

Gaspar Lopes Dias V.S.

Tax Arbitrage through Cross-Border Financial Engineering

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Hitting the right balance between greed and fear

– Charles Plambeck and David Crowe, in *Taxation of Financial Instruments*, Tax
Notes International, 1995

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List of Abbreviations

CJEU	Court of Justice of the European Union
DTC	Double Tax Convention
ETD	Exchange-Traded Derivatives
EU	European Union
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IBFD	International Bureau of Fiscal Documentation
IFA	International Fiscal Association
IFRS	International Financial Reporting Standards
I-RD	Interest and Royalties Directive
ISDA	International Swaps and Derivatives Association
OECD	Organization for Economic Cooperation and Development
OECD MC	Organization for Economic Cooperation and Development Model Tax Convention on Income and on Capital
OTC	Over-The-Counter
PE	Permanent Establishment
P-SD	Parent-Subsidiary Directive
US MC	United States Model Income Tax Convention
US	United States of America
UK	United Kingdom of Great Britain and Northern Ireland
UN MC	United Nations Model Tax Convention
VCLT	Vienna Convention on the Law of Treaties

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The European Tax College experience has come to its conclusion and the present book is the last project of this academic cycle.

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Above all, on a personal note, I leave here a warm word to my dear Anouk Huyghe, whose love and care are my ultimate cause.

1. Any comments on the content of the present book may be sent to: glopesdias@kpmg.com, I will be pleased to receive any reactions on the subject.

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CHAPTER 1

Introduction

§1.01	General Frame
§1.02	Scope and Delimitation
§1.03	Methodology
§1.04	Motivation
§1.05	Research Question
§1.06	Structure of the Book

§1.01 GENERAL FRAME

In the hodiernal world, in particular from the taxation standpoint, financial instruments owe their surmountable importance¹ to their specific flexibility. In this regard, derivative^{2,3} financial instruments are some of the most flexible structures available, the conceivable features and combinations of which tend to be unlimited.

Therefore, through a careful assembly process giving rise to complex financial instruments unique tax benefits can be attained in a cross-border context.^{4,5} Though,

-
1. Cf. 'This is because derivative financial instruments challenge some of the fundamental assumptions that underlie income tax systems'. In Gammie, M., *The Source Taxation of Derivative Financial Instruments, 'Synthetic Securities', Financial Hedging Transactions and Similar Innovative Financial Transactions*, Derivatives & Financial Instruments, IBFD, September/October 1999, p. 232.
 2. Cf. 'In *Derivatives: The Wild Beast of Finance*, 1998, Alfred Steinherr illustrates how a merchant in Venice in 1470 [could use] many of the techniques of modern derivative financial instruments to manage the risks associated with fifteenth century commerce. What has happened particularly over the last 25 years has been a spectacular growth in the markets for – and therefore access to and availability of – the products for managing modern day commercial and financial risks.' In *id.*, p. 231.
 3. Cf. It is a well-publicized fact that the world's GDP amounts to around 50 trillion USD, while the notional amount of the outstanding derivatives is presently worth 441 trillion USD.
 4. Cf. 'Hybrids enhance the performance of financial instruments by customizing them to the different needs of investors and issuers on the globalized market. The taxpayer may exploit the differences in their characterization, source, timing and amount for tax arbitrage purposes, though the General

uncertainty is a reality in some jurisdictions on behalf of taxpayers who pursue the most sophisticated financial options to their undertakings.

Accordingly, the initial quote – ‘*Hitting the right balance between greed and fear*’⁶ – reports, in our view, to the need to equitably consider the reservations and the corresponding disproportionate actions from both taxpayers and tax administrations, pertaining with particular accuracy to this field of international taxation.

In this sense, tax administrations nurture a natural zeal over the revenue from unfamiliar dynamics that may constitute potential threats⁷ and so countries may follow the course of over-taxing certain dealings ultimately resulting in their interdiction. Similarly, taxpayers can be subject to multiple-taxation, or to unlawfully enjoy tax benefits in several jurisdictions.

For instance, at the midst of the present financial crisis Governments strive to find new ways to collect revenue. Regarding the context of the scope of this study, a proposal was made for a Financial Transaction Tax within the European Union, even though the catastrophic effects of the Swedish experience in this respect are well known.

Yet, financial instruments and derivatives are generally recognized by experts as playing a fair and advantageous role in the economy, e.g., by promoting liquidity as well as an efficient allocation of resources.

Nevertheless, many countries worldwide already have similar transaction taxes which have not altogether destroyed the said market.

In fact, the proposed Financial Transaction Tax within the European Union is expected to privilege the geographical areas that are already financial centres, by providing an incentive to taxpayers of the countries adhering to the proposal, to finance elsewhere.

To continue to set the frame of the present essay, it is relevant to take into account that the technological⁸ advances that triggered the globalization process are at the origin both of the massive use of financial instruments and of other problematic concepts for international tax law.

Reporter concluded that this is normally not their main goal.’ In Pistone, P. & Romano, C., *Short Report on the Proceedings of the 54th IFA Congress, Munich 2000*, IBFD Bulletin, January 2001, p. 36.

5. Cf. ‘The general principal against tax evasion establishes the restriction of any abusive practice in tax arbitrage.’ In Rosembuj, T., *International Tax Arbitrage*, Intertax, Vol. 39, Issue 4, 2011, p. 158.
6. In Plambeck, C. & Crowe, D., *Taxation of Financial Instruments*, Tax Notes International, 1995.
7. Cf. ‘Several countries have so far adopted administrative procedures to limit tax arbitrage, such as the UK equity notes rules, the no-ruling policy by the Netherlands or the US corporate tax shelters rules.’ In Pistone, P. & Romano, C., *Short Report on the Proceedings of the 54th IFA Congress, Munich 2000*, IBFD Bulletin, January 2001, p. 36.
8. Cf. ‘...it is the increase in computing power needed to perform the complex mathematical computations which underlie derivative financial instruments and which has contributed to their growth.’ In Gammie, M., *The Source Taxation of Derivative Financial Instruments*, ‘Synthetic Securities’, *Financial Hedging Transactions and Similar Innovative Financial Transactions*, Derivatives & Financial Instruments, IBFD, September/October 1999, p. 232. This field may therefore continue to quickly evolve in pace with technological innovation, for example with the development of cryptocurrencies or high frequency trading.

Effectively, we are convinced that the cornerstone elements of the discussion on the taxation of cross-border financial instruments, namely in connection to the principles of residence and source, mostly apply to other areas of international taxation, in particular, where income is derived from intangibles or through electronic commerce.⁹

In our approach, there is not one specific instrument which is to be globally analysed throughout the present desideratum, although numerous instruments are mentioned with the view to illustrate certain points.

It is our hopeful prospect that along with an academic value, the work here undertaken could serve taxpayers by evidencing the potential features and difficulties of complex financial instruments such as hybrids, synthetics, and non-traditional financial instruments and consequently, the most appropriate course for each particular operation and setting.

Furthermore, the conclusions here taken could also aid governments and tax administrations, by categorizing inconsistencies and weighting the tax consequences of the legislative options nowadays in place with view to an increased neutrality of taxation.

§1.02 SCOPE AND DELIMITATION

The present book highlights the tax arbitrage opportunities in a cross-border context ensuing from financial engineering, which '*is the process of combining and/or stripping financial instruments in order to attain a specific, desired financial position.*'^{10,11}

As overtly known, there are basic building blocks to which financial instruments can deconstructed or built from,¹² so that a financial structure meets the requirements and qualifies for the tax benefits provided by the legal regimes applicable, in multiple jurisdictions.¹³

Therefore, in our study, the relevant concepts and their interrelations are clarified, as well as the cross-border hindrances of their usage from a tax planning

9. Cf. Ring, D.M., *Commentary: Exploring the Challenges of Electronic Commerce Taxation Through the Experience of Financial Instruments*, SelectedWorks, NYU Tax Law Review, January 1996, pp. 663-676, available at http://works.bepress.com/diane_ring/23/.

10. In Hilling, A., *Income Taxation of Derivatives and Other Financial Instruments – Economic Substance versus Legal Form*, Jönköping University, JIBS Dissertation Series No. 042, 2007, Note 56 on p. 12.

11. The emphasis is ours, since obtaining a certain financial position is the essence of structured finance.

12. Cf. e.g., Neftci, S.N., *Principles of Financial Engineering*, Elsevier Academic Press, 2004.

13. Cf. 'It has become a truism that any financial instrument can be expressed as the combination of a series of separate smaller components', in Duncan, J.A., *Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions*, General Report, in IFA *Cahiers De Droit Fiscal International*, Volume LXXXVa, Kluwer Law International, 2000, p. 30. In the note to this statement, the general reporter refers to KAU, *Carving Up Assets and Liabilities – Integration or Bifurcation of Financial Products*, 1990, which describes '13 alternative ways of replicating the cash-flow of a fixed-rate debt obligation', adding that, 'the commentator stopped not because he had run out of alternatives [...], but because he had made his point.'