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Application of the United Nations Model to payments received under certain financial instruments*

Summary

The paper examines a number of examples in which a taxpayer uses financial instruments in light of relevant provisions of the UN Model Double Taxation Convention. It suggests that payments made under such instruments should be treated either as "business profits" or "other income", with the treatment in any particular case depending on the motivations of the taxpayer in entering into the transaction.

* The present paper was prepared by Ms. Patricia Brown. The views and opinions expressed are those of the author and do not necessarily represent those of the United Nations.

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I. Introduction

1. In recent years, there have arisen questions about the appropriate treatment, for treaty purposes, of certain payments made pursuant to a variety of new financial instruments. Because it is likely that these instruments will become even more widely available and used by more companies, the number of disputes in this area is likely to increase. Therefore, it seems useful at this point to determine whether it is possible to develop a common approach to the characterization of such payments.

2. Part II of this paper provides some examples of the common characteristics and uses of such products. Part III analyzes the examples in light of the relevant provisions of the UN Model Tax Convention.

II. Description of common products

3. The issues that have arisen recently have tended to arise with respect to interest rate swaps, but could arise with respect to any type of "derivatives" contract. The name "derivatives" is based on the fact that the market value of the contract is derived from a reference rate, index, or the value of an underlying asset. Because of this relationship between the value of the derivative and the value of the "underlying" (ie, the relevant rate, index or asset), derivatives are an effective way to hedge against changes in the value of the underlying property.

4. There are four basic types of derivative transactions: forwards, futures, options and swaps. Forwards and futures obligate the holder to buy or sell a specific amount or value of the underlying at a specified price on a specified future date. Futures are generally standardized contracts traded on organized exchanges, while forwards are customized transactions entered into on over-the-counter markets. An option grants the holder the right, but not the obligation, to buy ("call") or sell ("put") a specific amount of the underlying at a particular price within a specific period (or on specific dates). A swap is an over-the-counter contract pursuant to which the counterparties agree to make periodic payments to each other for a specified period. Swaps are the newest and most subtle form of derivative.

5. Examples (in each case, assume that the counterparty to the transaction is in a different jurisdiction):

> 1) Forward contract – The income of farmers has traditionally been very erratic, based not only on the farmer's own production, but on a number of external factors, such as the weather in other countries that produce similar crops. Accordingly, the U.S. Department of Agriculture has, for a number of years, encouraged farmers to buy futures contracts as a hedge against decreases in prices. In other words, a farmer will enter into a contract to sell x bushels of wheat at a set price (y). The contract may be "cash-settled", meaning that the farmer does not actually deliver the wheat to the counterparty to the contract (in this case, the exchange). Instead, the farmer will receive the difference between the market value of the x bushels and the current market price. For example, assume that y = $40. On the closing date of the contract, the current market price for a bushel of wheat is $32. Under the cash-settled contract, the farmer will receive x (the number of bushels)

multiplied by $8 (the difference between the contract price and the current market rate). Assuming that the farmer actually sells his wheat on that date to a dealer for $32, then the farmer will be in exactly the same position (less transaction fees) as he would have been if the market price had been $40. That is, he receives $32x from selling the wheat, and $8x from the forward contract, for a total of $40x.

2) Forward contract - Assume the same facts as in #2, except that the market price for wheat on the closing date is $42. In that case, the farmer will have to pay $2 multiplied by x to the counterparty. However, assuming that the farmer sells his wheat for $42 per bushel, he will still be in the same position as he would have been in if he had sold the wheat for $40. That is, he receives $42x on the sale, and pays the counterparty on the forward contract $2x, leaving him with $40x.

3) Interest rate swap – A U.S. company is engaged in the business of making home loans, which generally carry a fixed interest rate. It would like to issue debt to increase its ability to make more loans, and it would like that borrowing to carry a fixed interest rate to provide a natural hedge of its assets. It borrows $100 million from a private investor, at a floating rate of LIBOR plus 1/2%, payable quarterly, for 10 years. It then enters into a 10-year interest rate swap with its investment bank, pursuant to which it will make "periodic payments" of 6% quarterly with respect to a "notional principal amount" of $100 million to the investment bank, and the investment bank will pay LIBOR plus 1/2% on that same "notional principal amount". Note that, in this case, the notional principal amount does not change hands. In fact, just as in the example regarding cash-settled futures above, only the net amount will be paid (which is why, in many countries, derivatives are known as "contracts for differences"). Thus, if LIBOR drops to 4 1/2%, then the U.S. company will pay the investment bank 1% multiplied by $100 million (divided by four since the payments are made quarterly). By entering into these contracts, the U.S. company has effectively changed its floating-rate obligation into a fixed-rate obligation.

4) Currency swap – An Indian company wants to borrow 2 billion rupees to expand its business. The company's investment banker informs the company that its cheapest source of funds is in the Euro-dollar market. The Indian company issues a Eurobond in the amount of $42 million with a 10-year term, paying interest at a rate of 7%. It then enters into a currency swap with its investment bank pursuant to which it will pay the investment bank $42 million upon issuance of the Eurobond and will receive from the investment bank 2 billion rupees. During the ten-year term of the arrangements, the Indian company will make periodic payments, in rupees, of a fixed rate appropriate to the rupee market, and it will receive from the investment bank periodic payments in U.S. dollars. At the end of the 10-year term, the investment bank will pay the Indian company $42 million (to allow it to pay off the Eurobond) and the Indian company will pay the investment bank 2 billion rupees. Thus, by entering into these transactions, the Indian company will have eliminated its dollar risk.

5) Equity swap – An investor in Malaysia, a country that does not have a tax treaty with the United States, would like to invest in stock of a U.S. company. However, he does not wish to pay the 30% withholding tax that would be imposed on dividends received from that company. Accordingly, his investment banker suggests that he enter into a single-stock equity swap. Under that agreement, the notional principal amount will be the proposed amount of the stock investment. The Malaysian investor will receive from the investment bank the amount of any dividends paid by the U.S. company over the 10-year life of the swap and the investor will pay a fixed or floating rate of interest. At the end of the 10 years, the Malaysian investor will receive from the investment bank any increase in the value of the underlying shares, and will pay to the investment bank any decrease in the value of the shares. As a result, the Malaysian investor will be in the same position as if he had borrowed money in order to purchase the shares, and then sold the shares at the end of the 10-year period.

III. Analysis of transactions

6. In Transactions #1 and 2, the farmer has sold his wheat for a market price, and has a gain or a loss on his hedging transactions to bring him to a price per barrel of wheat of $40. In both of these cases, it appears that sales of wheat would generate business profits. The hedging transactions also should be treated as generating business profits. Accordingly, the country in which the counterparty is located should not tax the gain on the forward contract (except in the unlikely circumstance that the farmer has a permanent establishment in the country in which the counterparty is located.

7. In Transaction #3, the question arises as to whether the amounts payable under the swap are "interest" within the meaning of the UN Model. The definition of interest is 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 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.

8. The term "debt-claims" is not defined in the Model. Accordingly, pursuant to Article 3, paragraph 2, it should be defined under the domestic law of the source state, unless the context otherwise requires. While there is therefore a theoretical possibility that a country could treat an interest rate swap as a "debt-claim", that seems difficult in light of the fact that no money changes hands upfront. That is, neither party has advanced funds to the other. Accordingly, the interest rates provided in the swap agreement are merely the ways in which the parties determine which side has "won" and which side has "lost" with respect to the transaction.

9. Again, because the mortgage company is using the interest rate swap to hedge a deductible expense, it seems appropriate to treat any gain that reduces that expense as business profits.

10. In Transaction #4, amounts of money have changed hands up-front, so the transaction looks somewhat more like a debt claim. However, these transactions were done at current market rates, so that the value of the rupees is more or less the value of the dollars. Accordingly, it would be hard to determine who has issued a debt claim to whom. In fact, the upfront transfer of funds is a convenience – it would have been possible to structure this as an interest rate swap with a series of spot foreign exchange contracts. When viewed this way, it is clear that the treaty analysis should be similar to that of Transaction #3.

11. It probably goes without saying, but in Transactions #1-4, the payments received by the investment bank should be treated as business profits as well.

12. In Transaction #5, the payments on the equity swap contract do not relate to any business of the investor. Accordingly, the payments must be analyzed under Articles 10 (Dividends) and 21 (Other Income). Article 10 provides the following definition of "dividends":

> The term "dividends" as used in this article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

13. It seems difficult to treat the payments as dividends. The payment from the investment bank is not "income from shares". It may, depending on the law of the State in which the underlying company is a resident, be income that is subjected to the same taxation treatment as income from shares, but it seems hard to conclude that the equity swap constitutes a "corporate right". As an aside, the issue is complicated further by the fact that the investment bank may be located in the same country as the company issuing the underlying shares, or in the country of the investor, or a third country altogether.

14. If it is not a dividend, then it falls within "other income". Under the UN Model, such income may be taxed by a Contracting State if it arises in that State; otherwise, it is taxable only in the country of residence (unless attributable to a permanent establishment in the other State). The UN Model does not provide general source rules, and certainly no rules with respect to the source of income from equity swaps. It would seem reasonable in this case for the country in which the company issuing the underlying shares is a resident to conclude that the payment on the equity swap "arises" in the state in which the company issuing the underlying shares is a resident. Accordingly, the source state could tax the payment under the other income article, and would not be bound to provide any reductions in withholding rates required by Article 10.

IV. Conclusions

15. The appropriate treatment of a financial product can be determined only after taking account of the purpose for entering into the transaction. Many, if not most,

financial derivative contracts are undertaken to hedge risks that arise in the ordinary course of doing business. It is therefore appropriate to treat such transactions as giving rise to business profits. With respect to financial institutions, entering into such transactions is a fundamental part of their business, and therefore such payment should clearly fall within the category of business profits. However, with respect to investors/speculators, income from such transactions is likely to fall into "other income" and to be taxable at source.