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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)

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

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). Art