The Qualification of Hybrid Instruments in Double Tax Treaties: an Analysis of Economic Substance and Context

A Qualificação de Instrumentos Híbridos nos Acordos de Bitributação: um Exame da Substância Econômica e do Contexto

Leonardo Thomaz Pignatari

Bacharel em Direito pela Universidade de São Paulo. Especialização em Direito Tributário Brasileiro no Instituto Brasileiro de Direito Tributário, em curso.

Advogado Tributarista em São Paulo. E-mail: *leonardo.pignatari@manesco.com.br*

Abstract

The internationalization of commercial trades and the process of globalization originated new financial instruments, which have both interest and dividend features, creating some barriers to qualify it for double tax treaties purposes. This complexity is enhanced by the reference to domestic legislation provided by art. 10 of the OECD Model Tax Convention (dividends) insofar as art. 11 (interest) does not make such reference. In this context, this Study aims to demonstrate that the qualification of hybrid instruments must start from the moderated analysis of its economic substance, confronted with the definition of interest and dividends used by the Contracting States as well the main goals of the tax treaty. The improvement of the system should guide this analysis, not its deconstruction.

Keywords: hybrid instruments, qualification, economic substance, interpretation, double tax treaties.

Resumo

A internacionalização das relações comerciais e o processo de globalização originaram novos instrumentos financeiros, os quais detêm características tanto de juros quanto de dividendos, fato que dificulta sua qualificação para fins de aplicação dos acordos de bitributação. Essa complexidade é intensificada pela referência à legislação doméstica prevista no art. 10 da Convenção-Modelo da OCDE (dividendos) na medida em que o art. 11 (juros) não realiza esta menção. Dentro deste contexto, o presente estudo pretende demonstrar que a qualificação dos instrumentos híbridos deve partir da análise moderada de sua substância econômica, confrontada com a definição de juros e dividendos empregada pelos Estados Contratantes, assim como os principais objetivos dos tratados. O aprimoramento do sistema deve guiar essa análise, e não sua desconstrução.

Palavras-chave: instrumentos híbridos, qualificação, substância econômica, interpretação, acordos de bitributação.

Introduction

The process of globalization, associated with technological development, has brought the overflow of national borders, expanding the set of commercial trades developed among different countries. Moreover, the expansion of foreign trade has opened space for the creation of hybrid financial instruments whose legal nature encompasses both equity and debt features.

This mixed character is responsible for major difficulties in qualifying the payments made through hybrid instruments, since the definition of dividends and interest provided by double tax treaties, especially those adhering to the OECD Model Tax Convention (OECD-MC), does not draw a clear line between the two allocation rules (arts. 10 and 11).

In other words, the existence of a blurry zone between dividends and interest for treaty purposes, in which the hybrid instruments transit, constitutes one of the major challenges in international taxation.

Despite the complexity of the challenge, the economic substance of a legal transaction that originated the payment must be analyzed, regardless of the legal form adopted. The first step consists on verifying the main characteristics of this business ("underlying relationship"), such as the participation in profits and losses; right to participate in the liquidation proceeds; fixed maturity date, among others.

These criteria must be examined in light of the concept of dividends and interest laid down in double tax treaties. From arts. 10 and 11, it is possible to extract two relevant and determinants expressions: "corporate rights" and "debt-claims of every kind", which have an autonomous interpretation under the treaty provisions.

However, the economic substance *per se* represents a dangerous approach, once it may deconstitute valid and effective legal business, restricting the field of international tax planning. The BEPS Project enhances this concern insofar as economic analysis gains *momentum* and the "minimal standards" are not sufficient to clear the blurry line between dividends and interest.

In this context, this study aims to demonstrate that the complex qualification of hybrid instruments depends on the analysis of the economic substance of payments made between companies or individuals resident in the Contracting States. On the other hand, the present analysis also depends on the interpretative resources proper to international agreements, considering the object and purpose of tax treaties.

1. Dividends and interest under OECD Model Tax Convention

According to arts. 10 and 11 of the OECD-MC, dividends and interest may be taxed in the residence State, but it also reserves a limited taxing right

to the source State if the beneficial owner is a resident of the other Contracting State.

In 2014, the OECD clarified that beneficial owner represents someone who detains the power to decide and the power to enjoy the dividends/interest without any limitation imposed by a contractual obligation[1].

The taxation of dividends or interest paid to non-residents can be illustrated by the following example: considering the existence of a double tax treaty between State A and State B, a company resident in State A pays dividends to another company resident in State B, which attracts the taxation in the resident State (B), reserving a limited taxing right to the source State (A).

The restriction imposed to the source taxation (percentage provided by the treaty) might be reduced by the Contracting States, according to their fiscal policy. For instance, the UN Model does not provide a threshold, granting the Contracting States more liberty to decide the source taxation right.

Moreover, it is important to address that the OECD-MC does not oblige Contracting States to tax dividends/interest derived by foreigner sources or paid to non-residents. DTTs serve as a mere limitation on tax liabilities, since the taxation depends on the domestic legislation, which is applicable with the thresholds provided by tax treaties.

The general premises set forth above are important to discuss the definition of dividends and interest for treaty purposes. Despite the existence of a definition of dividends and interest, the frequent use of hybrid instruments raises a lot of doubts regarding the qualification of such income.

This complexity led some States to foresee in their tax treaties a specific attribution to some hybrid instruments. For instance, Germany and Netherlands understand that certain hybrid instruments with both debt and equity features are more in the nature of equity than debt.

Irrespective that they may be debt claims (at least for part of their life), they are treated as equity for income tax purposes[2].

Therefore, it is important to draw a line, guaranteeing legal certainty to the international tax planning and legal businesses celebrated abroad.

At the end of this line, there is a pure loan with fixed interest and, at the other end, there is a pure equity investment with a shareholder position with all its rights attached, including the right to receive dividends.

However, at the middle, the problem consists on qualifying certain income as "corporate right" or "debt-claims of every kind", which is strictly con-

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[1] See Paragraph 12.4 of OECD Model Tax Convention Commentaries on art. 10 and Paragraph 9 on art. 11.

[2] Art. 14(3) of the Germany–Netherlands DTT goes on to specifically direct that "income derived from convertible bonds and participating debentures shall be subject to the provisions of Article 13 (the dividends Article)".

nected to the interpretation process and the economic substance of such payment.

2. Hybrid instruments: a blurry line in double tax treaties

2.1. Interpretation and the prevalence of tax treaty provisions over domestic law

Klaus Vogel clarifies the relationship between double tax treaties and domestic legislations, addressing that the treaty acts like a stencil that is placed over the pattern of domestic law and covers over some parts. When domestic tax liabilities are covered, the imposition of taxes is restricted or eliminated.

Concerning tax treaty interpretation, Michael Lang, analyzing art. 3(2)[3], OECD-MC stated that "domestic law is taken into account for the interpretation of a DTC when nothing more can be derived from the treaty itself" (LANG, 2013).

In other words, the use of domestic law is verified only when it is not possible to find a solution in DTT's provisions. DTT's wording and context must prevail, giving to the domestic legislation a subsidiary role.

Regarding the concept of dividends and interest, which are provided by tax treaties, the interpretation of the expressions "corporate rights" and "debt-claims", nuclear for the qualification process[4], depends on the ordinary meaning, the context and goals of tax treaties (art. 31, Vienna Convention on the Law of Treaties (VCLT). The meaning of words, context and purpose set the basis for treaty interpretation, whereas the reference to domestic law must be as restrictively as possible.

The interpretation of tax treaties does not distance itself from the interpretation of other international agreements, using the same methods. Brian Arnold argues that:

> "The basic interpretive approach set out in Art. 31(1) should not strike anyone as novel. The interpretation of any written material – newspapers, books, Articles, memos and legal documents – requires us to read the

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[3] Art. 3(2), OECD-MC: "As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes, to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."

[4] About the difference between interpretation and qualification, see SCHOUERI, Luís Eduardo. International tax law – qualification and substitution – Brazilian taxation of income derived from partnerships resident in Germany (Direito tributário internacional – qualificação e substituição – tributação, no Brasil, de rendimentos provenientes de sociedade de pessoas residente na Alemanha). *Revista Dialética de Direito Tributário* n. 54. São Paulo: Dialética, 2000, p. 133.

> words, sometimes several times, very carefully. Further, [...] the meaning of words is always dependent on the context in which they are used. And finally, all language is purposive. Obviously, the parties to a treaty are attempting to accomplish certain results, and the treaty should be interpreted to promote, rather than frustrate, those intentions or purposes. The same three major elements – the ordinary meaning of words (text), context, and purpose – form the foundation for the interpretation of language generally." (ARNOLD, 2010, p. 5)

Thus, considering that DTT's provisions prevail over domestic rules (*lex specialis*), the qualification of certain hybrid instruments under arts. 10 or 11 is strictly related to the meaning, context and goals agreed by both Contracting States.

2.2. Criteria to qualify a hybrid instrument for tax treaties purposes: a moderated economic substance analysis

Economically, debt and equity consists on mechanisms whose function is the same (enable the company to generate profits). Legally, their main difference is that the latter bears a higher risk.

Nonetheless, it is not any risk, but rather the one related to a shareholder status. Every creditor faces the risk of not receiving his payment, but this risk does not resemble that one borne by a shareholder relationship (entrepreneurial risk vs. creditor's risk).

Marjaana Helminen, Professor of International and Comparative Tax Law at the University of Helsinki, sums up the problem:

> "Hybrid instruments are often formed by adding certain elements of equity instruments to debt instruments. Interest on a loan contract may depend on company profits, the loan may be subordinated compared to other debt, it may be convertible to corporate shares or it may be perpetual. The return and risks of a debt investment may be made economically closer to the returns and risks of an equity investment. On the other hand, a share investment may be attached with a fixed return, or the shares may be redeemable. Therefore, sometimes debtor-creditor relationship may, in its economic substance, be very close to a shareholder relationship and vice versa." (HELMINEN, 2010, p. 164)

There is a blurry line between debt and equity, which must be lightened by the actual economic substance of hybrid instruments, since taxpayers could use them for tax avoidance purposes. In other words, "the tax classification of an instrument may also depend on whether the instrument includes more debt or more equity characteristics" (HELMINEN, 2010, p. 167).

Comparing the 1963 OECD Draft and the OECD Model (1977), the most important development was the removal of the reference to domestic legisla-

tion in the definition of interest. Notwithstanding, dividend's definition kept the reference to domestic tax law, which raises some barriers for the qualification process.

Art. 11(3), OECD-MC establishes a broad and exhaustive definition of interest[5], whose nuclear basis is the expression "debt claims of every kind". On the other hand, art. 10(3) kept the reference to domestic legislation – "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".

According to Kevin Holmes, there are two critical points in the definition of interest: (i) interest must arise from debt claims and (ii) it does not matter if the debt also carries a right to participate in debtor's profits (HOLMES, 2014).

Likewise, Haslehner suggests that the blurred line between arts. 10 and 11 should be examined through the concepts of "debt-claims of every kind" and "corporate rights"[6]:

> "[…] a better view appears to understand 'debt-claims' and 'corporate rights' as mutually exclusive categories so as to create a clear distinction between both categories of income and void a substantive overlap. *Such distinction would leave merely the need to classify each financial instrument as falling into one of the two categories*. […] In between these lines, *the exact boundary will depend on whether the income recipient shares in the entrepreneurial risk assumed by the debtor company as a consequence of the agreement*." (HASLEHNER, 2015)

Despite the reference to domestic tax law, art. 10(3) provides an autonomous definition of "corporate rights", which involves a "right held in the company, rather than against the company, which implies a direct derivation from a 'membership right' as opposed to the right of a creditor based on any other contractual or statutory relationship" (HASLEHNER, 2015). This concept includes the right to participate in profits and in the liquidation proceeds, but it does not encompass debt-claims.

Considering that the domestic tax legislation of many countries does not mention which hybrid instruments constitute debt and which constitute equity, it is imperious to analyze the main factors that may be taken into account for qualification purposes under the DTT provisions.

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5 See paragraph 21 of OECD Model Tax Convention Commentaries on art. 11.

6 See also SANTOS, Ramon Tomazela. *Controversial issues in international tax law*: BEPS, tax treaties and unilateral tax measures. 1. ed. Republic of Moldova: LAP Lambert Academic Publishing, 2017, p. 249.

In brilliant study about the controversial issues in international taxation, Santos (2017, p. 234) listed the typical features of dividends and interest, organized in the table below:

Dividends	*Interest*
Paid on a variable or fixed basis	Fixed amount or fixed percentage
Legally uncertainty	Legally certainty
Originated by an equity acquisition	Originated by a credit transaction

Similarly, Helminen (2010, p. 169) introduces another elements to distinguish debt and equity (interest and dividends), such as (i) right to enforce the payment; (ii) the certainty of return or risk involved; (iii) voting power; (iv) whether the payment is subjected to or preferred over other indebtedness in the liquidation proceeds; (v) dividend is based on a decision of a shareholders meeting while interest is based on a loan contract.

Although a new commercial agreement is able to create, in principle, a company-shareholder relationship, the substantial cause of the contract might be an underlying debt, since there is no participation in losses and the payment is totally secured.

If the company does not bear the risk of losing its capital, such income falls under art. 11. The mere denomination given to a certain instrument (for example, "preferred shares" or "jouissance shares") is not a condition for qualifying an income as dividends or interest.

For instance, there are some hybrid instruments named "jouissance shares", which have both features of equity and debt. The IBFD International Tax Glossary qualifies "jouissance shares" as a hybrid instrument that generates a "capital surplus (if any) upon liquidation" and annual profit distribution in favor of its holder:

> "[...] securities issued by companies in some countries which carry a *right to the capital surplus (if any) upon liquidation* of a company and may also entitle their holders to a *percentage of the annual profits*. Jouissance shares may be issued on the occasion of a company reorganization where part of the capital is amortized and the rights of the current shareholders are reduced. In such a case, to a certain extent, they represent compensation for the loss suffered by the shareholders." (ROGERS-GLABUSH, 2009, p. 255)

Considering that tax treaties do not impose taxes, but only limits tax liabilities, the Contracting States, in the exercise of their fiscal sovereignty, may decide not to tax this type of instrument as dividends.

Besides that, even if "jouissance shares" would have been included in DTT's definition of dividends, it only falls under art. 10 when is appropriately characterized as "corporate rights". If it is not, it is possible to qualify under art. 11 (interest) – right against the company, not held in the company.

Furthermore, if such income does not fall under art. 10 neither art. 11, it may fall under art. 21, which is a close provision. Schoueri (2015, p. 25) recognizes its narrow scope and "catch-all" character, but affirms that "it is not only assigned to items of income not falling within the distributive rules but also to income regularly covered by one of the allocation rules, but in circumstances that make the latter inapplicable", such as a hybrid instrument that cannot be qualified as dividends neither interest due to special circumstances.

In the same way, Haslehner claims that "dividend payments falling outside the territorial scope of Article 10 OECD and UN MC are taxable exclusively in the recipient's residence State by virtue of Article 21 OECD and UN MC, if the shares are not held as part of a business" (HASLEHNER, 2015).

The economic substance approach above-mentioned was already discussed and used in international case law.

In 2010, Bundesfinanzhof (Federal Fiscal Court)[7], under the Germany – Austria Income Tax Treaty, examined a case where the taxpayer, a bank resident in Austria, received three "jouissance shares" from a German bank, which did not entitle any voting rights and participation in losses.

Irrespective the dividends definition encompassed the term "jouissance shares", the Court qualified such income as interest for treaty purposes due to four specific reasons:

> – although the DTT does not include a specific definition of "jouissance shares", art. 11(3) has a broad meaning of interest ("debt-claims of every kind");
> – nominal value of the shares would be paid at the end of the term (security of the debt);
> – there was no loss participation, since the payment was accumulated in the following years; and
> – the treaty definition was sufficient, there was no need to refer to domestic tax law.

[7] GE: Bundesfinanzhof (Federal Fiscal Court), 26 August 2010, I R 53/09, Tax Treaty Case Law IBFD. See also: GE: Finanzgericht Nordrhein-Westfalen (Köln), 23 May 1996, 2K 2536/94, Tax Treaty Case Law IBFD; GE: Finanzgericht Nordrhein-Westfalen (Köln), 29 April 1999, 2 K 3998/95. Tax Treaty Case Law IBFD.

On other case, the Polish Supreme Administrative Court ruled that the "jouissance shares" may be qualified as dividend if the instrument provides participation in the profits[8].

The case involved the issuance of "jouissance shares" in exchange for part of a loan, which generated two types of remuneration: a fixed remuneration independent from the level of profits and a variable remuneration based on the profit level.

The Court agreed with the taxpayer's argument that the "*jouissance* shares" had no prevalence over any debt claims and further the shareholder had to face risk of losses, once the payment was connected to company's profit (existence of a entrepreneurial risk).

Thus, it is possible to acknowledge that the distinction between debt and equity lays down, mainly, on the entrepreneurial risk, which means the participation not only in the profits, but also on the losses.

This conclusion is aligned with the OECD Commentaries, which places the entrepreneurial risk as a relevant feature to determine the application of art. 10 or 11[9]. Even though the recommendations are not legally binding, they are not legally irrelevant, playing an important role in international practice[10].

Also, the lack or isolated presence of certain debt and equity features is not sufficient to qualify the income as dividends or interest. That is, the qualification process depends on the actual economic substance of the payment and the definition provided by arts. 10 and 11, OECD-MC, mainly, the interpretation of the expressions "corporate rights" and "debt-claims".

Although the economic substance analysis is extremely important to qualify hybrid instruments for treaty purposes and it has been used in international case law, it shall not restrict international tax planning developed within the legal framework, respecting the principle of free enterprise and tax treaties purposes.

This approach can be named as "moderated economic substance approach", since it considers the "economic underlying relationship" between the parties in order to qualify certain income, but also distinguishes "good tax planning" from "bad tax planning".

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[8] PO: Naczelny Sad Administracyjny (Supreme Administrative Court), 14 Jan. 2014, II FSK 187/12. Tax Treaty case Law IBFD.

[9] See Paragraph 25 of OECD Model Tax Convention Commentaries on art. 10 and paragraph 19 on art. 11.

[10] BLOKKER, Niels. Skating on thin ice? On the law of international organizations and the legal nature of the Commentaries on the OECD Model Tax Convention. In: DOUMA, Sjoerd; ENGELEN, Frank. The legal status of the OECD commentaries. Amsterdam: IBFD, 2008. v. 1.

Such difference lays down on aligning the businesses reached by taxpayers resident in the Contracting States with the object and purpose of the tax treaties and the guidelines established by the OECD in BEPS Project ("minimal standards").

In other words, if a tax planning or a commercial transaction does not violate the legal framework of the Contracting States and respect the object and purpose of a tax treaty ("good tax planning"), there is no need for requalification or deconstitution of the business.

The formal and economic analysis work together and are complementary, not contradictory, contributing for the improvement of the tax system rather than for its deconstruction or subsequent reconstruction.

3. Final remarks

As stated by Rothmann (2002, p. 33), the major problems involving hybrid instruments involve the interpretation, application and qualification of income under double tax treaties. This complexity is enhanced by the reference to the domestic legislation in art. 10, OECD-MC, which should be removed in order to avoid some unnecessary difficulties.

Moreover, it is possible to affirm that references to domestic legislation in double tax treaties only create legal uncertainty and open a dangerous gap for treaty override and abuses. As above – mentioned, the interpretation of tax treaties uses the same methods of other international arrangements, prevailing its provisions over the Contracting State domestic rules.

The qualification of an income as dividends or interest depends on the economic substance analysis, which covers the characterization as "corporate rights" or "debt-claims of every kind", respectively, under an autonomous interpretation. In other words, domestic rules do not matter, in principle, for the qualification process, since DTT's provisions are, for most cases, sufficient.

However, as stated by the present Study, the qualification of hybrid instruments process involves a "moderated economic substance approach", since it considers the "economic underlying relationship" developed by the taxpayer, but also distinguishes "good tax planning" from "bad tax planning". Such approach privileges, at the same time, economic freedom and the normative force of tax treaties.

Therefore, this study intended to expose that, despite the difficulties created by hybrid instruments, there are some guidelines which must be followed to qualify an income as dividends or interest:

i) the form/name of the hybrid instrument is not important to qualify it as dividends or interest;

ii) the economic substance, guided by different criteria (participation in losses; participation in profits; voting rights; right to the liquidation proceeds; fixed maturity date, among others) determines, in principle, the qualification for treaty purposes;
iii) the definition provided by OECD-MC is, in most cases, sufficient to qualify certain income under the two categories ("debt-claims of every kind" or "corporate rights");
iv) these two categories have an autonomous meaning, independent from the domestic definition of dividends and interest;
v) the Contracting States are allowed to tax a hybrid instrument as dividends or interest, depending on the definition provided by the tax treaty; and
vi) the "moderated economic substance approach" does not ignore the object and purpose of tax treaties, ensuring the taxpayer's right to develop his/her business within the legal framework of the Contracting States.

The objective of this study does not aim at exhausting the issue, but rather to provide clearer guidelines on the complex process of qualification of hybrid instruments in double tax treaties, which shall be developed according to a "moderated economic substance approach".

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