification, if and to what extent the differentiators found in this section as potentially appropriate are in line with the particular distributive articles of the OECD MTC, is subject of section 3.
- 176 Legal criteria were said to necessarily attach to and derive from domestic tax laws⁸⁷⁵. Due to their fundamental incompatibility with the conceptual features and specific peculiarities of financial instruments⁸⁷⁶, they were also said to be infinite. For this reason, they can themselves not serve as differentiators in the OECD MTC⁸⁷⁷. As an example, two comprehensive observative studies⁸⁷⁸ in a domestic tax law have been taken as an empirical basis. Notably, they have identified no less than 27 and 38 criteria respectively. Following the approach of the IAS/IFRS and the US federal tax law, an attempt will be made here to develop some higher-level or generic treaty types of differentiators as independent universal tests. They shall go beyond the formal ways and means of the varying domestic tax laws by evaluating their material or economic substance⁸⁷⁹. Or, as the approach

⁸⁷² See sec. 2.3.

⁸⁷³ See Illustration 3 on p. 43.

⁸⁷⁴ *David Hariton*, equity and debt, p. 523; *Michael Lang*, hybrids, p. 131; *William Plumb*, p. 409.

⁸⁷⁵ See par. 108(2).

⁸⁷⁶ See par. 100 and 108(3).

⁸⁷⁷ See however *Brown, Patricia*, The debt-equity conundrum – General Report, Series IFA Cahiers 2012, Vol. 97B, nonetheless still in this spirit by generally concluding that "perhaps the most elegant description of the debt-equity distinction is found in the branch report from Sri Lanka. It describes debt 'as a resource that does not belong to the company' and equity as 'capital which is part of the own resources of the company'."

⁸⁷⁸ *William Plumb*, p. 411 et seq. (concisely summarised, updated and amended by *Bowers, William C.*, Tax Aspects of Debt and Equity, Tulane Tax Institute 1989, Vol. 39); *Holzman, Robert S.*, The Interest-Dividend Guidelines, Taxes: The Tax Magazine 1969, Vol. 47, Issue 1, p. 4 et seqq.

⁸⁷⁹ See par. 37.

and spirit of this section have been well expressed: “If I can find some way to describe [...] five characteristics as 10 characteristics, does the scale tip doubly in my direction? They are all part of the same single truth: [...] The real question, then, is not how many debt characteristics does the instrument possess but rather to what extent does the instrument insulate the investor from the risks and rewards of the issuer’s business.”⁸⁸⁰

- 177 Equity providers were said to be dual-character investors, in that they can also provide debt capital⁸⁸¹, even simultaneously. While the former act under company law, the latter do so under contractual law. That is why many potential differentiators discussed in literature actually test to what extent dual-character investors deviate from the behaviour typically required by or observed under contractual law. However, income re-classifications are derivative concepts and as such subsequent to the genuine concept of income classification⁸⁸². In this context, speaking more generally, potential differentiators can principally be of three different kinds: (1) those testing genuine concepts, (2) those testing derivative concepts and (3) those testing both. This section focuses on potential differentiators only of the first type (1) and of the third type (3) with respect to genuine concepts. Differentiators of the second type (2) are generally outside the scope of this section⁸⁸³.
- 178 Tests can be categorised in many ways. For instance, according to the asset-based approach taken by the OECD MTC⁸⁸⁴, most of the differentiators turn out to apply each to the income or transaction on the one hand and analogously to the capital or principal on the other (i.e. the asset). The author has however decided to choose a categorisation which is as close as possible to the legal criteria discussed so far in recent literature. This is to ensure a maximum of mind-set compatibility, a smooth perceptive transition and therefore a better understanding.

2.4.2 Rights and obligations

2.4.2.1 Preliminary remarks

- 179 The legal form and therefore the domestic interpretation are naturally of essential importance for the understanding and relevance of rights and obligations⁸⁸⁵. However, the methodological approach of other collective laws⁸⁸⁶ demonstrates the alternative way. The material key question of which common criteria such domestic rights and obligations must show in order to potentially serve as differentiators can also be answered at the level of the OECD MTC by way of autonomous interpretation. The purpose of this section is therefore to analyse and discuss such common criteria in the field of domestic rights and obligations. It aims at potentially developing such independent universal standards (i.e. a tie-breaking test).

2.4.2.2 Reciprocity

- 180 Transactions were said to be economically reciprocal arrangements or exchanges of benefits described by an economic operation (i.e. legal obligations) and an economic return (i.e. legal entitlements)⁸⁸⁷. In real economy,

⁸⁸⁰ David Hariton, equity and debt, p. 522; similarly: Marjaana Helminen, dividend concept, p. 168.

⁸⁸¹ See par. 42.

⁸⁸² See par. 73.

⁸⁸³ See par. 10.

⁸⁸⁴ See par. 58.

⁸⁸⁵ See par. 80.

⁸⁸⁶ See par. 18.

⁸⁸⁷ See par. 52.

a mutual exchange of goods or services without any compensation in cash is actually not observable as a common practice. Instead, the economic operation is typically of a real nature, in that it refers to goods or services. In contrast, the economic return is typically of a monetary nature, in that it refers to cash or cash equivalents. This makes it easy to distinguish and classify the two. However, it is one of the specifics of financial transactions that they exchange their monetary and intangible benefits mutually in both directions. In addition, financial transactions can also exchange negative benefits (such as risk⁸⁸⁸). As a consequence, even this flow direction might be opposite to what is observable in real economy. True, just as in real economy it is possible to identify the suppliers more or less precisely, even though this depends typically on the subjective intention of the financial intermediary rather than on the objective facts or circumstances of the operation itself. However, it is much more difficult to identify the financial assets or transactions themselves, because of the particular sensitivity of financial transactions to such contextual or situative determinants⁸⁸⁹. That is why “financial assets”, unlike “real assets”, imply the (financial) transaction in a particularly weak manner⁸⁹⁰. And this might also be the reason why also the IAS/IFRS do not provide an abstract definition of financial instruments but instead a casuistic list or catalogue of examples⁸⁹¹.

Example 23: A precious metal dealer can be identified by the precious metal as the tangible object, whereas a financier of that precious metal cannot. Depending on the circumstances, the purchase and resale of the precious metal can be a real transaction (e.g. trade) or a financial transaction (e.g. reverse repurchase agreement). The example also demonstrates that any homogeneous and liquid goods or services can actually serve as a currency equivalent and therefore be subject of a financial transaction, making it particular hard to identify.

- 181 Transferring the divergent laws and principles of real economy to financial instruments may therefore lead to the temptation to disregard the role of legal entitlements. The reason is that legal entitlements represent economically the return in exchange for legal obligations⁸⁹². In real economy, this economic return is, however, typically of a monetary nature. It is not capable carrying or containing any qualitative element of the subjacent operation. Therefore it merely serves the purpose of quantitatively assessing the return⁸⁹³, even more so as it would be subject of the domestic interpretation⁸⁹⁴. It might therefore be concluded that legal entitlements may, if at all, serve merely as indicators to indirectly conclude to the subjacent legal obligations. But they were themselves never of any considerable significance for its autonomous classification. In other words: it was the legal obligations only which determined the autonomous character of a financial transaction. In contrast, however, financial instruments are capable of exchanging their intangible benefits mutually in both directions⁸⁹⁵.

⁸⁸⁸ See par. 60.

⁸⁸⁹ Similarly for IAS / IFRS: Haufe, IFRS, p. 1654 et seqq., par. 21 et seqq.; *Anna Verena Matthies*, p. 150. See also par. 59 and 88(3).

⁸⁹⁰ See par. 53.

⁸⁹¹ IAS 32.11.

⁸⁹² See par. 180.

⁸⁹³ See par. 56.

⁸⁹⁴ See par. 144.

⁸⁹⁵ See par. 180.

Example 24: A currency or interest swap can have a unilateral context such as where “sold” from a commercial financial intermediary to a private individual or a bilateral context such as where contracted for hedging purposes between two business enterprises in different currency areas. An option agreement is a one-sided shift of risks (i.e. legal obligations) from the option holder to the option writer. It can be compensated (i.e. legal entitlements), instead of a cash premium, by another converse shift of risk from the option writer to the option holder such as a premium in kind by way of another converse option agreement⁸⁹⁶.

Accordingly, legal entitlements have in principle a dual purpose of representing both the economic return for legal obligations and parts of the economic operation itself. In other words: unlike in the real economy, in the financial economy legal entitlements are more than just the economic return for legal obligations. They can also carry or contain elements or are even themselves an integral part of the economic operation. Methodologically, the legal entitlements must be subject of a precedent analysis in order to determine whether they represent parts of the operation (in which case they are to be interpreted autonomously) or a mere return for legal obligations (in which case they are to be interpreted domestically). It follows from these considerations that the analysis of autonomous criteria may not be limited or narrowed to the legal obligations only. Rather, it must also include the legal entitlements.

- 182 It can be further concluded from this reciprocity of financial instruments that any legal differentiator must be of equal relative importance, i.e. there cannot be a priority or subordination among them (equivalence of legal criteria). Otherwise classifying a mutual exchange of entitlements in its entirety, while in both directions representing parts of the economic operation, could lead to inconsistent or paradox or otherwise erratic results.

Example 25: Giving priority to one of its components or further down into their particular criteria, a debt-equity swap would be entirely classified into either debt or equity on both sides of the contracting parties.

Also a disaggregation and separate classification of those entitlements does not give rise to the necessity of giving different degrees of priority to the legal differentiators. The disaggregation process was said to stop where the components from the next iteration would not (significantly) change any more⁸⁹⁷. However, at this point any relative weight among the (legal) differentiators is obviously dispensable in that it is not comparatively relevant for their further (isolated) classification.

Example 25 (continued): Disaggregating the debt-equity swap into its debt and equity components or further down into their particular criteria in order to classify them separately makes their relative weights to each other per se unnecessary.

Finally, a priority or subordination of legal differentiators cannot be drawn quantitatively from economic considerations either. Given at arm's length conditions, it must rather be assumed that the legal entitlements (i.e. the economic return) and legal obligations (i.e. the economic operation) of that financial transaction

⁸⁹⁶ See par. 64.

⁸⁹⁷ See par. 101(3).

economically proportionate in equal benefits. Legal rights were said to be mere containers or allocational references for the economic value drivers⁸⁹⁸. For instance, a limit or cap of compensation, in that it does legally not participate in the profits, is nothing but an indemnification for the lower relative risk of also legally participating in the losses⁸⁹⁹. This leads to a principal economic equation of:

Legal criteria in favour of the issuer = legal criteria in favour of the holder \pm cash⁹⁰⁰

In other words: for their final objective of shifting equal benefits the contracting parties employ “whatever” legal instruments there are available. As a consequence, it was not possible to draw any evaluative conclusion from their relations, particularly not that some legal criterion (e.g. a participation in profits) was quantitatively more important or significant than some other (e.g. a participation in losses)⁹⁰¹. Even if transferred to the weighting of legal criteria, this would only lead to their evaluative equivalence as well. There could never be a quantitative disparity between legal entitlements and legal obligations justifying any further evaluative conclusion on the relative significance of legal criteria. And even if there was, this would be highly situative and therefore erratic, not allowing for any universal statement.

2.4.2.3 Control

- 183 On the one hand, it was stated that *control* appeared to be an important concept and constituent element of *beneficial ownership*⁹⁰². On the other hand, questions of capital attribution and ownership in general cannot be limited to the specific treaty concept of *beneficial ownership*⁹⁰³. Consequently, this inherent concept of capital attribution and ownership can be interpreted autonomously or domestically. In fact, there is no precursory field of international law (e.g. international private or corporate law) that would be able to apply prior to the OECD MTC. Hence, the question to be discussed here is whether or not *control* is or even can be relevant for such autonomous concept of attribution and ownership. To that end, *control* is understood in so far congruently with *beneficial ownership*. Pursuant to the *substance over form* principle⁹⁰⁴, it is an economic or factual relationship in the material sense (and not in the formal sense such as membership rights)⁹⁰⁵ between a person or subject and an object, which is the result of⁹⁰⁶ composite legal transactions between two or more persons or subjects⁹⁰⁷.
- 184 *Lang*⁹⁰⁸ argues that the *payer* and the *beneficial owner*, at least pursuant to Art. 11(5) and 11(6) OECD MTC, are not necessarily capable of holding legal rights. As a consequence, the term *debt-claim* in Art. 11 OECD MTC was formed by an economic understanding. Broadly speaking, *debt-claims* are characterised by the possession of the capital or principal without however holding also its ownership rights. This view implies

⁸⁹⁸ See par. 156.

⁸⁹⁹ Similarly: *David Hariton*, equity and debt, p. 500.

⁹⁰⁰ See par. 64.

⁹⁰¹ Similarly: *William Plumb*, p. 434 et seq.

⁹⁰² See par. 134.

⁹⁰³ See par. 124□.

⁹⁰⁴ See par. 72.

⁹⁰⁵ Equally: *William Plumb*, p. 447 et seqq. See also par. 107(6).

⁹⁰⁶ See par. 176.

⁹⁰⁷ See par. 119 et seq.

⁹⁰⁸ *Michael Lang*, hybrids, p. 96.

an economic understanding of the general aspect of attribution of the capital or principal itself⁹⁰⁹ and may thus potentially contribute to the general discussion of the control concept at this point. To the author's understanding, this standpoint nevertheless ignores the fact that Art. 11(5) and 11(6) OECD MTC actually employ fictions. It actually deems the treatment of other subjects, including those not capable of holding legal rights, to be equal with the *payer* and/or the *beneficial owner* by explicitly presupposing legal relationships between them. Notably, the *payer* and the *beneficial owner* must themselves be legal persons in order to ensure the legal enforceability supported by *Lang* himself. In that sense, this opinion falls victim to the same ambiguity between those two subject- and object-related aspects as mentioned above. As was stated before, the subject- and object-related aspects conceptually apply not only to the concept of *beneficial ownership* but also and in every way identically to the general aspect of attribution.

185 The IAS/IFRS apply a broad interpretation of *control*, which can be classified into the following criteria or uses cases⁹¹⁰. The legally effective⁹¹¹ contractual entitlements of the financial instrument

(1) retain its cash flows⁹¹² without actually being subject of an *economic relationship*⁹¹³ ("pass-through arrangement"⁹¹⁴)

Side note: The difference between the IAS/IFRS concepts of *control* and *economic relationship*⁹¹⁵ is that the former describes a relationship between a subject and an object, whereas the latter describes a relationship between two objects⁹¹⁶.

(2) and retain substantially⁹¹⁷ all its risks and rewards other than the cash flows⁹¹⁸ without actually transferring them ("risks and rewards approach"⁹¹⁹); or otherwise

(3) retain the ability to actually dispose of it unilaterally and in its entirety to an unrelated third party⁹²⁰ ("continuing involvement"⁹²¹)⁹²². In this context, actually does not just mean legally but effectively (e.g. active and liquid markets)⁹²³ and unilaterally means without the consent of any third party⁹²⁴.

⁹⁰⁹ Consequently: *Michael Lang*, hybrids, p. 97.

⁹¹⁰ See a summarising scheme in IFRS 9.B3.2.1.

⁹¹¹ Haufe, IFRS, p. 1672, par. 67 and 69 et seq. as well as p. 1673, par. 72.

⁹¹² IFRS 9.3.2.3(a) and 9.3.2.4(a).

⁹¹³ IFRS 9.3.2.3(b), 9.3.2.4(b) and 9.3.2.5.

⁹¹⁴ Haufe, IFRS, p. 1672, par. 69; *Weber, Christoph / Tietz-Weber, Susanne* in *Haisch, Martin L. / Helios, Marcus*, *Rechtshandbuch Finanzinstrumente*, Beck, Munich, 2011, p. 146, par. 144.

⁹¹⁵ See par. 135.

⁹¹⁶ See Illustration 9 on p. 73.

⁹¹⁷ Haufe, IFRS, p. 1676 et seq., par. 79 and 83; *Hartenberger, Heike* in *Beck, IFRS / IAS*, p. 161 et seq., par. 107.

⁹¹⁸ IFRS 9.3.2.6(a) and 9.3.2.6(b).

⁹¹⁹ *Hartenberger, Heike* in *Beck, IFRS / IAS*, p. 160, par. 104; *Weber, Christoph / Tietz-Weber, Susanne* in *Haisch, Martin L. / Helios, Marcus*, *Rechtshandbuch Finanzinstrumente*, Beck, Munich, 2011, p. 147, par. 147; *Christoph Berentzen*, p. 183.

⁹²⁰ IFRS 9.3.2.6(c), 9.3.2.9 and 9.B3.2.7 et seq.

⁹²¹ IFRS 9.3.2.16.

⁹²² Haufe, IFRS, p. 1747, par. 254.

⁹²³ IFRS 9.B3.2.8; Haufe, IFRS, p. 1678 et seq., par. 85 et seq.; *Christoph Berentzen*, p. 188 et seq.

⁹²⁴ *Christoph Berentzen*, p. 194 et seq. See also par. 188 et seqq.

- (4) or are being substituted or novated by substantially⁹²⁵ continuing or upholding the aforementioned retentions (“novation”)⁹²⁶.

186 So far, this interpretation is in line with the understanding of *substance over form*⁹²⁷. The broad character of this economic *control* concept comes from the fact that all these criteria contain a contextual restriction. Being congruent with the aggregation scheme⁹²⁸ to this extent, they establish a legal relationship between a criterion within one particular financial instrument and that of the same kind in another financial instrument or legal arrangement respectively⁹²⁹. As the result of those composite legal arrangements, they establish a factual relationship between a person or subject and an object⁹³⁰. In other words: the affirmation of *control* is not limited to that one particular object itself (e.g. a sale). It also depends on the context of other legal arrangements in order to avoid a carve-out or skimming of cash flows, risks and rewards as well as the ability to dispose. However, this leads to some basic conflicts:

- (1) The subjective determination of whether or not an object is attributed to a subject applies prior to the objective question whether that object is then to be (dis-)aggregated. If that subjective attribution however applies a broad and contextual *control* concept similar to that of the IAS/IFRS, does that not actually imply, include and pre-empt an aggregation and actually introduce it “through the backdoor”⁹³¹? In other words: would not any conclusion that an object was not to be attributed to a subject due to its relationship with another object, in fact be an aggregation of these two objects? This question is even more crucial, since the distinction of “classic”, “hybrid” or “derivative” financial instruments is illusory⁹³². Just as the (dis-)aggregation scheme, in practice any financial instrument is subject of the *control* concept.
- (2) The determination of whether or not an object is attributed to a subject is also prior to the concept of *beneficial ownership*⁹³³. So, would a broad and contextual *control* concept similar to that of the IAS/IFRS (particularly as regards the “pass-through arrangements”⁹³⁴ and the “continuing involvement”⁹³⁵) not actually imply, include and pre-empt the *beneficial ownership*⁹³⁶? Would this relieve the concept of *beneficial ownership* even from its role of representing an exception to the domestic interpretation of asset and income attribution⁹³⁷, making it a subject of autonomous interpretation? This question is even more crucial, since a *control* concept – unlike *beneficial ownership* – is not explicitly provided in the Art. 10(3), 11(3), 13(5) and 21(1) OECD MTC.

⁹²⁵ Hartenberger, Heike in Beck, IFRS / IAS, p. 161, par. 104, and p. 249, par. 380; IFRS 9.BC6.342.

⁹²⁶ IFRS 9.BC6.349. See also par. 81.

⁹²⁷ See par. 183.

⁹²⁸ See par. 88(3).

⁹²⁹ Hartenberger, Heike in Beck, IFRS / IAS, p. 238, par. 341.

⁹³⁰ Haufe, IFRS, p. 1669, par. 61, calling it “a combination of the formal legal and the economic concept” (translated by the author).

⁹³¹ See par. 95.

⁹³² See par. 87.

⁹³³ See par. 124.

⁹³⁴ See par. 185(1).

⁹³⁵ See par. 185(3).

⁹³⁶ Similarly: Achim Pross, p. 176.

⁹³⁷ See par. 144 and 117.

187 From the author's point of view, these conflicts demonstrate that such an extensive interpretation and application of the *substance over form* principle would be an overrun⁹³⁸. In particular, it would be contrary to the existence of other explicit provisions (e.g. *beneficial ownership*). And it would be contrary to other implicit principles (such as the domestic interpretation of the asset and income attribution) and findings (such as the restrictive aggregation or the formal interpretation of novations⁹³⁹). In addition to these literal and systematic considerations there are also methodological arguments. A teleological extension towards exceptional rules demands higher interpretation requirements than a teleological reduction towards the respective basic rules⁹⁴⁰. All this suggest that matters of attribution and ownership must basically follow the legal form (form over substance) and are therefore subject of the domestic interpretation⁹⁴¹, unless they fall under the treaty concept of *beneficial ownership*. Or in other words: there is no such thing as "economic ownership" in the Art. 10(3), 11(3), 13(5) and 21(1) OECD MTC other than *beneficial ownership*. Therefore, matters of attribution and ownership are basically not accessible to the treaty principle of *substance over form*. Instead, economic *control* concepts in general such as those suggested by the IAS/IFRS might rather be an inspirer for the interpretation of the OECD MTC concept of *beneficial ownership* in the asset itself, which is however out of scope of this study⁹⁴². The specific IAS/IFRS concept of *control* employs and therefore is dependent on that of *economic relationship*⁹⁴³: economically speaking, today's capital is tomorrow's income⁹⁴⁴. In contrast, in the OECD MTC concept of *beneficial ownership* the (re-)attribution of the asset is (legally) independent of that of the income⁹⁴⁵.

Side note: This is supposed to be the reason why IFRS 9.3.2.5 and 9.6.4.1(c)(i), despite their different wordings, nevertheless both focus on the credit risk⁹⁴⁶.

2.4.2.4 *Voluntariness, laterality and self-execution*

188 A similar⁹⁴⁷ but less comprehensive differentiator than *control*⁹⁴⁸ might be the criterion to what extent the source is legally⁹⁴⁹ bound or restricted in its genuine powers to decide (1) whether or not there shall be a payment (voluntariness) and (2) how this payment is to be used (enjoyment). It may potentially achieve better acceptance by allowing a partial and more precise focus on the mere disposal and/or the enjoyment of the income or capital, instead of on the entire asset⁹⁵⁰. The starting point of this consideration is that any claim implies some kind of "present obligation of the entity to transfer economic resources in some possible scenario in the future, including at liquidation"⁹⁵¹. On the one hand, there is no voluntariness possible where

⁹³⁸ See par. 100.

⁹³⁹ See par. 81.

⁹⁴⁰ See par. 142.

⁹⁴¹ See par. 71.

⁹⁴² See par. 116 and 128.

⁹⁴³ See par. 185(1).

⁹⁴⁴ See par. 160.

⁹⁴⁵ See par. 130.

⁹⁴⁶ Haufe, IFRS, p. 1673, par. 72. See also par. 138.

⁹⁴⁷ See par. 121 and 134.

⁹⁴⁸ See par. 183 et seqq.

⁹⁴⁹ See par. 80.

⁹⁵⁰ See Illustration 11 on p. 79.

⁹⁵¹ IAS Board, June 2015, 5A, p. 4, par. 11.

third parties are involved. That is why the aspect of voluntariness also bears a nexus with that of what in this study is called laterality. Laterality means whether the payment legally requires or involves two or more than two contracting parties. A payment is bilateral only if no legal consent is required from any third party other than the two contracting parties⁹⁵². Otherwise it is multilateral⁹⁵³.

- 189 On the other hand, the said restrictions can be arranged in two ways, either being directive in mandatorily taking legal action; or resolute in providing conditions or reservations. The aspect of voluntariness bears a nexus with that of self-execution. Self-execution means the unconditional payability without any contingent or discretionary action by the issuer⁹⁵⁴. The concept necessarily implies non-voluntariness and therefore bilateralism⁹⁵⁵. Self-execution particularly results in the fact that the payment of the income and/or the principal is determinable ex-ante by a mathematical formula. This ex-ante determinability is independent and must be carefully distinguished from the ex-ante determinability of certain parts or terms or variables of that formula. For instance, an one-to-one relation (e.g. “pay-out = periodic profit”) is ex-ante determinable by this mathematical formula as such, although its only term (i.e. “periodic profit”) is ex-ante indeterminable. While such term or variable might be uncertain in representing a risk, the formula describes the certain and thus self-executing response to that risk.
- 190 In other words: laterality describes potential payment conditions due to a third party’s subjective decision. Voluntariness describes potential payment conditions due to the source’s own subjective decision. As its opposite, self-execution describes the absence of such potential payment conditions due to the source’s own subjective decision. And restriction describes potential payment conditions due to any other objective circumstances. The following illustration visualises this understanding:

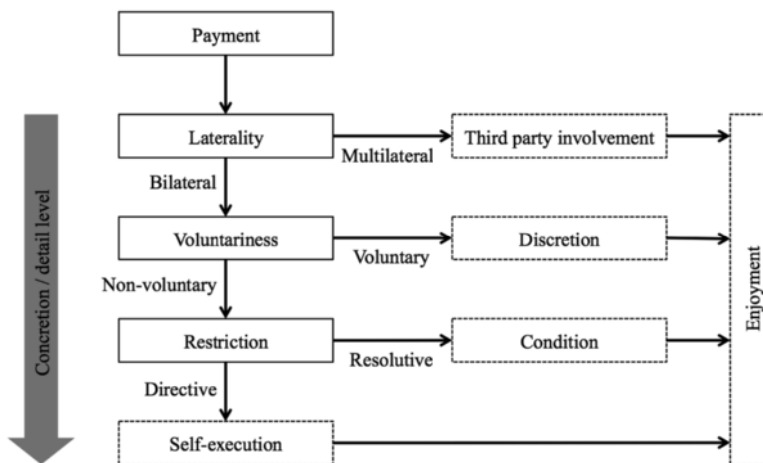


Illustration 13: The nexus between laterality, voluntariness, self-execution and enjoyment

⁹⁵² William Plumb, p. 414 and 452.

⁹⁵³ Anna Verena Matthies, p. 49.

⁹⁵⁴ Similarly: William Plumb, p. 424.

⁹⁵⁵ See par. 188.

- 191 Pursuant to the IAS/IFRS, yield bilateral payment condition basically falsifies equity. This applies in particular where the capital or principal is repaid following a termination by the investor or creditor.⁹⁵⁶ In that, the IAS/IFRS draw their differentiator from a higher or more abstract concretion or detail level than the proponents of the voluntariness. Notably, the aforementioned nexuses are the link between the two views. From the author's point of view, laterality is too general a concept to serve as an effective differentiator. In particular, it ignores the fact that in turn multilateral payment restrictions, while perhaps being a strong indicator, do, vice versa, neither falsify debts (e.g. factoring) nor verify equity (e.g. equity certificates)⁹⁵⁷. Therefore, such a differentiator based on laterality appeared to (1) be only one-sided or incomplete and (2) serve merely as a negative falsifier rather than as a positive verifier.

Example 26: Collective investment schemes can be constituted in a contractual (i.e. bilateral) or corporative (i.e. multilateral) form.

The reason for this is that laterality is a context-specific concept that is incapable of coping with analytical techniques and is therefore insensitive to more granular circumstances.

- 192 Instead, the author takes the view that voluntariness is a more effective concept for being a differentiator. First, the power to decide as to whether or not there shall be a payment (voluntariness) is actually the power over the entire economic benefits and therefore the entire value of the proprietary rights⁹⁵⁸. That is why this view is in line with the finding that proprietary rights merit substantive attention⁹⁵⁹, in that, economically, today's capital is tomorrow's income⁹⁶⁰. In addition, the power to decide as to whether or not there shall be a payment (voluntariness) logically applies prior to the subsequent power to decide how the payment is to be used⁹⁶¹. Even more, the entire aspect to what extent the source is bound or restricted in its payment decision is a "gatekeeper" for the enjoyment. In fact, the power to decide whether or not there shall be a payment at all can exclude yield beneficiary from enjoying it. Consequently, the power or right to decide how the payment is to be used (enjoyment) would, just as the concept of laterality⁹⁶², necessarily be incomplete. Therefore it cannot serve as a reliable differentiator, as well. It is important to note that this does not mean *e contrario* that voluntariness is to be deemed or treated as if it was one and the same as enjoyment. Instead, the two aspects are generally different from and subsequent to another. The power or right to decide how the payment is to be used (enjoyment) is no precedent aspect of ownership or control but rather a subsequent aspect of attribution⁹⁶³. And finally, a differentiator based on voluntariness also complies with the logical, legal and technical requirements to the tie-breaking test aspired to in this study⁹⁶⁴. It describes completely and conclusively the absence of any restriction and may therefore serve as a positive verifier.

⁹⁵⁶ IAS 32.16A and 32.BC11; *Anna Verena Matthies*, p. 144.

⁹⁵⁷ *Argumentum e contrario*.

⁹⁵⁸ See par. 156.

⁹⁵⁹ See par. 107(6).

⁹⁶⁰ See par. 160.

⁹⁶¹ See par. 134.

⁹⁶² See par. 191.

⁹⁶³ See Illustration 11 on p. 79 analogously.

⁹⁶⁴ See sec. 5.

- 193 Unlike those in terms of the capital or principal⁹⁶⁵, conditions of any discretionary action by the holder in addition to a contingency in terms of income payability are, however, not relevant as a differentiator. This follows from the consideration that such discretionary actions by the holder can only be of two qualitative kinds: (1) those averting the immediate pay-out and (2) those allowing a choice between diverse payment profiles. The first case (1) represents a use of disposable income in the sense of a transfer at the disposal of the *recipient or beneficial owner*⁹⁶⁶ (e.g. SCRIP or reinvested dividends). In particular, it does not represent a generation of taxable income and therefore cannot be relevant as its differentiator. Already the entitlement of the holder to suspend, accumulate, convert or defer the pay-out was said to be the legal event representing the realisation⁹⁶⁷ – not the execution of that option right⁹⁶⁸. This view disentangles or separates once again the causal nature of income (i.e. autonomous interpretative element) from its contextual nature (i.e. domestic interpretative element). The second case (2) has two principal sub-cases: (a) the diverse payment profiles are classified into the same income type (e.g. a fixed interest of X% or a floating interest based on an index for a certain time period) or (b) the diverse payment profiles are classified into different income types (e.g. a fixed income of X% or a profit share for a certain time period). In the first sub-case (a), the respective action by the holder is obviously not relevant as a differentiator for the income classification. In the second sub-case (b), each transaction triggered by the holder's or investor's action is classified individually anyway. This follows from the transaction-based approach⁹⁶⁹ in correspondence to the item-by-item structure of the OECD MTC⁹⁷⁰. In other words: as it is the concrete execution of that option that determines the one particular transaction respectively, i.e. the action taken by the holder itself, its classification is ultimately independent of whether it was actually contingent on that action or not.
- 194 The conclusion for the further course of this study is that self-execution is the strictest criterion, not only for indicating the internal organisation of the legal relationship between the holder and the issuer, but also for the internal nature of a financial instrument. More particularly, it represents a universal differentiator which allows the distinction between conditional (e.g. options) and unconditional (e.g. forward contracts, debts) financial instruments.

2.4.3 Time aspects

2.4.3.1 Preliminary remarks

- 195 Representing a physical parameter, time is incompatible with the legal interpretation, and is therefore inaccessible as a subject of such interpretation. In addition, it turns out that time can in some cases be converted or approximated by other non-legal parameters. For these reasons, time aspects can themselves not directly serve as differentiators in the OECD MTC. However, time has nevertheless a significant influence on a broad number of legal and economic aspects⁹⁷¹. The purpose of this section is therefore to analyse and discuss such potential differentiators. Their main driver or key characteristic is the lapse of time and therefore they are

⁹⁶⁵ See par. 191.

⁹⁶⁶ See par. 148.

⁹⁶⁷ See par. 173.

⁹⁶⁸ See par. 107(7).

⁹⁶⁹ See par. 58.

⁹⁷⁰ See par. 59.

⁹⁷¹ See par. 81.

mainly associated with and/or discussed as being somehow time-related in recent literature⁹⁷². Aspects of time are somewhat attached to these potential legal differentiators in sharing the same legal fate, including their relative importance and intensity.

2.4.3.2 *Maturity of principal*

- 196 Maturity is understood as the expiry of a financial instrument upon a resolatory condition. In a narrow sense, such a condition is typically meant as time-dependent (i.e. a finite duration). However, any condition is actually finite and it rather depends on its probability of occurrence when the duration ends. For instance, the fulfilment of the statutory purposes and objectives of a business enterprise (especially for limited-life entities⁹⁷³) is actually finite. In fact, this narrow understanding of maturity means a temporary provision or contribution of capital or principal and thus a kind of “reasonably expectable” time periods⁹⁷⁴. This is why it is conceptually weak in the timing of probable conditions (e.g. open-ended weather “derivatives”)⁹⁷⁵. For this reason, maturity can be more precisely described in the stochastic sense⁹⁷⁶: as a more or less certain or uncertain condition.

Example 27: The end of any time period is certain (e.g. bonds, options), whereas the fulfilment of the purposes and objectives of a business enterprise is uncertain. The condition or event of an open-ended weather “derivative” is certain, whereas that of a catastrophe bond is uncertain.

- 197 This approach does not conflict with the above conclusion that time aspects are basically to be interpreted pursuant to domestic tax law by following the legal form rather than the economic substance⁹⁷⁷. The approach taken here merely transforms and describes the parameter of time into and by the parameter of risk. However, risk obviously requires and presumes the parameter of time as a necessary precondition. In other words: the legal and domestic determination of when a time period ends is a logical pre-step to, and therefore independent of, its autonomous and possibly economic assessment by the OECD MTC, just as it is for other criteria⁹⁷⁸. Nevertheless, the autonomous assessment by way of this risk-based interpretation of maturity is bound by the general principles of interpretation found in this study. Aspects of time have been found to bear a nexus with the aspect of temporal aggregation and disaggregation, just as for other criteria⁹⁷⁹. Hence, any interpretation towards a temporal aggregation is subject to particularly strict requirements, which justify going beyond the literal or textual interpretation only as an absolute exception. As a consequence, the duration of legal time periods can de facto only be reduced by way of economic interpretation, but not extended. As is true for any other aspect, the temporal disaggregation is in fact a one-way downward⁹⁸⁰.

⁹⁷² See par. 178.

⁹⁷³ *Kubn / Hachmeister*, p. 614, par. 60.

⁹⁷⁴ Similarly: *David Hariton*, equity and debt, p. 506; *William Plumb*, p. 415, 504 et seq. and 599; for IAS / IFRS: *Anna Verena Matthies*, p. 157.

⁹⁷⁵ See par. 69.

⁹⁷⁶ See par. 60.

⁹⁷⁷ See par. 81.

⁹⁷⁸ See par. 21.

⁹⁷⁹ See par. 95.

⁹⁸⁰ See par. 101(1).

Example 28: The duration or maturity of an American-style option might be considered economically shorter than legally contracted. In contrast, the duration or maturity of a demand deposit or perpetual bond may basically not be considered economically longer than legally contracted.

2.4.3.3 *Maturity of remuneration*

- 198 This risk-based understanding of maturity⁹⁸¹ provides a relative and more flexible interpretation and application of time aspects than an absolute number does. However, it still requires a resolutive condition. Consequently, any differentiator based on the maturity of principal must necessarily fail where there is no such resolutive condition. It seems like a contradiction that this is often a feature of financial instruments classified as debt instruments (e.g. perpetual bonds), whose capital provision is even less temporary (i.e. less “reasonably expectable”) than those of equity instruments⁹⁸². This is caused by the fact that this understanding ignores the time value of money⁹⁸³. Due to the compound interest effect, the economic value of the right on the return of the principal becomes increasingly insignificant compared to the right on the time-based remuneration.

Example 29: The right on the return of the principal mathematically accounts for less than the right on the remuneration after 7 years at 10% per annum, 10 years at 7% per annum, 14 years at 5% per annum and 20 years at 3% per annum.

In other words: the more long-term a debt instrument is, the less important are its creditor’s rights. They might protect from the default of the principal at maturity, but they protect more from the default of the time-based remuneration. Accordingly, at least for financial instruments without resolutive conditions the interpretation of time aspects by the duration or maturity of principal may generally be replaced with that of remuneration. In order to ensure consistency and comparability by avoiding a dualism of methods, this should preferably also apply to those with resolutive conditions. For instance, the value of future remuneration payments tends towards zero, whereas their weighted average duration or maturity approximates to a constant value⁹⁸⁴. This is why it is also known in finance theory as the *real duration* and the *nominal* or *effective duration*⁹⁸⁵. True, the duration of such individual future remuneration payments may be infinite. However, the approach makes it possible to consistently determine in any case a meaningful and effective maturity at least to the relevant point, at which other differentiators are becoming more significant.

- 199 The approach also corresponds to the fact that the effective duration or maturity correlates with the default risk, i.e. credit risk increasingly resembling or correlating with the business risk⁹⁸⁶. This is because both aspects largely depend on the timing of the payment profile (e.g. deferrals)⁹⁸⁷. Both the remuneration of infinite

⁹⁸¹ See par. 196.

⁹⁸² Exemplarily *Sven-Eric Bärsch*, p. 235; for IAS / IFRS: *Kuhn / Hachmeister*, p. 614, par. 61; *Anna Verena Matthies*, p. 78 and 156; *Febér, Tamás* in *Eva Burgstaller*, p. 245.

⁹⁸³ *David Hariton*, equity and debt, p. 506. See also the detailed analysis in par. 208 et seqq.

⁹⁸⁴ *David Hariton*, equity and debt, p. 506.

⁹⁸⁵ *Frank Fabozzi*, p. 209 et seqq.

⁹⁸⁶ See par. 107(2).

⁹⁸⁷ See par. 107(4).

instruments and their principal are actually exposed to the business risk. However, only the former is also time-based, as infinity can never be time-based. The underlying economic reason is that a rational investor in a time-based investment will not accept an infinite duration or maturity of the remuneration payments where that of the principal is already infinite. This is likely the reason why, for instance, super-maturity and perpetual instruments typically make periodic payments⁹⁸⁸. This peculiarity gives rise to the apparent contradiction⁹⁸⁹ that remuneration payments are time-based and can coincidentally also be risk-based. In other words: the duration or maturity of the remuneration replaces that of the principal. Given that the former accounts for more than the latter, it becomes a hybrid concept in being both time-based and risk-based simultaneously. Consequently, the approach reveals an inherent systematic conflict or dualism between the two possible differentiators of time aspects and risk aspects. This dualism becomes particularly apparent by the example of financial instruments without any resolutive condition. Obviously, “the mere fact that most of the value conferred by a long-term debt instrument is in the right to periodic payments is not an equity characteristic, however.”⁹⁹⁰ This means as a conclusion for the further course of this study that time aspects must necessarily take precedence over risk aspects in cases where the two overlay. And further, the absence of a duration or maturity – be it an absolute or relative one – cannot be a differentiator. In result, the time-based understanding of duration or maturity generally cannot be maintained any more. Anything else would be inconsistent, incomparable and not universal by actually establishing a dualism of methods. From the methodological point of view, the interpretation of time aspects in the duration or maturity of principal should therefore be replaced by that of remuneration.

2.4.4 Payment profile

2.4.4.1 Preliminary remarks

- 200 The purpose of this section is to analyse and discuss potential differentiators, which are mainly characterised by the amounts paid or distributed from the financial instruments. On the one hand, this payment profile typically represents the starting point for domestically interpreting the *income*⁹⁹¹ (*income*-related aspect). On the other hand, at the same time it independently gives far-reaching indications which allow for an autonomous interpretation of the underlying transaction. As a consequence of the transaction-based approach⁹⁹², the payment profile is the most apparent and observable symptom of, and a reflex response to, the economic nature of the subjacent and masked transaction or operation. In that sense, differentiators in the field of the payment profile appear to be very promising for leading to the grounds of the debt-equity distinction (transaction-related aspect).

2.4.4.2 Absence of any income

- 201 Where a financial instrument does not pay out anything at all (not even deferred), this could be considered as irrelevant for the classification of income types. This is because the scope of the OECD MTC as a whole is basically limited to *income* from transactions, which are subject of a double taxation⁹⁹³. However,

⁹⁸⁸ Jakob Bundgaard, *perpetuals*, p. 127.

⁹⁸⁹ See par. 198.

⁹⁹⁰ David Hariton, *equity and debt*, p. 506.

⁹⁹¹ See par. 144.

⁹⁹² See par. 56.

⁹⁹³ See par. 19.

the OECD MTC necessarily applies to negative income as well⁹⁹⁴. Hence, an absence of any *income* at all might, for instance, be the surface result from a subjacent net settlement within one and the same financial instrument or across different financial instruments. In the former case, the question whether the absence of any *income* is relevant for its classification was a result from disaggregation considerations. In the latter case it was important for the question whether the source jurisdiction of both a positive and a negative *interest* was legitimated to impose tax only on the positive *interest*⁹⁹⁵. The separation from the *income*'s mathematical sign actually means also its independence from the *income*'s amount altogether⁹⁹⁶. This follows from the view that the interpretative element of autonomous income classification is the causal or contextual nature. Ergo, drawing reverse deductions from the *income*'s amount (e.g. zero) back to its contextual nature (i.e. the asset or transaction) does – just as from its mathematical sign⁹⁹⁷ – not only mix two different aspects but is also a circular reasoning. Pursuant to the explicit wording of the distributive articles⁹⁹⁸, the *income* classification derives from the asset or transaction⁹⁹⁹. Hence, the asset or transaction classification cannot vice versa derive from the *income*¹⁰⁰⁰. As an introductory conclusion for the further course of this section, the absence of any *income* at all from a financial instrument does not dispense from the principal necessity and feasibility of classifying that financial instrument into the distributive articles of the OECD MTC.

2.4.4.3 Participation in profits and losses

- 202 Taking a participation in the profits and/or losses of a business enterprise literally or formally and absolutely would lead to a circular reasoning¹⁰⁰¹. In fact, that participation is vice versa the result of this distinction. For instance, pursuant to the IAS/IFRS profits and losses are “a residual interest in the assets of an entity after deducting all of its liabilities”¹⁰⁰². Ergo, a right participates in profits and/or losses only if it is not previously classified as a deductible liability¹⁰⁰³. This self-contradiction can be solved by interpreting the participation in profits and losses relatively rather than absolutely, i.e. the participation in profits and/or losses was subordinate to the classification as interest. Alternatively, it can be solved based on an economic profit and loss equivalent, i.e. the participation in profits and/or losses was independent of the formal profit determination procedures of deducting the interest (e.g. by taking the EBIT or EBITDA as a profit and loss equivalent). As regards the latter, however, any compensation or pay-out actually requires and therefore participates in economic “profits” or pay-ins, which is why any compensation eventually also participates in the economic losses.

Example 30: “Excessive interest” actually skims economic profits¹⁰⁰⁴, which is the very reason for the anti-abuse provision of Art. 11(6) OECD MTC with regard to shareholder loans¹⁰⁰⁵.

⁹⁹⁴ See par. 139.

⁹⁹⁵ See footnote 711.

⁹⁹⁶ *William Plumb*, p. 433 et seq., critically citing several (domestic) US court decisions, which fail to see any difference between various free-of-charge capital or principal contributions.

⁹⁹⁷ See par. 139.

⁹⁹⁸ See par. 58.

⁹⁹⁹ See par. 53.

¹⁰⁰⁰ See par. 54.

¹⁰⁰¹ Equally for IAS / IFRS: *Kuhn / Hachmeister*, p. 601, par. 16.

¹⁰⁰² IAS 32.11.

¹⁰⁰³ Equally: *Peter Hongler*, p. 45.

¹⁰⁰⁴ *William Plumb*, p. 439 et seq.

¹⁰⁰⁵ See Example 8 on p. 35.

Conversely, it is objectively impossible for a regular debt to pay out any fixed interest where the debtor has not previously realised some economic profits¹⁰⁰⁶.

- 203 This leads back to, and is in line with, the finding that *income* cannot be distinguished from *capital* economically but only legally¹⁰⁰⁷. Any determination of a participation in profits and losses based on a profit and loss equivalent rather than on the actual profits and losses was flawed. It would imply a non-legal and thus artificial imagination of profit and loss as some hypothetical “adjusted” increment, arbitrarily negating certain deductibles¹⁰⁰⁸ and therefore negating itself. In other words: it is the legal finding process of formally calculating profits and losses (e.g. by way of accounting law), which represents the first logical step of identifying and determining those parts of the economic capital which are made available for realisation by a legal event. That is why any determination of a participation in profits and losses based on a profit and loss equivalent rather than on the actual profits and losses was also prejudicial. Consequently, an economic interpretation of the participation in profits and losses must be refused. In other words: if the existence of an income or transaction¹⁰⁰⁹ and the rights and obligations from financial instruments¹⁰¹⁰ in general already require a cautious invocation of the *substance over form* principle, its specific right on *participating in profits* and losses does even more so¹⁰¹¹.
- 204 Such cautious invocation of the *substance over form* principle means e contrario the application of form over substance. However, this may not tempt us to interpret the participation in profits and losses in that strict narrow sense of its formal legal determination, otherwise the requirement of a participation in profits and losses would fall short entirely. The mathematical formula of profit and loss calculation has in fact only one single final result. The only financial instrument participating in profits and losses, as formally determined by way of a final calculation, is a *share*. Any deviation from that formal result, however small, disqualifies it immediately. That is why it is not possible for two or more different classes of financial instruments to simultaneously participate in this one single final result. Instead, they can only participate either in different relative results (e.g. by sequentially referring to another) or in one single absolute – but then not final – result (e.g. EBIT or EBITDA). Consequently, there is no space for interpreting the participation in profits and losses other than relatively, in the subjective sense that it varies in priority among its beneficiaries. In other words: profit and loss is per se a resultative and therefore binary concept. In that, it requires a multi-static and therefore relative differentiator in order to make it meaningful and significant, whereas any absolute differentiator must necessarily fail. Saying that a financial instrument participating in EBIT was “more equivalent” to profit and loss than another financial instrument participating in EBITDA, was the same as saying that one glass was less empty than another. In fact, both glasses are equally empty, not full. Instead of such absolute references suggesting false accuracy, it appears more promising to focus on the relation between the two: one financial instrument is subordinate to the other, as EBIT applies prior to EBITDA. This understanding is also in line

¹⁰⁰⁶ William Plumb, p. 527.

¹⁰⁰⁷ See par. 158.

¹⁰⁰⁸ Equally: IAS Board, December 2016, 5B, p. 14, par. 43.

¹⁰⁰⁹ See par. 79.

¹⁰¹⁰ See par. 80.

¹⁰¹¹ Argumentum a maiore ad minus.

with the findings¹⁰¹² and the intuition that a participation in profits and/or losses is a flexible or fluid array of “more or less”¹⁰¹³ rather than of “yes or no”, as it can have an unlimited number of possible states or forms.

Example 31: A financial instrument can theoretically be designed to participate in every second profit by 100% and in every third loss by 150%.

- 205 The upside of such relative interpretation approach¹⁰¹⁴ is its separation of the two different aspects of profits and losses on the one hand and participation or non-participation on the other. This should not be misunderstood that participation was also possible without having a profit or loss. It merely means that once there is a profit or loss, the subsequent question of whether or not there is also participation is independent. As a result, the aspect of whether or not there is participation is made independent of the arm's length principle which is methodologically unnecessary and potentially unsatisfactory. It is not only limited to marketable and liquid transactions¹⁰¹⁵ but in fact also establishes a “parallel world”, meaning that the taxpayer is actually treated according to his environment rather than to his individual circumstances.

Example 32: The income classification of a “guaranteed compensation” actually depends substantially on whether its level is below (then entirely *interest*) or above (then partly *interest* and partly *dividends*) the market interest rates. In contrast, a relative interpretation would separate the “compensation” from the “guarantee” by limiting the arm's length principle only to the initial question as to what extent the level of the “compensation” makes it a *dividend* or *interest*. In contrast, the subsequent question as to what extent the “guarantee” represents a participation was dealt with independently.

- 206 The downside is, however, that the approach is nevertheless limited in allowing objective or universal statements. In fact, the differentiator may vary between different business enterprises and might therefore cause distortions¹⁰¹⁶. One might argue in favour that the participation or non-participation is more a subjective matter of the individual or situative circumstances rather than the objective classification as profit and loss. However, the question of how to operationalise the requirement of *participating in profits* and losses nevertheless depends on the subjacent conflict between the fundamental legal principles of adequacy versus relevance. This question is far too general and its answer so extensive that a satisfactory answer cannot be given here. With respect to the scope of this study¹⁰¹⁷, it is sufficient to hold that the potential distortions of that relative interpretation are in practice relativised through the interaction with other differentiators, which may therefore deserve a higher significance. As a final remark, all these systematic considerations are equally legitimate or valid within a domestic tax law. Therefore, they are at this point independent of the question as to what extent the participation in profits and losses is to be interpreted autonomously. Nevertheless, profit

¹⁰¹² See par. 91.

¹⁰¹³ Equally: *David Hariton*, equity and debt, p. 501.

¹⁰¹⁴ See par. 106.

¹⁰¹⁵ See par. 108(4).

¹⁰¹⁶ See par. 108(1).

¹⁰¹⁷ See sec. 1.2.

and loss as *income* is necessarily to be determined by reference to domestic tax law¹⁰¹⁸. However, the key question of whether or not there is participation in that *income* also allows an autonomous interpretation.

- 207 In summary, it is held for the further course of this study that the participation in profits and losses is understood as relatively subordinate to a non-participation in profits and losses. The two form a multi-static (non-binary) array of unlimited forms or states in the sense of a flexible or fluid “more or less” spectrum. Nevertheless, participation in profits and losses represents a non-legal risk-based concept, i.e. loss is a positive risk and profit a negative risk or chance. It can therefore be operationalised as a differentiator by the multi-stage process of risk identification, risk disaggregation and risk elimination¹⁰¹⁹. The ideal-type of a participation in profits and losses is represented by the regulatory core equity. The ideal-type of a non-participation in profits and losses is represented by the market interest rate for time-based positions, i.e. with the relatively lowest available risk. Its weakness of being limited in allowing objective or universal statements deserves, however, a cautious invocation and therefore relatively low significance when interacting with other differentiators.

2.4.4.4 Time value of money

- 208 Time-based financial instruments are the theoretical ideal-type of a *debt-claim*¹⁰²⁰ pursuant to Art. 11(3) OECD MTC. Therefore, they represent the natural complement to the participation in profits and losses¹⁰²¹. As a result of the transaction-based approach¹⁰²², the time value of money forms the starting point for the understanding of *interest*. On the one hand, the physical parameter of time¹⁰²³ is linear, so that any time-based remuneration can be and typically is contracted ex-ante. On the other hand, the interest rates as the “price of (investment) time” are also subject of market fluctuations in response to changes of supply and demand, just like any other prices. Where those changes are reflected in the payment profile rather than in the asset’s market value, the time-based remuneration can be contracted by a mathematical formula (e.g. floating rate notes) rather than by an absolute number (e.g. straight bond). In result, the time value of money is typically self-executive¹⁰²⁴.
- 209 Going further, the question arises, which and to what extent modifications of the payment profile represent a time-based remuneration. Or in other words: at which point does its purely time-based nature start and end. Particularly debatable are modifications in the¹⁰²⁵:
- (1) periodicity of being regular (e.g. every period) or irregular (e.g. only specific periods);
 - (2) certainty by being conditional (e.g. hurdles) or unconditional;
 - (3) amount multiplicatively (e.g. leverage) and/or additively (e.g. premium);
 - (4) payability by being deferred (e.g. vesting) or not deferred; and
 - (5) currency.

¹⁰¹⁸ See par. 144.

¹⁰¹⁹ See par. 101 et seqq.

¹⁰²⁰ See par. 103.

¹⁰²¹ See par. 202 et seqq.

¹⁰²² See par. 53 et seq.

¹⁰²³ See par. 81.

¹⁰²⁴ See par. 189.

¹⁰²⁵ Similarly: IAS Board, December 2016, 5B, p. 7 et seq., par. 26.

In all cases, it follows from the above equivalence of legal criteria¹⁰²⁶ that there cannot be any priority or subordination among them.

Periodicity

- 210 Analogous to the duration or maturity of the principal¹⁰²⁷, the first aspect (1) of periodicity of the remuneration payments can be understood as either time-based or risk-based. The difference between the maturity of the remuneration payments and that of the principal is that the former always has a resolutive condition, even where the latter has none. In other words: even where the maturity for repaying the principal is infinite (e.g. by requiring an action, such as a termination) and therefore unknown, that of each individual remuneration payment is ex-ante determined and therefore known (even where also its own duration is infinite¹⁰²⁸). Consequently, there is no compelling need for a risk-based understanding of the remuneration's maturity in order to ensure consistency, comparability and universality¹⁰²⁹. Therefore, the question remains, which and to what extent risk-based payment profiles represent a time-based remuneration – even more so since underwriting risk can replicate or be converted into timing risk¹⁰³⁰.
- 211 This question and the subjacent transformation of time into risk appears quite difficult to tackle. The reason is that the OECD MTC, in contrast to the domestic tax laws, does not have the requisite temporal framework in the sense of tax periods (e.g. tax years) but instead an item-by-item structure¹⁰³¹. However, the maturity of the remuneration payments – unlike that of the principal – is always known. Ergo, the congruence of time and risk could be assessed at these points in time (i.e. those of their resolutive conditions). In other words: the transformation of time into risk does not necessarily require an absolute temporal framework of tax periods but merely any relative temporal framework of time marks. As even an infinite duration or maturity of the principal necessarily entails a finite duration or maturity of the remuneration payments¹⁰³², these time marks are always ex-ante determinable. An exception to these principles, which is also in line with the IAS/IFRS¹⁰³³, is where the holder has a right to terminate the financial instrument¹⁰³⁴. In this case both the duration or maturity of the principal and that of the remuneration might be infinite. The right to terminate refers, however, to the primary market only. The financial instrument itself remains infinite and therefore still bears underwriting risk, even if disposed on the secondary market.

Example 33: A tracker certificate might be indirectly linked to a seasonal index instead of directly to the lapse of time. Where such certificate distributes any periodic remuneration, its time-based nature can be assessed at these payment dates. Where such certificate distributes no remuneration and its duration or maturity is finite, its time-based nature can be assessed at this duration or maturity. Where the certificate distributes no remuneration and its duration

¹⁰²⁶ See par. 182.

¹⁰²⁷ See par. 196.

¹⁰²⁸ See par. 198.

¹⁰²⁹ See par. 199.

¹⁰³⁰ See par. 69.

¹⁰³¹ See par. 59.

¹⁰³² See par. 199.

¹⁰³³ See par. 191.

¹⁰³⁴ Equally: *Peter Hongler*, p. 47.

or maturity is infinite but the holder has the right to terminate, its time-based nature can be assessed at this termination date¹⁰³⁵. Where the certificate distributes no remuneration, its duration or maturity is infinite and the holder has no right to terminate, it cannot be of a time-based nature.

- 212 For these reasons, periodicity can be used as a two-tier differentiator: its time-based nature is to be assessed by the congruence of the risk-based with the time-based remuneration (time equivalence), but only where the latter does not already exist. Where the risk-based remuneration is congruent to the time-based remuneration, the latter was found necessarily taking precedence over the former¹⁰³⁶. Where the long-term duration or maturity (especially if infinite) necessitates high interpretation significance and therefore a disaggregation of the time value of money¹⁰³⁷, this approach should allow for “extraction” from most financial instruments.

Example 34: A straight or finite zero bond is time-based to the extent its value change is congruent with the time value of money (i.e. the entire value change at maturity or the accrued interest when disposed). A tracker certificate on the straight bond is equivalent to the finite zero bond¹⁰³⁸. An infinite bond with periodic coupons is time-based. An infinite zero bond with termination right is equivalent to the finite zero bond. An infinite zero bond without termination right is not time-based. A tracker certificate on the infinite bond with periodic coupons is equivalent to the zero bond (i.e. time-based with termination right and not time-based without termination right). A *share* is not time-based, as its maturity is not ex-ante determinable¹⁰³⁹. In contrast, a tracker certificate on the *share* may be time-based to the extent that its value change is congruent with the time value of money, given that its (relative¹⁰⁴⁰) maturity is ex-ante determinable.

Certainty

- 213 The second aspect (2)¹⁰⁴¹ of certainty may naturally only refer to the timing risk of when the remuneration is paid¹⁰⁴² but not to the underwriting risk of whether it is paid at all¹⁰⁴³. However, this obviousness leads to the subjacent question at which point the financial instrument is to be classified¹⁰⁴⁴:
- (1) date of issuance or acquisition of the financial instrument (dynamic ex-ante view);
 - (2) date of *income* payment in isolation (static view);
 - (3) date of *income* payment in consideration of the remaining expectable lifetime of the financial instrument (dynamic forward-looking view); or
 - (4) at the end of the financial instrument’s entire lifetime (dynamic ex-post view).

¹⁰³⁵ Equally: IFRS 9.B4.3.7.

¹⁰³⁶ See par. 199.

¹⁰³⁷ See par. 107(4).

¹⁰³⁸ IFRS 9.B4.1.23.

¹⁰³⁹ See par. 210.

¹⁰⁴⁰ See par. 199.

¹⁰⁴¹ See par. 209(2).

¹⁰⁴² See par. 68.

¹⁰⁴³ Contrary: *Sven-Eric Bärsch*, p. 232, not distinguishing underwriting and timing risk. See also par. 67.

¹⁰⁴⁴ Similarly: *Peter Hongler*, p. 270 et seq. See also Example 3 on p. 41.

214 In the author's opinion, the *income* or transaction is basically to be classified according to the dynamic forward-looking view (3) for a number of reasons:

- Any conditional concept in the sense of criteria being subject to a reservation of whether or not an aspect applies at all would entirely fall short where instead only concepts would apply once something has effectively happened.
- Speaking more generally, aspects dealing with the grounds (e.g. conditions) methodologically apply prior to those dealing with the amounts (e.g. payments). Any other approach would mean nothing else than to ignore the cause and only consider the effects.
- In addition, any concept based on time periods would entirely fall short where only concepts would apply which are determined on a particular point in time.¹⁰⁴⁵
- Most notably, this does not only include all kinds of risk¹⁰⁴⁶ but also the entire asset as the starting point and interpretational baseline of the OECD MTC, which is not substituted but merely enlarged and disentangled by the transaction-based approach¹⁰⁴⁷.
- Furthermore, the classification of the *income* or transaction would be highly erratic. The reason is that its nature would solely depend on its particular context in the respective points in time rather than over the entire lifetime of the financial instrument¹⁰⁴⁸. Accordingly, the classification would be subject of more probable changes over time.

Example 35: Where a bond was featured with an increasing interest rate from below to above market interest rate, analysing the individual coupon payments separately might lead to their differing classifications (i.e. time-based and not time-based), compared to if they had been analysed by grouping them together as a coherent whole (i.e. time-based).

- And finally: the approach of basically classifying the income or transaction dynamically was therefore also taken by the IAS/IFRS¹⁰⁴⁹.

Consequently, where the remuneration is subject to a condition or reservation of whether or not it is paid at all, this underwriting risk must necessarily apply prior to and therefore falsify time equivalence and consequently the time-based nature of the financial instrument¹⁰⁵⁰.

Example 36: A structured product, whose coupon is subject of a netting of its interest component with its capital gain component, is not time-based – even if the coupon taken separately is congruent with the time value of money.

Amount modifications

215 As regards the third aspect (3)¹⁰⁵¹, the question is to what extent modified amounts represent the time value of money. Multiplicative modifications are leverage, which can be above (> 1) or below (< 1) time proportionality

¹⁰⁴⁵ Equally: *Sven-Eric Bärsch*, p. 80. See also Example 2 on p. 28.

¹⁰⁴⁶ See par. 69.

¹⁰⁴⁷ See par. 58.

¹⁰⁴⁸ Similarly: IFRS 9.B4.1.9C.

¹⁰⁴⁹ *Christoph Berentzen*, p. 83 et seq.

¹⁰⁵⁰ In result equally: *Peter Hongler*, p. 45. For the role of subordination in this respect, see par. 219 et seqq.

¹⁰⁵¹ See par. 209(3).

(= 1). Additive modifications can be premiums (> 0) or discounts (< 0). In this respect, the IAS/IFRS correspond with intuitive position that any positive modification (i.e. leverage > 1 and premiums) is basically not time-equivalent and therefore does not represent the time value of money. The reason is that any excess amount can eventually and economically only be yielded by equity (or perhaps by luck), implying, however, underwriting risk¹⁰⁵². This becomes particularly clear where the modification has results in an effect such as an if-at-all condition, i.e. the risk of reducing the amount to zero¹⁰⁵³. Analogously, any other opportunity costs compensating the lost or prospective time value of money are – unlike in the IAS/IFRS¹⁰⁵⁴ – not *interest* pursuant to Art. 11(3) OECD (e.g. the excess “interest” of inflation-linked bonds or notes). These can only be yielded by equity implying underwriting risk. Admittedly, also the time value of money itself can and must be yielded by implying underwriting risk (e.g. the deposit interest rate at the central bank). Nevertheless, it represents by definition the theoretical ideal-type of a *debt-claim* pursuant to Art. 11(3) OECD MTC in bearing the lowest relative underwriting risk¹⁰⁵⁵. One exception to this general principle is however where the long-term duration or maturity, especially if infinite, necessitates high interpretation significance and therefore a disaggregation of the time value of money¹⁰⁵⁶. Another exception is where the excess amounts, analysed by grouping them together as a coherent whole¹⁰⁵⁷, are exactly and certainly compensated by lower amounts elsewhere and therefore actually represent the time value of money. Such grouping of the remuneration payments from one and the same financial instrument for the purpose of dynamically¹⁰⁵⁸ classifying it represents a requisite exception from the finding that an aggregation of transactions upwards from their individual singularities is not justifiable¹⁰⁵⁹. However, where such lower compensating amounts are uncertain, this necessarily implies underwriting risk and therefore does not represent the time value of money. From this rationale follows *e contrario* that negative amount modifications (i.e. leverage < 1 and discounts) are time-equivalent. Therefore, they represent the time value of money where lower amounts, analysed by grouping them together as a coherent whole, are exactly and certainly compensated by excess amounts elsewhere, or where the long-term duration or maturity (especially if infinite) necessitates high interpretation significance and therefore a disaggregation of the time value of money.

Example 37: A finite structured product pays a periodic remuneration and, at maturity, a capital gain from its underlying. Where the remuneration is positively or negatively modified and the correspondingly lower or higher capital gain is certain (i.e. a forward component), the structured product is time-based (i.e. the forward component is in fact a positive or negative interest). Where the remuneration is positively or negatively modified and the correspondingly lower or higher capital gain is uncertain (e.g. an option component), the structured product is not time-based (i.e. the option component is in fact a positive or negative risk premium).

¹⁰⁵² *Christoph Berentzen*, p. 82.

¹⁰⁵³ See par. 213 et seq.

¹⁰⁵⁴ Haufe, IFRS, p. 1712, par. 166.

¹⁰⁵⁵ See par. 103.

¹⁰⁵⁶ See par. 212.

¹⁰⁵⁷ See Example 35 on p. 125.

¹⁰⁵⁸ See par. 214.

¹⁰⁵⁹ See par. 95.

Payability

- 216 The fourth aspect (4)¹⁰⁶⁰ of payability is basically analogous to the third aspect (3) of amount modifications¹⁰⁶¹. The difference is that the relevant period for assessing the time equivalence starts with the maturity of the remuneration. Accordingly, deferrals represent a negative amount modification and therefore not the time value of money, except where they bear interest as well (i.e. are subject of compound interest).¹⁰⁶²

Currency

- 217 As regards the last aspect (5)¹⁰⁶³, time equivalence must necessarily be determined in the currency, in which the principal nominates¹⁰⁶⁴ – even where the remuneration itself is paid in a different currency. This means in particular that any currency conversion is a subsequent logical step to the capital provision. Thus, currency risk has no influence on the assessment of the time equivalence.

2.4.5 Risks and opportunities

2.4.5.1 Preliminary remarks

- 218 The purpose of this section is to analyse and discuss potential differentiators which are mainly characterised by positive and negative risks arising from financial instruments¹⁰⁶⁵. On the one hand, *risk* as a mathematical and therefore quantitative parameter is an economic category¹⁰⁶⁶. Except for legal risk and timing risk, such quantitative parameters do not allow qualitative conclusions on the types of *risk*¹⁰⁶⁷. On the other hand, it was nevertheless found capable of indicating some general guidelines for the various fields of those potential differentiators. In addition, it was also found capable of being an interpretative and/or applicative assessment factor for methodologically evaluating the relative importance of these fields of criteria¹⁰⁶⁸. Especially for the systematic approach taken in this study¹⁰⁶⁹, *risk* turns out to be a crucial qualitative criterion. Its absolute and binary existence of “yes or no” and its relative and multi-static occurrence of “more or less” suffice in many aspects for revealing far-reaching indications. These allow for the interpretation of the nature of the underlying transaction autonomously and may therefore potentially lead to the grounds of the debt-equity distinction. Like the payment profile¹⁰⁷⁰, with which *risk* bears a natural nexus¹⁰⁷¹, the apparent and observable behavioural adaptations of the contracting counterparties of financial instrument to their particular *risk* exposures are symptoms of or reflex responses to the economic nature of the subjacent and masked transaction or operation. Differentiators in the field of risks and opportunities appear likewise to be very promising for contributing value added to this study.

¹⁰⁶⁰ See par. 209(4).

¹⁰⁶¹ See par. 215.

¹⁰⁶² IFRS 9.B4.1.14, example/instrument H.

¹⁰⁶³ See par. 209(5).

¹⁰⁶⁴ IFRS 9.B4.1.8.

¹⁰⁶⁵ See par. 60.

¹⁰⁶⁶ See par. 65.

¹⁰⁶⁷ See par. 101.

¹⁰⁶⁸ See par. 107.

¹⁰⁶⁹ See par. 13.

¹⁰⁷⁰ See par. 200.

¹⁰⁷¹ See par. 89.

2.4.5.2 Subordination

- 219 At first glance, subordination appears to be closely related to with the participation in profits and/or losses¹⁰⁷². Admittedly, a limit or cap of compensation, in that it does legally not participate in the profits, was said to be nothing but an indemnification for the subordinate and therefore lower relative risk of also legally participating in the losses¹⁰⁷³. As a consequence, there is typically a positive correlation between a participation in profits (and maybe losses) and subordination. For instance, any principal repayment actually requires and therefore participates in economic capital contributions or pay-ins, analogous to any compensation or pay-out¹⁰⁷⁴. For this reason, any capital or principal eventually also participates in the economic business risk¹⁰⁷⁵. However, this turns out to be an imprecise view, if looked at more closely. The positive correlation may not lead to the erroneous reverse deduction that there was, in turn, subordination wherever there is a participation in profits¹⁰⁷⁶ (and maybe losses). For instance, “hybrid” debts may participate in profits (and maybe losses) without however being subordinated. The primary reason is that subordination refers to and primarily means the principal (i.e. the asset), and does not necessarily also include the compensation (i.e. the income or transaction).

Example 38: *Shares* are subordinated in both principal and compensation, whereas (“hybrid”) debts are typically subordinated in principal only. A fortiori, in order to attract investors it is often a typical feature of such “hybrids” to grant priority or seniority for the income as an additional compensation for the subordination of the principal.

This follows from the fact that subordination is logically determined prior to and therefore in no way linked with the legal process of formally determining or calculating equity and liabilities¹⁰⁷⁷.

Side note: Just like the OECD MTC¹⁰⁷⁸, the IAS/IFRS apply an asset-based approach by defining equity as residual “assets of an entity after deducting all of its liabilities”¹⁰⁷⁹. “[...] distributions to holders of equity instruments are recognised directly in equity. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses [...]”¹⁰⁸⁰ In contrast, corporate law is typically more flexible, in that subordination in principal does not necessarily imply subordination also in the compensation.

Unlike the formally determined profits and/or losses¹⁰⁸¹, subordination is consequently not resultative or binary, and therefore not an absolute but rather a relative concept per se¹⁰⁸². While the formally determined profit and loss is an absolute figure of “yes or no”, subordination describes a relative relationship between

¹⁰⁷² See par. 202 et seqq.

¹⁰⁷³ See par. 182.

¹⁰⁷⁴ See par. 202.

¹⁰⁷⁵ Equally: *Sven-Eric Bärsch*, p. 80.

¹⁰⁷⁶ Cum hoc ergo propter hoc.

¹⁰⁷⁷ See par. 203.

¹⁰⁷⁸ See par. 58.

¹⁰⁷⁹ IAS 32.11. See also par. 202.

¹⁰⁸⁰ IFRIC 2.11.

¹⁰⁸¹ See par. 204.

¹⁰⁸² Equally: *David Hariton*, equity and debt, p. 522.

two figures in terms of a “more or less”. As a result, subordination can not only be interpreted relatively or economically but also absolutely and formally and therefore domestically.

Example 38 (continued): Interpreted relatively, the principal of equity was subordinate to the classification as a liability. Since “excessive debt” actually skims economic equity¹⁰⁸³, thin capitalisation rules often provide a debt-equity ratio instead of an interest-profit ratio. Interpreted economically, the principal of equity was independent of the formal equity determination procedures of deducting the liability.

- 220 Also, subordination represents a non-legal risk-based concept¹⁰⁸⁴. However, in contrast to the participation in profits and/or losses¹⁰⁸⁵, subordination cannot be operationalised as a differentiator by the multi-stage process of risk identification, risk disaggregation and risk elimination¹⁰⁸⁶. Unlike the relatively highest subordination represented by the regulatory core equity¹⁰⁸⁷, the ideal-type of the relatively lowest subordination (i.e. with the relatively lowest available risk) and therefore a requisite reference and the starting point for applying the model, is not determinable. Subordination in the principal is completely independent and therefore not deducible from that in the compensation¹⁰⁸⁸. Apart from that, subordination is – in contrast to profits and/or losses¹⁰⁸⁹ – already by its wording (“sub...”) a relative concept per se and as such determinable only on an individual or situative basis. Profits and losses *as such* are absolute figures, whereas the separate and subsequent question of whether or not there is also *participation*¹⁰⁹⁰ must be answered relatively. Therefore, profits and losses represent the reference and starting point for giving this answer. In contrast, subordination *as such* is a relative figure and therefore strongly depends on the context. As a consequence, subordination represents an erratic and inhomogeneous and therefore non-marketable and non-transferable risk¹⁰⁹¹. In the absence of any possibility for such standardisation there is no objectified reference for risks from subordination. In this light, the accurate notice that any subordination makes a financial instrument not necessarily a *debt-claim*¹⁰⁹² appears however meaningless. The undisputedly important criterion of subordination simply negated. Consequently, it is not even theoretically possible to draw any objective or universal statement at all, as a differentiator on such basis would be highly erratic and eventually arbitrary.

Example 39: One and the same financial instrument A can be subordinate to another financial instrument B in one context but simultaneously vice versa in another context.¹⁰⁹³ Financial

¹⁰⁸³ See Example 30 on p. 119.

¹⁰⁸⁴ See par. 107.

¹⁰⁸⁵ See par. 207.

¹⁰⁸⁶ See par. 101 et seqq.

¹⁰⁸⁷ IAS 33.5, ordinary share.

¹⁰⁸⁸ See par. 219.

¹⁰⁸⁹ See par. 204.

¹⁰⁹⁰ See par. 205 et seq.

¹⁰⁹¹ See par. 60.

¹⁰⁹² Among others: *Anna Verena Matthies*, p. 153 et seqq.

¹⁰⁹³ Similarly: *David Hariton*, equity and debt, p. 523, illustrating that “asking ‘how much’ without fitting the answer into an understanding of the issuer’s capital structure is like playing blind man and the elephant”; *William Plumb*, p. 605 et seq., noticing that “subordination to one or a limited number of creditors does not ordinarily have the same significance as subordination to all creditors”.

instrument A might be classified as debt in the one context but simultaneously as equity in the other.¹⁰⁹⁴

- 221 In other words: this conceptual weakness may still be acceptable or justifiable for the participation in profits and/or losses¹⁰⁹⁵ due to the existence of an objectified directional reference. But it can, in the absence of the same, not be maintained any more for subordination. A legal criterion that cannot possibly be relevant, however, cannot possibly be purposeful either. That is why even considering its paramount importance¹⁰⁹⁶, an autonomous interpretation of subordination must be excluded. This outcome is also in line with and supported by the finding that the default risk of not paying back the capital or principal itself must necessarily be a legal risk (i.e. the credit risk)¹⁰⁹⁷ and thus be interpreted domestically. For these reasons, it can be concluded *e contrario* that subordination must be interpreted formally and therefore necessarily pursuant to the domestic law. Unlike the participation in profits and/or losses¹⁰⁹⁸, any domestic law must necessarily apply a relative interpretation of subordination. However, the concurrence with its domestic interpretation as such while coincidentally being of significant importance may nevertheless frustrate the distinction of the OECD MTC income types of financial instruments, which would otherwise give rise to qualification conflicts. As a final remark, this domestic interpretation is also the reason why subordination is not capable of giving any indication as to whether the mutual exclusivity between Art. 10 and 11 OECD MTC – in contrast to the IAS/IFRS¹⁰⁹⁹ – is a result of either their subordinate relationship or of an equal position on the same level or rank¹¹⁰⁰.

2.4.5.3 Coverage and collateral

- 222 At first glance, both coverage and collateral appear to be protective measures against credit risk. Consequently, there is a substitutive effect and therefore typically a negative correlation between the two. However, this turns out to be an imprecise view if looked at more closely, in that coverage actually reduces the probability of the credit default event and collateral the value of the credit default event¹¹⁰¹. Credit default is a legal event due to the specific legal characteristics of debts given by law, which is why credit risk is a legal risk.¹¹⁰² As such it emerges as a result of the legal relationship, i.e. at the edge of the formal interface between the contracting parties: it represents the “residual” counterparty risk after having already included and netted all risk minimising effects within the financial instrument itself (e.g. coverage). In addition, credit risk ceases to exist as a hazard once the credit default event occurs, turning from uncertainty into certainty. From this perspective, coverage is understood here as any feature or protection within a financial instrument that minimises the probability of its credit risk. In contrast, collateral is understood as any compensation of a financial instrument for the adverse effects of its credit default event itself. On the one hand, neither of the two concepts is part of the credit risk itself. Also collateral does not reduce the credit risk itself but in fact

¹⁰⁹⁴ Equally: *William Plumb*, p. 475.

¹⁰⁹⁵ See par. 206.

¹⁰⁹⁶ See par. 107.

¹⁰⁹⁷ See par. 66.

¹⁰⁹⁸ See par. 205 et seq.

¹⁰⁹⁹ See par. 219.

¹¹⁰⁰ See par. 113.

¹¹⁰¹ See par. 60.

¹¹⁰² See par. 66.

reduces the credit amount economically. Where collateral is perfect, there is economically no credit or debt. The reason is that the provision or contribution of the capital or principal is perfectly compensated by the provision or contribution of the collateral, which becomes particularly clear from the example of a credit or debt in kind. Even where the provision or contribution of cash capital or principal was considered a formal credit or debt by legal convention, a collateralisation will typically not be a requirement by such convention but rather a response to it. In other words: collateralisation might be an indicator for credit risk, but cannot be a credit risk itself. On the other hand, the two concepts differ in the way that coverage is in fact part of the underwriting risk, being in effect just prior to the occurrence of the legal credit default event. In contrast, only collateral is complementarily related to the credit risk, coming into effect just after the occurrence of the legal credit default event. Considering coverage as equivalent with collateral was a circular reasoning, as it would imply a non-legal and thus artificial imagination of credit risk as some hypothetical “uncovered” state that actually negates coverage itself. Accordingly, there is a positive correlation between credit risk and collateral but a negative one between credit risk and coverage. Where coverage is perfect, there is no credit risk; but collateral is only necessary where there is credit risk. The following illustration visualises this understanding:

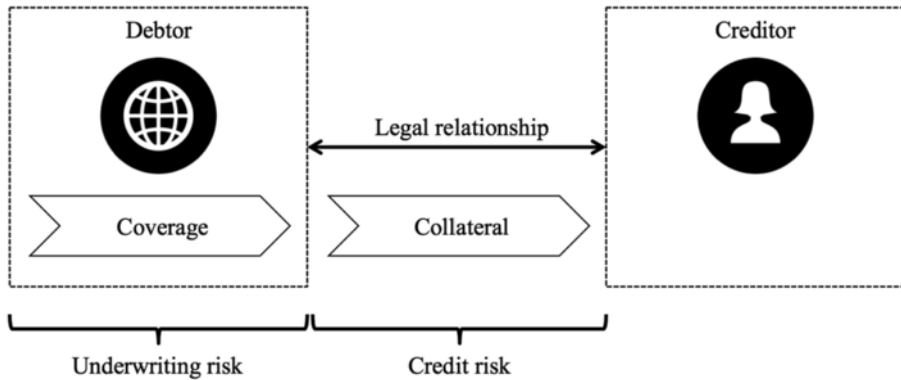


Illustration 14: Coverage as part of underwriting risk versus collateral as related to credit risk

- 223 After these considerations it might be naturally suggested that any conclusion in order to indicate credit risk and therefore *debt-claims* may be potentially drawn from collateral only but never from coverage. However, the question arises why it should be necessary at all to draw such conclusions from an effect that is obviously rooted in a debt classification already. The answer is that the positive correlation between credit risk and collateral¹¹⁰³ should not lead to the conclusion that there is in turn a credit risk wherever there is a collateral¹¹⁰⁴ (e.g. where the collateral is the coverage, such as commodity-backed payment-in-kind bonds). The substitutive economic effect between coverage and collateral¹¹⁰⁵ allows “squeezing” or carving out the material effects of collateral (i.e. minimising the adverse effects of the credit default event) by those of coverage (i.e. minimising the probability of the credit default event). As a consequence, credit risk can be “squeezed” or carved out by underwriting risk. That is why collateral is not capable of positively verifying credit risk in a reliable manner.

¹¹⁰³ See par. 222.

¹¹⁰⁴ Cum hoc ergo propter hoc.

¹¹⁰⁵ See par. 222.

- 224 On the other hand, it is not possible to vice versa “squeeze” or carve out the material effects of coverage by those of collateral, as the former logically applies prior to the latter, so that underwriting risk can in turn not be “squeezed” or carved out by credit risk. That is why coverage is capable of negatively falsifying credit risk reliably. In other words: the economic substitutability between coverage and collateral can be transformed into an economic approach that might open up new possibilities for differentiating the income types from financial instruments by identifying counterparty risk indirectly but more reliably in its form of underwriting risk (i.e. via coverage) rather than in its form of credit risk (i.e. via collateral). This is also why the approach does not violate the finding that credit risk is a legal risk, being accessible only by form over substance¹¹⁰⁶. The idea behind the approach is that uncovered debts bear the risk in the debtor’s ability to recover the capital or principal (i.e. credit risk). In contrast, covered debts merely bear the risk of ownership in the capital or principal itself (i.e. underwriting risk), which the creditor also had to take without having left it to the debtor.¹¹⁰⁷ As the sum of the two effects is always the same in value due to their economic substitutability, the existence or non-existence of coverage as a part of underwriting risk can indicate whether or not there is any space left for effective credit risk, making it a possible differentiator for *debt-claims*. This approach is even more promising as credit risk has a limited analytical value due to the fact that it cannot be “resolved” but only converted by transferring or re-allocating it and therefore accepting new legal risks¹¹⁰⁸.
- 225 Admittedly, it might be objected that this approach poses a number of systematically difficult problems, such as¹¹⁰⁹:
- (1) The look through the debt down to its coverage extends the economic character of the approach also to the understanding of capital or principal. In fact, it is split economically into the two logical aspects of lending cash (i.e. finance) and binding that cash in an utilisation (i.e. investment)¹¹¹⁰. In doing so, the approach goes beyond the mere provision or contribution of capital or principal between debtor and creditor (i.e. finance) by actually also involving its utilisation by the debtor (i.e. investment). Where coverage is perfect, a cash credit cannot be invested or capitalised in the sense of sourcing potential income. For example, a cash credit perfectly covered and therefore bound by a real asset cannot generate any income. Instead, cash can only generate income by being utilised other than by perfect coverage. That is why the economic understanding of capital and capitalisation necessitates the relinquishment of control over the cash for the purpose of income generation (i.e. investment). In other words: capital investment implies and requires counterparty risk as a necessary condition. Hence, the classification of the financial instrument and therefore the treatment of the creditor depend on the way in which the debtor effectively uses the borrowed capital or principal (inter-subjective classification chain).
 - (2) Beyond that, the further question arises which nature and what intensity the coverage must have in order to qualify as such a differentiator. Thinking it through to the end would mean that not only physical (e.g. by real assets) but also synthetic coverage (e.g. by other financial instruments) should be capable of qualifying. This appears to be a result from the economic character of the approach, according to which

¹¹⁰⁶ See par. 101(1).

¹¹⁰⁷ *Weissbrodt, Jan*, Die sonstige Kapitalforderung im Sinne von § 20 Absatz 1 No. 7 EStG, Deutsches Steuerrecht 2012, Vol. 31, p. 1535.

¹¹⁰⁸ See par. 101(2).

¹¹⁰⁹ *Weissbrodt, Jan*, Die sonstige Kapitalforderung im Sinne von § 20 Absatz 1 No. 7 EStG, Deutsches Steuerrecht 2012, Vol. 31, p. 1535 et seq.

¹¹¹⁰ *Zantow, Roger / Dinauer, Josef*, Finanzwirtschaft des Unternehmens: Die Grundlagen des modernen Finanzmanagements, Series wi wirtschaft, 4th edition, Pearson, Hallbergmoos, 2016, p. 24.

coverage is part of the underwriting risk, making no difference in any way between identical risk profiles of different kinds of assets.

- (3) Where the debt is not perfectly covered, it is either a question of whether to disaggregate the covered and the uncovered components, or a matter of degree, how much coverage is critical to turn the financial instrument entirely from being classified as covered into being classified as uncovered (or vice versa).

- 226 As regards the first objection (1), the dependency of the creditor's tax treatment on the debtor's behaviour might indeed be impermissible or inappropriate within the context of a domestic tax law. DTC have to integrate themselves as coherent elements by respecting and being bound to the instruments and principles granted by their domestic tax law systems, particularly the superior domestic (e.g. constitutional) laws¹¹¹¹. However, the purpose and function of DTC – even in jurisdictions applying the monistic system – are considerably different from or even opposite to those of their domestic tax laws¹¹¹². In fact, they focus on limiting the taxation of the source¹¹¹³ rather than on generating tax revenues. In this light, focussing likewise on the debtor as the source of *income from debt-claims* not only appears to be free of conflicts with the domestic tax law but also seems in line with the purpose and function of the OECD MTC and therefore necessary.
- 227 As regards the second objection (2), synthetic replication is possible only at the price of higher legal risks¹¹¹⁴. This would, however, run contrary to the initial idea of the approach to identify counterparty risk indirectly in its form of non-legal (i.e. underwriting) risk rather than in its form of legal (i.e. credit) risk¹¹¹⁵. Consequently, only physical and not synthetic coverage is capable of qualifying as a differentiator, whereby *physical* means that those assets do not bear any credit risk themselves. As the subprime mortgage crisis has shown, any discretionary level of insignificance for some minor credit risk allows for diluting the intensity of the coverage as a differentiator by way of disaggregating and re-aggregating credit risk.
- 228 As regards the third objection (3), this is also the reason why the disaggregation appears to be more purposeful and resilient than a discretionary level of insignificance for some minor credit risk. The process of successively disaggregating the underwriting risk stops where the counterparty risk can be distinctly attributed to the (non-)coverage¹¹¹⁶. In this point, the counterparty risk can be clearly distinguished and separated from other underwriting risks. This is why the absence of any coverage – just as the absence of any collateral – is still not an indicator and even less a verifier for a participation in underwriting risk, justifying a negation of debt¹¹¹⁷. This is also demonstrated by the fact that the credit rating typically does not change where collateral is transmuted into coverage or vice versa.
- 229 In conclusion, the economic substitutability between coverage and collateral allows for the use of coverage as a differentiator for identifying counterparty risk in a potentially more reliable manner than collateral, in

¹¹¹¹ See par. 71.

¹¹¹² See par. 5.

¹¹¹³ See par. 19.

¹¹¹⁴ See par. 103(3).

¹¹¹⁵ See par. 224.

¹¹¹⁶ See par. 101(3).

¹¹¹⁷ *William Plumb*, p. 468 and 506.

that it is capable of negatively falsifying credit risk. Such an approach is in line with the purpose and function of the OECD MTC and conflicts neither with previous systematic findings nor with the objectives and principles of the domestic tax laws. In particular, it does not violate the finding¹¹¹⁸ that credit risk as a legal risk cannot be interpreted economically but must necessarily be subject of form over substance, since coverage (i.e. underwriting risk) applies prior to and therefore independent of collateral (i.e. credit risk)¹¹¹⁹.

- 230 However, a special question that deserves particular attention is where the coverage or even the collateral is provided or represented by own equities (e.g. *shares*) of the issuer himself, or, speaking more generally, by physical assets bearing underwriting risk that significantly correlates with the issuer's own business risk. In these cases, the coverage meets all the requirements found here before¹¹²⁰. But the credit risk is merely converted into, and thus inextricably coalesced with, the business risk¹¹²¹ and therefore cannot be distinctly attributed to the (non-)coverage by way of successively disaggregating the underwriting risk¹¹²². The specific "hybrid" nature of such debts becomes particularly clear, when considering that in cases of default the equity appreciates in direct response to the debt's corresponding depreciation (circular effect). As a consequence, the creditor genuinely participates in the business risk for the benefit of the debtor (risk sharing)¹¹²³. Nevertheless, financial instruments providing the coverage or even the collateral by own equities merely represent a particular use case in a more general class of financial instruments, whose "amount of economic resources required to settle the claim is not independent of the entity's economic resources."¹¹²⁴ Such financial instruments touch a number of aspects which are subject in this study. This is why they are predominantly analysed in the following sub-section in the context of capital or principal repayment at maturity.¹¹²⁵

2.4.5.4 Termination risk

Definition

- 231 Time-based financial instruments were said to represent the theoretical ideal-type of a *debt-claim* pursuant to Art. 11(3) OECD MTC, in that they bear the lowest relative risk¹¹²⁶. Excluding credit risk¹¹²⁷ as a legal risk¹¹²⁸ and timing risk as an admissible non-legal risk¹¹²⁹, this means residually the lowest relative underwriting risk. This characteristic and requirement does not only apply to the income or transaction¹¹³⁰ but analogously also to the capital or principal¹¹³¹. Accordingly, the pure form of a *debt-claim* and the starting point for the understanding of *interest* basically implies and requires a perfect recovery of the invested capital (i.e. the

¹¹¹⁸ See par. 101(1).

¹¹¹⁹ See par. 224.

¹¹²⁰ See par. 227.

¹¹²¹ Equally: *David Hariton*, equity and debt, p. 513.

¹¹²² See par. 228.

¹¹²³ Equally: *David Hariton*, equity and debt, p. 510; similarly: IAS Board, September 2015, 5A, p. 10, par. 33.

¹¹²⁴ IAS Board, September 2015, 5A, p. 10, par. 31.

¹¹²⁵ See par. 178.

¹¹²⁶ See par. 103 and 215.

¹¹²⁷ See par. 101(1).

¹¹²⁸ See par. 66.

¹¹²⁹ See par. 213.

¹¹³⁰ See par. 208 et seqq.

¹¹³¹ See par. 178.

principal)¹¹³². Analogously to the time value of money (i.e. the income or transaction)¹¹³³, this capital recovery refers first of all to the primary market only. The reason is that any disposal of the financial instrument on the secondary market naturally happens before its maturity. As, economically, today's capital is tomorrow's income¹¹³⁴, the value of a financial instrument, however, depends also on the environmental influences¹¹³⁵ of potential alternative possibilities or opportunities to invest the capital for its remaining duration (opportunity costs)¹¹³⁶. In other words: these value fluctuations are merely reflex responses to the fixed-interest period of the financial instrument¹¹³⁷. The more the lapse of time approximates the end of the respective fixed-interest period, the fewer alternative possibilities or opportunities are available on the market, so that the value of the financial instrument correspondingly approximates the principal amount. As those value fluctuations are thus merely temporary, they represent in fact timing risk¹¹³⁸ and are therefore irrelevant with regard to the principal's underwriting risk.

Step 1: redemptions in kind

- 232 For these reasons, termination risk means any non-legal underwriting risk towards a non-perfect recovery of the capital or principal at maturity. In contrast to the multi-statically modifiable time value of money¹¹³⁹, (non-)perfection is a binary concept and therefore much more clearly and reliably determinable. This is why only the one use case shall be analysed in more detail here, in which the capital or principal is in result redeemed in kind instead of in the currency nominated. This understanding is broad and also includes, for instance, novations, substitutions or redemption in different currencies (e.g. physically-settled compo or quanto equity swaps¹¹⁴⁰, etc.).

Example 40: Payment-in-kind bonds are redeemed in their underlyings. Structured products in general can optionally be redeemed in their underlyings; convertible bonds in particular can optionally be redeemed in *shares*. Bonds can be perpetual where they are redeemed in an identical bond¹¹⁴¹.

The specific systematic question in this case is, what constitutes a potential difference between the capital or principal provided and that redeemed. The reason is the dual purpose of legal entitlements (i.e. the capital or principal) in potentially representing both the economic return for legal obligations and parts of the economic operation itself. This is why they must methodologically be subject of a precedent autonomous analysis in order to determine whether they represent parts of the operation, before being subject of a subsequent domestic analysis in order to determine whether they represent parts of the mere return for legal obligations¹¹⁴². For instance, where another financial instrument is both provided and redeemed as capital (e.g. covered securities

¹¹³² Equally: *Sven-Eric Bärsch*, p. 234.

¹¹³³ See par. 211.

¹¹³⁴ See par. 160.

¹¹³⁵ See par. 62 and 155.

¹¹³⁶ See par. 99.

¹¹³⁷ See par. 208.

¹¹³⁸ See par. 68.

¹¹³⁹ See par. 209.

¹¹⁴⁰ *Juan Ramirez*, p. 21 et seq.

¹¹⁴¹ IAS Board, June 2015, 5A, p. 9, par. 33.

¹¹⁴² See par. 181.

lending), there is actually no qualitative difference between the former and the latter. In other words: wherever the creditor bears the same underwriting risks with regard to the capital or principal as if he had not provided it to the creditor¹¹⁴³, the redemption he gets back is in fact the same as what he had once provided¹¹⁴⁴. Beforehand, the answer to that question can obviously not depend on what has been contractually agreed upon as the object of the capital provision and/or redemption, as this would likewise be true also for any object bearing underwriting risk. Consequently, non-perfection cannot depend on whether or not the creditor's subjective confidence in a perfect recovery (i.e. his risk expectation) is potentially or actually frustrated either.

Example 41: A finite delta-one payment-in-kind certificate on one *share* is a contractual agreement to be redeemed at maturity in the one *share*. Although the creditor's subjective expectation can necessarily be only be that he eventually gets back the one *share*, he obviously takes the underwriting risk of a non-perfect capital recovery (i.e. the price risk of that *share*).

- 233 It appears therefore that redemptions in kind not only demonstrate the particular overlay and the subsequent dependence of underwriting risk and timing risk¹¹⁴⁵. Moreover, they generally coalesce both the time-based (e.g. finance) and simultaneously also the risk-based aspect (e.g. speculation) in themselves¹¹⁴⁶. While there is actually no difference whatsoever between the time-based provision of cash and that of cash-equivalents, there is a considerable difference between the risk-based values of cash representing nominal goods and cash-equivalents representing real goods. In fact, the units of the latter are assessed in units of the former, but not vice versa¹¹⁴⁷. This is the reason why redemptions in cash are typically perfect, whereas redemptions in kind are typically non-perfect. Corresponding to the income or transaction (i.e. the time value of money), the inherent systematic conflict or dualism between the two possible differentiators of time aspects on the one hand and risk aspects on the other¹¹⁴⁸ appears to arise also in the context of the capital or principal. This becomes particularly apparent by the example of financial instruments with redemption in kind. Consequently, the conclusion that time aspects must necessarily take precedence over risk aspects in cases where the two overlay, must be the same. This means as an interim conclusion that termination risk as such can not be the sole or exclusive differentiator between time-based and risk-based financial instruments, in that it falls short of redemptions in kind. In such cases, the risk-based aspect, which potentially leads to a non-perfect redemption and therefore represents a falsifier for time equivalence and consequently for time-based financial instruments, is inextricably coalesced with the time-based aspect that leads to a perfect redemption and therefore represents a verifier for time-based financial instruments. Redemptions in kind are not per se a falsifier for time equivalence and consequently for time-based financial instruments, which can principally be established by way of providing cash-equivalents. Or, in other words: a debt is in the first instance a debt, regardless of what its object is¹¹⁴⁹.

¹¹⁴³ See par. 224.

¹¹⁴⁴ See par. 70.

¹¹⁴⁵ See par. 69.

¹¹⁴⁶ See par. 99.

¹¹⁴⁷ See Example 23 on p. 107.

¹¹⁴⁸ See par. 199.

¹¹⁴⁹ Equally: IAS 32.16(a)(i) e contrario; IAS 32.BC7 and 32.BC11; IAS Board, September 2015, 5A, p. 7, par. 18; IAS Board, June 2015, 5A, p. 8, par. 29.

Step 2: redemptions in own equities

- 234 Instead, the answer to that initial question of what constitutes a potential difference between the capital or principal provided and that redeemed¹¹⁵⁰, must be underneath. The approach to this subjacent criterion shall be to directly analyse the most ambiguous case of redemptions in own equities. While any potential differentiator able to tackle this case should allow universal statements analogously¹¹⁵¹, any potential differentiator on a higher level would in turn necessarily be flawed or incomplete. However, just like financial instruments with coverage or collateral by own equities¹¹⁵², those with redemptions in own equities represent in fact one and the same class of financial instruments, whose “amount of economic resources required to settle the claim is not independent of the entity’s economic resources.”¹¹⁵³. Indeed, this special class of structurally “hybrid” financial instruments seems to lead to the grounds of the debt-equity distinction. It shows features of both during their entire lifetimes, which are coalesced so inextricably that they cannot be separated or disaggregated¹¹⁵⁴.

Step 3: what can be learned from the IAS/IFRS

- 235 Correspondingly, the IAS/IFRS have identified this special class of financial instruments with own equities as underlying and dedicated a fundamental research project in the context of the IFRS framework¹¹⁵⁵ to them. Pursuant to their present legal status¹¹⁵⁶, the IAS/IFRS currently treat such financial instruments in this regard as equity where the following criteria are met¹¹⁵⁷:
- (1) it includes no contractual obligation for the issuer or creditor to deliver cash or another financial asset¹¹⁵⁸ or an unconditional right to refuse it¹¹⁵⁹; and it is
 - either a non-*derivative* with a variable number of own equity instruments as underlying¹¹⁶⁰; or
 - a *derivative* with a fixed number of own equity instruments as underlying, gross physically settled only by the issuer or creditor against a fixed amount of cash or another financial instrument (*fixed-for-fixed condition*)¹¹⁶¹; or
 - (2) the financial instrument
 - includes a contractual obligation for the issuer or creditor to redeem or repurchase the capital or principal for cash or another financial asset on exercise of the put by the holder or debtor (*puttable instrument*)¹¹⁶²; and
 - includes an entitlement to a pro rata part of the issuer’s or debtor’s net assets in the event of his liquidation. Net assets are those that remain after deducting all other claims on the gross assets. A pro

¹¹⁵⁰ See par. 232.

¹¹⁵¹ Argumentum a minori ad maius.

¹¹⁵² See par. 230.

¹¹⁵³ IAS Board, September 2015, 5A, p. 10, par. 31.

¹¹⁵⁴ Peter Hongler, p. 9.

¹¹⁵⁵ See par. 47.

¹¹⁵⁶ See par. 46.

¹¹⁵⁷ See a summarising scheme at Clemens, Ralf in Bohl, Werner / Beiersdorf, Kati, Beck’sches IFRS-Handbuch: Kommentierung der IFRS / IAS, 4th edition, C. H. Beck, Munich, 2013, p. 561, par. 10.

¹¹⁵⁸ IAS 32.16(a)(i). See also par. 98(1).

¹¹⁵⁹ IFRIC 2.7. IFRIC 2.8, applying these principles analogously to (unconditional) statutory or otherwise public redemption prohibitions, was de facto declared by the IAS / IFRS research project as being not applicable anymore (IAS Board, February 2017, 5B, p. 5, par. 19).

¹¹⁶⁰ IAS 32.16(b)(i).

¹¹⁶¹ IAS 32.16(b)(ii) and 32.22.

¹¹⁶² IAS 32.16A; IFRIC 2.6.

rata part is determined by the net assets on liquidation, divided into units of equal amount and then multiplied by the number of the units of the financial instrument held¹¹⁶³; and

- is unconditionally (e.g. non-convertible) subordinate to other claims to the assets of the entity on liquidation¹¹⁶⁴; and
- has total prospect cash flows over its lifetime which are based substantially on the profits or losses or on the change in the inventory or value of the net assets, excluding any effect of the financial instrument itself¹¹⁶⁵; and
- where it grants a choice to one of the contracting parties how it is settled (e.g. gross, net, cash, physically, etc.), all of the settlement alternatives would result into classifying it as an equity instrument¹¹⁶⁶.

236 The parts (1) and (2) take the issuer's or creditor's finance perspective¹¹⁶⁷ (put). The first part (1) represents a type of financial instruments on own equities featured with a net entitlement in his favour (long put). In contrast, the second part (2) represents that featured with a net obligation to his detriment (short put). Although both types bear termination risk in the broader sense (i.e. the first part a negative and the second part a positive one)¹¹⁶⁸, only a positive termination risk actually deserves the term *obligation*. It is the very nature of an *obligation* to uphold a commitment even though its conditions or effects are potentially unfavourable¹¹⁶⁹. This also includes contingencies¹¹⁷⁰ but no termination rights of the issuer or debtor¹¹⁷¹. On the contrary, it may include termination rights of the holder or creditor¹¹⁷², as the transfer or redemption is actually left to his discretion¹¹⁷³. Consequently, it is the second part (2) that covers redemptions in own equities due to its obligatory character and therefore has the potential to reveal the critical differentiator for the debt-equity distinction¹¹⁷⁴. In that, it also promises to resolve the inherent conflict between the possible differentiators of voluntariness¹¹⁷⁵ on the one hand and participation in profits and losses on the other¹¹⁷⁶. Consequently, the IAS/IFRS research project particularly focuses on this specific type of obligatory financial instruments on own equities. It successively analyses their various sub-types from the simplest to the most difficult ones. These most difficult ones are equity *derivatives*, which particularly demonstrate the dual purpose of legal entitlements by multiple leg modes, representing actually both the return for an obligation and the operation itself¹¹⁷⁷. The following illustration visualises this methodological cascade:

¹¹⁶³ IAS 32.16A(a).

¹¹⁶⁴ IAS 32.16A(b) and 32.16A(c).

¹¹⁶⁵ IAS 32.16A(e).

¹¹⁶⁶ See IAS 32.26.

¹¹⁶⁷ See par. 46(2).

¹¹⁶⁸ See par. 60.

¹¹⁶⁹ IAS 32.17.

¹¹⁷⁰ *Kuhn / Hachmeister*, p. 13, par. 64.

¹¹⁷¹ See par. 188.

¹¹⁷² See par. 211 and 191.

¹¹⁷³ *Clemens, Ralf in Bohl, Werner / Beiersdorf, Kati*, Beck'sches IFRS-Handbuch: Kommentierung der IFRS / IAS, 4th edition, C. H. Beck, Munich, 2013, p. 559, par. 6; equally: William Plumb, p. 418.

¹¹⁷⁴ See par. 234.

¹¹⁷⁵ See par. 188.

¹¹⁷⁶ See par. 202 et seqq.

¹¹⁷⁷ See par. 181.

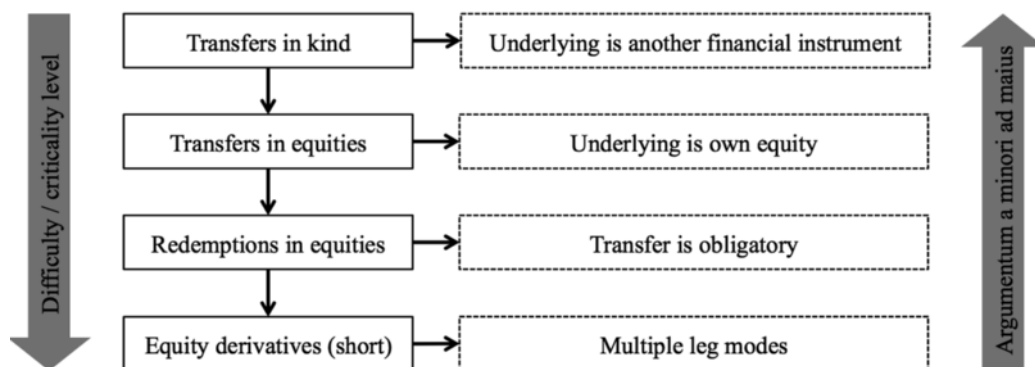


Illustration 15: Methodological cascade for debt-equity distinction

237 Pursuant to its current status¹¹⁷⁸, the IAS/IFRS research project has reached consensus that financial instrument shall be classified as

(1) debt where all of the following criteria are met:

- the financial instrument includes a contractual obligation for the issuer or creditor to redeem or repurchase the capital or principal (redemption obligation)¹¹⁷⁹; and
- subject of such transfer is either any economic resource of the issuer or debtor prior to his liquidation including an equivalent (i.e. fix) number of equity instruments in exchange for a variable amount (*variable-for-fixed* leg mode¹¹⁸⁰)¹¹⁸¹, or a cash amount including an equivalent (i.e. variable) number of equity instruments in exchange for a fixed amount (*fixed-for-variable* leg mode¹¹⁸²)¹¹⁸³ that is independent of his economic resources (*gamma approach*)¹¹⁸⁴; and
- such transfer is net-settled in cash¹¹⁸⁵ or another financial instrument (net share settlement)¹¹⁸⁶; and
- the issuer or debtor has no unconditional right either to avoid such transfer¹¹⁸⁷ nor to settle it at an amount that is not independent of his economic resources¹¹⁸⁸;

(2) equity where all of the following criteria are met:

- subject of its repayment transfer are – mandatorily¹¹⁸⁹ or optionally¹¹⁹⁰ – economic resources of the issuer or debtor only at his liquidation, from which their amount is not independent; and

¹¹⁷⁸ As per 15 September 2017.

¹¹⁷⁹ IAS Board, July 2016, 5D, p. 14, par. 57(a); IAS 32.23.

¹¹⁸⁰ IAS Board, July 2016, 5D, p. 6, par. 23.

¹¹⁸¹ IAS Board, July 2016, 5D, p. 19, par. 75(b).

¹¹⁸² IAS Board, July 2016, 5C, p. 8, par. 34(b).

¹¹⁸³ IAS Board, July 2016, 5C, p. 6 et seq., par. 24(b).

¹¹⁸⁴ IAS Board, September 2015, 5A, p. 20 et seq., par. 80.

¹¹⁸⁵ IAS Board, July 2016, 5C, p. 6 et seq., par. 24(a).

¹¹⁸⁶ IAS Board, July 2016, 5C, p. 7, par. 28.

¹¹⁸⁷ IAS 32.19; IAS Board, September 2015, 5A, p. 20, par. 80(a).

¹¹⁸⁸ IAS Board, February 2016, 5C, p. 15 et seq., par. 51.

¹¹⁸⁹ IAS Board, September 2015, 5A, p. 21, par. 81.

¹¹⁹⁰ IAS Board, February 2016, 5C, p. 16, par. 52.

- such transfer is settled in other financial instruments only, either gross physically¹¹⁹¹ or net *fixed-for-fixed*¹¹⁹².

The following illustration visualises the core of this (IAS/IFRS) understanding¹¹⁹³:

Leg mode → Settlement ↓	Fixed cash for fixed equities	Variable cash for fixed equities	Fixed cash for variable equities
Gross physical	Equity	Liability*	Liability
Net share	Equity*	Liability	Liability
Net cash	Liability	Liability	Liability

*) Proposed change of IAS 32

Illustration 16: Current IAS/IFRS debt-equity classification and proposed changes

238 These definitions and their changes are the result of the following key considerations:

- (1) Equity *derivatives* shall not be disaggregated but rather classified in their entirety¹¹⁹⁴. Apart from practical considerations¹¹⁹⁵, this is because the approach of disaggregating *derivatives* into other *derivatives* does not solve the principal classification problem¹¹⁹⁶. In addition, the IAS/IFRS also avoid the requirement of disaggregation particularly by limiting the equity classification to the *fixed-for-fixed condition*.¹¹⁹⁷
- (2) Equity *derivatives* involve a receive leg and a pay leg, which each can be fixed or variable and transfer equities or non-equities. Only their net effect determines whether or not the equity *derivative* depends in its entirety on the issuer's or debtor's economic resources.¹¹⁹⁸ Consequently, the classification of the equity *derivative* into equity depends on whether the pay leg transfers equity instruments equivalent to a cash amount that is dependent on the issuer's or debtor's economic resources.¹¹⁹⁹ This condition was found being fulfilled under the combination of a settlement in other financial instruments, either gross physically or net¹²⁰⁰, and the
 - *fixed-for-fixed condition* always¹²⁰¹;
 - *fixed-for-variable condition* never¹²⁰²;
 - *variable-for-fixed condition* to a certain extent¹²⁰³.

In contrast to the current application of the IAS/IFRS¹²⁰⁴, the *variable-for-fixed* leg mode must be classified into debt and not into equity, since equity *derivatives* shall not be disaggregated but rather classified in

¹¹⁹¹ IAS Board, July 2016, 5C, p. 3, par. 12(a), and p. 8, par. 32.

¹¹⁹² IAS Board, July 2016, 5C, p. 6, par. 21, and p. 13, par. 51.

¹¹⁹³ IAS Board, March 2017, 5A, Appendix B, p. 22 et seqq.; IAS Board, July 2016, 5C, Appendix A.

¹¹⁹⁴ IAS Board, July 2016, 5B, p. 10 et seq., par. 42(a) and 43.

¹¹⁹⁵ IAS Board, July 2016, 5B, p. 8, par. 33(a).

¹¹⁹⁶ IAS Board, July 2016, 5B, p. 8, par. 33(b).

¹¹⁹⁷ IAS Board, July 2016, 5B, p. 7, par. 29(a).

¹¹⁹⁸ IAS Board, December 2016, 5B, p. 5, par. 17.

¹¹⁹⁹ IAS Board, December 2016, 5B, p. 5 et seq., par. 18.

¹²⁰⁰ IAS Board, December 2016, 5B, p. 2 et seq., par. 6 et seqq.

¹²⁰¹ IAS Board, July 2016, 5C, p. 6, par. 21, and p. 8, par. 34(a).

¹²⁰² IAS Board, July 2016, 5C, p. 8, par. 34(b).

¹²⁰³ IAS Board, July 2016, 5C, p. 8, par. 34.

¹²⁰⁴ See par. 237(1).

their entirety¹²⁰⁵. Thus, the *fixed-for-fixed condition* was strengthened for the equity classification as a consequence of non-disaggregating equity *derivatives*¹²⁰⁶.

- (3) The current application of the IAS/IFRS¹²⁰⁷ falls victim to the finding in this study¹²⁰⁸ that it obviously seeks to solve the circular reasoning of the participation in profits and losses¹²⁰⁹ by actually defining an equity equivalent in the sense of its non-formal and thus artificial imagination as some hypothetical “adjusted” increment. By doing so, it actually negates its own formal IAS/IFRS accounting process and eventually itself¹²¹⁰, since such financial instruments shall in result be classified into equity as a residual instead of debt. This problem was identified by the IAS/IFRS project, which tried to resolve it by replacing the equity equivalent definition with the new term of *economic resources*¹²¹¹. The concept of *economic resources* takes a reverse approach¹²¹². It starts with identifying those obligatory financial instruments which are independent of the *residual amount* (i.e. the profit and loss), and then attributes the respective *economic resources* required to satisfy them. As a subsequent step, the remaining *economic resources* will be attributed to the remaining obligatory financial instruments, which are thus not independent of the *residual amount*. Where there are no *economic resources* left after satisfying all claims that are independent of the *residual amount*, there are actually no obligatory financial instruments capable of transferring any *economic resource* (i.e. equity). In other words: instead of distinguishing debt and equity by directly referring to the formal concept of the *residual amount*, the approach uses it merely indirectly as an attribution ratio for the material concept of the *economic resources*. On this basis, the IAS/IFRS research project analysed a number of variables for determining the value of obligatory financial instruments not independent of the *residual amount*. It found the following dependencies:
- The time value of money is not necessarily independent of the *residual amount* and therefore no verifier for debt. The reason is that the risk-based aspect also implies the time-based aspect.¹²¹³
 - Where the currency is not identical to the reporting currency, it is necessarily independent of the *residual amount* and therefore a verifier for debt.¹²¹⁴ Where the currency is conversely identical to the reporting currency, it is necessarily dependent on the *residual amount* and therefore a verifier for equity.
 - Anti-dilution provisions¹²¹⁵ and missed-dividends compensations¹²¹⁶ are basically dependent on the *residual amount* and are therefore verifiers for equity. An exception is where they ensure an absolute amount or an equivalent number of equity instruments rather than a relative proportion in the underlying equity instruments.

¹²⁰⁵ See par. 238(1).

¹²⁰⁶ IAS Board, July 2016, 5C, p. 13, par. 51.

¹²⁰⁷ See par. 235(2).

¹²⁰⁸ See par. 202.

¹²⁰⁹ IAS Board, September 2015, 5A, p. 9, par. 28(a).

¹²¹⁰ See par. 203.

¹²¹¹ IAS Board, December 2016, 5B, p. 4, par. 11.

¹²¹² IAS Board, December 2016, 5B, p. 4 et seq., par. 14.

¹²¹³ IAS Board, December 2016, 5B, p. 8, par. 28.

¹²¹⁴ IAS Board, December 2016, 5B, p. 9, par. 30.

¹²¹⁵ IAS Board, December 2016, 5B, p. 11, par. 33.

¹²¹⁶ IAS Board, December 2016, 5B, p. 12, par. 38 et seq.

- Any component of the *residual amount* (e.g. EBITDA)¹²¹⁷ as well as non-controlling interests¹²¹⁸ (i.e. minority participation) are necessarily dependent on the *residual amount* and therefore a verifier for equity. The reason is that the *economic resources* will always be sufficient for satisfying such claims.
- (4) On the one hand, the redemption obligation bears a nexus with the criterion of whether the transfer of the capital or principal is timed to either prior to or at the issuer's liquidation. Where the issuer has the right to postpone or delay the transfer until liquidation, the timing of settlement of the claim does not affect the prospected future cash flows as they are independent of the issuer's *economic resources*.¹²¹⁹ Consequently, the legal (formal) criterion of the redemption obligation is integrated into and therefore substituted by the (material) concept of *economic resources*. On the other hand, the redemption obligation also bears a nexus with the criterion of a contractual obligation for the issuer to redeem or repurchase the capital or principal for cash or another financial asset on exercise of the put by the holder (*puttable instrument*). The reason is that, pursuant to the current application of the IAS/IFRS¹²²⁰, those *puttable instruments* are the only exception from the general redemption obligation requirement. Notably, the necessity to uphold the *puttable instruments* exception was not yet¹²²¹ discussed within the IAS/IFRS research project¹²²². Thinking it through may, however, suggest that it will no longer be required, as the *puttable instruments* exception has in fact two aspects of formally constituting an *obligation*, which materially depends of the *residual amount* (i.e. participates in profits and losses). While the former is integrated into and therefore substituted by the likewise formal redemption obligation requirement, the latter is integrated into and therefore substituted by the material concept of *economic resources*. Thus, the redemption obligation requirement would be strengthened and the IAS/IFRS debt-equity classification scheme simplified from three dependent criteria (i.e. transfer prior to liquidation, redemption obligation requirement and *puttable instruments* exception) into just two independent ones (i.e. redemption obligation requirement and transfer of *economic resources*)¹²²³.

Step 4: transfer of the IAS/IFRS methodology to the OECD MTC

- 239 From the author's point of view, the first consideration (1) might be principally transferable to the OECD MTC. Admittedly, the theoretical¹²²⁴ and practical¹²²⁵ considerations of applying the disaggregation scheme have also been identified in the context of the OECD MTC. In addition, the *fixed-for-fixed condition* applied to the OECD MTC analogously would obviate the requirement for any disaggregation. However, the argument is fairly weak, even within the IAS/IFRS themselves. On the one hand, the second consideration (2) demonstrates that strengthening the *fixed-for-fixed condition* was in fact the consequence of non-disaggregating equity "derivatives" and therefore cannot simultaneously be its justification¹²²⁶. Even more, the *fixed-for-fixed condition* was found by the IAS/IFRS research project itself as a kind of fall-back or

¹²¹⁷ IAS Board, December 2016, 5B, p. 13 et seq., par. 42.

¹²¹⁸ IAS Board, December 2016, 5B, p. 15, par. 45.

¹²¹⁹ IAS Board, June 2015, 5A, p. 10, par. 39.

¹²²⁰ See par. 235(2).

¹²²¹ As per 15 September 2017.

¹²²² IAS Board, July 2016, 5D, p. 4, par. 14.

¹²²³ Equally: IFRIC 2.6 et seq.; IAS Board, February 2017, 5B, p. 11, par. 49(b).

¹²²⁴ See par. 88(1).

¹²²⁵ See par. 88(6).

¹²²⁶ Circular reasoning.

second-best solution for the problems caused just by the non-disaggregation¹²²⁷. Instead, the decision was actually to accept the problems either from the non-disaggregation or from the *variable-for-fixed* leg mode. On the other hand, the IAS/IFRS themselves are well aware of those theoretical and practical difficulties but nevertheless provide the disaggregation scheme elsewhere¹²²⁸. Consequently, there appears to be no reason why a certain class of financial instruments should be treated differently¹²²⁹. This is even more crucial, as the IAS/IFRS research project itself held in another context that “ring-fencing’ the fixed-for-fixed condition [...] is inconsistent”¹²³⁰. And secondly, such ring-fencing gives rise to another level of the very same problem, i.e. distinguishing equity “derivatives” from non-equity “derivatives”. In addition, the research project already came to the abstract-theoretical grounds of the IAS/IFRS debt-equity distinction, which do not seem to encounter any particular application problem for *variable-for-fixed* equity “derivatives”. Insofar, these principles also represent a concretisation of that current IAS/IFRS criterion, according to which all of the possible settlement alternatives must result into classifying the financial instrument as equity. In the author’s view, separating the pay leg from the receive leg by way of disaggregating the equity “derivative” makes it possible to determine relatively easily whether (then equity) or not (then debt) the former fulfils the critical condition of transferring either any economic resource of the issuer or debtor or an equivalent number of equity instruments. For these reasons, it is held as a conclusion for the further course of this study: where the IAS/IFRS rationale of distinguishing debt and equity by that critical condition is transferred to the OECD MTC, this must – contrary to the research project’s recommendations¹²³¹ – also apply to *variable-for-fixed* equity “derivatives” by way of disaggregating them into their pay leg and receive leg.

- 240 As regards the third consideration (3), the attempt to replace the formal equity equivalent definition with the material concept of *economic resources* appears as a consequent step from the IAS/IFRS perspective. However, in practice such an approach requires very detailed information about the internal flow of *economic resources*. In addition, these might not be available for a number of issuers or debtors (e.g. private individuals). Admittedly, the approach is applied by the IAS/IFRS from the issuer’s or creditor’s perspective¹²³², which is in line with the treaty purpose and function of primarily addressing the source jurisdiction¹²³³. However, transferring such an approach to the OECD MTC would eventually mean nothing else than giving the determination of the debt-equity distinction more or less exclusively into the hands of the source jurisdiction’s domestic law. Being aware of its systematical and methodological limitations and weaknesses¹²³⁴, it still appears to the author more purposeful and practicable to operationalise the dependency of the *residual amount* (i.e. the participation in profits and losses) by way of heuristic correlation¹²³⁵. In this point, however, the IAS/IFRS concept seems to embark upon the same path as this study. At least, it seems to support the methodological approach of identifying and analysing the particular legal (formal) attributes or features of a disaggregated financial instrument towards its (material) dependency of the issuer’s business risk. However, those concrete findings

¹²²⁷ IAS Board, July 2016, 5D, p. 7, par. 28, p. 8 et seq., par. 35, and p. 13 et seq., par. 53 et seqq.

¹²²⁸ See par. 98.

¹²²⁹ See par. 96.

¹²³⁰ IAS Board, July 2016, 5D, p. 19, par. 75(a).

¹²³¹ See Illustration 16 on p. 140.

¹²³² See par. 46(2) and 236.

¹²³³ See par. 19.

¹²³⁴ See par. 108.

¹²³⁵ See par. 106.

by the IAS/IFRS project are only examples and therefore not intended to comprehensively and exhaustively describe the debt-equity distinction. They are also significantly influenced by the *fixed-for-fixed condition* as a consequence of the IAS/IFRS non-disaggregation of equity “derivatives”¹²³⁶. For these reasons, reference is instead made to the corresponding analysis and its findings in this study¹²³⁷.

- 241 As regards the fourth consideration (4), the author must consequently disagree with the substitution of the redemption obligation requirement by the concept of *economic resources*, as the latter was already rejected for being purposively transferable to the OECD MTC¹²³⁸. Insofar, the redemption obligation requirement turns out to be indispensable. However, this is not only in line with the IAS/IFRS result but, advantageously, also substitutes the *puttable instruments* exception. Finally, the strengthening and purity of the redemption obligation requirement also correspond better with the narrow understanding of an obligation’s involuntary character¹²³⁹. Nevertheless, financial instruments actually transferring equity in any case bear termination risk in the form of genuine business risk¹²⁴⁰ (i.e. irrespective of which leg mode the redemption obligation applies to)¹²⁴¹. In this respect, the subsidiarity of business risk in the form of termination risk as a sub-type of underwriting risk to the formal redemption obligation requirement applies in fact form over substance¹²⁴². However, this is not only a consequent step from the IAS/IFRS perspective¹²⁴³ but also from the position taken in this study¹²⁴⁴, in that the existence of financial instruments must predominantly be a matter of the legal form.

2.4.5.5 Conclusions

- 242 Completing the circle, the following conclusions can be summarised as a result from this analysis:
- (1) Termination risk can be determined without applying different classification schemes on redemptions in cash and those in kind (ring-fencing). As a consequence of this independence, the partial adoption of the IAS/IFRS approach not only allows for the classification of equity “derivatives” of whatever leg modes, but also exchanges in kind (e.g. share-for-share “derivatives”) or exchanges of currencies (e.g. currency “derivatives”¹²⁴⁵).
 - (2) The initial question what constitutes a potential difference between the capital or principal provided and that redeemed¹²⁴⁶ can be answered as follows: termination risk arises where the pay leg of the financial instrument, separated by way of disaggregation, transfers a cash amount that is not solely dependent on the time value of money¹²⁴⁷ or an equivalent number of financial instruments¹²⁴⁸. Consequently, the concept of termination risk is understood as a falsifier for time equivalence and thus for the time value

¹²³⁶ See par. 239.

¹²³⁷ See par. 209 et seqq.

¹²³⁸ See par. 240.

¹²³⁹ See par. 236.

¹²⁴⁰ See par. 230.

¹²⁴¹ *David Hariton*, equity and debt, p. 510.

¹²⁴² Critically: *David Hariton*, equity and debt, p. 511 et seqq.

¹²⁴³ See par. 98(3).

¹²⁴⁴ See par. 77.

¹²⁴⁵ See par. 98(5).

¹²⁴⁶ See par. 232.

¹²⁴⁷ See par. 231.

¹²⁴⁸ See par. 239.

of money. In contrast, the corresponding IAS/IFRS concept of “termination risk” is a verifier for equity, which is, however, the result of not separating it from the dependency on the *residual amount* (i.e. the participation in profits and losses) as a consequence of not disaggregating equity “derivatives”.

- (3) The material criterion of termination risk principally implies and therefore potentially substitutes the legal redemption obligation requirement. The redemption obligation is understood in the narrow formal sense of involuntarily and therefore irrevocably upholding a commitment despite its possibly unfavourable conditions or effects¹²⁴⁹. Unlike the termination risk, the redemption obligation requirement implies, however, a time-based aspect¹²⁵⁰, in that it actually means only redemptions prior to the issuer’s liquidation¹²⁵¹. Hence, where the redemption obligation requirement ought to be substituted by the criterion of termination risk, this would simultaneously mean a high interpretation significance of that of the relative maturity¹²⁵². As the duration or maturity was, however, found incapable of being a differentiator¹²⁵³, a substitution of the redemption obligation requirement by the termination risk would necessarily lead to an incomplete set of differentiation criteria¹²⁵⁴ and therefore to remaining ambiguities. This is even more important as time aspects were found to necessarily take precedence over risk aspects in cases where the two overlay¹²⁵⁵. Consequently, the redemption obligation requirement remains indispensable as a differentiator¹²⁵⁶.

2.4.6 Origin of funds

2.4.6.1 Preliminary remarks

- 243 The repayment of funds focuses on the question of which conclusions can be drawn primarily from their origin by considering the entire lifetime of the financial instrument. In general, there are three possible sources of funds available for repaying capital or principal provisions or contributions: liquidation of assets, business profits and (re-)financing.

2.4.6.2 Liquidation of assets

- 244 As regards the first one, any kind of assets can be assumed to represent a necessary minimum condition (*conditio sine qua non*) for doing business. This means, in turn, that they are necessarily exposed to business risk. However, this may not elicit the false reverse deduction that all these assets do necessarily also have influences on the business risk. That is why it could be conceivable to apply an approach of “core assets”, without which the business could hypothetically not be operated as it actually is¹²⁵⁷. The approach is similar to the substance requirement of functional adequacy in international tax law. It is founded on the idea that the liquidation of “core assets” represents a partial liquidation of the business enterprise itself, and that, due to its ultimate subordination, its pay-out cannot be anything other than equity. On the contrary, the pay-out of

¹²⁴⁹ See par. 236.

¹²⁵⁰ See par. 196.

¹²⁵¹ Equally: *William Plumb*, p. 414. See also par. 238(4).

¹²⁵² See par. 198.

¹²⁵³ See par. 199.

¹²⁵⁴ See par. 5.

¹²⁵⁵ See par. 199.

¹²⁵⁶ See par. 241.

¹²⁵⁷ *William Plumb*, p. 520 et seq.

proceeds from the liquidation of non-“core assets” was debt¹²⁵⁸. This rationale of actually matching assets and capital according to their liquidability also corresponds with that behind the basic structure and taxonomy of the IAS/IFRS statement of financial positions¹²⁵⁹. Nevertheless, the approach was discarded quite early. The reason was predominantly the understanding that the assets’ and capital’s liquidability are not necessarily interlinked with their functional relevance¹²⁶⁰.

Example 42: Real property may be a “core asset” for a landlord but not for a property dealer. The example demonstrates that the functional relevance and the duration or maturity of an asset depend both on the context rather than on each other.

- 245 In other words: duration or maturity and functional relevance may often correlate, but they are nevertheless independent of each other¹²⁶¹. However, it appears that the two aspects at least coincide in the point where “the uncertainties of successful operation are such that the only reasonably assured source of funds for repayment, at maturity or within a reasonable time, is the liquidation of the enterprise”¹²⁶². At one end of the scale, an asset’s duration or maturity as an indicator of its liquidability is not capable of positively verifying the functional relevance of its corresponding capital. At the other end of the scale, it may nevertheless be capable of negatively falsifying it.

Example 43: A dividend distribution itself requires cash, which is the most liquid asset per se. Conversely, the basic working capital might be financed by long-term debt capital.

In other words: the less liquidable an asset, the stronger it indicates equity (but not vice versa). This approach would also be in line with the finding that the systematics within the OECD MTC basically do not conflict with the approach of classifying a recipient’s income or transactions (i.e. finance) by also considering the capital’s or principal’s utilisation by the source (i.e. investment)¹²⁶³. However, such approach would result into eventually locking-in the equity by introducing a deemed distribution order, which was in no way indicated and justifiable by the wording and system of the OECD MTC. In addition, and even worse, it was potentially liable to infringe financing neutrality. A classifier deduced from such a binary and unidirectional approach was also considerably weak, in that it would not provide significant new information beyond what could already be derived otherwise. Financial institutions have the business purpose and regulatory requirement to transform, match and balance maturities between their assets and capitals¹²⁶⁴. In contrast, most non-financial industries will typically show an incongruent and highly diverse duration or maturity structure between their assets and capitals. This is the reason why there are no qualitative, universal and resilient conclusions possible beyond confirming the natural intuition that the most illiquid or non-current class of assets of a business enterprise

¹²⁵⁸ “Furthermore, the Tax Court seems clearly correct in pointing out that an arm’s-length creditor would almost never lend to a business until the equity owners had at least provided the basic assets.” (*Goldstein, William M.*, Corporate Indebtedness to Shareholders: Thin Capitalization and Related Problems, *Tax Law Review* 1960, Vol. 16, Issue 1, p. 32).

¹²⁵⁹ IAS 1.64 et seq.

¹²⁶⁰ *William Plumb*, p. 522 et seq.

¹²⁶¹ Cum hoc ergo propter hoc.

¹²⁶² *William Plumb*, p. 526.

¹²⁶³ See par. 226.

¹²⁶⁴ IAS 1.63.

typically – but not necessarily – yield income on equity (i.e. dividends). But even this would probably be very rarely shown to be true in view of the large diversity of non-financial industries.

2.4.6.3 *Business profits*

Context and problem

- 246 As regards the second possible source of funds, there should be no doubt that business profits are the prototypical and most common use case of income on equity (i.e. dividends). *Income* in general is necessarily to be determined by reference to domestic tax law¹²⁶⁵ and so is basically also the specific determination of whether or not a pay-out is the result from the domestic law of tax accounting. On the other hand, the asset-based approach taken by the OECD MTC¹²⁶⁶ requires the autonomous distinction of *income* between that *from* an asset as the compensation for the capital or principal contribution (i.e. *dividends* and *interest*) and that *with* an asset as the capital or principal itself (i.e. *capital gains*).¹²⁶⁷ In this respect, the allocation of taxation rights to the source jurisdictions must be limited by new rights created through legal events from precursory fields of non-tax law. These new rights are to be distinguished by either referring or not referring to the asset in the sense of impairing the number of its critical ownership rights¹²⁶⁸. Where capital or principal provisions or contributions are, however, being repaid only in part, that number of ownership rights in the asset may not be impaired, although such pay-outs do not originate from business profits. It appears therefore that there is a nexus between business profits as the second possible source of funds and partial repayments of capital or principal provisions or contributions as the third possible source of funds. In particular, the question arises whether or not there is a further differentiator for the autonomous distinction within the OECD MTC between *dividends* and *interest* on the one hand and *capital gains* on the other. Such differentiator had to limit the domestic tax law also in treating partial repayments of capital or principal provisions or contributions as *income*. Similar to the terms *paid* in Art. 10(1) and 11(1) OECD MTC and *from* in Art. 10(3) and 11(3) OECD MTC¹²⁶⁹, this requisite systematic distinction within the OECD MTC between *dividends* and *interest* on the one hand and *capital gains* on the other could almost entirely be marginalised where the domestic interpretation of *income* is broad enough. For instance, where the domestic interpretation of *income* would encompass the partial repayment as a whole, the source jurisdiction had set itself in the position to skim the entire partial capital *gain* to the detriment of the jurisdiction of residence.

The difference between repayments and disposals

- 247 This question can be approached by setting it in the wider context of whether a repayment in general is actually the same as a disposal. If this question is to be answered in the affirmative, then partial repayments would be necessarily the same as partial disposals¹²⁷⁰. As a consequence, they had to be exclusively attributed to the income *with* the asset (i.e. *capital gains*)¹²⁷¹ and there was no nexus with business profits. In that case, a further analysis of (re-)financing sources as possible differentiators for the income types of financial instruments was actually dispensable. If, however, the question is to be answered in the negative, then there is no further

¹²⁶⁵ See par. 144.

¹²⁶⁶ See par. 58.

¹²⁶⁷ See par. 53.

¹²⁶⁸ See par. 160 et seqq.

¹²⁶⁹ See par. 149.

¹²⁷⁰ Argumentum e contrario.

¹²⁷¹ Argumentum a maiore ad minus.

distinction between business profits and partial repayments on the treaty level. As a consequence, their nexus would make (re-)financing sources impossible as differentiators due to the influence of the domestic *income* interpretation.

- 248 Contributions and repayments of equity are often compared with those of debts. The analysis shall therefore start with the initial illustrative example of a straightforward *debt-claim* or credit. At first glance, its repayment appears not to be the same as its disposal: it is the capital's or principal's mere possession that returns back into the hands of its owner without creating any new right. However, this turns out to be an incomplete view when looked at more closely. Such repayment simultaneously impairs the number of ownership rights in the straightforward *debt-claim* or credit itself – i.e. the ownership rights in the straightforward *debt-claim* or credit cease, so that its resumption requires a new contractual agreement. The difference and interaction between the two legal levels is made clear by the next illustrative example of a contingent *debt-claim* or credit such as an undrawn commitment (e.g. master credits, guarantees, demand deposits, etc.). Here, its repayment is obviously not the same as its disposal. True, it is likewise the capital's or principal's mere possession that returns into the hands of its owner without creating any new right. But this is notably not a right in the contingent *debt-claim* or credit itself – i.e. the ownership rights in the undrawn commitment do not cease, so that its resumption requires no new contractual agreement. For determining capital *gains*, it is necessary to focus on the ownership rights of the financial instrument as the asset itself rather than on those of its underlying capital or principal. However, taking both legal levels into account nevertheless builds the bridge for understanding the difference between repayments of debt capital and those of equity, and thus between business profits and repayments of capital or principal provisions or contributions in general. Unlike *debt-claims* or credits, repayments of equity represent a transfer of ownership rights in the underlying capital or principal from the payer to the payee, just as the original equity contribution was a transfer of ownership rights from the shareholder to the company. Unlike contingent *debt-claims* or credits, repayments of equity consequently create new rights. And unlike the repayment of straightforward *debt-claims* or credits, these rights cannot impair the number of ownership rights in the financial instrument (i.e. the share) itself, the reason being that the transfer of the ownership rights in the equity cannot simultaneously also be a transfer of the ownership rights in the share itself. In other words: the legal event creating that right cannot refer to the asset and simultaneously not to the asset. True, one and the same transaction can transfer both the capital or principal itself and the financial instrument as its legal veil at the same time (e.g. a capital decrease or liquidation by way of a total distribution with an immediate cancellation of the shares). However, the two objects are nevertheless sequenced in a logical one-way order. The following illustration visualises this understanding:

	Abstract	Examples	
Trigger	OECD MTC	Debt	Equity
– Legal event creating a new right	Chap. III		
• Refers on the assest	Art. 13(5)	Repayment of regular credit	n/a
• Refers not on the assest	Art. 10(3) or Art. 11(3)	n/a	Repayment of equity contribution
– No legal event creating a new right	n/a / chap. IV	Repayment of regular credit	n/a

Illustration 17: The difference between repayments of debt and equity

249 In fact, there appears to be a one-way dependency between the impairment of ownership rights in the financial instrument itself and that in its underlying capital or principal. The former is possible only where the latter is excluded, but not vice versa. Apparently, transferring the financial instrument is impossible where the capital or principal is transferred instead. Conversely, transferring the financial instrument is not requisite where the capital or principal is not transferred. This lays the ground for the key difference between repayments of equity and those of debt. Any pay-out from equity necessarily impair the ownership rights in the capital or principal itself. As a consequence, repayments of equity can e contrario never impair the ownership rights in the financial instrument itself. In contrast, any pay-out from debts can never impair the ownership rights in the capital or principal itself. Since the dependency is one-way, it does, however, not mean that they necessarily also impair the ownership rights in the financial instrument itself. Rather, this would require that they have also been triggered by a legal event. Accordingly, it is this legal event that is an inherent element of equity repayments, but not necessarily of debt repayments. As an interim conclusion, any comparison of equity repayments with those of debt capital or any analogy between them is insufficient for distinguishing them from business profits.

Developing a differentiator

250 The next level down in the analysis is to identify any autonomous differentiator from business profits within the equity contributions themselves. However, it turns out that this attempt is hopeless, in that equity repayments can normally not be distinguished objectively from business profits¹²⁷². Both are triggered by a legal event that does not impair the ownership rights in the share itself. Especially in a dynamic view over more than one period, the company typically has the possibility to accumulate the business profits. This includes the possibility to subjectively choose in later periods between taking pay-outs from those accumulated business profits or from equity contributions. The accumulated business profits are the result from the domestic law of tax accounting and thus necessarily determined by reference to domestic tax law¹²⁷³. Hence, the separation of other equity components (particularly equity contributions) becomes significantly dependent on the peculiarities of the source jurisdiction's tax system. The relevance of this aspect had already been identified by the OECD in the context of business profits¹²⁷⁴, and becomes even more relevant in interaction with other equity components as possible differentiators between *dividends* and capital *gains* (e.g. in the context of liquidation proceeds). Thus, there is in fact an inter-temporal nexus between equity contributions and business profits¹²⁷⁵. This nexus leads to an inextricable mix or "infection" of the former by the latter, making any attempt to disentangle the two in order to reach an autonomous interpretation of equity contributions impossible and illusory. The following illustration visualises this understanding:

¹²⁷² In result perhaps contrary without however going into this crucial practical question of how that theoretical distinction between business profits and equity repayments shall actually be made: OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-11, par. 28 and on Art. 13 OECD MTC, p. C(13)-13, par. 31; *Marjaana Helminen*, dividend concept, p. 141, 144 and 238.

¹²⁷³ See par. 246.

¹²⁷⁴ OECD (Working Party No. 1 of the Fiscal Committee, Working Group No. 23), Report on the Double Taxation of Dividends received by an Individual, ref. FA/WP1(71)6, Paris, 1971, comprehensively analysing the effects of various special tax systems.

¹²⁷⁵ See par. 247.

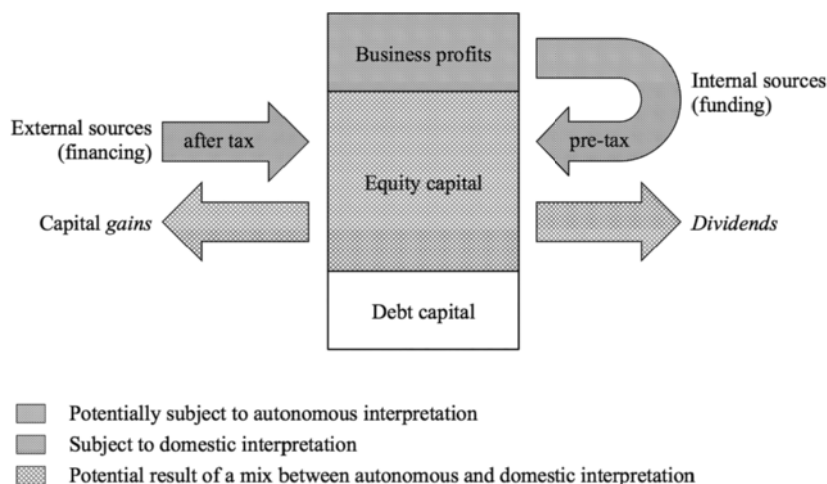


Illustration 18: Systematic inseparability of equity contributions and business profits

Interim conclusions

- 251 As a conclusion for the further course of this study it is therefore necessary to hold that the sources of funds for repaying capital or principal provisions or contributions are not capable of serving as an autonomous differentiator. This is predominantly rooted in purposive and systematic considerations and the peculiarities of equity: any limited application or autonomous interpretation of those sources was either non-universal or a circular reasoning. In addition, the results from such an interpretation dualism would conflict with the general principle that the consistent and coherent system of Art. 10(3) and 11(3) OECD MTC demands that their autonomous parts must lead to equivalent results¹²⁷⁶. Instead, the determination of these sources turns out to bear a comprehensive and inextricable nexus with that of the *income*, being entirely subject of the domestic interpretation.
- 252 These considerations, however, bring forth that repayments of capital or principal provisions or contributions can be basically one of three kinds: (1) income *from* the asset, (2) income *with* the asset and (3) no *income* at all. Repayments of equity capital are necessarily always covered by the term *dividends* pursuant to Art. 10(3) OECD MTC, being in that sense subject of the domestic interpretation. Repayments of debt capital can not be covered by the term *interest* pursuant to Art. 11(3) OECD MTC. Instead, they can only be covered by the term *capital gains* pursuant to Art. 13(5) OECD MTC or they are potentially out of scope of the OECD MTC altogether. This divergence reflects the fact that the difference between *dividends* and *interest* is a legal rather than an economic one¹²⁷⁷. Consequently, repayments of equity and debt capital can only be treated equally and in accordance with their economic nature (i.e. as a reduction of acquisition costs for the purpose of *capital gains*) under very specific conditions. An example could be, where the source jurisdiction's domestic tax law grants both a tax exemption of equity repayments¹²⁷⁸ and a deduction of equity and debt repayments from a later *capital gain*. As a result from these heterogeneous and complex requirements to the source jurisdiction,

¹²⁷⁶ See par. 113(1).

¹²⁷⁷ See par. 56.

¹²⁷⁸ Similarly: *William Plumb*, p. 553.

functional and inter-temporal qualification conflicts and/or a potential frustration or marginalisation of the residence jurisdiction's taxation rights must be considered possible and likely to occur in the context of partial capital or principal repayments.

253 Another conclusion can be drawn from these considerations with regard to the nominal value of debt instruments. This nominal value actually represents the encashment value and therefore basically describes the critical ownership rights in the debt instruments by type, quantity and unit. Where a partial repayment of debt contributions

- is equal to a simultaneous reduction of the nominal value, the ownership rights in the debt instrument are impaired (i.e. capital *gain*);
- does not reduce the nominal value, the ownership rights in the debt instrument are not impaired (i.e. no capital *gain*) but instead those in the debt capital or principal itself¹²⁷⁹ (i.e. no income);
- reduces the nominal value disproportionately, the ownership rights in the debt instrument are impaired only to this extent (i.e. capital *gain*)¹²⁸⁰. In contrast, the excess amount reduces the ownership rights in the debt capital or principal itself (i.e. no income)¹²⁸¹.

It appears therefore that the effective nominal value of debt instruments may potentially serve as a verifier for capital *gains*.

¹²⁷⁹ See par. 249.

¹²⁸⁰ See par. 162.

¹²⁸¹ Quantitative disaggregation (see par. 84).

Chapter 3

Analysis and discussion of the relevant distributive articles

3.1 Preliminary remarks

- 254 The purpose and objective of this section is to comprehensively analyse, compare and discuss the different interpretations of the relevant distributive articles of the OECD MTC. These are Art. 10(3) OECD MTC on *dividends*¹²⁸², Art. 11(3) OECD MTC on *interest*¹²⁸³, Art. 13(5) OECD on capital *gains*¹²⁸⁴ and Art. 21(1) OECD MTC on *other income*¹²⁸⁵. The intention is also to confront them with and integrate them into those systematic aspects found in the preceding sections. Where it is considered reasonable and appropriate, the author also endeavours to contribute his view to the current fields of discussion. These contributions are, however, limited to questions and topics on which there is a need to take position or where the author wishes to add some remarks relevant for the further course of this study. Another objective of this section is to identify specific key differentiators for the purpose of classifying the income types of financial instruments.
- 255 In contrast to the preceding analyses and discussions of basic principles¹²⁸⁶ and aspects of the systematic context¹²⁸⁷, this section takes its conclusions more from the legal wording than from systematic considerations. Unlike in the aforementioned analyses and discussions of possible differentiators¹²⁸⁸, this section concretely examines and verifies if and to what extent the differentiators found as potentially appropriate are in line with the scientific discourse on the particular distributive articles of the OECD MTC. Again, all this is carried out by carefully embedding the way of interpretation into those general guidelines and systematic aspects found in the preceding sections in order to ensure a maximum of consistency.

¹²⁸² See sec. 3.2.

¹²⁸³ See sec. 3.3.

¹²⁸⁴ See sec. 3.4.

¹²⁸⁵ See sec. 3.5.

¹²⁸⁶ See sec. 2.2.

¹²⁸⁷ See sec. 2.3.

¹²⁸⁸ See sec. 2.4.

3.2 Dividends

3.2.1 Structure of the provision

256 Art. 10(3) OECD MTC represents an incomplete “means” definition and so its subject matter must be positively found¹²⁸⁹. The current structure of the provision appears to have its origin in the endeavours of the OEEC Working Parties No. 12 and 14. Their aim was to cover all legal and organisational forms of structures in civil and common law jurisdictions, each considering either its incorporation or its place of management, as well as all typified tax treatments including as many domestic specifics as possible¹²⁹⁰. As a starting point, the majority of commentators¹²⁹¹ read Art. 10(3) OECD MTC in the sense of a 3-limb interpretation that is also taken as the baseline for the further course of this study (the enumeration has been added by the author accordingly):

“The term ‘dividends’ as used in this Article means income from

- shares, ‘jouissance’ shares or ‘jouissance’ rights, mining shares, founders’ shares [limb 1]
- or other rights, not being debt-claims, participating in profits, [limb 2]
- 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. [limb 3]”

257 In fact, most of these commentators seem to understand the provision as more or less one conjoined or integrated definition. As a result from the word *other*, it appears there is a general consensus that the structure of the provision reads in such a way that the three limbs open up from the most special use cases in limb 1 to the most general sub-type in limb 3 by each referring to its precedent one.¹²⁹² In other words: limb 2 is a subsidiary clause to limb 1 and limb 3 a subsidiary clause to limb 2, including limb 1. However, that word *other* has an ambiguous meaning. It can be understood either in the sense of *further* or in the sense of *different*¹²⁹³. It is therefore controversial and gives rise to discussions as to what extent and in which direction (up- or downwards) each limb takes which attributes from its precedent ones¹²⁹⁴. Depending on the position taken, this question also determines in what regard and to what extent the provision is to be interpreted domestically or autonomously¹²⁹⁵. It appears, however, that there is a general consensus that limb 2 provides a general and

¹²⁸⁹ Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.1.

¹²⁹⁰ For an overview on the provision's history see Avery Jones Commentaries.

¹²⁹¹ Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.2.1.; Haslechner, Werner in Klaus Vogel Commentaries 2015, p. 834, par. 85; Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lechner, p. 1211, par. 185; Kaeser, Christian / Wassermeyer, Franz in Wassermeyer Commentaries, p. 1253, par. 4; Gaspar Lopes Dias, debt-claims, sec. 1.2.; Santos, Ramon Tomazela, Tax Treaty Qualification of Income Derived from Hybrid Financial Instruments, Bulletin for International Taxation 2013, Vol. 67, No. 10, sec. 4.1.; Kopp, Karin E.M. in Wolfgang Schön, equity and debt, p. 844; May, Nicolás in Thomas Ecker, p. 415; Marjaana Helminen, dividend concept, p. 63; Marjaana Helminen, classification, p. 58; Avery Jones Commentaries, sec. 1; Giuliani, Federico Maria, Article 10(3) of the OECD Model and Borderline Cases of Corporate Distributions, Bulletin for International Taxation 2002, Vol. 56, No. 1, p. 11; Klaus Vogel Commentaries 1997, p. 649, par. 185; Hans Pijl, hybrid debts, sec. 4.4., suspecting a 2-limb interpretation due to the different conjunctions or suggesting a choice and as well as suggesting an enumeration.

¹²⁹² Haslechner, Werner in Klaus Vogel Commentaries 2015, p. 835, par. 90; Sven-Eric Bärsch, p. 99; Hans Pijl, hybrid debts, sec. 4.2., calling it “projection theory”; May, Nicolás in Thomas Ecker, p. 433; Marjaana Helminen, dividend concept, p. 96; Klaus Vogel Commentaries 1997, p. 649, par. 185, and p. 650, par. 188.

¹²⁹³ Hans Pijl, hybrid debts, sec. 4.4.

¹²⁹⁴ As will be elaborated in the following (see par. 265 and 271).

¹²⁹⁵ As will be elaborated in the following (see par. 269 et seq.).

therefore closed and exhaustive formula for assets not listed in limb 1¹²⁹⁶, and that it is in its entirety to be interpreted autonomously¹²⁹⁷. In contrast, both limbs 1 and 3 contain at least some parts which are more or less interpreted domestically.

- 258 In other words: it is limb 2 only, which undisputedly provides a short but positive and general definition of *dividends*, while also being exhaustively subject of a closed and autonomous interpretation. That is why limb 2 represents the key provision when it comes to the autonomous definition and delimitation of *dividends*. Interestingly, it is limb 3 that nevertheless enjoys much more attention. The reason is probably its appearance as a kind of ultimate residuary clause promising the ultimate definition of *dividend*. However, it should be kept in mind that the impact of limb 3 for the autonomous definition and delimitation of the term *dividends* is naturally limited due to its undisputed subsidiarity to limb 2 and its immanent and strong dependency of the domestic interpretation¹²⁹⁸. Indeed, the list of the most common and frequent examples in limb 1 is likely to solve the large majority of use cases in the treaty practice. Intermediate cases, however, are primarily to be solved by limb 2 rather than limb 3, which has been intended to be the ultima ratio ever since¹²⁹⁹. From this perspective, it is remarkable that the scientific discourse seems to deal predominantly with aspects of limb 3's formal relation to limb 1, negatively defining the limitations of the domestic interpretation. In contrast, the material substance of what a *dividend* in the treaty context actually is, enjoys comparably little attention. For these reasons, this study takes the alternative approach of putting the main focus on limb 2.
- 259 At the same time, some of the questions and findings from those legitimate discourses with regard to limbs 1 and 3 are also relevant for the interpretation of limb 2. This is why they shall, as far as relevant for this study, be analysed in the following. However, it deserves initial mentioning that most of these findings are negative criteria in the sense of what was *not* required for a *right* to qualify as a *dividend*. In contrast, as far as can be seen, the attempts to make a positive definition of minimum criteria are fairly limited¹³⁰⁰ and probably not deep or granular enough to provide sufficient clarity. Due to the complex structure of the provision allowing different ways of understanding an interpretation, the following illustration shall summarise and visualise the various discussion fields in order to compare the divergent positions in a clear and consistent manner:

¹²⁹⁶ Haslechner, Werner in *Klaus Vogel* Commentaries 2015, p. 840, par. 101; OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-9, par. 23.

¹²⁹⁷ Jakob Bundgaard, hybrids, p. 140; Tischbirek, Wolfgang / Specker, Gerhard in *Vogel / Lehner*, p. 1211, par. 186, and p. 1217, par. 198; Kaeser, Christian / Wassermeyer, Franz in *Wassermeyer* Commentaries, p. 1306, par. 108, p. 1325, par. 136, p. 1326, par. 139, and p. 1427, par. 71; Hans Pijl, hybrid debts, sec. 4.3.; Eberhartinger / Six, p. 8; Martin Six, hybrid finance, sec. 2.; Michael Lang, hybrids, p. 90; *Klaus Vogel* Commentaries 1997, p. 649, par. 186, and p. 655, par. 198; unclear: Haslechner, Werner in *Klaus Vogel* Commentaries 2015, in favour on p. 834, par. 86, and p. 840, par. 101 but in par. 89 on p. 834 supporting the opinion that rights shall be interpreted pursuant to domestic tax law of the treaty-applying jurisdiction leaving open what this means for limb 2 (why this opinion cannot be explained in more detail). See also par. 19 et seqq.

¹²⁹⁸ Equally: Fehér, Tamás in *Eva Burgstaller*, p. 240.

¹²⁹⁹ Avery Jones Commentaries, sec. 3.1.

¹³⁰⁰ OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-10, par. 25. See also par. 282.

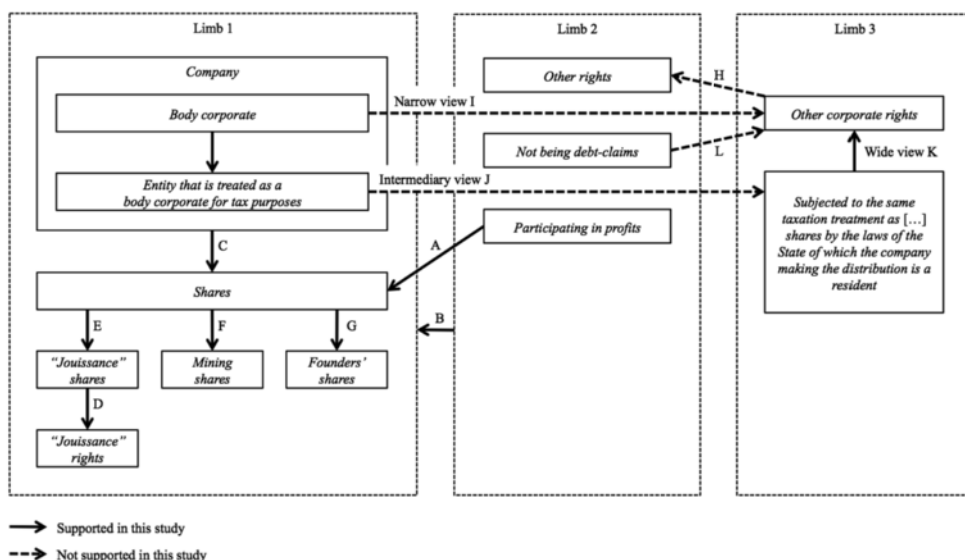


Illustration 19: The interpretational structure of Art. 10(3) OECD MTC

3.2.2 Shares and the like

260 The majority of commentators¹³⁰¹ came to the consensus view that limb 1 requires a *participating in profits* taken from limb 2 (A¹³⁰²). This is a result from the fact that limb 1 provides no abstract definition but contains a casuistic and non-exhaustive list or catalogue of typical examples empirically encountered in most OECD member states. In the sense of the lowest common denominator¹³⁰³, these examples were grouped by not entailing significant differences in them¹³⁰⁴. The function of limb 1 becomes particularly clear when set at the end of Art. 10(3) OECD MTC, such as by wording it “dividends *include in particular* income from shares, ‘jouissance’ shares or ‘jouissance’ rights, mining shares and founders’ shares”. In contrast, limb 2 provides such an abstract definition to those examples¹³⁰⁵ and therefore acts as a general clause to limb 1. Since a general clause represents an intersection with its special clauses, limb 1 is its subset and can take attributes upwards from limb 2 (B¹³⁰⁶). This applies even though limb 2 is in its entirety to be interpreted autonomously and limb 1 is not¹³⁰⁷. The benefit of such an approach is to serve as a convenience for the practitioner when applying the law. Similarly, this approach has also been taken by the IAS/IFRS in providing a general or generic definition based on what has legally happened in result, without however recurring to the domestic laws¹³⁰⁸.

¹³⁰¹ Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.2.2., supporting a wide view in that all shares regulated by corporate law qualify as participating in profits; Michael Lang, introduction, p. 100, par. 279; Hans Pijl, hybrid debts, sec. 4.8.; Klaus Vogel Commentaries 1997, p. 649, par. 185, and p. 655, par. 198, supporting a narrow view in that shares qualify as participating in profits only if they participate at the business opportunities equivalent to those of a shareholder including the liquidation proceeds or hidden reserves. All insofar applying the “2-limb-interpretation” (see footnote 1291).

¹³⁰² See Illustration 19 on p. 156.

¹³⁰³ See footnote 1489 analogously.

¹³⁰⁴ OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-9, par. 23.

¹³⁰⁵ See par. 258.

¹³⁰⁶ See Illustration 19 on p. 156.

¹³⁰⁷ See par. 257 et seq.

¹³⁰⁸ As an example, see IAS 32.13, giving a generic definition of contract.

Only subsequently, the IAS/IFRS also list the most common use cases in order to improve the Standard's usability¹³⁰⁹. Consequently, the word *other* in limb 2 is to be understood in the sense of *further*¹³¹⁰.

- 261 *Shares* are securitised holdings in public¹³¹¹ *companies* pursuant to Art. 3(1)(b) OECD MTC (C¹³¹²)¹³¹³ that was specifically inserted for this purpose¹³¹⁴ and reads as follows¹³¹⁵:

“For the purposes of this Convention, unless the context otherwise requires, the term ‘company’ means

- any body corporate
- or any entity that is treated as a body corporate for tax purposes.”

Unlike Art. 3(2) OECD MTC¹³¹⁶, the insertion *unless the context otherwise requires* in Art. 3(1)(b) OECD MTC is an interpretation aid originating from the Anglo-Saxon methodology and does not merit substantive attention¹³¹⁷.

- 262 The qualifying element for such holdings is the proprietary right. Proprietary rights, however, do not require full membership or ownership but include limited or preferential membership rights.¹³¹⁸ *Company* is a sub-type of *person* pursuant to Art. 3(1)(a) OECD MTC. As such, it takes all of a *person*'s attributes covering only those structures, which the domestic tax law grants the same rights as *persons*.¹³¹⁹ This means in particular that a structure is considered a *body corporate* only where it is subject to tax itself and independently¹³²⁰. This is the constituent or qualifying element of limb 1 and allows in so far an autonomous interpretation¹³²¹ despite the implicit reference to domestic tax law¹³²². A residency as separately defined in Art. 4 OECD MTC is

¹³⁰⁹ See par. 45.

¹³¹⁰ See par. 257.

¹³¹¹ *Haslehnner, Werner* in *Klaus Vogel* Commentaries 2015, p. 839, par. 97; OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-10, par. 24; unclear: *Kaesler, Christian / Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1318, par. 123, leaving open if he refers to the term body corporate or to that of entity.

¹³¹² See Illustration 19 on p. 156.

¹³¹³ *Harris, Peter A.* in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.1. and 5.1.2.2.; *Tischbirek, Wolfgang / Specker, Gerhard* in *Vogel / Lechner*, p. 1212, par. 188; OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-10, par. 24; *Klaus Vogel* Commentaries 1997, p. 651, par. 190.

¹³¹⁴ OECD Commentaries 2014 on Art. 3 OECD MTC, p. C(3)-1, par. 3.

¹³¹⁵ The enumeration has been added by the author according to *Avery Jones* Commentaries, sec. 2.1. and *Harris, Peter A.* in IBFD Commentaries on Art. 10 OECD MTC, sec. 6.3.1.

¹³¹⁶ See par. 20.

¹³¹⁷ *Klaus Vogel* Commentaries 1997, p. 169, par. 4.

¹³¹⁸ *Jakob Bundgaard*, hybrids, p. 141 and 149; *Gaspar Lopes Dias*, tax arbitrage, p. 121; *Haslehnner, Werner* in *Klaus Vogel* Commentaries 2015, p. 839, par. 97; *Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1326, par. 139; *Hans Pijl*, hybrid debts, sec. 4.7. and 6.; *Martin Six*, hybrid finance, No. 1, sec. 2.; *Jakob Bundgaard*, perpetuals, p. 139; *Marjaana Helminen*, classification, p. 59; *Carminio Rotondaro*, redemption, p. 266; *Klaus Vogel* Commentaries 1997, p. 650 et seq., par. 189, and p. 653, par. 192.

¹³¹⁹ *Dürschmitt, Daniel* in *Vogel / Lechner*, p. 504 et seq., par. 10 and 13; *Marjaana Helminen*, dividend concept, p. 77 et seq.; *Klaus Vogel* Commentaries 1997, p. 171 et seq., par. 15.

¹³²⁰ *Tischbirek, Wolfgang / Specker, Gerhard* in *Vogel / Lechner*, p. 1213 et seq., par. 190; *Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 251, par. 18; OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-1, par. 1 – 3; *Marjaana Helminen*, dividend concept, p. 80 et seq.; *Michael Lang*, hybrids, p. 117; *Klaus Vogel* Commentaries 1997, p. 651, par. 190; OECD, CFA/WP1(73)2, p. 6, par. 11.

¹³²¹ *Harris, Peter A.* in IBFD Commentaries on Art. 10 OECD MTC, sec. 6.3.1.2.; *Haslehnner, Werner* in *Klaus Vogel* Commentaries 2015, p. 834, par. 86, and p. 835, par. 91; *Klaus Vogel* Commentaries 1997, p. 649, par. 186; *Kaesler, Christian / Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1306, par. 108.

¹³²² OECD, CFA/WP1(73)2, p. 7, par. 11, p. 8, par. 14, and p. 9, par. 18.

not required¹³²³, nor is a special or effective taxation of the *income*¹³²⁴. Conversely, the income from a *resident body corporate* can in any case be nothing else than a *dividend*. This is why the reference to the domestic tax law has in this case a mere declaratory effect¹³²⁵. Not essential for a *company* either are any restrictions or limitations of membership rights¹³²⁶ or the unit of the nominal value (e.g. par/non-par value shares)¹³²⁷. The provision applies the incorporation system, meaning that the place or jurisdiction in which the *company* has been founded or incorporated is not of importance¹³²⁸. Finally, the legal form is not relevant either, so that rights of ownership or membership are generally not required. For instance, this allows non-corporate *entities* such as foundations or trusts¹³²⁹ as well as partnerships¹³³⁰ or other structures¹³³¹ with partial legal capacity¹³³² to qualify as *company*.

- 263 “*Jouissance*” rights grant ownership rights equal or similar to those of a shareholder but exclude certain or all membership rights (D¹³³³)¹³³⁴. “*Jouissance*” shares are securitised “*jouissance*” rights (E¹³³⁵)¹³³⁶. Mining shares are holdings in mining unions (F¹³³⁷)¹³³⁸. Founders’ shares are exclusively reserved for and issued to the originators of a *company*, and normally carry certain priority or subordination rights (G¹³³⁹)¹³⁴⁰. As limb 1 takes the

¹³²³ Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 6.3.1.2.; Wassermeyer, Franz in Wassermeyer Commentaries, p. 251, par. 18;

¹³²⁴ Wassermeyer, Franz in Wassermeyer Commentaries, p. 250, par. 18; Klaus Vogel Commentaries 1997, p. 172 et seq., par. 16 et seq.

¹³²⁵ Klaus Vogel Commentaries 1997, p. 652, par. 191.

¹³²⁶ Gaspar Lopes Dias, tax arbitrage, p. 121; Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lechner, p. 1212, par. 189, and p. 1214, par. 192; Kaeser, Christian / Wassermeyer, Franz in Wassermeyer Commentaries, p. 1317, par. 122 et seq.; Hans Pijl, hybrid debts, sec. 4.7. and 6.; Martin Six, hybrid finance, sec. 2.; Marjaana Helminen, classification, p. 59; Marjaana Helminen, dividend concept, p. 178; Carmine Rotondaro, redemption, p. 266; Klaus Vogel Commentaries 1997, p. 652 et seq., par. 192.

¹³²⁷ Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.2.2.; Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lechner, p. 1214, par. 192; Kaeser, Christian / Wassermeyer, Franz in Wassermeyer Commentaries, p. 1317, par. 122 et seq.; Kopp, Karin E.M. in Wolfgang Schön, equity and debt, p. 855; Klaus Vogel Commentaries 1997, p. 653, par. 192.

¹³²⁸ Dürschmitt, Daniel in Vogel / Lechner, p. 505, par. 13; Wassermeyer, Franz in Wassermeyer Commentaries, p. 252, par. 18a, and p. 1317, par. 122; Klaus Vogel Commentaries 1997, p. 171 et seq., par. 15, and p. 652, par. 191.

¹³²⁹ Dürschmitt, Daniel in Vogel / Lechner, p. 508, par. 16a; Wassermeyer, Franz in Wassermeyer Commentaries, p. 253, par. 19; Klaus Vogel Commentaries 1997, p. 172, par. 16.

¹³³⁰ Klaus Vogel Commentaries 1997, p. 173, par. 17.

¹³³¹ Klaus Vogel Commentaries 1997, p. 172 et seq., par. 16a.

¹³³² Dürschmitt, Daniel in Vogel / Lechner, p. 508 et seq., par. 18; Haslechner, Werner in Klaus Vogel Commentaries 2015, p. 835, par. 91; Wassermeyer, Franz in Wassermeyer Commentaries, p. 251, par. 18; May, Nicolás in Thomas Ecker, p. 157; Klaus Vogel Commentaries 1997, p. 172, par. 15; OECD, CFA/WP1(73)2, p. 7, par. 12(b).

¹³³³ See Illustration 19 on p. 156.

¹³³⁴ Jakob Bundgaard, hybrids, p. 141; Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.2.2.; Haslechner, Werner in Klaus Vogel Commentaries 2015, p. 839, par. 98; Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lechner, p. 1215, par. 193; Kaeser, Christian / Wassermeyer, Franz in Wassermeyer Commentaries, p. 1318, par. 124, and p. 1435, par. 87; Klaus Vogel Commentaries 1997, p. 653, par. 193; Michael Lang, hybrids, p. 141; OECD, CFA/WP1(73)2, p. 10, par. 20(a).

¹³³⁵ See Illustration 19 on p. 156.

¹³³⁶ Kaeser, Christian / Wassermeyer, Franz in Wassermeyer Commentaries, p. 1318, par. 125; Klaus Vogel Commentaries 1997, p. 654, par. 194.

¹³³⁷ See Illustration 19 on p. 156.

¹³³⁸ Haslechner, Werner in Klaus Vogel Commentaries 2015, p. 840, par. 101; Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lechner, p. 1216, par. 196; Kaeser, Christian / Wassermeyer, Franz in Wassermeyer Commentaries, p. 1320, par. 127; Klaus Vogel Commentaries 1997, p. 654, par. 196.

¹³³⁹ See Illustration 19 on p. 156.

¹³⁴⁰ Avery Jones Commentaries, sec. 2.2.3.; Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lechner, p. 1217, par. 197; OECD, CFA/WP1(73)2, p. 10, par. 20(b).

attribute *participating in profits* from limb 2¹³⁴¹, the provision is limited to equity-like “*jouissance*” shares and “*jouissance*” rights¹³⁴². This should analogously apply to *mining shares* and *founders’ shares*.

- 264 The extent to which limb 1 is interpreted autonomously is fairly limited¹³⁴³, whereas its coordinating character or function by directly or indirectly referring to domestic tax law is much stronger. As a result, the main discussion within limb 1 deals with questions to what extent the domestic interpretation shall be bound¹³⁴⁴. These legitimate questions are indeed considerably complex and important for the interpretation of limb 1 but are, however, not relevant for the scope this study¹³⁴⁵. That also explains why the question of whether Art. 10(3) OECD MTC is to be interpreted by two or three limbs is not of major importance for this study. It actually leads merely to the particular issue whether or not the domestic interpretation of limb 1 shall be bound by the attribute *not being debt-claims* taken from limb 2¹³⁴⁶.

3.2.3 Corporate rights

The corporate rights test

- 265 Due to the ambiguous meaning of the terms *as well as*¹³⁴⁷ and *other*¹³⁴⁸ in limb 3, it is controversial whether the term *other rights* in limb 2 requires *corporate rights* taken from limb 3 (H¹³⁴⁹). The proponents of such “corporate-rights test”¹³⁵⁰ understand the word *other* in limb 3 in the sense of *further* and consequently the term *as well as* in limb 3 in the sense of an enumeration. In contrast, the opponents to this view understand the word *other* in limb 3 in the sense of *different* and consequently the term *as well as* in limb 3 in the sense of a separation. As such, it was able only to extend but not to limit the scope of limb 2¹³⁵¹. They further argue that the term *rights* in limb 2 must obviously include *debt-claims* to make their exclusion reasonable¹³⁵². And lastly, even if limb 2 did require *corporate rights* taken from limb 3, some commentators¹³⁵³ emphasise that the attribute *corporate rights* would still be subsidiary to the attribute *not being debt-claims*. As such, it would consequently be the precedent criterion for defining and delimiting limb 2.

¹³⁴¹ See par. 260.

¹³⁴² *Hans Pijl*, hybrid debts, sec. 4.8.; *Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lebner*, p. 1216, par. 194 et seq.; *Kaesler, Christian / Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1320, par. 126; *Marjaana Helminen*, dividend concept, p. 189; *Klaus Vogel Commentaries* 1997, p. 654, par. 194.

¹³⁴³ See par. 259.

¹³⁴⁴ See par. 258.

¹³⁴⁵ See par. 9 and 14.

¹³⁴⁶ *Kaesler, Christian / Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1325, par. 136; *Haslechner, Werner* in *Klaus Vogel Commentaries* 2015, p. 840, par. 101; *Hans Pijl*, hybrid debts, sec. 2.3.1.

¹³⁴⁷ See footnote 1291.

¹³⁴⁸ See par. 257.

¹³⁴⁹ See Illustration 19 on p. 156.

¹³⁵⁰ *Jakob Bundgaard*, hybrids, p. 140 et seq.; *Gaspar Lopes Dias*, tax arbitrage, p. 115 and 127; *Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lebner*, p. 1211, par. 185, and p. 1212, par. 188; *Santos, Ramon Tomazela*, Tax Treaty Qualification of Income Derived from Hybrid Financial Instruments, Bulletin for International Taxation 2013, Vol. 67, No. 10, sec. 4.1.; *Marjaana Helminen*, dividend concept, p. 175; *Eberhartinger / Six*, p. 9; *Martin Six*, hybrid finance, sec. 2. and 4; *Marjaana Helminen*, classification, p. 58 et seq.; *Klaus Vogel Commentaries* 1997, p. 573, par. 185.

¹³⁵¹ *Fehér, Tamás* in *Eva Burgstaller*, 2007, p. 240.

¹³⁵² *Hans Pijl*, hybrid debts, sec. 4.7.

¹³⁵³ *Gaspar Lopes Dias*, tax arbitrage, p. 129, 131 and 133; *Fehér, Tamás* in *Eva Burgstaller*, p. 245 et seq.; according to *Harris, Peter A.* in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.3.1., this would be a rather “formalistic approach” but in line with OECD, CFA/ WP1(73)2, p. 8, par. 13.

266 These two opposing positions principally aim to differentiate *dividends* from *interest* by identifying a shared reference. Nevertheless, the definition of the term *other rights* in limb 2 by way of positively deriving it from the term *corporate rights* in limb 3 or by way of negatively delimitating it from Art. 11(3) OECD MTC by the term *not being debt-claims* in limb 2 must eventually lead to the same result. The proponents see this reference in the term *corporate rights* indirectly via limb 3, considering it the material opposite of *debt-claims*. Contrariwise, the opponents directly focus on the formal state of *not being debt-claims* within limb 2 that does not require *corporate rights* as an additional reference. However, due to the consensus view that limb 2 is entirely to be interpreted autonomously¹³⁵⁴, both *corporate rights* and *debt-claims* would also from the proponents' view be interpreted autonomously in this context according to the same material attributes. In other words: both views eventually mean the same "coin" and only take their justification from different sides of that "coin"¹³⁵⁵.

The relevance of the corporate rights test

267 Notwithstanding this resultative equivalence¹³⁵⁶, the author agrees with the opponents' view that the term *other rights* in limb 2 does not require the indirect reference to the attribute *corporate rights* taken from limb 3. On the one hand, this follows e contrario from the clear and explicit wording *not being debt-claims* in limb 2. In the absence of any reference to domestic tax law and even from the proponents' view, the term *not being debt-claims* is in any case to be interpreted autonomously¹³⁵⁷. On the other hand, any reference from limb 2 to limb 3 would represent a circular reasoning, as the latter itself is in fact subsidiary to the former¹³⁵⁸ and therefore cannot at the same time have any influence back on it. The said uncertainty as to whether limb 2 takes attributes from limb 3 (upwards) or vice versa (downwards), appears to be caused by the ambiguity of limb 3 in being either a general or a special clause. While the former includes the latter in the sense of a superset and therefore shares its attributes, the latter excludes the former in the sense of a carve-out or would otherwise make it redundant. Pursuant to the laws of logic, these two aspects are mutually exclusive. As it is undisputed that limb 2 is in any case to be interpreted autonomously in its entirety¹³⁵⁹, limb 3 cannot possibly be its general but only its special clause. While an autonomous provision can represent a general clause for a partly domestic provision (e.g. limb 2 for limb 1)¹³⁶⁰, a partly domestic provision cannot, vice versa, represent a general clause for an autonomous provision (i.e. limb 3 for limb 2). Consequently, any overlap between limb 2 and limb 3 must be rejected.

The limitations of the corporate rights test

268 But even if there was such reference, the term *other rights* in limb 2 itself is in any case to be interpreted autonomously. Admittedly, due to the particular uncertainty within limb 3 of whether *other corporate rights* is precedent or subsidiary to the reference to domestic tax law¹³⁶¹, it is controversial how far this reference is to be understood. Namely, whether *other corporate rights* in limb 3 shall be limited to rights in a *corporate body*

¹³⁵⁴ See par. 257 et seq.

¹³⁵⁵ Equally: *Michael Lang*, hybrids, p. 121.

¹³⁵⁶ See par. 113.

¹³⁵⁷ See also par. 288.

¹³⁵⁸ *Haslehnner, Werner* in *Klaus Vogel Commentaries* 2015, p. 835, par. 90; *Kaesler, Christian / Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1254, par. 4, and p. 1326, par. 139; *Hans Pijl*, hybrid debts, sec. 6. See also par. 258.

¹³⁵⁹ See par. 257.

¹³⁶⁰ See par. 260.

¹³⁶¹ See par. 113(1).

pursuant to limb 1 (narrow view I¹³⁶²) or shall also include rights in an *entity that is treated as a body corporate for tax purposes* pursuant to limb 1 (intermediary view J¹³⁶³) or shall also include other *rights subjected to the same taxation treatment as shares* pursuant to limb 3 (wide view K¹³⁶⁴):

- (1) The representatives of a narrow view (I)¹³⁶⁵ primarily argue:
 - As a result from the word *other*, limb 3 referred to *shares* in limb 1 and therefore to Art. 3(1)(b) OECD MTC. This view was supported by the clause *company making the distribution*. In that, limb 3 represented a closed and exhaustive definition, not being inaccessible to Art. 3(2) OECD MTC¹³⁶⁶.
 - Only *shares* could grant shareholder rights as required by Art. 10(3) OECD MTC in order to yield *dividends*.
- (2) In contrast, the representatives of an intermediary view (J)¹³⁶⁷ primarily argue:
 - The phrase *company making the distribution* suggested not only *shares*. The reason for this argument was that the English term *company* had, for Art. 3(1)(b) OECD-MTC as well, a wider meaning than the term *corporation*. This view was also supported by the fact that all other language versions use their wider terms as well.
 - The term *other corporate rights* already existed in the OEEC drafts before the reference to the domestic tax law of the source jurisdiction was included. This fact suggests the intention of a different (i.e. wider) understanding.
 - The purpose and function of limb 3 was to ensure that Art. 10(3) OECD MTC covers income from an *entity* falling under the definition of *company*.
- (3) The representatives of a wide view (K)¹³⁶⁸ primarily argue:
 - Limb 3 would entirely fall short, violating its purpose, intention and function.

269 Other commentators¹³⁶⁹ seem to read the provision in a way that supports a modified narrow view that the term *other corporate rights* in limb 3 shall also include the attribute *debt-claims participating in profits* in limb 3 and Art. 11(3) OECD MTC. The entire discussion, however, focuses on the key question of whether (intermediary view J) or not (narrow view I) limb 3, if not even genuinely subject of the domestic interpretation (wide view K), shall take the reference to the domestic tax law from limb 1. In other words: it is controversial whether the attribute *other corporate rights* in limb 3 is either to be interpreted autonomously (narrow view I) or domestically (intermediary view J and wide view K). To the author's understanding, the narrow view (B) is inconsistent with the 3-limb interpretation, which is supported mainly by the same representatives¹³⁷⁰. Any direct reference from limb 3 to limb 1 would not only conflict with the consensus view that limb 2 is first of all

¹³⁶² See Illustration 19 on p. 156.

¹³⁶³ See Illustration 19 on p. 156.

¹³⁶⁴ See Illustration 19 on p. 156.

¹³⁶⁵ *Tischbirek, Wolfgang / Specker, Gerhard* in *Vogel / Lebner*, p. 1212 et seq., par. 189, and p. 1215, par. 192; *Kaesler, Christian / Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1305, par. 107, p. 1317, par. 122, and p. 1327, par. 140; *May, Nicolás* in *Thomas Ecker*, p. 443; *Febér, Tamás* in *Eva Burgstaller*, p. 243 and 246; *Klaus Vogel Commentaries* 1997, p. 650, par. 188 and 651, par. 190; perhaps *Michael Lang*, hybrids, p. 90 and 132; unclear: *Haslehner, Werner* in *Klaus Vogel Commentaries* 2015, in favour on p. 840, par. 102 but in par. 89 on p. 834 supporting the view that rights shall be interpreted pursuant to domestic tax law of the treaty-applying jurisdiction.

¹³⁶⁶ See par. 20.

¹³⁶⁷ *Harris, Peter A.* in *IBFD Commentaries on Art. 10 OECD MTC*, sec. 5.1.2.4.2. and 5.1.3.1.; *Avery Jones Commentaries*, sec. 3.2. et seq.

¹³⁶⁸ OECD, Report on Thin Capitalization, Issues in International Taxation 1987, No. 2, p. 24, par. 57 et seq., and p. 33, par. 85(a); *Hans Pijl*, hybrid debts, sec. 4.2, 4.7., 5.8. and 6.

¹³⁶⁹ *Gaspar Lopes Dias*, tax arbitrage, p. 115 et seq.; *Eberhartinger / Six*, p. 9; *Martin Six*, hybrid finance, sec. 2.; *Marjaana Helminen*, classification, p. 59.

¹³⁷⁰ See footnotes 1291 and 1365.

a general clause for limb 1 (B)¹³⁷¹ but also with the finding that limb 3 is a special clause, which does not share its attributes at all¹³⁷². Such direct reference from limb 3 would actually establish a formal bridge or bracket to limb 1. It would ignore both the undisputed priority¹³⁷³ and the character of limb 2 that would at worst fall short entirely. In other words: it follows from its position between limbs 1 and 3 that the purpose and function of limb 2 may not be frustrated or marginalised by limb 3, which provides a domestic and special definition.

Own alternative view on the corporate rights test

- 270 Instead, limb 3 must in its entirety be interpreted domestically (i.e. wide view K) as a coherent whole. Unlike in limb 2¹³⁷⁴, the word *other* in limb 3 must consequently be understood in the sense of *different*¹³⁷⁵. This conclusion is in line with the asset-based approach implying and requiring the income or transaction¹³⁷⁶. It would not be reasonable and give rise to considerable systematic distortions to interpret the term *income* in limb 3 pursuant to domestic law, but the term *corporate rights* in limb 3 as the asset and source of that *income* autonomously¹³⁷⁷. Even if there was a reference from limb 2 to limb 3¹³⁷⁸, the autonomous term *other rights* in limb 2 had necessarily a different meaning than the domestic term *other corporate rights* in limb 3¹³⁷⁹. Consequently, the conclusion that *other rights* in limb 2 actually means *equity rights* (*corporate rights* test) must be drawn directly from the reference phrase *not being debt-claims* in conjunction with the attribute *participating in profits*. Namely, it cannot be drawn indirectly from the term *corporate rights* in limb 3.
- 271 On the other hand, there is a parallel discussion on the converse question whether limb 3 shall also take the attribute *not being debt-claims* from limb 2 (L¹³⁸⁰). This discussion is not of particular relevance for limb 2 as the focus of this study¹³⁸¹ and, even if it had been, it would have had to be rejected¹³⁸². However, the opponents of this view¹³⁸³ use the argument that pursuant to par. 15(d) of the OECD Commentaries 2014 on Art. 10 OECD MTC, Art. 10(2)(a) OECD MTC also covered certain *debt-claims*. This argument might potentially give rise to doubts within limb 2 as to whether it is the special function of its insertion *not being debt-claims* to actually differentiate and mutually exclude limb 2 from non-equity *rights*¹³⁸⁴. This argument does nevertheless not apply to limb 2, since pursuant to its tax-limiting function and correspondently its broad scope¹³⁸⁵, Art. 10(2)(a) OECD MTC must necessarily include limbs 1 and 3 as well. Accordingly, par. 15(d) of the OECD

¹³⁷¹ See par. 260.

¹³⁷² See par. 267.

¹³⁷³ See par. 258.

¹³⁷⁴ See par. 260.

¹³⁷⁵ See par. 265.

¹³⁷⁶ See par. 54.

¹³⁷⁷ *Marjaana Helminen*, dividend concept, p. 145.

¹³⁷⁸ See par. 268.

¹³⁷⁹ Equally: *Jakob Bundgaard*, hybrids, p. 148.

¹³⁸⁰ See Illustration 19 on p. 156.

¹³⁸¹ See par. 258.

¹³⁸² See par. 267.

¹³⁸³ See footnote 1368.

¹³⁸⁴ See par. 113(1).

¹³⁸⁵ See par. 112.

Commentaries 2014 on Art. 10 OECD MTC explicitly refers to the “internal law or practice” and therefore not to limb 2¹³⁸⁶.

Interim conclusions

- 272 From these systematic considerations follows as an interim conclusion for the further course of this study that limb 3 represents a special clause to limb 2. As such, limb 3 actually excludes limb 2 and therefore shares none of its own attributes. In contrast, limb 2 represents as a general clause an intersection with limb 1. As such, limb 2 includes limb 1 and therefore shares its own attributes. Or to put it the other way round: limb 1 takes attributes from limb 2, while limb 2 takes no attributes from limb 3. In particular, the attribute *other corporate rights* in limb 3 is not relevant for the interpretation of limb 2. This the reason why the subsequent question of whether that attribute is to be interpreted autonomously or domestically is not relevant for this study. This disentanglement of limb 2 from the formal requirement of a *corporate right* in limb 3 also corresponds to the examples of “*jouissance*” shares or “*jouissance*” rights in limb 1, which do apparently not meet this condition. That is why the term *other rights* in limb 2 is to be interpreted autonomously and actually means equity rights as opposed to *debt-claims*. Consequently, the word *other* in limb 3 is, unlike in limb 2, to be understood in the sense of *different*.

3.2.4 Participating in profits

The relevance of the profit participation

- 273 At first glance, the attribute *participating in profits* appears to be dispensable, in that it is mentioned in both Art. 10(3) and 11(3) OECD MTC. In other words: “the term ‘dividends’ as used in this Article [i.e. Art. 10(3) OECD MTC] means income from [...] other rights, [...] participating in profits” and thus seems to also fully include “income from debt-claims of every kind, [...] whether or not carrying a right to participate in the debtor’s profits” in the sense of Art. 11(3) OECD MTC. However, the syntax of the two provisions differs in that the attribute *participating in profits* is an integral part of the independent clause and therefore a constituent element of the positive definition in Art. 10(3) OECD MTC. Contrariwise, it is part of a dependent clause in Art. 11(3) OECD MTC and therefore an extension of the definition there. In other words: Art. 10(3) OECD MTC actually reads as “other rights, *which are* participating in profits”, whereas Art. 11(3) OECD MTC actually reads as “debt-claims, *even though* participating in profits”. This is the interpretational justification that the profit participation is a genuine and integral element and therefore a necessary minimum condition (*conditio sine qua non*) for *dividends*, but not for *debt-claims*. This conclusion is even more evident when set into a relationship with the phrase *not being debt-claims* in Art. 10(3) OECD MTC. This negating insertion appears, at first glance, as merely declaratory or even redundant. In fact, however, it supports the view that *debt-claims*, which are as such excluded from *other rights*, bear themselves no right to participate in profits. In other words: the significance of this interpretative detail arises as a consequence of the different logical levels, on which the two provisions interact by the word *debt-claims*. In that, it also supports the view that the term *other rights* in limb 2 must include *debt-claims* to make their exclusion reasonable¹³⁸⁷. The following illustration visualises this understanding:

¹³⁸⁶ Similarly: Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.2.4.2.; OECD, BEPS Action No. 6 – Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (Final Report), 5 October 2015, OECD, Paris, 2015, p. 70, par. 33.

¹³⁸⁷ See par. 265.

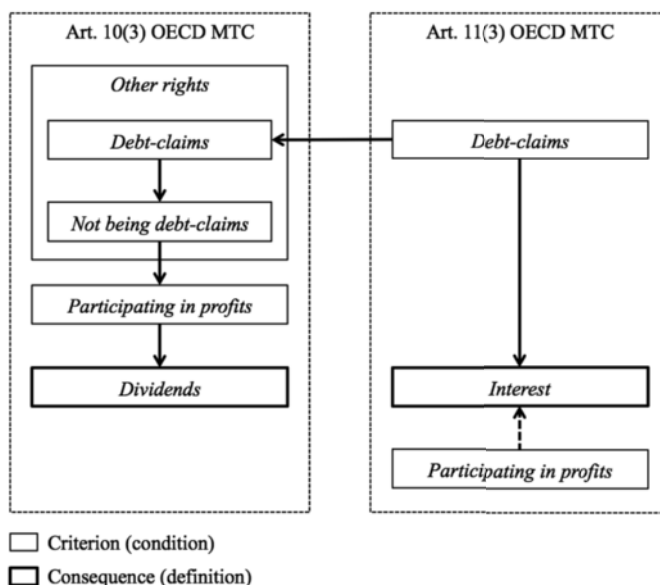


Illustration 20: The interaction of Art. 10(3) and 11(3) OECD MTC and the participation in profits

Modifications of the payment profile

- 274 Just as for the systematic considerations as regards the time value of money¹³⁸⁸, with regard to the interpretation of Art. 10(3) OECD MTC the question also arises, which and to what extent modifications of the payment profile represent a *participating in profits*¹³⁸⁹. Or in other words: at which point its risk-based nature starts and ends. Since *dividends* are per se risky in terms of periodicity¹³⁹⁰, certainty¹³⁹¹, payability¹³⁹² and currency¹³⁹³, debatable are particularly modifications in the
- (1) amount multiplicatively (e.g. leverage) and/or additively (e.g. premium)¹³⁹⁴; and
 - (2) symmetry (i.e. in its profits and maybe losses in equal or unequal proportions).
- Again, it follows from the equivalence of legal criteria¹³⁹⁵ that there cannot be any priority or subordination among them, in that one feature was more important or significant than any other.

- 275 As regards the first aspect (1), amount modifications are analogous to the time value of money¹³⁹⁶. They can have the multiplicative form of a leverage, which can be above (> 1) or below (< 1) profit-loss proportionality ($= 1$), or the additive form of premiums (> 0) or discounts (< 0). In this respect, the author takes the view that positive modifications can still represent a participation in profits (i.e. leverage > 1 and premiums, e.g.

¹³⁸⁸ See par. 209.

¹³⁸⁹ See par. 204.

¹³⁹⁰ See par. 209(1).

¹³⁹¹ See par. 209(2).

¹³⁹² See par. 209(4).

¹³⁹³ See par. 209(5).

¹³⁹⁴ See par. 209(3).

¹³⁹⁵ See par. 182.

¹³⁹⁶ See par. 215.

dividend step-ups). This follows *e contrario* from the systematic considerations with regard to the time value of money, according to which any excess amount can eventually and economically only be yielded by equity implying underwriting risk. Conversely, a rational investor will not accept negative modifications (i.e. leverage < 1 and discounts) while fully participating in underwriting risk. In other words: just like the theoretical ideal-type of *debt-claims* are time-based financial instruments not bearing any underwriting risk¹³⁹⁷, its natural complement and the theoretical ideal-type of equity *rights* are risk-based (i.e. underwriting risk) financial instruments¹³⁹⁸. While the return from the former is basically the time value of money, the return from the latter necessarily includes a risk premium¹³⁹⁹.

- 276 However, the fact that a rational investor will not accept negative modifications of the payment profile while fully participating in underwriting risk, may not lead to the erroneous conclusion that they actually do not exist in practice. Rather, it only means that they must be compensated otherwise, namely on the risk level, by limiting the investor's risk exposure. Notably, such negative modifications result in opposite risk-wise consequences for risk-based and time-based payment profiles: a negatively modified time-based payment profile implies a participation in risk, *turning* it into risk-based. In contrast, a negatively modified risk-based payment profile implies a limitation of risk, *keeping* it basically risk-based (except if it is time-equivalent¹⁴⁰⁰). In other words: in both cases the negative modification implies time-inequivalence¹⁴⁰¹ and therefore underwriting risk. However, for this reason the former turns into risk-based *due to* embedding the risk premium, whereas the latter remains risk-based *even though* embedding the risk premium. True, underwriting risk (superset) is not necessarily business risk (subset)¹⁴⁰², just as a risk premium (superset) is not necessarily a participation in profits (subset). However, as a risk premium (superset) compensates underwriting risk (superset), a participation in profits (subset) must necessarily compensate business risk (subset)¹⁴⁰³. From the author's view, this systematic rationale can be transferred to the OECD MTC by analogy. As a conclusion for the further course of this study, positive and – as opposed to the time value of money – also negative modifications of the payment profile *participating in profits* represent business risk.
- 277 These considerations also support the natural and widely accepted intuition that participation in profits is first of all a compensation for a participation in losses (i.e. business risk)¹⁴⁰⁴. In other words: participation in profits implies business risk, which represents the material link to the participation in losses¹⁴⁰⁵. Where the participation in profits and that in losses are asymmetric¹⁴⁰⁶, the financial instrument necessarily contains an optional component¹⁴⁰⁷. Such asymmetry¹⁴⁰⁸ is basically independent of possible amount modifications¹⁴⁰⁹,

¹³⁹⁷ See par. 213.

¹³⁹⁸ See par. 208 et seqq.

¹³⁹⁹ See par. 99.

¹⁴⁰⁰ See par. 212.

¹⁴⁰¹ See par. 215.

¹⁴⁰² See par. 103(3).

¹⁴⁰³ Argumentum a maiore ad minus.

¹⁴⁰⁴ See par. 182.

¹⁴⁰⁵ Similarly: *Gaspar Lopes Dias*, debt-claims, sec. 3.1.

¹⁴⁰⁶ See par. 64.

¹⁴⁰⁷ See par. 98(7).

¹⁴⁰⁸ See par. 279 et seq.

¹⁴⁰⁹ See par. 274.

since leverage can also be symmetric. Where such asymmetry¹⁴¹⁰ is, however, in favour of the participation in profits, there cannot possibly be a full participation in the business risk (economic insurance). A partial but positive participation due to a slight asymmetry may still represent business risk¹⁴¹¹. However, the asymmetry can be so strong that it seems to eventually eliminate business risk entirely and thus eliminate one of the constituting elements of *other equity rights* pursuant to Art. 10(3) OECD MTC¹⁴¹². The price to pay for such risk “elimination” is actually the premium of the embedded optional component, which represents itself a risk-based element. While the risk from the underlying is asymmetric, the optional component itself remains nevertheless risk-based. In other words: the elimination of business risk from the level of the underlying by embedding an optional component may not be confused with the business risk coincidentally transferred onto the level of the optional component itself. Even a strong asymmetry of the payment profile is thus not capable of actually “eliminating” the business risk (i.e. from the underlying) but can merely replace it by another risk (i.e. from the optional component), keeping the financial instrument as a whole risk-based. As a consequence, negative modifications of a risk-based payment profile *participating in profits* represent in any case business risk unless not being time-equivalent.

- 278 In addition, business risk is the link between a participation in profits and that in losses and as such bears a nexus with the timing¹⁴¹³. As a consequence, a participation in losses is inextricably coalesced with the loss of the capital or principal itself, just as a participation in profits is inextricably coalesced with the liquidation proceeds or hidden reserves. In fact, both are merely deferred¹⁴¹⁴. This structural mechanism, interpretatively deducible from the attribute *participating in profits*, is also the systematic reason why the participation in profits necessarily implies termination risk in the form of business risk. Another consequence and conclusion for the further course of this study is that the word *profits* in Art. 10(3) OECD MTC includes negative profits (i.e. losses), despite the fact that its narrow literal understanding might suggest a limitation to positive results only. On the one hand, the words *profits* and *income* are independent of each other, as the former is to be understood autonomously and in the sense of *potential*, whereas the latter is to be understood domestically¹⁴¹⁵ and in the sense of *actual*¹⁴¹⁶. On the other hand, the two terms were said to include also losses, which makes them eventually independent from the amount. As a consequence, the two terms have in common that even the absence of any profit at all (i.e. no *potential income*, e.g. zero-interest bond) does not negate the principal necessity and feasibility of classifying the respective financial instrument into the distributive articles of the OECD MTC¹⁴¹⁷.

¹⁴¹⁰ See par. 279 et seq.

¹⁴¹¹ See par. 276.

¹⁴¹² As will be elaborated in the following (see par. 282).

¹⁴¹³ See par. 69 and 250.

¹⁴¹⁴ Equally: *Michael Lang*, hybrids, p. 130; contrary: *Gaspar Lopes Dias*, debt-claims, sec. 3.1., ignoring this interdependent mechanism by formalising that “the predicament here resides in that the risk of not obtaining profits is not the same as the risk of losing the invested capital, as it is perfectly possible to hold a right to profits in a company and yet not have a share in the liquidation proceeds; one thing does not result from the other. Moreover, if the access to profits were necessarily a consideration for the total risk assumed, then it would be antithetical to accept that payments could be characterised as interest for treaty purposes if they were profit sharing. Therefore, the author fails to see a legally binding link that allows such requirement (to share in the liquidation proceeds indicating a business risk of total loss) to be attained based on the wording of article 10.”; *Jakob Bundgaard*, perpetuals, p. 140, merely observing that “the wording of Art. 10 of the OECD Model, however, does not explicitly list these criteria, nor does it go into detail on how these two criteria must be formulated in order for a specific hybrid instrument to be classified as a dividend-generating instrument (equity).” See also par. 219.

¹⁴¹⁵ See par. 144.

¹⁴¹⁶ See par. 158.

¹⁴¹⁷ See par. 201.

Symmetry of the payment profile

- 279 The second aspect (2)¹⁴¹⁸ of symmetry leads to the question which characteristics constitute a participation in profits (and losses).

Example 44: An optional convertible bond does not legally participate in profits and losses before having been converted into the *share*. However, the option to convert economically represents nevertheless a participation in the future value appreciation of that *share* (i.e. in the profits and losses).¹⁴¹⁹ The dependency becomes even more evident by the example of a mandatory convertible bond, whose market value is almost entirely determined by that of the *share*.¹⁴²⁰

On the one hand, the classification of an individual remuneration payment into the distributive articles of the OECD MTC depends on all other remuneration payments, including those paid at maturity¹⁴²¹. As a consequence, they were found to be analysed by grouping them together as a coherent whole¹⁴²². On the other hand, the payment profile as a whole interacts with the termination risk¹⁴²³. As a consequence, business risk as a sub-type of underwriting risk¹⁴²⁴ can necessarily be contained within the participation in profits and losses (e.g. “*jouissance*” *share*) or the capital or principal (e.g. equity-linked note) or both (e.g. *share*)¹⁴²⁵, the reason being that today’s capital is economically tomorrow’s income¹⁴²⁶, so that the requisite legal event does not only split-off income¹⁴²⁷ but also underwriting risk from capital. In fact, a *dividend* distribution reduces also the investor’s total investment risk over the *share*’s entire lifetime. This means in turn that underwriting risk remains left for capital *gains* unless being shifted at some point to the other income types by such legal event. In other words: the participation in losses implies business risk on both profits (i.e. opportunity costs) and the capital or principal itself (i.e. actual costs). Hence, the former represents in fact a remuneration risk (also referred to as “coupon at risk”) and the latter a termination risk (also referred to as “principal at risk”). The aspect of symmetry of the payment profile therefore points to two interpretational questions: (1) whether or not the remuneration risk must be seen as one logical unit or concept with the termination risk and (2) what the sources of interpretation for it are.

- 280 As regards the first question (1), to the author’s understanding the two aspects must be considered separately¹⁴²⁸. Notably, this applies irrespective of their nexus as both representing business risk. Both *participating in profits* and, due to the extended definition in Art. 11(3) OECD MTC¹⁴²⁹, also *debt-claims* imply business risk and cannot serve as a differentiator. Only termination risk is capable of falsifying time equivalence and consequently

¹⁴¹⁸ See par. 274(2).

¹⁴¹⁹ See par. 96.

¹⁴²⁰ David Hariton, equity and debt, p. 509.

¹⁴²¹ See Example 34 on p. 124 and Example 35 on p. 125.

¹⁴²² See par. 213 et seqq.

¹⁴²³ See par. 278.

¹⁴²⁴ See par. 276.

¹⁴²⁵ In result equally: OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-10, par. 25; William Plumb, p. 432. See also par. 219.

¹⁴²⁶ See par. 160.

¹⁴²⁷ See par. 158 and 163.

¹⁴²⁸ In result equally: Gaspar Lopes Dias, debt-claims, sec. 3.1.; Michael Lang, hybrids, p. 127 et seq.

¹⁴²⁹ See par. 273.

the time value of money¹⁴³⁰. In other words: business risk can be contained within both the participation in profits and losses (i.e. remuneration risk) and the capital or principal (i.e. termination risk)¹⁴³¹. However, only the former is covered by the extended definition of *debt-claims* in Art. 11(3) OECD MTC, as the latter is a falsifier for *debt-claims* as such¹⁴³². Any other conclusion would mean letting Art. 11(3) OECD MTC fall short entirely. Not only by ignoring the term *debt-claim* but also by the self-contradiction that the termination risk in the attribute *participating in profits* would negate its previous term *debt-claims*¹⁴³³. As a consequence, the attribute *participating in profits* not only has a different legal quality but also a different legal consequence within Art. 10(3) OECD MTC as compared to Art. 11(3) OECD MTC. In the former it means any form of business risk, whereas in the latter it means only business risk in the form of remuneration risk. The consequent tax planning possibilities and distortions by discretionarily structuring the business risk into the capital or principal¹⁴³⁴ have to be accepted¹⁴³⁵. Accordingly, the answer to the second question (2) is that the source of interpretation for the termination risk is not the attribute *participating in profits* but rather the composite phrase *other rights, not being debt-claims*. That is why the interpretative embedding of the termination risk into Art. 10(3) OECD MTC is discussed in the following separately¹⁴³⁶. As a conclusion for the further course of this study it is held that the attribute *participating in profits* cannot serve as a differentiator for the distinction between Art. 10(3) and 11(3) OECD MTC¹⁴³⁷. This result also corresponds to the systematic considerations and finding that this criterion has relatively low interpretation significance¹⁴³⁸.

3.2.5 Other rights

The corporate rights test by analogy

- 281 From the author's view, the requirement found in previous discussions¹⁴³⁹ that a structure must be abstractly and independently subject to tax itself in order to qualify for originating *shares* pursuant to limb 1 applies also to the term *other rights* in limb 2. This cannot be the result of any reference from limb 2 to limb 1, which would represent a circular reasoning, as the former shares its own attributes with the latter as its subset¹⁴⁴⁰ and not vice versa. However, limb 2 represents as its general clause an intersection with limb 1. This is why it is methodologically permissible to interpret limb 2 by drawing implicit reverse conclusions from the list or catalogue of particular examples in limb 1, which is the stronger provision (e.g. common characteristics), to the abstract definition in limb 2, which is the weaker provision¹⁴⁴¹. Notably, this may not be understood as creating a reference from limb 1 but rather as a methodology of interpretation within limb 2. Admittedly, this tends to make limb 1 redundant. However, this is the logical necessity of any intersection and therefore the very nature of any general clause as opposed to a residuary clause. This result as interpreted by such analogy is that a structure must be abstractly and independently subject to tax itself in order to qualify for *other*

¹⁴³⁰ See par. 242(2).

¹⁴³¹ See par. 279.

¹⁴³² See par. 273.

¹⁴³³ Argumentum e contrario.

¹⁴³⁴ See Example 19 on p. 76.

¹⁴³⁵ See par. 101(1).

¹⁴³⁶ See par. 282.

¹⁴³⁷ Equally: Harris, Peter A. in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.3.2.2.

¹⁴³⁸ See par. 206.

¹⁴³⁹ See par. 262.

¹⁴⁴⁰ See par. 260.

¹⁴⁴¹ Argumentum a minore ad maius.

rights pursuant to limb 2. It is also systematically in line with limb 1, as both are interpreted autonomously and clearly separated from *debt-claims*¹⁴⁴². According to the author's view, this tax subjectivity is concretely governed by the domestic tax law also for limb 2. This view is systematically in line with limb 1¹⁴⁴³ and limb 3¹⁴⁴⁴, as all three are interpreted domestically.

The relevance of business risk

282 There appears to be a certain consensus that the term *other rights* in limb 2 requires at least

- (1) an actual provision of capital¹⁴⁴⁵,
- (2) which participates in the business risk equivalent to that of a shareholder, including the risk of loss of the capital or principal itself¹⁴⁴⁶; and
- (3) in the business opportunities equivalent to those of a shareholder, including the liquidation proceeds or hidden reserves¹⁴⁴⁷.

However, this turns out to be an imprecise view, when looked at more closely, in that the term *other rights* was actually found to include *debt-claims*¹⁴⁴⁸. As was further concluded, the difference between *other equity rights* and *debt-claims* by way of business risk and opportunities cannot be taken from the attribute *participating in profits*¹⁴⁴⁹ either. Consequently, the difference between *other equity rights* and *debt-claims* by way of business risk and opportunities can only be deduced from the negating insertion *not being debt-claims* as the only remaining part of limb 2 justifying such interpretation. *Debt-claims* themselves bear no genuine right to participate in profits. This means in turn that they do not bear genuine business risk in either way¹⁴⁵⁰, even less where there is no participation in losses. This permissible reverse deduction is a result of the above systematic considerations¹⁴⁵¹ that such amounts exceeding the time value of money necessarily bear business risk. In that, the negating insertion *not being debt-claims* carves out the time value of money from limb 2 of Art. 10(3) OECD MTC, leaving the crucial aspect of business risk as a residuum within the term *other rights*. On the other hand, the attribute *participating in profits* in limb 2 of Art. 10(3) OECD MTC already accounts for the business risk to the extent that it is contained within the remuneration (i.e. the remuneration risk). However, it can simultaneously also be contained within the capital or principal itself (i.e. the termination risk)¹⁴⁵². At first glance, the negating insertion *not being debt-claims* appears a mere complementary exclusion. In fact,

¹⁴⁴² See par. 267.

¹⁴⁴³ See par. 262.

¹⁴⁴⁴ See par. 270.

¹⁴⁴⁵ See par. 106(3) and 113(1).

¹⁴⁴⁶ See footnote 1365. Also supported by *Jakob Bundgaard*, hybrids, p. 147; *Santos, Ramon Tomazela*, Tax Treaty Qualification of Income derived from Hybrid Financial Instruments, Bulletin for International Taxation 2013, Vol. 67, No. 10, sec. 4.1.; *Eberhartinger / Six*, p. 9; *Martin Six*, hybrid finance, sec. 2.; *Jakob Bundgaard*, perpetuals, p. 139; *Marjaana Helminen*, classification, p. 59; *Marjaana Helminen*, dividend concept, p. 178; *Giuliani, Federico Maria*, Article 10(3) of the OECD Model and Borderline Cases of Corporate Distributions, Bulletin for International Taxation 2002, Vol. 56, No. 1, p. 14; *Michael Lang*, hybrids, p. 112 and 127.

¹⁴⁴⁷ See footnote 1365. Also supported by *Jakob Bundgaard*, hybrids, p. 149; *Michael Lang*, introduction, p. 100, par. 280; *Eberhartinger / Six*, p. 9; *Martin Six*, hybrid finance, sec. 2.; *Marjaana Helminen*, classification, p. 58; *Marjaana Helminen*, dividend concept, p. 176; *Giuliani, Federico Maria*, Article 10(3) of the OECD Model and Borderline Cases of Corporate Distributions, Bulletin for International Taxation 2002, Vol. 56, No. 1, p. 14; *Michael Lang*, hybrids, p. 127; contrary: *Gaspar Lopes Dias*, debt-claims, sec. 3.1. and *Jakob Bundgaard*, perpetuals, p. 140 (both see footnote 1414).

¹⁴⁴⁸ See par. 273.

¹⁴⁴⁹ See par. 280.

¹⁴⁵⁰ Argumentum e contrario.

¹⁴⁵¹ See par. 215 and 275.

¹⁴⁵² See par. 279.

however, it consequently provides in conjunction with the attribute *participating in profits*¹⁴⁵³ the necessary clarification and specification to the debt-equity distinction. It leaves the business risk only in the form of termination risk as a residuum within the term *other rights* and therefore limb 2 of Art. 10(3) OECD MTC. This conclusion is in line with the finding¹⁴⁵⁴ that the material underwriting risk in general and therefore also its specific subset of business risk is basically subsidiary to the formal redemption obligation requirement (form over substance).

- 283 These conclusions are also independent of the finding¹⁴⁵⁵ that subordination and therefore business risk do not necessarily occur, wherever there is a participation in profits and losses. Subordination is merely one of multiple possible sources of business risk¹⁴⁵⁶. Admittedly, these considerations appear to apply to the theoretical ideal-types of equity *rights* and *debt-claims* only, while there are countless variations in between¹⁴⁵⁷. However, the methodological step of abstractly and textually interpreting Art. 10(3) OECD MTC has to be distinguished from that of concretely applying the provision (i.e. the case-by-case assessment of which variations are to be subsumed under the attribute *participating in profits*)¹⁴⁵⁸.

The relevance of securitisation

- 284 In order to ensure that limb 3 does not fall short, many commentators¹⁴⁵⁹ take the position that limb 2 applies to securitised *rights* only¹⁴⁶⁰. This requirement can however not be interpreted from the wording of limb 3 and also limb 1 was said to merely contain a non-exhaustive list of examples¹⁴⁶¹. Even more, *Lang*¹⁴⁶² and *Hongler*¹⁴⁶³ accurately refer to the rather general meaning of the term *rights*, being basically independent of domestic laws. In addition, systematic considerations do not necessitate such restriction¹⁴⁶⁴ either. And finally, the OECD Commentaries¹⁴⁶⁵ only refer “in the first instance” to stock-listed *companies* and therefore do not give an undisputable answer¹⁴⁶⁶. That is why the securitisation requirement is typically justified by way of historic interpretation, in that it originated from Germany’s pre-World-War-II DTC in order to be in line with its domestic taxation at that time¹⁴⁶⁷. However, not only did this specific never find its way

¹⁴⁵³ See par. 270.

¹⁴⁵⁴ See par. 241.

¹⁴⁵⁵ See par. 219.

¹⁴⁵⁶ Cum hoc ergo propter hoc.

¹⁴⁵⁷ See par. 91 and Illustration 8 on p. 63.

¹⁴⁵⁸ See par. 72.

¹⁴⁵⁹ *Haslechner, Werner* in *Klaus Vogel Commentaries* 2015, p. 840, par. 101; *Tischbirek, Wolfgang / Specker, Gerhard* in *Vogel / Lechner*, p. 1217, par. 198; *Kaeser, Christian / Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1319, par. 125, and p. 1326, par. 139, without justification; *Klaus Vogel Commentaries* 1997, p. 655, par. 198, merely referring to the OECD Commentaries; critically: *Harris, Peter A.* in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.2.3., calling such restriction as “an unnecessary and superfluous limitation into the definition”.

¹⁴⁶⁰ As will be explained and discussed in the following.

¹⁴⁶¹ Equally: *Hans Pijl*, hybrid debts, sec. 4.9. and 6.; *Michael Lang*, hybrids, p. 122 et seq.

¹⁴⁶² *Michael Lang*, hybrids, p. 122 et seq.

¹⁴⁶³ *Peter Hongler*, p. 244.

¹⁴⁶⁴ See par. 98(5).

¹⁴⁶⁵ OECD Commentaries 2014 on Art. 10 OECD MTC, p. C(10)-10, par. 24.

¹⁴⁶⁶ Equally: *Hans Pijl*, hybrid debts, sec. 4.9. and 6.

¹⁴⁶⁷ *Haslechner, Werner* in *Klaus Vogel Commentaries* 2015, p. 840, par. 101; *Tischbirek, Wolfgang / Specker, Gerhard* in *Vogel / Lechner*, p. 1217, par. 198; *Avery Jones Commentaries*, sec. 2.2.1. and 3.1.

into even the earliest OECD MTC 1963¹⁴⁶⁸, withdrawing this occurrence its historic significance¹⁴⁶⁹; in any case the dynamic interpretation of Art. 10(3) OECD MTC¹⁴⁷⁰ places more weight on the *substance over form* principle¹⁴⁷¹. As a consequence, it demands that the formal aspect of securitisation does not impact the material substance or nature of a *dividend*¹⁴⁷², just as the question of whether the *company* is publicly or privately held¹⁴⁷³. And even if it did, the purpose, intention and function of Art. 10(3) OECD MTC deserved more importance than its historical interpretation, and eventually did not justify such a conclusion.

3.2.6 Not being debt-claims

285 The negating insertion *not being debt-claims* was found leaving the aspect of business risk in the form of termination risk as a residuum within the term *other rights* and therefore limb 2 of Art. 10(3) OECD MTC¹⁴⁷⁴. In the absence of a logical equivalent within limb 2 of Art. 10(3) OECD MTC¹⁴⁷⁵, the term *debt-claims* represents the natural complement to the term *dividends*. On the one hand, the word *debt* etymologically originates from the Latin word *dēbitum* (“thing owed”). This term stems from the root word *dēbēre* (“to owe”) as a contraction of *dehibēre* (“to have from” or “to keep away from”), which combines the particles *de* (“from” or “away”) and *habēre* (“to have”)¹⁴⁷⁶. The word *claim* originates from the Latin word *clāmāre* (“to call”)¹⁴⁷⁷. Effectively it descends from its French version, which had been concretised into the meaning of a “thing demanded”¹⁴⁷⁸. The original meanings of these terms were thus already associated with a specifically dissociating and involuntary denotation. This is even more evident in the term *interest*, as implied by the term *debt-claim* due to the transaction-based approach¹⁴⁷⁹. The word *interest* originates from the identical Latin word and actually combines the particles *inter* (“between”) and *est* (“it is”)¹⁴⁸⁰. However, this word does not descend directly from Latin either but indirectly from its French version. It had been concretised from its original denotation of “it is of importance” or “it makes a difference” into the meaning of “damage”, “loss” or “harm” and was already used at that time in the financial sense of “money paid for the use of money lent” or “compensation due from a defaulting debtor”.¹⁴⁸¹ In contrast, the word *dividend* originates from the Latin word *dividēre* (“spread apart” or “cleave” or “distribute”)¹⁴⁸² and combines the particles *dis* (“asunder” or “apart” or “in two”) and *vidēre* (“to separate”)¹⁴⁸³. This etymology conversely demonstrates that the term *dividend* is associated with a specifically participating and voluntary denotation. In that sense, the negating insertion *not being debt-claims* represents the source of literal or textual interpretation and therefore the justification for

¹⁴⁶⁸ OECD, Draft Convention for the Avoidance of Double Taxation with respect to Taxes in Income and Capital, Paris, 30 July 1963.

¹⁴⁶⁹ Tischbirek, Wolfgang / Specker, Gerhard in Vogel / Lechner, p. 1217, par. 198; Klaus Vogel Commentaries 1997, p. 655, par. 198.

¹⁴⁷⁰ See par. 35.

¹⁴⁷¹ See sec. 2.2.4.

¹⁴⁷² Kopp, Karin E.M. in Wolfgang Schön, equity and debt, p. 868; Martin Six, jouissance rights, p. 111.

¹⁴⁷³ Haslechner, Werner in Klaus Vogel Commentaries 2015, p. 840, par. 101.

¹⁴⁷⁴ See par. 282.

¹⁴⁷⁵ See par. 273.

¹⁴⁷⁶ <https://en.wiktionary.org/wiki/debt> and www.etymonline.com/index.php?term=debt (last retrieved on 15 September 2017).

¹⁴⁷⁷ <https://en.wiktionary.org/wiki/claim> (last retrieved on 15 September 2017).

¹⁴⁷⁸ www.etymonline.com/index.php?term=claim (last retrieved on 15 September 2017).

¹⁴⁷⁹ See par. 53.

¹⁴⁸⁰ <https://en.wiktionary.org/wiki/interest> (last retrieved on 15 September 2017).

¹⁴⁸¹ www.etymonline.com/index.php?term=interest (last retrieved on 15 September 2017).

¹⁴⁸² <https://en.wiktionary.org/wiki/dividend> (last retrieved on 15 September 2017).

¹⁴⁸³ www.etymonline.com/index.php?term=dividend (last retrieved on 15 September 2017).

the criterion of voluntariness¹⁴⁸⁴. It excludes its logical complement of involuntariness¹⁴⁸⁵ from Art. 10(3) OECD MTC, elevating voluntariness to the status of a verifier for *dividends*¹⁴⁸⁶. In other words: voluntariness represents a sufficient maximum condition (*conditio per quam*) for constituting *dividends*, without however being necessarily the only one of that kind (no exclusivity).

3.3 Interest

3.3.1 Structure of the provision

286 Art. 11(3) OECD MTC reads 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.”

287 Like Art. 10(3) OECD MTC¹⁴⁸⁷, Art. 11(3) OECD MTC represents a “means” definition¹⁴⁸⁸ as well, and contains a casuistic list or catalogue of typical examples empirically encountered in most OECD member states¹⁴⁸⁹. Unlike limb 1 of Art. 10(3) OECD MTC¹⁴⁹⁰, the majority of commentators consider it nevertheless as exhaustive¹⁴⁹¹. Admittedly, the OECD originally considered that “in any case, the Article does not give a complete and exhaustive list of the various kinds of interest”, as “such a list might not be fully in harmony with the various States’ laws, which may differ among themselves in their interpretation of the concept of interest”¹⁴⁹². However, the only consequence drawn was that “it therefore seems preferable to include in a general formula [...]”¹⁴⁹³, which was obviously put in practice to the provision’s present shape.

¹⁴⁸⁴ See par. 188.

¹⁴⁸⁵ See par. 289.

¹⁴⁸⁶ In result equally: *Wolfgang Schön*, comparative analysis, p. 199 et seq.; *Sven-Eric Bärsch*, p. 76; *Peter Hongler*, p. 45; *Marjaana Helminen*, dividend concept, p. 166.

¹⁴⁸⁷ See par. 256.

¹⁴⁸⁸ *Hans Pijl*, hybrid debts, sec. 3.2., according to whom “only the necessary is said”; *Martin Six*, hybrid finance, sec. 3.; *Klaus Vogel* Commentaries 1997, p. 731, par. 56.

¹⁴⁸⁹ *Jakob Bundgaard*, hybrids, p. 144; *Haslehnner, Werner* in *Klaus Vogel* Commentaries 2015, p. 925, par. 87; *Pöllath, Reinhard / Lobbeck, Allit* in *Vogel / Lechner*, p. 1320, par. 60; *Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1430, par. 79; *Hans Pijl*, interest, sec. 6.1.; *Eberhartinger / Six*, p. 9; *Martin Six*, hybrid finance, sec. 3.; *Hans Pijl*, hybrid debts, sec. 3.2., according to whom the current structure of the provision appears to have its origin in being “more or less a common denominator of the existing interest definitions in tax treaties of the 1950s”; *Jakob Bundgaard*, perpetuals, p. 91.; *Achim Pross*, p. 174.

¹⁴⁹⁰ See par. 260.

¹⁴⁹¹ *Jakob Bundgaard*, hybrids, p. 144; *Helminen, Marjaana* in IBFD Commentaries on Art. 11 OECD MTC, sec. 5.1.1.1.3.; *Gaspar Lopes Dias*, debt-claims, sec. 1.3.; *Gaspar Lopes Dias*, tax arbitrage, p. 117; *Haslehnner, Werner* in *Klaus Vogel* Commentaries 2015, p. 923, par. 83; *Pöllath, Reinhard / Lobbeck, Allit* in *Vogel / Lechner*, p. 1318, par. 56, and p. 1320, par. 59a.; *Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1427, par. 71; OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-12, par. 21; *Peter Hongler*, p. 254; *Hans Pijl*, hybrid debts, sec. 2.2.2.; *Eberhartinger / Six*, p. 9; *Martin Six*, hybrid finance, sec. 3.; *Achim Pross*, p. 174; OECD, Taxation of new Financial Instruments, OECD, Paris, 1994, p. 33, par. 142; *Klaus Vogel* Commentaries 1997, p. 732, par. 59.

¹⁴⁹² OEEC (Working Party No. 11 of the Fiscal Committee), Fourth Report on the Taxation of Interest, ref. FC-WP11(61)1, Paris, 1961, p. 9 et seq.

¹⁴⁹³ OEEC (Working Party No. 11 of the Fiscal Committee), Fourth Report on the Taxation of Interest, ref. FC-WP11(61)1, Paris, 1961, p. 10.

288 The majority of commentators¹⁴⁹⁴ further take the position that the provision including the term *debt-claim*¹⁴⁹⁵ is to be interpreted autonomously. This is also supported by the fact that the original extending reference to the domestic tax law was removed in 1977¹⁴⁹⁶. Notably, this reference in the OECD MTC 1963¹⁴⁹⁷ was not the result from the conclusion that an exhaustive list or definition of *interest* was not possible¹⁴⁹⁸. Rather, it was owed to political considerations by the OEEC Fiscal Committee overruling Working Party No. 11, which had been aiming for an autonomous definition ever since¹⁴⁹⁹. Thus, it might even be suggested that the current remainder of the definition in Art. 11(3) OECD MTC has not been closed *by* the removal of that reference but was always closed from its very first introduction. In result, today's Art. 11(3) OECD MTC presents itself as a short but positive and general definition equivalent to limb 2 of Art. 10(3) OECD MTC¹⁵⁰⁰. It is subject of a closed and autonomous interpretation in its entirety, followed by a list or catalogue of typical examples equivalent to limb 1 of Art. 10(3) OECD MTC¹⁵⁰¹.

3.3.2 Debt-claims

The relevance of self-execution

289 A dissociating and involuntary denotation of both terms *debt-claims* and *interest*¹⁵⁰² was found to be suggested by their very etymology, justifying the criterion of involuntariness as the logical complement of voluntariness by way of literal or textual interpretation. The criterion of involuntariness elevates in turn to the status of a necessary minimum condition (*conditio sine qua non*) for *debt-claims* and consequently also for *interest*¹⁵⁰³. This criterion is represented by the redemption obligation¹⁵⁰⁴ (*debt-claim* test) in the sense of an absolute and unconditional¹⁵⁰⁵ legal right to be repaid. According to the view represented in this study, the material test for such formal feature is the criterion of self-execution¹⁵⁰⁶. The subsequent formal questions whether¹⁵⁰⁷

¹⁴⁹⁴ *Jakob Bundgaard*, hybrids, p. 144; *Helminen, Marjaana* in IBFD Commentaries on Art. 11 OECD MTC, sec. 5.1.1.4.5.2. and 6.2.2.; *Gaspar Lopes Dias*, debt-claims, sec. 1.3. and 2.3.; *Gaspar Lopes Dias*, tax arbitrage, p. 117 and 122; *Haslehnner, Werner* in *Klaus Vogel* Commentaries 2015, p. 923, par. 83; *Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1427, par. 71; OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-35, par. 21; *Avery Jones* Commentaries, sec. 4; *Eberhartinger / Six*, p. 9; *Martin Six*, hybrid finance, sec. 3.; *Jakob Bundgaard*, perpetuals, p. 139; German Bundesfinanzhof, judgement ref. I B 47/05, 2006; *Michael Lang*, hybrids, p. 109 and 120; OECD, Consolidated List of outstanding Points concerning the OECD Draft Convention on Income and Capital, ref. TFD/FC/218, Paris, 1967, p. 33, sec. A; contrary: *Achim Pross*, p. 175 et seqq.; Canadian Federal Court of Appeal, judgement ref. A-147-80, 1981, par. 16., in fact referring to Art. 3(2) OECD MTC without, however, providing further justification, particularly with regard to whether or not the exception rule unless the context otherwise requires may apply (see par. 14).

¹⁴⁹⁵ *Peter Hongler*, p. 57; *Febér, Tamás* in *Eva Burgstaller*, p. 247; contrary: *Michael Lang*, hybrids, p. 97 (see par. 184).

¹⁴⁹⁶ OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-35, par. 21; OEEC Fiscal Committee, Minutes of the 22nd session held at the Château de la Muette, Paris, on Tuesday 17th, Wednesday 18th, Thursday 19th and Friday 20th January 1961, ref. FC-M(61)1, Paris, 1961, p. 12; OEEC (Working Party No. 11 of the Fiscal Committee), Third Report on the Taxation of Interest, ref. FC-WP11(60)2, Paris, 1960, p. 3.

¹⁴⁹⁷ OECD, Draft Convention for the Avoidance of Double Taxation with respect to Taxes in Income and Capital, Paris, 30 July 1963.

¹⁴⁹⁸ *Hans Pijl*, hybrid debts, sec. 2.2.1. et seq. and 3.3.

¹⁴⁹⁹ *Fuentes Hernandez, Daniel* in *Thomas Ecker*, p. 462.

¹⁵⁰⁰ See par. 257 et seq.

¹⁵⁰¹ See par. 260.

¹⁵⁰² See par. 285.

¹⁵⁰³ *Argumentum e contrario*.

¹⁵⁰⁴ *Jakob Bundgaard*, hybrids, p. 144 et seq.; *Sven-Eric Bärsch*, p. 76; *Peter Hongler*, p. 45 et seqq.; *Marjaana Helminen*, dividend concept, p. 166; See also par. 241.

¹⁵⁰⁵ *Haslehnner, Werner* in *Klaus Vogel* Commentaries 2015, p. 924, par. 84; *Sven-Eric Bärsch*, p. 106; *Carmine Rotondaro*, redemption, p. 264 et seqq.; contrary: *Gaspar Lopes Dias*, tax arbitrage, p. 130, mixing legal and business risk by saying that "there is no such thing as an 'absolute and unconditional' right to repayment that admits the possibility of total loss" (see par. 231). See also par. 235(1) and 237(1).

¹⁵⁰⁶ Similarly: *William Plumb*, p. 431.

¹⁵⁰⁷ *Jakob Bundgaard*, hybrids, p. 144; *Gaspar Lopes Dias*, debt-claims, sec. 2.3. and 3.3.; *Gaspar Lopes Dias*, tax arbitrage, p. 117, 122 and 130; *Haslehnner, Werner* in *Klaus Vogel* Commentaries 2015, p. 923, par. 84; *Kuhn / Hachmeister*, p. 12, par. 61; *Kopp, Karin E.M.* in *Wolfgang*

or not¹⁵⁰⁸ a legal enforceability is required to constitute a redemption obligation and whether such legal enforceability had to be determined pursuant to domestic tax law¹⁵⁰⁹, are therefore not relevant for the further course of this analysis.

- 290 In contrast to the context of Art. 10(3) OECD MTC¹⁵¹⁰, in the context of Art. 11(3) OECD MTC self-execution includes also the participation in profits. In other words: income from *debt-claims* can only be *interest* where also a participation in profits is self-executing. On the one hand, profit and loss is basically a resultative and therefore binary concept¹⁵¹¹, being formally determined by domestic law¹⁵¹². Its aspect of quantitative proximity and characteristics must be (re-)interpreted as a multi-static array of unlimited forms or states in the sense of a flexible or fluid “more or less” spectrum to make it meaningful and significant for treaty purposes¹⁵¹³. On the contrary, its qualitative aspect of obtaining the genuine power to decide whether or not there shall be distribution (voluntariness) must necessarily remain an absolute and binary criterion of “yes or no”¹⁵¹⁴. In other words: any profit and loss equivalent¹⁵¹⁵ above the “total profits line” cannot possibly be featured with genuine corporate voluntariness. In contrast, any true participation in the genuine profits and losses below the “total profits line” is entitled to the legal shareholders only. Any further transfer of these formally determined profits and losses is necessarily a different legal relationship between these shareholders and third parties (e.g. sub-participation). As such, it is outside the company’s or entity’s sphere and consequently out of scope for potential (“hybrid”) financial instruments. On the other hand, any other conclusion would again mean letting Art. 11(3) OECD MTC fall short entirely. In fact, such result would not only ignore the term *interest*. It would also lead to the self-contradiction that the voluntariness in the attribute *participating in profits* would actually negate its previous term *debt-claims* instead of extending it. In result, the attribute *participating in profits* not only has a different legal quality¹⁵¹⁶ and a different legal consequence¹⁵¹⁷; it also has a different legal meaning within Art. 11(3) OECD MTC in the sense of self-executive, as compared to Art. 10(3) OECD MTC in the sense of voluntary.
- 291 Nevertheless, this aspect appears to be of minor practical relevance. A rational investor in a financial instrument with redemption obligation¹⁵¹⁸ will not accept an arrangement that puts the remuneration at the discretion of the debtor. The reason is that the redemption obligation is an expression of a subjacent conflict of interests between the two contracting parties¹⁵¹⁹, which does not only refer to the capital or principal but naturally also to the remuneration. In other words: as much as *interest* and its principal are payments to “someone else” and

Schön, equity and debt, p. 870; *Febér, Tamás* in *Eva Burgstaller*, p. 245; *David Hariton*, equity and debt, p. 523; *Michael Lang*, hybrids, p. 96.

¹⁵⁰⁸ *Kemmeren, Eric C.C.M.* in *Klaus Vogel Commentaries* 2015, p. 712, par. 11.

¹⁵⁰⁹ *Gaspar Lopes Dias*, debt-claims, sec. 2.3. and 3.3.; *Jakob Bundgaard*, perpetuities, p. 140.

¹⁵¹⁰ See par. 285.

¹⁵¹¹ See par. 204.

¹⁵¹² See par. 246.

¹⁵¹³ See par. 207.

¹⁵¹⁴ See par. 219.

¹⁵¹⁵ See par. 202 et seq.

¹⁵¹⁶ See par. 273.

¹⁵¹⁷ See par. 280.

¹⁵¹⁸ See par. 289.

¹⁵¹⁹ See par. 192.

therefore involuntary, *dividends* and their equity are payments to “oneself” and therefore voluntary.¹⁵²⁰ Whether or not an involuntary remuneration depends on further objective circumstances or resolute conditions¹⁵²¹ is merely a subsequent question towards the time value of money¹⁵²², but not backwards to a classification as a *dividend* pursuant to Art. 10(3) OECD MTC. That is why voluntariness represents a verifier for *dividends*¹⁵²³, whereas involuntariness is not in turn a verifier for *interest*.

The limitations of debt-claims

- 292 Pursuant to the IAS/IFRS understanding and rationale, the obligatory character does not only include certain redemptions¹⁵²⁴ but also repurchase obligations¹⁵²⁵ (*substance over form*). On the one hand, this view conflicts with the finding¹⁵²⁶ that disaggregation as a material aspect of substance is necessarily subsidiary to the formal redemption obligation requirement (form over substance). This was a consequence from the position that the existence of financial instruments must predominantly be a matter of the legal form¹⁵²⁷. On the other hand, it also conflicts with the finding¹⁵²⁸ that aggregation is subject to particularly strict requirements, justifying to go beyond the literal or textual interpretation only as an absolute exception. Any consolidation of an asset or transaction upwards from its legal form was said not to be justifiable by the *substance over form* principle. In other words: the literal and textual interpretation of the term *debt-claim* does not allow disaggregation in the broader sense¹⁵²⁹. Accordingly, the law application by way of aggregation in the narrow sense does not allow the consolidation of the resale and the repurchase either. Hence, the term *debt-claim* does not cover repurchase obligations¹⁵³⁰ (e.g. „wash sales“¹⁵³¹, Islamic finance¹⁵³², etc.). This view is supported by the fact that the UN Commentaries on Art. 11(3) UN MTC refer to the OECD Commentaries on Art. 11(3) OECD MTC only as a basic principle¹⁵³³. As an exception, they provide, however, the explicit addition of “certain non-traditional financial arrangements [...] assimilated to debt relations under domestic tax law [...]”¹⁵³⁴, “[...] for instance, to Islamic financial instruments where the economic reality of the contract underlying the instrument is a loan”¹⁵³⁵. In that, the term *interest* employed by Art. 11(3) UN MTC is actually broader

¹⁵²⁰ See par. 285.

¹⁵²¹ See par. 193.

¹⁵²² See par. 213.

¹⁵²³ See par. 285.

¹⁵²⁴ See par. 236.

¹⁵²⁵ IFRS 9.B3.2.16(a) – (d). See also par. 235(1) and 237(1).

¹⁵²⁶ See par. 241 and 282.

¹⁵²⁷ See par. 77.

¹⁵²⁸ See par. 95.

¹⁵²⁹ See Illustration 3 on p. 43.

¹⁵³⁰ Equally: *Hans Pijl*, hybrid debts, sec. 4.8.

¹⁵³¹ IFRS 9.B3.2.16(e).

¹⁵³² *Nethercott, Craig R. / Eisenberg, David M.*, Islamic Finance: Law and Practice, Oxford University Press, Oxford, 2012, sec. 6 et seqq; *Joseph, Anton*, Islamic Finance, Derivatives & Financial Instruments 2010, Vol. 12, No. 1, sec. 2 et seq.; UN Committee of Experts on International Cooperation in Tax Matters, Treatment of Islamic financial instruments under the United Nations Model Double Taxation Convention between Developed and Developing Countries – Note by the Working Group on Treatment of Islamic Financial Instruments (third Session in Geneva from 29 October – 2 November 2007), ref. E/C.18/2007/9, UN Economic and Social Council, Geneva, 2007.

¹⁵³³ See par. 36.

¹⁵³⁴ UN Commentaries on Art. 11 UN MTC, p. 192, par. 1, and p. 200, par. 19.

¹⁵³⁵ UN Commentaries on Art. 11 UN MTC, p. 192, par. 1, and p. 200, par. 19.1.

by incorporating domestic concepts as well. In contrast, Art. 11(3) OECD MTC employs an integrated and cohesive term which is exclusively to be interpreted autonomously¹⁵³⁶.

The relevance of risk

- 293 There is broad consensus that income from *debt-claims* bearing business risk is not *interest*¹⁵³⁷ and that remuneration risk alone is not considered business risk¹⁵³⁸. Business risk is basically understood in a broader sense here, being also represented by and contained within the participation in profits and losses¹⁵³⁹. However, the consensus view is supported by the above conclusions that the participation in profits and losses – including the business risk contained therein – can itself not serve as a differentiator for the distinction between Art. 10(3) and 11(3) OECD MTC¹⁵⁴⁰. In other words: where the remuneration cannot contribute to the debt-equity distinction, this must also be true for the remuneration risk. Instead, business risk was found to be the key differentiator only in its form of termination risk¹⁵⁴¹. Correspondingly, the red line in the sense of a falsifier for *debt-claims* pursuant to Art. 11(3) OECD MTC is where the creditor starts to participate in the business opportunities by way of liquidation proceeds (i.e. goodwill) or hidden reserves¹⁵⁴². This view is supported by the fact that Art. 11(3) OECD MTC, although applying the asset-based approach¹⁵⁴³, only mentions the participation *in profits*. This can in turn be interpreted in the sense that a participation in risks and chances (i.e. termination risk) is not part of the extended definition of the term *debt-claims*¹⁵⁴⁴. However, the economic participation in business risk by means of credit risk alone¹⁵⁴⁵ is considered not to be sufficient for bearing business risk¹⁵⁴⁶. This is in line with the understanding that credit risk as a legal risk must necessarily be subject of form over substance¹⁵⁴⁷. Or, as it has been accurately formulated: “Nevertheless, while the distinction between risk capital and a risky loan is an ‘elusive categorization,’ it is one which the law requires to be made.”¹⁵⁴⁸

The relevance of a remuneration

- 294 In order to qualify as *interest*, the literature suggests
(1) a remuneration¹⁵⁴⁹

¹⁵³⁶ See par. 287.

¹⁵³⁷ OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)–11, par. 19; *Jakob Bundgaard*, *perpetuals*, p. 139; *Giuliani, Federico Maria*, Article 10(3) of the OECD Model and Borderline Cases of Corporate Distributions, *Bulletin for International Taxation* 2002, Vol. 56, No. 1, p. 14; *Klaus Vogel* Commentaries 1997, p. 733, par. 60.

¹⁵³⁸ *Jakob Bundgaard*, *hybrids*, p. 147; *Gaspar Lopes Dias*, *debt-claims*, sec. 2.3.; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1428, par. 73; *Jakob Bundgaard*, *perpetuals*, p. 139; *Carmine Rotondaro*, *redemption*, p. 264; *Klaus Vogel* Commentaries 1997, p. 733, par. 60; *William Plumb*, p. 432.

¹⁵³⁹ See par. 279.

¹⁵⁴⁰ See par. 280.

¹⁵⁴¹ See par. 282.

¹⁵⁴² *Pöllath, Reinhard / Lobbeck, Allit* in *Vogel / Lehner*, p. 1321, par. 62; *Klaus Vogel* Commentaries 1997, p. 734, par. 61.

¹⁵⁴³ See par. 58.

¹⁵⁴⁴ *Argumentum e contrario*.

¹⁵⁴⁵ *William Plumb*, p. 505 et seq. and 526. See also par. 202 et seq.

¹⁵⁴⁶ *Gaspar Lopes Dias*, *debt-claims*, sec. 2.3.; *Gaspar Lopes Dias*, *tax arbitrage*, p. 125; *Haslechner, Werner* in *Klaus Vogel* Commentaries 2015, p. 927, par. 91; *Jakob Bundgaard*, *perpetuals*, p. 139; *Marjaana Helminen*, *classification*, p. 59; *Marjaana Helminen*, *dividend concept*, p. 178; *Michael Lang*, *hybrids*, p. 128; *Klaus Vogel* Commentaries 1997, p. 733, par. 60.

¹⁵⁴⁷ See par. 101(1).

¹⁵⁴⁸ *William Plumb*, p. 505.

¹⁵⁴⁹ *Gaspar Lopes Dias*, *debt-claims*, sec. 1.3.; *Achim Pross*, p. 131.

- (2) for the temporary¹⁵⁵⁰ provision of capital as principal¹⁵⁵¹ in the sense of an economical¹⁵⁵² transfer of such capital at the disposal of the debtor,
- (3) based on a nominal value¹⁵⁵³.

295 From the author's point of view, the first aspect (1) is redundant. On the one hand, the attribute is already covered by that of the *income*. This *income* is also the trigger for activating Art. 11(3) OECD MTC at all, so that there appears to be no need for another synonymous criterion. On the other hand, anything else would not be reasonable and would give rise to considerable systematic distortions. In case the remuneration were to be interpreted domestically, this would conflict with the autonomous interpretation of Art. 10(3) OECD MTC. In case the remuneration were to be interpreted autonomously, this would conflict with the domestic interpretation of the term *income*¹⁵⁵⁴. But even if the remuneration was meant in the sense of mere potential income, the principal necessity and feasibility of classifying financial instruments into the distributive articles of the OECD MTC is independent of the amounts actually paid and consequently from any *income* at all¹⁵⁵⁵. In other words: a time value of money in the amount of zero makes a capital provision not less a *debt-claim* (e.g. zero-interest bond)¹⁵⁵⁶. Consequently, the classification as a *debt-claim* is independent of whether its remuneration is fixed or floating¹⁵⁵⁷. In addition, variable¹⁵⁵⁸ and/or irregular¹⁵⁵⁹ payment profiles were not necessarily found to be in conflict with the time value of money either. And lastly, the extended definition of *debt-claims* in Art. 11(3) OECD MTC by the attribute *whether or not carrying a right to participate in the debtor's profits* must cover all amount modifications admissible for *shares* pursuant to Art. 10(3) OECD MTC¹⁵⁶⁰ in order to ensure systematically equivalent results¹⁵⁶¹. Importantly, this should, however, not be understood to mean that the remuneration was generally irrelevant for the classification of financial instruments. It only means that it is already covered by the existing *income* criterion. Consequently, it is in fact this actual *income* once having been *paid* which is eventually subject of such classification. The expectable income¹⁵⁶² during the financial instrument's remaining lifetime serves merely as an ancillary consideration¹⁵⁶³.

¹⁵⁵⁰ *Gaspar Lopes Dias*, debt-claims, sec. 2.3; *Gaspar Lopes Dias*, tax arbitrage, p. 122; *Haslehnner, Werner* in *Klaus Vogel Commentaries* 2015, p. 924, par. 85; *Pöllath, Reinhard / Lobbeck, Allit* in *Vogel / Lehner*, p. 1318, par. 56; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1431, par. 79; *Kopp, Karin E.M.* in *Wolfgang Schön*, equity and debt, p. 846; *Carmine Rotondaro*, redemption, p. 265; *Achim Pross*, p. 131.

¹⁵⁵¹ *Jakob Bundgaard*, hybrids, p. 145; *Gaspar Lopes Dias*, debt-claims, sec. 1.3.; *Pöllath, Reinhard / Lobbeck, Allit* in *Vogel / Lehner*, p. 1291, par. 56; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1431, par. 79; *Achim Pross*, p. 130; *Arnold, Brian J.*, Deductibility of Interest and other financing Charges in computing Income – General Report, Series IFA Cahiers 1994, Vol. 79a, International Fiscal Association, Rotterdam, 1994, p. 497.

¹⁵⁵² *Michael Lang*, hybrids, p. 96 et seq.

¹⁵⁵³ *Gaspar Lopes Dias*, debt-claims, sec. 1.3.; *Gaspar Lopes Dias*, tax arbitrage, p. 123; *Michael Lang*, hybrids, p. 129.

¹⁵⁵⁴ See par. 144.

¹⁵⁵⁵ See par. 201.

¹⁵⁵⁶ See par. 103 and 215.

¹⁵⁵⁷ *Helminen, Marjaana* in *IBFD Commentaries on Art. 11 OECD MTC*, sec. 5.1.1.3.1.; *Gaspar Lopes Dias*, tax arbitrage, p. 124; *Hans Pijl*, interest, sec. 6.1.; *Hans Pijl*, hybrid debts, sec. 3.2; *Febér, Tamás* in *Eva Burgstaller*, p. 245.

¹⁵⁵⁸ See par. 208 and Example 33 on p. 123.

¹⁵⁵⁹ See par. 211 et seq.

¹⁵⁶⁰ See par. 274 et seqq.

¹⁵⁶¹ See par. 113(1).

¹⁵⁶² See par. 278.

¹⁵⁶³ See par. 214.

The relevance of a temporary provision of capital

- 296 As regards the second aspect (2)¹⁵⁶⁴, the author basically shares the principal view that financial instruments can be considered *debt-claims* only if they represent ex ante a temporarily limited provision of capital. This is an expression of the redemption obligation requirement¹⁵⁶⁵ and the concept of time value of money¹⁵⁶⁶ under the dynamic forward-looking view¹⁵⁶⁷, meaning only redemptions prior to the issuer's liquidation¹⁵⁶⁸. However, this may not lead to the conclusion that there was any absolute temporal concept such as a fixed deadline. The absence of a duration or maturity was principally found incapable of being a differentiator¹⁵⁶⁹. In addition, the duration of legal time periods can only be reduced by way of economic interpretation but not extended¹⁵⁷⁰. Instead, the specific temporal concept of duration or maturity of the principal should rather be understood relatively by that of remuneration. Following the systematic interpretation of time aspects in general, it means the point in time in which the right on the return of the principal mathematically starts to account for less than the right on the remuneration.

Example 45: A zero-interest bond never amortises and therefore must basically be considered long-term. Where such economically interpreted duration or maturity (i.e. ∞) is, however, longer than its legal one (e.g. 1 year), it cannot be extended. The final interpretation result in this example is therefore 1 year.

A high-yield bond (e.g. 10% per annum) amortises quickly and therefore must basically be considered short-term. Where such economically interpreted duration or maturity (i.e. 7 years¹⁵⁷¹) is, however, shorter than its legal one (e.g. 10 years), it is reduced. The final interpretation result in this example is therefore 7 years.

- 297 The transfer of the capital as principal at the disposal of the debtor¹⁵⁷² may not be a mere economic one but must necessarily be a legal one in order to trigger Art. 11(3) OECD MTC¹⁵⁷³. On the one hand, matters of attribution and ownership other than *beneficial ownership* were found inaccessible to the treaty principle of *substance over form* but must rather follow the legal form (i.e. form over substance).¹⁵⁷⁴ This was a result from the systematic considerations that there cannot possibly be such a thing as “economic ownership” in Art. 11(3) OECD MTC. Accordingly, the capital or principal cannot be transferred from its mere *beneficial owner* to the debtor in order to trigger Art. 11(3) OECD MTC either, since *beneficial ownership* is the legal consequence of the provision and therefore cannot simultaneously be its precondition¹⁵⁷⁵. On the other hand, the asset (i.e. the *debt-claim*) is basically the result of the transaction (i.e. the transfer of the capital as principal) and not

¹⁵⁶⁴ See par. 294(2).

¹⁵⁶⁵ See par. 289.

¹⁵⁶⁶ See par. 103, 215 and 231.

¹⁵⁶⁷ See par. 213(3) and 214.

¹⁵⁶⁸ Equally: *Marjaana Helminen*, dividend concept, p. 166. See also par. 242(3).

¹⁵⁶⁹ See par. 199.

¹⁵⁷⁰ See par. 197 et seq.

¹⁵⁷¹ See Example 29 on p. 117.

¹⁵⁷² See par. 99.

¹⁵⁷³ Equally: *Jakob Bundgaard*, hybrids, p. 151; *Achim Pross*, p. 176; contrary: *Michael Lang*, hybrids, p. 96 et seq. (see par. 184).

¹⁵⁷⁴ See par. 187.

¹⁵⁷⁵ See par. 124.

vice versa¹⁵⁷⁶. The consequent domestic interpretation of both the transfer of the capital or principal as such and its subsequent attribution gives rise to potential qualification conflicts¹⁵⁷⁷. This result applies regardless of the admissible forms of transferable capital or principal (e.g. where capital or principal is a *debt-claim* itself, i.e. securities lending)¹⁵⁷⁸. This is because Art. 11(3) OECD MTC is not interpreted iteratively by referring back to its own legal consequences¹⁵⁷⁹. Instead, it must necessarily assess its legal requirements and conditions autonomously and independently from the same starting point, regardless of whether or not some attributes are themselves subject of a treaty. Otherwise such a classification chain could establish triangular relationships.

The relevance of a nominal value

- 298 As regards the third aspect (3)¹⁵⁸⁰, the nominal value is the legal value formally represented by a financial instrument. Financial instruments are typically, but not necessarily, featured with an ex-ante determinable, nominal value in order to make them self-executive¹⁵⁸¹. For debts, the nominal value usually, but not necessarily, represents their principal or redemption value. This redemption value can however be understood in a narrow sense of a fixed absolute face amount with a currency unit, or alternatively in a broad sense of any specified capital transferred for lending. The distinction between these two is fluid, as the examples of pool factor bonds, percentage- or yield-traded bonds or bonds in non-deliverable currencies demonstrate. On the one hand, the criterion of a nominal value appears to be merely a formal one, especially since the redemption value can principally differ from the nominal value¹⁵⁸². On the other hand, the concept of nominal value even in its broadest understanding represents a kind of logical link between the receive leg of what the creditor transfers to the debtor for lending and the pay leg of what the debtor owes in return to the creditor as the repayment. In contrast, where there is no such link (e.g. a tracker certificate¹⁵⁸³) there can by definition not possibly be any provision of capital¹⁵⁸⁴. This view is supported by the fact that *penalty charges*, which do not compensate capital provisions, are consequently not regarded as *interest* pursuant to Art. 11(3) OECD¹⁵⁸⁵.
- 299 This understanding of the nominal value requirement further supports the finding¹⁵⁸⁶ that a mere notional or floating principal is a falsifier for *debt-claims*¹⁵⁸⁷ but might rather be one indicator or even verifier for *other income*. In other words: the criterion of a nominal value abstractly implies and demonstrates a certain determination and fixation of the redemption value. In the most ambiguous class of equity “derivatives”¹⁵⁸⁸, this fixation leads in fact to the leg modes. True, the *fixed-for-fixed* and the *fixed-for-variable conditions*

¹⁵⁷⁶ See par. 52.

¹⁵⁷⁷ Equally: *Achim Pross*, p. 177 et seq. See also par. 117.

¹⁵⁷⁸ As will be discussed later (see par. 300 et seq.).

¹⁵⁷⁹ Circular reasoning.

¹⁵⁸⁰ See par. 294(3).

¹⁵⁸¹ See par. 189.

¹⁵⁸² See Example 46 on p. 181.

¹⁵⁸³ See Example 33 on p. 124.

¹⁵⁸⁴ See par. 294(2).

¹⁵⁸⁵ See Example 9 on p. 49.

¹⁵⁸⁶ See par. 106(3).

¹⁵⁸⁷ Equally: *Jakob Bundgaard*, hybrids, p. 145; *Gaspar Lopes Dias*, debt-claims, sec. 1.3.; *Pöllath, Reinhard / Lobbeck, Allit in Vogel / Lehner*, p. 1326, par. 74; OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-13, par. 21.1; OECD, *Taxation of new Financial Instruments*, OECD, Paris, 1994, p. 35, par. 158.

¹⁵⁸⁸ See par. 236.

are contrary in terms of transferring the issuer's or debtor's economic resources¹⁵⁸⁹ and thus business risk. However, both conditions always have a nominal value. Under the *fixed-for-fixed condition*, the repayment value the debtor owes to the creditor (pay leg) is fixed and therefore directly linked to what the creditor had previously transferred to the debtor for lending (receive leg). Under the *fixed-for-variable condition* the pay leg is variable, but nevertheless equal to the same value and therefore is indirectly linked to the receive leg. In contrast, under the *variable-for-fixed condition* the receive leg and the pay leg are typically self-executive by way of a mathematical formula¹⁵⁹⁰, but neither directly nor indirectly linked to each other. That this relation is actually floating is the very reason why such financial instruments bear termination risk¹⁵⁹¹. For these reasons, the author agrees to the formal criterion of a nominal value. As a conclusion for the further course of this study, this nominal value is, however, understood in the broad sense of any capital specified for repayment, which is either directly linked or at least equal to the same value and therefore is indirectly linked to what the creditor transfers to the debtor for lending. From the systematical point of view, the formal criterion of a legal nominal value is nevertheless included or covered and therefore should preferably be replaced by the material differentiator of termination risk.

3.3.3 Of every kind

Non-cash obligations

300 Pursuant to the OECD Commentaries, *interest* “is generally taken to mean remuneration on money lent”¹⁵⁹² in that “the term ‘debt-claims of every kind’ obviously embraces cash deposits and security in the form of money”¹⁵⁹³. Most commentators refer to these phrases, leaving however open whether the meaning of the word *debt-claim* is actually limited to cash obligations only¹⁵⁹⁴ or also includes non-cash obligations. At first glance, the scope of application and therefore the relevance of that question appears to be limited. In fact, many similar legal transactions fall under other distributive articles of the OECD MTC¹⁵⁹⁵ (e.g. rentals, royalties, instalment payments, leases, guarantees, etc.). Nevertheless, the issue gains in importance considering that many classes of financial instruments (e.g. convertibles, payment-in-kind bonds, securities lending, swaps, etc.) are effectively featured with alternative redemption or termination rights (e.g. physically, conversion, etc.). This raises at least the question as to whether Art. 11(3) OECD MTC requires a cash obligation or a cash redemption or even both. According to the author's point of view, the meaning of the word *debt-claim* is not limited to cash but also includes non-cash obligations¹⁵⁹⁶. This is the result from the following considerations:

301 On the one hand, the express wording of Art. 11(3) OECD MTC demands a broad interpretation of the term *debt-claims*¹⁵⁹⁷, comprehensively encompassing those of *every kind*. Also the clear and explicit wording of those

¹⁵⁸⁹ See par. 238(2).

¹⁵⁹⁰ *Marjaana Helminen*, dividend concept, p. 166.

¹⁵⁹¹ See par. 242(2) and 293.

¹⁵⁹² OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-1, par. 1.

¹⁵⁹³ OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-11, par. 18.

¹⁵⁹⁴ *Pöllath, Reinhard / Lobbeck, Allit in Vogel / Lehner*, p. 1318, par. 56.

¹⁵⁹⁵ *Klaus Vogel* Commentaries 1997, p. 738, par. 67, and p. 739, par. 68.

¹⁵⁹⁶ Contrary: *Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1440, par. 91, without justification.

¹⁵⁹⁷ *Jakob Bundgaard*, hybrids, p. 144; *Helminen, Marjaana* in IBFD Commentaries on Art. 11 OECD MTC, sec. 5.1.1.3.1.; *Haslechner, Werner* in *Klaus Vogel* Commentaries 2015, p. 923, par. 84; *Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1430, par. 79; *Kopp, Karin*

aforementioned phrases in the OECD Commentaries¹⁵⁹⁸ does not justify a more restrictive understanding. They are rooted in OEEC Working Party No. 11, according to which “in general meaning of the term ‘interest’ it is proper to include remuneration on money lent”¹⁵⁹⁹, making its non-exclusive denotation even more evident. On the other hand, any limitation to cash obligations would actually require a distinction between cash and non-cash capital. This would, however, lead to the circular reasoning that *debt-claims* as the most proximate equivalent to cash (e.g. demand deposits, short-term call money, debit or credit cards, complementary currencies, etc.) are themselves the legal consequence of Art. 11(3) OECD MTC. Therefore, they cannot simultaneously be a precondition for their application. The reason for this natural similarity of cash and debt is that any currency is itself a claim against its issuing central bank. As was stated, Art. 11(3) OECD MTC is not interpreted iteratively by referring back to its own legal consequences¹⁶⁰⁰. In addition, any ring-fencing of financial instruments, except where expressly or systematically required, is unpurposeful¹⁶⁰¹ and methodologically flawed¹⁶⁰². This becomes even more evident when considering that such ring-fencing is dispensable for the systematical and interpretational definition and delimitation of the term *debt-claims*¹⁶⁰³ and that financial instruments transfers are per se homogeneous and liquid forms of capital and therefore cash-equivalents¹⁶⁰⁴. That is why neither the literal or textual interpretation of the term *debt-claims*¹⁶⁰⁵ nor its key characteristics of risk¹⁶⁰⁶ and redemption obligation¹⁶⁰⁷ are qualitatively affected by the mere formal question of what its form of transferable capital is. Notably, this aspect (A) is independent and therefore must be carefully distinguished from the close and likewise formal but quantitative aspects of whether or not the financial instrument indexes any *debt-claim* as its underlying (B) and is covered and/or collateralised by its underlying¹⁶⁰⁸ (C). This is made clear by the fact that both cash and non-cash obligations (A) can each index or not index a *debt-claim* as their underlying (B) but can be covered/collateralised by something different (C).

Example 46: A certificate might index the price of gold (B) but be redeemed by the physical delivery of an equivalent amount of silver (A), while being partially covered/collateralised by platinum (C).

Instead, non-cash obligations were found not to be per se a falsifier for *debt-claims*, which can principally be established also by way of transferring cash-equivalents¹⁶⁰⁹.

E.M. in Wolfgang Schön, equity and debt, p. 858; *Jakob Bundgaard*, perpetuals, p. 140.; OECD, Report on Thin Capitalization, Issues in International Taxation 1987, No. 2, p. 24, par. 57 et seq.

¹⁵⁹⁸ See par. 300.

¹⁵⁹⁹ OEEC (Working Party No. 11 of the Fiscal Committee), Report on the Taxation of Interest, ref. FC-WP11(59)1, Paris, 1959, p. 1.

¹⁶⁰⁰ See par. 297.

¹⁶⁰¹ See par. 98(1).

¹⁶⁰² See par. 87.

¹⁶⁰³ See par. 242(1).

¹⁶⁰⁴ See Example 23 on p. 107.

¹⁶⁰⁵ See par. 285.

¹⁶⁰⁶ See par. 293.

¹⁶⁰⁷ See par. 289.

¹⁶⁰⁸ See par. 223, 225(1) and 226.

¹⁶⁰⁹ See par. 233.

The relevance of the origin of funds

- 302 Not essential for the classification as a *debt-claim* are the capital's or principal's origins or sources¹⁶¹⁰. This is a consequence from the systematic finding that the determination of these sources bears a comprehensive and inextricable nexus with that of the *income*, being entirely subject of the domestic interpretation¹⁶¹¹. Admittedly, repayments of debt capital were basically found incapable of being *interest* pursuant to Art. 11(3) OECD MTC¹⁶¹². This is owed to the fact that debt capital is basically not funded by business profits¹⁶¹³. However, this basic principal is explicitly repealed by the extended definition of *debt-claims* in Art. 11(3) OECD MTC by the attribute *whether or not carrying a right to participate in the debtor's profits*. In other words: just like equity capital, debt capital may participate in profits. In that sense it shares its fate of likewise bearing an inter-temporal nexus and therefore being inextricably "infected" with the business profits. In fact, debt capital is the formal result of the domestic law of tax accounting and as such of the peculiarities of the source jurisdiction's domestic tax law system. This is even more apparent, where the financial instrument is also featured with a self-executive profit accumulation, putting it in the same dynamic context of more than one period (e.g. tracker certificate without periodic coupons).

The relevance of coverage and collateral

- 303 It has further been suggested that the question whether financial instruments are collateralised was irrelevant for their classification as a *debt-claim* pursuant to Art. 11(3) OECD MTC¹⁶¹⁴. On the one hand, this view is in line with the findings that collateral is typically not required to legally constitute a *debt-claim*¹⁶¹⁵ but rather a response to it, and that, even if it was, it is not reliably capable of positively verifying credit risk¹⁶¹⁶. On the other hand, due to the economic substitutability between coverage and collateral, the latter was found capable of negatively falsifying credit risk¹⁶¹⁷. The predominant reason was that only uncovered debts bear the credit risk in the debtor's real and true ability to recover the capital or principal. In contrast, covered debts rather bear the underwriting risk of ownership in the capital or principal itself, which the creditor had also to take without having left it to the debtor¹⁶¹⁸.

Example 47: A depository receipt (also referred to as "certificate of deposit") is a certificate representing ownership rights of an underlying number of *shares*. A fully covered delta-one payment-in-kind certificate on one *share* is a contractual agreement to be redeemed in the one *share*¹⁶¹⁹. A fully covered (e.g. commodity-backed) payment-in-kind bond on precious metal is a contractual agreement to be redeemed in that precious metal¹⁶²⁰.

¹⁶¹⁰ Helminen, Marjaana in IBFD Commentaries on Art. 11 OECD MTC, sec. 5.1.1.3.1.; Pöllath, Reinhard/Lobbeck, Allit in Vogel/Lehner, p. 1320, par. 59b; Haslehner, Werner in Klaus Vogel Commentaries 2015, p. 923, par. 84.

¹⁶¹¹ See par. 251.

¹⁶¹² See par. 252.

¹⁶¹³ See par. 250.

¹⁶¹⁴ Gaspar Lopes Dias, debt-claims, sec. 2.3.; Gaspar Lopes Dias, tax arbitrage, p. 124; Haslehner, Werner in Klaus Vogel Commentaries 2015, p. 923, par. 84; Pöllath, Reinhard/Lobbeck, Allit in Vogel/Lehner, p. 1318, par. 56; OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-11, par. 18; Kopp, Karin E.M. in Wolfgang Schön, equity and debt, p. 858; Fehér, Tamás in Eva Burgstaller, p. 245.

¹⁶¹⁵ See par. 222, 292 and 297.

¹⁶¹⁶ See par. 223.

¹⁶¹⁷ See par. 229.

¹⁶¹⁸ See par. 224.

¹⁶¹⁹ See Example 41 on p. 136.

¹⁶²⁰ See Example 46 on p. 181.

It is therefore important to hold that the classification of financial instruments as a *debt-claim* pursuant to Art. 11(3) OECD MTC, while indeed being independent of collateralisation, may however depend on coverage. This is a conclusion from the approach of indirectly identifying counterparty risk by way of coverage (i.e. underwriting risk) rather than by collateral (i.e. credit risk). Nevertheless, it should in result not impact the concurring understanding and technique of treaty interpretation and application. The mere absence of credit risk as a constituent element of *debt-claims*¹⁶²¹ does not necessarily mean that there was no counterparty risk at all¹⁶²². Rather, it may actually represent a “managed” or “engineered” zero risk¹⁶²³. In other words: not the absence of credit risk alone but only full coverage is capable of effectively falsifying counterparty risk¹⁶²⁴. Its determination is merely shifted from the first methodological step of eliminating the legal credit risk to the subsequent methodological steps of successively disaggregating the underwriting risk¹⁶²⁵. As a conclusion for the further course of this study, fully covered obligatory financial instruments are not considered *debt-claims* but must instead be classified according to their underlying’s quality.

The relevance of other aspects

- 304 Lastly the purpose of a *debt-claim* and whether or not it is securitised¹⁶²⁶ or subordinated¹⁶²⁷ is not relevant for its classification as a *debt-claim*. As regards the securitisation, this view is analogous to limb 2 of Art. 10(3) OECD MTC¹⁶²⁸. Otherwise the system of Art. 10(3) and 11(3) OECD MTC was not consistent and coherent, in that their autonomous parts led to systematically equivalent results¹⁶²⁹. As regards the subordination, this position is a result from the finding that it is systematically not capable of being an autonomous differentiator. Instead, it was found to be interpreted formally and therefore pursuant to the domestic tax law¹⁶³⁰.
- 305 Also not relevant for the classification as *interest* is the aspect whether or not the amounts *paid* are admissible for being deducted from the debtor’s tax base, or have effectively been so deducted. “Interest does not suffer economic double taxation, i.e. it is not taxed both in the hands of the debtor and in the hands of the creditor”¹⁶³¹. However, this is exclusively governed by domestic tax law and therefore incapable of contributing anything to its autonomous interpretation and meaning¹⁶³². In addition, it would principally lead to the circular reasoning of being vice versa the result of such classification¹⁶³³. This becomes even more evident when considering the

¹⁶²¹ See par. 101(1).

¹⁶²² See par. 223.

¹⁶²³ See par. 101(2).

¹⁶²⁴ See par. 222 et seq.

¹⁶²⁵ See par. 101(3).

¹⁶²⁶ *Helminen, Marjaana* in IBFD Commentaries on Art. 11 OECD MTC, sec. 5.1.1.3.1.; *Gaspar Lopes Dias*, tax arbitrage, p. 124; *Hans Pijl*, hybrid debts, sec. 4.9., arguing that the (securitised) assets mentioned in par. 18 and 20 of the OECD Commentaries 2014 on Art. 11 OECD MTC are only examples of the main requirement of debt-claims of every kind.

¹⁶²⁷ *Gaspar Lopes Dias*, debt-claims, sec. 2.3.; *Haslebnér, Werner* in *Klaus Vogel* Commentaries 2015, p. 923, par. 84; *Marjaana Helminen*, dividend concept, p. 197 et seq.; *Fehér, Tamás* in *Eva Burgstaller*, p. 245.

¹⁶²⁸ See par. 284.

¹⁶²⁹ See par. 113(1).

¹⁶³⁰ See par. 220 et seq.

¹⁶³¹ OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-1, par. 1; similarly: *Tischbirek, Wolfgang / Specker, Gerhard* in *Vogel / Lechner*, p. 1213, par. 189.

¹⁶³² See par. 287.

¹⁶³³ See par. 202.

definition of *debt-claims* in Art. 11(3) OECD MTC extended by the attribute *whether or not carrying a right to participate in the debtor's profits*¹⁶³⁴.

3.3.4 Accrued interest

Accrued interest is imputed interest

- 306 Going further, there seems to be consensus that accrued interest shall be considered *paid*¹⁶³⁵, whereas imputed interest shall not¹⁶³⁶. Accrued interest is the interest entitlement accumulated over time but not yet paid out. Imputed interest is the time value of money that is calculated into the price of goods or services. At first glance, this position appears to be a contradiction. Accrued interest *is* in fact imputed interest with the only peculiarity that its financial instrument *can* possibly be quoted on some organised markets “ex-coupon” at the so-called “clean price” (i.e. the coupon is quoted separately from the nominal or face value). Nor can it be argued that accrued interest is, unlike other forms of imputed interest, a cyclical or periodical value fluctuation. This fluctuation is rather a natural characteristic and consequence of any time-dependent accrual. The key difference is, however, that those other forms of imputed interest are typically not a remuneration for the main or principal service: financing the purchase price of an asset is a service ancillary to the provision of that asset. This difference is rooted in the necessity to eventually disaggregate any remuneration in order to analyse the tax-wise nature of its corresponding operation for the purpose of treaty application¹⁶³⁷. In other words: irrespective of the *substance over form* principle, all factual analyses for applying a DTC necessarily include some form of disaggregation (in the narrow sense) as a preparatory methodological step in order to determine and classify the respective transaction. Unlike other forms of imputed interest, only accrued interest represents always and necessarily the remuneration for a finance transaction as the main or principal service.

Accrued interest is not realised

- 307 Having ascertained this distinction, a different question is whether or not accrued interest can be considered *paid*. On the one hand, it can be objected that accrued interest actually represents parts of *capital* rather than *income*. This is because it has not yet been realised by a legal event creating a new right¹⁶³⁸. Even if the *alienation* of the *debt-claim* itself was considered such a legal event, this would basically refer *to* the *debt-claim* and therefore perhaps also *to* the coupon right. However, this would potentially make it a capital *gain* rather than *interest*¹⁶³⁹. Any other conclusion would mean mixing the legal trigger of Art. 13 OECD MTC with the legal consequence of Art. 11 OECD MTC. It might further be argued that Art. 11 OECD MTC must lead to the same consistent results irrespective of any distinction between primary and secondary market¹⁶⁴⁰.

¹⁶³⁴ See par. 295 and 302.

¹⁶³⁵ Li, Jinyan / Avella, Francesco in IBFD Commentaries on Art. 13 OECD MTC, sec. 6.3.2.; Wassermeyer, Franz in Wassermeyer Commentaries, p. 1435, par. 86; OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-12, par. 20.1.; US Tax Court, judgement ref. 740-92, 1994.

¹⁶³⁶ Jakob Bundgaard, hybrids, p. 145; Gaspar Lopes Dias, debt-claims, sec. 1.3. and 2.3.; Gaspar Lopes Dias, tax arbitrage, p. 124; Pöllath, Reinhard / Lobbeck, Allit in Vogel / Lehner, p. 1319, par. 57; Wassermeyer, Franz in Wassermeyer Commentaries, p. 1431, par. 79, and p. 1440, par. 93; Klaus Vogel Commentaries 1997, p. 731 et seq., par. 57; equally for IAS/IFRS: IAS 32.AG11; unclear: Haslehnner, Werner in Klaus Vogel Commentaries 2015, in favour on p. 927, par. 90 but then contrary on p. 924, par. 85, as the term paid was to be understood in an economic sense.

¹⁶³⁷ See Illustration 3 on p. 43.

¹⁶³⁸ Pöllath, Reinhard / Lobbeck, Allit in Vogel / Lehner, p. 1326, par. 72. See also par. 158.

¹⁶³⁹ See par. 160 et seq.

¹⁶⁴⁰ See par. 98(1).

This distinction, which has been proved to be of principal relevance¹⁶⁴¹, is, however, the very purpose and function of Art. 13 OECD MTC¹⁶⁴². In other words: it is the very nature of Art. 13 OECD MTC to establish the secondary recovery of the debt capital by disposing it as an alternative way of realisation in addition to splitting it off as *interest*¹⁶⁴³. Notably, this additional and alternative way of realisation pursuant to Art. 13(5) OECD MTC is – unlike pursuant to Art. 11(3) OECD MTC – explicitly and completely independent of the tax-wise nature of its respective financial instrument¹⁶⁴⁴. The reason is that the OECD MTC has taken the transaction-based approach for capital *gains* but the asset-based approach for *interest*¹⁶⁴⁵. In addition, Art. 13(5) OECD MTC is the residuary clause for the asset-related Art. 13(1) to 13(4) OECD MTC¹⁶⁴⁶.

- 308 Considering the *beneficial ownership* concept governed in Art. 11(2) OECD MTC, it may also be suggested that the definition of the term *debt-claim* within the scope of Art. 11(3) OECD MTC was principally independent of who the payer pursuant to Art. 11(5) OECD MTC is. As a consequence, the *alienation* of the *debt-claim* itself could be considered a realisation of accrued interest from the buyer of the *debt-claim*. However, this would not be reasonable and give rise to considerable systematic distortions by establishing triangular interpretative and applicative relationships. Such deemed interest was actually subject of the DTC with the issuer's jurisdiction¹⁶⁴⁷, while the capital *gain* itself was simultaneously subject of the DTC with the buyer's jurisdiction. Consequently, it cannot be argued either that accrued interest paid to the seller of a *debt-claim* represents negative interest¹⁶⁴⁸. The underlying argument could be that such pass-through by way of *beneficial ownership* is not necessarily required to comply with all general principles of the OECD MTC¹⁶⁴⁹, particularly not the realisation requirement¹⁶⁵⁰. However, the concept of *beneficial ownership* explicitly takes the approach of constituting the replacement of one subject by another¹⁶⁵¹ exclusively at the receiver end. Hence, any additional equivalent at the payer end within the scope of Art. 13(5) OECD MTC is dispensable, even more as Art. 13(5) OECD MTC is subsidiary to Art. 11(2) OECD MTC¹⁶⁵².
- 309 It might be suggested by reference to the *substance over form* principle that the repurchase of a *debt-claim* by its issuer itself was to be considered an *interest* realisation. This might also be supported by the argument that, without such fiction, the distinction between primary and secondary market would make Art. 13(5) OECD MTC actually dependent to the situative aspect of who the contracting counterparty (i.e. the issuer versus another person). However, such fiction would not solve the problem but rather exacerbate it. In fact, it would establish the same dependency within Art. 11(3) OECD MTC. Repurchases of *debt-claims* by their issuers would then have to be treated differently (i.e. as *interest*) compared to those by other persons

¹⁶⁴¹ See par. 211 and 231.

¹⁶⁴² See par. 313.

¹⁶⁴³ See par. 145.

¹⁶⁴⁴ See par. 313.

¹⁶⁴⁵ See par. 58.

¹⁶⁴⁶ See par. 145.

¹⁶⁴⁷ See par. 143.

¹⁶⁴⁸ See par. 139.

¹⁶⁴⁹ See par. 140.

¹⁶⁵⁰ See Example 21 on p. 87.

¹⁶⁵¹ See par. 338.

¹⁶⁵² See par. 113(2).

(i.e. as capital *gains*). In addition, the term *debt-claims* generally does not cover repurchase obligations due to the restrictive application of the aggregation scheme¹⁶⁵³. This ensures and enhances the systematic coherence and consistence between Art. 11(3) and 13(5) OECD MTC. And lastly, even if the aggregation scheme was applied less restrictively, its result could not possibly be anything other than the *alienation* of the interest coupon pursuant to Art. 13(5) OECD MTC. As such, it was however not realised as *interest* pursuant to Art. 11(3) OECD MTC.

- 310 It might be argued that such a legal event was already represented, at the time the *debt-claim* was issued, by the one-time legal commitment to pay a periodic coupon in future periods. However, this would actually separate the realisation trigger from the realisation date, thus raising the additional issue of how the latter should then be determined. Instead, such unforfeitable entitlements or vested claims based on resolute conditions are typically considered not realised. The reason for this is that, until then, the accrued interest has not yet been *paid* in the sense of being actually transferred at the disposal of the *recipient* or *beneficial owner*¹⁶⁵⁴. This is also reasonable in the light of the economic fact that the coupon is, until actually transferred, typically exposed to credit risk¹⁶⁵⁵ and therefore – if at all – a *debt-claim* itself¹⁶⁵⁶.
- 311 For these systematic reasons it is the author's impression that the consensus view that accrued interest was *paid*¹⁶⁵⁷ actually appears to be a common or best practice rather than a justifiable legal principle¹⁶⁵⁸. In particular, any quotation requirement is not only a merely formal criterion but also and above all a very situative one (e.g. depending on the local market practices). This would create highly erratic or arbitrary and in any case coincidental results. Even understanding it in a broader sense of a merely calculatory or calculable interest does not alter the fact that accrued interest can only be realised as a capital *gain* pursuant to Art. 13(5) OECD MTC.

3.4 Capital gains

3.4.1 Structure of the provision

- 312 Art. 13(5) OECD MTC reads as follows¹⁶⁵⁹:

“Gains from the alienation of any property, other than that referred to in paragraphs 1 [i.e. immovable property], 2 [i.e. movable property attributed to a permanent establishment], 3 [i.e. ships or aircraft operated in international traffic] and 4 [i.e. shareholdings of more than 50%], shall be taxable only in the Contracting State of which the alienator is a resident.”

¹⁶⁵³ See par. 292.

¹⁶⁵⁴ See par. 120.

¹⁶⁵⁵ See par. 106(4).

¹⁶⁵⁶ See par. 303.

¹⁶⁵⁷ See par. 306.

¹⁶⁵⁸ In result equally: *Achim Pross*, p. 135.

¹⁶⁵⁹ The explanatory insertions in brackets have been added by the author.

- 313 Art. 13(5) OECD MTC is a residuary clause for Art. 13(1) to 13(4) OECD MTC¹⁶⁶⁰. Therefore, it applies to any other asset and in particular makes no difference between *shares*, *debt-claims* and positions yielding *other income*. In fact, capital *gains* are financial transactions as well, the only difference being that they are contracted on the secondary market. This deserves careful consideration when delimiting capital *gains* from other income types¹⁶⁶¹. From the absence of any reference to a situs of assets in Art. 13(5) OECD MTC, as opposed to Art. 13(1) to 13(4) OECD MTC, most commentators conclude that the provision also covers assets sited in third party jurisdictions¹⁶⁶². For this study, the interpretational issues within Art. 13(5) OECD MTC are therefore limited to the terms *gains* and *alienation*.

3.4.2 Alienation

- 314 According to the majority's view, the term *alienation* has a broad meaning¹⁶⁶³ and is to be interpreted autonomously¹⁶⁶⁴. It requires at least an asset transaction¹⁶⁶⁵ in the sense of an unrestricted transfer to another person or subject¹⁶⁶⁶ including the issuer itself¹⁶⁶⁷. This transfer is not necessarily required to be a legal one but may also an economic one in the sense of a "change in economic ownership" (*substance over form*)¹⁶⁶⁸. It shall contain two critical aspects of (1) the power to control whether or not there shall be a disposal of the asset and (2) the capacity to bear the risks of the asset¹⁶⁶⁹. This position shall now be analysed in more detail, as the term *alienation* actually coalesces the following different aspects discussed so far, which must however be distinguished carefully¹⁶⁷⁰:
- (1) a change of asset attribution;
 - (2) a transfer transaction as a result from that change¹⁶⁷¹;

¹⁶⁶⁰ Reimer, Ekkehart in *Klaus Vogel* Commentaries 2015, p. 1077, par. 138, and in *Vogel / Lebner*, p. 1476, par. 178, and p. 1479, par. 211; OECD Commentaries 2014 on Art. 13 OECD MTC, p. C(13)-12, par. 29; Michael Lang, introduction, p. 109, par. 322 et seq.; Klaus Vogel Commentaries 1997, p. 842, par. 91.

¹⁶⁶¹ As already noted while drafting the OECD Commentaries 1963 (*Li, Jinyan / Avella, Francesco* in IBFD Commentaries on Art. 13 OECD MTC, sec. 1.2.2.2.).

¹⁶⁶² Reimer, Ekkehart in *Klaus Vogel* Commentaries 2015, p. 1079, par. 149, and in *Vogel / Lebner*, p. 1480, par. 220; Wassermeyer, Franz in *Wassermeyer* Commentaries, p. 1645, par. 134, and p. 1649, par. 147; Klaus Vogel Commentaries 1997, p. 842, par. 94.

¹⁶⁶³ Stefano Simontacchi, p. 183; Philip Baker, p. 13-2, par. 13B.04.

¹⁶⁶⁴ Reimer, Ekkehart in *Klaus Vogel* Commentaries 2015, p. 1051, par. 11; Reimer, Ekkehart in *Vogel / Lebner*, p. 1441, par. 11; Wassermeyer, Franz in *Wassermeyer* Commentaries, p. 1609, par. 27; Dutch Hoge Raad der Nederlanden, judgement ref. 25308, 1991; deviating: Reimer, Ekkehart in *Klaus Vogel* Commentaries 2015, p. 1052, par. 15, and in *Vogel / Lebner*, p. 1442, par. 20, stating that "all around this core meaning, the semantic span of the term 'alienation' under treaty law is defined by domestic law" as well as (similarly) Stefano Simontacchi, p. 184 and 196, both briefly referring to Art. 3(2) OECD MTC and to the purpose of Art. 13 OECD MTC without however providing further justification, particularly with regard to whether or not the exception rule unless the context otherwise requires may apply (see par. 14).

¹⁶⁶⁵ Wassermeyer, Franz in *Wassermeyer* Commentaries, p. 1618, par. 37.

¹⁶⁶⁶ Reimer, Ekkehart in *Klaus Vogel* Commentaries 2015, p. 1051, par. 12; Reimer, Ekkehart in *Vogel / Lebner*, p. 1441, par. 15; Stefano Simontacchi, p. 176; Michael Lang, hybrids, p. 104.

¹⁶⁶⁷ Reimer, Ekkehart in *Klaus Vogel* Commentaries 2015, p. 1078, par. 145; Dutch Hoge Raad der Nederlanden, judgement ref. 38.461, 2003; Rainer Prokisch, share buy-backs, p. 402 et seq. The additional exception of a 365 day period inserted into Art. 10(2)(a) OECD MTC by the OECD MTC Draft Update, p. 14, par. 14, would not alter this result either and is thus not relevant for the scope of this study (see par. 10), as it does not affect but rather presupposes the genuine definition (see par. 73) of the term dividends pursuant to Art. 10(3) OECD MTC. Originally contrary: Dutch Hoge Raad der Nederlanden, judgement ref. 28.959, 1994, par. 9.3. et seq., first interpreting accurately that its wording and intention do not suggest Art. 13(5) OECD MTC being an exception rule (*lex specialis*) of Art. 10 OECD MTC but then going too far in concluding that there was an overlap between the two provisions, in which the latter would conversely take precedence. See also par. 113(2) and 309.

¹⁶⁶⁸ See footnote 1664.

¹⁶⁶⁹ Reimer, Ekkehart in *Michael Lang*, beneficial ownership, p. 263; Oliver, J. David B., Beneficial Ownership and the OECD Model, British Tax Review 2001, No. 1, p. 55 et seq.

¹⁶⁷⁰ Similarly: Stefano Simontacchi, p. 132.

¹⁶⁷¹ See par. 58.

- (3) the realisation of this transaction¹⁶⁷²; and
- (4) the attribution of (the capital *gain* from) this realised transaction¹⁶⁷³.

The change of asset attribution

315 To the author's understanding, the first aspect (1) is the starting point. In other words: it is not the change in the asset attribution, which is a logical result from the transfer transaction, but it is, conversely, the transfer transaction, which is a logical result from the change in the asset attribution. On the one hand, this does not conflict with the general principle that the asset is the result of the transaction (and not vice versa)¹⁶⁷⁴: Art. 13 OECD MTC takes the transaction-based approach per se¹⁶⁷⁵, which is completely independent of the asset¹⁶⁷⁶. On the other hand, anything else would mean actually leaving the question open of what then should constitute *alienation*. In contrast to the other distributive articles, the disposal of assets is the very nature and purpose of the *alienation* and therefore its constitutive characteristic. Accordingly, the change of asset attribution to the disposal of the acquirer may not be a merely economic one but must necessarily be a legal one in order to trigger Art. 13(5) OECD MTC. Matters of attribution and ownership other than *beneficial ownership* were found inaccessible to the treaty principle of *substance over form* but must rather follow the legal form (i.e. form over substance).¹⁶⁷⁷ This was a result from the above systematic considerations that there cannot possibly be such a thing as "economic ownership" in Art. 13(5) OECD MTC. This view is in line with the same question whether a change in the attribution of the capital or principal must be a legal or an economic one in order to constitute *debt-claims*¹⁶⁷⁸. It leads to equivalent results in so far as the possession of legal ownership rights in the capital or principal during the investment period is governed by Art. 11 OECD MTC, whereas their termination at the end of the investment period is governed by Art. 13 OECD MTC. Unlike Art. 13 OECD MTC, Art. 11 OECD MTC also contains an explicit provision for attributional aspects within the *substance over form* principle¹⁶⁷⁹. Accordingly, the asset cannot be transferred from its *beneficial owner* to the debtor in order to trigger Art. 13(5) OECD MTC either, since the *beneficial ownership* is its legal consequence and therefore cannot simultaneously be its precondition¹⁶⁸⁰. As an interim conclusion for the further course of this study it is therefore held that the particular aspect of changing the asset attribution to the disposal of the acquirer must be interpreted formally or legally and not economically. Therefore it is subject of Art. 3(2) OECD MTC and thus of the domestic tax law¹⁶⁸¹.

Example 48: Merely writing a put option (i.e. long put) can economically be seen as a present disposition of future interests in the underlying (i.e. its contingent value appreciation). However, it will not be considered a change of the underlying's attribution where the option contract is treated formally as a separate agreement (e.g. a bet)¹⁶⁸² by the domestic tax law.

¹⁶⁷² See par. 145.

¹⁶⁷³ See par. 142.

¹⁶⁷⁴ See par. 52.

¹⁶⁷⁵ See par. 58.

¹⁶⁷⁶ See par. 307.

¹⁶⁷⁷ See par. 187.

¹⁶⁷⁸ See par. 297.

¹⁶⁷⁹ Argumentum a minore ad maius.

¹⁶⁸⁰ See par. 142.

¹⁶⁸¹ Equally: Federal Court of Australia, judgement ref. NG 225 of 1997, 1997.

¹⁶⁸² See par. 96.

316 That is why it cannot be said at this first level of asset attribution that the treaty term *alienation* would exclude, for instance, non-physical or net settlements or hedges, where these change the asset attribution pursuant to domestic tax law. This might be the case where the domestic tax law itself would adhere more to substantive than to formal concepts. Also, the question of whether the substitution of one asset by another (e.g. corporate actions) represents a transfer for Art. 13(5) OECD MTC¹⁶⁸³ or rather a surrogate¹⁶⁸⁴ is subject of the domestic tax law. This becomes even more evident as a replacement by a surrogate is typically tax-exempt and therefore does not trigger but rather suspends double taxation, being typically out of scope of the OECD MTC at all. Even a temporal double taxation due to grandfathering effects was, however, not a matter of income classification but rather of income determination. This view is also in line with the finding that the subjacent aspect of novation must be interpreted formally and therefore pursuant to domestic tax law¹⁶⁸⁵. Actually, these consequences from the domestic interpretation of both the asset transfer and its subsequent attribution give rise to potential qualification conflicts¹⁶⁸⁶. However, they correspond to the finding that economic or factual power structures are ultimately reducible to legal powers or relations¹⁶⁸⁷. It is rather the transfer transaction as the result than the change in the asset attribution as such¹⁶⁸⁸, which may be subject of the *substance over form* principle and shall therefore be analysed now.

The transfer transaction

317 As regards this second aspect (2), the transfer transaction can be economically evaluated independent of the first aspect (1) of a change in the asset attribution¹⁶⁸⁹. The two aspects may, but not necessarily do, lead to the same results (i.e. “economic ownership” in the asset). However, they must nevertheless be analysed separately. Just as the legal change of the asset attribution does not necessarily imply a legal transaction (A), the legal change of the asset attribution does not necessarily imply an “economic transaction” (B) either.

Example 49: There may be assumed to be an asset (e.g. capital or principal), a legal transaction on this asset between a creditor and a debtor (e.g. debt) and another legal transaction on the debt between the creditor and a third party (e.g. credit “derivative”). The credit “derivative” is a legal transaction in relation to the debt, but may be seen as an “economic transaction” in relation to the asset. A straight debt as a legal transaction typically does not provide a change in the legal ownership of the asset to the debtor (A). The credit “derivative” as an “economic transaction” does not necessarily provide a change in the legal ownership of the asset to the third party (B).

In other words, “economic ownership” in an asset (e.g. precious metal) can principally be transferred in two ways: either by a change in the economic attribution of the asset itself (e.g. “derivative” on that precious metal)¹⁶⁹⁰ or in the legal attribution of another composite legal transaction with that asset (e.g. securities

¹⁶⁸³ See par. 181.

¹⁶⁸⁴ See par. 148.

¹⁶⁸⁵ See par. 81.

¹⁶⁸⁶ See par. 117 and 297.

¹⁶⁸⁷ See par. 80.

¹⁶⁸⁸ See par. 72.

¹⁶⁸⁹ *Weissbrodt, Jan*, Die sonstige Kapitalforderung im Sinne von § 20 Absatz 1 No. 7 EStG, Deutsches Steuerrecht 2012, Vol. 31, p. 1534 et seq., footnotes 18 and 20.

¹⁶⁹⁰ See par. 314(1).

lending with that “derivative”¹⁶⁹¹. Both aspects are matters of attribution and ownership. As such, they must necessarily follow the legal form (i.e. form over substance)¹⁶⁹². However, as the former was rejected¹⁶⁹³, only the latter remains left for potentially justifying a change of “economic ownership” in an asset within the scope of Art. 13(5) OECD MTC.

- 318 The issue discussed here appears to bear a striking resemblance to the object-related aspect of “*beneficial ownership*”¹⁶⁹⁴. This is owed to the fact that it tackles the same conceptual problem. It might therefore be reasonably suggested that the second aspect (2) of economically evaluating changes in an asset’s legal attribution as the result of composite legal transactions resembles the transaction-related or (re)attributional aspect of *beneficial ownership*¹⁶⁹⁵. This would not only support the finding that the first aspect (1) of changes in the economic attribution of the asset itself must be rejected¹⁶⁹⁶. The reason is that, conversely, it appears to resemble the asset-related (anti-abuse) aspect of *beneficial ownership*, which does not implicitly subsist in Art. 13(5) OECD MTC¹⁶⁹⁷. It would also lead to the conclusion that Art. 13(5) OECD MTC, unlike Art. 10 and 11 OECD MTC, would eventually imply a certain form of “economic ownership” in the asset other than *beneficial ownership*¹⁶⁹⁸, since the transaction-related or (re-)attributional aspect of *beneficial ownership* subsists implicitly in Art. 13(5) OECD MTC.
- 319 However, this turns out to be an imprecise view, when looked at more closely. In contrast to the other distributive articles, it is the particular nature of Art. 13 OECD MTC that it deals with the disposal of assets. This is the very reason why the OECD MTC had to take the transaction-based approach for capital *gains*¹⁶⁹⁹. The transaction-based approach, however, necessarily contains an asset-related aspect¹⁷⁰⁰ and therefore gives rise to the temptation of confusing¹⁷⁰¹ the change of asset attribution¹⁷⁰² and the transfer transaction as a result from that change¹⁷⁰³. In other words: the term *alienation* coalesces both a static element (i.e. the asset as such) and a dynamic element (i.e. its disposal) in itself. Therefore, it is methodologically flawed to reestablish the static and asset-related aspect, which has already been rejected for systematic considerations by way of the dynamic and transaction-related aspect¹⁷⁰⁴. This is the very source of that confusion. It becomes particularly evident by recognising the circular reasoning that such a form of “economic ownership” in the asset would again depend on the composite legal transaction, whereas it was found to actually represent the starting point¹⁷⁰⁵. In addition, the concept of *beneficial ownership* may be limited in scope to its transaction-related

¹⁶⁹¹ See par. 314(2).

¹⁶⁹² See par. 187.

¹⁶⁹³ See par. 315.

¹⁶⁹⁴ See Illustration 9 on p. 73.

¹⁶⁹⁵ See par. 128.

¹⁶⁹⁶ See par. 315.

¹⁶⁹⁷ See par. 142.

¹⁶⁹⁸ See par. 187 and 297.

¹⁶⁹⁹ See par. 58.

¹⁷⁰⁰ See par. 53.

¹⁷⁰¹ See par. 131.

¹⁷⁰² See par. 314(1).

¹⁷⁰³ See par. 314(2).

¹⁷⁰⁴ Circular reasoning.

¹⁷⁰⁵ See par. 315.

or (re-)attributional aspect, but it is nevertheless implied in Art. 13(5) OECD MTC as a coherent whole. In other words: it was systematically and methodologically flawed to conclude that the integral concept of *beneficial ownership* had any other role or relevance in Art. 13(5) OECD MTC as compared to Art. 10 and 11 OECD MTC. Consequently, the transaction-related or (re)attributional aspect of *beneficial ownership* cannot, within the scope of Art. 13(5) OECD MTC, possibly be more than merely its legal consequence and simultaneously its precondition¹⁷⁰⁶. As an interim conclusion for the further course of this study it is therefore held that the particular aspect within the term *alienation* of a transfer transaction as a result from the change of the asset attribution must be interpreted formally or legally rather than economically, and therefore pursuant to domestic tax law.

The realisation of the transfer transaction

- 320 As regards the third aspect (3)¹⁷⁰⁷, the realisation requirement reflected by the term *alienation* was found to be subject of a limited autonomous interpretation applying form over substance. It requires at least a legal event arising from a domestic field of law that is precursory to its tax law and refers *to* the asset, in that it impairs the mathematical number of the critical ownership rights *in* the asset¹⁷⁰⁸. This limited autonomous interpretation of the term *alienation* includes partial disposals¹⁷⁰⁹, being in line with the finding that these must also be determined pursuant to domestic law (particularly their distinction from partial redemptions)¹⁷¹⁰. Only at this third level of the realisation requirement are the varieties of domestic asset attribution¹⁷¹¹ and transfer transactions¹⁷¹² restricted by the tax-limiting function of Art. 13(5) OECD MTC¹⁷¹³ and therefore by the autonomous interpretation¹⁷¹⁴.

The attribution of the gain from the transfer transaction

- 321 As regards the fourth aspect (4)¹⁷¹⁵, the attribution of the capital *gain* from the realised transaction was found to be subject of the *substance over form* principle in the form of the *beneficial ownership* concept¹⁷¹⁶. Its transaction-related or (re-)attributional aspect was found to subsist implicitly also in Art. 13(5) OECD MTC¹⁷¹⁷.

The relevance of the change in economic ownership is limited

- 322 It is important to note that the aforementioned considerations demonstrate that the *substance over form* principle takes effect only upon the last aspect of the subjective attribution of the capital *gain*. In other

¹⁷⁰⁶ See par. 142.

¹⁷⁰⁷ See par. 314(3).

¹⁷⁰⁸ See par. 307.

¹⁷⁰⁹ OECD Commentaries 2014 on Art. 13 OECD MTC, p. C(13)-2, par. 5; Reimer, Ekkehart in *Klaus Vogel* Commentaries 2015, p. 1050, par. 7; *Klaus Vogel* Commentaries 1997, p. 818, par. 24.

¹⁷¹⁰ See par. 252.

¹⁷¹¹ See par. 316.

¹⁷¹² See Example 49 on p. 190.

¹⁷¹³ See par. 19.

¹⁷¹⁴ See par. 314.

¹⁷¹⁵ See par. 314(4).

¹⁷¹⁶ Contrary: *Wassermeyer, Franz* in *Wassermeyer* Commentaries, p. 1622, par. 53, instead briefly referring to Art. 3(2) OECD MTC without, however, providing further justification, particularly with regard to whether or not the exception rule unless the context otherwise requires may apply (see par. 14).

¹⁷¹⁷ See par. 142.

words: it is the pass-through of the realised *income* rather than the ownership rights in the asset itself, which are interpretatively influenced by the economic perspective. The following illustration visualises this understanding:

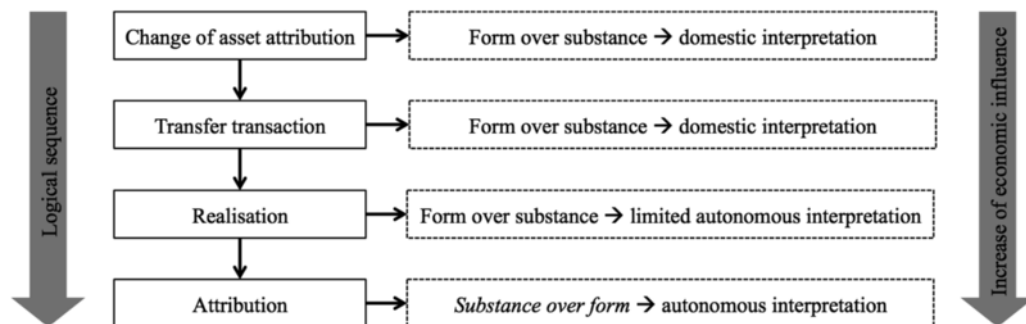


Illustration 21: The different aspects of the term *alienation* in Art. 13(5) OECD MTC

- 323 While this conclusion makes a big difference from the systematical point of view, its impact on the treaty interpretation nevertheless appears to be limited. Again, the reason is the said specific nature of Art. 13 OECD MTC that deals with the disposal of assets *per se*¹⁷¹⁸. True, an asset can principally be transferred, if not legally, either directly by changing the economic asset attribution or indirectly by changing the legal composite transaction attribution¹⁷¹⁹. However, this concurrency can lead to different results only in terms of who is considered the attributee of the asset¹⁷²⁰. Nevertheless, once someone is determined as this attributee of the asset in either way, any deviation from the attributee of the capital *gains* can necessarily only be rooted in the transaction-related or (re)attributional aspect of *beneficial ownership*. In contrast to *dividends* or *interest*, it can particularly not be rooted in any form of “economic ownership” in the asset itself. The reason shall be explained based on the following illustration:

¹⁷¹⁸ See par. 319.

¹⁷¹⁹ See par. 317.

¹⁷²⁰ See Example 49 on p. 190.

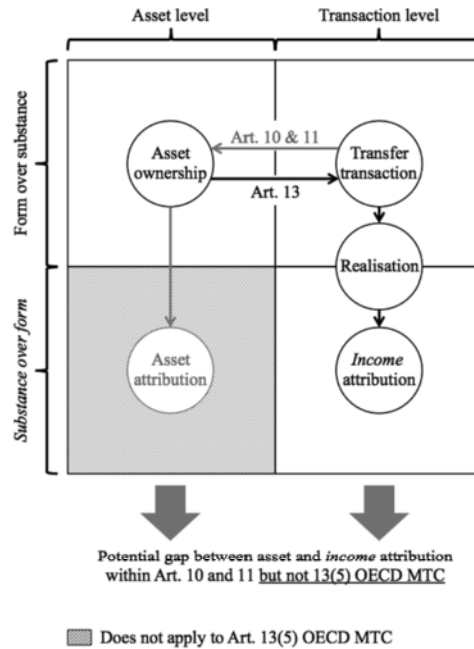


Illustration 22: The genuine attributee of capital *gains* is always identical to the attributee of the asset

In contrast to Art. 10(3) and 11(3) OECD MTC, the starting point within Art. 13(5) OECD MTC is the change in the asset attribution.¹⁷²¹ This change follows form over substance (i.e. legal asset ownership): matters of attribution and ownership other than *beneficial ownership* are inaccessible to the treaty principle of *substance over form*, and the asset-related aspect of *beneficial ownership* does not apply to Art. 13(5) OECD¹⁷²². At the same time, this legal singularity of the asset attribution leads to the systematic and methodological consequence that the transaction as the subsequent logical step is not capable of transferring “economic ownership” in the asset¹⁷²³ either. Thus, the attributee of the asset cannot differ from its legal owner, who is identical with the attributee of the capital *gains* (i.e. the recipient), unless passed-through to the *beneficial owner*.

Example 50: *Dividends* and *interest*¹⁷²⁴ are independent rights, whereas a capital *gain* is a dependent increment. In contrast to *dividends* and *interest*, an asset can therefore not be legally encumbered in a way that its capital *gain* is entitled to one beneficiary while its principal or underlying right is entitled to another beneficiary. Both are inextricably coalesced by one and the same right, i.e. the ownership right in the asset itself. That is why the capital *gain* can merely be passed-through in amount to the *beneficial owner*, without, however, altering that legal indivisibility.

¹⁷²¹ See par. 315.

¹⁷²² See par. 318.

¹⁷²³ See par. 319.

¹⁷²⁴ See Example 19 on p. 76.

Conclusions

- 324 Hence, the influence of the *substance over form* principle is limited to the (re)attributional aspect of *beneficial ownership*. As a result, the genuine attributee of *income* in the form of capital *gains* (i.e. the recipient) is, unlike that of *dividends* or *interest*, always identical to the attributee of the asset itself (i.e. its legal owner). In other words: the beneficiaries of capital *gains* and those of the asset itself are in a way the same, as the former is an integral and inseparable part of the latter. Consequently, the conclusion that the *substance over form* principle takes effect only upon the *income* attribution of Art. 13(5) OECD MTC and not upon the asset itself¹⁷²⁵ appears to be of limited relevance for the theory of treaty interpretation¹⁷²⁶ (but is perhaps relevant for the practice of treaty application¹⁷²⁷). This becomes even more evident when remembering that the subject of the distributive articles is actually the tax treatment of *income* and not of assets. Coming back to the initial question¹⁷²⁸, the author agrees therefore only with the reservations explained in this section to the majority's view and condensed statement that the term *alienation* could in result be said to require an asset transaction in the sense of a "change in economic ownership".
- 325 These reservations are also the reason why this economic view does not conflict with the finding that the realisation of capital *gains* requires and presumes a legal event as a necessary minimum condition (form over substance)¹⁷²⁹. The reason is that *beneficial ownership* is a specific exception from the general principles of attribution (form over substance). As such, it is a rule subsequent to the definition of the term capital *gain* and a derivative concept to the genuine concept of *alienation*, which in no way justifies generalisations¹⁷³⁰. In other words: even less permissible than the reverse deduction from the realisation to the transaction¹⁷³¹ is the reverse deduction from the realisation to the asset attribution¹⁷³². The reason is that, within the scope of Art. 13(5) OECD MTC, the transaction is a logical pre-step of the asset attribution¹⁷³³. In summary, the term *gains from the alienation* requires (1) a legal event that (2) changes the "economic ownership".
- 326 Going further, the provision takes the alienator's perspective¹⁷³⁴, which stipulates an asset outflow¹⁷³⁵ and focuses on the mere disposal. In this respect, the duration or maturity of the pending transaction in cases of deferrals between obligation and execution is not relevant, so that forwards or options can principally be disposals as well.¹⁷³⁶ However, *alienation* requires at least some asset inflow, i.e. an acquisition or receipt¹⁷³⁷. Otherwise it would not truly represent a "transfer" to another person or subject¹⁷³⁸. Consequently, cases

¹⁷²⁵ See par. 322.

¹⁷²⁶ See par. 323.

¹⁷²⁷ See par. 143.

¹⁷²⁸ See par. 314.

¹⁷²⁹ See par. 158 et seqq.

¹⁷³⁰ See par. 140.

¹⁷³¹ See par. 170.

¹⁷³² Argumentum a minore ad maius.

¹⁷³³ See par. 315.

¹⁷³⁴ Wassermeyer, Franz in Wassermeyer Commentaries, p. 1611, par. 28.

¹⁷³⁵ Philip Baker, p. 13-2, par. 13B.04.

¹⁷³⁶ Wassermeyer, Franz in Wassermeyer Commentaries, p. 1619, par. 39. See also Example 48 on p. 259.

¹⁷³⁷ Michael Lang, hybrids, p. 104.

¹⁷³⁸ See par. 314.

of unilateral termination are not covered by the term *alienation* (e.g. renunciation, liquidation¹⁷³⁹, expiry, destruction¹⁷⁴⁰, etc.)¹⁷⁴¹. This corresponds with the natural understanding of a capital *gain* that would otherwise not actually be computable. As a further consequence of the alienator's perspective, the return from the disposal is not relevant either. Therefore, the term *alienation* also includes non-cash exchange transactions (e.g. transfers to a company in exchange for stock)¹⁷⁴² and transactions without any return at all¹⁷⁴³ (e.g. gifts¹⁷⁴⁴ or inheritances). That is why the information to what extent the ratio between the number of the critical ownership rights in the asset and their proportional value may change as a result of the transaction¹⁷⁴⁵ cannot be used as an universal differentiator for Art. 13(5) OECD MTC. In addition, the origin¹⁷⁴⁶ of the asset or the motivation¹⁷⁴⁷ for the transfer (e.g. expropriation¹⁷⁴⁸) aren't relevant for the classification as a capital *gain*. An important exception is, of course, where the disposal of the asset represents the fulfilment of a legal redemption obligation¹⁷⁴⁹. For the practice of treaty application, this reservation appears to be of limited relevance, as the legal redemption obligation typically excludes the concurrent legal ownership rights in the capital or principal¹⁷⁵⁰ and/or is unilaterally terminated. For the theory of treaty interpretation, the reservation is relevant, however. The conclusion that the redemption obligation is a necessary minimum condition (*conditio sine qua non*) for Art. 11(3) OECD MTC¹⁷⁵¹ and the consensus view that the distributive articles are mutually exclusive¹⁷⁵² lead to the systematic result that Art. 13(5) OECD MTC must necessarily be subsidiary to Art. 11(3) OECD MTC.

3.5 Other income

3.5.1 Structure of the provision

327 Art. 21(1) OECD MTC reads as follows:

“Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.”

¹⁷³⁹ Contrary: *Marjaana Helminen*, dividend concept, p. 235, and Dutch Hoge Raad der Nederlanden, judgement ref. 41376, 2006, both applying however the domestic tax law by actually referring to limb 3 of Art. 10(3) OECD MTC (see par. 270).

¹⁷⁴⁰ *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1614, par. 32.

¹⁷⁴¹ See par. 81.

¹⁷⁴² OECD Commentaries 2014 on Art. 13 OECD MTC, p. C(13)-2, par. 5; *Klaus Vogel Commentaries* 1997, p. 818, par. 24; League of Nations, Annex to London and Mexico Model Tax Conventions Commentary and Text, Geneva, November 1946, available online at <http://adc.library.usyd.edu.au> (last retrieved on 15 September 2017), p. 67.

¹⁷⁴³ Reimer, Ekkehart in *Klaus Vogel Commentaries* 2015, p. 1050, par. 5.

¹⁷⁴⁴ Tax Court of Canada, judgement “*William C. Krafcov vs. M.N.R.*”, 1983.

¹⁷⁴⁵ See par. 162 and 253.

¹⁷⁴⁶ OECD Commentaries 2014 on Art. 13 OECD MTC, p. C(13)-3, par. 11.

¹⁷⁴⁷ *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1611, par. 28.

¹⁷⁴⁸ OECD Commentaries 2014 on Art. 13 OECD MTC, p. C(13)-2, par. 5; *Klaus Vogel Commentaries* 1997, p. 818, par. 24.

¹⁷⁴⁹ See par. 300 et seq.

¹⁷⁵⁰ See par. 315.

¹⁷⁵¹ See par. 289.

¹⁷⁵² See par. 113.

- 328 The provision is a residuary clause for all other distributive articles of the OECD MTC¹⁷⁵³, which is why this brief section serves the sole purpose of completeness.
- 329 The provision also covers assets sited in third party jurisdictions. This follows from its character as a residuary clause, from the phrase *wherever arising* and from the absence of any reference to a situs of assets.¹⁷⁵⁴ According to the majority of commentators, the term *items* is to be interpreted autonomously.¹⁷⁵⁵ This is a logical reverse deduction¹⁷⁵⁶ from the residuary character of Art. 21(1) OECD MTC for all other distributive articles, which are to be interpreted autonomously¹⁷⁵⁷. On the one hand, these interpretations and the provision's systematic context of being basically as broad or comprehensive as possible¹⁷⁵⁸ suggest a wide meaning of the term *items*. On the other hand, the scope of application is substantially re-narrowed due to the fact that the purpose and function of Art. 21(1) OECD MTC is not to resolve interpretation problems in other articles¹⁷⁵⁹. That is why, for instance, it does not include deemed income of other distributive articles, which is a matter of realisation¹⁷⁶⁰ rather than of a specific income type¹⁷⁶¹.

3.5.2 Gamble

- 330 At first glance, the most relevant use case and distinction of Art. 21(1) OECD MTC from the other distributive articles appears to be the gamble (e.g. lotteries, bets, etc.). A gamble is typically considered as any claim on benefits which is more or less contingent on the random principle. As such, it was said to be in fact a negative insurance in the sense of taking a negative underwriting risk (i.e. granting a chance)¹⁷⁶². Therefore, income from gambling obviously does not represent the time value of money¹⁷⁶³. Art. 13(5) OECD MTC is not intended to apply to prizes in a lottery or to premiums and prizes attaching to bonds or debentures either.¹⁷⁶⁴ To the author's understanding, this should also apply to equivalent or similar forms of gambles. Consequently, the delimitation seems to put the focus on the particular question of whether (then *dividends* or *interest*) or not (then *other income*) gambling can represent a participation in profits.

¹⁷⁵³ See par. 113.

¹⁷⁵⁴ *Alexander Bosman*, p. 79 et seq. and 87 et seqq.; *Rust, Alexander* in *Klaus Vogel Commentaries* 2015, p. 1547, par. 33, and in *Vogel / Lechner*, p. 1920, par. 3; *Wassermeyer, Franz / Kaeser, Christian* in *Wassermeyer Commentaries*, p. 2053, par. 1; OECD Commentaries 2014 on Art. 21 OECD MTC, p. C(21)-1, par. 1; *Cui, Shanshan* in *Thomas Ecker*, p. 639; *Michael Lang*, hybrids, p. 107; *Klaus Vogel Commentaries* 1997, p. 1071, par. 7.

¹⁷⁵⁵ *Rust, Alexander* in *Klaus Vogel Commentaries* 2015, p. 1541, par. 25, and in *Vogel / Lechner*, p. 1922, par. 10; *Wassermeyer, Franz / Kaeser, Christian* in *Wassermeyer Commentaries*, p. 2057, par. 16; *Klaus Vogel Commentaries* 1997, p. 1072, par. 11; perhaps contrary: *Cui, Shanshan* in *Thomas Ecker*, p. 638, generally referring to Art. 3(2) OECD MTC but leaving open whether or not the exception rule unless the context otherwise requires may actually apply.

¹⁷⁵⁶ *Argumentum e contrario*.

¹⁷⁵⁷ See par. 257, 287, 314 and 320.

¹⁷⁵⁸ See par. 111 et seq.

¹⁷⁵⁹ *Alexander Bosman*, p. 79; *Rust, Alexander* in *Klaus Vogel Commentaries* 2015, p. 1542, par. 27 and 29, and in *Vogel / Lechner*, p. 1923, par. 12; *Michael Lang*, hybrids, p. 106; *Klaus Vogel Commentaries* 1997, p. 915, par. 12.

¹⁷⁶⁰ Accurate: *Rust, Alexander* in *Klaus Vogel Commentaries* 2015, p. 1544, par. 30; Swedish *Högsta Förvaltningsdomstolen*, judgement ref. 6687-11, 2012. Unclear: *Alexander Bosman*, in favour on p. 81 et seq. but contrary on p. 322.

¹⁷⁶¹ In this sense, however: Dutch *Gerechtshof Amsterdam*, judgement ref. 03/03165, 2005; *Wattel / Marres*, fictitious income, p. 69. See also par. 144 et seqq.

¹⁷⁶² See par. 70.

¹⁷⁶³ See par. 213.

¹⁷⁶⁴ *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1618, par. 38; OECD Commentaries 2014 on Art. 13 OECD MTC, p. C(13)-6, par. 19.

- 331 However, as an overall result from the findings and conclusions in this study, the issue is of fairly small significance for the practice of treaty application. The scope of Art. 21(1) OECD MTC was said to be limited, in that the resolution of interpretation problems from other distributive articles is not its purpose and function¹⁷⁶⁵. In addition, the issue turns out to be of limited relevance also for the theory of treaty interpretation. True, while the attribute *participating in profits* cannot serve as a differentiator for the distinction between Art. 10(3) and 11(3) OECD MTC¹⁷⁶⁶, it might nevertheless be considered a classifier for Art. 21(1) OECD MTC. However, the criterion of profit participation emerges explicitly in Art. 10(3) and 11(3) OECD MTC. Therefore, it ought to have a reasonable role within Art. 21(1) OECD MTC only as a falsifier, i.e. a non-participation in profits would negate *other income*. Nevertheless, its specific character as a residuary clause generally excludes such falsifiers by itself, since any residuum is the result of such negation (double negation). Or in other words: “the rest” cannot be defined positively¹⁷⁶⁷. As a result for its further course, the definition and delimitation of gambles is not capable of contributing any value to this study.

¹⁷⁶⁵ See par. 329.

¹⁷⁶⁶ See par. 280.

¹⁷⁶⁷ Similarly: *Achim Pross*, p. 177.

Chapter 4

Summary of conclusions

- 332 This section is an abstract of the most important conclusions found so far, briefly summarising the storyline of this study.
- 333 The OECD MTC is a collective law in the sense of a multi-jurisdictional compromise. It aggregates the heterogeneous peculiarities of individual (domestic) or cultural (regional) tax laws and tax systems into a generic and autonomous taxonomy.¹⁷⁶⁸ In this respect, the OECD MTC shares the same nature with other collective tax laws. This justifies them to be consulted as inspirational legal sources for the systematic interpretation of the OECD MTC, particularly as regards aspects and concepts under the *substance over form* principle.¹⁷⁶⁹ The approach can help interpreting and applying the OECD MTC more consistently by consulting other legal sources, which have similar problems to solve or are even closer to a solution of these problems.
- 334 This study takes the transaction-based approach as a basis of its analyses. It derives the income classification directly from the effective operation rather than indirectly from its source or origin¹⁷⁷⁰, like the asset-based approach taken by the OECD MTC does¹⁷⁷¹. In that the transaction-based approach decomposes the object of law into the asset-related and the transaction-related bit of information, the asset-based approach implies and requires the transaction-based approach¹⁷⁷². Consequently, the transaction-based approach is no substitute for the asset-based approach but rather an enlargement and breakdown of it. The benefit of this approach is that it provides a better understanding of multiple aspects in the interpretation and application of the OECD MTC. These include, for instance, fundamental concepts such as *beneficial ownership*, the realisation principle or the role of the payment profile. But they also help to solve practical problems such as the delimitation of *income* and capital *gains*, the qualification of accrued interest and the classification of ambiguous financial instruments.

¹⁷⁶⁸ See par. 18.

¹⁷⁶⁹ See par. 45.

¹⁷⁷⁰ See par. 52.

¹⁷⁷¹ See par. 58.

¹⁷⁷² See par. 54.

- 335 Risk is a mathematical and economic¹⁷⁷³ parameter, and therefore a more quantitative one¹⁷⁷⁴. It is principally limited in allowing conclusions on the qualitative aspects and concepts of law¹⁷⁷⁵. In that, risk is however not only an important interpretative and/or applicative assessment factor for methodologically evaluating the relative importance of potential differentiators or criteria for the classification of income from financial instruments. The most relevant risk types for this study are symmetric versus asymmetric risk¹⁷⁷⁶, formal versus material risk¹⁷⁷⁷, legal versus non-legal risk¹⁷⁷⁸ and underwriting versus timing risk¹⁷⁷⁹. Although risk is principally masked, it can often be spotted by behavioural adaptations of the contracting counterparties of financial instrument to their risk exposures. The systematic approach of this study, the mere existence of certain types of risk therefore makes it possible in many aspects to reveal qualitative indications and conclusions towards the nature of the underlying transaction or operation. In that, it particularly helps to limit, structure and allocate the relevant and significant attributes for the interpretation and application of the OECD MTC.
- 336 This study focuses on genuine legal concepts of income classification, whereas derivative legal concepts are out of scope¹⁷⁸⁰. While these typically trigger the same legal consequences, the difference between them is that the latter implies and requires the former as a necessary precondition¹⁷⁸¹. Whether a legal provision or term in the OECD MTC belongs to the one or the other concept can often be concluded neither from their wording nor from their purpose, intention or function¹⁷⁸². Therefore, this study primarily concentrates on the systematic element of interpretation. From this systematic element of interpretation the most important conclusions can be drawn:
- The mere existence of financial instruments as the asset¹⁷⁸³ and consequently also the income or transaction¹⁷⁸⁴ require a cautious invocation of the *substance over form* principle.
 - Risk must be separated into legal and non-legal risks¹⁷⁸⁵.
 - “Non-legal rights and obligations” are not relevant for the classification of income types from financial instruments into the distributive articles of the OECD MTC¹⁷⁸⁶.
 - Time represents a physical parameter and therefore is principally incompatible with and inaccessible to legal interpretation¹⁷⁸⁷. However, time aspects interact and therefore bear a nexus with a broad number of

¹⁷⁷³ See par. 65.

¹⁷⁷⁴ See par. 60.

¹⁷⁷⁵ See par. 218.

¹⁷⁷⁶ See par. 64.

¹⁷⁷⁷ See par. 65.

¹⁷⁷⁸ See par. 66.

¹⁷⁷⁹ See par. 67 et seqq.

¹⁷⁸⁰ See par. 75.

¹⁷⁸¹ See par. 73.

¹⁷⁸² See par. 74.

¹⁷⁸³ See par. 77.

¹⁷⁸⁴ See par. 79.

¹⁷⁸⁵ See par. 78.

¹⁷⁸⁶ See par. 80.

¹⁷⁸⁷ See par. 81.

legal and economic aspects by interacting with them. That is why they are attached to them and basically share their same legal fate¹⁷⁸⁸.

On the one hand, the separation of genuine and derivative concept helps to focus on the actual root causes of challenges to the OECD MTC. On the other hand, the key insight of focussing on the systematic interpretation is: which attributes of financial instruments and the OECD MTC are generally accessible to an autonomous or an domestic interpretation respectively. With regard to the autonomous interpretation, they also set the scope of aspects for which the interpretation and/or application of the OECD MTC might be inspired by other comparable legal sources. In combination, the approach fosters the primary law and thus strengthens the legal certainty and the role of the OECD MTC as the world's leading and most influential standard template for the negotiation of DTC.

337 Aggregation and disaggregation are applicative techniques for preparing the legal case as a pre-step for the subsequent abstract interpretation of the law.¹⁷⁸⁹ While the application actually refers to the object of the legal issue, the interpretation refers to the target of the legal issue. The approach transferred from finance theory and domestic tax policy making of “atomising” and replicating the economic risk-return profile of financial instruments by options as their ultimate building blocks¹⁷⁹⁰ principally allows us to draw conclusions towards legal differentiators. In imperfect tax systems such as the OECD MTC it leaves a theoretical residuum of building blocks with specific risk characteristics¹⁷⁹¹. Combined with the systematic considerations by the IAS/IFRS and the techniques of finance theory, this approach led to the following conclusions:

- Aggregation cannot be justified by the *substance over form* principle¹⁷⁹². It would create highly erratic or arbitrary and eventually coincidental results, which would not be in line with the purpose, intention and function of the OECD MTC's distributive articles.
- The necessity of disaggregating financial instruments for the application of the OECD MTC cannot be generally rejected.¹⁷⁹³
- Legal risks in general¹⁷⁹⁴ and membership rights in particular¹⁷⁹⁵ must be excluded from disaggregation.
- Financial instruments not formally referring to a *share* as their underlying are not *shares* pursuant to Art. 10(3) OECD MTC and are not profit-participating *debt-claims* pursuant to Art. 11(3) OECD MTC¹⁷⁹⁶.
- Subordination has a major influence on the investor's exposure to business risk, in that it represents the primary absorber for business losses¹⁷⁹⁷.
- The maturity of financial instruments considerably affects their risk-return profiles, in that the default risks increase the longer the durations are¹⁷⁹⁸.

¹⁷⁸⁸ See par. 195.

¹⁷⁸⁹ See par. 85 et seq.

¹⁷⁹⁰ See par. 89.

¹⁷⁹¹ See par. 92.

¹⁷⁹² See par. 95.

¹⁷⁹³ See par. 96.

¹⁷⁹⁴ See par. 101(2).

¹⁷⁹⁵ See par. 106(6).

¹⁷⁹⁶ See par. 103(3).

¹⁷⁹⁷ See par. 107.

¹⁷⁹⁸ See par. 107(2).

- Financial instruments with a mere notional or floating principal cannot be *shares* pursuant to Art. 10(3) OECD MTC or *debt-claims* pursuant to Art. 11(3) OECD MTC. However, they are an indicator for *other income* pursuant to Art. 21(1) OECD MTC¹⁷⁹⁹.
- The temporal payment profile¹⁸⁰⁰ and the origin of the capital or principal¹⁸⁰¹ basically have little interpretation significance. This is why the time-based and risk-based components are not to be separated by way of disaggregation.
- Option rights and optional components are not to be separated from their underlyings but instead represent an integral part of them¹⁸⁰².

The key insight of these conclusions is to set the scope and an important limitation for the *substance over form* principle. By providing a clear rule against a consolidated view of separate legal instruments, it accentuates the legal form of financial instruments as the general baseline. It actually determines the upper limitation and the largest logical unit for the interpretation and application of the OECD MTC. On the other hand, the approach gives important guidelines for certain fields of potential differentiators, in that it further limits their number and indicates their significance.

- 338 *Beneficial ownership* is an indirect relation between a subject (i.e. a person) and an object (i.e. the asset or transaction) by way of composite legal transactions¹⁸⁰³. The concept must be separated into *beneficial ownership* in the income or transaction and *beneficial ownership* in the asset¹⁸⁰⁴. While the former serves the (re-)attributional purpose, the latter serves the anti-abuse purpose¹⁸⁰⁵. The (re)attributional aspect subsists explicitly in Art. 10(2) and 11(2) OECD MTC but implicitly in Art. 13(5) and 21(1) OECD MTC. In contrast, the anti-abuse aspect subsists in Art. 10(2) and 11(2) OECD MTC only¹⁸⁰⁶. The concept does not affect the genuine legal concepts and the interpretation of the terms *dividends* and *interest*¹⁸⁰⁷. It replaces one subject by another instead of (re-)classifying one object into another¹⁸⁰⁸. Consequently, it leaves the general principles and requirements to the inflow untouched (i.e. the *income*) but applies them to the outflow (i.e. the re-attribution) in a comparably less stringent manner¹⁸⁰⁹. The concept of *beneficial ownership* might principally be operationalised by a narrow risk test similar to the IAS/IFRS concept of *economic relationship*.¹⁸¹⁰ In systematic correspondence to the converse approach for the disaggregation scheme, this risk test is founded on a causal relation between the in- and outflows of individual transactions¹⁸¹¹. This causal relation must be quantitatively observable by an expected negative correlation depending on the same risk, and the in- and outflows must proportionate in approximately equal amounts or benefits. Where there is a dominating credit risk because of a time gap between the in- and outflow of an individual transaction, there cannot possibly

¹⁷⁹⁹ See par. 107(3).

¹⁸⁰⁰ See par. 107(4).

¹⁸⁰¹ See par. 107(5).

¹⁸⁰² See par. 107(7).

¹⁸⁰³ See par. 119 et seqq.

¹⁸⁰⁴ See par. 127.

¹⁸⁰⁵ See par. 128.

¹⁸⁰⁶ See par. 142.

¹⁸⁰⁷ See par. 124 and 129.

¹⁸⁰⁸ See par. 132.

¹⁸⁰⁹ See par. 140.

¹⁸¹⁰ See par. 135.

¹⁸¹¹ See par. 137.

be an *economic relationship* between them. As a consequence, a non-dominating credit risk is not capable positively verifying *beneficial ownership*, whereas a dominating credit risk is capable negatively falsifying it¹⁸¹². The key outcome of this section for the application of the OECD MTC to financial instruments is to introduce the concept of *beneficial ownership* as an important link between the various differentiators. It helps to better understand the treatment of basic terms such as *income*, accrued *interest* or capital *gains*. In that, it also contributes to avoid narrowing the view and thus constricting some crucial attributes towards meaninglessness.

- 339 The concept of *beneficial ownership* leads to the systematic conclusion that the term *income* has to be separated into an autonomous and qualitative aspect of its causal or contextual nature on the one hand and the domestic and quantitative determination of the tax base on the other¹⁸¹³. This makes negative income accessible to the general principles of the OECD MTC. The actual separation of the *income's* causal or contextual nature from its mathematical sign also means its independence from the *income's* amount¹⁸¹⁴. As a consequence, the absence of any *income* from a financial instrument at all does not remove the necessity and feasibility of classifying it into the distributive articles of the OECD MTC.
- 340 The terms *paid* in Art. 10(1) and 11(1) OECD MTC and *from* in Art. 10(3) and 11(3) OECD MTC form one logical unit or concept to be interpreted autonomously¹⁸¹⁵. They further limit the domestic interpretation of *income*¹⁸¹⁶.
- 341 *Capital* pursuant to chap. IV of the OECD MTC cannot be distinguished from *income* pursuant to chap. III of the OECD MTC economically but only legally.¹⁸¹⁷ Consequently, any *income* including capital *gains* must be realised at least by way of a legal event that creates a new right arising from a domestic field of law that is precursory to its tax law.¹⁸¹⁸ Thus, the OECD MTC represents a realisation-based tax system rather than an accretion-based tax system, being subject of a limited autonomous interpretation. Such a realisation principle sets the scope for the classification of income types from financial instruments in so far as deemed or notional income is basically not accessible to the OECD MTC.¹⁸¹⁹ The differentiator of capital *gains* pursuant to Art. 13(5) OECD MTC as opposed to the other income types of financial instruments is that the legal event must refer *to* the asset, in that it impairs the mathematical number of the critical ownership rights *in* the asset.¹⁸²⁰
- 342 The key benefit of these sections for the interpretation and application of the OECD MTC is to demonstrate and disentangle the ambiguous meaning of the term *income* as an important link between the treaty law and the domestic tax law. As such, it particularly contributes to the understanding and role of the realisation

¹⁸¹² See par. 138.

¹⁸¹³ See par. 139.

¹⁸¹⁴ See par. 201.

¹⁸¹⁵ See par. 151.

¹⁸¹⁶ See par. 152.

¹⁸¹⁷ See par. 158.

¹⁸¹⁸ See par. 163(1).

¹⁸¹⁹ See par. 173.

¹⁸²⁰ See par. 160 et seqq.

principle in the distinction between *income* pursuant to chap. III of the OECD MTC, capital *gains* pursuant to Art. 13(5) OECD MTC and *capital* pursuant to chap. IV of the OECD MTC.

- 343 Financial instruments are particularly sensitive to contextual or situative determinants.¹⁸²¹ This is why legal entitlements have a dual purpose of potentially representing both the economic return for legal obligations and parts of the economic operation itself.¹⁸²² Therefore, the legal entitlements must be subject of a precedent analysis in order to determine whether they represent the former (then to be interpreted domestically) or the latter (then in so far to be interpreted autonomously). Apart from this, the various legal criteria are principally equivalent.¹⁸²³ The main outcome of this section is to call attention to some peculiarities of financial instruments and to recommend a respective orientation for the perspective in which the OECD MTC should be applied in this respect.
- 344 Within the scope of this study¹⁸²⁴, matters of attribution and ownership are not accessible to the treaty principle of *substance over form* other than the concept of *beneficial ownership*¹⁸²⁵. In particular, there is no inherent systematic principle like an “economic ownership” in the Art. 10(3), 11(3), 13(5) and 21(1) OECD MTC. In order to constitute a *debt-claim* pursuant to Art. 11(3) OECD MTC¹⁸²⁶ or capital *gains* pursuant to Art. 13(5) OECD MTC¹⁸²⁷, the transfer of the capital as principal may consequently not be a mere economic one but must necessarily be a legal one. The result of this section for the interpretation and application of the OECD MTC is to strengthen the role and purity of the *beneficial ownership* concept. In that, it provides clarity in regards to alternative concepts of attribution and ownership and thus helps to further focus on the relevant aspects when dealing with financial instruments.
- 345 The voluntariness test describes potential payment conditions due to the source’s subjective decision on whether or not there shall be a payment or distribution.¹⁸²⁸ Voluntariness represents a sufficient maximum condition for constituting *other equity rights* and consequently also for *dividends* pursuant to Art. 10(3) OECD MTC.¹⁸²⁹ In the sense of a non-exclusive verifier, it can also be interpreted from the term’s etymological origin. Multilateralism in the sense of an involvement of more than two contracting parties can be an indicator for voluntariness, but neither be its verifier nor a falsifier for its complement of involuntariness.¹⁸³⁰
- 346 Involuntariness is represented by the redemption obligation in the sense of an absolute and unconditional legal right to be repaid¹⁸³¹ and can likewise be interpreted from the term’s etymological origin¹⁸³². However, it has merely the status of a necessary minimum condition (i.e. not of a verifier) for constituting time value of

¹⁸²¹ See par. 180.

¹⁸²² See par. 181.

¹⁸²³ See par. 182.

¹⁸²⁴ See sec. 1.2.

¹⁸²⁵ See par. 187.

¹⁸²⁶ See par. 297.

¹⁸²⁷ See par. 359 and seq.

¹⁸²⁸ See par. 188.

¹⁸²⁹ See par. 285.

¹⁸³⁰ See par. 191.

¹⁸³¹ See par. 289.

¹⁸³² See par. 285.

money¹⁸³³ and consequently also for genuine *debt-claims* and *interest* pursuant to Art. 11(3) OECD MTC¹⁸³⁴. The material test for the formal criterion of involuntariness is self-execution.¹⁸³⁵ It describes the absence of any payment condition at all.¹⁸³⁶ The redemption obligation and therefore Art. 11(3) OECD MTC do not apply to repurchase obligations.¹⁸³⁷

- 347 The concept of duration or maturity, which is reflected by the redemption obligation¹⁸³⁸, can be more precisely described in the stochastic sense as a more or less certain or uncertain condition¹⁸³⁹. It is most meaningful when being replaced with the stochastic concept of remuneration.¹⁸⁴⁰ In that, it becomes a hybrid concept, which is, at the same time, both time-based and risk-based. The subjacent conflict or dualism between aspects of time and those of risk must be solved in favour of the former where the two overlay.¹⁸⁴¹ This leads to the conclusion that the absence of a duration or maturity cannot be a differentiator for the income types of financial instruments. Where a duration of legal time periods actually exists, it can only be reduced by way of economic interpretation, and not extended.¹⁸⁴²
- 348 Participation in profits and losses is a relative concept and subordinate to a non-participation in profits and losses¹⁸⁴³. The two form a multi-static array of unlimited forms or states in the sense of a flexible or fluid “more or less” spectrum. As a consequence, it is systematically divided into the two different aspects of profits and losses on the one hand and participation or non-participation on the other.¹⁸⁴⁴ While actual profits and losses as *income* are to be determined by reference to domestic tax law, the question whether there is participation in that *income* also allows an autonomous interpretation. However, the purposive weakness of this approach in not allowing objective or universal statements, potentially deserves a cautious invocation and therefore relatively little interpretation significance of the participation in profits and losses criterion.¹⁸⁴⁵ The criterion is legally reflected by the attribute *participating in profits* in both Art. 10(3) and 11(3) OECD MTC. It represents a constituent element of the term *other rights* but an extending modification of the term *debt-claims*.¹⁸⁴⁶ Set into a relationship with the negating insertion *not being debt-claims* in Art. 10(3) OECD MTC, this interaction of the two provisions on different logical levels is the interpretational justification that the term *debt-claims* bears itself no genuine right to participate in profits. Beyond that, the attribute *participating in profits* is, however, not capable of serving as a differentiator for distinguishing equity and debt.¹⁸⁴⁷

¹⁸³³ See par. 242(3).

¹⁸³⁴ See par. 291.

¹⁸³⁵ See par. 289.

¹⁸³⁶ See par. 189.

¹⁸³⁷ See par. 292.

¹⁸³⁸ See par. 296.

¹⁸³⁹ See par. 196.

¹⁸⁴⁰ See par. 198.

¹⁸⁴¹ See par. 199.

¹⁸⁴² See par. 197.

¹⁸⁴³ See par. 204.

¹⁸⁴⁴ See par. 205.

¹⁸⁴⁵ See par. 206.

¹⁸⁴⁶ See par. 273.

¹⁸⁴⁷ See par. 280 and 295.

349 Modifications of the payment profile represent a time-based remuneration:

- independent of its periodicity, if the remuneration is either time-based or risk-based but time-equivalent¹⁸⁴⁸;
- if an uncertainty refers only to the timing risk of when the remuneration is paid, but not to the underwriting risk of whether or not it is paid at all¹⁸⁴⁹;
- where modified amounts from remuneration payments, analysed by grouping them together as a coherent whole, are exactly and certainly compensated by other remuneration payments from the same financial instrument¹⁸⁵⁰;
- if deferred payments bear compound interest¹⁸⁵¹; and
- independent of currency risk¹⁸⁵².

The *income* or transaction is basically to be classified according to the dynamic forward-looking view¹⁸⁵³. This is at the date of *income* payment, but in consideration of the remaining expectable lifetime of the financial instrument.

350 Unless they are time-equivalent¹⁸⁵⁴, positive modifications of the payment profile still represent a participation in profits and – in contrast to the time value of money¹⁸⁵⁵ – negative ones as well. The word *profits* in Art. 10(3) OECD MTC also includes losses. As a consequence, business risk is necessarily contained in and inextricably coalesced with both the participation in profits and losses (remuneration risk) and the capital or principal itself (termination risk).¹⁸⁵⁶ Nevertheless, the two aspects must be kept separated because the term *debt-claims* in Art. 11(3) OECD MTC, which bears itself no termination risk, is extended only by the remuneration risk¹⁸⁵⁷. This conceptual deficiency within the OECD MTC is due to the necessity that the underwriting risk in general and thus also the business risk in particular must be subsidiary to the redemption obligation requirement in order to constitute *debt-claims* as a legal construct (form over substance).¹⁸⁵⁸ Thus, the negating insertion *not being debt-claims* in conjunction with the attribute *participating in profits* turns out as to be the interpretational key element for the debt-equity distinction¹⁸⁵⁹. It leaves the crucial aspect of business risk only in the form of termination risk as a residuum within the term *other rights* and therefore Art. 10(3) OECD MTC.

351 Termination risk is the non-legal underwriting risk towards a non-perfect recovery of the capital or principal at maturity.¹⁸⁶⁰ It is capable of falsifying time equivalence and consequently the time value of money.¹⁸⁶¹ Termination risk arises where the pay leg of a financial instrument, separated by way of disaggregation,

¹⁸⁴⁸ See par. 211 et seq.

¹⁸⁴⁹ See par. 213.

¹⁸⁵⁰ See par. 215.

¹⁸⁵¹ See par. 216.

¹⁸⁵² See par. 217.

¹⁸⁵³ See par. 214.

¹⁸⁵⁴ See par. 276 et seq.

¹⁸⁵⁵ See par. 349.

¹⁸⁵⁶ See par. 279.

¹⁸⁵⁷ See par. 280.

¹⁸⁵⁸ See par. 346 et seq.

¹⁸⁵⁹ See par. 282 and 293.

¹⁸⁶⁰ See par. 232.

¹⁸⁶¹ See par. 242(2).

transfers a cash amount that is not solely dependent on the time value of money or an equivalent number of financial instruments.¹⁸⁶² In that, termination risk can principally be determined without applying different classification schemes for various classes of financial instruments (ring-fencing). The material termination risk test includes the formal criterion of a nominal value.¹⁸⁶³ The nominal value represents the redemption value and therefore a logical link between and fixation of what the creditor transfers to the debtor for lending (receive leg) and what the debtor owes in return to the creditor as the repayment (pay leg).¹⁸⁶⁴ This fixation is the legal justification for the transferrable finding from the IAS/IFRS that the pay leg and the receive leg correspond to each other under the *fixed-for-fixed condition* in a direct way and under the *fixed-for-variable condition* in an indirect way, whereas under the *variable-for-fixed* they correspond in neither way. Consequently, where there is no such link there cannot be any provision of capital. As a result, a mere notional or floating principal is a falsifier for *dividends* pursuant to Art. 10(3) OECD MTC¹⁸⁶⁵ and for *debt-claims* pursuant to Art. 11(3) OECD MTC¹⁸⁶⁶ and therefore a verifier for *other income* pursuant to Art. 21(1) OECD MTC¹⁸⁶⁷.

- 352 Subordination cannot be operationalised in a purposeful way as an autonomous differentiator, as it is determinable only on an individual or situative basis not allowing objective or universal statements.¹⁸⁶⁸ Instead, subordination must be interpreted formally and therefore pursuant to the domestic law, giving rise to potential qualification conflicts.
- 353 Coverage and collateral are economically substitutable. This allows the use of coverage as a differentiator for identifying counterparty risk in a potentially more reliable manner than collateral, in that it is capable of negatively falsifying credit risk.¹⁸⁶⁹ Fully covered obligatory financial instruments are not considered *debt-claims* pursuant to Art. 11(3) OECD MTC, but must rather be classified according to their underlying's nature.¹⁸⁷⁰
- 354 Sources of funds for repaying capital or principal provisions or contributions are not capable of serving as an autonomous differentiator for distinguishing equity and debt¹⁸⁷¹. The reasons are:
- Proceeds from the liquidation of assets are individual or situative, not allowing objective or universal and significant new statements.¹⁸⁷²
 - Business profits are to be determined by reference to domestic tax law.¹⁸⁷³
 - (Re-)financing sources bear a nexus with business profits, making any attempt to disentangle the two in order to reach an autonomous interpretation impossible.¹⁸⁷⁴

¹⁸⁶² See par. 348.

¹⁸⁶³ See par. 299.

¹⁸⁶⁴ See par. 298.

¹⁸⁶⁵ See par. 282.

¹⁸⁶⁶ See par. 299.

¹⁸⁶⁷ See par. 337.

¹⁸⁶⁸ See par. 220 et seq.

¹⁸⁶⁹ See par. 229.

¹⁸⁷⁰ See par. 303.

¹⁸⁷¹ See par. 251.

¹⁸⁷² See par. 244 et seq.

¹⁸⁷³ See par. 246.

¹⁸⁷⁴ See par. 250.

Instead, the determination of these sources bears a comprehensive and inextricable nexus with that of the *income*. They actually represent an inseparable mix or “infection” of the former by the latter. In that, they are entirely subject of the domestic interpretation¹⁸⁷⁵ and therefore give rise to potential qualification conflicts¹⁸⁷⁶. Due to the phrase *whether or not carrying a right to participate in the debtor’s profits*, this also applies to *debt-claims* pursuant to Art. 11(3) OECD MTC.¹⁸⁷⁷

- 355 Limb 2 of Art. 10(3) OECD MTC acts as a general clause for limb 1 in the sense of an intersection¹⁸⁷⁸, whereas limb 3 acts as a special clause for limb 2 in the sense of a carve-out¹⁸⁷⁹. As a consequence, limb 2 can share its attributes with limb 1 (upwards) but not take any attribute from limb 3 (downwards). In particular, the attribute *other corporate rights* as such is not relevant for the interpretation of the term *other rights*.¹⁸⁸⁰ Instead, it is to be interpreted autonomously and actually means equity *rights* as opposed to *debt-claims*. Consequently, the word *other* in limb 2 is to be understood in a different sense than the word *other* in limb 3.¹⁸⁸¹
- 356 The meaning of the word *debt-claim* is not limited to cash but also includes non-cash obligations.¹⁸⁸² The purpose of the *debt-claim* and whether or not it is securitised or subordinated¹⁸⁸³ is not relevant for its classification pursuant to Art. 11(3) OECD MTC, nor is the deduction from the debtor’s tax base¹⁸⁸⁴.
- 357 The difference between accrued interest and other forms of imputed interest is that the latter is no remuneration for the main or principal service of financing.¹⁸⁸⁵ However, to the author’s understanding, the consensus view that accrued interest shall be considered *paid* is not a justifiable legal principle but rather appears to be a common or best practice¹⁸⁸⁶.
- 358 The following illustration visualises and summarises the understanding of debt-equity delimitation as represented in this study:

¹⁸⁷⁵ See par. 251.

¹⁸⁷⁶ See par. 252.

¹⁸⁷⁷ See par. 302.

¹⁸⁷⁸ See par. 260 and 272.

¹⁸⁷⁹ See par. 267 and 272.

¹⁸⁸⁰ See par. 272.

¹⁸⁸¹ See par. 270 and 272.

¹⁸⁸² See par. 300 et seq.

¹⁸⁸³ See par. 304.

¹⁸⁸⁴ See par. 305.

¹⁸⁸⁵ See par. 306.

¹⁸⁸⁶ See par. 307 et seqq.

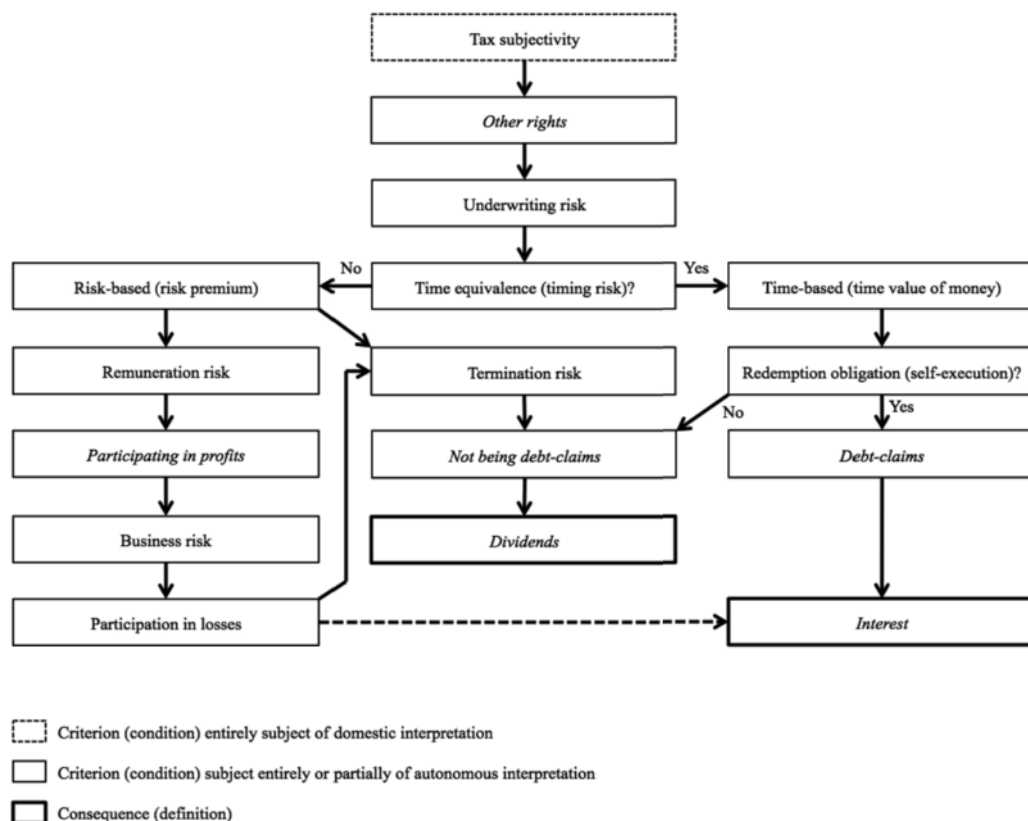


Illustration 23: Logical debt-equity delimitation scheme (high-level)

- 359 The main outcome of these sections is not only to introduce, analyse and distinguish some inherent concepts in what is discussed in the jurisprudential research and discourse as potential differentiators between debt and equity. In particular, these concepts are embedded and discussed in a thorough legal interpretation of Art. 10(3) and 11(3) OECD MTC. Beyond that, those concepts are also operationalised into concrete tie-breaking tests. In addition, the sections further analyse the relations between these classifiers and their relative significance. In that, they are re-evaluated against each other and reduced to a compact set of clear and meaningful differentiators for the interpretation and application of the OECD MTC to financial instruments. As the key objective, the study thus recommends a system of classifiers, which are coherent, consistent, universal, complete, mutually exclusive, justifiable, autonomous, objective, resilient and operationalizable¹⁸⁸⁷.
- 360 As regards capital *gains* pursuant to Art. 13(5) OECD MTC, the term *alienation* must be subject of a differentiated interpretation. The reason is that it actually coalesces the following different aspects:¹⁸⁸⁸

¹⁸⁸⁷ See sec. 1.1.2.

¹⁸⁸⁸ See par. 314.

- A change in the asset attribution, which must be interpreted formally or legally and therefore under the terms of domestic tax law pursuant to Art. 3(2) OECD MTC.¹⁸⁸⁹
- A transfer transaction as a result from that change, which must likewise be interpreted formally or legally and therefore under the terms of domestic tax law.¹⁸⁹⁰
- The realisation of this transaction, which includes partial disposals and is subject of a limited autonomous interpretation applying form over substance.¹⁸⁹¹ It requires at least a legal event arising from a domestic field of law that is precursory to its tax law and refers *to* the asset, in that it impairs the mathematical number of the critical ownership rights *in* the asset pursuant to domestic law.
- The attribution of the capital *gain* from this realised transaction, which is subject of the *substance over form* principle in the form of the *beneficial ownership* concept.¹⁸⁹²

361 Hence, the *substance over form* principle theoretically takes effect only upon the subjective attribution of the capital *gains*, i.e. the pass-through of the realised *income* rather than the ownership rights in the asset itself.¹⁸⁹³ This view is however not of major relevance for the theory of interpreting Art. 13(5) OECD MTC (but may be relevant for the practice of its application). The reason is that the genuine attributee of capital *gains* is always identical with the attributee of the asset itself.¹⁸⁹⁴ Only with this reservation and to this extent does the author agree with the majority view that the term *alienation* could in result be said to require a “change in economic ownership”.¹⁸⁹⁵

362 Cases of unilateral termination without a transfer to another person or subject are not included in the term *alienation* pursuant to Art. 13(5) OECD MTC.¹⁸⁹⁶ Among the bilateral transfers to another person or subject, the return for the disposal is not relevant either. As a consequence, the term *alienation* also includes non-cash exchange transactions and transactions without any return at all. That is why the information to what extent the ratio between the number of the critical ownership rights in the asset and their proportional value changes as a result of the transaction¹⁸⁹⁷ cannot be used as a differentiator for capital *gains*.¹⁸⁹⁸

363 The key benefit of these sections is to complement the recommended debt-equity delimitation by a corresponding analysis and presentation of capital *gains*. In that, the study not only contributes to the better understanding and application of numerous DTC to financial instruments; altogether, it also reveals and demonstrates the limitations, deficiencies and areas for potential improvements of the OECD MTC when tackling the specific challenges of modern financial instruments.

¹⁸⁸⁹ See par. 315.

¹⁸⁹⁰ See par. 317 et seqq.

¹⁸⁹¹ See par. 320.

¹⁸⁹² See par. 321.

¹⁸⁹³ See par. 322.

¹⁸⁹⁴ See par. 323.

¹⁸⁹⁵ See par. 324.

¹⁸⁹⁶ See par. 326.

¹⁸⁹⁷ See par. 162 and 253.

¹⁸⁹⁸ See par. 326.

364 While Art. 21(1) OECD MT is a residuary clause for all other distributive articles of the OECD MTC¹⁸⁹⁹, the definition and delimitation of gambles is in result not relevant for this study¹⁹⁰⁰.

¹⁸⁹⁹ See par. 328.

¹⁹⁰⁰ See par. 330 et seq.

Chapter 5

Classification of selected types of financial instruments

5.1 Preliminary remarks

365 The purpose and objective of this practice section is to concretely subsume a variety of financial instruments under the relevant distributive articles of Art. 10(3), 11(3), 13(5) or 21(1) OECD MTC. The classification is made on the level of types or classes described by one or more specific features. As a consequence, the analysis remains on a certain abstraction level. Furthermore, the range of financial instruments chosen for such application represents an open selection without making any claim to be complete or exhaustive. Facing a vast diversity of new innovations and modifications as well as an almost infinite number of financial instruments throughout the world¹⁹⁰¹, it picks those types or classes which the author encountered during this study and which seem conceptually the most ambiguous and controversial ones. The selection starts with forward transactions, including options and swaps as the building blocks¹⁹⁰² of many financial instruments¹⁹⁰³, particularly convertibles¹⁹⁰⁴. It then proceeds to so-called *linkers*¹⁹⁰⁵ as a kind of “integrated convertibles” and eventually to preference shares¹⁹⁰⁶, which in some respect may be seen as the conceptual opposite of such *linkers*. The section ends with a side note on strips¹⁹⁰⁷ because of their specific ambiguity between *income* (transaction) and *capital* (asset) and a side note on the cross-sectional class of non-cash based financial instruments¹⁹⁰⁸, which exhibits some very specific features which give rise to additional systematic issues.

¹⁹⁰¹ See par. 8.

¹⁹⁰² See par. 89.

¹⁹⁰³ See sec. 5.2.

¹⁹⁰⁴ See sec. 5.3.

¹⁹⁰⁵ See sec. 5.4.

¹⁹⁰⁶ See sec. 5.5.

¹⁹⁰⁷ See sec. 5.6.

¹⁹⁰⁸ See sec. 5.7.

5.2 Forward transactions and swaps

5.2.1 Structure

- 366 Forward transactions in the broader sense are financial instruments featured with a deferral between obligation and execution. The minimum length of this deferral period in order to separate spot and forward transactions is typically set by convention¹⁹⁰⁹ and depends to a large extent on the respective market practice (e.g. currency forwards between institutional counterparties can be intra-day). The underlyings of forward transactions in the broader sense can be assets (e.g. securities, currencies) but also future cash flows (e.g. interest¹⁹¹⁰, mortgages¹⁹¹¹, etc.) or risks (e.g. credit default swap¹⁹¹², variance or volatility swaps¹⁹¹³, compound or split-fee options). Swaps are recurring or repetitive forward transactions, which actually means that the execution of the entire financial instrument is spread over more than one single time.
- 367 As a general issue applying to all kinds of such forward transactions in the broader sense, the question arises whether the deferral as such has any relevance for the income classification. To the author's understanding, the answer must be in the negative. The reason is that it is not the mere entering into an obligation or commitment which is a transfer at the disposal of the counterparty¹⁹¹⁴ and thus a realised tax event¹⁹¹⁵, but rather its later execution. This becomes even more evident by considering that the amount of the future *income* pursuant to chap. III of the OECD MTC is not even known at this early point in time. Although it can admittedly be argued that an option premium is such realised *income*, this is, however, not a consequence of the deferral as such but rather of the financial instrument's optional nature¹⁹¹⁶. The reason is that the option premium is realised solely and exclusively because the option holder has to compensate the option writer definitively for taking the definitive risk of maybe not executing the option in future. This becomes particularly clear when considering that, if the financial instrument was not optional and thus that risk not definitive, any premium would be merely a provisional pre-payment (e.g. margin payments) on the total income (i.e. the actual capital *gain*) and could therefore not yet be realised. While the purpose and value of the optional component depends on the deferral (i.e. the longer the maturity the higher usually the option premium), the deferral does, in turn, not depend on the optional component. The natural reason is that the deferral is a constituent feature of all kinds of forward transactions, whereas the optional component is a constituent feature only of a specific class of forward transactions (hereinafter referred to as "options"). For these reasons, it can be held as an interim conclusion for the further course of this study that a deferral between the obligation and execution of financial instruments has itself no relevance for their classification. Therefore, forward transactions are – in this temporal respect – nothing but the respective spot transactions and therefore basically share their underlyings' fate. For instance, a forward purchase – just as a spot purchase – is not a realised tax event, whereas a forward sale is basically nothing other than a spot sale and therefore principally capable of realising a capital *gain*¹⁹¹⁷.

¹⁹⁰⁹ See Example 10 on p. 41.

¹⁹¹⁰ For a comprehensive overview of common products observable on the market see *Frank Fabozzi*, p. 756 et seqq.

¹⁹¹¹ *Frank Fabozzi*, p. 775 et seqq.

¹⁹¹² *Frank Fabozzi*, p. 790 et seqq.

¹⁹¹³ *Juan Ramirez*, p. 58 et seqq.

¹⁹¹⁴ See par. 148, 169 and 320.

¹⁹¹⁵ As will be shown in the following (see par. 370).

¹⁹¹⁶ See par. 369 et seqq.

¹⁹¹⁷ See par. 326.

- 368 Going further, the relevant legal features of forward transactions in that broader sense are:
- (1) optionality, i.e. whether or not the execution is at the discretion of one contracting party;
 - (2) seriality, i.e. whether or not the execution is spread over more than one single time;
 - (3) the tax-wise nature of the underlying pursuant to the distributive articles of the OECD MTC; and
 - (4) the way or method of settlement, i.e. gross physically or net cash or net share.

5.2.2 Optionality

- 369 As regards the first aspect (1), options are different from non-optional forward transactions (i.e. in the narrow sense, hereinafter referred to as “forwards”). The difference is that the deferred execution is subject to the holder’s subjective decision or discretion. In fact, such unilateral participation in value appreciation without also participating in value depreciation represents a separation of the underlying’s risks and chances. It is followed by a shift of solely the underlying’s risks from the option holder to the option writer (i.e. an asymmetric net risk¹⁹¹⁸), which is typically compensated by the risk premium¹⁹¹⁹ as the price of the option agreement (economic insurance). This option price is the expectable (risk-adjusted) return or income of the option holder from the underlying (e.g. the expected capital gain), which is correspondingly the expectable loss of the option writer from that underlying. Unlike the actual capital *gain* of forwards, this return or income is typically, but not necessarily¹⁹²⁰, paid in advance. In fact, this merely means that it is debt-financed by the option writer¹⁹²¹ and therefore reduced (discounted) by the respective debit interest (time-adjusted)¹⁹²². However, this advance financing is not the constituent or qualifying feature of options¹⁹²³. And even if it was, such financing of the expected return or income was ancillary to the main or principal service of the underlying operation itself (e.g. transferring the underlying asset) and therefore gave rise to imputed interest only¹⁹²⁴. In addition, the typical short-term duration or maturity of options does not necessitate a high application significance and therefore a disaggregation of that interest component¹⁹²⁵. In result, the only question remaining is therefore whether options and consequently realised option premiums are *ceteris paribus* to be classified separated from their underlyings.

Options are to be classified at their maturity

- 370 In this respect, it was stated that risk considerations principally support the view of not separating options from their underlyings but instead of treating the two as one logical concept or mechanism. The reason was that already upon entering into the option obligation or commitment the underlying’s risk burden as one of its most important economic interests, just as selling the underlying spot, changes from the option holder to the option writer¹⁹²⁶. However, this autonomous view basically conflicts with the semi-autonomous

¹⁹¹⁸ See par. 64.

¹⁹¹⁹ See Example 24 on p. 108.

¹⁹²⁰ IAS Board, December 2016, 5B, p. 8 et seq., par. 29(a).

¹⁹²¹ See par. 106(7).

¹⁹²² *Black, Fischer / Scholes, Myron*, The Pricing of Options and Corporate Liabilities, The Journal of Political Economy 1973, Vol. 81, No. 3, p. 644.

¹⁹²³ See par. 89 and 91.

¹⁹²⁴ See par. 306.

¹⁹²⁵ Perhaps contrary: *Achim Pross*, p. 167 et seq., discussing the principal separability of the interest component of swaps only in the general context of financial engineering without, however, taking a clear position on whether or not it is actually suggested in the particular context of the OECD MTC. See also par. 106(4) and 212.

¹⁹²⁶ See par. 106(7).

interpretation of the realisation requirement, particularly where the option is not executed¹⁹²⁷. In this case, the genuine *income* is not yet transferred at the disposal of the *recipient* or *beneficial owner* in the manner required by contract or by custom¹⁹²⁸ (e.g. *interest* exchanged with an optional forward rate agreement). Where the underlying is an asset, it also conflicts with the domestically interpreted change of the asset attribution¹⁹²⁹ as a necessary minimum condition (*conditio sine qua non*) for constituting capital *gains* pursuant to Art. 13(5) OECD MTC¹⁹³⁰. In this case, the formally interpreted legal event could not refer to the asset, as the mathematical number of its critical ownership rights is not impaired. These conflicts are actually caused by the optional nature of perhaps not being executed and therefore not transferring the underlying. And, secondly, they are rooted in the deferral between the realisation of the option premium and the realisation of the underlying. In fact, the optional character was found to be independent of the realisation itself and therefore irrelevant for the income classification¹⁹³¹, even more as the mere advance payment as such is no constituent or qualifying feature of options¹⁹³². In other words: the payment date cannot possibly alter the genuine nature and therefore the classification of the income. In fact, the option premium represents a participation in the positive economic interests without necessarily transferring also the underlying itself, which are however both required by Art. 10(3), 11(3) and 13(5) OECD MTC. As the temporal element is irrelevant, the distributive articles are consequently triggered *as soon as* the last legal condition or requirement is fulfilled, just as for any other structured transfer (e.g. pre-payments, initial public offerings). In other words: the distributive articles require an actual transfer at the disposal of the counterparty. Consequently, the nature and therefore the classification of an option premium – even though being realised itself¹⁹³³ – can eventually not be determined before the option is due. This also reflects the key difference between the nature of options and any form of capital provision (i.e. debt or equity), in that a capital provision actually represents a total of *two* closed transfers (i.e. the provision and repayment of the underlying), *each* out of one opening (i.e. the obligation) and one closing event (i.e. the execution). In contrast, an option actually represents a total of just *one* transfer (i.e. of the underlying) out of one opening and one closing event (pending transaction). In addition, this understanding is also in line with the dynamic forward-looking view of income classification, which must consider the remaining expectable lifetime of the option¹⁹³⁴. Ergo, once the option is executed and settled gross physically, the option premium fulfils all information requirements to be classified into the distributive articles of the OECD MTC.

Example 51: The option premium of a “deep-in-the-money option”¹⁹³⁵ (short call or long put) should regularly be subsumable under Art. 13(5) OECD MTC if gross-physically settled.

¹⁹²⁷ See par. 320 et seqq.

¹⁹²⁸ See par. 148.

¹⁹²⁹ See par. 315.

¹⁹³⁰ See par. 314.

¹⁹³¹ See par. 367.

¹⁹³² See par. 369.

¹⁹³³ See par. 367.

¹⁹³⁴ See par. 214.

¹⁹³⁵ See Example 5 on p. 30.

Obviously, these principals of such late classification only at closing (“wait and see” approach¹⁹³⁶) are even more evident for forwards¹⁹³⁷, which bear symmetric risks and therefore do not pay out any risk premium at all. As regards the option right itself, its execution represents a unilateral termination without a transfer to another person or subject and therefore no *alienation* pursuant to Art. 13(5) OECD MTC¹⁹³⁸.

Premiums of expired options are other income pursuant to Art. 21(1) OECD MTC

371 Hence, where the option expires, the option premium does not fulfil the requirements to a capital *gain* pursuant to Art. 13(5) OECD MTC. However, the subsequent question arises whether its participation in the positive economic interests of the underlying may makes the option premium itself a *dividend* pursuant to Art. 10(3) OECD MTC or perhaps a profit-participating *debt-claim* pursuant to Art. 11(3) OECD MTC. Beforehand, this could only be the case if the option formally refers to a *share* as its underlying.¹⁹³⁹ Otherwise the option premium must necessarily be subsumed under Art. 21(1) OECD MTC. Given this formal reference, such mere partial participation in only the positive economic interests of the underlying can still represent a participation in profits. The reason is that the word *profits* in Art. 10(3) OECD MTC can, but not necessarily must, include losses.¹⁹⁴⁰ In addition, the business risk from the level of the underlying is merely replaced by the business risk coincidentally transferred into the level of the option itself.¹⁹⁴¹ Due to the concept of time equivalence¹⁹⁴², it also does not principally conflict with the time value of money as a constituting element¹⁹⁴³ of genuine *debt-claims*, even more as any option always has a time-based duration or maturity. However, the premium of an expired option obviously does not represent a requisite capital provision to constitute a genuine *share* or *debt-claim*. In fact, there is no capital provision with a total of *two* closed transfers¹⁹⁴⁴ of a provision and a repayment of capital or principal. As a consequence, the extending modification in Art. 11(3) OECD MTC cannot come into effect either.

372 Lastly, the option premium of an expired option cannot represent a derivative *dividend* or *interest* by way of *beneficial ownership* either. The reason here is not that an option is not a capital provision¹⁹⁴⁵, as the concept of *beneficial ownership* was found to be separated into the asset-related and transaction-related aspect¹⁹⁴⁶. Instead, the reason is that *beneficial ownership* is not a (re-)classification of the option premium into a *dividend* or *interest* but rather a replacement of its *recipient* by the *beneficial owner*.¹⁹⁴⁷ Therefore it still requires a genuine *dividend* or *interest* as a necessary minimum condition (*conditio sine qua non*) to apply. For the following reasons, this can never be true:

¹⁹³⁶ See footnote 809.

¹⁹³⁷ Argumentum a minori ad maius.

¹⁹³⁸ See par. 326.

¹⁹³⁹ See par. 103(3).

¹⁹⁴⁰ See par. 350.

¹⁹⁴¹ See par. 277.

¹⁹⁴² See par. 212.

¹⁹⁴³ See par. 296.

¹⁹⁴⁴ See par. 370.

¹⁹⁴⁵ See par. 371.

¹⁹⁴⁶ See par. 122 et seqq.

¹⁹⁴⁷ See par. 132.

- (1) Where the expired option aims at the change of the asset attribution, the option premium as the risk- and time-adjusted capital *gain*¹⁹⁴⁸ depends solely on its unrealised value appreciation. Therefore it is independent of any legal event creating a new right.¹⁹⁴⁹
- (2) Where the underlying is neither a *share* nor a *dividend* or *interest* cash flow there is no requisite formal reference.
- (3) From the long perspective of the expired option, the option premium is paid out and not received.
- (4) Where the short option is a call, the option writer as the receiver of the option premium had to pay out the *dividend* or *interest* cash flow to the option holder (i.e. in the opposite direction of the option premium), so that the former cannot possibly replace the latter.
- (5) Where the expired short option is a put on an *interest* cash flow, the actual *interest* cash flow is obviously higher than agreed, as the option would otherwise have been executed by the option holder. Consequently, the option premium would represent – if at all – a negatively modified “interest”. This was however found incompatible with the concept of time value of money¹⁹⁵⁰ as one of the constituting elements¹⁹⁵¹ of genuine *debt-claims* pursuant to Art. 11(3) OECD MTC. This result remains valid irrespective of the extending modification towards a profit participation, which can thus not come into effect, even more as the financial instrument obviously contains an optional component¹⁹⁵².
- (6) Where the expired short option is a put on a *dividend* cash flow, the actual *dividend* cash flow is obviously higher than agreed, as the option would otherwise have been executed by the option holder. Admittedly, the option premium could analogously represent a negatively modified “dividend”, which was found not to be in conflict with business risk¹⁹⁵³ as one of the constituting elements of *other* (equity) *rights* pursuant to Art. 10(3) OECD MTC¹⁹⁵⁴. In addition, the transfer of such *dividend* cash flow should also comply with the requirement of *beneficial ownership* of a causal relation between the in- and outflows of individual transactions, quantitatively observable by an (expected negative) correlation depending on the same risk¹⁹⁵⁵. In the author’s view, the transfer of such *dividend* cash flow does not, however, comply with the requirement of *beneficial ownership* that the in- and outflows must also proportionate in approximately equal amounts or benefits, which was found to be interpreted in a particularly restrictive sense¹⁹⁵⁶. In other words: negatively modified cash flows on the one hand and passed-through ones on the other may – each taken separately – represent *dividends* pursuant to Art. 10(3) OECD MTC. But the particularly high demands of the *beneficial ownership* concept on the proportionality of the in- and outflows make it eventually impossible to also subsume the combination of both under Art. 10(3) OECD MTC (i.e. negatively modified cash flows passed-through).

¹⁹⁴⁸ See par. 369.

¹⁹⁴⁹ See par. 158.

¹⁹⁵⁰ See par. 215.

¹⁹⁵¹ See par. 296.

¹⁹⁵² See par. 213.

¹⁹⁵³ See par. 276 et seq.

¹⁹⁵⁴ See par. 282.

¹⁹⁵⁵ See par. 338.

¹⁹⁵⁶ See par. 135.

For these reasons, the option premium must necessarily be subsumed under Art. 21(1) OECD MTC, where the option expires. As regards the option itself, its expiry represents a unilateral termination without a transfer to another person or subject and therefore not an *alienation* pursuant to Art. 13(5) OECD MTC¹⁹⁵⁷.

5.2.3 Seriality

373 As regards the second aspect (2) of seriality¹⁹⁵⁸, the execution of forward transactions can be spread over more than one single time (swaps)¹⁹⁵⁹. In this respect, it might initially be suggested that swaps are to be disaggregated into a series of forward transactions. In fact, such disaggregation turns out to be unnecessary. The reason is that those partial executions are nothing other than partial transfers of the underlying. Where the underlying is an asset, partial disposals were found to be included in the term *alienation* pursuant to Art. 13(5) OECD MTC¹⁹⁶⁰. Where the underlying is a cash-flow, however, (e.g. total return swap), the question arises what the difference is between a realised partial transfer and a provisional and therefore not yet realised pre-payment on the total income¹⁹⁶¹ from the swap – even more as swaps can themselves be optional (swaption). To the author's understanding, the difference is that partial transfers are themselves closed and cohesive transactions. They refer to different legal events (e.g. time periods, obligations, etc.) and are therefore independent from each other. In contrast, provisional pre-payments are related transactions as they refer to one and the same legal event and are therefore interdependent on each other. Correspondingly, the IAS/IFRS do not recognise payments as assets which compensate future benefits instead of past or actual ones¹⁹⁶² either. Consequently, there are principally three types of payments to be distinguished:

- *Income*, i.e. partial (e.g. swap) or total (e.g. forward) transfers being realised and classifiable on their payment date;
- *Option premiums*, i.e. partial (e.g. swaption) or total (e.g. option) transfers being actually realised but classifiable only on the option's maturity date; and
- *Provisional prepayments*, i.e. partial transfers (e.g. margin payments) not being realised, as the requisite legal event of the realisation requirement is in the future.

In other words: the periodic transfers of swaps and swaptions with a cash flow or any other non-asset as their underlying are ultimately transferred at the disposal of the *recipient* or *beneficial owner* in the manner required by contract or by custom.¹⁹⁶³ In that, they represent realised partial transfers analogous and equivalent to partial disposals pursuant to Art. 13(5) OECD MTC. Consequently, swaps and swaptions *are* already somewhat disaggregated, making any disaggregation dispensable as a separate preparatory step¹⁹⁶⁴. This also means that each particular swap or swaption period is in result subject of an individual analysis.

¹⁹⁵⁷ See par. 326.

¹⁹⁵⁸ See par. 368(2).

¹⁹⁵⁹ See par. 366.

¹⁹⁶⁰ See par. 320.

¹⁹⁶¹ See par. 367.

¹⁹⁶² IAS 32.AG11.

¹⁹⁶³ See par. 148.

¹⁹⁶⁴ See par. 86.

5.2.4 Underlying

The underlying's classification as the general principle

- 374 Concerning the third aspect (3)¹⁹⁶⁵, gross-physically settled forward transactions were found to share their underlyings' tax-wise nature¹⁹⁶⁶. Regardless of whether optional or non-optional, they are thus to be classified into the same distributive articles of the OECD MTC as their underlyings. In that, they also reflect and integrate themselves into the systematic structure and taxonomy of the OECD MTC. Hence, where the underlying is an asset, its gross-physically settled disposal by way of a forward transaction constitutes a capital *gain* pursuant to Art. 13(5) OECD MTC¹⁹⁶⁷, where a legal event from the domestic law changes the asset attribution by impairing the mathematical number of the asset's critical ownership rights. Accordingly, where the underlying is a cash flow (e.g. forward rate agreement) or any other non-asset (e.g. total return swap), its gross-physically settled transfer at the *recipient's* or *beneficial owner's*¹⁹⁶⁸ disposal by way of a forward transaction may principally constitute a *dividend* or *interest*¹⁹⁶⁹, depending on the underlying's classification. In contrast, premiums from expired options and swaptions generally constitute *other income* pursuant to Art. 21(1) OECD MTC.¹⁹⁷⁰

The relevance of beneficial ownership in general

- 375 However, like expired options¹⁹⁷¹, gross-physically settled forward transactions with a cash flow or any other non-asset as their underlying must be analysed methodologically as by applying a two-tier approach. The reason is that they might either represent genuine *dividends* or *interest* or, if not, passed-through *income* by way of the derivative concept of *beneficial ownership*. While this two-tier approach principally also applies to Art. 13(5) OECD MTC, disposals by way of forward transactions represent, however, genuine capital *gains*. This is due to the fact that the genuine attributee of capital *gains* is always identical to the attributee of the asset itself.¹⁹⁷² In contrast, gross-physically settled forward transactions with a cash flow or any other non-asset as their underlying can not represent genuine *dividends* or *interest*. The reason is that those financial instruments can be featured in such a way that the transfer either includes or excludes the asset itself. In the former case, the financial instrument does not transfer the mere cash flow but actually the asset itself and therefore falls as a capital *gain* under Art. 13(5) OECD MTC. In the latter case, the financial instrument has – even if seen as a capital provision with a total of *two* closed transfers¹⁹⁷³ – a mere notional capital or

¹⁹⁶⁵ See par. 368(3).

¹⁹⁶⁶ See par. 367.

¹⁹⁶⁷ Perhaps contrary: Federal Court of Canada, judgement ref. T-3194-78, 1979, par. 21, leaving however open whether the exercise of the option was considered not a genuine alienation of the underlying capital asset(s) at all or, instead, was actually considered such genuine alienation but constituted and thus to be classified in the derivative context of employment income (see par. 10 and 74) as the subject of this case.

¹⁹⁶⁸ Swiss Bundesgericht, judgement ref. 2C_364/2012 and 2C_895/2012, 2015.

¹⁹⁶⁹ Perhaps Contrary: Pöllath, Reinhard / Lobbeck, Allit in Vogel / Lechner, p. 1327, par. 75, without justification.

¹⁹⁷⁰ See par. 372.

¹⁹⁷¹ See par. 371 et seq.

¹⁹⁷² See par. 323.

¹⁹⁷³ See par. 370.

principal¹⁹⁷⁴. Therefore it cannot be a genuine *share*¹⁹⁷⁵ or *debt-claim*¹⁹⁷⁶ but, in the absence of any finance transaction, basically only *other income*.

The relevance of beneficial ownership where the underlying is not an asset

- 376 However, Art. 21(1) OECD MTC is not only subsidiary to Art. 10(3) and 11(3) OECD MTC but also to Art. 10(2) and 11(2) OECD MTC and thus to the *beneficial ownership*. The concept of *beneficial ownership* was found to be separated into the asset-related and transaction-related aspects¹⁹⁷⁷. As a derivative concept, it is not necessarily required to comply with all the general principles of the OECD MTC applicable to genuine concepts.¹⁹⁷⁸ In other words: where the underlying is classified as a *share* or *debt-claim* (i.e. a cash flow or risk with no mere notional capital or principal), the question of whether its gross-physical settlement represents *beneficial ownership* pursuant to Art. 10(2) or 11(2) OECD MTC (i.e. the underlying level) methodologically applies prior to the subsequent potential classification of the forward transaction itself as *other income* pursuant to Art. 21(1) OECD MTC (i.e. the “derivative” level). In the author’s view, the transfer of cash flows from such forward transactions basically complies with the requirement of a causal relation between the in- and outflows of individual transactions quantitatively observable by an expected negative correlation depending on the same risk, whereby the in- and outflows proportionate in approximately equal amounts or benefits¹⁹⁷⁹.

The special case of put options

- 377 In the absence of a respective inflow, these conclusions do not apply to uncovered long puts on a *dividend* or *interest* cash flow (i.e. forward short sales). These represent actually a net-cash settlement, which will be analysed separately¹⁹⁸⁰. Apart from this exception, it applies, however, to gross-physically settled short puts on *dividend*¹⁹⁸¹ and *interest*¹⁹⁸² cash flows. Admittedly, the actual cash flow is obviously lower than agreed and therefore could be seen as a positively modified “interest”. This was found to be incompatible with the concept of time value of money¹⁹⁸³ as one of the constituting elements¹⁹⁸⁴ of genuine *debt-claims* pursuant to Art. 11(3) OECD MTC. And it also does not comply with the restrictive requirement to *beneficial ownership* that the in- and outflows must also proportionate in approximately equal amounts or benefits, as the option would otherwise not have been executed by the option holder. In contrast to expired options, the gross-physically settlement produces, however, an additional payment that exactly amounts to the actual cash flow and eventually complements or replaces the option premium received (i.e. pass-through). As a consequence, short put options represent *beneficial ownership* where the underlying is subsumed under Art. 10(3) and 11(3) OECD MTC respectively.

¹⁹⁷⁴ Equally: *Edward Kleinbard*, financial innovations, p. 1333.

¹⁹⁷⁵ See par. 282.

¹⁹⁷⁶ Equally: *Gaspar Lopes Dias*, debt-claims, sec. 1.3.; OECD, Taxation of new Financial Instruments, OECD, Paris, 1994, p. 13, par. 36, and p. 32, par. 141. See also par. 299.

¹⁹⁷⁷ See par. 122 et seqq.

¹⁹⁷⁸ See par. 140.

¹⁹⁷⁹ See par. 338.

¹⁹⁸⁰ See par. 380.

¹⁹⁸¹ See par. 372(6).

¹⁹⁸² See par. 372(5).

¹⁹⁸³ See par. 215.

¹⁹⁸⁴ See par. 296.

5.2.5 Settlement

- 378 Regarding the fourth aspect (4)¹⁹⁸⁵, to the author's understanding, any form of net settlement principally implies an additional realisation transaction.

Example 52: A net-settled forward sale, long put or short call constitutes not only a disposal of the underlying at the forward price. In addition, it also constitutes the immediate reacquisition of the underlying at the spot price. A net-settled forward purchase, long call or short put constitutes not only an acquisition of the underlying at the forward price. In addition, it also constitutes its immediate resale at the spot price.

While this should be obvious with net cash settlements, it also applies to net share settlements. The reason is that the gross receive leg actually represents a surrogate for the return.¹⁹⁸⁶ As such, it is covered by the term *paid* in Art. 10(1) and 11(1) OECD MTC and analogously also by the term *alienation*¹⁹⁸⁷ in Art. 13(5) OECD MTC¹⁹⁸⁸. However, where the underlying is an asset, the application of Art. 13(5) OECD MTC fails at least in the absence of its actual transfer in the sense of formally and legally changing its attribution¹⁹⁸⁹. In contrast, Art. 10(3) and 11(3) OECD MTC naturally do not provide such a restrictive formal requirement of an asset transfer¹⁹⁹⁰. Consequently, only where the underlying is a cash flow from a financial instrument classified as *shares* or *debt-claims*, the question remains whether or not the settlement method gains in significance for the classification of financial instruments. Admittedly, financial instruments with a mere notional principal which always coincides with net-settlements were thus found to be unclassifiable as a *share* or *debt-claim*.¹⁹⁹¹ Instead, they should be treated as *other income*. However, such residual classification was said to be subsidiary to the concept of *beneficial ownership*. Ergo, the question arises whether a net-settled cash flow from financial instrument classified as *shares* or *debt-claims* can still represent a passed-through *dividend* or *interest*, just as gross-physically settled cash flows from *shares* or *debt-claims* do.

- 379 From the author's point of view, the answer must be in the negative¹⁹⁹². On the one hand, the disaggregation of net-settled options into their hypothetic forward and spot components or legs was found incapable of contributing any value added¹⁹⁹³. The reason was that options represent the building blocks of financial instruments, and are replicable only by other options (put-call parity) without however impacting the economic substance. In result, this applies also to forwards, although in this sense they represent "more complex" financial instruments. The reason is that their multi-stage processing of risk identification, risk disaggregation and risk elimination¹⁹⁹⁴ could bring forth only one single non-legal risk type: the underwriting risk from the underlying itself. Obviously, it is this underwriting risk from the underlying itself to which

¹⁹⁸⁵ See par. 368(4).

¹⁹⁸⁶ See par. 181.

¹⁹⁸⁷ See par. 145.

¹⁹⁸⁸ See par. 316.

¹⁹⁸⁹ Equally: Wassermeyer, Franz in Wassermeyer Commentaries, p. 1618, par. 37. See also par. 315.

¹⁹⁹⁰ See par. 162.

¹⁹⁹¹ See par. 375 et seq.

¹⁹⁹² In result perhaps equally: Carmine Rotondaro, credit derivatives, p. 89 et seqq.

¹⁹⁹³ See par. 89.

¹⁹⁹⁴ See par. 101 et seqq.

both hypothetical components or legs necessarily refer¹⁹⁹⁵. This applies, for instance, also to debt-equity swaps. Their receive leg is merely the return for the underlying operation represented by the pay leg¹⁹⁹⁶ and is thus as the *income* out of scope for any disaggregation. In other words: any disaggregation of forwards still could not resolve the problem of allocating the net-settlement amounts to the hypothetical forward and spot components or legs respectively. In contrast, net-settled options strategies can also represent “more complex” financial instruments if incorporated into one legal contract (e.g. spreads, straddles, strangles, cliquets, etc.) and may, depending on the individual circumstances, be subject of disaggregation.

- 380 Considering the net-settlement of forward transactions thus as one coherent whole, net-settled cash flows from *shares* or *debt-claims* as their underlying would represent a modified payment profile. While the hypothetical “interest” or debt leg as the basis would be negatively modified by the profit or “dividend”, the hypothetical “dividend” or equity leg as the basis would in turn be negatively modified by the time value of money or “interest”. In the former case, negatively modified “interest” was found incompatible with the concept of time value of money¹⁹⁹⁷ as one of the constituting elements¹⁹⁹⁸ of genuine *debt-claims* pursuant to Art. 11(3) OECD MTC. Again, this applies irrespective of the extending modification towards a profit participation, which can thus not come into effect, and even more where the financial instrument contains an optional component¹⁹⁹⁹. In the latter case, negatively modified “dividends” were, however, found to be basically compatible with the attribute *participating in profits*²⁰⁰⁰. This applies even more as any optional component would necessarily have to refer to and thus derive from one and the same underlying (i.e. the *share*). As a consequence, even disaggregating the financial instrument’s risk profile could reveal nothing other than that the risk from the underlying (i.e. the *share*) is replaced by the literally identical risk from the optional component²⁰⁰¹. In result, it is therefore held as a conclusion for the further course of this study that income from net-settled forward transactions must basically be classified as *other income* pursuant to Art. 21(1) OECD MTC. An important exception is the income from the equity leg, which must – given the requisite formal reference to a *share*²⁰⁰² as its underlying – be classified as genuine *dividends* pursuant to Art. 10(3) OECD MTC.

¹⁹⁹⁵ See par. 277.

¹⁹⁹⁶ See par. 181.

¹⁹⁹⁷ See par. 215.

¹⁹⁹⁸ See par. 296.

¹⁹⁹⁹ In result equally: *Pöllath, Reinhard / Lobbeck, Allit in Vogel / Lehner*, p. 1327, par. 75. See also par. 213 and 371 et seq.

²⁰⁰⁰ Contrary: *Pöllath, Reinhard / Lobbeck, Allit in Vogel / Lehner*, p. 1212, par. 188, arguing that dividend swaps do not give rise to corporate rights and thus referring either to membership rights (see par. 262) or to limb 3 of Art. 10(3) OECD MTC to be interpreted domestically (see par. 270), both however not being relevant. See also par. 276 et seq.

²⁰⁰¹ See par. 379.

²⁰⁰² See par. 103(3).

5.2.6 Conclusions

381 The following illustration visualises and summarises the overall subsumption of forward transactions as understood and represented in this study:

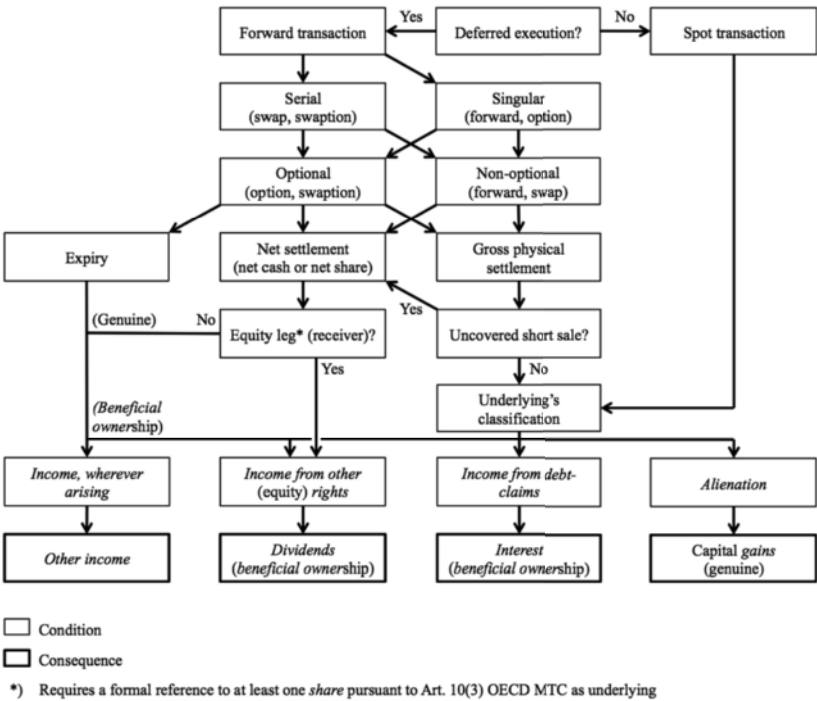


Illustration 24: Classification/subsumption scheme of forward transactions

5.3 Convertibles

5.3.1 Structure

Debt-into-equity convertibles are more common

382 Generally speaking, a convertible is a financial instrument that can be converted into another financial instrument (e.g. exchangeable preferred stock). In the real-life “more or less” spectrum between pure debt and pure equity²⁰⁰³, however, the conversion into financial instruments of the same issuer is typically one-directional “towards equity” (e.g. bond into *shares* or preferred stock into ordinary *shares* but not vice versa). The reason is probably that a rational investor will not accept the other way around. On the one hand, such conversion from “more equity” into “more debt” would basically reduce the investor’s entire risk-return position. On the other hand, “more equity” usually confers more discretion upon the issuer as regards distributing or retaining the return. In fact, this goes along with a higher discretion with regard to

²⁰⁰³ See par. 103.

temporarily²⁰⁰⁴ compensating the investor for his provision of risk capital (voluntariness)²⁰⁰⁵. In other words: the possibility of having certainly participated in more risk in the past but not certainly also participating in more return in the future gives rise to an asymmetry. Notably, this asymmetry has a temporal nature, in that the risk depends on the investor's actual holding period until the financial instrument is converted. Unlike "more debt", "more equity" is typically organised multilaterally²⁰⁰⁶. This is why such temporal asymmetry can typically not be compensated between issuer and investor on an individual basis but only by way of "one size fits all". This would necessarily give rise to systemic distortions between the investors (e.g. arbitrage). In contrast to similar occurrences (e.g. accrued interest), the distorting effects of such singular events are also often too complex for their compensation between the investors to be operationalised on organised markets. This leaves the what the critical quality of a conversion is in order to either classify or re-classify a financial instrument from a *debt-claim* pursuant to Art. 11(3) OECD MTC into an *other equity right* pursuant to Art. 10(3) OECD MTC. For these reasons, the following analysis primarily puts the focus on debt-into-equity convertibles.

Conversion is a feature and not a transaction

- 383 At first glance, it might be suggested that the conversion was a result of classifying the financial instruments before and after the conversion. In other words: if the two financial instruments before and after the conversion were classified into different distributive articles of the OECD MTC, the conversion would be a transaction itself rather than a feature of the financial instrument. In fact, conversions principally appear to have a dual character: they are actually both a feature of financial instruments (i.e. convertibility) and possibly also an actual transaction (i.e. the conversion itself). However, focussing only on the conversion transaction by disregarding the convertibility feature²⁰⁰⁷ would imply a static²⁰⁰⁸ or perhaps ex-post²⁰⁰⁹ view of income classification. It would take a potentially uncertain conversion for certain. In that, it would actually ignore the important temporal mechanism²⁰¹⁰ that the investor, even without an actual conversion, is long since exposed to and thus also compensated for qualitatively different risks (i.e. timing versus underwriting risk)²⁰¹¹. In addition, such transaction could only be a capital *gain* (i.e. an exchange transaction²⁰¹²), which, conversely, was found to stipulate the existence of the financial instrument²⁰¹³. Admittedly, the conceptual difference between the convertibility as a feature and/or the conversion as a transaction appears to be of limited relevance for the practice of treaty application: the vast majority of convertibles are unilaterally terminated by the conversion anyway (expiry) and therefore eventually cannot represent a capital *gain* transaction at all²⁰¹⁴.

²⁰⁰⁴ See par. 250.

²⁰⁰⁵ See par. 188, 192 and 285.

²⁰⁰⁶ See par. 188.

²⁰⁰⁷ *Harris, Peter A.* in IBFD Commentaries on Art. 10 OECD MTC, sec. 5.1.3.2.3.; *Jakob Bundgaard*, hybrids, p. 151; *Haslehnner, Werner* in *Klaus Vogel* Commentaries 2015, p. 842, par. 106; *Kopp, Karin E.M.* in *Wolfgang Schön*, equity and debt, p. 860; OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-11, par. 18 and on Art. 10 OECD MTC, p. C(10)-10, par. 24; Norwegian *Høyesterett*, judgement ref. HR-2011-02285-A (Sak No. 2011/869), 2011; *Marjaana Helminen*, dividend concept, p. 193; A.A.R., judgement ref. 175 Taxman 139, 2008; Michael Lang, hybrids, p. 145.

²⁰⁰⁸ See par. 213(2).

²⁰⁰⁹ See par. 213(4).

²⁰¹⁰ See par. 382.

²⁰¹¹ OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-11, par. 19. See also par. 214 and Example 44 on p. 228.

²⁰¹² See par. 326.

²⁰¹³ See par. 315.

²⁰¹⁴ As will be discussed later in more detail (see par. 387).

For these reasons, conversions are understood and regarded as relevant primarily by their aspect of being features rather than transactions themselves.

The key questions to be answered

- 384 All kinds of financial instruments can be equipped with a separate conversion feature (warrant) attached to the provision of the capital or principal (packaged convertibles, also referred to as “bond cum warrant”). However, only those with a redemption obligation²⁰¹⁵ can also be equipped with a conjoined or integrated conversion feature embedded into the provision of the principal itself. The borderline between these two types is, however, fluid. The reason is that a separately attached formal conversion feature can also, in a material way, be entangled with the provision of the principal. Examples of this effect are variable conversion ratios (ratchet convertible²⁰¹⁶) or providing an acquisition of the new equity-like financial instrument at preferential conditions in return for non-preferential conditions of the original debt-like instrument. In addition, the conversion feature can be timed or not timed and optional or non-optional (mandatory convertibles). Such option can be in favour of either the investor (i.e. long call from the investor’s perspective) or the issuer (i.e. short put from the investor’s perspective, reverse convertible²⁰¹⁷) and non-optional convertibles can be contingent (e.g. contingent convertible bonds) or non-contingent²⁰¹⁸. It should be permissible to take the general assumption that all these variations basically bear underwriting risk, which need not necessarily be time-inequivalent²⁰¹⁹. As a consequence, the analysis of classifying this variety of convertibles into the distributive articles of the OECD MTC must address the key questions²⁰²⁰ of whether or not the
- (1) convertible has to be disaggregated into its components²⁰²¹;
 - (2) convertible provides a self-executive redemption obligation²⁰²²;
 - (3) investor is exposed to business risk in the form of termination risk²⁰²³;
 - (4) remuneration can principally represent the time value of money in order to constitute a genuine *debt-claim* pursuant to Art. 11(3) OECD MTC²⁰²⁴; and
 - (5) remuneration – if any – is self-executive²⁰²⁵.

5.3.2 Disaggregation

- 385 Convertibility appears to bear a nexus in an ambiguous way with the following aspects already discussed:
- The existence of the financial instruments as such²⁰²⁶: whether or not the financial instrument before the conversion ceases to exist (i.e. is expired or renounced) or continues to exist (i.e. is substituted by the financial instrument after the conversion as its surrogate);

²⁰¹⁵ See par. 242(3).

²⁰¹⁶ IAS Board, February 2016, 5C, p. 6, par. 18(d).

²⁰¹⁷ IAS Board, February 2016, 5C, p. 14, par. 47(a).

²⁰¹⁸ For a comprehensive overview see and Jakob Bundgaard, hybrids, p. 303 et seqq. and Jakob Bundgaard, convertibles, sec. 2.

²⁰¹⁹ See par. 211.

²⁰²⁰ See par. 358.

²⁰²¹ See par. 86.

²⁰²² See par. 289.

²⁰²³ See par. 282.

²⁰²⁴ See par. 296.

²⁰²⁵ See par. 290.

²⁰²⁶ See par. 77.

- The redemption obligation²⁰²⁷: whether the capital or principal is redeemed or rather the entire financial instrument as its legal veil is exchanged;
- The *income*²⁰²⁸: whether or not the conversion as such represents a realisation event; and
- The termination risk²⁰²⁹: whether or not the conversion exposes the holder to the risk of a non-perfect recovery or redemption of the capital or principal provided.

The first three of these aspects were found to adhere to form over substance and thus cannot be overruled by the *substance over form* principle. Instead, the *substance over form* principle takes effect primarily in the context of the subsequent fourth aspect (4) of termination risk²⁰³⁰. Consequently, also for the classification or subsumption of convertibles, the above first question (1) of disaggregation as a specific sub-type of the *substance over form* principle applies only subsidiary to the second one (2) of the redemption obligation. In contrast to most discussions of convertibles, the redemption obligation therefore represents the starting point of the following analysis. In other words: any financial instrument is likewise object of the same legal subsumption²⁰³¹ (i.e. no ring-fencing²⁰³²). Therefore, it was prejudicial and methodologically flawed to run a disaggregative risk analysis towards the underlying's tax-wise nature before having actually verified whether the financial instrument as a whole can even come potentially into question for being a *debt-claim* by fulfilling its most necessary minimum condition²⁰³³.

Example 53: A zero bond might be legally equipped with a formal “conversion” feature of two partial hedging options. These can be combined in a way that their net cash settlement perfectly replicates or synthesises the interest (synthetic zero coupon convertible)²⁰³⁴. The question is whether or not such feature can be considered a “conversion”.

5.3.3 Redemption obligation

- 386 The conversion feature is actually nothing other than a forward transaction²⁰³⁵ with another asset as its underlying. As regards the second question (2) as the starting point, convertibles must thus be separated into those still upholding a self-executive redemption obligation and those which do not. The redemption obligation is a necessary minimum condition (*conditio sine qua non*) for Art. 11(3) OECD MTC.²⁰³⁶ It was said to be principally independent of any time-based duration or maturity²⁰³⁷ but to require an absolute and unconditional legal right to be repaid²⁰³⁸ prior to the issuer's liquidation²⁰³⁹. This condition should be fulfilled for all packaged convertibles²⁰⁴⁰, for all mandatory convertibles as well as for all optional convertibles

²⁰²⁷ See par. 241.

²⁰²⁸ See par. 144 and 316.

²⁰²⁹ See par. 232.

²⁰³⁰ See par. 101 and 388 et seq.

²⁰³¹ See par. 87.

²⁰³² See par. 301.

²⁰³³ Equally: *Achim Pross*, p. 147.

²⁰³⁴ *Febér, Tamás* in *Eva Burgstaller*, p. 248.

²⁰³⁵ See sec. 5.2.

²⁰³⁶ See par. 326.

²⁰³⁷ See par. 198 et seq.

²⁰³⁸ See par. 289.

²⁰³⁹ See par. 296.

²⁰⁴⁰ Equally: *Kopp, Karin E.M.* in *Wolfgang Schön*, equity and debt, p. 861; *Michael Lang*, hybrids, p. 147.

in favour of the holder (i.e. long call from the investor's perspective) or in favour of the issuer (i.e. short put from the investor's perspective), unless the latter does not leave it to the discretion of the issuer whether or not he redeems the capital or principal at all²⁰⁴¹. Importantly, the redemption obligation itself is independent of the third subsumption step (3) of termination risk²⁰⁴². In particular, the type and value of what the issuer repays to the investor (e.g. the underlying) is not relevant for the existence of a redemption obligation as such²⁰⁴³. In other words: an alternative settlement right is nevertheless still a settlement obligation. This can be demonstrated by the example of mandatory convertibles or by the example of reverse convertibles. Although putting only the conversion as such and therefore its mere quantitative effect at the discretion of the issuer, they do not suspend him from fulfilling the qualitative redemption obligation. In other words: termination risk can falsify time equivalence and therefore the time-based nature of the financial instrument (material level)²⁰⁴⁴, but not its legal redemption obligation as such (formal level). The reason is the equivalence of legal criteria²⁰⁴⁵, according to which it was flawed and impermissible to suggest that the expected total benefits represented in all legal rights in favour of the holder (i.e. the redemption and remuneration value) was lower than his expected total costs (i.e. the capital or principal provided to the issuer). In fact, this assumption would actually mix the ex post view (quantitative risk) and the ex ante view (qualitative redemption obligation). Therefore, these considerations lead e contrario to the result that all other convertibles cannot possibly be classified as *debt-claims* pursuant to Art. 11(3) OECD MTC. Such contingent convertibles and optional convertibles, which leave to discretion of the issuer whether or not he redeems the capital or principal at all, include for example:

- Contingent convertible bonds (CoCo)²⁰⁴⁶: they put the repayment optionally at the discretion of the issuer and typically also to the consent of the regulator.²⁰⁴⁷
- Other structured notes tied to binary events such as certain insurance-linked securities (ILS, e.g. catastrophe bonds): they redeem the capital or principal depending on whether or not a predefined trigger event occurs.
- Convertible preferred equity certificates (CPEC): they are often non-terminable until the issuer is liquidated.²⁰⁴⁸

387 This also leads to the further conclusion that these financial instruments before and after the conversion must be classified separately²⁰⁴⁹, at least where there is a redemption obligation. Importantly, this no consequence of any form of disaggregation but rather of the fact that the financial instrument before the conversion is redeemed and thus does actually cease to exist (i.e. is expired or renounced)²⁰⁵⁰. Accordingly, such conversions fulfilling a redemption obligation cannot possibly constitute capital *gains* pursuant to Art. 13(5) OECD MTC.²⁰⁵¹

²⁰⁴¹ See par. 236.

²⁰⁴² See par. 388 et seq.

²⁰⁴³ Perhaps contrary: *Fehér, Tamás* in *Eva Burgstaller*, p. 248, mixing the two aspects by saying that “if a drop in the share price were lead to a drop in the redeemable amount of the contribution, then we could hardly speak of a genuine claim in respect of the principal”.

²⁰⁴⁴ See par. 242(2).

²⁰⁴⁵ See par. 182.

²⁰⁴⁶ *Juan Ramirez*, p. 127 et seq.

²⁰⁴⁷ Equally: IBFD, Introduction to the Comparative Survey, Derivatives & Financial Instruments 2011, Vol. 13, No. 3.

²⁰⁴⁸ Equally: *Jakob Bundgaard*, convertibles, sec. 2.3., footnote 37.

²⁰⁴⁹ Equally: *Marjaana Helminen*, dividend concept, p. 191 et seq.

²⁰⁵⁰ Equally: *Fehér, Tamás* in *Eva Burgstaller*, p. 247.

²⁰⁵¹ See par. 314 et seqq.

They do not represent a transfer transaction at all but rather a unilateral termination that was found not to be covered by the term *alienation*²⁰⁵². Notably, this may, however, not lead to the erroneous reverse deduction that conversions not fulfilling a redemption obligation would necessarily constitute capital *gains* pursuant to Art. 13(5) OECD MTC. The reason is that a conversion alone gives no indications on whether the convertible itself ceases or continues to exist, which is subject to the *alienation* test on the convertible level²⁰⁵³. In market practice, the large majority of debt-into-equity conversions, even if not fulfilling a redemption obligation, should, however, unilaterally terminate (e.g. CoCo) or otherwise not dispose (e.g. packaged convertibles) of their convertibles. In result, capital *gains* pursuant to Art. 13(5) OECD MTC triggered by conversions appear to be fairly rare²⁰⁵⁴.

5.3.4 Termination risk

388 Having thus verified the redemption obligation as the first step, the classification or subsumption of convertibles must now proceed with the above third question (3) of whether (then potentially *dividends* or *interest*) or not (then potentially *other income* or *interest*) the financial instrument bears business risk. And, if yes, whether (then *dividend*) or not (then *dividends* or *interest*, depending on the redemption obligation²⁰⁵⁵) this business risk is limited to the specific form of termination risk. These two sub-questions apparently require a (qualitative) disaggregation of the financial instrument, which is indispensable but subsequently takes effect only now. Beforehand, business risk requires a formal reference to a *share* as its underlying²⁰⁵⁶. Given this formal reference, the above multi-stage process of risk identification, risk disaggregation and risk elimination²⁰⁵⁷ reveals whether or not the underlying's underwriting risk qualitatively resembles business risk²⁰⁵⁸. One result of such risk disaggregation will be that the time-based element (i.e. timing risk) of packaged convertibles is basically independent of their risk-based element (i.e. underwriting risk). This is the systematic reason why packaged convertibles can also quantitatively be separated into their debt and option components²⁰⁵⁹. Even where the underwriting risk contained in the conversion feature (warrant) is inextricably entangled with the timing risk contained in the provision of the principal (e.g. ratchet convertibles)²⁰⁶⁰, the risk disaggregation scheme is principally capable of determining whether or not the compound financial instrument qualitatively approximates equity. Apart from this special case, the underlying's underwriting risk should actually resemble business risk for all convertibles with one or more *shares* as their underlyings. In any case, the option feature itself isn't part of the time-based element in the sense of an *interest* in kind²⁰⁶¹. The reason is that it is actually not granted as a "free bonus" but only in return for a correspondingly lower remuneration from the convertible's debt component.

²⁰⁵² See par. 326.

²⁰⁵³ Equally: *Michael Lang*, hybrids, p. 146.

²⁰⁵⁴ See par. 326.

²⁰⁵⁵ See par. 386.

²⁰⁵⁶ See par. 103(3).

²⁰⁵⁷ See par. 101 et seqq.

²⁰⁵⁸ IFRS 9.B4.3.5 and 9.B4.3.8; comprehensively: *Kubn / Hachmeister*, p. 715 et seqq.

²⁰⁵⁹ *Jakob Bundgaard*, hybrids, p. 341; *Jakob Bundgaard*, convertibles, sec. 8.4.; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1434, par. 85a; *Michael Lang*, hybrids, p. 147.

²⁰⁶⁰ See par. 384.

²⁰⁶¹ *Achim Pross*, p. 155.

389 The conversion event naturally occurs at the end of the financial instrument's duration or maturity, i.e. is a form of termination. Therefore, the underwriting (business) risk will typically also have the form of the termination risk. In fact, there appear to be only very few cases where the business risk is limited to mere remuneration risk. This is also the reason why even a high interpretation significance and therefore a disaggregation of the time value of money due to the convertible's long-term duration or maturity eventually does not alter its classification²⁰⁶². Due to the interdependency between termination risk and remuneration risk²⁰⁶³, this is principally conceivable only where the pay and receive legs of convertibles proportionate in equal values²⁰⁶⁴ (i.e. the financial instruments before and after the conversion). This was found to be always true only under the *fixed-for-variable condition*, but never under the *fixed-for-fixed* and the *variable-for-fixed conditions*. Consequently, convertibles with one or more *shares* as their underlyings must, at least under the *fixed-for-fixed* and the *variable-for-fixed conditions*, necessarily be classified as *shares* pursuant to Art. 10(3) OECD MTC²⁰⁶⁵. These include for example:

- Mandatory convertibles²⁰⁶⁶: these apply either a fixed conversion ratio (i.e. *fixed-for-fixed condition*) or a variable conversion ratio that typically does not convert into a variable number of *shares* equivalent to the fixed redemption amount and therefore not does not fulfil the *fixed-for-variable condition*.
- Contingent convertibles: these put the repayment not just optionally at the discretion of the issuer but typically also to the consent of the regulator²⁰⁶⁷; thus, the repayment is supposed to predominantly depend on the business risk.
- Reverse convertibles²⁰⁶⁸: these put the conversion option in favour of the issuer (i.e. puttable in favour of the issuer), effectively allowing him to redeem a value lower than what the holder provided to him and therefore not to fulfil the *fixed-for-variable condition*.
- Some types of convertible preferred stock, such as preferred equity redemption cumulative stock (PERCS)²⁰⁶⁹ or dividend enhanced convertible securities (DECS, also referred to as “dividend enhanced convertible stock” or “debt exchangeable for common stock”)²⁰⁷⁰: these typically apply a variable conversion ratio that is not equivalent to the fixed redemption amount and therefore does not fulfil the *fixed-for-variable condition*. The reason is that this conversion ratio depends on the strike price of the embedded put option (i.e. puttable in favour of the issuer).
- Depository receipts²⁰⁷¹ and delta-one-certificates: even where granting a conversion right to the holder (i.e. callable in favour of the investor), these typically apply a fixed conversion ratio (i.e. *fixed-for-fixed condition*).

²⁰⁶² As will be shown hereinafter (see par. 390 et seq.).

²⁰⁶³ See par. 278.

²⁰⁶⁴ See par. 299 and 351.

²⁰⁶⁵ Equally: Dutch Hoge Raad der Nederlanden, judgement ref. 43.643, 2007.

²⁰⁶⁶ Equally: *Fehér, Tamás* in *Eva Burgstaller*, p. 248.

²⁰⁶⁷ See footnote 2047.

²⁰⁶⁸ Equally: *Carmin Rotondaro*, redemption, p. 265 et seqq. and 271.

²⁰⁶⁹ Equally: IAS Board, March 2017, 5A, Appendix B, p. 21.

²⁰⁷⁰ *Juan Ramirez*, p. 118 et seqq.; *Frank Fabozzi*, p. 295.

²⁰⁷¹ *Frank Fabozzi*, p. 166.

5.3.5 Remuneration

390 As regards the fourth question (4)²⁰⁷², termination risk was found capable of falsifying the time value of money²⁰⁷³ as one of the constituting elements²⁰⁷⁴ of genuine *debt-claims* pursuant to Art. 11(3) OECD MTC. Conversely, the remuneration from a convertible can thus potentially represent the time value of money only where there is a redemption obligation and no termination risk²⁰⁷⁵. Admittedly, it is the economic purpose of convertibles and their peculiarity to combine their periodic remuneration before the financial instrument is converted with their termination proceeds from the conversion itself. As a consequence, the time value of money could basically be determined only by considering the total return²⁰⁷⁶. In other words: as the remuneration risk forms one logical unit or concept with the termination risk²⁰⁷⁷, the remuneration itself forms one logical unit or concept with the termination proceeds. Thus, the conversion of convertibles typically contains not only a redemption component but also a remuneration component.

Example 54: Cumulative rate reset preferred shares can be featured in a way that retained remunerations are accumulated and distributed at the deferred reset date²⁰⁷⁸. Where such financial instruments are also callable in favour of the issuer or puttable in favour of the holder, their periodic remuneration is inextricably entangled with their conversion proceeds.

391 However, the termination proceeds and thus the total return are typically unknown or even unexpected at the time the remuneration is paid. In addition, the legal interpretation brought forth compelling systematic reasons why the two aspects of remuneration and termination must nevertheless be kept separated²⁰⁷⁹. While this requisite separation was a finding in the context of risk in Art. 10(3) OECD MTC, it must apply to the remuneration in Art. 11(3) OECD MTC²⁰⁸⁰, too. The reasons are that

- the time value of money is the natural complement of the risk-based remuneration²⁰⁸¹;
- the remuneration is a reflex response to risk²⁰⁸²; and
- the consistent and coherent system of Art. 10(3) and 11(3) OECD MTC principally demands that their autonomous parts must lead to equivalent results²⁰⁸³.

This means as an interim conclusion that the time value of money is a test that is not per se falsified by the convertibility feature. In as much as these two aspects are actually independent from each other, the periodic remuneration of convertibles can principally represent the time value of money in order to constitute, *ceteris paribus*, a genuine *debt-claim* pursuant to Art. 11(3) OECD MTC.

²⁰⁷² See par. 384(4).

²⁰⁷³ See par. 242(2).

²⁰⁷⁴ See par. 296.

²⁰⁷⁵ Argumentum e contrario.

²⁰⁷⁶ See Example 34 on p. 124 and Example 35 on p. 125.

²⁰⁷⁷ See par. 279.

²⁰⁷⁸ IAS Board, February 2016, 5C, p. 7, par. 21.

²⁰⁷⁹ See par. 280.

²⁰⁸⁰ Argumentum e contrario.

²⁰⁸¹ See par. 208 et seqq. and 275.

²⁰⁸² See par. 200.

²⁰⁸³ See par. 113(1).

392 However, in the practice of applying the OECD MTC to convertibles this is just half of the truth. In fact, the independence of remuneration and termination is a mere necessary minimum condition (*conditio sine qua non*) but not a sufficient maximum condition (*conditio per quam*) or verifier for the time value of money. This can be demonstrated by the example of callable convertibles (i.e. in favour of the holder). Callable convertibles actually may participate in general business risk, but not in its specific form of termination risk as one of the constituting elements of *other equity rights* pursuant to Art. 10(3) OECD MTC²⁰⁸⁴. Instead, they leave the termination risk entirely to the issuer²⁰⁸⁵ and thus only participate in the termination chances²⁰⁸⁶. In that, their net-settled payment profile inextricably coalesces the time-based remuneration received (interest component) and the risk-based remuneration (option component) paid out. Again considering the two as one coherent whole²⁰⁸⁷, such negatively modified payment profile cannot possibly constitute *interest* pursuant to Art. 11(3) OECD MTC²⁰⁸⁸ either. This becomes even more evident against the background of the call option itself, which is risk-based²⁰⁸⁹ and may expire²⁰⁹⁰. This means as a conclusion for the further course of this study that the remuneration from callable convertibles basically represents neither *interest* pursuant to Art. 11(3) OECD MTC nor *dividends* pursuant to Art. 10(3) OECD MTC. Instead, it is to be classified as *other income* pursuant to Art. 21(1) OECD MTC. Exceptions to this general principle might appear where a long-term duration or maturity necessitates high interpretation significance and therefore a disaggregation of the time value of money (e.g. infinite or open-ended convertibles)²⁰⁹¹.

5.3.6 Self-execution

393 The last question (5)²⁰⁹² with regard to the debt-equity distinction of convertibles is whether or not the remuneration is self-executive. On the one hand, this question is less difficult to answer for the periodic remuneration before the financial instrument is converted²⁰⁹³. On the other hand, in the context of self-execution the question arises how relevant the peculiarity of convertibles is that the periodic remuneration actually forms one logical unit or concept with the termination proceeds. For instance, it could be legitimately concluded that the total remuneration cannot possibly be self-executive where there is no redemption obligation, which is always self-executive²⁰⁹⁴. Adding to the aforementioned arguments²⁰⁹⁵, such conclusion was however incomplete as well. Convertibility does not necessarily imply or include a redemption obligation (e.g. CoCo). Just as the qualitative redemption obligation as such must be separated from the quantitative termination risk²⁰⁹⁶, it must be even more separated from the quantitative termination proceeds and therefore from its self-execution²⁰⁹⁷. In other words: the remuneration contained in the conversion can logically be

²⁰⁸⁴ See par. 282.

²⁰⁸⁵ See par. 371.

²⁰⁸⁶ See par. 369.

²⁰⁸⁷ See par. 380.

²⁰⁸⁸ In result equally: *Michael Lang*, hybrids, p. 139. See also par. 215.

²⁰⁸⁹ See par. 277, Example 36 on p. 126 and Example 37 on p. 127.

²⁰⁹⁰ See par. 370.

²⁰⁹¹ See par. 212.

²⁰⁹² See par. 384(5).

²⁰⁹³ See par. 290.

²⁰⁹⁴ See par. 289.

²⁰⁹⁵ See par. 390 et seqq.

²⁰⁹⁶ See par. 386.

²⁰⁹⁷ Argumentum a maiore ad minus.

self-executive as such, even though there is no redemption obligation at all. Consequently, the remuneration's self-execution as such for convertibles is independent of the redemption obligation.

394 As another argument, it might be suggested that in the practice of treaty application the remuneration's self-execution was only subsequently relevant for classification purposes where there is no termination risk at all²⁰⁹⁸. Otherwise the financial instrument was unclassifiable as a *debt-claim* pursuant to Art. 11(3) OECD MTC anyway. It might also be suggested that where there is remuneration risk, there could not possibly be self-execution. However, this approach was methodologically flawed as it implied that there was necessarily remuneration risk wherever there is no termination risk. However, convertibles are conceivable which bear neither remuneration risk nor termination risk (e.g. convertibles under the *fixed-for-variable condition* and with a fixed coupon). In addition, remuneration is just a reflex response to risk²⁰⁹⁹, which is why their temporal distribution is principally independent of each other²¹⁰⁰. As a consequence, termination risk could principally be – and typically is – fully compensated by the periodic and self-executive remuneration until the financial instrument is converted²¹⁰¹. Lastly, the only types of convertibles complying with both necessary minimum conditions of the redemption obligation and the absence of termination risk are packaged and callable convertibles (i.e. in favour of the holder). However, packaged convertibles were found to be disaggregated into their time-based and risk-based components²¹⁰², and thus to be independent of each other anyway. In addition, the risk premium for callable convertibles is paid out instead of received and therefore cannot possibly be relevant for the self-execution test. Consequently, the remuneration's self-execution remains principally independent of the termination risk.

395 As a consequence, the remuneration's self-execution is an independent test for convertibles as well. Notably, it appears that this test can be performed in perfect analogy with non-convertible financial instruments. The reason is that, since the remuneration risk and the termination risk must be considered separately²¹⁰³, the periodic remuneration itself and the termination proceeds must also be considered separately²¹⁰⁴. In other words: with regard to the self-execution test of the remuneration, convertibles do not differ in any way from other financial instruments. While the remuneration from packaged convertibles is to be quantitatively disaggregated into its time-based component (i.e. *interest* if self-executive²¹⁰⁵) and risk-based component (i.e. basically a capital *gain*²¹⁰⁶), the qualitative risk disaggregation of the remuneration from non-packaged convertibles is principally capable of determining whether such compound remuneration approximates more closely to equity or to debt²¹⁰⁷. The remaining tax planning possibilities and distortions by discretionarily structuring the risk premium into or out of the periodic remuneration have to be accepted²¹⁰⁸. In the market

²⁰⁹⁸ See par. 389.

²⁰⁹⁹ See par. 200.

²¹⁰⁰ See par. 369.

²¹⁰¹ See par. 382 et seq.

²¹⁰² See par. 388.

²¹⁰³ See par. 280.

²¹⁰⁴ See par. 391 et seqq.

²¹⁰⁵ See par. 290.

²¹⁰⁶ See par. 367.

²¹⁰⁷ See par. 388.

²¹⁰⁸ See par. 101(1).

practice, most debt-into-equity convertibles can be assumed to typically distribute their periodic remuneration self-executively.

5.3.7 Conclusions

396 Combining all these necessary minimum conditions of a redemption obligation, the absence of termination risk, the time value of money and the self-execution of the remuneration describes the fairly limited scope for convertibles being *debt-claims* pursuant to Art. 11(3) OECD MTC. For example, it includes packaged convertibles with self-executive remuneration, whose qualitative disaggregation will typically give rise to a straight bond and an option, so that its quantitative disaggregation will typically constitute *interest*. The following illustration visualises and summarises the overall subsumption of convertibles as understood and represented in this study:

Convertible type	Redemption obligation	Business risk ¹ in the form of termination risk	Time value of money	Self-executive remuneration ²	Classification (Art. OECD MTC)
Packaged	☑	☒	☑	☑	11 (<i>interest</i>)
Mandatory	☑	☑	☒	☑	10 (<i>dividend</i>)
Contingent	☒	☑	☒	☒	10 (<i>dividend</i>)
Callable ³	☑	☒	☒	☑	21 (<i>other income</i>) ⁴
Puttable ⁵ (reverse)	☑	☑	☒	☑	10 (<i>dividend</i>)
Fixed conversion ratio ⁶	☑	☑	☒	☑ ⁹	10 (<i>dividend</i>)
Variable conversion ratio	☑	☑ ⁷	☒	☑ ⁹	10 (<i>dividend</i>) ⁷
Variable nominal value ⁸	☒	☑	☒	☑ ⁹	10 (<i>dividend</i>)

1) Requires a formal reference to at least one *share* pursuant to Art. 10(3) OECD MTC as underlying

2) As typically – but not necessarily – observable in practice

3) From the holder's or investor's perspective

4) Unless long-term

5) From the issuer's perspective

6) Fixed-for-fixed condition

7) Unless the financial instruments before and after the conversion proportionate in equal values (i.e. fixed-for-variable condition)

8) Variable-for-fixed condition

9) Unless contingent

☒☑ Decisive criterion (condition)

☒☒ Non-decisive criterion (condition)

Illustration 25: Classification table of convertibles

397 As a side note, the question arises of how to subsume financial instruments, which are featured in a way that eventually allows them to change their own classification. While this is a general problem of all financial instruments, it is nevertheless typical for convertibles due to their difficult debt-equity-delimitation and their corresponding variety.

Example 55: A puttable financial instrument (i.e. in favour of the issuer) might be featured in the way that, if the put option expires, its redemption amount successively increases at a certain rate over time.²¹⁰⁹ In that, it actually changes from *dividend* classification (i.e. reverse convertible) to *interest* classification (i.e. zero bond).

According to the dynamic forward-looking view, each *income* or transaction from such financial instruments must be classified individually at the date of payment but in consideration of the remaining expectable lifetime of the financial instrument²¹¹⁰. This is a compromise in the conflict between the dynamic criterion of risk on the one hand and the static position-by-position or item-by-item approach of the OECD MTC on the other²¹¹¹. Consequently, the risk-based *income* from such financial instruments before being converted differs qualitatively from the time-based *income* after having been converted, in that it also accounts for the future convertibility²¹¹². In other words: while the future underwriting risk impacts the classification of the *income* before being converted (i.e. contains a risk premium), the elapsed underwriting risk does not impact the classification of the *income* after being converted (i.e. contains no risk premium). Art. 10(3) and 11(3) OECD MTC on the one hand are independent of Art. 13(5) OECD MTC on the other²¹¹³. This is why the classification of *income from* the financial instrument (i.e. the transaction) is also independent of the classification of capital *gains with* the financial instrument itself (i.e. the asset). Hence, a change in the *income's* classification is possible even though the convertible itself has not been alienated²¹¹⁴.

5.4 Other debt-based financial instruments

5.4.1 Structure

- 398 As a starting point, other non-convertible “hybrids” likewise raise issues regarding the classification or subsumption into the distributive articles of the OECD MTC but have not yet been discussed elsewhere in this study. They can roughly be grouped according to their determinants, i.e. rights on the provision of capital, time value of money and redemption obligation²¹¹⁵. In summary, they encompass financial instruments, which
- (1) yield income that exceeds the time value of money;
 - (2) bear risks, which however are typical or even constitutive for *debt-claims*; and/or
 - (3) replicate or synthesise the risk-return profile of debt-based financial instruments.
- In addition, this section presents a side note on negative interest.

5.4.2 Linkers

- 399 As regards the first group (1), in market practice there is a broad variety of financial instruments yielding income in excess of the time value of money. Such excessive payment profile is typically, but not necessarily, structured by linking the remuneration and/or the capital or principal to an underlying (*linkers*, e.g. index-

²¹⁰⁹ IAS Board, February 2016, 5C, p. 4 et seq., par. 15(a).

²¹¹⁰ See par. 214.

²¹¹¹ See par. 59.

²¹¹² See par. 383.

²¹¹³ See par. 113 and 315.

²¹¹⁴ Equally: IAS 32.AG32.

²¹¹⁵ See par. 358.

linked, equity-linked, inflation-linked²¹¹⁶, etc.). Here, we have already reached the crucial point for subsuming or not subsuming such financial instruments under the distributive articles of the OECD MTC. On the one hand, positive modifications of the payment profile beyond the mere time value of money can be compatible with the extending attribute *whether or not carrying a right to participate in the debtor's profits*²¹¹⁷ in Art. 11(3) OECD MTC. In contrast, they are, however, incompatible with, and falsify, the constituent element of genuine *debt-claims*²¹¹⁸. In other words: on the level of the income, the remuneration amount basically forms one logical unit or concept with the remuneration risk and thus shares its irrelevance for the debt-equity distinction. On the level of the capital or principal, the redemption amount basically forms one logical unit or concept with the termination risk and thus shares its relevance for the debt-equity distinction. On the other hand, the extending attribute of the profit participation is limited to business risk and thus incompatible with any other risk. Combining both aspects means in turn that, where either the remuneration bears any non-business risk or the redemption bears any risk (particularly business risk), linkers cannot possibly be classified as a *debt-claim*²¹¹⁹. Just as for convertibles in particular²¹²⁰, Art. 11(3) OECD MTC generally demands a careful analysis and distinction of whether (then potentially *dividend*) or not (then *interest* or *other income*) the amount in excess of the time value of money is paid as an integral part of the redemption amount or, if not, whether (then potentially *interest*) or not (then *other income*) it represents a business profit. This is particularly difficult when we remember that business risk can be contained in both the remuneration risk and the termination risk²¹²¹, so that profit participation is also contained in both the remuneration amount and the redemption amount²¹²².

400 In this respect, the OECD Commentaries are not clear:

- In favour of *dividends*: “[...] the interest on such bonds [i.e. convertibles] should be considered as a dividend if the loan effectively shares the risks run by the debtor company”²¹²³. In the author’s view, this must apply analogously to comparable non-convertible financial instruments. In fact, any income that exceeds the time value of money is basically not time-equivalent and therefore cannot possibly constitute a genuine *debt-claim*²¹²⁴.
- Contra *interest*: “[...] premiums or prizes attaching thereto [i.e. government securities, bonds and debentures] constitute interest”²¹²⁵. In the author’s view, this must apply analogously to comparable financial instruments. Apparently, excessive redemption amounts above par are typically in no way “attached” but rather its integral part.
- In favour of *interest*: “Generally speaking, what constitutes interest yielded by a loan security [...] is all that the institution issuing the loan pays over and above the amount paid by the subscriber, that is to say,

²¹¹⁶ See par. 215.

²¹¹⁷ See par. 280.

²¹¹⁸ See par. 275 and 293.

²¹¹⁹ Argumentum e contrario.

²¹²⁰ See par. 390.

²¹²¹ See par. 279.

²¹²² *Achim Pross*, p. 160 et seq. See also par. 278.

²¹²³ OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-11, par. 19. The explanatory insertion in brackets has been added by the author.

²¹²⁴ See par. 215.

²¹²⁵ OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-11, par. 20. The explanatory insertion in brackets has been added by the author.

the interest accruing plus any premium paid at redemption or at issue.”²¹²⁶ While this may be undisputed, it is, however, not a sufficient maximum condition (*conditio per quam*) or verifier for Art. 11(3) OECD MTC.

- *Contra interest*: “On the other hand, the definition of interest does not cover any profit or loss that cannot be attributed to a difference between what the issuer received and paid (e.g. a profit or loss, not representing accrued interest or original issue discount or premium, which a holder of a security such as a bond or debenture realises by the sale thereof to another person or by the repayment of the principal of a security that he has acquired from a previous holder for an amount that is different from the amount received by the issuer of the security).”²¹²⁷ The reference for that difference is the nominal value, which was found to represent such fixation only for the *fixed-for-fixed* and the *fixed-for-variable conditions* but not for the *variable-for-fixed condition*²¹²⁸, which is, however, typical for linkers.
- *In favour of interest*: “The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest [...]”²¹²⁹. While this is obviously a subjunctive wording, it reads as corresponding to the previous statements as regards accrued interest and premiums.

401 To the author’s understanding, it was therefore an imprecise misinterpretation and overrun to understand these specific statements in the general sense that any positive difference between what the creditor transfers to the debtor for lending and what the debtor owes in return to the creditor as the repayment was *interest*²¹³⁰. It was also methodologically flawed, prejudicial and unpurposeful. In fact, it would actually ignore the role of the payment profile for the income classification as an inextricable reflex response to its risk exposure. Further, it would confuse the extending character of the profit participation with the genuine term of *debt-claims*. And lastly, it would entirely level any distinguishability between Art. 10(3) and 11(3) OECD MTC²¹³¹. Instead, these statements within the OECD Commentaries accurately and consistently integrate themselves into the systematic understanding of this study, if considered in the context of remunerations paid concurrently with, but detached from, the redemption. This is always the case for any amount separately paid at maturity (e.g. coupons, agios or premiums paid in arrear) and, according to the majority view²¹³², also to accrued interest. In other words: in order to apply these statements of the OECD Commentaries in a consistent and meaningful way to linkers, it is actually required and essential to draw a certain line in respect of whether or not the amount in excess of the time value of money is paid as an integral part of the redemption amount and, subsequently, whether or not it represents business profits.

²¹²⁶ OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-11, par. 20.

²¹²⁷ OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(11)-12, par. 20.

²¹²⁸ See par. 299.

²¹²⁹ OECD Commentaries 2014 on Art. 11 OECD MTC, p. C(13)-13, par. 31.

²¹³⁰ Equally: Wassermeyer, Franz in Wassermeyer Commentaries, p. 1429 et seq., par. 75.

²¹³¹ Equally: Achim Pross, p. 160.

²¹³² See par. 306.

402 Drawing this line from the author's point of view, linkers are structured identically to non-packaged²¹³³ net-settled²¹³⁴ convertibles. As such, they are typically – but not necessarily – cash-settled and therefore typically – but not necessarily – have a variable nominal value²¹³⁵. Consequently, they have to be classified accordingly. Making thus reference to the subsumption of convertibles²¹³⁶, the only question left is whether or not the net settlement of the embedded forward component as the only differentiator between linkers and convertibles alters those aforementioned conclusions. This becomes particularly clear, when remembering that non-packaged convertibles can also yield genuine *dividends* pursuant to Art. 10(3) OECD MTC, whereas net-settled forward transactions can also yield genuine *other income* pursuant to Art. 21(1) OECD MTC²¹³⁷. According to the view represented here, this question is to be answered in the negative by drawing an analogy to convertibles again²¹³⁸. Given the requisite formal reference to a *share* as the underlying²¹³⁹, the qualitative disaggregation process of risk identification, risk disaggregation and risk elimination²¹⁴⁰ would reveal whether the linker's underwriting risk is more distinctly determined by the embedded forward transaction (then potentially *other income*) or by the underlying itself (then *dividend*). However, the forward transaction is actually derived from the linker's underlying itself²¹⁴¹. As a consequence, their risks are literally identical²¹⁴². True, in the absence of a secondary market transfer²¹⁴³ of the asset, a net settlement of forward transactions cannot yield capital *gains* pursuant to Art. 13(5) OECD MTC. Nevertheless, this aspect is obviously independent of the fact that it can bear business risk. In that linkers actually combine primary market transactions (i.e. the capital provision) and secondary market transactions (i.e. the capital's realisation by way of net-settlement), they also coalesce the respective income types in themselves. However, these different income types have no impact on the results from the underwriting risk disaggregation. In result, this peculiarity of linkers is therefore a false problem for their classification. For these reasons, it is held as a conclusion for the further course of this study that linkers cannot possibly represent genuine *debt-claims* pursuant to Art. 11(3) OECD MTC, irrespective of the extending modification towards a profit participation that can thus not come into effect.

5.4.3 Linkers on debt-specific risks

403 As regards the second group (2)²¹⁴⁴, the question arises whether it alters the aforementioned conclusion that linkers cannot be subsumed under Art. 11(3) OECD MTC where their underlying bears risks (i.e. the linker is risk-based), which are typical or even constitutive for *debt-claims* (e.g. credit risk, currency risk, interest rate risk, etc.). Typical examples are credit-linked notes (CLN)²¹⁴⁵, inverse floating rate notes or targeted accrual

²¹³³ See par. 384.

²¹³⁴ See par. 378.

²¹³⁵ See par. 389.

²¹³⁶ See Illustration 25 on p. 234.

²¹³⁷ See par. 380.

²¹³⁸ See par. 392.

²¹³⁹ See par. 103(3).

²¹⁴⁰ See par. 101 et seqq.

²¹⁴¹ See par. 369.

²¹⁴² Equally: IFRS 9.B4.3.8(a), 9.B4.3.8(c) and 9.B4.3.8(g). IFRS 9.B4.3.5(c) and IFRS 9.B4.3.5(d) are no contradiction, as they (quantitatively) separate the time-based and risk-based components (*Kuhn / Hachmeister*, p. 706, par. 17) rather than (qualitatively) the risk-based element of the forward transaction from the risk-based element of the underlying itself.

²¹⁴³ See par. 313.

²¹⁴⁴ See par. 398(2).

²¹⁴⁵ *Frank Fabozzi*, p. 792 et seq.

redemption notes (TARN), dual- or multi-currency notes or collateralised debt obligations (CDO)²¹⁴⁶. Like linkers with a formal reference to a *share* as their underlying²¹⁴⁷, classifying such financial instruments by way of disaggregating their risk profile reveals only that it is more distinctly determined by debt-specific elements. The question therefore arises whether the risk-based nature of the financial instrument as such is subsidiary to the fact that it is a debt-specific risk profile (then *interest*) or vice versa (then *other income*).

404 However, it was stated that the entire methodological step of risk disaggregation as a specific sub-type of the material *substance over form* principle cannot overrule and must instead apply only subsidiarily to the formal redemption obligation. Therefore, the redemption obligation represents the starting point of the subsumption²¹⁴⁸, which must also apply to linkers²¹⁴⁹ with debt-specific underlyings. They are to be classified in analogy to non-packaged net-settled convertibles and thus are likewise object of the same legal subsumption (i.e. no ring-fencing). Again, it was prejudicial and methodologically flawed to run a disaggregative risk analysis towards their underlying's tax-wise nature before having verified whether the linker as such can even come potentially into question for being a *debt-claim* by fulfilling its most necessary minimum condition. On the one hand, linkers will often – but not necessarily – have a formal redemption obligation, which is also independent of the material termination risk²¹⁵⁰. On the other hand, their termination risk of any type whatsoever (i.e. even if debt-specific) nevertheless falsifies the time value of money²¹⁵¹ and therefore genuine *debt-claims*, so that linkers are basically risk-based financial instruments²¹⁵².

405 The reason is that underwriting risk is broader than underlying risk, so that the former is not necessarily rooted in the latter. Namely, the total underwriting risk contains the risk arising from the underlying (e.g. currency risk) and that arising from the financial instrument as such (e.g. legal risk). However, termination risk is always underlying risk²¹⁵³ and not underwriting risk, as the concept of underwriting risk would otherwise be self-referential²¹⁵⁴. In this case, for instance, cascading financial instruments would be positively “infected” in the sense of: *debt-claim* once and forever. In that, the underwriting risk arising from one financial instrument as such (e.g. legal risk of a bond) is actually converted into the underlying risk of a different financial instrument (e.g. CDO). Or in other words: the legal veil turns into an underlying itself. As a consequence from this consideration, the qualitative classification of the risk type as being typical or even constitutive for *debt-claims* is not of any relevance for the preceding quantitative determination of whether there is any termination risk at all²¹⁵⁵. To the author's understanding, debt-specific underlyings therefore do not alter the aforementioned conclusion that linkers cannot be subsumed under Art. 11(3) OECD MTC²¹⁵⁶. Instead, these must be classified pursuant to the general rules applicable for non-packaged net-settled convertibles.

²¹⁴⁶ Frank Fabozzi, p. 483 et seqq.

²¹⁴⁷ See par. 402.

²¹⁴⁸ See par. 385.

²¹⁴⁹ Equally: Achim Pross, p. 163.

²¹⁵⁰ See par. 386.

²¹⁵¹ See par. 242(2).

²¹⁵² See Illustration 25 on p. 234.

²¹⁵³ See par. 232.

²¹⁵⁴ Circular reasoning.

²¹⁵⁵ See par. 404.

²¹⁵⁶ Equally: Carmine Rotondaro, credit derivatives, p. 94 et seq.

5.4.4 Replicated debts

- 406 As regards the third group (3)²¹⁵⁷, the risk-return profile of debt-based financial instruments can be replicated or synthesised in countless varieties²¹⁵⁸. True, the restrictive application of the aggregation scheme excludes most of them from being classified as *debt-claims* pursuant to Art. 11(3) OECD MTC (e.g. the consolidated treatment of composite strategies with two or more forward transactions²¹⁵⁹)²¹⁶⁰. However, underwriting risk can generally replicate timing risk²¹⁶¹, so that risk-based debt-like financial instruments can be structured in such a way that they replicate time-based financial instruments (e.g. synthetic zero bonds²¹⁶² such as repurchase obligations²¹⁶³ incorporated into one legal contract). The question raised by this particularly ambiguous group of financial instruments is therefore whether the risk-based nature of the underlying itself is subsidiary to its hedge by the embedded forward transactions (then *interest*) or vice versa (then *dividends* or *other income*, depending on the formal reference to any underlying classified as a *share*).
- 407 Approaching this question, the methodological interim step or starting point of subsumption must again be the redemption obligation²¹⁶⁴. However, it should be permissible to assume that all such interest-replicating linkers always and necessarily have a redemption obligation. On the one hand, any replication of a time-based risk-return profile implies and requires two or more counteractive positions, whose risk components (e.g. variables, optionalities, contingencies, etc.) refer to one and the same trigger event or occurrence in order to constitute a perfect hedge. At least one of these positions, the pay leg, must however contain an obligatory element. While even options²¹⁶⁵ as the smallest available building blocks of financial instruments²¹⁶⁶ may not represent a redemption obligation themselves in the sense of a capital provision with a total of *two* closed transfers²¹⁶⁷, they nevertheless have an obligatory character²¹⁶⁸. In addition, the debt-based financial instruments transfer an actual and not a mere notional capital or principal²¹⁶⁹ or would otherwise have to be classified as *other income*. Combining the two aspects means as a consequence that the transfer of the capital or principal by interest-replicating linkers is subject of an absolute and unconditional formal right to actually be repaid (redemption obligation)²¹⁷⁰. The formal credit risk from this right is also independent of the material termination risk²¹⁷¹.

²¹⁵⁷ See par. 398(3).

²¹⁵⁸ See par. 61.

²¹⁵⁹ See par. 292.

²¹⁶⁰ See par. 95.

²¹⁶¹ See par. 69.

²¹⁶² See Example 53 on p. 227.

²¹⁶³ *Frank Fabozzi*, p. 173 et seqq. See also par. 292.

²¹⁶⁴ See par. 385.

²¹⁶⁵ See par. 236.

²¹⁶⁶ See par. 89.

²¹⁶⁷ See par. 371.

²¹⁶⁸ *Argumentum a minori ad maius*. Contrary: *Achim Pross*, p. 142 et seq., ignoring this obligatory element of options when concluding from the disaggregation of synthetic zero bonds that there may be a creditor but there was no debtor.

²¹⁶⁹ Contrary: *Achim Pross*, p. 142 et seq., ignoring this actual transfer of the capital or principal of synthetic zero bonds in contrast to options (i.e. the second closed transaction, see par. 370) when suggesting to disaggregate the former into the latter. See also par. 406.

²¹⁷⁰ See par. 289.

²¹⁷¹ See par. 386.

- 408 Again, any financial instrument is likewise object of the same legal subsumption²¹⁷² (i.e. no ring-fencing²¹⁷³), so that it was prejudicial and methodologically flawed to run a disaggregative risk analysis towards its underlying's tax-wise nature before having verified whether the financial instrument as a whole can even potentially come into question for being a *debt-claim* by fulfilling its most necessary minimum condition. Beyond the redemption obligation, which has been verified now, this also includes the time value of money²¹⁷⁴. Continuing the analysis, interest-replicating linkers do not bear any termination risk but merely timing risk. The reason is that its risk components refer to exactly the same trigger event or occurrence (e.g. the same underlying) in order to constitute a perfect hedge²¹⁷⁵. As a consequence, their counteractive risks are literally identical²¹⁷⁶ and the process of risk determination thus is not capable of eventually validating more than just the "managed" or "engineered" (i.e. hedged) net risk²¹⁷⁷, which amounts in fact only to timing risk. In other words: the evaluative process of risk assessment cannot do more than verify time equivalence²¹⁷⁸. Notably, this is not a consequence of any form of disaggregation as a qualitative risk classification but rather of the prior methodological step of a quantitative underwriting risk determination. Coming back to the initial question²¹⁷⁹, it is therefore held as an interim conclusion that the risk-based nature of the underlying itself is subsidiary to its hedge by the embedded forward transactions.
- 409 The time value of money is a quantitative concept in the sense that any risk type can amount to time equivalence, as time is a physical and thus a universal parameter²¹⁸⁰. In contrast, business risk is not only a qualitative concept in the sense that it is one specific risk type out of many but it is eventually also situative to the individual business enterprise. Consequently, genuine business risk was found not to be qualitatively or universally replicable or synthesisable, but instead to require a formal reference to any underlying classified as a *share* pursuant to Art. 10(3) OECD MTC²¹⁸¹. In contrast, the time value of money is quantitatively and universally replicable²¹⁸², so that genuine *debt-claims* as such do not in turn require a formal reference to any underlying classified as a *debt-claim*. However, due to the extending modification in Art. 11(3) OECD MTC, profit-participating *debt-claims* likewise require a formal reference to any underlying classified as a *share* pursuant to Art. 10(3) OECD MTC. It is therefore held as a conclusion that a time-equivalent remuneration replicated by linkers is to be classified as *interest* pursuant to Art. 11(3) OECD MTC, even without referring to an underlying classified as a *debt-claim* and even when referring to an underlying classified as a *share*. In contrast, a time-inequivalent remuneration replicated by linkers can principally be classified as profit-participating *interest* pursuant to Art. 11(3) OECD MTC or as *dividend* pursuant to Art. 10(3) OECD MTC, if they formally refer to any underlying classified as a *share* pursuant to Art. 10(3) OECD MTC. Otherwise they are to be classified as *other income* pursuant to Art. 21(1) OECD MTC.

²¹⁷² See par. 87.

²¹⁷³ See par. 301.

²¹⁷⁴ See par. 358.

²¹⁷⁵ See par. 407.

²¹⁷⁶ Equally: IFRS 9.B4.3.8(a); *Kuhn / Hachmeister*, p. 706, par. 17. See also par. 402.

²¹⁷⁷ See par. 101(2).

²¹⁷⁸ See par. 212.

²¹⁷⁹ See par. 406.

²¹⁸⁰ See par. 81.

²¹⁸¹ See par. 103(3).

²¹⁸² See par. 69.

5.4.5 Negative interest

- 410 The last topic that should be discussed here in the form of a short side note is the nature of negative *interest*. On the one hand, the phenomenon of negative *interest* is nothing new. For instance, Switzerland introduced a “commission” of 2% on the value appreciation of foreign cash deposits as early as 1972²¹⁸³. The majority of commentators²¹⁸⁴ came to the consensus view that negative *interest* can and must eventually be subsumed under Art. 11(3) OECD MTC. On the other hand, it appears that no systematic justification for this conclusion has been discussed yet. The key issue in this context is the question whether (then no *income* at all but maybe costs) or not (then *income*) the underlying transaction changes its economic nature if its price drops from positive into negative.
- 411 In this respect, it might initially be suggested that the qualitative classification or subsumption of income may not depend on its quantitative assessment or calculation. The latter deals with the grounds (cause) and therefore methodologically applies prior to the former that deals with the amounts (effects). On the other hand, mathematically speaking, the particular disparity between positive and negative amounts may be seen as more than just in the quantitative sense of being an absolute difference between two figures. Rather, it may also be seen in the qualitative sense of representing two entirely diverse numerical ranges. In other words: their opposite mathematical signs constitute a qualitative disparity beyond their mere quantitative difference in pivoting to diametrical directions. Or, shorter: “positive and negative” is more than just “more or less”. This qualitative element can be set in the context of the fact that the payment profile is an apparent and observable symptom of or reflex response to subjacent and masked qualifiers for the economic nature of the transaction or operation²¹⁸⁵. In this context, it might be assumed that changes in the direction of cash flows actually indicate changes in the subjacent nature of the transaction or operation, particularly from a positive into a negative asset²¹⁸⁶. This approach of drawing qualitative reverse deductions from quantitative facts and figures is a common and accepted legal methodology. It becomes evident when we consider that the mere direction of paying a positive or negative risk premium determines whether a legal relationship is, for instance, a bet or an insurance²¹⁸⁷.
- 412 To the author’s understanding, a negative price of the time value of money as the market “price of investment time”²¹⁸⁸ does not impact the operation’s economic nature as a finance transaction²¹⁸⁹. Without going too deep into economic theory, the systematic reason can, however, not be understood without some very briefly explained basics. In economic theory, negative assets in the broader sense are characterised by negative *utility*, i.e. the negative *net residual* of gross costs and gross benefit. In the narrow sense, negative assets are characterised by negative gross *benefit*. Obviously, where the gross benefit is already negative, this must be even more true for the net utility²¹⁹⁰ (but due to the cost impact not necessarily also vice versa). The difference

²¹⁸³ Art. 5(1) of the Swiss Verordnung über die Verzinsung ausländischer Gelder from 5 Juli 1972, Sammlung der eidgenössischen Gesetze: Amtliche Sammlung der Bundesgesetze und Verordnungen, supplement of Bundesblatt der Schweizerischen Eidgenossenschaft, Stämpfli, Berne, 1973, p. 1522.

²¹⁸⁴ See footnote 711.

²¹⁸⁵ See par. 200.

²¹⁸⁶ See par. 60.

²¹⁸⁷ See par. 70.

²¹⁸⁸ See par. 208.

²¹⁸⁹ See par. 295.

²¹⁹⁰ Argumentum a minori ad maius.

between negative utility and negative benefit is the “social dimension”²¹⁹¹. The former takes the individual or subjective perspective and thus is situative or relative in having a positive individual benefit merely exceeded by individual costs. In contrast, the latter takes the social or objective perspective and thus is global or absolute in having no positive benefit at all (i.e. for nobody).

Example 56: Drugs, crime or recyclable waste (e.g. second-hand goods) may be negative assets in the broader sense by having positive individual benefit exceeded by individual costs. Pollution, risk²¹⁹², physical harm (e.g. diseases, death) or non-recyclable (e.g. radioactive) waste may be negative assets in the narrow sense by having a negative benefit (i.e. for everybody).

- 413 Due to the quantitative interdependency of the social benefit as the sum of all individual benefits, the borderline between the two concepts is fluid. The more individuals derive negative benefit from an asset (e.g. due to scientific findings), the more it turns first from a positive into a negative one (e.g. smoking) and eventually from a negative one in the broader sense into a negative one in the narrow sense (e.g. carcinogenic construction materials). One important determining factor of such successive revaluation is glut in the market in the sense that most assets naturally turn from positive into negative as soon as they pass saturation (e.g. carbon dioxide). This is made even more evident by considering that market prices are determined by marginal utility (i.e. of the asset's last additional unit) rather than by absolute utility (i.e. of the asset's total units). In respect of capital supply, glutted markets are, however, always and necessarily temporarily and even also locally limited. The reason is that capital is a requisite production factor and as such can never be a negative asset in the narrow sense. In other words: no matter how much a particular market is glutted, there is always and necessarily sooner or later a minimum demand for capital. For instance, central banks raise negative *interest* only on the respective currency deposits of financial institutions, which actually represent the secondary market for capital, in order to increase their individual capital costs. By doing so, it is their very intention to meet the existing positive capital demand directly on the primary market. Consequently, a temporarily and locally negative “price of investment time” alone may not lead to the false reverse deductions that debt capital as such had a negative benefit. For these reasons the debt capital does not change its subjacent nature of being a finance transaction or operation, for instance, into a mere custody service²¹⁹³. In other words: a bad deal is nevertheless still a deal.
- 414 Thinking this argumentation to its end, it may legitimately be suggested by analogy that any negative price paid for disposing of negative assets in the broader sense could potentially represent negative sales proceeds pursuant to Art. 13(5) OECD MTC (e.g. an insurance premium as the sales price of the risk). Indeed, this is a logical consequence of the above disentanglement or separation of the causal or contextual nature of *income* from its mathematical sign²¹⁹⁴. In fact, no one will seriously doubt that, for instance, negative electricity prices in any way alter the fact that the underlying transaction or operation remains the disposal of electricity. In other words: in that the scope of its distributive articles must be basically as broad or comprehensive as

²¹⁹¹ *Fuchs, Hans Gerd / Klose, Alfred / Kramer, Rolf*, Güter und Ungüter: Eine Freundesgabe für Gerhard Merk zum 60. Geburtstag, Duncker & Humblot, Berlin, 1991, p. 4 et seq.

²¹⁹² See par. 60.

²¹⁹³ Cum hoc ergo propter hoc.

²¹⁹⁴ See par. 139.

possible²¹⁹⁵, the OECD MTC is principally open and accessible for all kinds of positive (e.g. capital *gains*) and negative income (e.g. capital losses) from both positive (e.g. bets) and negative assets (e.g. insurances), irrespective of what their price is. However, for the practice of treaty application, the issue is presumably of fairly low significance. The reason is that the terms *income* and capital *gains* are to be interpreted pursuant to the domestic tax law²¹⁹⁶. This typically adheres non-treaty purposes (e.g. to generate tax revenue²¹⁹⁷) and thus applies additional principles (e.g. an intention of making profits)²¹⁹⁸ re-narrowing this comprehensive autonomous understanding of *income*.

5.5 Other equity-based financial instruments

5.5.1 Structure

- 415 The most important class of other non-convertible and non-“derivative” equity-based “hybrids” are preference shares (also referred to as “preferred stock”). Preference shares actually form a class of financial instruments that is so diverse that a comprehensive and detailed analysis cannot be given here satisfactorily. Instead, their most typical and relevant features may be roughly grouped into:

- (1) redeemability;
- (2) preference in the remuneration;
- (3) preference in the event of liquidation; and
- (4) preference in membership rights.

5.5.2 Redeemability

- 416 As a starting point, it should be permissible to assume that preference shares generally bear business risk. Hence, the crucial question and critical differentiator for classifying them is whether or not this business risk is limited to the specific form of termination risk. Approaching this question, the methodological interim step or starting point of subsumption must again be the redemption obligation. In this first respect (1), preference shares can be featured in a way that formally provides the repayment of their capital or principal (e.g. redeemable preferred stock), which is also independent of the material termination risk. To the extent that such redeemability substantiates into an absolute and unconditional legal right to be repaid²¹⁹⁹, preference shares *ceteris paribus* have a structure identical to that of linkers with own “ordinary” *shares* of the issuer²²⁰⁰ itself as their underlying. Consequently, they have to be classified accordingly²²⁰¹. However, a substantial difference emerges in cases where such qualitative redemption obligation also includes a perfect quantitative recovery of the invested capital²²⁰², i.e. where there is no termination risk at all (e.g. guaranteed redeemable preferred stock). Those specific kinds of guaranteed redeemable preference shares might in fact be seen as representing rather the conceptual opposite of linkers. In fact, their business risk is exclusively limited to

²¹⁹⁵ See par. 111.

²¹⁹⁶ See par. 144.

²¹⁹⁷ See par. 226.

²¹⁹⁸ See par. 5.

²¹⁹⁹ See par. 289.

²²⁰⁰ See par. 382.

²²⁰¹ See par. 402.

²²⁰² Equally: *Michael Lang*, hybrids, p. 138. See also par. 231 et seq.

remuneration risk, whereas that of typical linkers is exclusively limited to termination risk²²⁰³. It is probably this dichotomy that gives rise to the association of linkers with debt instruments and that of preference shares with equity instruments. Nevertheless, the exclusion of termination risk actually limits the investor's business risk exposure and thus impacts the payment profile²²⁰⁴ as compared to ordinary *shares* (i.e. a lower remuneration), which is the very economic purpose of preference shares. Hence, the question arises whether or not such specific combination of redemption obligation and business risk in the form of remuneration risk as the only key differentiator between preference shares and linkers alters the prior conclusions. This becomes particularly clear when considering the apparent contradiction that linkers, although associated as "debt-like", primarily yield genuine *dividends* pursuant to Art. 10(3) OECD MTC²²⁰⁵. In contrast, guaranteed redeemable preference shares, although associated as "equity-like", seem to fulfil all legal requirements for a classification as profit-participating *debt-claims* pursuant to Art. 11(3) OECD MTC. The answer to this question is to be found in the remuneration, which will be analysed in the following.

5.5.3 Preference in the remuneration

- 417 As regards the second group (2)²²⁰⁶, the remuneration from preference shares can be featured in a way that its risks in respect of (a) periodicity, (b) certainty, (c) payability, (d) currency and/or its (e) payment profile²²⁰⁷ approximate to the time value of money²²⁰⁸. In terms of periodicity (a), preference shares might distribute their remuneration at maturity instead of periodically (e.g. zero-dividend preferred stock). However, it was found that it is the very nature of time equivalence to be independent of any temporal framework²²⁰⁹. In other words: the periodicity of remuneration payments is not a differentiator for subsuming preference shares under Art. 10(3) or 11(3) OECD MTC. As a consequence, the question of whether or not the remuneration is paid in regular periods is irrelevant.
- 418 In terms of certainty (b), the remuneration from preference shares can also be featured in a way that the remuneration risk is reduced compared to ordinary *shares*. For instance, it may grant priority distribution (e.g. preferred dividend stock) or even guarantee a remuneration (e.g. fixed dividend preferred stock). The critical element is, however, self-execution in the sense of an ex-ante determinability at least by a mathematical formula²²¹⁰. While not being a verifier for *interest* pursuant to Art. 11(3) OECD MTC²²¹¹, self-execution is nevertheless a falsifier for *dividends* pursuant to Art. 10(3) OECD MTC²²¹². In other words: no matter how much the remuneration risk is quantitatively reduced, it takes effect on the income classification only if qualitatively eliminated. However, as there is no absolutely riskless state in practice²²¹³, the determination of what can still be associated with the lowest relative risk must probably be set by convention (e.g. where the distribution is subject to a very likely condition). Where preference shares guarantee a remuneration that is

²²⁰³ See par. 389.

²²⁰⁴ See par. 399.

²²⁰⁵ See par. 402.

²²⁰⁶ See par. 415(2).

²²⁰⁷ See par. 274 et seqq.

²²⁰⁸ See par. 212 et seqq.

²²⁰⁹ See par. 211 et seq. and 302 as well as Example 33 on p. 123 and Example 34 on p. 124.

²²¹⁰ See par. 189.

²²¹¹ See par. 291.

²²¹² See par. 285.

²²¹³ See par. 62.

considered the lowest relative risk (i.e. no remuneration risk), they can – in the absence of voluntariness – not possibly be subsumed under Art. 10(3) OECD MTC. Instead, they must *ceteris paribus* rather be classified under Art. 11(3) OECD MTC²²¹⁴.

- 419 In terms of payability (c)²²¹⁵, the remuneration from preference shares can also be featured in a way that the distribution is deferred. The most typical use case is where the remuneration is not actually distributed but accumulated for future payment (e.g. cumulative preferred stock²²¹⁶). As was found²²¹⁷, deferrals basically represent a negative amount modification of the payment profile (e). Therefore, they represent the time value of money only in case they bear interest themselves (i.e. are subject of compound interest), which may be assumed to be highly uncommon in practice. In that, the payability feature actually coincides with the payment profile (e), which is analysed separately in the following.
- 420 Currency effects (d)²²¹⁸ are likewise no differentiator for subsuming preference shares (e.g. dual- or multi-currency preferred stock) under Art. 10(3) or 11(3) OECD MTC. In result, the question in which currency the principal nominates or the remuneration is distributed is principally irrelevant²²¹⁹. As regards the former, time equivalence was said to have been determined in the currency in which the principal nominates. That is why any currency conversions are subsequent logical steps to the capital provision, so that currency risk has no (negating) impact on the time equivalence. As regards the latter, currency effects coincide with the payment profile (e), which is analysed separately in the following.
- 421 In terms of the payment profile (e)²²²⁰, the remuneration distributions from preference shares can also be featured in a way that their amounts – if analysed by grouping them together as a coherent whole – approximate to the time value of money²²²¹. This is typical for guaranteed redeemable preference shares, in that it is the consequent economic response to their aforementioned limitation of the investor's business risk exposure to its form of remuneration risk²²²². Admittedly, due to the extending modification towards a profit participation in Art. 11(3) OECD MTC, the quantitative remuneration amounts cannot serve as a differentiator for classifying preference shares²²²³. However, the remuneration distribution is typically subject of qualitative voluntariness²²²⁴ (e.g. participating preferred stock), whereas the redemption obligation remains self-executive²²²⁵. In other words: it is this specific combination of self-executive redemption obligation (i.e. no termination risk) but voluntary remuneration distribution (i.e. remuneration risk) as the distinctive feature of guaranteed redeemable preference shares, which makes them a particularly ambiguous group of financial

²²¹⁴ See par. 290.

²²¹⁵ See par. 417.

²²¹⁶ See Example 54 on p. 231.

²²¹⁷ See par. 216.

²²¹⁸ See par. 417.

²²¹⁹ See par. 217.

²²²⁰ See par. 417.

²²²¹ See par. 215.

²²²² See par. 416.

²²²³ See par. 280.

²²²⁴ See par. 285.

²²²⁵ See par. 289.

instruments in respect of whether they actually represent a profit-participating *debt-claim* (then *interest*) or rather a negatively modified risk-based payment profile (then *dividend*)²²²⁶.

- 422 However, it was found that the extending attribute of profit participation in Art. 11(3) OECD MTC also requires self-execution in order to constitute *debt-claims*²²²⁷. In addition, the principle of reciprocity²²²⁸ demands that a rational investor will basically not accept negative modifications or even voluntariness²²²⁹ with regard to the payment profile (lower risk premium) unless compensated on the risk level (no termination risk)²²³⁰. This principle was found to result in opposite classification consequences for risk-based remunerations (preference shares) and time-based remunerations (linkers²²³¹). Negative modifications of a time-based remuneration or even voluntariness demand a *participation* in *negative* risk (chances) *turning* it into risk-based (termination risk). Contrariwise, negative modifications of a risk-based remuneration demand a *limitation* of *positive* risk *keeping* it basically risk-based. Combining those two findings means that the additional requirement whether or not the remuneration is self-executive is the reference point for the question whether a financial instrument represents a profit-participating *debt-claim* (then *interest*) or rather a negatively modified risk-based payment profile (then *dividend*). In other words: while both profit-participating *debt-claims* and guaranteed redeemable preference shares participate in remuneration risk but not in termination risk, the former is subject of self-execution and is thus a profit-participating *debt-claim* (*interest*). In contrast, the latter is subject of voluntariness and is thus a negatively modified risk-based payment profile (*dividend*). In that, the superficial aspect of payment profile actually reveals that subjacent qualitative difference between linkers, profit-participating *debt-claims* and those specific kinds of guaranteed redeemable preference shares. It also resolves the apparent contradiction that the one as a “debt-like” instrument primarily yields genuine *dividends*²²³², whereas the other as an “equity-like” instrument seems to call for a classification as profit-participating *debt-claim*. Linkers are risk-based *due to* embedding a risk premium²²³³ for their termination risk. Preference shares remain risk-based *even though* embedding a risk premium for their voluntary remuneration. And profit-participating *debt-claims* embed none of such risk premiums at all. This view is also in line with the aforementioned analogy of preference shares with linkers and thus with non-packaged net-settled convertibles²²³⁴. Such embedded risk premiums actually turn the holder into the equity leg receiver. Accordingly, linkers represent genuine *shares* pursuant to Art. 10(3) OECD MTC due to their termination risk. Preference shares represent a negatively modified risk-based payment profile and therefore genuine *shares* as well due to their voluntary remuneration. On the contrary, profit-participating *debt-claims* are to be subsumed under Art. 11(3) OECD MTC due to their self-execution. The following illustration visualises this understanding:

²²²⁶ See par. 277.

²²²⁷ See par. 290.

²²²⁸ See par. 180.

²²²⁹ See par. 291.

²²³⁰ See par. 276.

²²³¹ See par. 391 and 402.

²²³² See par. 402.

²²³³ See par. 392 and 402.

²²³⁴ See par. 416.

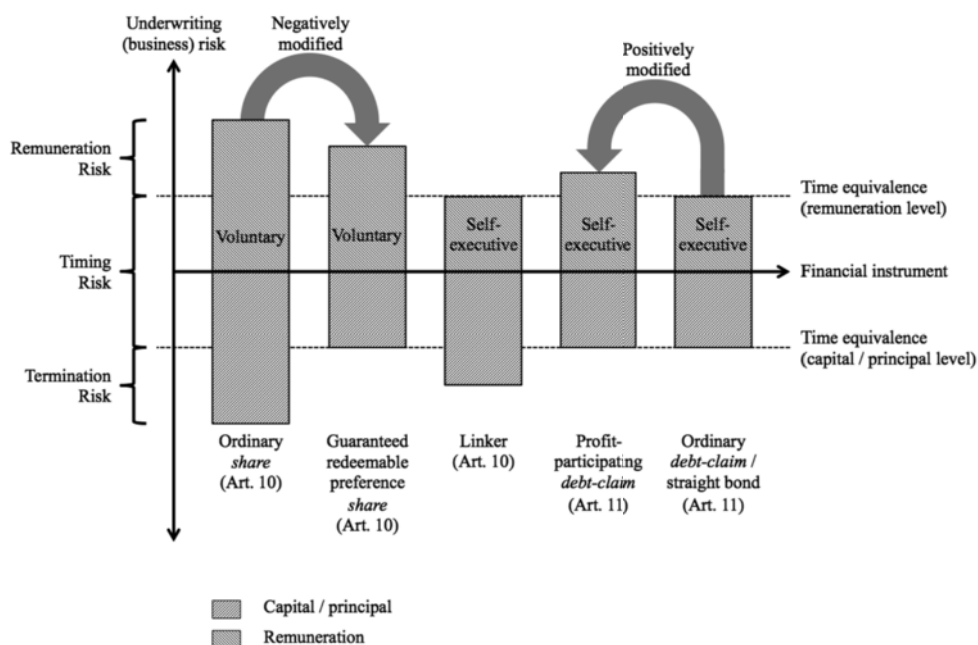


Illustration 26: The delimitation of preference shares, profit-participating *debt-claims* and linkers

5.5.4 Preference in the event of liquidation

- 423 As regards the third group (3)²²³⁵, preference shares can also be featured in a way that they participate in the liquidation proceeds, which are senior to those of ordinary *shares*. Such participation was found to be a necessary minimum condition (*conditio sine qua non*) in order to constitute *shares* pursuant to Art. 10(3) OECD MTC²²³⁶. The reason is that it represents a part of negative termination risk by participating in the business opportunities equivalent to those of a shareholder. Accordingly, seniority actually represents a form of negative subordination, which was found incapable of being a differentiator²²³⁷. In other words: while the participation in the liquidation proceeds supports the subsumption of preference shares under Art. 10(3) OECD MTC²²³⁸, its seniority cannot possibly falsify this classification²²³⁹. In contrast, preference shares that do not participate in the liquidation proceeds (e.g. debt-like “*jouissance*” *shares* or “*jouissance*” *rights*) are – even if redeemable at liquidation – not to be classified as *shares* pursuant to Art. 10(3) OECD MTC.

²²³⁵ See par. 415(3).

²²³⁶ See par. 278 and 282.

²²³⁷ See par. 220 et seq.

²²³⁸ Equally: *Jakob Bundgaard*, hybrids, p. 384; *Haslehnner*, *Werner* in *Klaus Vogel Commentaries* 2015, p. 842, par. 106; *Jakob Bundgaard*, debt-flavored equities, p. 425; *Marjaana Helminen*, dividend concept, p. 203.

²²³⁹ Perhaps Contrary: *Marjaana Helminen*, dividend concept, p. 203, by holding that “the only situation where a preferred share may not qualify as a corporate right is when it contains [...] and a provision that grants liquidation preference”.

5.5.5 Preference in membership rights

- 424 As regards the fourth group (4)²²⁴⁰, preference shares can also be featured in a way that gives preference in membership rights. On the one hand, membership rights were basically found incapable of being a differentiator²²⁴¹. On the other hand, membership rights can be so preferential that – even though being merely formal or legal – they actually impact the proprietary rights and thus might eventually have influence on the material differentiators discussed in this study (e.g. super-voting preferred stock, class A shares). For instance, class A shares distort the concordance between benefit as a proprietary right and control as a membership right by actually exposing the former to the latter. In that, they seem to erode the differentiator of voluntariness, which is, however, relevant for classifying the class B shares. Such influence is a natural consequence of the fact that the peculiarities of financial instruments and thus the delimitation of their various types are in large part the result and effect of legal relationships²²⁴². Consequently, the subjacent question arises whether or not those interdependencies merit substantive attention. Or in more general terms: which conflicts between those potential differentiators are relevant or not relevant for the income classification.
- 425 This question is so general and its answer so extensive that it cannot be given here satisfactorily. With respect to the particular use case of super-voting preference shares, it is sufficient to hold that the exposure of the underrepresented owner of the proprietary rights to the control of the overrepresented owner of the membership rights isn't materially relevant for the income classification²²⁴³ either. The reason for this is that voluntariness as the source's own decision presumes bilateralism in the sense that there is no external consent required from any third party other than the two contracting parties. These two are only the particular investor in the financial instrument and the source as such, regardless of any of the source's other investor²²⁴⁴. In other words: where the source's decision is merely bound by other owners of proprietary rights, this is actually no involuntariness but rather indicates the internal organisation within the source itself (i.e. between the investors). The voluntariness at the source level cannot be infringed by the investor level, as anything else would mean to actually confuse the source's legal position with that of its investors, which would give rise to considerable systematic distortions. In particular, this approach would create a relative classification concept similar to subordination²²⁴⁵. As such, it would not allow any universal statement but rather be highly sensitive to the contextual or situative determinants among the various investors and therefore lead to inconsistent, paradoxical or otherwise erratic results. This becomes particularly clear when considering the contradiction that the underrepresented owner of the proprietary rights might – and typically will – own some membership rights as well. Hence, although being underrepresented, he actually binds the source's decision qualitatively. As a consequence, even his own influence would impact the material differentiator of voluntariness²²⁴⁶ or otherwise would have had to be quantitatively assessed against the overrepresented owner of the membership rights. This means as a conclusion for the further course of this study that it does not alter the prior conclusion that membership rights are incapable of being a differentiator. This remains valid even where they are so

²²⁴⁰ See par. 415(4).

²²⁴¹ See par. 262.

²²⁴² See par. 56 and 77.

²²⁴³ In result equally: *Jakob Bundgaard*, hybrids, p. 384 et seq.; *Haslehner, Werner* in *Klaus Vogel Commentaries* 2015, p. 842, par. 106; *Jakob Bundgaard*, debt-flavored equities, p. 425; *Marjaana Helminen*, dividend concept, p. 202 et seq.; *Michael Lang*, hybrids, p. 137.

²²⁴⁴ See par. 188.

²²⁴⁵ See par. 220.

²²⁴⁶ Circular reasoning.

preferential that they might impact the proprietary rights and even where they are detached from the proprietary rights or otherwise delegated from the original owner to any third party.

Example 57: A *company* has just one single *share*, from which its one single voting right was split-off (stripped), traded separately and also delegated from its new owner to a bank. The owner of the remaining proprietary rights in that *share* himself had no influence on the decision whether a dividend is distributed. However, voluntariness takes the *company's* (i.e. the source's) disposal perspective rather than the shareholder's enjoyment perspective²²⁴⁷. Therefore, it is in no way limited or restricted as compared to ordinary unstripped free-float *shares* (i.e. of minority shareholders). Ergo, the internal organisation between the owner of the proprietary right and the owner of the membership right does not impact the *company's* (i.e. the source's) decision as to whether or not a dividend shall be distributed.

5.5.6 Conclusions

426 The following illustration visualises and summarises the overall classification of preference shares as understood and represented in this study:

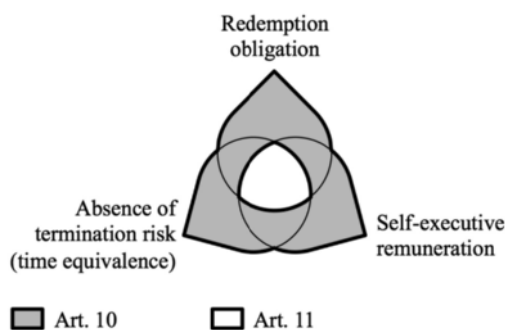


Illustration 27: Classifiers/differentiators for preference shares

5.6 Strips

5.6.1 Structure

427 Strips originally stands for “separate trading of registered interest and principal securities”. In the narrow sense, they are the earnings coupons (e.g. *interest* or *dividend* coupons) detached from the capital or principal of their respective securities (e.g. bonds or *shares*) and traded independently (e.g. strip bond and zero coupon bond, also referred to as “z-bonds”). In more general terms, strips are the claims on only the income stream as a partial proprietary right²²⁴⁸ from a capital provision, isolated into a separate financial instrument. The reason

²²⁴⁷ See par. 192.

²²⁴⁸ See Example 57 on p. 250 for the analogous strip of a membership right.

for devoting this separate section to them is their specific ambiguity in appearing as *income* (transaction) and *capital* (asset) simultaneously²²⁴⁹, which gives rise to the following systematic key issues:

- (1) the role or relevance of the separate capital or principal;
- (2) the conflict between termination and remuneration risk; and
- (3) the conflict between *dividends* or *interest* on the one hand and capital *gains* on the other.

5.6.2 The relevance of the separate capital

428 The first issue (1) sets the general course for the subsumption of strips, in that it actually determines whether they are to be classified independently or by considering the capital or principal securitised into a separate financial instrument. The subjacent question is whether (then *other income*) or not (then potentially *dividends* or *interest*) a coupon stripping turns a capital provision as a finance transaction into something different. On the one hand, it seems reasonable to suggest that considering also the separate capital or principal would actually represent a form of aggregating the two financial instruments which is subject to particularly strict requirements²²⁵⁰. On the other hand, the concept of *beneficial ownership* was found to be a requisite and explicit exception to that aggregation scheme²²⁵¹. However, *beneficial ownership* is the replacement of the *recipient* by the *beneficial owner* and therefore requires an inflow and an outflow²²⁵². In contrast, strips have neither two subjects (i.e. the *recipient* and the *beneficial owner*) nor two objects (i.e. the genuine *dividend* or *interest* as the inflow and a pass-through outflow) but instead only one of each. It is this peculiarity of strips which makes the difference to similar financial instruments such as gross-physically settled forward transactions with a cash flow as their underlying²²⁵³ or securities lending transactions. Countering this, it may be argued that *beneficial ownership* actually required neither those two subjects nor those two objects. This is demonstrated by the example of an ordinary *dividend* that apparently has also at least one *beneficial owner*²²⁵⁴. However, pursuant to its purpose, intention and function, the concept of *beneficial ownership* is obviously necessary and meaningful only in cases where the *recipient* and the *beneficial owner* differ from each other. As a consequence, the example of an ordinary *dividend* represents in so far its counterexception rather than its general rule. Therefore, it would be methodologically flawed to draw any reverse deduction from such exception to a general rule. This is even more true as anything else would unintentionally frustrate the restrictions to the aggregation scheme and eventually let them fall short entirely. For these reasons, it can initially be held that it is impermissible to put strips in a context of the separate capital or principal by way of *beneficial ownership*²²⁵⁵.

429 Instead, associating this context of strips with the separate capital or principal by way of the aggregation scheme at all appears to be a false problem. In fact, the determination whether or not a payment represents a remuneration for a capital provision as a qualified finance transaction is an essential and indispensable material element and the starting point of the subsumption of any financial instrument. As such, it is subject of the

²²⁴⁹ See Example 22 on p. 95.

²²⁵⁰ See par. 95.

²²⁵¹ See par. 121.

²²⁵² See par. 132.

²²⁵³ See par. 376.

²²⁵⁴ See par. 116.

²²⁵⁵ Contrary: Dutch Hoge Raad der Nederlanden, judgement ref. 28638, 1994, merely holding that “the interested party has, by purchasing the dividend coupons, become their owner. This Court may further assume that the interested party had, after their purchase, the free disposal of the dividend coupons and, after cashing them, of the distributions received and that, when cashing the dividend coupons, it did not act as an agent or nominee. Under these circumstances, the interested party may be considered to be the beneficial owner of the dividends.” (translation from *Hans Pijl*, beneficial owner, p. 258).

substance over form principle per se²²⁵⁶. Suggesting that the capital provision as a finance transaction was also another differentiator between Art. 10 and 11 OECD MTC on the one hand and Art. 21 OECD MTC on the other would actually elevate the concept of aggregation to the status of a general principle within chap. III or even the entire OECD MTC. This argument is far too fundamental and extensive to discuss here satisfactorily. It shall therefore be sufficient to hold that the concept of aggregation and disaggregation is by all means a result of the specific flexibility of financial instruments to synthesise any legal and economic effect²²⁵⁷. As such, they are however replicable only into each other and never into “real assets”²²⁵⁸. As a consequence, the concept of aggregation and disaggregation appears to be dispensable for the identification of financial instruments subject of Art. 10 or 11 OECD MTC as opposed to other assets such as those subject of Art. 13 or 21 OECD MTC. Instead, it seems to apply within the group of what has priorly been identified as financial instruments and therefore to point predominantly at the delimitation of the respective Art. 10 and 11 OECD MTC.

- 430 Accordingly, strips represent an overlay of the *substance over form* principle in general and that in its specific form of the aggregation scheme, whereby the former methodologically applies prior to the latter. In other words: before the aggregation scheme can potentially affect the classification of a financial instrument, it must priorly be determined whether or not there is a qualified finance transaction at all. That is why setting strips in the context of the separate capital or principal for determining whether or not they represent a financial instrument at all is, at this stage, no exception from the restrictions to the aggregation scheme. The reason is that the aggregation scheme does not yet come into effect on this first subsumption level. It appears that the specific ambiguity of strips is rooted in the subjacent conflict between these two aspects or layers of the *substance over form* principle in actually taking different perspectives: on the one hand, splitting a composite finance operation sufficiently into partial transactions leads to the point where the individual component – taken separately – cannot be considered a finance operation anymore²²⁵⁹. This is even more evident where its key element of the capital provision is attributable to another person. On the other hand, this view in favour of the aggregation aspect actually takes the holder’s or investor’s perspective. In contrast, from the issuer’s perspective strips obviously represent the genuine remuneration for a qualified finance operation. Considering that the classification of strips cannot possibly depend on the situative context of whether (then potentially *dividends* or *interest*) or not (then potentially *other income*) their owner also holds or held the separate capital or principal²²⁶⁰ makes evident, however, that the general aspect of the *substance over form* principle must – in the sense of “one fits all” – principally take precedence over its specific aggregation aspect.
- 431 This result for strips is in natural contrast to the classification of forward sales that depends on whether or not their underlying is actually available for sale and thus the forward transaction gross-physically settleable²²⁶¹. The existence of both capital *gains* and *beneficial ownership* requires two composite transactions (i.e. acquisition and sale as well as inflow and outflow) as a necessary minimum condition (*conditio sine qua*

²²⁵⁶ See par. 56.

²²⁵⁷ See par. 76.

²²⁵⁸ See par. 1 and 180.

²²⁵⁹ See par. 306.

²²⁶⁰ In this sense, however: *Tischbirek, Wolfgang / Specker, Gerhard* in *Vogel / Lechner*, p. 1215, par. 192; *Wassermeyer, Franz* in *Wassermeyer Commentaries*, p. 1616, par. 35; *Marjaana Helminen*, dividend concept, p. 102.

²²⁶¹ See par. 376.

non). In contrast, genuine *dividends* or *interest*, as demonstrated by strips, are singular events. As a conclusion for the further course of this study, strips cannot per se be excluded from representing a genuine material return for a qualified finance transaction pursuant to Art. 10(3) or 11(3) OECD MTC respectively. This is regardless of the subsequent fact that this return is formally or legally isolated into a separate financial instrument. Or to answer the initial question²²⁶² in other words: a coupon stripping as such does not turn a capital provision as a finance transaction into something different. It is this peculiarity of strips, which makes the difference to similar financial instruments, such as those with a mere notional capital or principal²²⁶³, uncovered long puts with a cash flow as their underlying²²⁶⁴ or repurchase obligations²²⁶⁵.

5.6.3 The conflict between termination and remuneration risk

- 432 As regards the second issue (2)²²⁶⁶, the general relevance of the capital or principal for the determination whether or not the strip represents a qualified finance operation²²⁶⁷ may not lead to the conclusion that it was automatically also relevant for the subsequent subsumption level, i.e. the determination of the strip's particular classification characteristics. The reason is that this aspect, which distributive article applies within the group of priorly identified finance transactions (i.e. Art. 10 or 11 OECD MTC), is governed by the *substance over form* principle in its specific form of the aggregation scheme, which comes only now into effect on this subsequent subsumption level. At first glance, strips seem to not differ in any way from other financial instruments carving-out or skimming-off cash flows (e.g. replicating financial instruments) in merely "picking and extracting"²²⁶⁸ the quantitative earnings or *income* cash flow. Hence, there appear to be no compelling reasons to refrain from those particular aggregation restrictions. However, in contrast to any of those other financial instruments carving-out or skimming-off cash flows, strips represent also a qualitative proprietary right²²⁶⁹ in their respective finance transaction itself. The first subsumption step of determining whether or not the strip represents a qualified finance operation at all is an economic problem²²⁷⁰. On the contrary, the second subsumption step of determining the existence of the strip as a financial instrument was said to be predominantly a matter of the legal form²²⁷¹. Just as the former, the latter must take the issuer's perspective as well in order to be coherent and consistent. Anything else would give rise to inconsistent or paradoxical or otherwise considerable systematic distortions.

Example 58: Where an issuer's entire equity was stripped, he would – from the holder's or investor's perspective – not have any *share* pursuant to Art. 10(3) OECD MTC and thus would have no shareholders at all. If, in addition, also his entire debt capital was stripped, there would be – from the holder's or investor's perspective – no *debt-claims* pursuant to Art. 11(3) OECD MTC either. Thus, there would be no finance transaction at all, even though a *company*

²²⁶² See par. 428.

²²⁶³ See par. 282 and 299.

²²⁶⁴ See par. 377.

²²⁶⁵ See par. 292.

²²⁶⁶ See par. 427(2).

²²⁶⁷ See par. 429 et seqq.

²²⁶⁸ See par. 91.

²²⁶⁹ See par. 427.

²²⁷⁰ See par. 430.

²²⁷¹ See par. 77.

pursuant to Art. 3(1)(b) OECD MTC can be financed only by equity and/or debt. As a consequence, the legal and the economic view on the same aspect (i.e. the determination of whether or not a strip represents a finance transaction at all) would fall apart in such a severe way that such a view cannot be considered in line with the purpose, intention and function of Art. 10(3) and 11(3) OECD MTC.

- 433 In other words: only the issuer's perspective is capable of giving an overall picture for the determination whether or not a reciprocal relationship represents an economic finance transaction in general. Any debt-equity distinction in particular must stand against the *company* pursuant to Art. 3(1)(b) OECD MTC as an issuer capable of operating debt and equity simultaneously. As a consequence, the systematic approach must necessarily correlate for both the economic and the legal aspect in order to avoid a dualism of methods. Insofar, strips – in having just one subject (i.e. the *recipient* and *beneficial owner*²²⁷²) and one object (i.e. the *income*)²²⁷³ – coalesce both an economic return for a finance operation²²⁷⁴ and simultaneously also a legal proprietary right in this finance operation itself. It is this peculiarity of strips which makes the difference to similar financial instruments carving-out or skimming-off cash flows (e.g. replicating financial instruments). As such, it provides not only a criterion for consistently and resiliently distinguishing them in this respect for the purpose of treaty application. It is also the systematic justification for the fact that setting strips in the context with their separate capital or principal²²⁷⁵ represents a legitimate exception from the restrictions to the aggregation scheme.
- 434 The issuer's perspective²²⁷⁶ is in line with the IAS/IFRS classification scheme²²⁷⁷ and with the tax-limiting purpose, intention and function of the distributive articles, in that it primarily addresses the source jurisdiction²²⁷⁸. Considering the separate capital or principal for the classification of strips is therefore not arbitrary either by implying any prejudicial and artificial imagination of an "original" financial instrument (ring-fencing²²⁷⁹). Even considering that any financial instrument is actually the object of the same legal subsumption²²⁸⁰, the strip's legal participation as a proprietary right in the finance operation itself actually makes it part of the genuine capital provision. In addition, this view does not conflict either with the fact that the formal or legal interpretation necessarily adheres to the domestic tax law. The reason is that the domestic tax law is limited to the strip's mere existence as such²²⁸¹ and does not necessarily also include its context. As a conclusion for the further course of this study, the strip's context to the separate capital or principal is not

²²⁷² Equally: *Marjaana Helminen*, dividend concept, p. 102.

²²⁷³ See par. 428.

²²⁷⁴ *David Hasen*, p. 419, even suggesting that a strip economically represents rather an individual but entire bond or share itself due to the economic inseparability of capital and income (see also par. 158).

²²⁷⁵ In result equally: *Harris, Peter A.* in *IBFD Commentaries on Art. 10 OECD MTC*, sec. 5.1.2.4.2.; *Reimer, Ekkehart* in *Klaus Vogel Commentaries* 2015, p. 1078, par. 147.

²²⁷⁶ See par. 430.

²²⁷⁷ See par. 236.

²²⁷⁸ See par. 19.

²²⁷⁹ See par. 301.

²²⁸⁰ See par. 87.

²²⁸¹ See par. 81.

limited to its economic determination as a finance transaction. Instead, it also includes its legal determination as being subsumed under either Art. 10(3) or 11(3) OECD MTC respectively²²⁸².

435 As a consequence of such aggregation, the redemption obligation and therefore the timing or termination risk of strips is not to be determined separately and individually but by also considering the characteristics of their capital or principal. Following the general principles of the debt-equity delimitation²²⁸³, strips may thus be either risk-based or time-based. And, in the former case, they may bear either business risk or non-business risk, depending on their formal reference to a *share*²²⁸⁴.

436 The following illustration visualises this understanding:

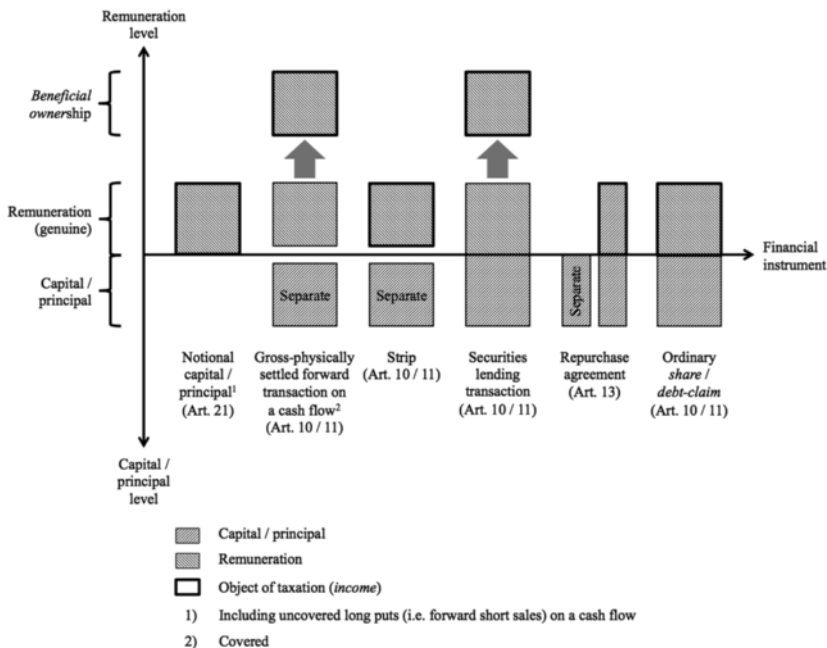


Illustration 28: Delimitation of strips and similar financial instruments

437 Having ascertained the general relevance of the capital or principal, the subsequent question arises who is to be considered the attributee of the *income* (i.e. the strip holder or the shareholder). Obviously, the attributee of the *income* is the strip holder, even though he is not also the holder of the capital or principal and thus does typically not provide the capital himself. This is even more evident by considering that both Art. 10(3)²²⁸⁵

²²⁸² In result equally: *Harris, Peter A.* in *IBFD Commentaries on Art. 10 OECD MTC*, sec. 5.1.2.4.2.; *Reimer, Ekkehart* in *Klaus Vogel Commentaries* 2015, p. 1078, par. 147; unclear: *Wassermeyer, Franz* in *Wassermeyer Commentaries*, contrary on p. 1430, par. 75 but then in favour on p. 1435, p. 86.

²²⁸³ See par. 358.

²²⁸⁴ See par. 103(3).

²²⁸⁵ Equally: *Marjaana Helminen*, dividend concept, p. 97 and 102.

and 11(3)²²⁸⁶ OECD MTC do not provide any *income* attribution rule. That the provision of the capital as the operation and the remuneration as the return actually fall apart in such a way, is the consequence of the issuer's perspective to be taken for the determination whether or not the strip represents a finance operation at all²²⁸⁷. However, such determination was said to be not so much a legal as an economic problem. From this economic perspective the strip holder does nothing else than to compensate and credit the shareholder for his lost profits, so that he actually participates indirectly in the genuine capital provision as well.

5.6.4 Dividends or interest versus capital gains

- 438 With respect to the third issue (3)²²⁸⁸, it cannot be argued either that the compensation of the shareholder for his lost profits by the strip holder actually represents a pass-through of the genuine *income* by the latter back to the former. Admittedly, such transfer may comply with the requirement to *beneficial ownership* of a causal relation between the in- and outflows of individual transactions, quantitatively observable by expected negative correlation depending on the same risk²²⁸⁹. And, of course, an inflow in the form of *income* (*dividends* or *interest*) can also be passed-through as an outflow in the form of sales proceeds (*capital gains*)²²⁹⁰. However, in the author's view such transfer does not comply with the requirement for *beneficial ownership* that the in- and outflows must also proportionate in approximately equal amounts or benefits, which was found to be interpreted in a particular restrictive sense²²⁹¹. The reason is that the compensation as the outflow can only account for expected amounts (*ex ante*). On the contrary, the genuine *income* naturally accounts for the actual amounts (*ex post*). This means as a conclusion that the strip holder is not only the *recipient* but also remains the *beneficial owner* of the respective *income*. And where the (re-)attributional purpose of the specific and explicit *beneficial ownership* concept is not sufficient to substitute the nature of an *income*²²⁹², this must be even more true for the general and implicit *substance over form* principle²²⁹³.
- 439 Going further, the realisation of the *income* from the strip by the strip holder is no capital *gain* pursuant to Art. 13(5) OECD MTC. Even where its total value was distributed, it might quantitatively have a zero value but nevertheless qualitatively continues to exist as a right (at least on future distributions)²²⁹⁴. Consequently, such distribution represents a legal event that does not refer to the strip in the sense of impairing the mathematical number of the critical ownership rights in the strip²²⁹⁵. This means as a conclusion that the *income* from the strip also keeps its original nature, i.e. its realisation does not turn it into something different (particularly not into capital *gain*)²²⁹⁶.

²²⁸⁶ Helminen, Marjaana in IBFD Commentaries on Art. 11 OECD MTC, sec. 5.1.1.3.2.

²²⁸⁷ See par. 429 et seqq.

²²⁸⁸ See par. 427(3).

²²⁸⁹ See par. 338.

²²⁹⁰ See par. 138.

²²⁹¹ See par. 135.

²²⁹² See par. 129.

²²⁹³ Argumentum a minori ad maius.

²²⁹⁴ See Example 61 on p. 263.

²²⁹⁵ See par. 160 et seqq.

²²⁹⁶ Equally: Reimer, Ekkehart in Klaus Vogel Commentaries 2015, p. 1078, par. 147; perhaps contrary: OECD, CFA/WP1(73)2, p. 11, par. 21, but probably referring to limb 3 of Art. 10(3) OECD MTC in saying that "the definition has been widened to that the term dividends also covers income arising from the alienation of dividend coupons or other similar rights where the capital relating thereto has not been transferred at the same time".

5.7 Non-cash based financial instruments

5.7.1 Structure

Non-cash based transactions represent a horizontal cross type rather than a vertical class of financial instruments. Non-cash elements can principally be attached to a number of different features and classifiers (e.g. financial operation in general, capital or principal in particular, remuneration, underlying, etc.). The reason for devoting this separate section to them is that non-cash based financial instruments or transactions give rise to specific ambiguities, which may be roughly grouped into the following issues:

- (1) As was found, non-cash assets may represent parts of both the operation or obligation (i.e. the pay leg) to be interpreted autonomously and/or of the return or redemption (i.e. the receive leg) to be interpreted domestically²²⁹⁷, each on both the capital or principal level and/or the remuneration level. This directional aspect as a consequence of reciprocity has a significant impact on the financial instrument's classification, which is solely determined by the operation²²⁹⁸.
- (2) Any asset other than the tax currency itself bears underwriting risk, in that its assessment depends on the currency exchange rates to the tax currency. These risk-driven aspects of assessment necessitate a careful distinction and consideration of risk types which are relevant for the income classification and those which are not.
- (3) Where non-cash assets are mutually exchanged, they can interact with each other in a way that the net result of the two is not equal to the sum of their individual cash-equivalents. Such synergetic effects challenge even more the aspects of assessment. This applies in particular to financial instruments, which can or may not be disaggregated²²⁹⁹ or are subject of the *fixed-for-fixed condition*²³⁰⁰.
- (4) All financial instruments allow for the replication or synthesis of any variety of economic features by way of embedding other financial instruments. However, non-cash based financial instruments allow for these features to becoming effective also legally in that they materialise from a mere variable into a non-cash asset (e.g. the underlying) by – so to say – “piercing the legal veil”. This peculiarity raises additional issues, such as on which level (e.g. the underlying or the financial instrument itself) and thus at which point in time such features take effect on the income classification.

In addition, this section presents a side note on securities lending transactions.

5.7.2 Determination of the operation

The remuneration as the starting point

As regards the first issue (1), the question of whether a non-cash asset represents parts of the operation or obligation (i.e. the pay leg) or rather of its return (i.e. the receive leg) is particularly difficult to answer where negative assets are subject of the financial transaction. At first glance, this problem appears to arise only from the operation or obligation side and not from the return or redemption side. The reason is that this return or redemption side is typically positive and should therefore be easy to identify as anything received by the contracting parties (i.e. the receive leg).

²²⁹⁷ See par. 180 et seq.

²²⁹⁸ See par. 56.

²²⁹⁹ OECD, ST/SG/AC.8/2001/CRP.8, p. 30, par. 110.

²³⁰⁰ See par. 299.

Example 59: Taking an option risk (i.e. a negative asset) in exchange for *shares* (i.e. a positive asset), these *shares* could be considered as *income* for taking the option risk²³⁰¹ (i.e. as option premium in kind). Alternatively, the *shares* could also be considered as alienated themselves realising a capital *gain*. In fact, they are both simultaneously: one contracting party receives the *shares* as *income* (i.e. the receive leg) in exchange for taking the option risk as the transaction or operation (i.e. the pay leg); the other contracting party receives the option as *income* (i.e. the receive leg) for disposing of the *shares* as the transaction or operation (i.e. the pay leg).

Bearing this in mind, it might be suggested to take the receive leg as the starting point for resolving this directional problem. The reason is that it is admissible to assume that the direction of cash flows and equivalents actually indicates the subjacent nature of the underlying operation²³⁰². However, in fact a remuneration can also be negative, so that focussing merely on the receive leg as the starting point is incomplete.

Example 59 (continued): Taking the same option risk (i.e. a negative asset) in exchange for paying negative *interest*²³⁰³ (i.e. a negative asset), this negative *interest* could analogously be considered as *income* for taking the option risk (i.e. as option premium). Alternatively, the negative *interest* could be considered as *interest* itself. Obviously, it cannot possibly be both simultaneously, as there is just one contracting party receiving both the option and the negative *interest*.

This is a natural consequence of the fact that financial instruments are cash equivalents and as such particularly sensitive to contextual or situative determinants. That is why legal entitlements were found to have a dual purpose of potentially representing both the economic return for legal obligations and parts of the economic operation itself²³⁰⁴.

Example 60: Depending on the context, taking obligations (i.e. a negative asset) can be considered a kind of operation (e.g. factoring) or a kind of payment (e.g. debt assumption).

- 442 In consideration of this inescapable dual purpose, there is still no other way than to either stick to the receive leg as the indirect starting point for the income classification or to go for the pay leg directly (i.e. the operation or obligation). From the author's point of view, the receive leg appears as more expedient for theoretical and practical considerations. On the one hand, such approach is the same as for a positive remuneration²³⁰⁵, avoiding a dualism of methods. On the other hand, there are at least three kinds of negative assets on the operation level which are relevant for the income classification (i.e. redemption obligation, termination risk and business risk). On the contrary, only one kind of negative *income* can be seen on the remuneration level (i.e. negative *interest*). Financial instruments mutually exchange negative non-cash values by combining them into new negative non-cash assets within one legal contract (e.g. swaps, composite option strategies). In contrast, negative remunerations for such assets appear to be fairly rare. The delimitation between the two

²³⁰¹ See Illustration 24 on p. 224.

²³⁰² See par. 411.

²³⁰³ See par. 410 et seqq.

²³⁰⁴ See par. 343.

²³⁰⁵ See par. 358.

levels of operation (receive leg) and remuneration (pay leg) is the legal form in the sense that the former would require qualitative disaggregation and the latter quantitative disaggregation. However, both are subsequent methodological steps to the legal form of the financial instrument as such²³⁰⁶. In other words: the holder of the financial instrument may be obliged to economically compensate more than what the contract explicitly dedicates to the remuneration (e.g. by also taking certain non-cash obligations). But the pay leg is understood here only in the sense of what that contract explicitly dedicates to the remuneration (form over substance). The reason is that any additional remuneration component would eventually require and imply disaggregation (i.e. *substance over form*). This approach is also in line with the working assumption that the subjective intention of the parties involved basically coincides with the objective observables²³⁰⁷.

- 443 In this light, the particular issue of determining the relevant operation for classifying non-cash based financial transactions swapping negative values seems to be limited to negative *interest*. It might be suggested that there would be no particular problem with identifying negative *interest*. However, non-cash based financial instruments are object of the same legal subsumption (no ring-fencing) as well. It was therefore prejudicial and methodologically flawed to pre-classify one of the two legs as *interest*, which represents the final result rather than the starting point of the treaty interpretation and application process. This becomes even more evident when remembering that negative *interest* can also be replicated or synthesised²³⁰⁸. Notably, these considerations may not be misunderstood in such a way that the transaction would be classified by the remuneration rather than by the operation²³⁰⁹. As an interim conclusion for the further course of this study, it means only that the remuneration represents the mere starting point for resolving the directional issue of identifying the operation where both are non-cash values.

The more homogeneous and/or liquid asset represents the remuneration (receive leg)

- 444 Having set the formal remuneration as that starting point, the next step in the analysis is its concrete identification. To the author's understanding, the key to resolving this issue appears to be rooted again in the difference between negative assets in the broader or relative sense (negative for someone) and those in the narrow or absolute sense (negative for anyone)²³¹⁰. Although the term *income* pursuant to chap. III of the OECD MTC principally includes negative income as well²³¹¹, it nevertheless focuses primarily on positive income as the very purpose, intention and function of the OECD MTC of limiting the allocation of taxation rights to the source jurisdiction²³¹². In fact, negative assets in the narrow or absolute sense can themselves not represent *income*²³¹³. Simply put: the OECD MTC associates the term *income* with "something positive", while nevertheless being accessible to a "certain grey area" (i.e. negative income in the broader or relative sense)²³¹⁴, unless not obviously being "something negative" per se (i.e. negative income in the narrow or absolute sense). The natural reason is the collective character of the OECD MTC in the sense of a multinational or

²³⁰⁶ See par. 93.

²³⁰⁷ See par. 10.

²³⁰⁸ See par. 408 et seq.

²³⁰⁹ See par. 56.

²³¹⁰ See par. 412 et seq.

²³¹¹ See par. 139.

²³¹² See par. 19.

²³¹³ Argumentum e contrario.

²³¹⁴ See par. 414.

multi-jurisdictional compromise across multiple domestic tax laws. It reflects their homogeneous purpose of generating tax revenue²³¹⁵ on the one hand and their heterogeneous recognition and treatment of certain types of negative income on the other. As a consequence, *income* in the widest sense is not only the appreciation of potentially or subjectively positive assets but also the depreciation of absolutely or objectively negative assets. In that, *income* coessentially shares the same nature with cash, which is a positive asset by convention. This remains true even though the technical requirements to an economic currency function of merely being homogeneous and liquid²³¹⁶ could principally also be fulfilled by a negative asset²³¹⁷. In the context of financial instruments, any risk or obligation is obviously an absolutely or objectively negative assets, as it cannot be resolved but only transferred or re-allocated²³¹⁸. In contrast, negative *interest* is a relatively or subjectively negative asset and as such – although negative – closer to a cash equivalent. This is the systematic justification, why a transfer of any risk or obligation must always and necessarily represent the operation (pay leg). On the contrary, negative *interest* represents the remuneration (“receive” leg). These considerations regarding the example of non-cash based financial transactions swapping negative values again demonstrate the requisite precedent analysis in order to determine whether the legal entitlements represent parts of the operation or the remuneration²³¹⁹. As a general conclusion for non-cash based financial instruments, the remuneration (pay leg) is always represented by the non-cash asset that is closer to a cash equivalent (i.e. more homogeneous and/or liquid). Notably, such analysis may be much more difficult where only absolutely or objectively negative assets are exchanged, which may however be assumed as highly uncommon in practice²³²⁰.

5.7.3 Relevant risk types

- 445 As regards the second issue (2)²³²¹, spot transactions in kind can be assumed to bear no significant risks (e.g. stock swap). The reason is that the pay and receive legs must necessarily equal the same values and are typically also settled within a short period of time. Due to the natural nexus between risk and timing²³²², the dependency of the income classification on risk-related aspects rather takes effect on forward transactions or financial instruments with embedded forward components. In this respect, forward elements are meant here in the general economic sense of any future fixation of uncertain income determinators, and not in the specific legal sense of one transaction out of one opening and one closing event (pending transaction)²³²³. For such forward transactions in kind, any legal risk was found to be generally irrelevant for the classification²³²⁴. The elimination of legal risks should also be easy to identify and to apply, since risks in general can as such not possibly be transferred in kind but only through a legal medium (e.g. cash or stock). Timing risk and consequently also interest rate risk can be ignored for the following reasons:

²³¹⁵ See par. 18.

²³¹⁶ See Example 23 on p. 107.

²³¹⁷ See Example 60 on p. 258.

²³¹⁸ See par. 59.

²³¹⁹ See par. 181.

²³²⁰ See par. 442.

²³²¹ See par. 440(2).

²³²² See par. 69.

²³²³ See par. 370.

²³²⁴ See par. 231.

- Although the time value of money is a constituting element²³²⁵ of genuine *debt-claims*, it is an immanent part of all forward elements anyway²³²⁶.
- In regards to a potential remuneration, the extending modification in Art. 11(3) OECD MTC covers all attributes of *shares* pursuant to Art. 10(3) OECD MTC anyway²³²⁷. This particularly includes general time-inequivalence in its specific forms of both remuneration risk and business risk.
- Termination risk falsifies the time value of money²³²⁸ and therefore represents its natural complement²³²⁹.

As a consequence, there is no need for two differentiators with eventually the same logical meaning.

Lastly, currency risk is no differentiator either. In terms of termination risk, currency risk was found to be subsequent to the capital provision. In terms of remuneration risk, currency risk was found to coincide with the payment profile, sharing all attributes of *shares* due to the extending modification in Art. 11(3) OECD MTC²³³⁰.

5.7.4 Synergetic effects

- 446 As regards the third issue (3)²³³¹, the most typical use case of financial instruments exchanging non-cash assets which interact in such a way that their consolidated net result is not equal to the sum of their individual cash-equivalents (synergetic effects), is a swap. In fact, a swap is an exchange of partially hedged risks²³³². As risks can themselves not be transferred in kind but only through a medium (e.g. cash or stock)²³³³, such swaps are typically net-settled. Since the payment profile is a reflex response to risk²³³⁴, the issue leads back to the finding²³³⁵ that synergetic effects – considered analogously as one coherent whole – give rise to an independently classifiable risk-return profile. In that, the example of such swaps as financial instruments mutually shifting risks coalesces the systematic link between the findings made on the level of the payment profile (e.g. net-settlements²³³⁶) with those made on the level of the risk profile (e.g. interest replication or synthesis²³³⁷). Consequently, their risk consolidation (hedge), which is typically lower than the sum of the individual risk components, actually represents a “managed” or “engineered” net risk²³³⁸.
- 447 Where this net risk is lower than the timing risk, it should be permissible to conclude that the corresponding net remuneration does not compensate the time value of money²³³⁹. As a consequence, it cannot possibly constitute genuine *debt-claims* pursuant to Art. 11(3) OECD MTC but must rather give rise to *other income*

²³²⁵ See par. 296.

²³²⁶ See par. 367.

²³²⁷ See par. 295.

²³²⁸ See par. 242(2).

²³²⁹ See par. 208 et seqq. and 275.

²³³⁰ See par. 420.

²³³¹ See par. 440(3).

²³³² See Example 24 on p. 108.

²³³³ See par. 445.

²³³⁴ See par. 200.

²³³⁵ See par. 379.

²³³⁶ See par. 380.

²³³⁷ See par. 406 et seqq.

²³³⁸ See par. 101(2).

²³³⁹ See par. 215.

pursuant to Art. 21(1) OECD MTC. On the one hand, this finding is in line with finance theory²³⁴⁰, according to which such synergetic effects necessarily imply and require the respective risks to be diverse in their nature (risk diversification). This is why they cannot possibly comply with the *fixed-for-fixed condition*. On the other hand, swaps as forward transactions do not comply with the *fixed-for-variable condition* either. The reason is that the exchanged amounts are typically not ex-ante determinable and typically do not ex-post equal the same values²³⁴¹. Such swaps do therefore not fulfil the necessary minimum conditions (*conditio sine qua non*) for a nominal value and are thus to be subsumed under Art. 21(1) OECD MTC²³⁴². Conversely, where the net risk is higher than the timing risk, it should be permissible to conclude that the corresponding net remuneration compensates also underwriting risk. Depending on the requisite formal reference to a *share*²³⁴³ (equity leg²³⁴⁴) and on whether or not such remuneration is self-executive²³⁴⁵, it thus represents either *dividends* pursuant to Art. 10(3) OECD MTC or *interest* pursuant to Art. 11(3) OECD MTC. As a result, the analysis of asset swaps comes to the same interpretative and applicative implications via the risk level as well. As the systematic link between the payment profile and risk, it demonstrates that the previous analyses have led to consistent and resilient results.

5.7.5 The relevant level

- 448 As regards the last issue (4)²³⁴⁶, it is the distinctive nature of non-cash based financial instruments that their remuneration basically takes the specific peculiarities of the respective non-cash asset. In other words: financial transactions generally exchange monetary benefits²³⁴⁷ in the economic sense of the two-dimensional risk-return profile²³⁴⁸. But non-cash assets are nevertheless inhomogeneous in representing a multi-dimensional bundle of principally unlimited attributes (e.g. risks, payment profile, obligatory elements, etc.). On the contrary, cash is – apart from the currency – a homogeneous asset in representing a merely binary concept of “yes or no”. Insofar, non-cash based financial instruments are characterised by coalescing not only the features of their underlyings but also those of the respective non-cash asset as a cash equivalent in the sense of an “inhomogeneous currency”²³⁴⁹. Notably, this view is based on the legal form as the baseline of treaty interpretation and application²³⁵⁰. Consequently, once the domestic tax law treats the non-cash based financial instrument as separate from the non-cash asset instead of as one coherent whole²³⁵¹, the two must be kept separated also at the treaty level. In particular, they may not be fused with the argument that the non-cash based financial instrument was influenced by the non-cash asset. The reason is that the return or remuneration (i.e. the *income*), regardless of whether in cash or kind, represents just a small part of a financial instrument’s overall attributes relevant for its classification. In other words: given their separate treatment by the domestic tax law, the existence of the non-cash based financial instrument as such is in any case independent of the

²³⁴⁰ See Illustration 8 on p. 63.

²³⁴¹ See par 438.

²³⁴² See par. 298 et seq.

²³⁴³ See par. 103(3).

²³⁴⁴ See par. 380.

²³⁴⁵ See par. 422.

²³⁴⁶ See par. 440(4).

²³⁴⁷ See par. 180.

²³⁴⁸ See par. 89.

²³⁴⁹ See Example 46 on p. 181.

²³⁵⁰ See par. 72.

²³⁵¹ See par. 81.

existence of the non-cash asset as such. In contrast, the non-cash asset affects the non-cash based financial instrument only subsequently at the level of particular attributes. This important systematic distinction sets the ground particularly for those configurations in which the non-cash assets has influence on the non-cash based financial instrument's classification (e.g. risks, payment profile, etc.) and those, in which it does not (e.g. asset attribution²³⁵², transfer transactions²³⁵³, redemption obligation²³⁵⁴, etc.).

449 Applied to the abstract findings in the previous sections on cash-based financial instruments, this view supports the following implications:

- (1) The non-cash based financial instrument continues to exist irrespective of whether the non-cash asset itself ceases to exist.

Example 61: Where the *share* goes into default (e.g. the *company's* bankruptcy), the convertible might (quantitatively) have a zero value but nevertheless (qualitatively) continues to exist. Where an underlying *debt-claim* ceases to exist by fusing debtor and creditor, the structured product on this *debt-claim* nevertheless continues to exist. Where the receive leg of a stock swap (*share A*) ceases to exist by being merged into another *share* (B), the pay leg nevertheless represents an *alienation* (*share C*).

- (2) Corresponding to how the non-cash based financial instrument comes into existence independent of the non-cash asset²³⁵⁵, the latter, conversely, also comes into existence independent of the former. In particular, the non-cash asset is neither (re-)attributed nor transferred by the non-cash based financial instrument's opening but – if at all – only by its settlement.

Example 61 (continued): The *share* is (re-)attributed and transferred only by redeeming the convertible. The *debt-claim* is (re-)attributed and transferred only by redeeming the structured product on this *debt-claim*. The underlying is (re)attributed and transferred only by gross-physically settling the forward transaction²³⁵⁶.

- (3) The question of whether the non-cash based financial instrument constitutes or repeals *beneficial ownership* in the non-cash asset (i.e. its asset-related aspect), is basically not of major importance for this study²³⁵⁷. True, there are some non-cash based transactions which constitute *beneficial ownership* in the non-cash asset and simultaneously give rise to the constitution of *beneficial ownership* also in the *income* from that non-cash asset²³⁵⁸. Notably, this is, however, not a result *due to* but rather *despite* the non-cash character of that asset. As a consequence, any reverse deduction from this circumstance to *beneficial ownership* – particularly that in the *income* – was a false conclusion²³⁵⁹. Nevertheless, the same question

²³⁵² See par. 315.

²³⁵³ See par. 317 et seqq.

²³⁵⁴ See par. 384.

²³⁵⁵ See par. 449(1).

²³⁵⁶ See par. 374.

²³⁵⁷ See par. 116.

²³⁵⁸ As will be elaborated in the following (see par. 450).

²³⁵⁹ Cum hoc ergo propter hoc. See also par. 129.

also arises when it comes to a remuneration in kind. However, within the concept of *beneficial ownership*, such remuneration in kind actually represents the inflow (i.e. the *income*), whose general principles and requirements (e.g. realisation) were found to be left untouched. The reason was that it merely replaces one subject (i.e. the *recipient*) by another (i.e. the *beneficial owner*)²³⁶⁰. Hence, corresponding to how non-cash based financial instruments come into existence²³⁶¹ and cease to exist²³⁶² independently of the non-cash asset, the latter is – also when receipted as a remuneration in kind – not realised by the non-cash based financial instrument's opening. Instead, it is realised only when actually being transferred at the disposal of the *recipient* or *beneficial owner* in the manner required by contract or by custom²³⁶³.

Example 62: New *shares* distributed by way of a stock *dividend* (A) from original *shares* (B) are realised as *dividend* pursuant to Art. 10(3) OECD MTC and thus acquired pursuant to Art. 13(5) OECD MTC only by actually being transferred at the payment date. Consequently, those new *shares* (A) cannot possibly be subject of any prior *beneficial ownership*, particularly not through the original *shares* (B).

- (4) In contrast, the non-cash asset indeed impacts the non-cash based financial instrument's attributional aspects, particularly its risk profile.

Example 61 (continued): The *share's* risk profile makes the convertible typically a risk-based asset itself and thus a *share* pursuant to Art. 10(3) OECD MTC²³⁶⁴. Typically, the *debt-claim's* risk profile keeps the structured product a time-based asset and thus a *debt-claim* itself. The reason is that any qualitative disaggregation process of risk identification, risk disaggregation and risk elimination could reveal nothing else than that the *debt-claim's* risks are literally identical to those of the structured product itself²³⁶⁵.

Example 62 (continued): The new *shares* (A) represent *income* from the original *shares* (B). The risk profile of the new *shares* (A) makes that *dividend* risk-based pursuant to Art. 10(3) OECD MTC and consequently also the original *shares* (B) themselves.

- (5) Lastly, with respect to a net share settlement, the non-cash asset may have influence on the non-cash based financial instrument's classification. It often simplifies the identification of whether or not the non-cash based financial instrument provides the requisite formal reference to a *share*²³⁶⁶ (equity leg) in order to constitute *dividends* pursuant to Art. 10(3) OECD MTC²³⁶⁷.

²³⁶⁰ See par. 132.

²³⁶¹ See par. 449(1).

²³⁶² See par. 449(2).

²³⁶³ See par. 148.

²³⁶⁴ See Illustration 25 on p. 234.

²³⁶⁵ See par. 402 et seqq.

²³⁶⁶ See par. 103(3).

²³⁶⁷ See par. 447.

Example 63: *Shares* received from the net share settlement of a total return swap obviously represent the receiver's equity leg²³⁶⁸. Unlike a corresponding total return swaption, this equity leg is also self-executive. Therefore it represents a negatively modified risk-based remuneration that is *ceteris paribus* to be subsumed under Art. 10(3) OECD MTC²³⁶⁹.

5.7.6 Securities lending transactions

450 The last topic that should be discussed here in the form of a short side note, are securities lending transactions (also referred to as “share loan agreements”)²³⁷⁰. On the one hand, such non-cash obligations were found to be basically covered by Art. 11(3) OECD MTC²³⁷¹. The reason was that their genuine remuneration (i.e. the lending fee) was *ceteris paribus* considered as genuine *interest*²³⁷², even more as they typically fulfil the *fixed-for-fixed condition*²³⁷³. On the other hand, the further question arises how to classify their additional compensation payments, i.e. the passed-through *income* from the borrowed asset. In contrast to the majority view²³⁷⁴ it is the author's understanding that such payments basically share the non-cash asset's fate by actually representing *beneficial ownership*. The one-to-one transfer of such cash flows obviously complies with all its requirements of a causal relation between the in- and outflows²³⁷⁵, quantitatively observable by expected negative correlation depending on the same risk. These in- and outflows proportionate also in approximately equal amounts or benefits²³⁷⁶ and are typically not dominated by credit risk in the sense of a time gap between them²³⁷⁷. This is a result of the finding that the concept of *beneficial ownership* replaces one subject (i.e. the *recipient*) by another (i.e. the *beneficial owner*) instead of (re-)classifying one object (e.g. the genuine *dividend* from the borrowed *share*) into another (e.g. an *interest* from the securities lending transaction)²³⁷⁸. In particular, mixing the classification of the genuine remuneration (i.e. the lending fee) from the securities lending transaction as an *interest* with the independent classification of the additional compensation payment (i.e. the passed-through *income* from the borrowed asset) was found to be methodologically flawed²³⁷⁹. In other words: securities lending transactions turn out to be the ideal-typical example, demonstrating the specific capability of financial instruments to represent both transactions giving rise to genuine *income* and simultaneously also *beneficial ownership* giving rise to derivative *income* from another asset.

²³⁶⁸ See par. 380.

²³⁶⁹ See par. 422.

²³⁷⁰ For an overview see *Castelijin, Bas / van der Veen, Ivo*, Securities Lending: A Market Perspective on the Changing Securities Lending Landscape, Derivatives & Financial Instruments 2015, Vol. 17, No. 2, IBFD, Amsterdam, 2015; *Juan Ramirez*, p. 26 et seqq.

²³⁷¹ See par. 300 et seq.

²³⁷² Contrary: *Alexander Bosman*, p. 336; *Katja Dyppel Weber*, sec. 4.3.

²³⁷³ See par. 299.

²³⁷⁴ *Alexander Bosman*, p. 272; *Katja Dyppel Weber*, sec. 4.2.; both mixing the asset-related and transaction-related aspects of *beneficial ownership*; Finnish Korkein Hallinto-oikeus, judgement ref. KHO:2002:71, 2002.

²³⁷⁵ See par. 137.

²³⁷⁶ See par. 135.

²³⁷⁷ See par. 138.

²³⁷⁸ See par. 132.

²³⁷⁹ See par. 449(3).

Chapter 6

General discussion

- 451 In contrast to the above summary of conclusions in section 4, the purpose and objective of this final section is to give a brief outline of the key finding from each topic, embedding them into the high-level storyline of this study. It forms a contentual framework by taking up the introductory remarks in section 1 and sets the aspirations and conclusions of this study into the higher evaluative context of a perspective outlook.
- 452 Like most other commercial activities, financial instruments and transactions transfer economic attributes by using legal contracts. It is, however, their peculiar capability to extract these economic attributes from basically all kinds of real assets, transform these into freely substitutable cash-equivalents and transfer them under considerably low frictions. This economic purity enjoys a multi-faceted universality independent of the normal physical constraints (i.e. *ratione temporis*, *ratione loci* and *ratione materiae*). It causes an exceptional detachment from their legal grounds, giving rise to the motivation for this study and the problems discussed therein²³⁸⁰. At the same time, it is also the primary reason why the treatment of financial instruments and transactions under the OECD MTC calls for putting a comparably strong emphasis on the systematic element of interpretation²³⁸¹. To a certain extent, this systematic element of interpretation necessarily includes the abstract-theoretical grounds and mechanisms of financial instruments as well as their basic principles in terms of economic and financial theory. This is in order to understand their inherent rationales and structural links to the corresponding legal concepts within the OECD MTC. The interaction within and between these conceptual economic and legal levels turned out to be a strongly interdependent matter. It therefore had to be disentangled as the methodological starting point in this study.
- 453 The basic principles²³⁸² encompass first of all the conceptual perspectives and their mutual interactions of the asset as explicitly mentioned in Art. 10(3), 11(3) and 13(5) OECD MTC and the transaction. As a dynamic reference, the transaction is closer to the nature and object of an income tax and therefore has been identified as the relevant basis of the further analysis²³⁸³. In the following, the key concept of risk was introduced and

²³⁸⁰ See sec. 1.1.1.

²³⁸¹ See sec. 1.3.

²³⁸² See sec. 2.2.

²³⁸³ See sec. 2.2.2.

structured in all its relevant forms²³⁸⁴, notably applied only within and not beyond the scope of that legal transaction. Risk can be understood in a material and formal sense and it allows reverse deduction to the material nature of the underlying economic operation. These considerations led to the principal discussion of potential measures and/or guidelines indicating the general applicability and scope of the *substance over form* principle in all its relevant aspects²³⁸⁵. The analysis concluded with the discussion of potential measures and/or guidelines indicating if and to what extent financial instruments and transactions are to be aggregated or disaggregated²³⁸⁶. Combining and condensing all the previous outcomes into this question, the examination came to the major conclusion that there are good reasons to restrict aggregation and to permit disaggregation, even if only selectively and on a rule base.

- 454 This first step of the basic principles represents the first building block for the elaboration of differentiators in order to develop a tie-breaking test as the primary objective of this study²³⁸⁷. The examination has illustrated the implicitness of fundamental concepts, which can be interpreted only indirectly from inherent interdependencies within the OECD MTC. In this respect, it has shown on the one hand that the normative research area of tax policy making is able to contribute valuable insights into those conceptual interrelationships. On the other hand, it also demonstrated that other collective legal frameworks may well be unbinding, but are still compatible in so far as they deal with similar economic situations and may perhaps have reached a more advanced evolutionary stage (e.g. US federal tax law²³⁸⁸, IAS/IFRS²³⁸⁹). In that, they are able to give inspiration to structure those interlinkages, notably where their subjacent structural rationales are appropriately comparable and transferable to those of the OECD MTC²³⁹⁰. As the key insight from this section, this transfer demonstrates that the OECD MTC – like other comparable legal frameworks are already – might perhaps be more open for inter-disciplinary concepts (e.g. economic theories, behavioural science, policy making, mathematic modelling, etc.). Accumulating more and more diverse information might promise to make it even more universal and compatible, more flexible and resilient and thus eventually more durable and competitive with other international legal frameworks.
- 455 Having set this baseline of conceptual mechanisms, the study went on by shedding light on the systematic legal context of, and the relations between, those relevant distributive articles²³⁹¹ by carefully embedding the argumentation into the previous findings. The analysis held their completeness and comprehensiveness in generally covering all income as well as their mutual exclusivity in being generally not overlapped.²³⁹² It continued by putting the focus particularly on the concept of *beneficial ownership*²³⁹³ and the realisation principle²³⁹⁴. *Beneficial ownership* was found not to affect the genuine legal concepts of *dividends* and *interest*, but its (re-)attributional aspect was concluded to subsist not only in Art. 10(2) and 11(2) OECD MTC but

²³⁸⁴ See sec. 2.2.3.

²³⁸⁵ See sec. 2.2.4.

²³⁸⁶ See sec. 2.2.5.

²³⁸⁷ See sec. 1.1.2.

²³⁸⁸ See sec. 1.4.4.

²³⁸⁹ See sec. 1.4.6.

²³⁹⁰ See sec. 1.4.

²³⁹¹ See sec. 2.3.

²³⁹² See sec. 2.3.2.

²³⁹³ See sec. 2.3.3.

²³⁹⁴ See sec. 2.3.4.

also in Art. 13(5) and 21(1) OECD MTC. While independent of the income classification, the concept was found to be of major importance for applying the OECD MTC accurately to a number of ambiguous and controversial financial instruments and transactions. The realisation principle was found to have an autonomous core element, which particularly allows and requires to delimit *income* pursuant to chap. III from *capital* pursuant to chap. IV of the OECD MTC.

- 456 This second step of the systematic context of the distributive articles represents the second building block for the elaboration of differentiators in order to develop a tie-breaking test as the primary objective of this study²³⁹⁵. The topic has illustrated the interpretational relevance of the legal interdependencies within the OECD MTC for the subject of this study. It has also demonstrated that considering the various relevant aspects between the pure and isolated concepts of *dividends*, *interest*, *capital gains* and *other income* mitigates the risks of constricting the individual attributes towards meaninglessness and/or distorting their classification into inconsistency²³⁹⁶. As the main outcome, the section has illustrated the conceptual limitations of the OECD MTC to deal with “organic topics” such as financial instruments, which can hardly be described by individually picking out certain isolated aspects. Complementing the OECD MTC with additional legal techniques and applicative methodologies such as, for instance, tests or the rigorous separation of genuine and derivative concepts might reduce ambiguities and increase its clarity and usability.
- 457 Having thus prepared the building blocks, the study continued with combining and condensing all those outcomes into an analysis and discussion of potential differentiators.²³⁹⁷ The formal aspect of legal rights and obligations was found to play a particularly important role for the distinction between *dividends* and *interest* on the one hand and of capital *gains* on the other.²³⁹⁸ In contrast, time turned out to be a hybrid and multi-character auxiliary concept that coalesces interconvertible temporal and risk-related aspects in itself, whereby the former takes precedence and may be understood substantially to a certain extent.²³⁹⁹ The payment profile of financial instruments was proved to likewise have an autonomous core element.²⁴⁰⁰ Although conceptually and legally limited, it was nevertheless found to be of superior relevance for the distinction between *dividends* and *interest*. In terms of risks and obligations, the concept of risk was separated and classified into a matrix of termination risk versus remuneration risk on the one hand and business risk versus other risks on the other.²⁴⁰¹ The concept of risk was likewise found to be of major importance for the distinction between *dividends* and *interest*. Coverage was distinguished from collateral and found to qualitatively and quantitatively indicate risk. In contrast, subordination and the origin of funds have both been discarded as differentiators.²⁴⁰²
- 458 The discussion has illustrated the strong systematic interdependencies within and between the economic and the legal layer. It has proven that the “funnel approach” of making a methodological compromise by

²³⁹⁵ See sec. 1.1.2.

²³⁹⁶ See sec. 1.2.

²³⁹⁷ See sec. 2.4.

²³⁹⁸ See sec. 2.4.2.

²³⁹⁹ See sec. 2.4.3.

²⁴⁰⁰ See sec. 2.4.4.

²⁴⁰¹ See sec. 2.4.5.

²⁴⁰² See sec. 2.4.6.

combining a holistic or synthetic with the reductive or analytical view as imperative and expedient.²⁴⁰³ The analysis made also clear that appropriate differentiators on the level of the OECD MTC as a collective tax law system cannot purposively be found among the infinite and incompatible formal features of domestic tax laws. Instead, the section reduced or compressed them to their substantial “key messages” in order to then transform these into truly autonomous test criteria²⁴⁰⁴. In addition, the aspect of such strong interweavement resulted in a segregation of main and auxiliary attributes, and the approach of such substantive compression grouped them into entire attribute classes, which made it possible to reduce the potential differentiators to a fairly modest number. The main outcome of this section was thus not only to introduce, analyse and distinguish some inherent concepts in what is discussed in the jurisprudential research and discourse as potential differentiators between debt and equity. Beyond that, these concepts were also operationalised into concrete tie-breaking tests. As the key objective of this study, they were also re-evaluated against each other and reduced to a compact set of clear and meaningful classifiers which are coherent, consistent, universal, complete, mutually exclusive, justifiable, autonomous, objective, resilient and operationalizable.

- 459 As the next methodological step, the study proceeded to test these concrete but still potential differentiators interpretatively against the legal texts within the relevant distributive articles of Art. 10(3), 11(3), 13(5) and 21(1) OECD MTC.²⁴⁰⁵ The analysis of Art. 10(3) OECD MTC produced a way of interpretation that does not only allow us to isolate its relevant parts entirely from any domestic influence and to seamlessly deduce the key differentiators of payment profile and business risk from the provision²⁴⁰⁶. The interpretation found is also capable of separating the concept of *dividends* distinctly from the concept of *interest*.²⁴⁰⁷ In this respect, the examination further verified the crucial importance of business risk in the form of termination risk as a falsifier for the time value of money and the relevance of the self-execution test. The concept of capital *gains* was found to coalesce multiple closely related aspects in itself.²⁴⁰⁸ It depends to a large extent on the formalities of the domestic laws, in that the *substance over form* principle comes into effect only in the context of realisation and *income* attribution. While *other income* was held as being a residuary schedule, gambles were proven not to be relevant for this study.²⁴⁰⁹
- 460 This step of analysing and discussing the relevant distributive articles built in large parts on all the previous outcomes. It took up those structural findings and embedded them conclusively into a technical interpretation of the concrete legal texts. It has proven that most of the priorly acquired potential differentiators are reflected by the respective sources of law in a recognisable and justifiable manner. The examination further demonstrated that the condensation to a compact set of clear and meaningful attributes makes these stronger and thus provides a higher degree of consistency and resilience. Not least, the analysis also integrated a wide range of dissenting opinions into the discourse. It set them into the context of the insights gained in this study and thus contributed to the clarification of current disputes. As an important result, the section has illustrated that the respective phrases in the OECD MTC might offer opportunities for improvements in order to adapt

²⁴⁰³ See sec. 1.3.

²⁴⁰⁴ See sec. 1.1.2.

²⁴⁰⁵ See sec. 3.

²⁴⁰⁶ See sec. 3.2.

²⁴⁰⁷ See sec. 3.3.

²⁴⁰⁸ See sec. 3.4.

²⁴⁰⁹ See sec. 3.5.

to the challenges of modern financial instruments. While their wording may have been re-considered in all major updates of the OECD MTC and the treatment of financial instruments is actually a hot topic in the current OECD initiatives, these phrases nevertheless remain almost unchanged since they were introduced.

- 461 Closing the theoretical parts at this point, the study then proceeded with practically applying all the abstract findings to a selection of concrete financial instruments and transactions.²⁴¹⁰ The classification of forward transactions and swaps revolves around the interplay between the level of the underlying versus that of the forward transaction itself. It was found to be predominantly dependent on how the forward transaction is terminated and apart from that on highly technical details.²⁴¹¹ Building on these conclusions, the income from debt-into-equity convertibles was shown to have been classified as *dividends* pursuant to Art. 10(3) OECD MTC in most configurations.²⁴¹² Other debt-based financial instruments, such as particularly so-called *linkers*, were systematically deduced from non-packaged net-settled convertibles. As such, they share their fate²⁴¹³, whereas negative interest was argued to be classifiable as genuine *interest* pursuant to Art. 11(3) OECD MTC. Other equity-based financial instruments, such as particularly so-called preference shares, appear to be the conceptual opposite of linkers. Nevertheless, they were also classified as *dividends* pursuant to Art. 10(3) OECD MTC in most configurations.²⁴¹⁴ Strips were proved to represent genuine *income* from their capital or principal, sharing likewise their fates as being subsumable under Art. 10(3) or 11(3) OECD MTC respectively.²⁴¹⁵ Finally, the cross-sectional topic of non-cash based financial instruments has revealed specific systematic insights such as regarding the identification of operation versus *income*, aspects of risk, synergetic effects or the relevant classification level.²⁴¹⁶ These conclusions may be transferrable to a number of various configurations or classes of transactions featured with non-cash elements.
- 462 Facing the historic origins and context of the OECD MTC and considering the consequent interpretation difficulties²⁴¹⁷, this section has demonstrated that the tie-breaking test developed as the primary objective of this study²⁴¹⁸ is actually practicable. While their relation to each other might be subject of the legitimate discussions, the test meets the required logical, legal and technical criteria to the maximum possible extent. In particular, it is capable of solving the conceptually most ambiguous and controversial use cases discussed to date in research and practice. The fairly few remaining inconsistencies and distortions have to be accepted as a “sacrifice” to the rule of law and the legality principle as the admissible limit of legal interpretation.
- 463 Accordingly, these remaining inconsistencies and distortions can be overcome only by undertaking a reform of the OECD MTC. On the one hand, such reform would perhaps have to take only quite selective and focussed measures. On the other hand, these measures would certainly have to touch some of the most fundamental principles of the OECD MTC with a correspondingly high risk of side effects. Considering its purpose,

²⁴¹⁰ See sec. 5.

²⁴¹¹ See sec. 5.2.

²⁴¹² See sec. 5.3.

²⁴¹³ See sec. 5.4.

²⁴¹⁴ See sec. 5.5.

²⁴¹⁵ See sec. 5.6.

²⁴¹⁶ See sec. 5.7.

²⁴¹⁷ See sec. 1.1.3.

²⁴¹⁸ See sec. 1.1.2.

intention and function of being a compromise of making a large number of diverse tax law systems compatible with each other, such fundamental reform appears as a fairly long and drawn out process. As a consequence, it remains to be seen how the inevitable drift and tensions between the diverse domestic tax law systems, which operate on different levels and at different paces of development, will affect the OECD MTC. This will be even more interesting against the background of the acute situation nowadays and the corresponding momentum in the international developments concerning the taxation of financial instruments.

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Valorisation Addendum

1 Relevance

For the scientific and practical relevance of this doctoral thesis reference is made to section 1.1.3.

2 Target groups

This dissertation contains an abstract theoretical part with fundamentals in section 2, an abstract methodological part with interpretations in section 3 and a practical application part with subsumptions in section 5. With these main contents, this thesis is aimed to reach the broadest possible audience of interested readers.

The abstract theoretical part with fundamentals addresses primarily law-making and related function holders such as tax policy makers, politicians in the field of regulatory governance or interdisciplinary scholars, as well as jurisprudence and other interested conceptualists. These could include, for instance, national ministries, other public authorities and expert committees in the field of tax affairs, supra-national organizations, think tanks and sectoral working groups, (law) faculties of universities, courts or conceptual specialists in such institutions.

The abstract methodological part with interpretations addresses primarily legal practitioners entrusted with the interpretation of the law, but also jurisprudence. In addition to the previously mentioned target groups, this could include, for instance, lawyers and professional chambers, sectoral and economic interest groups as well as other interested legal experts, for example from other disciplines parallel to tax law.

The practical application part addresses primarily legal practitioners entrusted with solving concrete cases, such as generalists, specialised media and educational institutions. In addition to the previously mentioned target groups, this could include, for instance, tax consultants and tax officers of companies, philanthropy and administrative authorities, specialised publishers as well as specialised educational programmes in universities and colleges.

3 Activities/Products

This study intends to have a descriptive purpose in the sense that it attempts to respect and interpret the OECD MTC as it actually is (*de lege lata*). In particular it does not intend to have a normative purpose in the sense that it indicates any evaluative suggestion beyond the OECD MTC as it actually is (*de lege ferenda*). In the background of this general intention, the following concrete activities/products emerge as outcomes of this dissertation for the potential audiences mentioned before:

Referring to the law-making audience, one aim of this thesis is to point to the conceptual limits, ruptures and weaknesses of the OECD MTC related to financial instruments and to critically challenge its capabilities and expedience. On the other hand, it should also be demonstrated which far-reaching possibilities an interdisciplinary and structural interpretation methodology offers in acceptance of these (possibly necessary or unavoidable) limits and weaknesses. In that regard, this dissertation is also intended to encourage acknowledging the findings of other areas of scientific research and to exploit these for the jurisprudence in an unconventional and value-adding way.

Referring to the law-interpreting audience, a further objective of this thesis is to develop a concrete tie-breaking test in order to distinguish *shares* yielding *dividends* pursuant to Art. 10(3) OECD MTC, *debt-claims* yielding *interest* pursuant to Art. 11(3) OECD MTC, capital *gains* pursuant to Art. 13(5) OECD MTC and *other income* pursuant to Art. 21(1) OECD MTC. This test shall be capable of solving the conceptually most ambiguous and controversial use cases discussed to date in research and practice; in doing so the main focus is on the systematic element of interpretation. For the target properties or characteristics of such a test reference is made to section 1.1.2.

Referring to the law-practicing audience, another goal of this thesis is to apply a concrete catalogue of those conceptually most ambiguous and controversial use cases based on that test. On the one hand, this should validate and demonstrate the capability and expedience of the self-developed test. On the other hand it should contribute a consistent own opinion on the tax treatment of the relevant financial instruments for the expert discussion.

4 Innovation

From the author's point of view, this dissertation draws its innovative character from several methodological approaches and techniques:

As a subject of tax law and thus of the OECD MTC, this study goes comparatively deep into the economic structure and dependencies of financial instruments (e.g. finance theory). This results, on the one hand, from the intentional and, secondly, the systematic element of interpretation of the OECD MTC, which aim both to address these relationships appropriately.

At this level of those relatively fundamental economic structure and dependencies, this thesis also draws analogies from other legal-like systems with similar problems (e.g. IAS / IFRS) by transferring their more advanced approaches and techniques to the OECD MTC. In addition, this paper also makes legal comparisons with some more advanced approaches and techniques of other tax laws (e.g. US federal tax law), which have already adopted the findings of those other research areas mentioned above and use them to solve the conceptual problems dealt with herein.

A reverse approach from the perspective of European interpretation methodology also results from the “funnel approach” taken in this study: it starts with the general and fundamental principles, which are embedded in the systematic legal setting afterwards. The results are condensed or broken down to potential differentiators and only then are they interpretatively tested against the concrete legal texts.

Finally, this study also represents an attempt to conceptually and terminologically unlink the autonomously interpreted concepts and norms of the OECD MTC as well as components of them from the patterns of local tax laws to the maximum possible extent. Through this generic approach, the above-mentioned test and the differentiating criteria flowing into it should attain a particularly high degree of universality and objectivity.

For further aspects of the approach taken here reference is made to section 1.3.

5 Implementation

The aforementioned activities/products for the respective audiences could be implemented by the following examples:

Referring to the law-making readers, the conceptual limits and weaknesses of the OECD MTC identified in this thesis could be the subject of subsequent scientific studies. As part of a fundamental consideration of dogmatic and pragmatic arguments, these studies would at first have to clarify the normative question to what extent the possibilities for tax avoidance and tax structuring of financial instruments resulting from those weaknesses are acceptable. To the extent any need for change is identified, they could further derive technical and/or fundamental suggestions from this thesis for improving the capabilities and expedience of the OECD MTC.

Irrespective of these normative possibilities for further development, the structural inter-dependencies and criteria identified in this dissertation could be analogously applied to similar use cases. In particular, transactions cited herein are those such as insurance, letting and leasing, royalties and annuities, betting and gambling or those embedded in MTC taxonomy (e.g. business or employment). Such a transfer could potentially address also a variety of further research issues, as there are, for instance, the systematic relationship of Art. 10, 11, and 13 OECD MTC with those of other distributive articles (e.g. Art. 12 OECD MTC). Perhaps, such an analysis would ultimately lead to the fundamental question to what extent the OECD MTC that is tied in physical patterns is even capable to actually deal with economic substance. In other words: in which relation the material object (axiom) and the formal evidence (pragmatics) necessary for its recognition stand.

Also for the law-interpreting audience the tie-breaking test developed in this study could be further developed for both normative and descriptive purposes. Normative in a way that the structural interdependencies flowing into that test could be used for the design of revised income articles by developing the test back into a suggested wording. Descriptive in the sense that the identified differentiators could be amplified into a practice guide on the classification and treatment of financial instruments pursuant to international tax law. Irrespective of this, the test and possibly also those differentiators could eventually be used as guidelines for

potential compatibility or harmonisation efforts where appropriate (e.g. between different domestic tax laws or with other disciplines such as accounting law).

For the law-practicing audience, the tie-breaking test and the differentiators can at first be used for tax structuring (in particular the development of innovative financial instruments), as long as the legislators continue to leave the fundamental problem of the legal discrepancy between the economic substance and its physical medium unsolved. In addition, the tie-breaking test developed in this thesis could be used as a guideline for a comparative study of the treatment of financial instruments under various domestic tax laws (e.g. in the form of a practitioner handbook).

Curriculum Vitae



Jan Weissbrodt, born in Berlin (Germany) on 15 February 1979, graduated with an economic degree in Business Administration and Management at the University of Mannheim (Germany) with the specialisations in Corporate Tax, Accounting, Audit & Valuation as well as Banking & Finance.

While he was working as a tax advisor and assistant auditor for a tax, audit and advisory boutique in Frankfurt am Main (Germany), he was approved and admitted to the Chamber of Certified German Tax Consultants.

After having changed to Credit Suisse in Zurich (Switzerland) as an in-house tax specialist, he obtained his Masters degree (LL.M.) in International Tax Law at the University of Zurich (Switzerland).

During his work as a Senior Tax Manager for KPMG in Zurich (Switzerland), he started his dissertation in International Tax Law at the University of Maastricht (Netherlands). Today he holds a position as Global Head of Tax of the Sportradar Group in St. Gallen (Switzerland).

Jan Weissbrodt has published articles in renowned German and Swiss tax journals and held educational lectures in academic and professional programs.