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Some Reflections on the Proposed Revisions to the OECD Model and Commentaries, and on the Multilateral Instrument, With Respect to Fiscally Transparent Entities

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Abstract

This article sets out some reflections of the authors on those aspects of the OECD's October 2015 final report on Neutralising the Effects of Hybrid Mismatch Arrangements (the Hybrids Report) that relate to revisions to the OECD Model to add a specific provision on fiscally transparent entities (as a new Article 1(2)), and to build on the Commentaries already in place in this regard (the HR Proposals). It also considers the similar and related provisions contained in the multilateral instrument to implement the tax treaty related BEPS measures (the MLI) that was released on 24 November 2016. The authors conduct an extensive review of the issues and raise a number of interpretive and technical questions, as well as policy considerations. This review is set against the backdrop of an examination of similar provisions (or provisions with similar purposes) in the US Models and in various existing bilateral treaties, as well as under domestic laws, of the countries represented by the authors. The authors also provide some observations with respect to potential scope and drafting or implementation of alternatives, with a view to contributing to the ongoing international debate and reform project.

As part of the OECD/G20 Base Erosion and Profit Shifting Project, the OECD on 5 October 2015 released a final report on *Neutralising the Effects of Hybrid Mismatch Arrangements* (the Hybrids Report).¹ In Chapter 14, the Hybrids Report proposes revisions to the OECD Model and

* It is not the editorial policy of this *Review* to publish articles that are scheduled to appear in other reviews. However, in agreement with the editorial board of the *Bulletin for International Taxation*, we have decided to make an exception for this article by a group of distinguished authors. The articles written by this group have been published by both the BTR and IBFD over many years. Because of this history and the high quality of this article, both editorial boards were of the opinion that this article deserved maximum exposure. Therefore, the same article appears in the September 2017 and October 2017 print issues of the *Bulletin for International Taxation*. The article should be cited with reference to both journals.

¹ See OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (Paris: OECD Publishing, 2015), available at: <http://dx.doi.org/10.1787/9789264241138-en> [Accessed 30 June 2017]. This report supersedes the 16 September 2014 interim report OECD/G20 Base Erosion

Commentaries² that would add a specific provision on fiscally transparent entities to the OECD Model (proposed Article 1(2) of the OECD Model) and would build on the Commentaries already in place in this regard (the HR Proposals). In addition, on 24 November 2016, it was announced that negotiations on the multilateral instrument to implement the tax treaty related BEPS measures (the MLI) were concluded, and the instrument was released together with an Explanatory Statement.³ The MLI contains provisions on fiscally transparent entities (the MLI Provisions).⁴

This article sets out some reflections of the authors on the HR Proposals and MLI Provisions based both on our experiences to date in considering and working with similar provisions in various existing treaties, and on our analysis of these Proposals and Provisions. The authors raise a number of interpretive and technical questions, as well as policy considerations.⁵ The authors compare the HR Proposals and MLI Provisions with similar provisions (or provisions with similar purposes) in the US Models⁶ and in various existing bilateral treaties, as well as under domestic laws, of the countries represented by the authors. The authors then provide some observations with respect to potential scope and drafting or implementation alternatives, with a view to contributing to the ongoing international debate and reform project.

Purpose of Proposals

Stated purpose

While the Hybrids Report⁷ acknowledges that the “main conclusions” of the 1999 OECD report on *The Application of the OECD Model Tax Convention to Partnerships* (the Partnership Report)⁸

and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements* (Paris: OECD Publishing, 2014) (the Interim Hybrids Report). However, the Interim Hybrids Report and the final Hybrids Report are essentially the same with respect to the parts dealing with the proposed addition of a general provision on fiscally transparent entities.

² See OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2014* (Paris: OECD Publishing, 2014), available at: http://dx.doi.org/10.1787/mtc_cond-2014-en [Accessed 30 June 2017].

³ See, respectively, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, done at Paris, 24 November 2016, available at: <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf> [Accessed 30 June 2017], and the Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, available at: <http://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf> [Accessed 30 June 2017].

⁴ See, mainly, MLI, above fn.3, Art.3.

⁵ Numerous submissions were received by the OECD on the Public Discussion Drafts on BEPS Action 2 (see OECD, *Public Discussion Draft, BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* and OECD, *Public Discussion Draft, BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)* (19 March 2014)), but very few of these directly addressed these particular proposals. In addition, several pieces of commentary have been written on the Interim Hybrids Report and now also on the Hybrids Report, above fn.1. The authors acknowledge these contributions to the study of this matter without naming them individually.

⁶ On 17 February 2016, the US Department of the Treasury released an updated United States Model Income Tax Convention (the 2016 US Model), replacing the 2006 United States Model Income Tax Convention (the 2006 US Model) (herein collectively referred to as the US Models). The US Department of the Treasury has not yet released the 2016 United States Model Technical Explanation (replacing the 2006 United States Model Technical Explanation).

⁷ The Hybrids Report, above fn.1.

⁸ OECD, *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation, No. 6 (Paris: OECD Publishing, 1999), available at: <http://dx.doi.org/10.1787/9789264173316-en> [Accessed 30 June

have already been included in the Commentaries, the Hybrids Report posits the need for further action on the basis that the Partnership Report “did not expressly address the application of tax treaties to entities other than partnerships”, and that “some countries have found it difficult to apply the conclusions of the Partnership Report”.⁹ Thus, the stated purpose of the proposals is to “ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership Report”,¹⁰ in order to “ensure not only that the benefits of tax treaties are granted in appropriate cases but also that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity as the income of one of its residents”.¹¹

As discussed below in greater detail, there may be considerable uncertainty and disagreement among states as to what are regarded as “appropriate cases”. It is not surprising, therefore, that the adoption of particular provisions on fiscally transparent entities is not a minimum standard under the BEPS initiative or that the MLI Provisions are optional.

The HR Proposals would add a single provision to the OECD Model—namely, the following new Article 1(2):

- “2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax

2017]. The authors note that the Partnership Report is not the first attempt to deal with partnerships in the treaty context. See, in particular, the early deliberations and reports of Working Party 14 of the Fiscal Committee of the Organization for European Economic Co-operation, as well as those of the overall Fiscal Committee—in particular, documents FC/WP14(61)1, 9 January 1961; FC/WP14(61)2, 18 September 1961; FC/WP14(62)1, 8 January 1962; FC/WP14(62)2, 28 February 1962; and FC(62)1, 9 April 1962, available in the database located at “History of Tax Treaties”: <http://www.taxtreatieshistory.org> [Accessed 26 May 2017].

⁹Hybrids Report, above fn.1, para.435. For example, Annex II of the Partnership Report, above fn.8, sets out formal reservations by France, Germany, The Netherlands, Portugal and Switzerland. See also the observations to the Commentaries on Art.1 of the OCED Model reflected in paras 27 (Chile), 27.1 (The Netherlands), 27.2 (France), 27.3 (Portugal) and 27.10 (Mexico). As discussed below in greater detail, these formal statements do not necessarily reflect all the difficulties that countries had with respect to the changes to the Commentaries adopted through the 2000 Revisions. It should be noted that the reservation of Switzerland concerns only conflicts of qualification and the Commentaries on Art.23: “Switzerland reserves its right not to apply the rules laid down in paragraph 32 in cases where a conflict of qualification results from a modification to the internal law of the State of source subsequent to the conclusion of a Convention.” On the other hand, Switzerland has not made any reservation to or observation on the recommendations of the Partnership Report, above fn.8, concerning conflicts of attribution and included in the Commentaries on Art.1. For example, in a decision of 23 December 2003 (Swiss FTA decision of 23 December 2003 in Locher, K./Meier, W./Siebenthal, R/Kolb, A., *Doppelbesteuerungsabkommen Schweiz-Deutschland 1971 und 1978*, Basel, B 10.1 23), the Swiss Federal Tax Administration (FTA) referred to and endorsed the reasoning of the Partnership Report, above fn.8, in relation to a case involving a German fiscally transparent partnership with a Swiss resident partner deriving income from Denmark. In this case, the FTA held that the Swiss resident partner was entitled to claim treaty benefits based on the Partnership Report’s additions to the 2000 Commentary (see K. Locher, et al., *Doppelbesteuerungsabkommen Schweiz-Deutschland* (Basel: Helbing Lichtenhahn publishing house, 2013), B 10.1 no 23 (looseleaf)). As regards the application of treaties to trusts, see also Circular Letter of 22 August 2007 (KS) which although not expressly referring to the Partnership Report, above fn.8, adopts an approach which is very similar. For a discussion of this administrative practice, see R. Danon, “L’imposition du ‘private express trust’: analyse critique de la Circulaire CSI du 22 août 2007 et proposition de modèle d’imposition de lege ferenda” (2008) 76(8) *Archives de droit fiscal suisse* (ASA) 435–474.

¹⁰The Partnership Report, above fn.8, sets out 12 examples with respect to the application of tax treaties by the source state, and another six examples with respect to the application of tax treaties by the residence state. The proposed additions to the Commentaries would also have an example (in proposed para.26.7 of the Commentaries on Art.1) but this would be consistent with other examples already in the Partnership Report.

¹¹Hybrids Report, above fn.1, para.435.

law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.”¹²

The HR Proposals would also add new paragraphs 26.3 to 26.16 to the Commentaries on Article 1 of the OECD Model, expanding on the discussion contained mainly in existing paragraphs 2 to 6.7 of the Commentaries on Article 1 of the OECD Model.¹³

The MLI Provisions are essentially the same—containing really only two main operative provisions, Article 3(1) of which being the following:

- “1. For the purposes of a Covered Tax Agreement, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting Jurisdiction shall be considered to be income of a resident of a Contracting Jurisdiction but only to the extent that the income is treated, for purposes of taxation by that Contracting Jurisdiction, as the income of a resident of that Contracting Jurisdiction.”¹⁴

The MLI Explanatory Statement notes that Article 3(1) of the MLI “replicates” the text of proposed Article 1(2), “with changes made solely to conform the terminology used in the model provision to the terminology used in the Convention”.¹⁵ Since the MLI Explanatory Statement

¹² In the Interim Hybrids Report, above fn.1, proposed Art.1(2) included a second sentence setting out a short-form “saving clause”, as follows: “In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State’s right to tax the residents of that State.” The version in the Hybrids Report, above fn.1, does not include this because a more elaborate “saving clause” is proposed in the more general report on granting treaty benefits, OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD Publishing, 2015) (the Treaty Benefits Report), available at: <http://dx.doi.org/10.1787/9789264241695-en> [Accessed 30 June 2017], paras 61–64. This matter is discussed below in considerable detail under the heading “Taxation by the residence state—saving clause and relief from double taxation”. Interestingly, the 2015 Sweden-UK Treaty contains the deleted second sentence in its Art.1(2).

The MLI, above fn.3, would add a more elaborate “saving clause” under Art.11 of the MLI, along the lines of that in the Treaty Benefits Report, but that would be optional. Thus, with respect to what are referred to in the MLI as “Covered Tax Agreements” for which one or more Parties has made the reservation described in Art.11(3)(a) (Application of Tax Agreements to Restrict a Party’s Right to Tax its Own Residents), MLI Art.3(3) provides that the following sentence will be added at the end of Art.3(1): “In no case shall the provisions of this paragraph be construed to affect a Contracting Jurisdiction’s right to tax the residents of that Contracting Jurisdiction.”

¹³ Issues relating to partnerships are also discussed in various other paragraphs of the Commentaries, such as 8.8 on Art.4, 19.1 and 42.38 on Art.5, 2, 11 and 27 on Art.10, 26 and 28.5 on Art.13, 6.1 and 6.2 on Art.15, 32.4–32.7, and 69.1–69.3 on Arts 23A and 23B. See also, for example, Commentaries on Art.1 paras 6.8–6.34 relating to collective investment vehicles (CIVs).

¹⁴ The second main operative provision, Art.3(2), eliminates any residence state credit or exemption obligations with reference to income taxed by both states on the basis of residence. See the discussion below under “Taxation by the residence state—saving clause and relief from double taxation”. There is also Art.3(4), which provides that Art.3(1) (as it may be modified by Art.3(3) with regard to adding a “saving clause” element—see the discussion above in fn.12) “shall apply in place of or in the absence of provisions of a Covered Tax Agreement to the extent that they address whether income derived by or through entities or arrangements that are treated as fiscally transparent under the tax law of either Contracting Jurisdiction (whether through a general rule or by identifying in detail the treatment of specific fact patterns and types of entities or arrangements) shall be treated as income of a resident of a Contracting Jurisdiction”. In addition, Option C under MLI Art.5 also displaces certain credit obligations. See the discussion below under “Partial residence provisions”.

¹⁵ See MLI Explanatory Statement, above fn.3, paras 39–48.

does not otherwise elaborate on the interpretation of its Article 3(1),¹⁶ presumably the intention is that the Commentaries on proposed Article 1(2) would be relevant in that regard.¹⁷

General policy considerations and intended effect of proposed Article 1(2) of the OECD Model

Tax treaties are generally concluded in order to restrict the taxing rights of the Contracting States, including, with respect to their own residents, through undertakings by the states to provide certain reliefs to their own residents, as a means of eliminating double taxation—with the ultimate objective of reducing fiscal barriers to cross-border trade and investment.¹⁸ Occasionally, however, concerns have arisen that these objectives could be defeated or exceeded by various types of conflicts that can arise between the laws and practices of states with respect to questions of qualification and attribution. The Partnership Report¹⁹ and the subsequent 2000 Revisions attempted to tackle some of these conflicts—specifically, those arising in relation to partnerships.

In the most general sense, only humans are “real” persons but the non-tax laws of almost all, if not all, countries recognise (and enable) the existence of “artificial” persons, which are at once both treated as being distinct from, and to some extent identified with, their members, beneficiaries and participants for various purposes. In general, artificial persons are (directly or indirectly) associations of natural persons (or even single persons) upon which has been bestowed (or superimposed) legal personality or existence that is to a greater or lesser extent, depending on the country and the context, distinct from their constituent natural persons. Some of these artificial persons are relatively clearly distinct (such as most “corporations”), while others are less distinct. At common law, partnerships are normally viewed as mere contractual relationships among the members, governed by a branch of agency law.²⁰ In some jurisdictions (more often civil law jurisdictions), there is a greater degree of variance with respect to the personification of such relationships and thus with respect to the distinctness of the entity.²¹ Then there is the “trust” and similar relationships or entities, including the “estate” (or “succession” or “inheritance” in civil law jurisdictions), as well as the “foundation”,²² to mention but a few variations.

For tax purposes, there is a considerable degree of variance with respect to the treatment of these relationships or entities as distinct taxable units as opposed to pass-through vehicles, which does not necessarily align with variances in their non-tax characteristics. There can be non-tax

¹⁶ Unless otherwise specified, the comments in this article directed at proposed Art.1(2) are equally directed at MLI, above fn.3, Art.3(1).

¹⁷ The Explanatory Statement, above fn.3, prevaricates about this matter. At para.4, the suggestion is made that “models” need to be updated by the “Final BEPS package”. At para.12, however, where the interpretive value of extra-textual sources such as commentary is discussed, no mention is made of an update to the models but instead this statement is made: “The commentary that was developed during the course of the BEPS Project and reflected in the Final BEPS Package has particular relevance.”

¹⁸ See, for example, the discussion in para.7 of the Commentaries on Art.1. It should be noted, however, that the Treaty Benefits Report, above fn.12, proposes to introduce a number of revisions in this regard. See Pt B of that report, “Clarification that tax treaties are not intended to be used to generate double non-taxation”.

¹⁹ The Partnership Report, above fn.8.

²⁰ See, for example, R.A. Banks, *Lindley & Banks on Partnership*, 19th edn (Sweet & Maxwell, 2016).

²¹ A detailed examination of the non-tax features of partnerships and other entities under various legal systems is beyond the scope of this article.

²² For a discussion of the characterisation for Canadian tax purposes of an Austrian private foundation (a *privatstiftung*, governed by the *Privatstiftungsgesetz*), see *Sommerer v The Queen*, 2011 TCC 212, and *The Queen v Sommerer*, 2012 FCA 207, which suggest that they should not be assimilated to trusts for Canadian tax purposes.

law corporations that are treated as pass-through vehicles, and non-tax law contractual relationships without legal personality that are treated as distinct taxable units, as well as several variations. In addition, these treatments often vary from one jurisdiction to another, and may be elective, which can give rise to mismatches resulting in double taxation and double non-taxation as well as other potentially unintended consequences.

The OECD Model has long recognised that there can be contractual relationships without legal personality that are treated as distinct taxable units. For example, the term “company” means “any body corporate or any entity which is treated as a body corporate for tax purposes”.²³ However, despite various attempts over several decades, the OECD has not been able to achieve a broad and satisfactory consensus, for domestic tax law and treaty purposes, with respect to relationships or entities that give rise to mismatches in their treatment between Contracting States.

The objectives of these efforts have been, traditionally, to achieve consistent or at least coherent treatment for treaty purposes between Contracting States.²⁴ One approach is that reflected in the Partnership Report²⁵ and in proposed Article 1(2) of the OECD Model. This approach is focused on what are referred to as “fiscally transparent” entities or arrangements, and seeks to achieve consistency, essentially, by mandating that the source state take into account the residence state’s attribution of income derived by or through such entities or arrangements, at least for the purposes of determining the extent to which treaty benefits should be granted, though not for the purposes of determining which person or entity, and which events, the source state can tax.

As noted above, whether or not the addition of a provision such as proposed Article 1(2) of the OECD Model is necessary remains controversial, particularly with respect to entities other than partnerships. One of the authors of this article, Danon, feels strongly that the connecting terms contained in the distributive rules, such as “paid to” or “derived by” ought to be given a contextual and autonomous interpretation which would be broad enough to subsume the general recommendations in the Partnership Report.²⁶ Accordingly, under this approach, the source state should generally consider, but only for treaty purposes, that an item of income is “paid to” a resident of the other Contracting State whenever this latter state allocates this item to a resident pursuant to its own fiscal attribution rules. Under this line of reasoning, the general recommendations in the Partnership Report²⁷ become applicable to other entities (such as trusts) and other source-residence conflicts of attribution (for example, those which involve a controlled foreign company (CFC) rule that operates based on direct attribution of the underlying income),

²³ OECD Model Art.3(1)(b).

²⁴ Currently, the objectives of these co-ordination efforts have been expanded to address “double deduction” and “deduction/non-inclusion” consequences under domestic laws, as discussed in the Hybrids Report, above fn.1, Pt I.

²⁵ The Partnership Report, above fn.8.

²⁶ The Partnership Report, above fn.8. See R. Danon, *Switzerland’s direct and international taxation of private express trusts: with particular references to US, Canadian, and New Zealand trust taxation* (Université de Genève, Schulthess, thesis, 2003), pp.296–326; R. Danon, “Conflicts of attribution involving trusts under the OECD Model Convention” (2004) *International Tax Review* 210; R. Danon, “Qualification of Taxable Entities and Treaty Protection” (2014) 68(4/5) *Bulletin for International Taxation* 192. See also in the same vein J. Salom and H. Salomé, “Qualification of taxable entities and treaty protection — Swiss national report” (2014) 99b *Cahiers de droit fiscal international* 803; H. Salomé, “BEPS Action 2 Treaty Provisions on Hybrid entities” in R. Danon (ed), *Base Erosion and Profit Shifting (BEPS), Impact for European and international tax policy* (Schulthess Editions Romandes, 2016), 65 and following.

²⁷ The Partnership Report, above fn.8.

even in the absence of an express provision such as proposed Article 1(2) of the OECD Model. Further, because under this view the general recommendations in the Partnership Report²⁸ merely codify the appropriate contextual interpretation of the distributive rules, they also apply to tax treaties concluded before the 2000 update of the Commentaries. Overall, and with respect to fiscally transparent entities, however, this interpretation leads to results which are very similar, if not identical in many instances, to the ones produced by proposed Article 1(2) of the OECD Model, and may have similar shortcomings as discussed below in greater detail. By contrast, a different in nature and more comprehensive approach, suggested by Wheeler, would be to fundamentally amend the structure of the OECD Model.²⁹

While the foregoing approaches would increase consistency and coherence, the other authors of this article believe that these approaches would also more broadly displace the traditional principle that each taxing state should apply the treaty in accordance with its own approach to qualification and attribution.³⁰ As this remains an important principle, the question becomes: what is the right balance between achieving consistency and coherence, on the one hand, and respecting the taxing state's jurisdiction to determine, and approach to, qualification and attribution, on the other?

As noted above, and as will be discussed below in greater detail, proposed Article 1(2) of the OECD Model is not intended to affect the source state's right to determine, based on its domestic law, which non-resident persons or entities and which events it can tax. It is also not intended to affect the manner in which a state determines its universe of residents, nor how it taxes its residents, under its domestic law, although that emerges more clearly from the introduction of a "saving clause".³¹

The first point is more subtle. There is no doubt that proposed Article 1(2) of the OECD Model is intended to have some effect on the manner in which, or the extent to which, the source state would tax the income in the absence of such a provision, but that effect is deliberately limited to (certain aspects of) the application of the treaty and the granting of treaty benefits. In the authors' view, what proposed Article 1(2) of the OECD Model is intended to do is to mandate a two-step process for the granting of treaty benefits. The first step is the application by the source state of its usual approach to determining, in accordance with its domestic law, which non-resident persons or entities and which events it seeks to tax. It is intended that that will remain unaffected by proposed Article 1(2) of the OECD Model. Once the relevant taxpayer(s) and relevant taxable event(s) have been determined by the source state, the second step is for the source state to determine the extent to which the relevant taxpayer(s) should be granted or denied treaty benefits with respect to any income that may arise from the perspective of the source state as a result of the relevant taxable event(s). It is at this point that the provision may have an impact. Rather than granting or denying treaty benefits as a function of the source state's own approach to the qualification of entities and arrangements as between those that are fiscally transparent and those that are fiscally opaque, and to the consequent attribution of any income

²⁸ The Partnership Report, above fn.8.

²⁹ See J. Wheeler, *The Missing Keystone of Income Tax Treaties*, IBFD Doctoral Series, Vol. 23 (IBFD, 2012).

³⁰ This principle is reflected in OECD Model Art.3(2), among other reflections.

³¹ See the discussion below under the heading "Taxation by the residence state—saving clause and relief from double taxation".

arising from the relevant taxable event(s), the source state would be required to grant or deny treaty benefits, to the same relevant taxpayer(s) and with respect to the same relevant taxable event(s), as a function of the residence state's qualification of entities and arrangements, as between those that are fiscally transparent and those that are fiscally opaque, and the consequent residence state attribution of any income arising from the relevant taxable event(s).

Whether the relevant taxpayer(s) and event(s), from the perspective of the source state, would be or would not be taxable under the domestic law of the source state if that state had the same approach as the residence state to the qualification of entities and arrangements, as between those that are fiscally transparent and those that are fiscally opaque, is not intended to affect the determination of whether or not they are taxable under the domestic law of the source state. For example, where the source state sees an entity as being fiscally opaque and as a company that is a resident of that state, but the residence state of a member of the entity sees the entity as being fiscally transparent, the fact that the residence state would regard a distribution from the entity as a non-taxable partnership distribution, or as a non-event in the case of a single-member entity, and that this would also be viewed as a non-taxable distribution or non-event under the domestic law of the source state if it had the same approach as the residence state to the qualification of entities, are not intended to affect the source state's qualification of the distribution as a taxable distribution—a dividend within Article 10—from a company that is a resident of that state.³² However, in applying the treaty with respect to that dividend, and in determining whether to grant or deny treaty benefits with respect to that dividend, it is intended that the source state would be required to apply Article 1(2) of the OECD Model if that dividend is considered to be derived *by or through* a fiscally transparent entity—which in this example would have to be the dividend recipient rather than the entity making the distribution, in order to determine what treaty benefits would be available or denied. Another way to put it—more simply—is that proposed Article 1(2) of the OECD Model is intended to affect the availability of treaty benefits for income that is considered by a source state to be derived *by or through* a fiscally transparent entity rather than income that is considered by the source state to be derived *from* a fiscally transparent entity. The income item relevant to the analysis is that received by a relevant fiscally transparent entity, not one that is paid by a fiscally transparent entity, unless of course the item is paid by one fiscally transparent entity to another.³³

Another consequence of proposed Article 1(2) of the OECD Model being intended to apply only in respect of income considered to be derived *by or through* rather than *from* a fiscally transparent entity is that it is not intended to affect treaty benefits that might otherwise be available in respect of a payment by the entity that is deductible under the domestic law of the source state

³² See Example 18 in the Partnership Report, above fn.8, as well as the discussion below under the heading “Taxation of distributions from the entity by the source state”.

³³ It should be noted, for example, by way of contrast, that provisions on fiscally transparent entities were added to the Canada-United States Treaty by the 2007 Protocol thereto—and there are three such provisions, namely Arts IV(6) and IV(7)(a) dealing with income derived by or through fiscally transparent entities, and Art.IV(7)(b) dealing with income derived from fiscally transparent entities. Moreover, the caption of the analogous US Treasury Regulations (Internal Revenue Service 26 CFR Part 1) (i.e. §1.894-1(d)(1), referred to herein as the “894(c) Regulations”) is “Special rule for items of income received by entities” and the first sentence refers to “an item of income received by an entity”. These regulations also contain separate provisions for payments by or from fiscally transparent entities—applicable to “domestic reverse hybrid” entities, under §1.894-1(d)(2).

even if it does not effectively result in taxation in the residence state of the recipient because of a conflict of qualification.³⁴ This might be, for example, because the residence state either grants the member a deduction that essentially corresponds to and offsets the inclusion resulting from the payment, or treats the payment as a non-taxable distribution, or just disregards the payment altogether. However, this is a manifestation of hybrid mismatches that is separately addressed in the Hybrids Report, and in certain treaties or domestic laws.³⁵

A final general observation with regard to the phrase “income derived by or through an entity or arrangement” is that its components align with the two main paradigms at which it is directed, and the two main functions it is intended to fulfill. First, there is the reference to “income derived by ... an entity”, which suggests that the source state sees the entity as one that is fiscally opaque, and derives the income (and seeks to claim treaty benefits) in its own right rather than as an agent or nominee or other intermediary for some other person. Secondly, there is the reference to “income derived ... through an entity”, which suggests that the source state sees the entity as one that is fiscally transparent, and thus sees the members of the entity as those that derive the income, through and in accordance with their interests in the entity. Understanding these references from the perspective of the source state is consistent with the earlier observation that proposed Article 1(2) of the OECD Model is not intended to affect the determination of the persons or events which the source state is taxing. Where the source state sees the entity as one that is fiscally opaque, and derives the income in its own right, then treaty benefits would normally be granted by the source state if the entity was a resident of the other state entitled to those benefits, which would normally be the case where the entity is also fiscally opaque in the other state. It is where the entity is not also fiscally opaque—and thus normally “liable to tax”, etc.—in the other state that there is a mismatch to which proposed Article 1(2) of the OECD Model is directed—directing the source state to overlook what it sees as fiscal opacity (and consequent denial of treaty benefits) and to instead *grant* treaty benefits not *to* different persons (since it is not taxing different persons) but (to the entity) *with reference to* the benefits that different persons would be entitled to on the same income—being the members of the entity to the extent that they are residents of the other state. In contrast, where the source state sees the entity as fiscally transparent and thus sees the members of the entity as those that derive the income through the entity, it would normally grant treaty benefits to those members in the absence of a provision such as proposed Article 1(2) of the OECD Model or similar rule or principle, and regardless of the other state’s treatment of the entity. Accordingly, here the intended effect of proposed Article 1(2) of the OECD Model is to *deny* treaty benefits that would otherwise be granted by the source

³⁴ See Example 13 in the Partnership Report, above fn.8, where there is no suggestion that the source state should altogether deny treaty benefits in such a case, and it is stated that “partner A is clearly entitled to the benefits of the R-P Convention”.

³⁵ See Hybrids Report, above fn.1, Ch.3 which includes proposed measures on “disregarded hybrid payments”, as well as the Canada-US Treaty Art.IV(7)(b) and the 894(c) Regulations s.1.894-1(d)(2). These 894(c) Regulations apply notwithstanding any contrary rules in a US treaty. For a more detailed discussion of the provisions on fiscally transparent entities in the Canada-US Treaty Arts IV(6) and (7)(a) and (b), see M. Darro and A. Nikolakakis, “The New Rules on Limitation on Benefits and Fiscally Transparent Entities”, *Report of Proceedings of Sixty-First Tax Conference, 2009 Conference Report* (Toronto: Canadian Tax Foundation, 2010), 26:1-59.

state—where the other state sees the entity as opaque, except to the extent that it sees the entity as a resident of the other state.³⁶

Relationship to current Commentaries

The current Commentaries already incorporate the Partnership Report³⁷ but, as noted in the Hybrids Report, “some countries have found it difficult to apply the conclusions of the Partnership Report”.³⁸ Indeed, it would seem to be fair to say that the tax authorities in some countries found it *impossible* to apply the conclusions in the Partnership Report, particularly with reference to entities regarded by them as companies or otherwise fiscally opaque.³⁹ The main reason for this is that many states have traditionally applied tax treaties on the basis of their own attribution, qualification and interpretation rules and principles, and not on the basis of those which may be applicable under the laws of the other state party to a particular treaty.⁴⁰ That is the innovation contemplated by the Partnership Report—that source states should apply tax treaties on the basis of the attribution and to some extent the qualification (and more general tax treatment) rules and principles applicable under the laws of the other state. The stated rationale for this approach (referred to as a “principle”) is that “the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident”.⁴¹

While the factual context in which income arises and other aspects of the factual context are of course important in general for the application of a provision of a particular tax treaty, only facts and circumstances that are required to be tested in accordance with the provisions of the particular treaty (and the domestic laws of the taxing state) are determinative. If the provisions of a particular treaty do not test the treatment of the income from the perspective of the residence state (for example, by virtue of a “subject to tax” provision, or a provision such as proposed Article 1(2) of the OECD Model), then facts and circumstances that go toward determinations in that regard would be relevant or not only as a function of the domestic laws and practices of the source state. As discussed below in greater detail, some states—the US in particular—have domestic law provisions that mandate determinations with respect to treatment in the residence state, while others have and rely on administrative practices to a similar effect, while still others have neither.⁴² If all bilateral treaties had a provision such as proposed Article 1(2) of the OECD

³⁶ Under the Canada-United States Treaty, the two functions—of granting benefits and of denying benefits—are fulfilled by separate provisions—respectively, Arts IV(6) and IV(7)(a). In that and certain other respects these particular provisions are unusual.

³⁷ The Partnership Report, above fn.8.

³⁸ Hybrids Report, above fn.1, para.435.

³⁹ The application of the conclusions in the Partnership Report, above fn.8, by the countries represented by the authors is discussed below.

⁴⁰ This is consistent with the OECD Model Art.3(2). See, however, the comment in the Partnership Report, above fn.8, para.62 where it says that Art.3(2) is not in point because it is a question of the factual context and not an interpretive issue, and that if it is in point then the context otherwise requires.

⁴¹ See the Commentaries on Art.1 para.6.3.

⁴² While a detailed discussion of the classification of entities under the laws of the states represented by the authors is beyond the scope of this article, it should be noted that none of these states in general classifies entities as a function of their classification under the tax laws of another state, except South Africa and Australia which have domestic

Model, then the treatment of the income from the perspective of the residence state would be relevant in all cases under such a provision.⁴³ However, there would still be the possibility that different states would interpret and apply such a provision differently, as discussed below.

Moreover, as noted above, proposed Article 1(2) of the OECD Model, while mandating determinations with respect to the attribution of the income from the perspective of the residence state, is not intended to preclude the source state from applying its own rules and principles exclusively in determining which person is the proper taxpayer in respect of the particular item of income (before looking to the attribution rules of the residence state with respect to such income). Indeed, the Partnership Report states that:

“Where income is derived from a particular State, the determination of the tax consequences in that State will first require the application of the domestic tax laws of that State. It is the

hybrid rules (see below). In general, these states classify entities, and make similar or related determinations, based on their respective general principles, and subject to any applicable specific provisions in their laws. For a more detailed discussion, see J.F. Avery Jones, et al., “Characterization of Other States’ Partnerships for Income Tax” (2002) 56(7) *Bulletin for International Taxation* 288 and [2002] BTR 375, among many other sources. Various aspects of this issue area, and related issues, have also been addressed over the decades in the proceedings and Cahiers of the International Fiscal Association, including the following: Q.H. Zhou, “Qualification of taxable entities and treaty protection” (2013) 99b *Cahiers de Droit Fiscal International* 219, J.C. Wheeler, “Conflicts in the attribution of income to a person” (2007) 92b *Cahiers de Droit Fiscal International*, International Fiscal Association Staff, “International income tax problems of partnerships” (1995) 80a *Cahiers de Droit Fiscal International*, “The disregard of a legal entity for tax purposes” (1989) 74a *Cahiers de Droit Fiscal International*, “Recognition of foreign enterprises as taxable entities” (1988) 73a *Cahiers de Droit Fiscal International*, “Partnerships and joint enterprises in international tax law” (1973) 58b *Cahiers de Droit Fiscal International*, “Taxation with regard to the earnings of limited companies with international interests” (1939) 1 *Cahiers de Droit Fiscal International*.

Under South Africa’s domestic law statutory hybrid rules, any “partnership, association, body of persons or entity” that is formed under foreign law is treated as being fiscally transparent in South Africa if it is not liable or subject to income tax in its country of formation but its members are required to “take into account” their interest in such an entity in that country (the definition requires *all* members to have an income tax liability in the country of formation in respect of their member’s interest). If the foreign country concerned does not have an income tax, then the test is whether receipts or expenses are concurrently allocated to members in terms of an agreement between them, and distributions to members should not exceed allocations agreed between them (see the definition of “foreign partnership” in the Income Tax Act, 1962 (Act No.58 of 1962) s.1. The stated aim of South Africa’s domestic hybrid rule is twofold: to establish “certainty about the tax treatment of foreign LLPs and LLCs because of their growing use by South Africans investing offshore and foreigners investing in South Africa” and to “assist in curbing some forms of cross-border entity arbitrage that often results from the different treatment of entities under different jurisdictions” (Explanatory Memorandum, Taxation Laws Amendment Bill, 2010, 86). In Australia, in general they characterise LPs, LLPs and LLCs as companies under domestic tax law. However, for the purposes of their CFC rules and as an election for foreign investment funds (but not in the inbound context) these entities are treated as fiscally transparent in Australia if they are treated as fiscally transparent under the tax law of their country of formation and not treated as a resident under another foreign country’s tax law (see Division 830 “Foreign Hybrids” of the Income Tax Assessment Act 1997). There was also ambivalence in France with regard to the relevance of foreign tax classification after the decision of the Conseil d’Etat in the *Diebold* case (8 / 9 SSR, du 13 octobre 1999, 191191), which seems to have abated because of the more recent decision in the *Artemis* case (3 / 8 / 9 / 10 SSR, 24/11/2014, 363556)). In Switzerland, the trend seems to be going in the opposite direction, with one decision of the Federal Tribunal holding that foreign tax characterisation is not relevant, and a later decision (involving a US LLC) taking foreign tax characterisation into account (see, respectively, Federal Tribunal Judgment 2C_664/2013 et 2C_665/2013 (28 April 2014), para.5.1, and Federal Tribunal Judgment 2C_894/2013 et 2C_895/2013 (18 September 2015), para.3.1 (also confirmed in Federal Tribunal Judgment 2C_123/2014 of 30 September 2015).

⁴³This may come about under the MLI, above fn.3—although, as noted, the adoption of provisions on fiscally transparent entities is not a minimum standard and is optional under the MLI.

provisions of these laws that will determine who may be subjected to tax on that income in that State.”⁴⁴

In this respect, the existing Commentaries and those to be added under the proposals are consistent in principle, although the latter would be more explicit—stating that proposed Article 1(2) of the OECD Model “only applies for the purposes of the Convention and does not, therefore, require a Contracting State to change the way in which it attributes income or characterizes entities for the purposes of its domestic law”.⁴⁵

In other respects, it is less clear whether the proposals are intended to modify the outcomes (and analysis) contemplated by the current Commentaries (and the Partnership Report), putting aside the specific cases of application to entities other than partnerships and to partly transparent entities. As noted above, the proposals would add new paragraphs to the Commentaries, but would not replace the existing paragraphs. Thus, one question is whether both the existing and the new paragraphs would be applicable to fully transparent partnerships, and only the new paragraphs would be applicable to partly transparent partnerships and other entities. In the authors’ view it is doubtful whether such a bifurcated approach would be intended, but it would nevertheless be preferable for this to be clarified or at least for the older and newer Commentaries to be consolidated.

A further question is whether the addition of proposed Article 1(2) of the OECD Model, and the related additions to the Commentaries, would have implications outside the application of the distributive provisions in Articles 6 to 21 of the OECD Model by the source state.⁴⁶ For example, would these affect the application of the treaty by the residence state—in particular, the application of Article 23 of the OECD Model?⁴⁷ The earlier changes to the Commentaries to incorporate the Partnership Report⁴⁸ introduced new or revised paragraphs to the Commentaries on various other provisions—including Article 23. The Hybrids Report does not propose to

⁴⁴Partnership Report, above fn.8, para.27. See also, for example, paras 60 (Example 4) and 63 (Example 5). Reference may also be made to the Australian decision in *Resource Capital Fund III LP v Commissioner of Taxation* [2013] FCA 363 (Fed. Ct. of Austr.), where it had been decided at first instance that Australian taxation of certain gains on Australian real property interests was precluded by a provision such as proposed Art.1(2) in the treaty with the US, on the curious basis that the provision did not authorise taxation at the level of a third country partnership which was regarded as opaque by Australia and transparent by the US. This decision was reversed on appeal in respect of this aspect (see *Commissioner of Taxation v Resource Capital Fund III LP* [2014] FCAFC 37 (April 3, 2014)).

⁴⁵Proposed para.26.15 of the Commentaries on Art.1.

⁴⁶It would seem that the same considerations arise for taxes on capital so it is odd that proposed Art.1(2) in the OECD Model context is limited to income (as opposed to a US Model context given that the 2016 US Model like the 2006 US Model only covers income). Perhaps the scope of proposed Art.1(2) of the OECD Model should be extended to capital and Art.22.

⁴⁷To some extent, the MLI Provisions are broader than the HR Proposals in that MLI, above fn.3, Art.3(2) would address aspects of residence state taxation. However, the MLI Explanatory Statement, above fn.3, does note (in para.41) that Art.3(2) “implements changes related to the elimination of double taxation, as described in paragraph 64 of the [Treaty Benefits Report, above fn.12], which were agreed as part of the follow-up work on Action 6”. It is stated that this provision “is intended to modify the application of the provisions related to methods for the elimination of double taxation, such as those found in Articles 23A and 23B of the OECD and UN Model Tax Conventions”. The focus of those changes is to displace any obligations to grant exemption or credit for income or taxes that could be taxed or imposed by reason only of residence in contexts involving fiscally transparent entities. See the discussion below under “Taxation by the residence state—saving clause and relief from double taxation”.

⁴⁸The Partnership Report, above fn.8.

modify or add any Commentaries outside those on Article 1.⁴⁹ Depending on the particular Article in question, this may or may not be relevant from the perspective of certain states. Also, the Partnership Report⁵⁰ and the existing Commentaries do in various contexts note the existence of disagreements between states and other “difficulties” with respect to the application of various Articles,⁵¹ and do not purport to resolve these in a definitive manner. Neither does the Hybrids Report—which acknowledges that “the provision does not deal exhaustively with all treaty issues that may arise from the legal nature of certain entities and arrangements and may therefore need to be supplemented by other provisions to address such issues”.⁵²

The Partnership Report⁵³ and the existing Commentaries also in various contexts note (with some equivocation) alternative arguments that could be advanced to grant or deny treaty benefits in certain circumstances, including with respect to “beneficial ownership” issues in general.⁵⁴ The Hybrids Report does not propose to address these issues through further modifications of either the OECD Model or the Commentaries. On the contrary, the Hybrids Report is clear that:

“Whilst the paragraph ensures that the various allocative rules of the Convention are applied to the extent that income of fiscally transparent entities is treated, under domestic law, as income of a resident of a Contracting State, the paragraph does not prejudice the issue of whether the recipient is the beneficial owner of the relevant income. Where, for example, a fiscally transparent partnership receives dividends as an agent or nominee for a person who is not a partner, the fact that the dividend may be considered as income of a resident of a Contracting State under the domestic law of that State will not preclude the State of source from considering that neither the partnership nor the partners are the beneficial owners of the dividend.”⁵⁵

Importantly, with respect to the application of Article 10(2)(a) of the OECD Model, which may turn on various issues including issues in relation to the (beneficial) ownership of equity interests in a company and of the dividends thereon, the Partnership Report⁵⁶ and current Commentaries proceed on the basis that benefits are excluded, so there is not much discussion of the receipt of dividends by partnerships. The Hybrids Report likewise does not address the issue to any

⁴⁹ Hybrids Report, above fn.1. However, the Treaty Benefits Report, above fn.12, para.64 would modify paras 23A(1) and 23B(1) and would add a new para.11.1 to the Commentary on Arts 23A and 23B and possible “other consequential changes”.

⁵⁰ The Partnership Report, above fn.8.

⁵¹ See also the formal reservations by several countries, which are not necessarily complete, since (for example) Canada did not enter a reservation but clearly did not accept the Partnership Report, above fn.8.

⁵² Hybrids Report, above fn.1. See proposed para.26.15 of the Commentaries on Art.1.

⁵³ The Partnership Report, above fn.8.

⁵⁴ See the Partnership Report, above fn.8, para.54 which discusses the beneficial owner concept being determined based on residence state rather than source state rules or principles.

⁵⁵ Hybrids Report, above fn.1. See proposed para.26.14 of the Commentaries on Art.1. This wording is also picked up in the Australian Explanatory Memorandum to the *Agreement between Australia and the Federal Republic of Germany for the Elimination of Double Taxation with respect to Taxes on Income and on Capital and the Prevention of Fiscal Evasion and Avoidance and Protocol*, signed at Berlin on 12 November 2015 (Germany-Australia Treaty (2015)) (Australian Explanatory Memorandum), at para.1.43. See Appendix B for greater detail.

⁵⁶ The Partnership Report, above fn.8.

significant degree,⁵⁷ leaving uncertainties in this regard, since the existing exclusion from Article 10(2)(a) for dividends paid to partnerships would not be modified under the Hybrids Report, but not all fiscally transparent entities to which proposed Article 1(2) of the OECD Model would be applicable would be partnerships, and that provision would not deem them to be partnerships.⁵⁸ It is therefore unclear whether the proposals are intended to affect the application of Article 10(2)(a) in respect of dividends paid to any or all fiscally transparent entities, although the authors think it would be strange if that were not intended, particularly because many OECD countries do not include the Article 10(2)(a) partnership restriction in (all of) their actual treaties. The authors believe this is a specific area of concern that should be addressed through a corresponding revision to paragraph 10(2)(a) of the OECD Model (and to the related Commentaries),⁵⁹ but no such revision is proposed in the Hybrids Report.⁶⁰

Accordingly, it is likely that this uncertainty and many other important “difficulties” may continue to arise notwithstanding the adoption of the changes proposed by the Hybrids Report. It would be preferable, in the authors’ view, for the OECD and potential signatories to the MLI to go further in achieving consensus on the application of tax treaties in the context of fiscally transparent entities, and in developing technical solutions to more of these “difficulties”, particularly with respect to the application of such a provision in relation to trusts and other entities or arrangements, as discussed below in greater detail.

A final point relates to administrative matters. Neither the Partnership Report nor the Hybrids Report really addresses the administrative aspects of obtaining refunds with respect to taxes withheld on amounts paid to fiscally transparent entities, by virtue of a provision such as proposed Article 1(2) of the OECD Model.⁶¹ For example, where the source state sees the entity as opaque but the residence state of a member sees it as transparent, it may be that the entity would be entitled to a refund of taxes withheld on payments to the entity but it may be uneconomic for the entity to pursue the matter if it relates to an insufficient number of its members. In such a case, would a member be entitled to obtain a refund? On the basis that proposed Article 1(2) of the OECD Model is not intended to affect the person(s) or event(s) that the source state is taxing, it is not at all obvious that a member would be entitled to obtain a refund of tax the source state

⁵⁷ Hybrids Report, above fn.1. Proposed para.26.13 of the Commentaries on Art.1 would note, for example, that “the income to which it applies will be considered to be ... dividends or interest ‘paid to’ for the purposes of Articles 10 and 11”. This is consistent with the general comments in existing para.6.4 of the Commentaries on Art.1.

⁵⁸ There is a Swedish ruling discussed in fn.121 where the tax administration seems to have concluded as a matter of interpretation rather than characterisation, following the US characterisation, that a US LLC could be within scope of the word “partnership” in the partial residence provision of their treaty.

⁵⁹ The authors believe it would be insufficient or ineffective to try to address the issue only through revisions to these Commentaries, since there is an unambiguous exclusion in Art.10(2)(a) so it is difficult to say this is a matter of interpretation, although such an interpretation was adopted in the context of the recent Germany-Australia Treaty (2015), above fn.55.

⁶⁰ Hybrids Report, above fn.1. See the discussion below under the headings “Beneficial ownership” and “Article 10(2)(a) of the OECD Model”.

⁶¹ The Partnership Report, above fn.8, and the Hybrids Report, above fn.1. Except to say a source state may wish to apply the refund mechanism, rather than reducing payer withholding obligations, as a compliance measure (see proposed para.26.6 of the Commentaries on Art.1, as well as the Partnership Report, above fn.8, para.78). To some extent, administrative issues are dealt with in the sample provision for CIVs in the Commentaries on Art.1 para.6.28. The authors do not in this article address administrative or compliance issues more generally, whether arising in relation to items that the source state may tax on a gross or net basis.

sees as having been imposed on the entity where the source state sees the entity as opaque. Could a member compel the entity to act—on the basis of some sort of derivative action? Even then, would the economic value of the refund be allocated exclusively to the member, or would it have to be shared with other members, given the terms and conditions of the membership interests, which may not contemplate such considerations? If the member does not compel the entity to act or does not get the full economic benefit of such a refund, will that member be entitled to a credit for that tax under the tax laws of its residence? The answers to these questions would seem to depend on the tax and non-tax laws applicable in particular countries and to particular entities.

Comparison to US Models and Internal Revenue Code, section 894(c) (the 894(c) Regulations)

US Models

Proposed Article 1(2) of the OECD Model is obviously inspired largely by US treaty practice. The 2006 US Model included the following provision as Article 1(6):

- “6. An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.”

The language of proposed Article 1(2) of the OECD Model compares to the language in the 2006 US Model as follows:

US Model	HR Proposals
	<u>For the purposes of this Convention,</u>
<u>An item of income, profit or gain</u>	income
derived	derived
through	<u>by or</u> through
an entity	an entity <u>or arrangement</u>
that is fiscally transparent	that is <u>treated as wholly or partly</u> fiscally transparent
under the laws of either Contracting State	under the <u>tax</u> law of either Contracting State
shall be considered	shall be considered
to be <u>derived by</u> a resident of a State	to be <u>income of</u> a resident of a <u>Contracting State</u>
to the extent that the <u>item</u> is treated for purposes of <u>the taxation law of such Contracting State</u>	<u>but only</u> to the extent that the <u>income</u> is treated, for purposes of <u>taxation by that State,</u>
as the <u>income, profit or gain</u> of a resident.	as the income of a resident of <u>that State.</u>

In the 2016 US Model, this provision has been modified slightly, in a manner that is closer to proposed Article 1(2) of the OECD Model, but it is still not identical:

- “6. For the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, but only to the extent that the item is treated for purposes of the taxation laws of such Contracting State as the income, profit or gain of a resident.”⁶²

As a result, proposed Article 1(2) of the OECD Model now compares to the language in the 2016 US Model as follows:

US Model	HR Proposals
For the purposes of this Convention,	For the purposes of this Convention,
<u>an item of income, profit or gain</u>	income
derived	derived
by or through	by or through
an entity	an entity <u>or arrangement</u>
that is treated as wholly or partly fiscally transparent	that is treated as wholly or partly fiscally transparent
under the <u>taxation laws</u> of either Contracting State	under the tax law of either Contracting State
shall be considered	shall be considered
to be <u>derived by</u> a resident of a Contracting State,	to be <u>income of</u> a resident of a Contracting State
but only to the extent that the <u>item</u> is treated for purposes of the <u>taxation law of such Contracting State</u>	but only to the extent that the <u>income</u> is treated, for purposes of <u>taxation by that State,</u>
as the <u>income, profit or gain</u> of a resident.	as the income of a resident <u>of that State.</u>

Arguably, none of these differences in wording implies or requires a different interpretation of the purpose or effect of the provision. An example is the reference to “income, profit or gain” in Article 1(6) of the US Models, compared with the reference to “income” in proposed Article 1(2) of the OECD Model. While the wording of the provision in the US Models is clearer and thus preferable to the wording that would be in the OECD Model, the latter can and is intended to be interpreted to the same effect.⁶³ Similarly, the references in the OECD Model provision to an “entity or arrangement” (rather than just to an “entity”),⁶⁴ and to it being “wholly or partly fiscally transparent” (rather than just to it being “fiscally transparent” as under the 2006 US Model), do not imply or require an interpretation of the purpose or effect of the OECD Model or the 2016 US Model provision that is different from the intended interpretation of the purpose or effect of the 2006 US Model provision, read in light of the US Model Technical Explanation, and in light of US domestic law and practice (including the 894(c) Regulations), under which it is clear that both entities and arrangements are intended to be within scope and that the relevant

⁶² Underlining represents differences between the two US Models.

⁶³ See, for example, proposed para.26.13 of the Commentaries on Art.1. This view is also consistent with an interpretation of the generic reference to “income” in other places which can, depending on the circumstances, cover Articles using different terms, such as the OECD Model Art.7(4) and Art.23.

⁶⁴ Although we do think the word “arrangement” is ambiguous in this context. See the discussion below under the heading “Beneficial ownership” and in fn.137.

determinations are to be made on an “item by item” basis and not on an “entity by entity” basis.⁶⁵ Similarly, although the 2006 US Model provision referred to source state attribution “to the extent” of residence state attribution, and did not say “but only to the extent”, it is clear that both provisions are intended equally to grant and to deny treaty benefits.⁶⁶

The 894(c) Regulations

As noted above, proposed Article 1(2) of the OECD Model is inspired heavily by Article 1(6) of the US Models, which are read and interpreted, by the US at least, in accordance with the 894(c) Regulations. It is therefore relevant for states to have an understanding of these regulations and of how they may assist in or reflect upon the interpretation of proposed Article 1(2) of the OECD Model.⁶⁷

For example, and quite importantly, it is not clear—despite the use of identical wording in this regard—that the same interpretation and effect are intended with respect to the expression “fiscally transparent”, which is fundamental to the application of these provisions. The 894(c) Regulations set out a number of statements and examples intended to clarify the interpretation of this expression. The Hybrids Report, for its part, would simply introduce the following general statements (emphasis added):

“The concept of ‘fiscally transparent’ used in the paragraph refers to situations where, under the domestic law of a Contracting State, *the income (or part thereof) of the entity or arrangement is not taxed at the level of the entity or the arrangement but at the level of the persons who have an interest in that entity or arrangement.* This will normally be the case where the amount of tax payable on a share of the income of an entity or arrangement is determined separately in relation to the personal characteristics of the person who is entitled to that share so that the tax will depend on whether that person is taxable or not, on the other income that the person has, on the personal allowances to which the person is entitled and on the tax rate applicable to that person; *also, the character and source, as well as the timing of the realisation, of the income for tax purposes will not be affected by the fact that it has been earned through the entity or arrangement.* The fact that the income is computed at the level of the entity or arrangement before the share is allocated to the person will not affect that result. [footnote] States wishing to clarify the definition of ‘fiscally transparent’

⁶⁵ There can be entities that may be regarded as being “translucent”—being transparent as to some items or members but opaque as to others.

⁶⁶ Some treaties distinguish between granting and denying benefits in separate provisions. See, for example, the Canada-US Treaty Arts IV(6) and (7). Some treaties make this dependent on type of income, such as where treaty benefits are not denied by a source state to dividend income derived by an entity that is fiscally opaque in (but not a treaty resident of) the residence state of a member, since the income would not have been taxable in the residence state in any event if the recipient entity was fiscally transparent in all states. This is discussed below in greater detail.

⁶⁷ Admittedly, it is less likely for the courts of some states to be inclined to refer to these regulations as an aid in interpreting the OECD Model Commentaries, or the provisions of their own treaties or of the MLI, above fn.3. Moreover, the status of such regulations under the Vienna Convention on the Law of Treaties is not particularly clear. See Vienna Convention on the Law of Treaties, signed at Vienna on May 23, 1969, UN doc. A/Conf. 39/27, fourth annex, UNTS 1155/331.

in their bilateral conventions are free to include a definition of that term based on the above explanations.”⁶⁸

In addition, the Hybrids Report would introduce the following statements (emphasis added):

“In the case of an entity or arrangement which is treated as partly fiscally transparent under the domestic law of one of the Contracting States, only part of the income of the entity or arrangement might be taxed at the level of the persons who have an interest in that entity or arrangement as described in the preceding paragraph whilst the rest would remain taxable at the level of the entity or arrangement. This, for example, is how some trusts and limited liability partnerships are treated in some countries (i.e. in some countries, the part of the income derived through a trust that is *distributed* to beneficiaries is taxed in the hands of these beneficiaries whilst the part of that income that is *accumulated* is taxed in the hands of the trust or trustees; similarly, in some countries, income derived through a limited partnership is taxed in the hands of the general partner as regards that *partner's share of that income* but is considered to be the income of the limited partnership as regards the *limited partners' share* of the income). To the extent that the entity or arrangement qualifies as a resident of a Contracting State, the paragraph will ensure that the benefits of the treaty also apply to the share of the income that is attributed to the entity or arrangement under the domestic law of that State (subject to any anti-abuse provision such as a limitation-on-benefits rule).”⁶⁹

These statements are ambiguous, in particular, with respect to the relevance to the application by a Contracting State of proposed Article 1(2) of the OECD Model of the effect under the tax law of the other state of distributions from an entity (or arrangement).⁷⁰

The 894(c) Regulations are clear that being “fiscally transparent” requires the underlying income to retain its character, source and timing “whether or not distributed”.⁷¹ In addition, those

⁶⁸ Hybrids Report, above fn.1. See proposed para.26.10 of the Commentaries on Art.1. It seems clear that the origin of this formulation of the test for fiscal transparency—that is, that the character and source, as well as the timing of the realisation, of the income for tax purposes is not affected by the fact that it has been earned through the entity or arrangement—is the 894(c) Regulations, as well as the US Model Technical Explanation. What is less clear is whether these words in proposed para.26.10 of the Commentaries on Art.1 are intended to be interpreted in the same manner as discussed and explained in the 894(c) Regulations and their examples.

⁶⁹ See proposed para.26.11 of the Commentaries on Art.1.

⁷⁰ The Partnership Report, above fn.8, does not address this issue. The authors would note that the concept or event of “distribution” may be treated differently by various states. For example, for some states and in some contexts, such as with respect to the taxation of trusts and their beneficiaries, distribution may be treated as being interchangeable with definitive entitlement, and fiscal transparency or at least member-level taxation rather than entity-level taxation may arise by virtue of definitive entitlement short of physical distribution.

⁷¹ See, for example, the 894(c) Regulations s.1.894–1(d)(3)(ii)(A), which also states that “[i]n determining whether an entity is fiscally transparent with respect to an item of income in the entity’s jurisdiction, it is irrelevant that, under the laws of the entity’s jurisdiction, the entity is permitted to exclude such item from gross income or that the entity is required to include such item in gross income but is entitled to a deduction for distributions to its interest holders”. Interestingly, the 2006 US Model Technical Explanation does not explicitly state any such “whether or not distributed” requirement for an entity to be considered to be “fiscally transparent”, although the authors understand that the US Model’s references to “fiscally transparent” are interpreted in a manner that is consistent with these regulations, presumably in accordance with Art.3(2). Moreover, that would be consistent with the statement in the US Model Technical Explanation that “[i]n general, paragraph 6 relates to entities that are not subject to tax at the entity level, as distinct from entities that are subject to tax, but with respect to which tax may be relieved under an integrated

regulations set out additional commentary and 12 examples to clarify the interpretation of that expression and other aspects of the application of these regulations.⁷² In Examples 4 and 5, the 894(c) Regulations contrast their application with respect to a “grantor trust” and a “complex trust”.⁷³

In Example 4, the “grantor trust” example, the premise is that “Country Y requires M [the grantor] to take into account all items of A’s income [i.e. the trust’s income] in the taxable year, whether or not distributed to M, and determines the character of each item in M’s hands as if such item was realized directly from the source from which realized by A.” The conclusion is that “under the laws of Country Y, A is fiscally transparent”.⁷⁴

In contrast, in Example 5, the “complex trust” example,⁷⁵ the conclusion is that “A is not fiscally transparent ... under the laws of Country Y”. The distinction between the two does not depend on whether or not the trust in fact accumulates rather than currently distributes its income, or on whether that income retains its character in the hands of M. The example specifically posits that “[a]lthough the trust document governing A does not require that A distribute any of its income on a current basis, some distributions are made currently to M”, and that “[u]nder the laws of Country Y, with respect to current distributions, the character of the item of income in

system”. There are also several statements in various Technical Explanations to actual US bilateral tax treaties that indicate that their fiscally transparent entity (FTE) provisions are intended to be interpreted in a manner consistent with the 894(c) Regulations.

⁷²The examples are in the 894(c) Regulations s.1.894-1(d)(5).

⁷³Under the US “grantor trust” rules in 26 U.S.C. (US Code) Pt I, Subpart E - Grantors and Others Treated as Substantial Owners, the income and activities of the trust (or a portion of a trust) can be attributed in the first place to the “grantor”. The “grantor” is a person that holds certain powers over the trustee or the corpus of the trust. Under US Code §672(f)(1) and (2), however, attribution to a grantor only applies to the extent such application results in an amount being currently taken into account (directly or through one or more entities) in computing the income of a citizen or resident of the US or a domestic corporation (or CFC) unless either the power to revest absolutely in the grantor title to the trust property is exercisable solely by the grantor (without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor), or the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.

The US Code also addresses the “simple trust”, which is a trust (or a portion of a trust) other than a “grantor trust”, but in respect of which the trustee is required to make current distributions as specified under the trust—either of income only or income and other amounts. The treatment of the income of a “simple trust” is a bit more ambiguous in that it is more difficult to consider it to be attributed in the first place to the relevant beneficiaries. However, although the trust is a taxable unit (under US Code Pt I, Subpart A - General Rules for Taxation of Estates and Trusts), it can be said that the income of the trust that is required to be currently distributed retains its character, timing and source in the hands of the beneficiaries whether or not it is in fact distributed, through the application of a combination of a deduction for the trust and corresponding inclusions for the beneficiaries, together with character-retention supporting rules (under US Code §§ 651 – 652, and 661 – 662).

A “complex trust” is a trust (or a portion of a trust) that is not a “grantor trust” or a “simple trust”, and in respect of which the trustee has significant discretion and powers with respect to distributions under the trust. A “complex trust” is also a taxable unit, but can deduct income that is distributed to beneficiaries (under US Code §§ 661), and such distributed income does retain its character and source for US tax purposes (under US Code §§ 662), but not necessarily its timing because, other than in the case of income required to be currently distributed, it is only attributed to beneficiaries in the tax year in which the distribution is made or credited, or required to be made.

⁷⁴CFR Title 26 Chapter I Subchapter A Pt 1 s.1.894-1(d)(5), Example 4, Treatment of grantor trust.

⁷⁵CFR Title 26 Chapter I Subchapter A Pt 1 s.1.894-1(d)(5), Example 5, Treatment of complex trust. In this example, the entity is treated as a “grantor trust” under the laws of the source state (i.e. the US), but as a “complex trust” under the laws of the residence state. This seems to mean that, for US tax purposes, a discretionary trust that is not a “grantor trust” under the laws of the residence state is not “fiscally transparent” even if in fact the trustee exercises its discretion and allocates all of the trust income every year to beneficiaries.

the hands of the interest holder is determined as if such item were realized directly from the source from which realized by A”. Thus, the distinction depends on the proposition that “under the laws of Country Y, M is not *required* to take into account his share of A’s interest income on a current basis *whether or not distributed*” (emphasis added).⁷⁶

This seems to conflict directly with the statement in proposed paragraph 26.11 of the Commentaries on Article 1 with respect to trusts that “in some countries, the part of the income derived through a trust that *is distributed* to beneficiaries is taxed in the hands of these beneficiaries whilst the part of that income that is *accumulated* is taxed in the hands of the trust or trustees” (emphasis added), as an example of an entity or arrangement which is regarded under these proposed Commentaries as being “partly fiscally transparent”.⁷⁷ To be consistent with US practice in this regard, the statement would have to say that “in some countries, the part of the income derived through a trust that is *required to be currently distributed to, or vests indefeasibly in, particular* beneficiaries is taxed in the hands of these beneficiaries”. It is not clear, however, that these comments are intended necessarily to be consistent with US practice.

One point which seems clear under the 894(c) Regulations is that CFC rules and similar regimes are not (normally) considered to give rise to “fiscally transparent” treatment for the affected entities and interest holders, as discussed in Example 6⁷⁸ in those regulations. What is not clear is the logic. The premises include that “Country Z does require T, who is treated as owning 60-percent of the stock of A, to take into account its respective share of the royalty income of A under an anti-deferral regime applicable to certain passive income of controlled foreign corporations”. On this premise, the stated analysis in its entirety is that (emphasis added):

“T is still not eligible to claim treaty benefits with respect to the royalty income. T is not treated as deriving the U.S. source royalty income for purposes of the U.S.-Z income tax treaty under paragraph (d)(3)(iii) of this section because T is only required to take into account its pro rata share of the U.S. source royalty income *by reason of Country Z’s anti-deferral regime*.”⁷⁹

This is counter-intuitive because, presumably, under Country Z’s anti-deferral regime, current taxation of T would be mandated regardless of whether or not the underlying income is distributed, and the example does not posit that the character or source of the underlying income would not be retained under this anti-deferral regime. On the contrary, it seems to suggest that it would be retained, in stating that T would be required “to take into account its respective share of the

⁷⁶ See also CFR Title 26 Chapter I Subchapter A Pt 1 s.1.894-1(d)(5), Example 9, Treatment of investment company when entity receives distribution deductions, and all distributions sourced by residence of entity, and Example 10, Item by item determination of fiscal transparency, which deal with an investment company that is “entitled to a distribution deduction for amounts distributed to its interest holders on a current basis”, concluding that this is not sufficient to cause it to be fiscally transparent, and regardless of whether or not there is also a change to character and source (there is such a change in Example 9 but in part there is no change in Example 10). There is also Example 7, Treatment of contractual arrangements operating as collective investment vehicles, which features contractual arrangements operating as collective investment vehicles, without legal personality, and which is not considered to be “fiscally transparent” because “[u]nder the laws of Country X, however, investors in A only take into account their respective share of A’s income upon distribution from the Common Fund”.

⁷⁷ Of course, trusts also raise some unique “beneficial owner” issues, which are considered below.

⁷⁸ CFR Title 26 Chapter I Subchapter A Pt 1 s.1.894-1(d)(5), Example 6, Treatment of interest holders required to include passive income under anti-deferral regime.

⁷⁹ CFR Title 26 Chapter I Subchapter A Pt 1 s.1.894-1(d)(5), Example 6, above fn.78, (ii) Analysis.

royalty income of A”.

There certainly are differences between the manner in which particular CFC regimes operate, and there can be debate as to whether they may operate to tax the underlying income as such in the hands of the relevant members rather than taxing the members in respect of a distinct and fictitious item of income, whether as a deemed dividend or just deemed income other than the underlying income as such.⁸⁰ Interestingly, this is not a distinction that is drawn out by Example 6 of the 894(c) Regulations.⁸¹ Rather, the distinction that seems to be drawn is between what could be referred to as a “systemic regime” *versus* an “anti-deferral” regime, but that distinction is not always obvious—in particular, in the context of the treatment of trusts, and in various other situations where there is attribution for tax purposes that is inconsistent with legal ownership or entitlement.⁸²

The Hybrids Report⁸³ does not address the issue, so we are left wondering whether or not it may be that some or all CFC-type anti-deferral regimes could be within the scope of proposed Article 1(2) of the OECD Model. It should also be noted that, in the OECD’s 5 October 2015 final report on *Designing Effective Controlled Foreign Company Rules* (the CFC Report), the OECD posits that (emphasis added):

“Existing CFC rules take several different approaches, including treating attributed income as a deemed dividend or *treating it as having been earned by the taxpayer directly* (i.e., the CFC is *essentially treated as a partnership or flow-through entity* but only for the purposes of attributing CFC income).”⁸⁴

It is unclear whether or not “essentially” treating something as a partnership or flow-through entity, as contemplated by the CFC Report, is a treatment that is intended by the Hybrids Report to come within the scope of proposed Article 1(2).⁸⁵ This also gives rise to an important policy

⁸⁰ See Appendix C for a review of the manner in which the CFC rules operate in this respect in the countries represented by the authors.

⁸¹ This question is also not addressed in the US Model Technical Explanation, although there is also no suggestion there that CFC-type anti-deferral regimes are intended to be within scope.

⁸² Yet a further question is whether or not the requirements of being “fiscally transparent” would be met in situations where the tax regime in question includes other forms of income attribution rules—for example, to attribute income from one spouse to another or from dependent children to their parents, or for that matter in relation to a broader range of regimes applicable in certain countries involving income attribution in respect of income or assets transferred with a tax-avoidance purpose. All of the countries represented by the authors include some such regimes. There is no clear guidance in this regard in the Hybrids Report, above fn.1, or in the US Models or US Model Technical Explanations or in the 894(c) Regulations, apart from any analogy that may be drawn from the treatment of the US “grantor trust” regime, or from Example 7 of the 894(c) Regulations (which as noted in fn.76, features contractual arrangements operating as collective investment vehicles, and posits that the arrangement “is treated as a partnership for U.S. income tax purposes”). Nevertheless, the authors doubt that it would be intended that the application of such attribution regimes should be within the scope (or defeat the application) of proposed Art.1(2) of the OECD Model. Based on what is posited in Example 7 of the 894(c) Regulations, this example supports the view that in US practice the word “entity” includes “a contractual arrangement without legal personality”, but it seems difficult to go from that type of an arrangement to the relationship between spouses or more generally still to their status as spouses.

⁸³ Hybrids Report, above fn.1.

⁸⁴ See OECD/G20 Base Erosion and Profit Shifting Project, *Designing Effective Controlled Foreign Company Rules, Action 3—2015 Final Report* (Paris: OECD Publishing, 2015), available at: <http://dx.doi.org/10.1787/9789264241152-en> [Accessed 30 June 2017], para.118.

⁸⁵ Losses generally do not flow through CFCs, but it is not clear under the Hybrids Report, above fn.1, whether an entity should be considered to be “fiscally transparent” if its income flows through but not its losses. This is true for at least certain partnerships or trusts in at least certain countries. Many countries have some limitations on the flow

question as to whether or not this type of regime should be within scope as a matter of principle, as discussed below.

Nevertheless, the authors doubt that proposed Article 1(2) is intended to encompass CFC regimes (or foreign trust regimes that operate in a manner similar to CFC regimes) other than any that may go so far as to treat the CFC (or trust) as a non-separate entity.⁸⁶ Perhaps a useful way to conceptualise the distinction is as between “primary attribution” and “secondary attribution” regimes. Under a “primary attribution” regime, the income in question is attributed in the first place to the particular taxpayer, such as where a state does not see a partnership (or a CFC or trust) as a distinct unit of taxation (with respect to a particular item of income) and thus attributes the partnership’s income in the first place to its members, through and by virtue of their interests in the partnership. In contrast, under a “secondary attribution” regime, the income in question is attributed in the first place to a different taxpayer (the “primary taxpayer”, under the state’s “primary attribution” regimes, whether that primary taxpayer would otherwise be taxable on that income or not—such as an exempt taxpayer or, in the context of a CFC or foreign trust regime, a non-resident taxpayer). Then, in the second place, the income of the primary taxpayer (or some derivative of that income) is (re)attributed to the particular taxpayer, as income of another person, under a specific regime (or it could be a principle), generally though not necessarily as an anti-abuse or anti-deferral measure.⁸⁷ The authors would argue that it is the effect of the regime (that is, whether it provides for “primary attribution” rather than “secondary attribution”) which is important rather than what motivated the introduction of the regime.⁸⁸ However, this distinction may be difficult to apply in certain cases, as the US “simple trust” example illustrates.⁸⁹

Perhaps another way to conceptualise this distinction—more simply—is as between regimes that have the effect of attributing the income of an entity or arrangement as such to its members (or beneficiaries) rather than seeing the latter as having a separate source of income (being their interests in the entity). The question, however, remains whether this must be automatic rather than requiring some action on the part of (the administrators of) the entity or arrangement. The phrase “whether or not distributed” does not directly or completely address this issue. On the one hand, a regime that positively requires a distribution (that is, a physical transfer) of the income is quite difficult to see as one that operates on the attribution of the income “whether or not distributed”. However, while distributions may be discretionary, not all discretionary actions

through of partnership losses, and losses generally do not flow through trusts in common law countries (although they do in some cases such as under the US “grantor trust” rules).

⁸⁶ As noted above in Appendix C, Swedish CFC rules treat the foreign entity as transparent, so they could be in this category.

⁸⁷ The regime may even be voluntary, such as under voluntary corporate grouping provisions applicable in certain states, or may be mandatory but still simply intended to achieve corporate group consolidation rather than having been introduced as an anti-abuse measure.

⁸⁸ In theory, even a regime that is intended simply to achieve corporate group consolidation could fall within the scope of proposed Art.1(2) of the OECD Model if it operates as a “primary attribution” regime whereby the subsidiaries of the parent are disregarded as separate entities for tax purposes (e.g. Australia’s “single entity” regime), rather than as a “secondary attribution” regime whereby the income of the subsidiaries is first attributed to them and only then (re)attributed to the parent (or consolidated with the income of the parent and of other subsidiaries) as the income of its subsidiaries.

⁸⁹ See the discussion above in fn.73.

are distributions. It does not seem to the authors that the phrase “whether or not distributed” precludes the application of proposed Article 1(2) of the OECD Model in cases where some discretionary action may be required short of actual distribution. For example, a trustee may have a discretion with respect to the allocation of income to specific beneficiaries but may also have the power to accumulate that same allocated income rather than distributing it. The same would be true of many normal partnerships. It is not at all uncommon in the context of professional partnerships, for example, for the managing partner(s) to review each member’s relative contribution for a particular year at the end of the year and to then determine each such partner’s relative income entitlement for the year, quite apart from any separate determination as to what portion, if any, of the partnership’s income is to be distributed currently rather than being accumulated for whatever common purposes. Indeed, even where the allocation is automatic (that is, fixed or determined before (the end of) the year) it is not uncommon for distributions to be conditional or even discretionary. Thus, in order for a regime to be regarded as one that results in “fiscally transparent” entities or arrangements (or at least gets over any “whether or not distributed” requirement), it may be sufficient that it can provide for income attribution in the absence of actual distribution (assuming retention of character, timing and source), regardless of any requirements that may be present under that regime with respect to allocation. In brief, the fact that allocation decisions may often be coupled with distribution decisions should not be a reason to treat the two as interchangeable, and any such “whether or not distributed” requirement should be considered to not be satisfied only where income attribution is conditional on distribution as such and results in the distribution being treated as coming from a separate source of income (that is, the distribution is the income).

Review of various issues

Several bilateral treaties concluded by the countries represented by the authors include provisions that are similar to (or have purposes similar to those in) proposed Article 1(2) of the OECD Model. Further, several of these bilateral treaties complement such provisions with additional provisions designed to address other issues—or to address them more directly, or differently. The discussion below highlights some of these issues and provisions, but without attempting to articulate a comprehensive review.

Fiscally transparent

The most basic question in relation to proposed Article 1(2) of the OECD Model is what the requirements are in order for an entity to be considered to be “fiscally transparent”. As noted above, the proposed changes to the Commentaries included in the Hybrids Report do contain certain statements in this regard (for example, that “the character and source, as well as the timing of the realization, of the income for tax purposes will not be affected by the fact that it has been earned through the entity or arrangement”), but also do not purport to address this question in a definitive manner, noting that “[s]tates wishing to clarify the definition of ‘fiscally transparent’

in their bilateral conventions are free to include a definition of that term based on the above explanations”⁹⁰.

To summarise, one can posit the following questions in relation to the interpretation and requirements of the term “fiscally transparent”:

1. Is there and should there be any “whether or not distributed” requirement—in particular, should proposed Article 1(2) apply to discretionary allocations/distributions where the character, source and timing are preserved?
2. Is there and should there be any “same-year” requirement—in particular, should treaty benefits be granted in respect of income that is distributed in a subsequent period, assuming it retains its character and source? A related question is whether any “same-year” requirement would be satisfied if the income must be taken into account by a member in a following period by virtue of a difference between the taxable period of the entity and that of a member.
3. How strict is the “same” character and source requirement? Do the character and source and *all other aspects* of the treatment of the income have to be *exactly* the same as they would be had the income been derived directly rather than through the entity?
4. How strict *should* the “same” character and source requirement be? Should treaty benefits be granted where the existence of the entity does result in a change to the character and source of the income but the income is nevertheless *taxable to the same extent* in the hands of the member (for example, as a taxable trust distribution rather than as taxable interest income derived through a trust)?
5. Does the attribution of the income of a CFC to its members result in the CFC being considered to be “fiscally transparent”—in particular, where the relevant CFC regime attributes the CFC’s income as such as opposed to resulting in a deemed dividend or other notional item of income? What about the application of other income attribution regimes? Should—and, if so, how should—“primary attribution” regimes be distinguished from “secondary attribution” regimes?
6. Where the entity is not “fiscally transparent” under the laws of a member’s residence state, should treaty benefits be denied by virtue of proposed Article 1(2) even where there would not have been any taxation in the residence state in any event (for example, because of a “participation exemption”) if the entity had been “fiscally transparent” under the laws of the residence state?⁹¹
7. Would and should treaty benefits be denied under proposed Article 1(2) where the particular item of income that is taxed by the source state is not of a type that is

⁹⁰ See proposed para.26.10 of the Commentaries on Art.1 of the OECD Model.

⁹¹ As discussed below, a related question, though not one that goes to the “fiscally transparent” requirement, is whether treaty benefits should be denied under proposed Art.1(2) in addition to the deductibility of the payment being denied under a “reverse hybrid rule” as described in Ch.4 of the Hybrids Report, above fn.1. Although these are distinct issues in some ways, they come together where the usual treatment in the source state is being altered in order to defeat “double non-taxation”. It is not necessary, and indeed it seems to some of the authors of this article to be inappropriate, to defeat “double non-taxation” more than once with respect to the same item of income.

recognised by the residence state, whether or not the entity is in general “fiscally transparent” under the laws of a member’s residence state?

Where different individuals or states stand on some of these questions to some extent depends on whether they see the principle which is sought to be implemented here as being that treaty benefits should be allowed or denied as a function of the presence or absence of a broader conception of mischief rather than the presence or absence of a narrower conception of immediate and primary attribution to a resident of the residence state. It is the authors’ hope, however, that states will consider these issues (dare we say these “difficulties”) and try to address them in the context of adopting or implementing provisions such as proposed Article 1(2) of the OECD Model either bilaterally or under Article 3 of the MLI.

This issue presents itself most acutely in relation to trusts, which are treated in a variety of ways under the domestic laws of different states,⁹² or may be unfamiliar under the laws of some (civil law) states.⁹³ Thus, there may be differences between the perspectives of various countries with respect to the necessity for or the application of the “whether or not distributed” requirement. For example, in light of its treatment of trusts, the authors understand that Australia would not consider this to be a requirement, and would thus consider a trust to be “fiscally transparent” even if current taxation and retention of character and source in the hands of the beneficiaries results from discretionary distributions to them.⁹⁴ The situation in other countries is less clear.⁹⁵

⁹² A detailed discussion of the treatment of trusts under the laws of various states is beyond the scope of this article.

⁹³ For example, there is no trust regime in German civil law, among other private law systems.

⁹⁴ That said, Australia probably does not attribute the ownership of trust assets or the conduct of trust activities to the beneficiaries as such, and hence has insisted on the addition of a specific provision for trusts to this effect since 1985 (such as the Germany-Australia Treaty (2015), above fn.55, Art.7(7)). For earlier treaties, a clarification (or override) to the same effect was inserted in the International Tax Agreements Act 1953 which implements Australia’s tax treaties. Exceptionally, the Australia-US Treaty Art.7(9) (inserted by the 2001 Protocol) applies the provision to fiscally transparent entities generally. The Australian Explanatory Memorandum indicates that “[t]he term ‘fiscally transparent entity’ has been used to cover any entity, not just trusts, that may be taxed on a ‘look-through’ basis (e.g., US limited liability companies treated as partnerships for US tax purposes)”, 47, para.2.11. US 2003 Technical Explanation to the 2001 Australia-US Protocol, 3, states that: “The Protocol does not change the basic rules of Article 7 (Business Profits) of the Convention. Rather, new paragraph (9) simply clarifies the treatment of fiscally transparent entities (including trusts) and beneficial owners thereof under Article 7 of the Convention. Australia requested this clarification because, under Australian law, the trustees of a trust, as the legal owner of the trust property, might be regarded as the only person having a permanent establishment (rather than the beneficiaries of the trust, who have a beneficial entitlement to the income but no legal ownership). Thus, absent this clarification, any permanent establishment resulting from that trade or business might be considered to be that of the trustees, rather than that of the beneficiaries.” One should not presume, however, that the drafters of the Technical Explanation had a full understanding of the US taxation of trusts, much less the Australian taxation of trusts.

⁹⁵ With respect to Italy, it may be noted that there are two Italian tax rulings (i.e. Ruling no. 17/E of January 27, 2006 and Ruling no. 167/E of April 21, 2008), involving foreign CIVs, where the Italian Revenue Agency seems to apply the Partnership Report approach and to allow treaty benefits to foreign participants in a “fiscally transparent entity” but only if the entity is bound to pay out its net proceeds at least on a yearly basis.

With respect to the UK, it may be noted here that, in the 24 July 2001 Exchange of Notes related to the 2001 Protocol to the UK-US Tax Treaty, the UK undertakes “exceptionally” to regard an item of income, profit or gain arising to a person as falling within the equivalent paragraph of that treaty (i.e. Art.1(8)) where another person is charged to UK tax in respect of that item of income, profit or gain either under, ICTA 1988 s.660A or s.739, or under, TCGA s.77 or s.86. It may be relevant that the income tax items are all cases where the character of income is not preserved, and the capital gains tax items are cases where an amount equal to the gains less losses of the year is charged on the settlor, rather than the settlor being treated as having made the gains. The Exchange of Notes also states that “a person shall be regarded as fiscally transparent under the laws of the United Kingdom in relation to an

Accordingly, three basic questions emerge, which states may wish to specifically address or clarify. First, does proposed Article 1(2) of the OECD Model incorporate a “whether or not distributed” requirement as a technical matter? The answer to this question is far from clear, and various countries may have different views in this regard, including as to what “distributed” really means, and as to whether a regime that attributes income based on discretionary allocation (separate from distribution) should be considered to result in fiscally transparent entities or arrangements. Secondly, there is the policy question of whether or not there should be any such requirement in principle. The third question is whether or not there should even be any strict “character, timing and source” retention requirement.

Whether or not distributed

It is the authors’ view that, from a policy perspective, there should not be any “whether or not distributed” requirement, at least not one that is overly strict, in order to qualify for treaty benefits as a substantive matter (that is, apart from withholding tax considerations). If the purpose of proposed Article 1(2) of the OECD Model is, in part, to “ensure that the benefits of tax treaties are granted in appropriate cases”, then it seems to the authors to be inappropriate to deny treaty benefits because of technical distinctions such as that current taxation and retention of character and source requires current distribution under the particular tax regime in question in the sense that the trust deed or domestic trust law must allocate income to beneficiaries on a current basis and that discretionary allocation/distribution by the trustee under a discretionary trust is not enough even if every year the trustee allocates the full income of the trust. If there is current taxation and retention of character (and possibly even if there is just current taxation), that should be enough to justify treaty benefits.

The limitation in the US regulations may be explained by the fact that the Regulations apply only to amounts subjected to withholding. In order for a withholding requirement to be imposed, eligibility for treaty benefits must be known at the time the income is paid. The FTE provision in treaties, however, applies to withholdable and non-withholdable amounts. In any event, tax administrators could address the issue either by relying on self-certification or by requiring that the taxpayer provide evidence of inclusion under CFC rules (and any other relevant evidence of treaty benefit entitlement) in an application for a refund.

Indeed, at least some of the authors of this article would suggest that consideration be given to expanding the scope of proposed Article 1(2) of the OECD Model to income that is taxable in the hands of a treaty resident within a more extended period of time—such as the statutory

item of income, profit or gain where a charge is made on another person on that item either: a) by virtue of section 13, Taxation of Chargeable Gains Act 1992; or b) because that other person has (or, under section 118, Finance Act 1993, is treated as having) an equitable right in possession in a trust.” This “exceptional” treatment by the UK, and the more general clarification, demonstrates that Contracting States that have different views in this regard would do well to specify the desired treatment.

In South Africa, under a judicially developed doctrine of the “conduit pipe”, either the existence of a vested right for a beneficiary under a trust or the exercise of discretion by a trustee to vest trust income or assets in a beneficiary determines current taxation of the beneficiary with retention of character and source, causing the trust to be considered transparent (*Amstrong v CIR* 1938 AD 343). When the “conduit pipe” is not brought into operation, the trust is considered by statute to be opaque and taxed as a separate person (Income Tax Act, 58 of 1962 s.25B). The “conduit pipe” principle can also operate partially.

period within which the source state may redetermine the tax consequences arising from the income in question.⁹⁶ The authors note that there are competing considerations here, including additional complexity and administrative difficulties in dealing with revisiting items in multiple years, and the fact that under certain regimes a deferral benefit might be present that may not be viewed as appropriate.⁹⁷ The additional complexity and administrative difficulties may be more manageable than addressing the issue of deferral benefit. Source states can adopt administrative practices that require the claimant to demonstrate that the relevant conditions have been satisfied, which presumably would likewise have to be done in order to verify treaty benefit entitlement even if a same-year requirement is adopted.⁹⁸ The deferral benefit must be addressed by some sort of mechanism that allows the source state, or some sort of requirement that obliges the residence state,⁹⁹ to increase its taxation of the income as a function of the time-value of money,¹⁰⁰ or it must be ignored within certain limits,¹⁰¹ or accepted as a reason to adopt a same-year requirement even if that may result in hardship in certain cases.¹⁰²

Character and source retention requirement

The authors would also argue that, from a policy perspective, the character and source retention requirement should be more flexible, accommodating situations in which a technical change of character and source nevertheless does not result in a change to ultimate tax liability. For example, leaving aside any differences in timing, the authors find it difficult to understand why benefits should not be granted in a situation where the beneficiary of a trust distribution is fully taxable

⁹⁶ The current proposal would admit “dual benefits” (concurrent and contemporaneous) where both the member and the entity are attributed the income under different state domestic laws (see para 6.5 of the existing Commentaries on Art. 1), so there should not be a conceptual problem of concurrent benefits that are not contemporaneous. See also the discussion below in fn.189.

⁹⁷ Reference may be made to the discussion in para.6.25 of the Commentaries on Art.1, which reviews some of these issues in relation to CIVs.

⁹⁸ The authors note that certain existing bilateral treaties require effective exchange of information between the source state and the entity’s state as a condition of applying their equivalent to proposed Art.1(2) of the OECD Model. See, for example, the UK-France Treaty (Art.4(5)), the Australia-France Treaty (Art.29(2)), the France-China Treaty (Art.4(4)), the France-US Treaty (Art.4(3)) and the Japan-Netherlands Treaty (Art.4(5)). Some bilateral treaties have an even narrower equivalent to proposed Art.1(2), which altogether exclude (or in any event do not include) third-country entities. See, for example, the Japan-France Treaty (Art.4(6)) (subject to the Protocol (item 13A) which provides for potential relief under the mutual agreement procedure), the Japan-UK Treaty (Art.4(5)) and the Japan-Switzerland Treaty (Art.4(5)). Proposed Art.1(2) would not have any such condition or exclusion, which is also consistent with Art.1(6) of the US Models and with most such provisions in US bilateral tax treaties.

⁹⁹ If the treaty benefit is initially denied by the source state, then there is less of a concern from that state’s perspective, since it will have had the interim use of the funds.

¹⁰⁰ Under the US “throw-back rules”, an interest charge is imposed on “accumulation distributions” from a foreign trust. See Code §666-68. Australia also has time value rules for distributions, to residents, of foreign income from foreign trusts where the income is not caught under the Australian transferor (“grantor”) trust regime.

¹⁰¹ With respect to timing, it should be noted that the 894(c) Regulations do contemplate a degree of slippage (see §1.894-1(d)(3)(ii)(B)):

“An interest holder will be treated as taking into account that person’s share of income paid to an entity on a current basis even if such amount is taken into account by the interest holder in a taxable year other than the taxable year of the entity if the difference is due solely to differing taxable years.”

¹⁰² If a same-year requirement is not adopted, a related issue is whether there should be any requirement that the income would have given rise to the particular treaty benefits (or equivalent benefits under that or another treaty) if it had been currently distributed—for example, to address situations in which there is a change to the residence or status of the relevant beneficiary or member.

on that distribution to the same extent as it would be taxable if the distribution had retained its character as, say, interest income. The authors note that the actual language of proposed Article 1(2) refers only to “the extent that the income is treated ... as the income of a resident of that State”. It does not actually refer to the income having the “same” treatment in the residence state as it would have if it had been earned directly by the members.¹⁰³ Thus, the language does seem to be open to a broader interpretation than that reflected in US practice.

Even if the “same” character, source and timing are retained as requirements, it is arguable in the authors’ view that they must be applied flexibly. It will be found under the domestic laws of many countries that tax transparency in partnership and trust situations does not always literally produce exactly the same outcome as if the income had been derived directly. For example, some countries aggregate business or partnership revenues and expenses,¹⁰⁴ and some countries¹⁰⁵ have rules limiting the pass-through of partnership losses to the extent of the partner’s investment in the partnership,¹⁰⁶ a restriction which would not apply if the income (that is, the loss) had been derived directly, and many countries do not allow the pass-through of trust losses.¹⁰⁷ Some existing treaties may go even further, referring to “taxation *in all respects* as though such amounts had been derived ... directly” (for example, Article 29 Australia-France 2006). The authors do not recommend the general proliferation of such terminology.

¹⁰³ In contrast, the Canada-United States Treaty Art.IV(6) refers to “the *treatment* of the amount under the taxation law of that State [being] *the same* as its treatment would be if that amount had been derived directly by that person” (emphasis added).

¹⁰⁴ The US Code s.702(a)(8) provides for pass-through on a net basis of residual items of income and deduction of a partnership (though items having a different tax treatment to a partner depending on its status, such as foreign source income or income having a particular character such as capital gain or loss, generally are required to be stated separately). The authors further note that the 894(c) Regulations provide that “an entity will be fiscally transparent with respect to the item of income even if the item of income is not separately taken into account by the interest holder, provided the item of income, if separately taken into account by the interest holder, would not result in an income tax liability for that interest holder different from that which would result if the interest holder did not take the item into account separately, and provided the interest holder is required to take into account on a current basis the interest holder’s share of all such nonseparately stated items of income paid to the entity, whether or not distributed to the interest holder”. They also provide that “[a]n interest holder will be treated as taking into account that person’s share of income paid to an entity on a current basis even if such amount is taken into account by such person in a taxable year other than the taxable year of the entity if the difference is due solely to differing taxable years”. See ss.(d)(3)(ii)(A) and (B), and (d)(3)(iii)(A) and (B). Reference may also be made to the following observation of the UK Supreme Court in *Anson v HMRC (Anson)* [2015] UKSC 44 (at [114]):

“The words ‘the same’ are ordinary English words. It should however be borne in mind that a degree of pragmatism in their application may be necessary in some circumstances if the object of the Convention is to be achieved, for example where differences between UK and foreign accounting and tax rules prevent a precise matching of the income by reference to which tax is computed in the two jurisdictions.”

¹⁰⁵ This includes Canada, Australia, Japan, South Africa, the UK and the US.

¹⁰⁶ Partner-level expenses or credits may also be treated differently than they would be if the related income or activities had been derived or carried on directly.

¹⁰⁷ This includes Canada except in the cases where the trust is essentially disregarded for tax purposes. This also includes Australia. Similarly, other than in the case of a “grantor trust”, the US generally does not allow pass-through of a trust’s losses prior to the liquidation of the trust (see Code §42(h)). Japan also imposes a certain restriction on the pass-through of trust losses for both individual and corporate beneficiaries. India, likewise, does not permit the flow-through of trust losses unless the trust is a non-discretionary trust and does not earn business income. South Africa only allows trust losses to flow through to non-resident beneficiaries, but not in any other case. When a trust is disregarded for income tax purposes in South Africa, the excess of trust expenses over income are, however, carried forward for offset against future income (Income Tax Act, 58 of 1962 s.25B(5), (7)).

CFC regimes

This brings us to the more difficult questions of whether or not the scope of proposed Article 1(2) of the OECD Model would or should extend to CFC regimes, and other “anti-deferral” and “anti-avoidance” regimes. Here, too, if we proceed from principle, it seems to at least some of the authors of this article to be difficult to distinguish the situation in which the income of an entity is attributed as such to its members because the entity is, for example, disregarded rather than because it is a regarded CFC. Indeed, in some cases it will be open to the relevant taxpayers to elect out of regarded CFC treatment and into disregarded entity treatment,¹⁰⁸ and thereby modify taxation in the source state without any important substantive change to the taxation in the residence state. Thus, some of the authors of this article would argue that, from a policy perspective,¹⁰⁹ consideration should be given to expanding the scope of proposed Article 1(2) of the OECD Model to income of the entity that is (for whatever reason) taxable as such in the hands of a treaty resident or that can reasonably be considered to be taken into consideration in determining an amount that is taxable in the hands of a treaty resident, whether or not the latter amount has or is deemed to have the same character and source. That the CFC may be established in a third state should not be an objection, since proposed Article 1(2) of the OECD Model would in any event apply to third state entities. Taxation is taxation, and (apart from administrative and compliance complexities) that should in general be the essential litmus test for granting treaty benefits under the logic of proposed Article 1(2).¹¹⁰ On the other hand, some of the authors do not favour such an extension of proposed Article 1(2), on the basis that, to avoid complexity, it should be applied only to “primary attribution” regimes.¹¹¹

¹⁰⁸ See US Treasury Regulation §301.7701-2-3 (which provides for the “check-the-box” elections).

¹⁰⁹ From a technical perspective, as noted above, whether or not a particular CFC regime would come within the scope of proposed Art.1(2) of the OECD Model may depend on how exactly that regime operates, as between attributing the CFC’s income as such *versus* attributing a distinct item of deemed income to the member(s).

¹¹⁰ The authors note that taxation by virtue of the application of a CFC is intended under the Hybrids Report, above fn.1, to be potentially relevant to the application of the recommended domestic law changes aimed at neutralising hybrid mismatch arrangements. See, for example, Hybrids Report, above fn.1, paras 36–40.

¹¹¹ The authors note that the EU Parent-Subsidiary Directive (Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2011] OJ L345/8) Art.4(2) relies on a subtle but perhaps important distinction. It provides as follows (emphasis added):

“Nothing in this Directive shall prevent the Member State of the parent company from considering a subsidiary to be fiscally transparent on the basis of that Member State’s assessment of the *legal characteristics* of that subsidiary arising from the law under which it is constituted and therefore from taxing the parent company on its share of the profits of its subsidiary as and when those profits arise. In this case the Member State of the parent company shall refrain from taxing the distributed profits of the subsidiary.

When assessing the parent company’s share of the profits of its subsidiary as they arise the Member State of the parent company shall either exempt those profits or authorize the parent company to deduct from the amount of tax due that fraction of the corporation tax related to the parent company’s share of profits and paid by its subsidiary and any lower-tier subsidiary, subject to the condition that at each tier a company and its lower-tier subsidiary fall within the definitions laid down in Article 2 and meet the requirements provided for in Article 3, up to the limit of the amount of the corresponding tax due.”

It is understood that the reference to the “legal characteristics” of the subsidiary was purposefully made to avoid that CFC regimes of the EU Member States would be treated in the same manner as transparency because of entity classification. This understanding is based on the preparatory works that led to the amendment of the Directive in 2003 and that resulted in the inclusion of the rules on fiscally transparent entities, including the working papers of the EU Council sent to the Working Group at that time. The authors also note that the new Council Directive (EU)

Cases of no mischief

It is generally accepted that, even in the absence of taxation in the residence state as a result of a particular exemption (or other particular treatment), it is appropriate for the source state to grant treaty benefits. What if a residence state would not have taxed the income (which is taxed by the source state) in any event if it had been derived directly by a resident member of the entity (for example, because it would have granted a “participation exemption” to the member either under its domestic laws or by virtue of a treaty)?¹¹² In such circumstances, it seems inappropriate to some of the authors for the source state not to grant treaty benefits (assuming the source state would view the treaty resident member as the recipient and beneficial owner where required) simply because the reason for such non-taxation in the residence state is that the residence state attributes the income to a non-resident entity rather than to the member.¹¹³ This issue is addressed under the Netherlands-UK 2008 Treaty, and under the Netherlands-Switzerland (2010) Treaty (subject to competent authority agreement).¹¹⁴ It is also addressed with respect to pension funds under the Netherlands-US Treaty, through a 2003 competent authority agreement,¹¹⁵ and also

2016/1164 of July 12 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1 (the ATAD Directive) Arts 2(9) (Definitions) and 9 (Hybrid Mismatches) explicitly refer to the “legal characterisation” of an entity for the purpose of the EU anti-hybrid entity mismatch rule. There seems, therefore, to be a sort of trend aimed at excluding fiscal transparency based on CFC regimes from the rules dealing with fiscally transparent entities. However, from a textual perspective, the choice of “legal characteristics” or “legal characterisation”, as the wording to distinguish between regimes that involve fiscal transparency and thus primary attribution rather than secondary attribution such as under CFC regimes, seems to raise some issues because sometimes fiscal transparency does not depend on differences in legal characteristics or legal characterisation, such as where fiscal transparency is elective or depends on group membership such as in a consolidation regime. In such cases, an entity that has a legal characterisation as a corporation, and would normally be fiscally opaque, can be fiscally transparent. This point is discussed below in greater detail under the heading “What to do about all this?”

¹¹² A similar situation is where the residence state would not have taxed the income because it does not tax that category of income in general (e.g. capital gains).

¹¹³ A related question is what the relationship may be between proposed Art.1(2) of the OECD Model and a “triangular provision” such as that contemplated in paras 49–52 of the Treaty Benefits Report, above fn.12. In the authors’ view, and as somewhat of a refinement to the point made above, each provision should have an independent function such that benefits that may be allowed under proposed Art.1(2) could be denied under such a “triangular provision”, but should not be denied under proposed Art.1(2) if the income would not have been taxable in the residence country in any event (i.e. even if it had been derived directly) because of a “participation exemption” under the residence country’s domestic laws or a treaty unless such benefits would have been denied in such a case under an applicable “triangular provision” in the treaty with the source state. A related issue is whether (current) taxation in a third state (i.e. the entity’s state or a PE state) should justify the extension or non-denial of treaty benefits under proposed Art.1(2), as it seems to do in the “triangular provision” contemplated in the Treaty Benefits Report, above fn.12.

A further related question is whether the denial of a deduction by the source state in respect of a payment that would otherwise be deductible should be enough to justify granting treaty benefits in respect of the payment. Such a denial of a deduction is contemplated under the “reverse hybrid rule” described in Ch.4 of the Hybrids Report, above fn.1. If the denial of a deduction in the source state is seen as something that neutralises the absence of taxation in the residence state, then it should likewise neutralise the justification for denying treaty benefits under proposed Art.1(2), to the extent that this justification is based on the absence of taxation in the residence state. On the other hand, this is not necessarily the justification for proposed Art.1(2), which for some may simply be the narrower objective of restricting treaty benefits to cases where the income is seen by the residence state as the income of one of its residents.

At the very least the OECD as part of its ongoing BEPS work should clarify the interaction of proposed Art.1(2) with CFC regimes, domestic hybrid rules and the triangular PE provision.

¹¹⁴ See, respectively, Netherlands-Switzerland (2010) Treaty Arts 22(2)-(5), Protocol Art.I.

¹¹⁵ See the Competent Authority Agreement reached on 23 March 2003, as reported in Announcement 2003-21, 2003-17 I.R.B. 846 (for purposes of dividends and interest under Art.35, such as where a US pension fund earns such income from Netherlands sources through an LLC).

reflected, by a provision permitting the competent authorities to reach such an understanding, in an exchange of notes accompanying the 2004 Protocol to that treaty. An exception under proposed Article 1(2) for such types of cases generally would seem to some of the authors of this article to be reasonable, given that the mischief targeted by proposed Article 1(2) of the OECD Model is simply not present in these circumstances, since the existence of the mismatch does not undermine any inherent expectation of current residence state taxation underlying the grant of treaty benefits, since there is no such expectation in these circumstances.¹¹⁶ On the other hand, some of the authors prefer that treaty benefits should be denied in such circumstances, or that exceptions should only exist if specifically agreed by the contracting states or competent authorities, on the basis that the income is simply not attributed to the relevant treaty residents under a “primary attribution” regime, and any exceptions, which by their nature create complexity for the withholding agent and revenue authorities, should be considered individually.

A second example of where it may be appropriate to grant (or not deny) benefits despite an attribution mismatch is where there would not have been any taxation in the residence state because that state would not have recognised the income in question even if the entity did not exist. This can arise because of a conflict of qualification, such as where the source state recognises a deemed dividend but the residence state does not recognise a deemed dividend in the same circumstances.¹¹⁷ It is arguable in our view that benefits should be granted in circumstances in which the source state would view the income as derived by a resident of the residence state, since no taxation in the residence state would have arisen in any event if it considered the entity to be “fiscally transparent”. It does not appear that mere conflicts of qualification as between the source state and the residence state are intended to defeat the application of proposed Article 1(2) of the OECD Model. It is only where qualification or treatment more generally changes in the residence state alone by virtue of the income having been derived through an entity (rather than having been derived directly) that treaty benefits may

¹¹⁶The authors would note that Example 4.1 on the Hybrids Report, above fn. 1, seems to be animated by this perspective. This example relates to the: “Use of reverse hybrid by a tax exempt entity” to derive interest income. Although the “reverse hybrid rule” contemplated by Ch.4 of the Hybrids Report would normally be applicable on the facts posited in this example if the member of the entity were generally taxable under the laws of its residence state, thereby triggering denial of deductibility for the payment under the laws of the source state, the analysis in the example concludes that “the receipt of the interest payment is not recognised under the laws of either Country A or B and therefore the payment gives rise to a D/Ni outcome, however the mismatch will not be treated as a hybrid mismatch unless the payment would have been included in ordinary income if it had been made directly to the investor” and, even more clearly to the point, that “where income is allocated by a reverse hybrid to a tax exempt entity, the payment would not have been taxable even if it had been made directly to the investor and the reverse hybrid rule should therefore not apply to deny the deduction”.

¹¹⁷Under the Canada-US Treaty, Art.IV(6) provides that “an amount of income, profit or gain shall be considered to be derived by a person who is a resident of a Contracting State where: (a) The person is considered under the taxation law of that State to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and (b) By reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person”. Canadian revenue authorities have taken the position that this language cannot be applied to deemed dividends where the event that gives rise to those deemed dividends from a Canadian perspective is not a recognised event (i.e. is disregarded) from a US perspective. However, Canadian revenue authorities do accept that treaty benefits should be granted where the event is regarded from a US perspective but its treatment for US tax purposes is different from its treatment for Canadian tax purposes. See, for example, the Technical Interpretation dated February 11, 2010 (No. 2009-0345351C6 (E)).

not be intended to be applicable under proposed Article 1(2) of the OECD Model. If there is no material change to the taxation (or lack of taxation) of the income in the residence state by virtue of the existence of the entity, then, in the view of some of the authors, it could be argued that treaty benefits should be granted. On the other hand, if the residence state did consider that a deemed dividend arose from the relevant event or transaction, it would not have attributed that dividend to a resident, since the entity would be “fiscally opaque” in that state. Thus, it can also be argued that this circumstance is within the spirit of proposed Article 1(2).

A similar question is whether treaty benefits would and should be granted under proposed Article 1(2) where the entity is in general “fiscally transparent” under the laws of a member’s residence state but that state does not recognise the particular item of income that is taxed by the source state. Again, the deemed dividend example is apposite, where the source state taxes it but the residence state does not recognise the event, even assuming the entity is in general transparent from the perspective of the residence state. From a technical perspective, the question is whether or not it can be said that “the income is treated, for purposes of taxation by [the residence State], as the income of a resident of that State”, and this question seems to arise whether or not the entity is also “fiscally transparent” for source state purposes, since there is no requirement that the entity be “fiscally transparent” in *only one* of the contracting states. In the authors’ view, the answer to the technical question is not obvious but from a policy perspective treaty benefits should be granted in such a situation because the existence of the entity does not *change* the treatment of the income in the residence state. Not only is the contemplated mischief lacking in these circumstances but also it is the case that, under the laws of the residence state, the “primary attribution” in general of the entity’s activities (and thus, if not of the income as seen by the source state then at least of the event or transaction that gives rise to the income) is to a resident of that state. Everything is the same as if the entity did not exist, except for the treaty benefit denial.

Partial residence provisions

Another basic question is what the relationship would be between a provision such as proposed Article 1(2) of the OECD Model and what the authors will refer to as “partial residence” provisions that are present in various bilateral tax treaties, including treaties entered into by states represented by the authors.¹¹⁸ One example of such a provision—relating only to trusts—is found in Article IV(1) of the Canada-US Treaty, which reads in part as follows (emphasis added):

“For the purposes of this Convention, the term ‘resident’ of a Contracting State means any person that, under the laws of that State, is liable to tax therein by reason of that person’s domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature, *but in the case of an estate or trust, only to the extent that income derived by the estate or trust is liable to tax in that State, either in its hands or in the hands of its beneficiaries.*”¹¹⁹

¹¹⁸ This type of provision is mainly found in US treaties and was the US predecessor to the fiscally transparent entity provision in the US Models and now adopted by the OECD. It is, however, found in other treaties as well.

¹¹⁹ Many of these provisions also refer to “partnerships”. For a discussion of the 1996 Swiss-United States Treaty Art.4(1)(d), see Danon (2003), above fn.26, 286 and following. It should be noted that Canada’s treaty with France

As discussed below in greater detail, other treaties have the same or similar provisions that also cover partnerships and other entities, and in some cases these provisions are framed in terms of limiting treaty residence whereas in other cases they are framed in terms of deeming treaty residence to exist, generally in relation to income that may be taxable in the residence state or only if such taxation is based on the residence of the member. Some of these provisions may also be more generous in that they adopt a threshold approach such that full residence is achieved if a sufficient proportion of the income meets the specified requirements.

In the Partnership Report, there is a discussion of such provisions which concludes that they are not the recommended approach to advancing the principles of that report.¹²⁰ Nevertheless, since many bilateral treaties do contain such provisions, it would be important to consider the relationship between them and a provision such as proposed Article 1(2) of the OECD Model.¹²¹

(Art.4(1)) takes this approach with respect to certain partnerships, and with the UK (under the 2014 Interpretative Protocol para.1) with respect to UK LLPs.

¹²⁰ See the Partnership Report, above fn.8, paras 43–46.

¹²¹ A variation is reflected in the Italy-US Treaty. Article 4(1)(b) provides that “in the case of income derived or paid by a partnership, estate, or trust, this term [i.e. resident of a Contracting State] applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State, either in its hands or in the hands of its partners or beneficiaries”. Moreover, Art.1(5)(d) of the Protocol to the treaty states that: “The provisions of subparagraph 1(b) of Article 4 (Resident) of the Convention shall apply to determine the residence of an entity that is treated as fiscally transparent under the laws of either Contracting State.” This wording is consistent with the usual wording of a “partial residence” provision. However, the Technical Explanation contains statements that seem to interpret this provision in a manner more consistent with a “fiscally transparent entity” provision such as proposed Art.1(2) of the OECD Model:

“In general, subparagraph (b) of paragraph 1 of Article 4, as clarified by the Protocol, relates to entities that are not subject to tax at the entity level, as distinct from entities that are subject to tax, but with respect to which tax may be relieved under an integrated system. This subparagraph applies to any resident of a Contracting State who is entitled to income derived through an entity that is treated as fiscally transparent under the laws of either Contracting State. Entities falling under this description in the United States would include partnerships, common investment trusts under section 584 and grantor trusts. This subparagraph also applies to U.S. limited liability companies (‘LLC’s) that are treated as partnerships for US tax purposes.

This subparagraph provides that an item of income derived by such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if the resident is treated under the taxation laws of the State where he is resident as deriving the item of income. For example, if a corporation resident in Italy distributes a dividend to an entity that is treated as fiscally transparent for US tax purposes, the dividend will be considered derived by a resident of the United States only to the extent that the taxation laws of the United States treat one or more US residents (whose status as US residents is determined, for this purpose, under US tax laws) as deriving the dividend income for US tax purposes. In the case of a partnership, the persons who are, under US tax laws, treated as partners of the entity would normally be the persons whom the US tax laws would treat as deriving the dividend income through the partnership. Thus, it also follows that persons whom the US treats as partners but who are not US residents for US tax purposes may not claim a benefit for the dividend paid to the entity under the Convention. Although these partners are treated as deriving the income for US tax purposes, they are not residents of the United States for purposes of the treaty. If, however, they are treated as residents of a third country under the provisions of an income tax convention which that country has with Italy, they may be entitled to claim a benefit under that convention. In contrast, if an entity is organized under US laws and is classified as a corporation for US tax purposes, dividends paid by a corporation resident in Italy to the U.S. entity will be considered derived by a resident of the United States since the US corporation is treated under US taxation laws as a resident of the United States and as deriving the income. [...]

It seems to the authors to be rather difficult to reconcile this interpretation, and various other comments to the same effect in that Technical Explanation, with the actual language in the treaty and protocol.

Similarly, in Sweden, in RÅ 2004 ref. 20, a matter involving a ruling application, a royalty was to be paid from a Swedish company to a US corporation X. X proposed to become an LLC, whose owner Z would elect to make X transparent for federal income tax purposes. After a lengthy discussion, the advance rulings board concluded that

Presumably, it would necessarily not be intended that a provision such as proposed Article 1(2) of the OECD Model would defeat treaty benefits that would, in the absence of such a provision, be granted by virtue of a partial residence provision applying, for example, to the income of a discretionary trust (or other entity) that is distributed to and taxed in the hands of beneficiary (or member).¹²² Some treaties include both, while in some cases the partial residence rule was deleted when a fiscally transparent entity provision was added, such as US-Netherlands (2004), which is said in the related Technical Explanation to be no longer necessary. In our view, the exact relationship between these provisions may have to be worked out on a treaty-by-treaty basis.

Interestingly, although Article 3 (and 11) of the MLI is designed to provide for considerable flexibility, it does not seem to contemplate the possibility of a state choosing to implement Article 3(1) alongside of a partial residence provision. If a particular treaty already contains a provision such as proposed Article 1(2) and a partial residence provision, a party can choose to not have Article 3 of the MLI apply to that treaty at all, such that both provisions survive. In contrast, none of the specified variations for the complete or partial application of Article 3(1) of the MLI clearly contemplates this. Article 3(4) contemplates the possibility that Article 3(1) “shall apply in place of or in the absence of” provisions of a Covered Tax Agreement “to the extent that they address whether income derived by or through entities or arrangements that are treated as fiscally transparent under the tax law of either Contracting Jurisdiction (whether through a general rule or by identifying in detail the treatment of specific fact patterns and types of entities or arrangements) shall be treated as income of a resident of a Contracting Jurisdiction”. In other words, there is no option here to have Article 3(1) apply “in addition to” any other existing provision in a treaty—such as a partial residence provision—if (or, rather, to the extent, that) any other provision is viewed as one that addresses fiscally transparent entities. If (or to the extent that) an existing partial residence provision comes within this description, the adoption of Article 3(1) would seem to displace it under Article 3(4).

The various optional configurations for the implementation of Article 3(1) of the MLI that are set out in Article 3(5)¹²³ are as follows:

“A Party may reserve the right:

- a) for the entirety of this Article not to apply to its Covered Tax Agreements;
- b) for paragraph 1 not to apply to its Covered Tax Agreements that already contain a provision described in paragraph 4;
- c) for paragraph 1 not to apply to its Covered Tax Agreements that already contain a provision described in paragraph 4 which denies treaty benefits in the case of income derived by or through an entity or arrangement established in a third jurisdiction;

corporations whose owners choose transparent taxation qualified as “partnerships” under the treaty’s partial residence provision, which referred to a “partnership, estate, or trust”, where the treaty did not contain a provision such as proposed Art.1(2). Thus, X was treated as the recipient of the royalty under Art.12 and, consequently, the royalty would not be taxed in Sweden. For fiscal years beginning 1 January 2007, the 2006 Protocol to that treaty revised Art.4 and added a provision such as proposed Art.1(2).

¹²² Including proposed Art.1(2) in the OECD Model of course has no effect on existing treaties.

¹²³ There are also options contemplated under Art.3(3), with respect to the “saving clause” election under Art.11.

- d) for paragraph 1 not to apply to its Covered Tax Agreements that already contain a provision described in paragraph 4 which identifies in detail the treatment of specific fact patterns and types of entities or arrangements;
- e) for paragraph 1 not to apply to its Covered Tax Agreements that already contain a provision described in paragraph 4 which identifies in detail the treatment of specific fact patterns and types of entities or arrangements and denies treaty benefits in the case of income derived by or through an entity or arrangement established in a third jurisdiction;
- f) for paragraph 2 not to apply to its Covered Tax Agreements;
- g) for paragraph 1 to apply only to its Covered Tax Agreements that already contain a provision described in paragraph 4 which identifies in detail the treatment of specific fact patterns and types of entities or arrangements.”

Under paragraph (a), nothing changes for a state’s tax treaties. Under paragraph (b), only treaties that do not contain any provision on fiscally transparent entities get supplemented with Article 3(1). Paragraph (c) contemplates supplementing all treaties with Article 3(1) except those that deny treaty benefits in respect of third state fiscally transparent entities. So, if a state takes this route, it will have some treaties undisturbed by Article 3(1) where benefits are denied to third state fiscally transparent entities, and some where Article 3(1) applies, which will not deny treaty benefits to third state fiscally transparent entities. Paragraph (d) contemplates a similar two track approach—but instead distinguishing between a “provision described in paragraph 4 which *identifies in detail* the treatment of specific fact patterns and types of entities or arrangements” and a provision which is articulated as “a general rule” (to refer back to the language in Article 3(4)). This preserves existing “detailed” provisions and supplements those that have no “general rule” or only have a “general rule”. The opposite is contemplated by paragraph (g), which makes Article 3(1) applicable only to treaties containing a “detailed” provision. This leaves existing “general rule” treaties intact, and does not supplement treaties that do not contain an existing provision. Paragraph (e) combines paragraphs (c) and (d). Thus, none of these options contemplates supplementing a treaty with Article 3(1) where that treaty already contains another provision (whether “detailed” or “general”) described in Article 3(4).¹²⁴

It is also clear from the MLI Explanatory Statement that a partial residence provision is intended to be regarded as an existing provision contemplated by Article 3. Paragraph 43, which relates to Article 3(4), states as follows (emphasis added):

“A significant number of Covered Tax Agreements already include provisions addressing fiscally transparent entities, and these provisions take a variety of forms. *For example, while the provision reflected in paragraph 1 is framed in terms when income is derived by a transparent entity, some provisions are framed instead as definitions of the term ‘resident’.* Other provisions contain more detailed rules setting out particular circumstances under which income earned through an entity treated as transparent under the laws of one of the Contracting Jurisdictions will be entitled to benefits.”

Paragraph 44 adds the following (emphasis added):

¹²⁴ Para.(f) relates to Art.3(2).

“Paragraph 4 is the compatibility clause, which addresses the relationship between Article 3(1) (as it may be modified by Article 3(3)) and existing provisions of the same type. It is intended to address all of the above types of provision, by indicating that Article 3(1) (as it may be modified by Article 3(3)) would *replace* provisions of a Covered Tax Agreement to the extent that they address whether income derived through entities or arrangements that are treated as fiscally transparent under the tax law of a Contracting Jurisdiction will be treated as income of a resident of a Contracting Jurisdiction, *or* would be *added* where such provisions *do not exist*. Where an existing provision addresses *both* the treatment of *fiscally transparent entities and arrangements* and the treatment of *tax exempt entities that are not fiscally transparent*, such a provision would be superseded *only with respect to the treatment of fiscally transparent entities*.”

This paragraph does not appear to contemplate displacing partial residence provisions only with respect to aspects other than partial residence.¹²⁵

Reference may also be made to the last two sentences in Article 3(6), the last of which states that “paragraph 1 (as it may be modified by paragraph 3) shall supersede the provisions of the Covered Tax Agreement only to the extent that those provisions are incompatible with paragraph 1 (as it may be modified by paragraph 3)”. What exactly is meant by “incompatible” in this context is not clear (and is not explained in the MLI Explanatory Statement), but it seems to the authors to be difficult to conclude that this is intended to preserve partial residence aspects of existing provisions—or even specifically tailored CIV provisions. If that were intended, it could have been stated quite clearly in the MLI Explanatory Statement.

Another distinction made in the MLI Explanatory Statement is between rules attributing income to residents and so-called “detailed integrity rules”. Paragraph 45 states as follows (emphasis added):

“[...] It is not intended, however, that Article 3(1) (as it may be modified by paragraph 3) would replace provisions that contain *detailed ‘integrity rules’* clarifying how an article of a Covered Tax Agreement applies to a particular item of income derived by a resident of a Contracting Jurisdiction, *such as a rule deeming a beneficiary of a business trust to have a permanent establishment and attributing to that permanent establishment the share of the business profits of the trust to which the beneficiary is beneficially entitled*. Although these latter types of integrity provision may apply to income that is derived by or through an entity or arrangement that is treated as fiscally transparent under the tax law of a Contracting Jurisdiction, they do not address whether that income will be treated as income of a resident of a Contracting Jurisdiction for the purposes of Article 3(4). Rather, these latter provisions only operate where the relevant item of income is already treated as income of a resident of a Contracting Jurisdiction entitled to benefits under the relevant Covered Tax Agreement.”¹²⁶

¹²⁵ Also, it does not appear that countries can make different reservations under Art.3(5) with respect to different Covered Tax Agreements—for example, making the reservation under para.(b) for some Covered Tax Agreements and no reservation or a different reservation for other Covered Tax Agreements.

¹²⁶ MLI Explanatory Statement, above fn.3, para.45.

Certain existing treaties contain such provisions, as discussed below in greater detail. Thus, as Article 3(1) would not add such provisions to treaties, it would not displace any such existing provisions either.

This is an important question because some of these provisions would grant treaty benefits, subject to any separate limitation on benefits provision and other conditions, in cases where proposed Article 1(2) of the OECD Model would not grant benefits or at least not grant them to the same extent. One example of this may be the provision in Article 28(3) of the Italy-Austria Treaty 1981, which grants treaty benefits under Articles 10, 11 and 12 to a partnership that is “organized” under the laws of a Contracting State if it has its “seat” in that state and at least three quarters of the partnership’s profits are attributable to persons that are resident in that state. That would mean that up to 25 per cent of the income of the partnership could be attributable to persons that are not resident or taxable in that state, and yet 100 per cent of the income of the partnership would be eligible for treaty benefits.¹²⁷

Other such provisions limit residence—hence the expression “partial residence” provisions—to the extent that the income of the entity is taxable in the relevant state either in the hands of the entity or its members or beneficiaries. Such a provision might still be broader than under proposed Article 1(2) of the OECD Model, since that might include the portion attributable to residents and the portion attributable to non-residents that are taxable in the relevant state because the income is attributable to a Permanent Establishment (PE) in that state of the partnership.¹²⁸ In a sense, this is inconsistent with the policy considerations reflected in the Canadian decision in *Crown Forest Industries v Canada*, which held that a non-US entity could not be regarded as a resident of the US if it was taxable under US law only by reason of having a US trade or business in the US.¹²⁹ This aspect of such provisions is also one of the reasons given in the Partnership Report for not advancing such an approach.¹³⁰

Some of these provisions, however, would grant/allow treaty benefits to the same proportion of the income of the entity as proposed Article 1(2) of the OECD Model, since they are explicitly

¹²⁷ Partnership Report, above fn.8. While this provision does not deem the partnership to be a resident as such, it grants treaty benefits to the partnership as such on an all or nothing basis rather than in proportion to the benefits that would be applicable to its members. This is not typical—and is maybe more akin to newer CIV provisions described in the Commentaries under Art. 4. See also the “partial residence” provisions for CIVs in the Australia-New Zealand Treaty (Art.4(4)) and the Germany-Australia Treaty (2015) (Art.4(4)), which use a membership threshold to grant complete residence to the relevant entity, but still grant partial residence to the entity below the threshold.

¹²⁸ See, for example, the Australia-France Treaty (Art.4(5)), the France-Japan Treaty (Art.4(5)), the France-UK Treaty (Art.4(4)), the France-Canada Treaty (Art.4(1)), the Germany-Albania Treaty (Art.4(4)), the Germany-Algeria Treaty (Art.4(4)), the Germany-Syria Treaty (Protocol No. 2), the Germany-Uruguay Treaty (Art.4(4)), the Italy-US Treaty (Art.4(1)), the Italy-Germany Treaty (Protocol No. 2), as well as many US treaties, including the one with Canada (Art.IV(1)), which however relates only to an estate or trust. There is an interpretive issue here—in that, although these provisions do not expressly refer to the taxation of members on the basis of their residence, they may be interpreted that way in practice. There are also the Germany-Philippines Treaty (Art.4(4)) and the Germany-Taiwan Treaty, as well as the Italy-France Treaty (Art.4(3)), which treat partnerships as resident where they have their effective management and do not even test for tax liability.

¹²⁹ See *Crown Forest Industries v Canada*, 95 DTC 5389; [1995] 2 CTC 64; [1995] 2 S.C.R. 802. For an interesting contrast, reference may be made to European case law requiring residence countries to give the same benefits to permanent establishments as to residents. See, for example, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt* (C-307/97) EU:C:1999:438; [2000] STC 854 (21 September 1999).

¹³⁰ See Partnership Report, above fn.8, paras 43–45.

limited to the extent of the entity's income attributable to residents.¹³¹ Nevertheless, there can still be important differences between treating the entity as a resident and treating its income as that of its members, where the treaty benefit depends on the status of the relevant resident—for example, where Article 10(2)(a) might apply if the entity is the relevant resident (and it can be viewed as a “company”) but would not apply if the members were the relevant residents (say, because they are individuals), or *vice versa*.¹³²

Accordingly, countries contemplating the implementation of Article 3(1) of the MLI must carefully consider the impact on existing provisions including any partial residence provisions that may be of general application or perhaps aimed more specifically at CIVs.¹³³ These may not all be as “detailed”. If a state wished to implement Article 3(1) of the MLI and to preserve its existing partial residence provisions, it could opt to exclude application to all treaties that have existing provisions on fiscally transparent entities (that is, Article 3(5)(b)). If all its partial residence provisions (or categories of them—for example, those aimed at CIVs) are more “detailed”, it could opt to exclude application to all treaties that have existing provisions on fiscally transparent entities that are more “detailed” (that is, Article 3(5)(d)). If they are more “general”, they would be displaced unless the option in Article 3(5)(b) is adopted.¹³⁴ Also, taxpayers and advisers should not assume that partial residence provisions (including for CIVs) or any aspect of them will necessarily have survived the complete or even partial implementation of Article 3(1) of the MLI.

¹³¹ See, for example, the “partial residence” provisions for CIVs in the Australia-New Zealand Treaty (Art.4(7)) and the Australia-Germany Treaty (Art.4(4)), the Australia-US Treaty (Art.4(1)), and the Italy-Austria Treaty (Art.28(4)). There is also the somewhat hybrid provision for a “French Qualified Partnership” in the France-US Treaty (Art.4(2c)).

¹³² It should be noted that at least one court has held that Art.10(2)(a) can apply to dividends paid to a US S-Corporation, which was viewed as fiscally transparent and had US individuals as its members. See the German case *Re US S Corporation's German withholding tax status* - IR 48/12 (2013) 16 ITLR 428. The authors have doubts that this decision reflects a correct interpretation of the relevant treaty provision, since treaty benefits exceed those that would be granted if the individual members of the US S-Corporation had received the relevant dividends directly. Moreover, according to the German Federal Central Tax Office and a Circular of the Federal Ministry of Finance dated 26 September 2014 (m.no. 2.1.2), the German tax authorities interpret the German ITA s.50d para.1 sent.11, which was enacted after the BFH decision, in a way that “overrides” this decision. Also, Protocol No. 3 to the Australia-Germany Treaty “overrides” this decision by deeming the resident (partner) to have derived the dividend directly.

Interestingly, Canada treats S-Corporations as residents of the US under the Canada-US Treaty, on the view that they are indeed “liable to tax”, whereas the US treats them as fiscally transparent entities, and this is acknowledged in the Technical Explanation to the 2007 Protocol amending the treaty to insert provisions on fiscally transparent entities. There is also the Canadian decision in *TD Securities (USA) LLC v The Queen (TD Securities (USA) LLC)*, 2010 TCC 186; 2010 DTC 1137; [2010] 5 CTC 2426, where the Court held that a US LLC that was fiscally transparent for US tax purposes should be treated as a US treaty resident because its income was taxable in the hands of its US-resident member. This is another decision that the authors have doubts about. Reference may also be made to *Linklaters LLP v ITO* (2010), 132 TTJ 20 (Mumbai ITAT), where the Indian courts came to a similar conclusion with reference to a UK LLP that was fiscally transparent from a UK perspective.

¹³³ It is interesting to note that the 894(c) Regulations do seem to contemplate the coexistence of the fiscally transparent entity approach and partial residence provisions (see §1.894-1(d)(1)). After noting that income would be considered to be derived by an entity only if it is not fiscally transparent under its relevant jurisdiction, the following comment is made:

“Notwithstanding the preceding two sentences, an item of income paid directly to a type of entity specifically identified in a treaty as a resident of a treaty jurisdiction shall be treated as derived by a resident of that treaty jurisdiction.”

¹³⁴ There would perhaps be other configurations given Arts 3(5)(c), (e) and (f) but the point remains that this choice is a serious one and a country may not in all cases be able to both implement Art.3(1) and keep existing partial residence provisions.

Beneficial ownership

As noted above, proposed Article 1(2) of the OECD Model and the related additions to the Commentaries would not address the determination of the “beneficial owner” of the income, which is relevant to the application of certain of the distributive provisions in tax treaties—namely, those applicable to dividends, interest and royalties (as in Articles 10, 11 and 12 of the OECD Model).¹³⁵ This gives rise to a number of concerns—including the possibility that various states may approach this determination differently, as well as the possibility that it may be difficult to conclude that a member of an entity (that, for example, has legal personality or, in any event, is not legally transparent) should be regarded as the beneficial owner of the income of the entity even if the income is attributed to that member by the residence state,¹³⁶ or conversely that an entity (such as a partnership that is legally transparent or a trustee which is bound by fiduciary obligations) to which income is attributed as contemplated by proposed Article 1(2) of the OECD Model should be regarded as the beneficial owner.¹³⁷ Some existing bilateral treaties address these issues, but most do not.¹³⁸

Stated differently, the question is whether beneficial ownership and other attribution rules or principles (including conduit rules or principles) should be applied before or after a provision such as proposed Article 1(2) of the OECD Model. In other words, should a source state begin by applying beneficial ownership and other attribution rules or principles (as part of Step 1 of the process) and only then apply a provision such as proposed Article 1(2) of the OECD Model in relation to an entity to which the income is attributed under the first set of rules or principles, or should a source state begin by applying a provision such as proposed Article 1(2) of the OECD Model if the income is derived by or through a fiscally transparent entity and only then apply beneficial ownership and other attribution rules or principles in relation to the person to whom the income is attributed?

The proposed Commentaries included in the Hybrids Report are not entirely clear in this regard. As noted above, proposed paragraph 26.14 of the Commentaries on Article 1 states as follows (emphasis added):

“Whilst the paragraph ensures that the various allocative rules of the Convention are applied to the extent that income of fiscally transparent entities is treated, under domestic law, as income of a resident of a Contracting State, the paragraph does not prejudice the issue of whether the recipient is the beneficial owner of the relevant income. *Where, for example, a fiscally transparent partnership receives dividends as an agent or nominee for a person who is not a partner, the fact that the dividend may be considered as income of a resident*

¹³⁵ In contrast, the existing Commentaries on Art.1 deal rather extensively with the determination of the beneficial owner of the income of a collective investment vehicle.

¹³⁶ For example, the Technical Explanation on the “fiscally transparent entity” provisions in the Canada-US Treaty (Arts IV(6) and (7)) demonstrates that each party has a different view of how to approach this issue. Canada seems to determine beneficial ownership before applying the fiscally transparent entity provisions, and the US seems to do it both before and after.

¹³⁷ For partnerships and trusts, the issue has more general import than simply in relation to the application of proposed Art.1(2) of the OECD Model because it may arise even where the partnership or trust is not fiscally transparent from the perspective of either state.

¹³⁸ See, for example, The Australia-New Zealand Treaty (Art.3(4), for trusts in relation to Arts 10, 11 and 12, and Art.3(7), the “partial residence” provision for CIVs). This is a common feature of New Zealand treaty practice.

of a Contracting State under the domestic law of that State will not preclude the State of source from considering that neither the partnership nor the partners are the beneficial owners of the dividend.”¹³⁹

This language suggests that the determination of beneficial ownership should be made as part of Step 1 of the process, such that a provision such as proposed Article 1(2) of the OECD Model would then be applied only where Step 1 results in the source state reaching the conclusion that the beneficial owner is a fiscally transparent entity (considered opaque by the source state, such that the income is derived “by” it) or its member(s) (where the entity is fiscally transparent from the source state’s perspective, such that the income is derived by the members “through” the entity).

Some of the authors of this article believe this is the appropriate approach. In the view of these authors, it is preferable to determine beneficial ownership separately from and before the application of proposed Article 1(2) of the OECD Model. This is because these authors believe that beneficial ownership is a factual determination to be made by the source state based on its own qualification and attribution rules and principles and without regard to the other state’s rules and principles, and on the same footing whether or not the recipient is a fiscally transparent entity. In other words, in the view of these authors, whether or not the other state sees the entity as fiscally transparent or opaque, the source state’s determination of beneficial ownership should not be affected. This is consistent with proposed Article 1(2) of the OECD Model not prejudging the issue of whether the recipient is the “beneficial owner” of the relevant income.

However, this approach may give rise to difficulties. For example, where the source state sees the entity as opaque and as the beneficial owner, but is required to grant to the entity treaty benefits with reference to the benefits to which the entity’s members would have been entitled on the same income, the source state may have difficulty concluding that the members would meet beneficial ownership requirements. Similarly, where the source state sees the entity as fiscally transparent and sees its members as the beneficial owners of the income, but is required to grant treaty benefits with reference to the benefits the entity would have been entitled to, it may have difficulty concluding that the entity would meet beneficial ownership requirements. Thus, to avoid these difficulties, some of the authors prefer that beneficial ownership be tested after the application of a provision such as proposed Article 1(2), with respect to each person that income is attributed to by the residence state(s).

Where all the authors agree is with respect to the proposition that treaty benefits should not fail where the application of a provision such as proposed Article 1(2) of the OECD Model would result in the income in question being attributed to a resident of the other state, assuming no relevant party (that is entity or member) is acting as an agent or nominee or other intermediary for a third party from the source state’s perspective. This result may require some deeming rules or principles in particular cases—for example, a rule that deems the beneficial ownership requirement to be satisfied by a member or the entity where income is attributed to the member or entity under a provision such as proposed Article 1(2), provided no relevant party is acting as an agent or nominee or other intermediary for a third party from the source state’s perspective.

¹³⁹ Hybrids Report, above fn.1. In contrast, the authors note that beneficial ownership is addressed in the sample provisions for CIVs in paras 6.17, 6.21, 6.26, 6.27 and 6.32 of the Commentaries on Art.1.

There is also the question of whether beneficial ownership and other attribution rules or principles should be considered to trigger the application of a provision such as proposed Article 1(2) of the OECD Model. For example, in the context of a “back-to-back loan”, the source state may consider that interest paid by a resident of the source state (that is, the “ultimate borrower”) is beneficially owned not by the lender to that resident (that is, the “intermediary lender”) but by that lender’s lender (that is, the “ultimate lender”). The question which then arises is whether the ultimate lender should be considered, from the source state’s perspective, to have derived the source state interest income *through an entity or arrangement that is treated as wholly or partly fiscally transparent*, thereby engaging the application of a provision such as proposed Article 1(2) of the OECD Model. If so, this could lead to the denial of treaty benefits even if the ultimate lender is a treaty resident and is taxable in its state of residence on the interest income earned from its loan to the intermediary lender, since that is not, strictly speaking, the same income as the interest income paid by the ultimate borrower to the intermediary lender, and may not be treated as the same income by the ultimate lender’s state of residence. This would be contrary to existing Commentaries in relation to beneficial ownership, which contemplate that benefits should apply in respect of income paid to an intermediary as long as a resident is the ultimate beneficial owner.¹⁴⁰ In addition, the attribution of income away from the intermediary lender and toward the ultimate lender on the basis of beneficial ownership rules or principles (or on the basis of conduit rules or principles) does not seem to the authors to reflect an example of the application of a “systemic regime” relating to fiscal transparency. Finally, the authors would add here that the statements in proposed paragraph 26.14 of the Commentaries on Article 1 would seem to suggest that proposed Article 1(2) is not intended to apply in a situation where income merely passes through the hands of an agent, nominee or other intermediary, assuming the principal is not a fiscally transparent entity.¹⁴¹ However, at a minimum, the reference to an “arrangement” should be clarified.¹⁴²

¹⁴⁰ See, for example, para.12.2 of the Commentaries on Art.10, para.11 of the Commentaries on Art.11, and para.4.2 of the Commentaries on Art.12, of the OECD Model.

¹⁴¹ It is also interesting to note that proposed para.26.14 of the Commentaries on Art.1 posits a situation where a fiscally transparent partnership receives dividends as an agent or nominee for a person who is not a partner, and yet the dividend may be considered as income of a resident of a Contracting State under the domestic law of that state. It goes on to state that this will not preclude the source state from considering that neither the partnership nor the partners are the beneficial owners of the dividend. This raises the spectre of the source state applying a different approach to determining beneficial ownership than the residence state, or in any event that the residence state may attribute income or impose taxation on a basis other than one that is consistent with the beneficial ownership concept applicable for treaty purposes. Indeed, it may have the same approach as the source state to determining beneficial ownership for treaty purposes when it is a source state but may use a different approach as a residence state. Although this might be unusual for certain combinations of countries, it is certainly possible and even likely for other combinations. The authors note, for example, the UK which in many cases taxes the “person receiving or entitled to” income (see ITEPA ss.572, 576, 579, 579C, 614, 618, 622, 632, 636, 662, 680; ITTOIA ss.8, 230, 245, 271, 332, 338, 348, 352, 371, 385, 404, 425, 554, 581, 611, 616, 637(7), 685, 689; and CTA 2010 s.1086(5)). A nominee could be taxed as a person receiving income. This would apply to non-UK source income only if the nominee and beneficial owner were both resident in the UK.

¹⁴² The authors note that this term is used in different ways in various contexts. The term is used in some contexts with reference to “conduit arrangements”. It is also used in the Hybrids Report, above fn.1, Pt I with reference to “structured arrangements”. It is also used as part of general anti-avoidance rules. It is an ambiguous term. However, the authors note that Example 7 in the 894(c) Regulations features a contractual arrangement without legal personality operating as a CIV. This suggests that purely contractual arrangements may be within the intended scope of rules such as

In light of the above, the authors offer the following suggested approach to integrating the determination of the beneficial ownership of income and the application of provisions such as proposed Article 1(2) of the OECD Model:

1. Step 1 should be for the source state to determine if the entity is an agent or nominee or other intermediary. If so, then the source state would skip the entity and go to the person or entity for which the entity is a nominee, etc. If the person or entity for which the entity is a nominee, etc., is not a fiscally transparent entity, then proposed Article 1(2) of the OECD Model is not in play. If the entity is a nominee, etc., for another fiscally transparent entity, then proposed Article 1(2) of the OECD Model is in play with regard to that other fiscally transparent entity, and from then the analysis is the same with regard to that other fiscally transparent entity.
2. Step 2 applies where the entity is a fiscally transparent entity and is not a nominee, etc. (or where it is a nominee, etc., for another fiscally transparent entity). Step 2 involves applying proposed Article 1(2) of the OECD Model in accordance with the following prescriptions:
 - (a) Where the entity is fiscally transparent from the source state perspective:
 - (i) If the entity is fiscally opaque from the residence state perspective, then the source state should be required to apply the treaty as if the beneficial owner is the entity, regardless of the legal nature of the entity or the effect of that on the source state's normal application of beneficial ownership principles.
 - (ii) If the entity is fiscally transparent from the residence state perspective, then we look to the members. If the member is a resident of the residence state, then the source state should be required to apply the treaty on the basis that the member is the beneficial owner, unless the member is a nominee, etc., with respect to its interest in the entity. That too should be determined from the source state perspective. If from the source state perspective the member is not a nominee, etc., with respect to its interest, then it should be treated as the beneficial owner.¹⁴³ Where the member is a nominee, etc., with respect to its interest, then the analysis should depend on the nature and residence of the principal. If the principal is not a fiscally transparent entity and is a resident of the residence state, then the beneficial ownership requirement should be considered to be satisfied. If the principal is not a fiscally transparent entity and is not a resident of the residence state, then the beneficial ownership requirement should not be considered to be satisfied. If the

proposed Art.1(2) of the OECD Model, although it does not follow from this example that every contractual form of legal representation—such as an agent or a nominee—is within scope.

¹⁴³In most cases where the entity is not a nominee, etc., and the member is not a nominee, etc., and the entity is fiscally transparent from both states' perspectives, all should be fine.

- principal is yet another fiscally transparent entity, then the analytical process repeats from the beginning of Step 2.¹⁴⁴
- (b) Where the entity is opaque from the source state perspective:
- (i) If the entity is fiscally transparent from the residence state perspective, then the source state should be required to apply the treaty as if the member is the beneficial owner regardless of the source state's perspective that it is opaque for tax and regardless of the non-tax nature of the entity, unless the member is a nominee, etc., with respect to its interest. As noted above, that should be determined from the source state perspective. If from the source state perspective the member is not a nominee, etc., with respect to its interest, then it should be treated as the beneficial owner.¹⁴⁵ Where the member is a nominee, etc., with respect to its interest, then the analysis should depend on the nature and residence of the principal. If the principal is not a fiscally transparent entity and is a resident of the residence state, then the beneficial ownership requirement should be considered to be satisfied. If the principal is not a fiscally transparent entity and is not a resident of the residence state, then the beneficial ownership requirement should not be considered to be satisfied. If the principal is yet another fiscally transparent entity, then the analytical process repeats from the beginning of Step 2.¹⁴⁶
- (ii) If the entity is fiscally opaque from both states' perspectives, then it should be treated as the beneficial owner regardless of the legal nature of the entity, but this is not a case for applying proposed Article 1(2) of the OECD Model, since here we are assuming (see above) that it is a fiscally transparent entity.

In brief, while this approach relies initially and otherwise on the source state's approach to determining beneficial ownership, and is thus consistent with the principle reflected in proposed paragraph 26.14 of the Commentaries to Article 1, it is intended to overcome technical tax and non-tax impediments to granting treaty benefits in relation to beneficial ownership requirements.¹⁴⁷

A final point here relates to identifying some examples of intermediary situations that may not in and of themselves give rise to the application of provisions such as proposed Article 1(2) of the OECD Model:

¹⁴⁴ This is not different in principle from the situation in which a member of a fiscally transparent entity is itself a fiscally transparent entity. In that case, there is direct ownership by one fiscally transparent entity of an interest in another fiscally transparent entity. Proposed Art.1(2) of the OECD Model would be applied iteratively. In principle it should be the same where the bridge between the two fiscally transparent entities is a nominee, since the nominee is nothing but a representative of the principal so here too the principal fiscally transparent entity is in law the owner of the interest in the other fiscally transparent entity.

¹⁴⁵ In most cases where the entity is not a nominee, etc., and the member is not a nominee, etc., and the entity is fiscally transparent from both states' perspectives, all should be fine.

¹⁴⁶ Here, too, the comments in fn.144 are relevant.

¹⁴⁷ See also the alternative drafting suggestions in Appendix A which do try to address this issue.

1. Financial intermediaries (and others) that are agents or nominees or otherwise mere intermediaries for their account holders (or principals).¹⁴⁸

¹⁴⁸ As noted above in fn.54, the Partnership Report, above fn.8, para.54 discusses the beneficial owner concept being determined based on residence state rather than source state rules or principles, and in doing so refers to this as “another approach”, to be compared with—not equated to—the fiscally transparent entity approach described in that report. This supports the view that an agency, nominee or similar financial intermediary arrangement is not intended to be within the scope of proposed Art.1(2) of the OECD Model, as does para.26.14 of the Commentaries to proposed Art.1(2).

Moreover, the authors understand it has never been the practice of any state represented by the authors to apply a provision such as proposed Art.1(2) of the OECD Model in the context of an ordinary financial intermediary. The fact that such an intermediary is or is not fiscally transparent with respect to its own taxation or that of its members is immaterial because the tested income is not its income or that of its members. The UK example where a pure intermediary may be taxed is interesting but unusual. If both the source state and the residence state see the income as that of the same beneficial owner (i.e. the principal), there should be no issue of proposed Art.1(2) of the OECD Model being applicable and treaty benefits should be granted if that beneficial owner is a resident of the residence state. If the source state sees the principal as the beneficial owner but the residence state sees the income as that of the intermediary, that should not change the source state’s analysis if this situation does not engage proposed Art.1(2).

The authors would also observe that the fact that a state taxes an intermediary does not necessarily mean that it sees the income as that of the intermediary. It may be taxing the income in the hands of the intermediary but on behalf of the principal—in effect, as a collection mechanism. In a sense, this is what happens with all trustees as well although trusts have in many countries been treated as separate taxpayers or at least their trustees have had their tax liabilities qua trustees segregated from their tax liabilities qua taxpayers in their own right or qua trustees of other trusts. But this is not the same as taxing a pure intermediary on behalf of the principal. There the intermediary is quite plainly being taxed on income as the income of another.

Another point is that who actually pays the tax (if any!) does not technically matter under either the usual beneficial ownership principles or under proposed Art.1(2) of the OECD Model. While it may be an indicator at some level of beneficial ownership or income attribution it is not actually tested or required under these principles or under proposed Art.1(2) of the OECD Model. That said, there can be attribution mismatches arising in such cases which can result in non-taxation. But non-taxation alone, or attribution mismatch alone, is not the test as such under these principles or under proposed Art.1(2) of the OECD Model. For example, the source state may see a resident of the residence state as the beneficial owner of income, and yet the residence state may have rules that attribute that income to another person such as the resident’s spouse in the absence of any payment or other arrangement between the spouses. That spouse may be resident in that same state, in which case there is no policy problem, but what if that spouse is resident in a third state? The source state would not say the spouse is the one deriving income *through* a fiscally transparent entity or arrangement because the spouse is not deriving any income from the source state’s perspective, and the resident is not a fiscally transparent entity and there is no arrangement. Thus, the source state would say the resident is the one deriving the income and not through a fiscally transparent entity or arrangement, so benefits would be granted. Conversely, if it was the spouse that was resident in the residence state and the resident that were resident in a third state, no benefits would be granted. This is simply to say that proposed Art.1(2) of the OECD Model is not aimed at every conceivable manifestation of attribution mismatch. Thus, in the context of a normal financial intermediary, while there is a contractual arrangement in place that establishes the principal-agent relationship, that relationship does not constitute or create an interest in an entity, and even though proposed Art.1(2) of the OECD Model refers to an “arrangement” it seems difficult to say the principal is deriving the income *through* an arrangement in the sense contemplated by proposed Art.1(2) of the OECD Model. Otherwise, the comments in proposed para.26.14 of the Commentaries to Art.1 are very difficult to understand.

The authors would also refer to the following comments in the Technical Explanation to the Canada-United States Treaty with respect to the addition of the fiscally transparent entity provisions under the 2007 Protocol:

“Interaction of paragraphs 6 and 7 with the determination of ‘beneficial ownership’—With respect to payments of income, profits or gain arising in a Contracting State and derived directly by a resident of the other Contracting State (and not through a fiscally transparent entity), the term ‘beneficial owner’ is defined under the internal law of the country imposing tax (i.e., the source State). Thus, if the payment arising in a Contracting State is derived by a resident of the other State who under the laws of the first-mentioned State is determined to be a nominee or agent acting on behalf of a person that is not a resident of that other State, the payment will not be entitled to the benefits of the Convention. However, payments arising in a Contracting State and derived by a nominee on

2. Back-to-back loans and such where the source state sees (or deems) the very income paid to an intermediary lender as having been paid instead to that lender's lender (that is, conduits).¹⁴⁹
3. Back-to-back loans and such where the source state deems fictitious income to be derived by the ultimate lender.¹⁵⁰

Article 10(2)(a) of the OECD Model

It would seem to the authors to be appropriate for the OECD to address the relationship between proposed Article 1(2) of the OECD Model and the exclusion of certain partnerships from benefits arising under Article 10(2)(a) of the OECD Model where the beneficial owner must be “a company (other than a partnership)”. As noted above, the Hybrids Report¹⁵¹ does not propose to change this exclusion through a change to Article 10(2)(a) of the OECD Model or to change its interpretation through revised or additional Commentaries. Many of the treaties entered into by the countries represented by the authors do not contain such an explicit exclusion,¹⁵² but some

behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the Commentary to Article 10 of the OECD Model.”

This paragraph is then followed by a number of others which discuss the two states' different approaches to determining beneficial ownership and integrating it with the fiscally transparent entity provisions, but what is important to the present discussion is the statement that “payments arising in a Contracting State and derived by a nominee on behalf of a resident of that other State would be entitled to benefits”. The first part of this paragraph describes a person deriving income “directly”, but the part just noted describes a nominee situation and does not treat that situation as one in which the principal is deriving the income *through* a fiscally transparent entity or arrangement.

The situation is even less clear in the context of a “bare trust”. Some countries such as Canada may disregard such entities in general or at least for certain purposes, and yet the Technical Explanation to the Canada-United States Treaty with respect to the addition of the fiscally transparent entity provisions under the 2007 Protocol does state that Canada would treat such a trust as a fiscally transparent entity. It can be very difficult to distinguish a bare trust from a purely contractual agency or nominee (and a trust can arise in the context of a nominee arrangement—see, for example, in *Hardoon v Belilios* [1901] AC 118 (Privy Council (Hong Kong))) although an important difference may be that with a trust a beneficial interest arises *through* which the income is derived by the beneficiary.

¹⁴⁹ For the same reasons as a financial intermediary, the authors would say it should be immaterial here whether the intermediary lender is itself a fiscally transparent entity, and that this should not be viewed as the resident deriving income through an arrangement in the sense contemplated by proposed Art.1(2) of the OECD Model in light of the comments in proposed para.26.14 of the Commentaries to Art.1.

¹⁵⁰ Canada has recently introduced such a regime (subs.212(3.2) and related provisions of the ITA). These rules do not re-attribute the income paid to the intermediate lender, which qualifies separately for normal treaty benefits. Rather, in order to defeat any tax benefit by reason of a differential between the treaty benefits (or other rate reduction) enjoyed by the intermediate lender and the benefits that would have been enjoyed by the ultimate lender on that income, an entirely separate amount of interest is deemed to be paid to the ultimate lender, in an amount which may not be the same as that paid to the intermediate lender, calculated as a function of the rate applicable to the intermediate lender versus that applicable to the ultimate lender, to produce an amount which when taxed at the rate applicable to the ultimate lender will cover the rate reduction being sought to be defeated. In this context, the authors would say that the fictitious income attributed by the source state to the resident should likewise not be considered to be derived by the resident through any entity or arrangement. It arises purely as an effect of the source state's law and is attributed directly to the resident. The residence state may not even see any such income, which as noted above might create different difficulties where that resident holds an interest in an entity that holds the loan to the intermediary lender.

¹⁵¹ The Hybrids Report, above fn.1.

¹⁵² Australia has at least two treaties with the exclusion (Norway 2006, and Germany (2015)) but it was agreed during negotiations on the Norway treaty that it does not apply to limited partnerships which are taxed as companies (as reflected in the Australian Explanatory Memorandum referred to in fn.55). See also the Australian Explanatory Memorandum on the Australia-Germany Treaty (at 1.189). Italy has concluded some treaties that provide for the explicit exclusion: Italy-Belarus (2005), Italy-Congo (2003), Italy-Denmark (1999), Italy-Estonia (1997), Italy-Finland

countries may have difficulty concluding that a member of an entity that derives dividends should be regarded as the beneficial owner of any part of the dividends or that the member “holds directly at least 25 per cent of the capital of the company paying the dividends” as required by Article 10(2)(a) of the OECD Model or meets similar requirements applicable under a relevant treaty.

For example, under a modification to Article X(2)(a) of the Canada-US Treaty, it is provided that “a company that is a resident of a Contracting State shall be considered to own the voting stock owned by an entity that is considered fiscally transparent under the laws of that State and that is not a resident of the Contracting State of which the company paying the dividends is a resident, in proportion to the company’s ownership interest in that entity”. This was added under the 2007 Protocol which added provisions on fiscally transparent entities.¹⁵³ Canada’s traditional position had been that even the members of a legally transparent partnership could not be considered to own shares held by the partnership, notwithstanding that Canada would have considered the members to be the beneficial owners of the dividends on those shares.¹⁵⁴ The point is that the mere inclusion of a provision such as proposed Article 1(2) of the OECD Model may not be sufficient for some states to achieve the grant of treaty benefits contemplated by provisions such as Article 10(2)(a) of the OECD Model, and in some cases may even be taken too far. The 2016 US Model now includes an ownership attribution rule for Article 10(2)(a) to deal with fiscally transparent entities. Addressing this issue through a specific treaty provision seems preferable but sometimes it is not dealt with at all or dealt with in a protocol or even only in an explanatory memorandum.

(1981), Italy-Ghana (2004), Italy-Iceland (2002), Italy-Indonesia (1990), Italy-Israel (1995), Italy-Korea (1989), Italy-Latvia (1997), Italy-Lithuania (1996), Italy-Macedonia FYROM (1996), Italy-Oman (1998), Italy-San Marino (2002), Italy-Saudi Arabia (2007), Italy-Slovenia (2001), Italy-Ukraine (1997). See also the revised Japan-Portugal tax treaty signed on 19 December 2011 (however, a protocol to which provides “6. For the purposes of subparagraph a) of paragraph 2 of Article 10 of the Convention: It is understood that the term ‘partnership’ does not include any entity that is treated as a body corporate for tax purposes in a Contracting State and is a resident of that Contracting State”) and the revised Japan-Germany tax treaty signed on 17 December 2015. India has this restriction in its treaties with Lithuania, Montenegro, Serbia, Syrian Arab Republic, Tajikistan and The Ukraine. However, India imposes a distribution tax on the distributing company rather than a tax on the recipient, so this restriction does not come into play.

¹⁵³ It should be noted that this provision relates only to para.X(2)(a), and does not constitute a general “deemed ownership provision”. Thus, in the context of the ownership tests in the Limitation on Benefits provision, the parties adopt an interpretation to the same effect through comments in the Technical Explanation, which is less satisfactory. However, this provision has been interpreted as being capable of accommodating tiered multiple partnership situations. See the Technical Interpretation dated 13 July 2009 (No. 2009-0318701E5 (E)).

¹⁵⁴ See, for example, the Technical Interpretation dated 10 August 1990 (No. 59341 (E)). On the other hand, Canadian tax authorities had permitted taxpayers to overcome this impediment in the context of the treaty with the US through the issuance of voting shares in the company to the partners of the partnership, bypassing the partnership with respect to voting rights but not distributions. See the Ruling dated 1 January 2003 (No. 2003-0032923 (E)). Interestingly, the Canadian tax authorities have even taken the position that the treaty with France Art.10(2)(a) cannot apply to a French Société en Nom Collectif (SNC) (treated by Canada as a partnership) even where the SNC elects to be taxed as a corporation for French purposes. See the Technical Interpretation dated 13 September 2001 (No. 2000-0048855 (E)), which is based on the reasoning that “the election by an SNC to be taxed in the same manner as French domestic corporations does not make the SNC a body corporate for tax purposes”.

Recent experience seems to indicate that the relevant issues are not fully understood or not fully addressed.¹⁵⁵ In the authors' view:

1. Article 10(2)(a) of the OECD Model should be revised to remove the partnership exclusion (and perhaps the definition of "company" should be revised to restrict it to something like "any entity treated as a company for tax purposes");
2. if the partnership exclusion is retained, then it should be revised so that it applies equally to all forms of legal entity or arrangement that are treated the same way for tax purposes; and
3. if Article 10(2)(a) of the OECD Model is intended to apply to dividends received by "fiscally transparent" entities, then it should be revised to deem the members of the entity to be the "beneficial owners" of any dividends received by the entity (assuming that the entity would normally be regarded as the beneficial owner of the dividends and that the members are the beneficial owners of their interests in the entity) and, in such a case, to deem them to own any shares held by the entity, in both cases to the extent of their respective proportionate interests in the entity.¹⁵⁶

A similar issue relates to the analogous provision of many treaties where the language is a bit different, in referring to "a company that controls directly or indirectly at least 10 per cent of the voting power" (see, for example, Article 10(2)(a)(ii) Canada-Australia). In the context of such a provision, it may be easier to conclude that a member that controls a corporate entity should be considered to control a subsidiary of the entity, but where the entity is a partnership it is not clear how this type of language should be applied, for example, in respect of a limited partnership where the general partner may have functional control over the decisions of the partnership even though it may have a much smaller percentage interest in the equity of the partnership. Similarly, with an entity that is a trust, can it be said that it is the beneficiary, rather than the trustee, that controls the underlying company? That may depend on the terms and conditions of the trust—and, in particular, what powers a beneficiary may be able to exercise—but it would be unusual for a beneficiary to possess such powers.

Moreover, there may be states that would grant treaty benefits under provisions such as Article 10(2)(a) of the OECD Model with respect to dividends derived by a company other than a partnership even if that company is not considered by those states to be a treaty resident of the other state (that is, the company's state) and is considered by those states to be a fiscally transparent entity because its income is attributed as such to its members, and those members are individuals resident in that other state.¹⁵⁷ It does not appear that this is the intended effect of

¹⁵⁵ See Appendix B for a more detailed discussion of certain examples of states attempting to address the application of Art.10(2)(a) in the context of shares held by fiscally transparent entities, both with and without provisions such as proposed Art.1(2) of the OECD Model.

¹⁵⁶ However, the authors would note that, if beneficial ownership (or direct ownership in general) is an issue in Art.10(2)(a) for fiscally transparent entities which are legal persons, then it is a broader problem for all occurrences of the beneficial ownership requirement in the treaty and should be solved more generally. The "holds directly" requirement is a specific Art.10(2)(a) problem that can be dealt with in that provision, perhaps by simply adding a reference to "indirectly".

¹⁵⁷ See the discussion of the German case involving a US S-Corporation in fn.132. It should be noted that Canadian revenue authorities take the position that there is no treaty protection from Canadian branch taxes afforded to US LLCs with individual members, since LLCs are viewed as non-resident corporations that are subjected to Canadian

proposed Article 1(2) of the OECD Model, since it is intended to grant treaty benefits with reference to a member's treaty entitlements only to the same extent as they would have been granted had the income been derived directly by the member, and not necessarily to the same extent as they would have been granted had the entity been regarded as a treaty resident.¹⁵⁸ This could and should be clarified, perhaps through minor changes to the drafting of proposed Article 1(2) of the OECD Model by replacing the second reference to "a resident" with a reference to "the resident", and also maybe clarifying that proposed Article 1(2) of the OECD Model does not have the effect of deeming an entity in relation to which it applies to be a (partial) treaty resident.

Permanent establishments

A somewhat similar issue relates to the attribution to members of a "fiscally transparent" entity, or to the entity, of any PE that the entity or members may have, or any activities that could be relevant to the determination of whether or not the entity or the members have a PE. The Hybrids Report does not address this issue directly,¹⁵⁹ although the Partnership Report does note that a PE of a partnership should be attributed to the members of the partnership.¹⁶⁰ The same approach is taken in various contexts in the existing Commentaries.¹⁶¹

While this may be a relatively uncontroversial approach with some partnerships—for example, partnerships that are legally transparent or in respect of which the partnership may be regarded as an agent of the partners—it is not at all obvious in certain countries that the same approach could be taken with respect to a "fiscally transparent" entity that has a distinct legal personality

branch taxes but not viewed as being entitled to treaty benefits in their own right, and the "fiscally transparent entity" provision in Art.IV(6) is considered to extend to such LLCs only the treaty benefits that their members would be entitled to. Thus, since individuals do not benefit from treaty protection in respect of Canadian branch taxes, which of course is because individuals are not subjected to Canadian branch taxes under domestic law in the first place, an LLC cannot gain such treaty benefits from its individual members. See the Technical Interpretation dated 23 October 2012 (No. 2012-0440101E5 (E)). This is quite ironic. The decision in *TD Securities (USA) LLC*, above fn.132, 2010 TCC 186; 2010 DTC 1137; [2010] 5 CTC 2426 involved treaty benefits in respect of Canadian branch taxes in favour of such an LLC, and the Court held that the LLC was entitled to them in its own right as a treaty resident, but the Court specifically limited the effect of its decision to periods before the Canada-US Treaty included the "fiscally transparent entity" provision in Art.IV(6). Whether or not such a limitation can be put on the effect of a judicial decision is rather unclear, but it is also unclear that the decision was correct on the main issue of treaty residence. The France-US Treaty (Art.10(8b)) includes a branch tax rule for corporate partners.

¹⁵⁸ This is a potential difference between a provision such as proposed Art.1(2) of the OECD Model and a partial residence provision if the latter applies to a company. See the discussion above in fn.132.

¹⁵⁹ Hybrids Report, above fn.1. See proposed para.26.13 of the Commentaries on Art.1 of the OECD Model.

¹⁶⁰ Partnership Report, above fn.8. See Partnership Report para.81 (under Example 11). See also the discussion of Example 12 of the Partnership Report which features a "fixed base". Reference may also be made to the discussions of Examples 13, 14 and 15 of the Partnership Report.

¹⁶¹ See para.19.1 of the Commentaries on Art.5 (which incorporates the views expressed in relation to Example 11 of the Partnership Report, above fn.8), para.42.38 of the Commentaries on Art.5 (in relation to services PEs), and paras 32.4 and 32.7 of the Commentaries on Art.23. Reference may also be made to the 2012 OECD Revised Permanent Establishment draft (see OECD, *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)* (Paris, 2012)), which will generalise para.19.1 of the Commentaries on Art.5, as well as the German *Bundesfinanzhof* (BFH) case (dated 24 August 2011, *Re E-LP (English Private Equity Fund)* IR 46/10 (2011) 14 ITLR 339 (BFH)).

or is otherwise not legally transparent.¹⁶² Certain bilateral treaties entered into by the countries represented by the authors do address some aspects of this issue, but not in any comprehensive manner.¹⁶³ Such provisions are referred to as “detailed integrity rules” in paragraph 45 of the MLI Explanatory Statement, and are not intended to be affected by the implementation of Article 3 of the MLI, but the MLI also does not purport to introduce any such rules, as noted above.¹⁶⁴ The 2016 US Model also addresses the issue in the definitions of “enterprise of a Contracting State” and “enterprise of the other Contracting State”, in providing that “the terms also include an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State”.

It would seem to be easier to attribute the activities and assets of an entity to its members than to attribute those of a member to the entity, or to simply aggregate them in determining the application of the PE exclusions in provisions such as Article 5(4) of the OECD Model. This context also gives rise to difficult tax policy considerations. For example, where the entity’s direct activities do not amount to a PE but would amount to a PE if aggregated with those of a particular member, should such an aggregation result in a PE with reference to all the entity’s members or only with reference to the particular member?

Other distributive rules

Similar issues can also arise under other distributive rules. For example, under Article 11(5), interest is deemed to arise in a Contracting State when the payer is a resident of that state, or where the person paying the interest, whether he is a resident of a Contracting State or not, has in the Contracting State a PE in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such PE.¹⁶⁵ If the payer is a “fiscally transparent” entity which is not a resident of a Contracting State, the first condition would not be met in relation to the entity (although it could perhaps be met in relation to a member that is a resident of that state if the payment is treated as having been made by the member), although the second condition could perhaps be met where the entity has a PE in a Contracting State. Here, too, however, one question is whether the activities of the entity and its member(s) should be aggregated for the purposes of this determination.

Under Article 15(2), there is an exemption for the remuneration of a resident of a particular state where, among other conditions, the remuneration is paid by, or on behalf of, an “employer” who is not a resident of the other state, and the remuneration is not borne by a PE which the “employer” has in the other state. It is not clear how to apply this provision in the context of a

¹⁶² US case law has been very clear for many years that such an approach should be taken regardless of legal personality. See *Unger v Comm’r*, 936 F2d 1316 (DC Cir. 1991); *Donroy Ltd v United States*, 301 F2d 200 (9th Cir. 1962).

¹⁶³ See, for example, the Australia-New Zealand Treaty (Art.7(7)), the Australia-France Treaty (Art.29(3)), the Australia-US Treaty (Art.7(9)), the France-US Treaty (Arts 7(4) and 10(5)(c)), the France-UK Treaty (Protocol Point 3), the France-Switzerland Treaty (Arts 7(8) and 24(4)) and the Australia-Japan Treaty (Art.7(9)). See also the Technical Explanation to the Canada-US Treaty, which states the interpretation that a “US LLC’s profits will be treated as having been derived by its U.S. resident owner inclusive of all attributes of that income (e.g., such as having been earned through a permanent establishment)”.

¹⁶⁴ See the discussion above under “Partial residence provisions”.

¹⁶⁵ Analogous sourcing rules apply under Art.12 of many bilateral treaties, though not the OECD Model.

“fiscally transparent” entity. This is an issue addressed by paragraphs 6.1 and 6.2 of the Commentaries on Article 15. In the relevant part, paragraph 6.2 provides as follows:

“[...] In order to achieve a meaningful interpretation of subparagraph b) that would accord with its context and its object, it should therefore be considered that, in the case of fiscally transparent partnerships, that subparagraph applies at the level of the partners. Thus, the concepts of ‘employer’ and ‘resident’, as found in subparagraph b), are applied at the level of the partners rather than at the level of a fiscally transparent partnership. This approach is consistent with that under which other provisions of tax conventions must be applied at the partners’ rather than at the partnership’s level. While this interpretation could create difficulties where the partners reside in different States, such difficulties could be addressed through the mutual agreement procedure by determining, for example, the State in which the partners who own the majority of the interests in the partnership reside (i.e. the State in which the greatest part of the deduction will be claimed).”

This approach may be sensible from a tax policy perspective,¹⁶⁶ and may be easy to apply for certain states or in the context of certain types of entities that are legally transparent, but certain states may have difficulties applying it in the context of a “fiscally transparent” entity that is not legally transparent. For those states, the addition of proposed Article 1(2) of the OECD Model would not seem to provide any assistance.

One problem is that the language of proposed Article 1(2) of the OECD Model only speaks to the attribution of income, and thus does not necessarily require or permit a departure from a state’s normal qualification rules and principles with respect to the attribution of activities.¹⁶⁷ The same type of problem is present in the context of the discussion above relating to PEs and beneficial ownership, as well as the application of Article 10(2)(a). Thus, although these issues could perhaps be addressed in the Commentaries, the Commentaries should not be inconsistent with the OECD Model, nor extrapolate too far from the more ordinary and natural interpretation of the relevant language,¹⁶⁸ so a more effective approach would be to develop one or more provisions to be added to the OECD Model that include the right language—which could either

¹⁶⁶ See, however, the German observation in no. 13.1 of the Commentaries on Art.15.

¹⁶⁷ The authors would also note that proposed Art.1(2) of the OECD Model refers to income being regarded as the “income of a resident”, which does not mesh perfectly with other aspects of certain distributive Articles—for example, those that refer to income being “paid to” a resident (i.e. including Arts 10 and 11) or “derived by” a resident (i.e. including Art.13). This is a minor interpretive issue in the authors’ view but still it would be preferable to have a stronger or more coherent connection between the language of such a provision and that of other provisions in the OECD Model.

¹⁶⁸ As noted (at [10] and [11]) by the Canadian Federal Court of Appeal in *The Queen v Prévost Car Inc*, 2009 FCA 57; 2009 DTC 5053; [2009] 3 CTC 160, a case on the interpretation of the term “beneficial owner” in the Canada-Netherlands Tax Treaty Art.10(2), while the Commentaries are a “widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions” (citing *Crown Forest Industries v Canada*, above fn.129, [1995] 2 S.C.R. 802, and K. Vogel, *Klaus Vogel on Double Taxation Conventions*, 3rd edn (The Hague: Kluwer Law International, 1997), 43), “[t]he same may be said with respect to later commentaries, when they represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered and when, of course, neither treaty partner has registered an objection to the new Commentaries”.

specifically address the issues or at least be drafted in terms that are general enough to cover issues that could be elaborated on in the Commentaries.¹⁶⁹

The other problem, as noted further above, is that proposed Article 1(2) of the OECD Model is aimed at treaty benefits that may be available to the recipient of the payment in respect of amounts derived by or through a fiscally transparent entity, and is not intended to affect the determination of which person or entity and which events the source state may tax under its domestic laws. Thus, it does not address the case of a payment by or amount received from a fiscally transparent entity. It may be necessary, therefore, to address such cases through a different provision that relates to payments *by and from* fiscally transparent entities.

Taxation by the residence state—saving clause and relief from double taxation

As noted above, the version of proposed Article 1(2) of the OECD Model in the Hybrids Report no longer includes a second sentence which sets out a “saving clause”,¹⁷⁰ but a more elaborate version of such a provision, together with proposed Commentaries, is included in the Treaty Benefits Report.¹⁷¹ Under the MLI, the degree to which to address the “saving clause” issue is optional, in that states can select either the detailed version under Article 11 or, failing which, a simplified version tacked onto Article 3(1) under Article 3(3). It is important to note that these two alternatives may not have the same effects. There is also Article 3(2) of the MLI, as well as Option C under Article 5 of the MLI, dealing with certain credit and exemption obligations, along the lines described in paragraph 64 of the Treaty Benefits Report, which are optional.

Under the Treaty Benefits Report, this provision would be added as Article 1(3) of the OECD Model, as follows:

“This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 A [23 B], 24 and 25 and 28.”¹⁷²

Under Article 11 of the MLI, a fairly detailed provision would also be added along these lines, although articulated in more generic terms without reference to particular Article numbers, as it must be. Interestingly, under Article 3(3) of the MLI, with respect to Covered Tax Agreements for which one or more parties has made the reservation in Article 11(3)(a) (Application of Tax Agreements to Restrict a Party’s Right to Tax its Own Residents), the following sentence would be added at the end of Article 3(1) paragraph 1:

“In no case shall the provisions of this paragraph be construed to affect a Contracting Jurisdiction’s right to tax the residents of that Contracting Jurisdiction.”

It seems important, thus, to emphasise that the effect of Article 3(3) of the MLI would not reproduce the short version in the Treaty Benefits Report; it would not explicitly preserve treaty obligations under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23A

¹⁶⁹ Certain drafting alternatives are discussed below under the heading “What to do about all this?”

¹⁷⁰ See, however, proposed para.26.16 of the Commentaries on Art.1.

¹⁷¹ Treaty Benefits Report, above fn.12. See paras 61–64 of that report.

¹⁷² The Treaty Benefits Report, above fn.12, also proposes to add paras 26.17–26.21 to the Commentaries on Art.1.

[23B], 24 and 25 and 28 of the OECD Model.¹⁷³ That may be immaterial from the perspectives of some jurisdictions (where viewed as unnecessary) but it may matter to others.

While not directly linked to proposed Article 1(2) of the OECD Model, proposed Article 1(3) is obviously intended to ensure that proposed Article 1(2) of the OECD Model, among other provisions in the OECD Model, does not preclude the Contracting States from taxing their own residents, subject to retaining the obligation to provide relief from double taxation under provisions such as Article 23 of the OECD Model (and subject to other qualifications). The same can be said for Article 11 of the MLI.¹⁷⁴ The existing Commentaries and the Partnership Report also address this area to some extent.¹⁷⁵

Article 3(2) and Article 5 of the MLI also speak to taxation by a residence state—or, more specifically, to the obligation of a residence state to provide an exemption or credit in respect of income that the other state is also entitled to tax as a residence state. The authors would note that, although Article 3(2) of the MLI seems to be intended to address situations involving fiscally transparent entities (see paragraph 41 of the MLI Explanatory Statement, referring to paragraph 64 of the Treaty Benefits Report¹⁷⁶), its wording does not seem to be restricted to that context. It simply states as follows:

“Provisions of a Covered Tax Agreement that require a Contracting Jurisdiction to exempt from income tax or provide a deduction or credit equal to the income tax paid with respect to income derived by a resident of that Contracting Jurisdiction which may be taxed in the other Contracting Jurisdiction according to the provisions of the Covered Tax Agreement shall not apply to the extent that such provisions allow taxation by that other Contracting Jurisdiction solely because the income is also income derived by a resident of that other Contracting Jurisdiction.”¹⁷⁷

Paragraph 64 of the Treaty Benefits Report provides the following example, as part of a proposed new paragraph 11.1 of the Commentaries on Articles 23A and 23B:

“11.1 In some cases, the same income or capital may be taxed by each Contracting State as income or capital of one of its residents. This may happen where, for example, one of the Contracting States taxes the worldwide income of an entity that is a resident of that State whereas the other State views that entity as fiscally transparent and taxes the members of that entity who are residents of that other State on their respective share of the income. The phrase ‘(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State)’ clarifies that in such cases, both States

¹⁷³ MLI, above fn.3, Art.11 would seem to cover all the items in proposed Art.1(3) plus additional matters as contemplated in the Treaty Benefits Report, above fn.12, para.63.

¹⁷⁴ As noted, this is not entirely true for the “saving clause” elements that are directly linked to the fiscally transparent entity provision in Art.3(1) which would add a “second sentence” under Art.3(3) where the broader provision in Art.11 is displaced by a reservation, because this would not necessarily preserve the obligation to provide relief from double taxation under provisions such as Art.23 of the OECD Model (or the application of other provisions).

¹⁷⁵ See para.6.1 of the Commentaries on Art.1, as well as paras 32.1–32.7 of the Commentaries on Art.23, in addition to the Partnership Report, above fn.8, paras 93 and following.

¹⁷⁶ Treaty Benefits Report, above fn.12.

¹⁷⁷ MLI, above fn.3, Art.3(2).

are not reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer and that each State is therefore only obliged to provide relief of double taxation to the extent that taxation by the other State is in accordance with provisions of the Convention that allow taxation of the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable, thereby excluding taxation that would solely be in accordance with paragraph 3 of Article 1. Whilst this result would logically follow from the wording of Articles 23 A and 23 B even in the absence of that phrase, the addition of the phrase removes any doubt in this respect.¹⁷⁸

Similarly, Option C under Article 5 of the MLI, which only applies to credit-based relief along the lines of Article 23B of the OECD Model, would limit relief obligations on the part of a residence state "to the extent that [the provisions of the treaty] allow taxation by that other Contracting Jurisdiction solely because the income is also income derived by a resident of that other Contracting Jurisdiction".¹⁷⁹

This approach may give rise to an issue under some treaties. For example, it is common for UK treaties to provide for a credit where the same income is taxed by the other state even where it is taxed in the hands of two different persons by each state, and thus quite possibly in both cases by reason of residence, for reasons having nothing to do with the existence of a fiscally transparent entity.¹⁸⁰ Would this provision apply where there is double residence taxation in a context not involving a fiscally transparent entity? That is not clear. It is also not clear that such a provision would be necessary in some countries. Looking again at the UK, the authors note the decision in *Bayfine UK v HMRC*,¹⁸¹ where the Court of Appeal held, based on general principles, that both states are not reciprocally obliged to provide relief for each other's tax—or, rather, more precisely, that the UK was not obliged to provide relief for US tax imposed on a residence basis (in a context involving a fiscally transparent entity, which was opaque and resident in the UK) in respect of income that at first instance but not in the Court of Appeal was considered to arise in the UK.¹⁸² The authors would also note that the above approach to Article 23 would seem to displace the obligations of both states to provide relief with respect to third state income, since both would be taxing it only because of residence, resulting in the possibility of double taxation.¹⁸³

¹⁷⁸ Treaty Benefits Report, above fn.12, para.64.

¹⁷⁹ Somewhat curiously, there is no option as such in the MLI, above fn.3, Art.5 in relation to exemption-based relief along the lines of the OECD Model Art.23A, despite such a proposal in the Treaty Benefits Report, above fn.12, para.64.

¹⁸⁰ It is understood that the UK is not proposing to adopt Art.3(2) or Option C of Art.5 of the MLI, above fn.3, so this may not be a problem in practice in the UK.

¹⁸¹ *Bayfine UK v HMRC* [2011] EWCA Civ 304; [2011] STC 717.

¹⁸² Art.23(3) of the treaty excluded relief on the part of the UK for certain US taxes imposed on the basis of citizenship, but this provision did not technically apply in respect of US tax imposed on the basis of residence.

¹⁸³ The risk of double taxation would be avoided under a "reverse saving clause" approach, which can preclude residence-based taxation. See the discussion below.

These issues are discussed below in greater detail. However, the authors pause here to note that these are not the only issues that could or should be addressed or considered in this context. There are at least five good questions here:

1. Where an entity is considered to be fiscally transparent by a Contracting State in which one of the members is a resident, and the entity is a treaty resident of the other Contracting State, can the state in which the member is a resident tax that member's share of the income of the entity if the entity does not have a PE (or other source of income) in that state? This the authors will refer to as the "Padmore question",¹⁸⁴ which in other words involves the issue of whether or not a treaty benefit which may be available to the entity would preclude the taxation of (or must likewise be granted to) the member.
2. Where an entity is considered to be fiscally opaque by a Contracting State which considers the entity to be resident therein, and the entity has members that are resident in the other Contracting State which considers the entity to be fiscally transparent, does the requirement under proposed Article 1(2) of the OECD Model to apply the treaty as if the income were the income of the members resident in the other state (in accordance with the other state's treatment) preclude the state in which the entity is resident from taxing the entity in a manner that is inconsistent with the manner in which it could tax the members (for example, on business profits from a PE outside that state, or even income from a source within that state that is not attributable to a PE in that state)?
3. Where an entity is considered to be fiscally opaque by a Contracting State which considers the entity to be resident therein, does the requirement under proposed Article 1(2) of the OECD Model to apply the treaty as if the income were the income of the members resident in the other state (in accordance with the other state's treatment) preclude the state in which the entity is resident from taxing (or otherwise restrict its taxation of) those non-resident members on distributions from the entity?
4. If the answer to the questions in 2 or 3 is "no", then the related question that is dealt with under Article 3(2) and Option C under Article 5 of the MLI arises: is the other state required to provide an exemption or give credit to the members in respect of taxes imposed by the source state on the entity or those members in respect of the underlying income of or distributions from the entity?
5. Where an entity is considered to be fiscally opaque by a Contracting State in which one of the members is a resident, and the entity is considered to be fiscally transparent by the other Contracting State, is the residence state required to give credit to the member in respect of any tax imposed on the member by the other state in respect of the entity's income, or to exempt what it views as the member's

¹⁸⁴ See *Padmore v IRC (Padmore)* [1989] STC 493; [1989] BTC 221 (CA) where the Court held that the UK could not tax a UK resident member of a partnership if it could not tax the partnership.

income from its interest in the entity (depending on the provisions of the relevant treaty)? This the authors will refer to as the “Anson question”.¹⁸⁵

In addition to the US treaties, which include a general “saving clause” along the lines of that contemplated in the Treaty Benefits Report¹⁸⁶ and Article 11 of the MLI, a number of bilateral treaties entered into by the states represented by the authors address at least some of these questions, as well as other issues,¹⁸⁷ but may not be as comprehensive as proposed Article 1(3) of the OECD Model or Article 11 of the MLI.

The Padmore question

The existing Commentaries are relatively clear in this regard, in saying that “the provisions of the Convention that restrict the other Contracting State’s right to tax the partnership on its income do not apply to restrict that other State’s right to tax the partners who are its own residents on their share of the income of the partnership”.¹⁸⁸ The courts of some countries may accept this proposition under general principles,¹⁸⁹ but something more may be thought to be required in other states. Thus, states may have provisions in their bilateral treaties, or even domestic law provisions, that specifically address the question, such as Canada does.¹⁹⁰ Such provisions are generally (though not always) aimed at ensuring that the residence state of the member can tax

¹⁸⁵ See *Anson*, above fn.104, [2015] UKSC 44; [2015] STC 1777.

¹⁸⁶ Treaty Benefits Report, above fn.12.

¹⁸⁷ See, for example, the Australia-France Treaty (Art.29(4) and 4(5)), the Australia-UK Treaty (Art.24), the Canada-France Treaty (Art.29(1)), the France-US Treaty (Arts 14 and 29(2)), the France-UK Treaty (Protocol Point 5), the Netherlands-Switzerland Treaty (Protocol), the Netherlands-UK Treaty (Art.22). Similarly, the US 894(c) Regulations are explicit that a domestic entity which is viewed as opaque by the US may be taxed without regard to the attribution of income in the residence state of one of its members (see §1.894-1(d)(2)). Indian treaties do not contain any such “saving clause” (except for the India-US Treaty).

With respect to relief from double taxation, see the Australia-New Zealand Treaty (Art.23(3)), the Australia-France Treaty (Art.29(1)), the Australia-France Treaty (Art 29(4)), the Australia-UK Treaty (Art.24), the France-Japan Treaty (Protocol 13A), the France-UK Treaty (Protocol Point 5), the Italy-US Treaty (Protocol 4).

¹⁸⁸ See para.6.1 of the Commentaries, as well as Example 16 in the Partnership Report, above fn.8.

¹⁸⁹ For example, in Germany, this was the issue in the BFH case of 25 May 2011 (*Re German Taxation of Hungarian Partnership (Conflict of Qualification)* IR 95/10 (2011) 17 ITLR 884 (BFH), together with commentary by J. Luedicke at pp.886–892). The BFH case clearly stated that Germany is not prevented by its treaty with the residence state of the entity in question (being a Hungarian betéti társaság) from attributing income of the entity to a German-resident member, although it also held that, in so far as the income was attributable to the entity’s PE in Hungary, it had to be exempted under the treaty (subject to the progression clause).

In similar circumstances, the language in the sourcing rule in the France-UK Treaty (“but any such income, profits or gains shall be treated for the purposes of Article 24 as income, profits or gains from sources in that other State”) seems to cover all income derived by the partnership from sources in whatsoever state. Thus, if the state of residence of the partner is an exemption state, it would read this clause as deeming all income to be PE income from the state of the partnership with the consequence that it has to be exempted under the treaty between these two states. On the contrary, in the absence of such a clause income derived by the partnership from a PE in a third state could be taxed by the state of residence of the partner without any restriction imposed by the treaty with the state of the partnership.

¹⁹⁰ See, for example, the Canada-Australia Treaty Art.26A, which provides that “[n]othing in this Convention shall be construed as preventing Canada from imposing a tax on amounts included in the income of a resident of Canada with respect to a partnership, trust, or controlled foreign affiliate, in which that resident has an interest”, as well as the Canadian Income Tax Conventions Interpretation Act, RSC 1985, c. I-4 s.6.2, as amended, which provides that notwithstanding the provisions of an income tax convention, the law of Canada is that for the purposes of the application of the convention and the Act to a person who is a resident of Canada, “a partnership of which that person is a member is neither a resident nor an enterprise of that other state”.

the member on the member's share of the income of an entity that the state regards as being "fiscally transparent", or even in some cases aimed at ensuring that the state can tax the member more generally in respect of the member's interest in an entity irrespective of whether the state regards the entity as being "fiscally transparent". The "saving clause" provisions in proposed Article 1(3) and Articles 3(3) and 11 of the MLI would make it clear that the treaty does not preclude either state from taxing its residents, subject to the specified exceptions (other than under Article 3(3) of the MLI) including obligations to give credit.¹⁹¹

Taxation of the entity as a resident

Undoubtedly, the OECD Model and the existing Commentaries in general are premised on the proposition that each state may apply its own approach to the determination of which entities it considers to be its residents and the manner in which to tax them. However, the OECD Model does not currently include proposed Article 1(2) of the OECD Model and so there is nothing in it that would explicitly mandate the approach of focusing upon whom the income is to be attributed under the laws of a member's residence state. In contrast, if treaty benefits must be granted by the state in which the entity is resident on the same basis as if the income were that of its non-resident members, it is not obvious, in the absence of a "saving clause", why that state would be entitled to tax that income if that income is from a source outside that state, or why that state would be entitled to tax that income at rates that exceed those provided for in Articles 10, 11 and 12, or in circumstances beyond those contemplated by Article 13, even if the income does arise in that state but is not attributable to a PE in that state (for example, where the entity derives dividends, interest, royalties or capital gains from that state). On the assumptions mandated by proposed Article 1(2) of the OECD Model, that could perhaps constitute taxation on a par with the taxation of non-residents in respect of foreign source income, which is generally precluded by Article 21 of the OECD Model,¹⁹² or the taxation of non-residents at rates or in circumstances exceeding the limitations in Articles 10, 11, 12 and 13.¹⁹³ This issue is addressed in Example 17 of the Partnership Report,¹⁹⁴ but there it is noted that a majority of states would not have considered that the treaty restricts their capacity to tax the entity even if they in general would have applied the conclusions of the Partnership Report, but some states took a contrary view, at least at that time.

¹⁹¹ The Germany-Australia Treaty (2015) contains a provision such as proposed Art.1(2), and in the Protocol there is the following statement regarding relief from double taxation:

"If, in accordance with paragraph 2 of Article 1, income is taxed in a Contracting State in the hands of an entity or arrangement that is treated as wholly or partly fiscally transparent under the laws of the other Contracting State and is also taxed in the hands of a resident of that other State as a participant in such entity or arrangement, and this results in double taxation, the competent authorities of the Contracting States shall consult each other pursuant to Art 25 to find an appropriate solution."

Not clear from this, among other things, is how the existence of double taxation would be measured in such a case. Is it double taxation if the effective rate exceeds the rate that would be payable by the member (or the entity?) if both states treated the entity or transparent or as opaque? It is also not clear what the "appropriate solution" might be and whether this would be generalised or could be different in each case.

¹⁹² Art.21 considerations also arise in the context of the Padmore issue.

¹⁹³ This issue is also dealt with in the next section below.

¹⁹⁴ Partnership Report, above fn.8.

The assumptions in Example 17 of the Partnership Report are that P is a partnership established in State P, A and B are P's partners who reside in State R, State P treats P as a taxable entity while State R treats it as a transparent entity, and P derives royalty income from State P that is not attributable to a permanent establishment in that state. On these assumptions, the Partnership Report states that:

“[...] State P would, under its domestic law, impose tax on the royalties in the hands of the partnership. From its perspective, P is a resident taxpayer and as such liable to tax on its income arising in State P. Thus, Article 12 of the Convention would not apply since the royalties arise in State P and are paid to a resident of State P. [...]”¹⁹⁵

As noted above, it is the authors' view that the application of proposed Article 1(2) of the OECD Model involves a two-step process, the first of which is to be conducted without regard to proposed Article 1(2), wherein the taxing state (that is, the source state) determines, based on its own approach, which persons to tax and in respect of which events. If the treaty includes a provision such as proposed Article 1(2), however, the taxing state must recognise an exemption or a rate reduction that would be available to a member of an entity that is fiscally transparent under the laws of the member's residence state. Thus, it may be constrained in the manner or as to the degree to which it may be permitted to tax its own resident (just as it may be constrained in the manner or as to the degree to which it may be permitted to tax an entity based in the other jurisdiction or even a third state). On the other hand, the “saving clause” in proposed Article 1(3) of the OECD Model (or Article 3(3) or 11 of the MLI) would clearly preclude the entity from asserting treaty benefits that would be available to its members.

Taxation of distributions from the entity by the source state

Interestingly, if proposed Article 1(3) of the OECD Model (or Article 3(3) or 11 of the MLI) is adopted, the “saving clause” based on *residence* would not save the taxation that the source state would be able to levy against an entity that it regards as opaque and not resident in that state, since it does not save the taxation of *non-residents*. Indeed, that is the whole point of granting to the entity benefits that would be available to the member(s) where the entity is fiscally transparent in a member's state, notwithstanding that no benefits would be available if the income were attributed to the entity under the normal attribution rules of the source state—for example, where the entity would be regarded by the source state as being resident in a non-treaty state.¹⁹⁶

¹⁹⁵ See the Partnership Report, above fn.8, paras 130 and 131 which state this as the majority view. It is also noted in the Partnership Report (at para.132) that:

“Some delegates, however, would continue to follow the principle that State P, in applying the Convention, should take into account the fact that, under the allocation of income rules in State R, the income would be liable to tax in the hands of A and B. Their position would be that State P is obliged to relieve the potential resulting double taxation by applying Article 12 to exempt the income in the hands of the partners, thus leaving the exclusive taxing right with State R.”

¹⁹⁶ In a very important sense, the effect of this in some cases is to extend treaty benefits to non-treaty entities, although the authors do not suggest that there is necessarily anything wrong with that (although that too is debatable and may not be welcomed, in particular, by developing countries—see D. Sanghavi, “BEPS Hybrid Entities Proposal: A Slippery Slope, Especially for Developing Countries” (23 January 2017) 85(4) *Tax Notes International* 357). That would also mean that if there are good non-tax reasons for holding assets through a particular non-treaty country, there would not be a tax disadvantage in doing so because of non-treaty status, assuming the entity is fiscally transparent

However, that is not exactly the same as the source state taxing non-resident members in respect of distributions from an entity that it considers to be a resident of that state. Clearly, that is permitted by Article 10 of the OECD Model, at the rates specified in that Article, but is it obvious that proposed Article 1(2) of the OECD Model would not affect that? As noted above, a “saving clause” based on residence, such as proposed Article 1(3), would not save the taxation of non-residents, so the question would be whether the taxation of non-resident members in respect of distributions from the entity would be affected in the first place by proposed Article 1(2) of the OECD Model.

This situation is considered in Example 18 of the Partnership Report,¹⁹⁷ but the discussion in that Example focuses more on the question of whether the treaty requires the residence state of the member to give credit to the member for any tax imposed by the source state in respect of the entity’s income or on a distribution from the entity, or to exempt that income or distribution. It does not set out any analysis with respect to the question of whether the treaty could restrict the source state from taxing that income or distributions based on the qualification applied by the residence state of the member.

Presumably, the premise here is that there is no such restriction based on the propositions articulated in relation to Examples 13 and 15 of the Partnership Report, where it is assumed that the entity is fiscally transparent in both states but that there is nevertheless a conflict of qualification because one of the states recognises loans from members to a partnership while the other does not. Paragraphs 102 and 103 of the Partnership Report provide as follows:

- “102. The Committee agreed that, in addressing conflicts of qualification problems faced by the State of residence, a useful starting point is the recognition of the principle that the domestic law of the State applying its tax governs all matters regarding how and in the hands of whom an item of income is taxed. The effect of tax conventions can only be to limit or eliminate the taxing rights of the Contracting States. In the case of the source State, the right to tax items of income is limited by provisions based on Articles 6 through 21 of the Model Tax Convention. In the case of the residence State, while provisions based on Articles such as 8 and 19 might be relevant, the primary restriction would arise from the provisions of the Article on Elimination of Double Taxation (Article 23 in the Model Tax Convention), by which the residence State agrees to either exempt income that the

in the member’s residence state. This can also give a very different result from a “limitation on benefits” provision (also put forward in the Treaty Benefits Report, above fn.12), in cases where fiscally transparent member-based vicarious treaty benefits would be better than entity-based derivative benefits (given also any Limitation on Benefits (LOB) applicable to a member), although the opposite can also be true, that entity-based derivative benefits (and subject to a LOB) can be better than member-based treaty benefits.

As a more general point, the authors note that the introduction of provisions such as proposed Art.1(2) of the OECD Model can enhance treaty benefits over those currently being enjoyed (if any) resulting in the source state’s taxation being limited by more than one treaty—in some cases effectively entitling the entity and/or its members to the better of the rates applicable under multiple treaties. For example, where the entity is fiscally opaque in its own residence and fiscally transparent in the residence(s) of its member(s), more than one treaty may apply and they may provide for different rates or even different rules on PEs and other differences. See the discussion in existing para.6.5 of the Commentaries on Art.1, noting the possibility of “dual benefits”. See also Example 3 in the 894(c) Regulations.

¹⁹⁷ Partnership Report, above fn.8.

source State may tax under the Convention or to give a credit for the tax levied by the source State on that item of income.

103. When taxing an item of income, the source State therefore applies its domestic law, subject to the restrictions and limitations imposed on it by the provisions of its tax conventions. The way that the State of residence qualifies an item of income for treaty purposes has no relevance on how and in the hands of whom the State of source taxes that item of income. The reverse, however, is not true. The way the State of residence eliminates double taxation will depend, to some extent, on how the Convention has been applied by the State of source.¹⁹⁸

However, there is no compelling discussion in these examples as to how to reconcile the principle that the source state applies its domestic law, subject to the restrictions and limitations imposed on it by the provisions of its tax conventions, and the principle that the domestic laws of the residence state should have an impact on the way in which the source state applies the provisions of (and restrictions contained in) the treaty. The fact that these Examples also assume that the entity is treated as a fiscally transparent partnership in both states also does not help in understanding what the implications of proposed Article 1(2) of the OECD Model would be where it may be engaged and thus at least in theory could affect the application of the treaty by the source state.

Interestingly, it should also be noted that some treaties include what may be referred to as a “reverse saving clause”, which can preclude residence-based taxation of an entity by the state in which it is a resident, and preclude the taxation by that state of distributions by that entity. An example would be the 2001 Netherlands-Belgium Treaty (Article 2 of the Protocol), which provides, among other things, as follows:

“Where a company is subject to tax as such in a Contracting State but the income or capital of this company is, in the other Contracting State, taxed as income or capital of the participants in this company, the provisions of this Convention shall not be allowed to result in a double taxation or a total or partial exemption of such income or capital. In order to avoid such effect, the tax, the income and the capital of the company shall be considered as the tax, income and capital of the participants in this company in proportion to their entitlement to the company’s capital. To the extent necessary, the participants in the company should be allowed, each for their part, to credit the tax levied on the company in respect of this income or this capital (including any tax withheld at the source in third States) against the tax for which they are liable in respect of the same income or the same capital, and that the State of residence of the company waives possible taxation of the participants in this company who are residents of the other Contracting State in respect of the profits distributed by this company to such participants.”¹⁹⁹

And further provides (in Article 4(b)) as follows:

“Where a company is not subject to tax as such in a Contracting State and is subject to tax as such in the other Contracting State, the other Contracting State shall apply, at the request

¹⁹⁸ Partnership Report, above fn.8, paras 102 and 103.

¹⁹⁹ Netherlands-Belgium Treaty 2001, Art.2 of the Protocol.

of the company, the provisions of Chapters III, IV and V of this Convention insofar as these provisions would have had to be applied if the persons having rights in the company's capital had directly received or possessed, each proportionally to its share in that company, the income or capital of said company. The application of the preceding sentence shall in no way affect that the other Contracting State shall determine pursuant to its domestic laws the taxable base of the company and shall reduce this base only insofar as such reduction results directly from the preceding sentence.²⁰⁰

While these provisions would seem to be consistent with the more general objectives espoused by the Partnership Report and the Hybrids Report—to ensure that there is neither double taxation nor double non-taxation—the approach adopted is inconsistent, in that the premise of the Partnership Report and the Hybrids Report is that a state in which the entity is a resident may tax the entity and tax distributions from the entity.²⁰¹

With respect to the taxation of distributions from the entity, it seems clear that the formulation of the “saving clause” contemplated by the Treaty Benefits Report or the MLI does not quite fit the case, in that it speaks to the taxation of residents, not the taxation of non-residents. This point, too, is clarified in certain treaties, such as the Netherlands-US Treaty, which in a related Memorandum of Understanding²⁰² states that the provision in that treaty which is parallel to proposed Article 1(2) of the OECD Model “shall not prevent either State from taxing the item as the income of the person considered by that State to have derived the item of income”, but then sets out an example as follows (emphasis added):

“Individual Z, a resident of the Netherlands, is the sole member of Y, a U.S. limited liability company (LLC). Y owns X, a U.S. corporation. Y has elected under the U.S. entity classification rules to be taxed as a U.S. corporation. Under Netherlands law, however, Y is treated, in this situation, as a fiscally transparent entity. On date A, X distributes a \$100 dividend to Y. On date B, Y distributes a \$100 dividend to Z. Under Netherlands law, the dividend from X to Y is considered to be derived by Z. The two States agree that, in these circumstances, the United States is not prevented from exercising full taxing jurisdiction over Y (which is treated as a U.S. corporation) and, accordingly, the United States may tax the dividends from X to Y *and from Y to Z* in accordance with its domestic law. However, with respect to the dividend from Y to Z, the rate of tax applicable to the dividend shall be determined in accordance with Article 10.”²⁰³

Clearly, the taxation by the US of “dividends from ... Y to Z” would be the taxation of a resident of The Netherlands, not the taxation of a US resident.

In the authors' view, as noted above, proposed Article 1(2) of the OECD Model can be viewed as contemplating a two-step process for the granting of treaty benefits. The first step is the

²⁰⁰ Netherlands-Belgium Treaty 2001, Art.4(b).

²⁰¹ Partnership Report, above fn.8. Hybrids Report, above fn.1. Double residence taxation is normally addressed through the usual types of residence tie-breaker provisions, but these are not effective where it arises because the existence of a fiscally transparent entity (which is not itself a resident of both states) results in the taxation of two different residents.

²⁰² See Memorandum of Understanding, 2004, Art.XIV, under (a).

²⁰³ Memorandum of Understanding, 2004, Art.XIV.

application by the source state of its usual approach to determining, in accordance with its domestic law, which non-resident persons or entities and which events it seeks to tax. That is intended to remain unaffected by proposed Article 1(2) of the OECD Model. Thus, proposed paragraph 1(2) is not intended to preclude the residence state of a distributing entity from taxing non-residents in respect of distributions from the entity. Consistently, proposed Article 1(2) of the OECD Model is intended to apply only in respect of income considered to be derived *by or through* an entity rather income derived *from* a fiscally transparent entity.²⁰⁴ Thus, proposed paragraph 1(2) should not affect the taxation of distributions (or other payments) that it makes, except to the extent that they may be made to yet another fiscally transparent entity that can claim the benefits of a treaty applicable to it or its members.

Nevertheless, the authors believe it would be preferable to clarify the matter in the OECD Model. If the consensus is that a state should be entitled to tax an entity that it regards as one of its residents and to tax non-resident members in respect of distributions (or other payments) from the entity, then it may be preferable to have a broader “saving clause” than the one currently contemplated—which would address not only the taxation by a state of its own residents but also the taxation of non-residents in respect of distributions (and other payments) from its own residents (or from non-residents having PEs within its jurisdiction), subject of course to appropriate limitations. It may also be sufficient to further clarify this in the commentaries on proposed Articles 1(2) and (3) of the OECD Model. The authors note that Article 3(2) of the MLI does not achieve this, because it too is focused on the taxation of residents, not non-residents.

Relief from double taxation granted by residence state in respect of underlying income and distributions

Where Member State treats entity as transparent

As noted above, the state of residence of a member may treat the entity as being fiscally transparent while the other state may treat the entity as being fiscally opaque and as one of its own residents. In that context, the discussion in Example 18 of the Partnership Report concludes that the state of residence of the member would be in theory required to grant credit in respect of source state tax on (or to exempt) both underlying income and distributions, although the following is noted:

- “137. A clear distinction must be made between the generation of profits and the distribution of those profits. State R, if it is an exemption State, has to exempt from tax the generation of profits in year 1 and therefore is not permitted under the Convention to tax the profits when earned on the basis that Article 10 would allow them to be taxed when distributed. Similarly, however, State R (if it is a credit State) should not be expected to credit the tax levied by State P upon distribution against its own tax levied upon generation.
138. Once it is agreed that State R does not levy tax on the distribution, the second difficulty, i.e. the timing mismatch, is no longer relevant. While timing mismatches frequently create problems for foreign tax credit purposes, which leads States to

²⁰⁴ See the 894(c) Regulations s.1.894-1(d)(2)(ii).

adopt rules allowing for the carry-back or carry-forward of foreign tax credits, the issue does not arise in this example since there is no double taxation of the distribution.

139. The third difficulty concerns only States that apply the credit method and relates to the fact that both States impose tax upon the same income, but on different taxpayers. The issue is therefore whether State R, which taxes partner A on his share in the partnership profits, is obliged, under the Convention, to give credit for the source tax that is levied in State P on partnership P, which State P treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that State R flows-through the income of the partnership to the partners for the purpose of taxing them, it should be consistent and flow-through the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partners. In other words, if the corporate status given to the partnership by State P is ignored for purposes of taxing the share in the profits, it should likewise be ignored for purposes of giving access to the foreign tax credit.²⁰⁵

Analytically, these propositions are coherent, but there can nevertheless be a substantive concern in certain situations. If both states treated the entity as being fiscally transparent, then all taxes imposed by the source state could be credited in the residence state of the member or might not be relevant if the member were exempt (or simply not taxable) in respect of the underlying income of and distributions from the entity. Thus, no double taxation would arise. Moreover, no double taxation would arise if the source state taxed the underlying income of the entity at a higher rate and did not impose any tax on distributions from the entity. For example, if both states taxed the underlying income at a rate of 40 per cent (and did not tax the distributions), the effect of combined taxation would be tax at a rate of 40 per cent. In contrast, if the source state taxes the underlying income at a rate of 25 per cent and then imposes a tax on distributions at a rate of 20 per cent, and the residence state of the member only taxed the underlying income at a rate of 40 per cent, the effect of combined taxation would be tax at a rate of 55 per cent, being source state taxation of the underlying income in the amount of 25 (assuming a base of 100) plus residence state taxation of that income in the amount of 15 (after credit for the source state

²⁰⁵ Partnership Report, above fn.8, Example 18. The availability of credit relief varies from country to country. Germany gives a credit for the foreign corporate tax of the entity (but not for foreign withholding taxes on dividends, if any) when taxing the member (i.e. if the income is not exempt as PE income). The tax authorities seem to give such credit also in the absence of any treaty (and there is no particular provision to this effect in the domestic law). Australia takes a similar position in general under an express provision in domestic law, although the matter is also provided for in certain treaties, such as the Australia-New Zealand Treaty (Art.23(3)). Canada takes this position where the foreign entity is legally transparent or at least is treated as a “partnership” for Canadian tax purposes. See *4145356 Canada Limited v The Queen*, 2011 TCC 220; 2011 DTC 1171; [2011] 4 CTC 2207, where a Canadian member of a Delaware limited partnership that had elected to be taxed as a corporation for US tax purposes was considered to have paid the US tax imposed on the partnership as a separate entity. On the other hand, the US would allow a credit for the withholding tax, and the regulations under the US Code specifically contemplate a credit for taxes imposed on payments that the US does not recognise as income due to a conflict of characterisation. In South Africa, resident partners in foreign partnerships are not able to claim foreign tax credit relief. South Africa provides unilateral tax credit relief for foreign income tax only with regard to a resident’s participation in a CFC, or where attribution rules apply to foreign trust income or gains and tax these to a resident beneficiary. The UK generally permits a credit for taxes imposed on the same income even if on different persons. See the discussion below.

taxation), plus an additional layer of source state taxation on the distribution in the amount of 15 (assuming a distribution of 75), for a total of 55 if the residence state does not allow a credit or other relief for the withholding tax. This calculation assumes a source state rate of 20 per cent on the distribution, which would be higher than the rate generally permitted under Article 10 of the OECD Model. If the assumed rate is instead 15 per cent or even 5 per cent, the overall rate becomes 51.25 per cent or 43.75 per cent, which in any event exceeds 40 per cent in both cases.

In the view of some of the authors, this should be a cause for concern from a tax policy perspective even if it can be justified from an analytical perspective. However, different countries will have different views on the relationship between entity-level taxation and member-level taxation, and whether there should be more or less “integration” or (economic) “double taxation” in this regard. That noted, if the consensus reached in relation to proposed Article 1(2) of the OECD Model were that the source state should apply the treaty in a manner that is affected by the other state’s qualification, then it does not seem to some of the authors to be too big a leap to require the other state to give credit more broadly than it might otherwise do in order to eliminate effective double taxation or increased taxation arising from the qualification mismatch.

But this does not appear to be the consensus. On the contrary, the effect of Article 3(2) and Option C under Article 5 of the MLI would seem to displace at least some of the relief obligations that would otherwise arise. In particular, Article 3(2) and Option C under Article 5 of the MLI would displace relief obligations for income or taxation arising “solely because the income is also income derived by a resident of that other Contracting Jurisdiction”,²⁰⁶ thereby displacing paragraph 139 of the Partnership Report²⁰⁷ in so far as it relates to third state income. Interestingly, however, it is arguable that this covers only the earnings of and taxes imposed on the entity, not taxes imposed on a member in respect of a distribution from the entity. Thus, the residence state of the member would still in theory seem to have obligations to exempt or give credit for taxes imposed on distributions, although it would normally not be taxing those distributions and so exemption may be moot and it may not be required to give credit as a practical matter, depending on the language and effect of the applicable treaty provision or domestic law.

The Anson question

There is also cause for concern in the view of some of the authors in the converse situation (and subject to the same caveats with respect to differing perspectives on “integration” and (economic) “double taxation”), where the source state treats the entity as being fiscally transparent but the other state treats it as being fiscally opaque and thus taxes the member only in respect of distributions (or, perhaps, also in respect of the entity’s income under its CFC regime, assuming it is not taxing the underlying income as such). In such a case, it is not clear that taxes imposed by the source state on the member in respect of the underlying income of the entity could be relieved by the residence state by virtue of a treaty. In *Anson*,²⁰⁸ that is the conclusion that was reached at all four levels of judicial consideration, except that at first instance and in the Supreme Court relief was ultimately granted on the view that the income of the entity should be attributed

²⁰⁶ The language in Option C under the MLI, above fn.3, Art.5 is slightly different but to the same effect.

²⁰⁷ Partnership Report, above fn.8.

²⁰⁸ *Anson*, above fn.104, [2015] UKSC 44.

to the member as such (that is, that it was the “same income” being taxed by both states) even though the member was not considered to have a direct or indirect proprietary interest in any of the entity’s property or income. Thus, double or increased taxation was avoided by avoiding a conflict of attribution based on general principles.²⁰⁹

Arguably, in the view of some authors, such double or increased taxation should always be avoided—either based on general principles or, if necessary, through the application of appropriately tailored treaty provisions to that effect.²¹⁰ Such double or increased taxation cannot be justified by mere analytical validity in the context of the wide-ranging effort to reform the international tax system. Indeed, with respect to hybrid mismatches, the Hybrids Report posits a scope for measures that look not only at the immediate transaction between two entities, and thus two states, but also at so-called “imported” mismatches,²¹¹ thereby implicating the treatment of transactions in a third state, as well as the impact of CFC rules,²¹² thereby implicating the treatment of transactions in a fourth state. Against that background, it seems to some of the authors of this article to be difficult if not unfair to say that it would be too complex or undesirable to develop solutions to the problem of double or increased taxation presented in *Anson*.²¹³

What to do about all this?

Where this takes us is to the conclusion that proposed Articles 1(2) and (3) of the OECD Model and the existing and proposed additions to the Commentaries, as well as Articles 3, 5 and 11 of the MLI, are inadequate in the authors’ view to address in a satisfactory manner the various

²⁰⁹ Here, too, the MLI, above fn.3, Art.3(2) and Option C would not restrict relief because the US taxes were not imposed on Anson by reason of residence (and, in any event, it is understood that the UK is not proposing to adopt either provision).

²¹⁰ In a circular dated 21 January 2003 (OFD (Oberfinanzdirektion) Berlin, Vfg. (Verfügung) v (dated) 21 January 2003, St 127 - S 1301-USA - 4/97, published in: Internationales Steuerrecht (IStR) 2003 (Volume 12), 138), the German regional tax office of Berlin published an interesting order on the treatment of distributions made by an S-Corp. In the underlying case, the S-Corp is treated as transparent from a US perspective and opaque from a German perspective. The US is taxing the shareholders irrespective of any actual “distribution”, at their individual income tax rates. If one of the shareholders is a dual resident with a preceding residency in Germany, the German tax authorities may tax the distribution as a dividend. The US tax is not creditable in Germany. However, the regional tax office of Berlin grants a reduction of the German tax base (i.e. a deduction) for the amount of the US tax paid, essentially for reasons of equity, to treat the German individual in the same manner as he or she would have been treated in the context of a distribution from a normal US corporation, in which case the distribution would be reduced by the US tax payable by the corporation.

The Italian Revenue Agency took substantially the same approach with respect to distributions from foreign partnerships to Italian resident partners, which under Italian domestic law are always seen as distributions made by “opaque” entities (i.e. as if they were corporations). See Circular Letter No. 9/E of February 15, 2015.

In Sweden, in RÅ 2001 ref. 46 (sometimes referred to as the *Alecta* case), the Supreme Administrative Court (SAC) dealt with an appealed advance ruling concerning a Swedish resident’s investments in US real estate through a Swedish limited liability company (*kommunditbolag*) investing in turn in US limited partnerships or single member limited liability companies. The Court interpreted the Sweden-US Treaty (1994) Art.23(2)(a), to the effect that a credit for US taxes required that it was the same person that received the income that was taxed in both states. In this case, the court found that the income was received by the US limited partnerships or single limited liability companies, and thus not by the Swedish resident. Accordingly, no foreign tax credit was required by the treaty (nor under domestic Swedish foreign tax credit rules, which were later changed).

²¹¹ Hybrids Report, above fn.1, Ch.8.

²¹² Hybrids Report, above fn.1, paras 36–40.

²¹³ *Anson*, above fn.104, [2015] UKSC 44.

concerns that arise in this context. These measures and the related Commentaries would leave open too many uncertainties and several gaps. The authors note the following salient items:

1. There remains considerable uncertainty and a degree of incoherence with respect to the interpretation and application of the term “fiscally transparent entity” under proposed Article 1(2) of the OECD Model. This is the case, in particular, with respect to trusts.
2. As a policy matter, the scope of proposed Article 1(2) of the OECD Model may be too narrow to achieve the objective of ensuring that the benefits of tax treaties are granted in appropriate cases where there is current or at least eventual taxation of the relevant items of income. Similarly, subject to administrative considerations, its scope may be too broad with respect to denying these benefits where neither Contracting State treats, under its domestic law, the income of an entity as the income of one of its residents, where the residence state would not have taxed the income in any event—such as where it would have granted a participation exemption or would not have recognised the income under its domestic law.
3. The interaction of proposed Article 1(2) with Article 10(2)(a) of the OECD Model and other distributive articles remains unclear and rather incoherent. At a minimum, the exclusion from paragraph 10(2)(a) of a company that is a partnership should be removed. It should also be clarified that treaty benefits should be determined as a function of the status of the members of a “fiscally transparent entity”, not its status as a company or other type of entity. There should be an attribution rule that attributes the ownership or control of shares held by the entity, as well as the beneficial ownership of income, or other assets and activities which may result in a permanent establishment, to its members (or to the entity, as appropriate).
4. The relationship between proposed Article 1(2) of the OECD Model and “partial residence” provisions in many existing bilateral treaties should be clarified—particularly with respect to CIVs.
5. Additional work may be required to clarify the application of proposed Article 1(3) and its interaction with proposed Article 1(2) of the OECD Model, as well as to deal with issues that arise in the context of taxing non-residents. The same can be said for Article 3(2), Option C under Article 5 and Article 11 of the MLI.
6. Additional work may be required to ensure that double or otherwise inordinate taxation does not arise where the source state taxes a non-resident member in respect of the income of a “fiscally transparent entity” which the member’s residence state treats as fiscally opaque.

The authors would thus prefer an alternative formulation of a treaty provision, together with additional supporting provisions and more detailed Commentaries, as well as authority for competent authority agreements as appropriate. The authors would also suggest that consideration be given to establishing parameters for domestic law solutions that could be implemented in specific circumstances. While the US Model may be a good starting point for these types of provisions, a number of bilateral treaties contain variations that taken as a whole address a broader range of issues or the same issues in a more satisfactory manner.

In terms of an alternative formulation of a treaty provision, two approaches would seem to the authors to be conceivable—a more detailed provision that would require less extrapolation (by way of Commentaries, memoranda of understanding or protocols between implementing states, or competent authority agreements), or a provision drafted at a higher level of generality so that it could accommodate more extrapolation. Appendix A sets out examples of alternative formulations based on these approaches.

Conclusion

The authors are hopeful that this article will be helpful to those who may be involved in the daunting task of working through the development and implementation of solutions to the many “difficulties” that have for decades been and continue to be associated with the application of tax treaties in relation to fiscally transparent entities and arrangements, as well as other similar or more or less analogous regimes. There are numerous such “difficulties” and unfortunately the authors believe that proposed Articles 1(2) and (3) of the OECD Model, with their related proposed Commentaries, and the relevant provisions of the MLI, do not resolve many of them, at least not in a satisfactory manner. They will otherwise have to be resolved by the courts over time, with sometimes unexpected results.

As a separate general consideration, it may be useful to say something about the nature of the exercise when tax law is applied to hybrid entities or arrangements, as opposed to other fields of related law (such as conflicts of law). The rule in proposed Article 1(2) of the OECD Model is superficially similar to a conflicts rule, but the difference is that the tax law exercise is essentially concerned with statutory construction of domestic law, and tax treaty interpretation at the cross-border level. In both spheres the construction exercise draws from the general law classification of the persons involved in the hybrid entity or their arrangements with each other, but general law is ultimately not decisive. Conflicts of law may help establish the applicable general law to those persons and/or arrangements, but the tax outcome is a question of statutory or treaty interpretation. The rule in proposed Article 1(2) of the OECD Model may be perceived as mechanistic, similar to a conflicts rule (that is, directing one state to follow the domestic tax treatment in the other based on a connecting factor). However, there is more to the tax exercise because construction is a normative exercise involving consideration of the purpose, objective and aim of the treaty provision. All this is simply to say that in the process of designing a new rule for the OECD Model, a high premium should be placed on clarity about the precise purpose, aim and objective of the new rule. The proposed reference to unarticulated principles in the Partnership Report,²¹⁴ and the stated aim to ensure a grant of treaty benefits in “appropriate cases” give important clues about purpose and aim, but could be improved by being more precise and articulate.

Appendix A—Alternative Drafting

This Appendix sets out two alternative formulations of a treaty provision, based on either a higher level of generality so that the provision could accommodate more extrapolation (by way

²¹⁴ Partnership Report, above fn.8.

of Commentaries, memoranda of understanding or protocols between implementing states, or competent authority agreements), and a more detailed provision that would require less extrapolation.

While the authors do not purport to have considered or addressed all the issues that may be of concern in this regard, something along the lines of the first approach (the general approach) might look like the following:

Where a resident of a Contracting State has a direct or indirect interest in an entity or arrangement (wherever established) that is fiscally transparent under the laws of that Contracting State, the other Contracting State shall apply the provisions of this convention as though the entity or arrangement is fiscally transparent under the laws of that other Contracting State, and where a resident of a Contracting State is, or has a direct or indirect interest in an entity or arrangement (wherever established) that is, not fiscally transparent under the laws of that Contracting State, the other Contracting State shall apply the provisions of this convention as though the entity or arrangement is not fiscally transparent under the laws of that other Contracting State; provided, further, that:

- (a) the competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article, including any exceptions and extensions to the application of this Article [and in doing so they shall take into account any statements in the Commentary from time to time issued by the OECD relating to this provision];
- (b) the provisions of this paragraph shall not be applied so as to restrict in any way a Contracting State's right to tax the residents of the other Contracting State in respect of income derived from an entity or arrangement that is not fiscally transparent under the laws of that Contracting State, and in that event the other Contracting State shall in taxing a resident of that other Contracting State give credit for the relevant proportion of such tax; and
- (c) where a Contracting State taxes a resident of the other Contracting State in respect of income arising in that Contracting State and derived through an entity or arrangement that is fiscally transparent under the laws of that Contracting State, the other Contracting State shall in taxing a resident of that other Contracting State in respect of that income or in respect of income derived from that income give credit for the relevant proportion of such tax.

The authors note that this approach is closer to the current approach reflected in proposed Article 1(2) of the OECD Model than the more detailed approach would be, although the authors consider that improved language and a bit more detail to clarify certain issues and not change the intended effect (except with respect to certain cases involving relief from double taxation) would be helpful.

It is also the authors' view that this approach addresses most of the important issues, including applications (of the treaty or domestic laws, as the case may be) which depend on whether a particular taxpayer owns or controls something or has a PE or an activity that may be relevant. This is the principal flaw of proposed Article 1(2) of the OECD Model, in that it only speaks to the attribution of income, from which it is difficult to extrapolate in relation to other factors

without simply ignoring or departing too far from the text. The principal improvement of this alternative approach to the drafting is that it speaks more generally, and thus to a broader range of factors that may be relevant to the application of the tax in question, and is easier to extrapolate in Commentaries without ignoring or departing too far from the text.

A more detailed provision—which also tries to cover a broader range of factors that may be relevant to the application of the tax in question but through even more specific drafting (a more “rules oriented” approach rather than a more “principles oriented” approach) might look like the following:

- (1) Where, and only where, an item of income arising in a Contracting State is derived by or through one or more than one entity or arrangement (wherever established) and the item is attributed for tax purposes by the other Contracting State to a resident of that State not being the entity or arrangement (or would be so attributed if the State recognised the item for tax purposes), Articles 6 to 21 of this Convention shall apply to such item on the basis that:
 - (a) where the item is the profits (or a share in the profits) of an enterprise carried on by the entity or arrangement (or would be the profits of an enterprise carried on by the entity or arrangement if it were a person) the resident shall be treated as carrying on the enterprise (and accordingly be treated as an enterprise of that other Contracting State), and for the purpose of determining whether the enterprise is carried on through a permanent establishment in the first-mentioned Contracting State the activities of the entity or arrangement and its ownership of the goods or merchandise used by it in carrying on the enterprise shall (in addition to the activities of the resident and the ownership of goods and merchandise used by the resident including his interest in the entity or arrangement) be treated as carried on by, used by, and belonging to, the enterprise so treated as carried on;
 - (b) if the item does not fall within (a) above it shall be treated as paid to or, as the case may be, derived by the resident; and the resident (and no other person) shall be treated as the beneficial owner of the item and the beneficial owner shall be treated as having the attributes of the resident;
 - (c) the resident (and no other person) shall be treated as owning or holding the asset from which the item is derived (and directly holding it if that is the result of such treatment) and the voting power over the asset for the period of ownership of the entity or arrangement or, as the case may be, as the alienator of such asset;
 - (d) If at a later time than the taxation of the item by the first-mentioned State the item is attributed for tax purposes by the other Contracting State to a person other than the entity or arrangement and either the conditions for the application of this provision become satisfied or, as the case may be, cease to be satisfied, and those conditions would have been satisfied or, as the case may be, not satisfied, at the time the item was derived if at that time the item had been attributed for tax purposes to that person then, regardless of the original treatment of the item for the purpose of this

Convention by the first-mentioned State, this provision shall apply or, as the case may be, cease to apply, at the later time and that State shall amend its taxation of the item accordingly but only so long as the later time occurs within the time limits imposed by that State for making such amendment.

- (2) If the entity or arrangement has material connections with a State other than a Contracting State, so long as it is possible to exchange information concerning the entity or arrangement or its participators or beneficiaries under the terms of a taxation convention or tax information exchange agreement between the Contracting State in which the income arises and the third State, this provision shall apply notwithstanding that the third State does not attribute the item to the resident but if it does so attribute the item the application of this provision is subject to any contrary provisions in a taxation convention between a Contracting State and the third State.
- (3) Where an item of income arising in a Contracting State is considered by that Contracting State to be derived through one or more than one entity or arrangement (wherever established) and the item is attributed by the other Contracting State to an entity or arrangement, the item shall be eligible for the benefits of the Convention that would be granted to a resident of that other Contracting State, without regard to whether the item is treated as the income of that entity or arrangement under the tax laws of the first-mentioned State, if such entity or arrangement is a resident of that other Contracting State and satisfies any other conditions specified in the Convention. The question whether the entity or arrangement is the beneficial owner of the item shall be determined according to the facts but on the assumption that the person entitled to the item is the entity or arrangement, and if the entity or arrangement is a trustee it shall be treated as the beneficial owner if no beneficiary of the trust is entitled to the item for tax purposes in that other Contracting State in the relevant tax year.
- (4) In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State's right to tax the residents of that State and in that event the other Contracting State shall in taxing a resident of that other State give credit for the relevant proportion of such tax.
- (5) The provisions of this paragraph shall not be applied so as to restrict in any way a Contracting State's right to tax the residents of the other Contracting State in respect of an item of income derived from an entity or arrangement that the first-mentioned State does not attribute to a resident of the other Contracting State, and the other Contracting State shall in taxing a resident of that other Contracting State give credit for the relevant proportion of such tax.
- (6) Where a Contracting State taxes a resident of the other Contracting State in respect of an item of income arising in that Contracting State and derived through an entity or arrangement that is attributed by that Contracting State to a resident of the other Contracting State, the other Contracting State shall in taxing a resident of that other Contracting State in respect of that income or in respect of income derived from that income give credit for the relevant proportion of such tax.

- (7) The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.

This more detailed formulation could be coupled with commentaries along the following lines:

Commentary

Paragraph (1). The “and only where” language is intended to block benefits. That is appropriate except where benefits are blocked in a case where the income would not have been taxable in any event even if the residence state did attribute it to one of its residents. For example, the FTE receives dividends and the source state attributes the dividends to the member and the residence state attributes the dividends to the entity—say, a third country entity. If the dividends had been attributed by the residence state to the member, the member would not have been taxable because it would have had a participation exemption or a full direct and indirect credit. In such a case, there is no avoidance by virtue of the fact that the residence state does not attribute the income to the member, and thus benefits should not be blocked. Some treaties have this exception and some provide for the possibility of competent authority relief in such a case.

Avoiding reference to “fiscally transparent” is deliberate because this implies that the timing of the realisation of the income for tax purposes is not changed (proposed Commentary paragraph 26.10) which is a situation that needs to be covered for trusts, see paragraph (d) below. In any case that statement in the proposed Commentary is inconsistent with the statement in proposed Commentary paragraph 26.12 in referring to distribution to a beneficiary. Avoiding this reference also makes sure that the provision will be applicable to entities that are not regarded as transparent by some states (like French “translucent” partnerships).²¹⁵

Subparagraph (a). Since as a matter of general law the entity or arrangement might be the person carrying on the enterprise (assuming it to be a person) this combines the attributes of the entity or arrangement with those of the person who is taxed, particularly for determining whether the enterprise is carried on through a permanent establishment, having regard for example to Article 5(4) of the Model. It avoids the problem where trustees carry on the enterprise through a permanent establishment but the beneficiary, who does not carry it on, is taxed and might therefore not have a permanent establishment.²¹⁶

Subparagraph (b). The beneficial ownership provision is based on the assumption that a state would not attribute income to a person who was not the beneficial owner, and would not attribute income to a member of the entity or arrangement which was a nominee, etc. The UK is an exception to this and could attribute income to a UK resident nominee for a UK resident, which would be necessary to cover specifically.

Subparagraph (c). This is drafted with the case of a partnership owning shares, the effect of “directly” in relation to transparent entities generally and Article 10(2)(a) of the Model in mind. It would seem that a better solution would be to delete the reference to partnerships

²¹⁵ See the decision in *Artemis*, discussed above in fn.42 (3 / 8 / 9 / 10 SSR).

²¹⁶ This and others below can be described as “detailed integrity rules”, to borrow the phrase used in the MLI Explanatory Statement para.45.

in the Model leaving it to be included in treaties by those states that need it, for example France. The effect of “directly” in relation to transparent entities needs to be covered because some states may regard this as referring to the situation in general law, while others may read it as applying to the situation in tax law. The US Technical Explanation to its 2006 Model is an example of the latter, saying: “Companies holding shares through fiscally transparent entities such as partnerships are considered for purposes of this paragraph to hold their proportionate interest in the shares held by the intermediate entity.”²¹⁷ The reference to voting power over an asset is included with the proposed LOB provision in mind.

Subparagraph (d). The somewhat involved drafting is to deal with a beneficiary of a discretionary trust who receives a distribution at a later time and the distribution causes the provision to apply or to cease to apply. It needs to prevent the provision from applying where there is a change in residence of the beneficiary or of beneficial ownership between the income arising and its being distributed.

Paragraph (2). This deals with third state entities. The expression “material Connections” is used to avoid reference to residence of a transparent entity. The last part is taken from Article 29(2)(a) of the Australia-France Treaty but its purpose is unclear.

Paragraph (3). This deals with the opposite situation where the source state regards the residence state’s entity as transparent but the residence state regards it as opaque, and applies the treaty on the basis of the residence state’s treatment. It would not prevent paragraph (1)(d) from applying subsequently as that applies regardless of the original treatment of the income by the source state. Beneficial ownership of a trustee is specifically dealt with. It is possible that a similar provision may be needed if a partnership is not regarded as owning its assets beneficially.

Paragraphs (5) and (6). These deal with the issues raised under the heading “Taxation by the residence state—saving clause and relief from double taxation”, paragraph (5) dealing with taxation of distributions by an entity by its country of residence, and paragraph (6) with what we have called the “Anson question”.

Appendix B—Article 10(2)(a)

This Appendix reviews certain examples of states attempting to address the application of Article 10(2)(a) in the context of shares held by fiscally transparent entities, both with and without provisions such as proposed Article 1(2) of the OECD Model.

It is noted, first, that some states may conclude that provisions such as proposed Article 1(2) of the OECD Model are insufficient to address all the requirements applicable under Article 10(2)(a), while other states may conclude that provisions such as proposed Article 1(2) of the OECD Model go too far.

For example, the German Federal Central Tax Office seems to deny a treaty rate reduction down to 5 per cent/0 per cent in the case of a US limited liability company (LLC) that is a “fiscally transparent entity” for US tax purposes even if its members are US corporations because the wording of Articles 10(2)(a) and (3)(a) of the US-Germany Treaty requires that the beneficial

²¹⁷ United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, p.35.

owner “holds directly” the relevant shareholdings, and it is their view seemingly that the corporate members of the LLC do not “hold directly” the shares of the German company.²¹⁸ This is somewhat surprising in that the US Technical Explanation clearly states that: “Companies holding shares through fiscally transparent entities such as partnerships are considered for purposes of this paragraph to hold their proportionate interest in the shares held by the intermediate entity.”²¹⁹ Although the Technical Explanation²²⁰ only mentions partnerships, this seems to be given as an example rather than in any limiting sense. The US generally includes such language in its Technical Explanations without consulting the other country, so it is not surprising that other countries may take a different view. These various Technical Explanations have two main forms: one as in the 2006 Model Technical Explanation, attributing the look through result to the fiscally transparent entity provision; the other just making the bald statement when the treaty does not have the modern US fiscally transparent entity provision.

Like Germany, Australia is unlikely to agree with the US view stated in the Technical Explanation to the 2001 Protocol.²²¹ Germany and Australia have tried to deal with this issue in their recent treaty (2015),²²² although not as clearly and coherently as they might have. The Protocol No. 3 states, with reference to paragraph 2 of Article 1 and Article 10, as follows:

“It is understood that where dividends derived by or through a fiscally transparent entity or arrangement are treated, for the purposes of taxation by a Contracting State, as the income, profits or gains of a resident of that State, Article 10 shall apply as if that resident had derived the dividends directly.”²²³

²¹⁸ It is interesting to note that Art. VI(1)(b) of the 2002 protocol on the German-Switzerland Treaty expressly provides that: “For the purpose of clarification, it is stated that holding shares in a company through a partnership shall not preclude the application of paragraph 3 of Article 10.” It is understood that the German tax administration is not prepared to accept the same for any other treaty, subject to specific provisions to the contrary.

In contrast, the authors note, for example, that the interposition of a partnership does not necessarily seem to hinder the application of the participation exemption in the EU Parent-Subsidiary Directive (Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2011] OJ L345/8). See G. Kofler, *Mutter-Tochter-Richtlinie, Kommentar* (Wien: LexisNexis, 2011). Kofler quotes the prevailing opinion (herrschende Ansicht hA) in fn.124 and gives his own reasoning in m.no. 28 on the Parent-Subsidiary Directive Art.3. Kofler is citing the prevailing opinion in tax literature opining that the shareholding through a transparent partnership does not affect the applicability of the Parent-Subsidiary Directive.

²¹⁹ Department of the Treasury Technical Explanation of the Protocol Signed at Berlin on June 1, 2006 Amending the Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes Signed on 29th August 1989 (Technical Explanation to the US-Germany Treaty), 15.

²²⁰ Technical Explanation to the US-Germany Treaty, above fn.219.

²²¹ Department of the Treasury Technical Explanation of the Protocol Between the Government of the United States of America and the Government of Australia Signed at Canberra on September 27, 2001, Amending the Convention Between the United States of America and Australia with Respect to Taxes on Income Signed at Sydney on August 6, 1982 (Technical Explanation to the 2001 Protocol).

²²² Agreement Between Australia and the Federal Republic of Germany for the Elimination of Double Taxation with Respect to Taxes on Income and on Capital and the Prevention of Fiscal Evasion and Avoidance (November 2015) (Germany/Australia Treaty).

²²³ Protocol to the Agreement Between Australia and the Federal Republic of Germany for the Elimination of Double Taxation with Respect to Taxes on Income and on Capital and the Prevention of Fiscal Evasion and Avoidance (November 2015), para.3 with reference to para.2 of Art.1 and Art.10.

What is not clear from this, among other things, is whether this approach is also intended to apply with respect to ownership requirements in Article 10. For example, Article 10(2)(a) refers to a “beneficial owner of the dividends” that is “a company (other than a partnership) which holds directly at least 10 per cent of the voting power of the company paying the dividends throughout a 6 month period.”²²⁴ There is also the 0 per cent rate rule in Article 10(3) that refers to cases where the “beneficial owner of the dividends is a company (other than a partnership) that is a resident of the other Contracting State that has held directly shares representing 80 per cent or more of the voting power of the company paying the dividends for a 12 month period”.²²⁵

The Australian Explanatory Memorandum to the Act which has incorporated the treaty into domestic law is a bit perplexing. With respect to Article 1(2) in general, it states as follows:

- “1.43 Paragraph 2 of this Article does not prejudice the issue of whether the recipient is the beneficial owner of the relevant income. Where, for example, a fiscally transparent partnership receives dividends as an agent or nominee for a person who is not a partner, the fact that the dividend may be considered as income of a resident of one country under the domestic law of that country will not preclude the country of source from considering that neither the partnership nor the partners are the beneficial owners of the dividend.”²²⁶

Then, with respect to Article 10, it states as follows:

- “1.44 Similarly, paragraph 2 of this Article is not intended to in any way change the need to separately satisfy any other requirements set out in the other relevant provisions of the German agreement in order to obtain the treaty benefits. For instance, in order to access the dividends exemption set out in paragraph 3 of Article 10 (Dividends), all the requirements of paragraph 3 would still need to be met.
- 1.45 Paragraph 2 of this Article only applies for the purposes of the German agreement and does not, therefore, require either country to change the way in which it attributes income or characterises entities for the purposes of its domestic law. [Article 1, paragraph 2.]
- 1.46 Additionally, paragraph 2 of this Article is not intended to operate to alter the specific treaty benefit that would be available for an item of income in the absence of this paragraph. For instance, where German dividends are derived through a third country limited liability company that is treated as fiscally transparent by Australia and Germany and those dividends are taxed by Australia in the hands of an Australian resident individual participant in the limited liability company, paragraph 2 does not operate to require Germany to apply the dividend exemption set out in paragraph 3 of Article 10 (Dividends). This is confirmed by the understanding set out in paragraph 3 of the Protocol to the German agreement:

²²⁴ Germany/Australia Treaty, above fn.222, Art.10(2)(a).

²²⁵ Germany/Australia Treaty, above fn.222, Art.10(3).

²²⁶ International Tax Agreements Amendment Bill 2016, The Parliament of the Commonwealth of Australia House of Representatives, International Tax Agreements Amendment Bill 2016 Explanatory Memorandum (circulated by authority of the Treasurer, the Hon Scott Morrison MP) (Australian Explanatory Memorandum), para.1.43.

‘It is understood that where dividends derived by or through a fiscally transparent entity or arrangement are treated, for the purposes of taxation by a Contracting State, as the income, profits or gains of a resident of that State, Article 10 shall apply as if that resident had derived the dividends directly.’

1.47 Like paragraph 2 of this Article itself (see paragraph 1.47 [sic.]²²⁷ above), this understanding was not intended to in any way change the need to separately satisfy any other requirements set out in the other relevant provisions of the German agreement in order to obtain the treaty benefits, including the requirements set out in Article 10 (Dividends). [Protocol, paragraph 3.]

1.48 The following example illustrates both the application of paragraph 3 of the Protocol and the application of paragraph 2 of Article 1 (Persons Covered) where income (including profits or gains) is derived from sources in one country through a third country entity which is treated as fiscally transparent in the other country (that is, income derived through that entity is taxed in that other country in the hands of the beneficiaries, members or participants of the entity).

Example 1.2

In the above diagram [omitted], a German company pays dividend income to a United States Limited Liability Company. The United States Limited Liability Company includes three partners who share equally in all the partnership’s income: two Australian partners (X Co and Y) who are residents of Australia for the purposes of the German agreement and a non-resident partner (Z Co) who is a resident of a fourth country.

As the United States Limited Liability Company is treated as a partnership for United States tax law purposes, it is also treated as a partnership for Australian tax law purposes under Australia’s foreign hybrid rules.

In this example, the dividend income derived through the United States Limited Liability Company on which the Australian resident partners are assessable under Australian income tax law would be eligible for the benefits of the German agreement. Subject to separately meeting the other requirements set out in Article 10 (Dividends) to qualify for the relevant treaty benefits, X Co may be entitled to the 5 per cent rate limit set out in subparagraph 2(a) of Article 10 and Y may be entitled to the 15 per cent rate limit set out in subparagraph 2(b) of Article 10.

Treaty relief under the German agreement will not apply to income derived by any partners that are not residents of Australia for purposes of the German agreement (in this example, Z Co).

Eligibility for the treaty benefits will also be subject to the potential application of the anti-avoidance and limitation of benefits provisions contained in the German agreement.

[...]

²²⁷The reference should be to Australian Explanatory Memorandum, above fn.226, para.1.45.

1.208 Exclusion of partnerships

Consistent with Germany's tax treaty practice and the OECD Model, paragraphs 2 and 3 of this Article expressly exclude companies that are partnerships from qualifying for the 5 per cent rate or exemption for intercorporate dividends. However in the course of negotiations, the two delegations agreed:

‘... the exclusion of partnerships in subparagraph 2(a) and paragraph 3 of Article 10 does not exclude partnerships subject to the same taxation treatment as companies in Australia or the Federal Republic of Germany from the application of those provisions.’

1.209 Accordingly, a partnership that falls within the definition of company under subparagraph 1(e) of Article 3 (General Definitions) will still qualify for the benefits specified in paragraphs 2 and 3 of this Article, provided that they satisfy all other requirements in those paragraphs.

1.210 In the case of Australia, this means Australian corporate limited partnerships that are treated in the same way as companies for Australian tax purposes may qualify for those benefits.

1.211 Dividends derived by or through a fiscally transparent entity

Where dividends are derived by or through a fiscally transparent entity or arrangement and are treated, for the purposes of taxation by one of the two countries, as the income, profits or gains of a resident of that country, this Article will apply as if that resident had derived the dividends directly. As explained in 1.47, this is not intended to operate to alter the specific treaty benefit that would be available for an item of income in the absence of paragraph 2 of Article 1 (Persons Covered). That resident would therefore need to satisfy the relevant requirements set out in paragraphs 2 or 3 of this Article in order for either of those paragraphs to apply. Further, if that resident is the beneficial owner of the dividends and is not a company (as defined in subparagraph 1(e) of Article 3 (General Definitions)), paragraph 3 of the Protocol ensures that that resident can only seek to claim the benefits of subparagraph 2(b) of Article 10 (Dividends). [Protocol, paragraph 3.]²²⁸

Nevertheless, what is meant by “the need to separately satisfy any other requirements” is not clear and it is odd, in particular, that this Explanatory Memorandum does not clearly address the “holds directly” requirement.

Also interestingly, the German Denkschrift on the recent German-Australian Treaty (2015)²²⁹ gives an example regarding the application of new Article 1(2) of the OECD Model and does not even mention the technical requirements of Article 10. The example features a dividend payment from a GmbH to an Australian Company A having two individual shareholders, B and

²²⁸ Australian Explanatory Memorandum, above fn.226, paras 1.44–1.48 and 1.208–1.211.

²²⁹ Germany/Australia Treaty (2015), above fn.222, BR-Drucks. 242/16, p.38.

C. B is a resident of Australia, C is not. A is transparent under Australian tax law and opaque under German tax law. Regarding B's share, the example notes that Germany has to apply Article 10(2)(b) but the question whether or not B is the beneficial owner of his share in the dividend is not even mentioned.

Reference may also be made to the comments in the Technical Explanation to the Italy-US Treaty, which state that corporate members of a "fiscally transparent entity" should benefit from Article 10(2)(a) on the basis that shares held by the entity should be attributed to the entity's members:

"Companies holding shares through fiscally transparent entities such as partnerships are considered for purposes of this paragraph to hold their proportionate interest in the shares held by the intermediate entity. As a result, companies holding shares through such entities may be able to claim the benefits of subparagraph (a) under certain circumstances. The lower rate applies when the company's proportionate share of the shares held by the intermediate entity meets the 10 percent voting stock threshold. Whether this ownership threshold is satisfied may be difficult to determine and often will require an analysis of the partnership or trust agreement."²³⁰

The reference to "the 10 percent voting stock threshold" is erroneous, since the threshold is 25 per cent. It is also interesting that this treaty requires that the "beneficial owner" of the dividends "has owned" the relevant voting stock for a 12 month period before the dividend is declared, and this is interpreted in the Technical Explanation to exclude: "Indirect ownership of voting shares (through tiers of corporations)."²³¹ Thus, indirect ownership is considered acceptable if through a "fiscally transparent entity" but not through a "fiscally opaque entity". As noted above in footnote 121 of the main article, it seems difficult to reconcile this Technical Explanation with the relevant operative wording.

Another example of how different countries may have difficulty looking through a "fiscally transparent entity" for various purposes is the decision of the French Administrative Supreme Court in *Artémis SA*,²³² where it was held that a French parent company could not benefit from a participation exemption in France in respect of dividends received through a Delaware general partnership, on the basis that French law required a direct participation and the "fiscally transparent entity" provision in Article 7(4) of the treaty was of no assistance in that regard since it was applicable only for purposes of Article 7. The Court also found that the Delaware partnership should be considered to have legal personality distinct from its members. A similar conclusion was reached by the Japanese Supreme Court with respect to the characterisation for Japanese tax purposes of a Delaware limited partnership, in a case involving the allocation of partnership losses to a Japanese resident partner.²³³

²³⁰ Department of the Treasury Technical Explanation of the Convention Between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion signed on August 25, 1999 (Technical Explanation to the Italy-US Treaty) Art.10 para.3.

²³¹ Technical Explanation to the Italy-US Treaty, above fn.230, Art.10 para.2.

²³² *Artémis* case (3 / 8 / 9 / 10 SSR, 24/11/2014, 363556), above fn.42.

²³³ See Supreme Court Judgment of July 17, 2015, 2013 (Gyo-Hi) 166, Minshu Vol.69, No.5, p.1253, 18 ITR 194.

Appendix C—CFC Rules

This Appendix reviews some differences between the manner in which particular CFC regimes in the countries represented by the authors operate—with reference to whether they may operate to tax the underlying income as such in the hands of the relevant members rather than taxing the members in respect of a distinct and fictitious item of income, whether as a deemed dividend or just deemed income other than the underlying income as such.

Swedish CFC rules treat the foreign entity as transparent, and thus tax the member on its share of the underlying income as such. In RÅ 2008 ref.24, read in conjunction with RÅ 2010 ref.112, the Swedish Supreme Administrative Court applied CFC rules, in spite of the treaty with Switzerland, to the income of a Swiss insurance subsidiary with a Swedish parent company. The main reason was that this type of company was specifically mentioned in the statute. Finland also treats the foreign entity as transparent under its CFC rules and the Finnish Supreme Administrative Court stated that the tax treaty did not prevent taxation of the Finnish parent on the income of its Belgian finance subsidiary.²³⁴

German CFC rules operate by deeming the members to have received dividends from the CFC on the first day after the end of the CFC's business year. However, normal dividend relief is not granted.

The US CFC rules treat the aggregate items of income subject to inclusion, net of applicable deductions, as a generic or nonspecific type of income, and neither as a pass-through item nor as a dividend. This is also true for Australian CFC rules. For cases where the character of CFC income matters, such as under the former foreign tax credit which had a separate basket for passive income, CFC attributed income was defined as being passive income, implying that it was separate from underlying income (for example, royalties) which was included in the CFC calculation of attributable income.

Canadian rules are similar in this regard, although a degree of confusion may arise from the decision in *Canwest MediaWorks Inc v The Queen*,²³⁵ where the Tax Court of Canada held that the saving clause in Article XXX(2) of the Canada-Barbados Income Tax Agreement, 1980 (the Treaty) does not override the reassessment time limitation provision in Article XXVII(3) of that Treaty. These provisions stated as follows:

“XXX(2) Nothing in this Agreement shall be construed so as to prevent Canada from imposing its tax on amounts included in the income of a resident of Canada according to section 91 of the Canadian *Income Tax Act*.

XXVII(3) A Contracting State shall not, after the expiry of the time limits provided in its national laws and, in any case, after five years from the end of the taxable period in which the income concerned has accrued, increase the tax base of a resident of either Contracting State by including therein items of income which have also been charged to tax in the other Contracting State. This paragraph shall not apply in the case of fraud, wilful default or neglect.”²³⁶

²³⁴ Finnish Supreme Administrative Court decision KHO 2002:26.

²³⁵ *Canwest MediaWorks Inc v The Queen*, 2007 DTC 109 (TCC); [2007] 1 CTC 2479.

²³⁶ Canada-Barbados Income Tax Agreement, 1980, Arts XXX(2) and XXVII(3).

Thus, the question is whether any “amounts included in the income of a resident of Canada” under Canada’s CFC rules constitute “items of income which have also been charged to tax in the other Contracting State”. If the former are distinct and fictitious items of income, then they are not the CFC’s items of income as such, and thus not within the scope of Article XXVII(3) of this Treaty. While this question was not directly addressed by the Court, the conclusion that attributed CFC income can come within the scope of Article XXVII(3) of this Treaty would seem to imply that such income can be viewed as being the same income as the CFC’s income. This decision was reversed by the Canadian Federal Court of Appeal also without any direct discussion of this issue.²³⁷ That Court reasoned as follows:

“The FAPI Provision [XXX(2)] stipulates that the ability of Canada to tax FAPI inclusions in the income of Canadian residents is to be unfettered by any provision of the Treaty. The language of the FAPI Provision is unqualified and demonstrates that the FAPI Provision is intended to prevail over every other potentially contrary provision of the Treaty. There is no indication in the FAPI Provision or elsewhere in the Treaty that this paramountcy is to be applicable only in respect of other provisions of the Treaty that may contain interpretational uncertainties. Moreover, as indicated, nothing in the language of the Limitation Provision indicates that it is to be exempted from the application of the FAPI Provision.”²³⁸

One could argue that the underlying premise of this reasoning is again that attributed CFC income can be viewed as being the same income as the CFC’s income (that is, or else there cannot be any conflict between the two provisions), but that does not necessarily follow from the Court’s conclusion because it would be the same conclusion regardless of whether or not this is the case.

In the UK, it has been held that their CFC rules do not tax the CFC’s income as such but rather a distinct item of imputed income.²³⁹ The US courts have reached a similar conclusion.

The Japanese CFC rules similarly tax the CFC’s income as a generic or nonspecific item of fictitious income, and neither as a pass-through item nor as a dividend.²⁴⁰

In France, which does not treat the CFC as transparent, the Conseil d’Etat held that the treaty overrode domestic CFC rules.²⁴¹

Under South African CFC rules, the attributed income does not retain the character of the underlying income.

There is also growing practice in other countries. For example, in *Eagle Distribuidora de Bebidas SA v Second Group of the Revenue Department in Brasilia*,²⁴² and *Companhia Vale do Rio Doce v National Treasury*,²⁴³ the Brazilian CFC regime was held to breach the business profits provisions of OECD Model-based tax treaties.

²³⁷ *The Queen v Canwest Mediaworks Inc*, 2008 DTC 6070 (FCA); [2008] 2 CTC 172.

²³⁸ *The Queen v Canwest Mediaworks Inc*, above fn.237, 2008 DTC 6070 (FCA) at [18].

²³⁹ *Bricom Holdings Ltd v IRC* [1997] STC 1179 (CA).

²⁴⁰ See Supreme Court Judgment of October 29, 2009, 2009 (Gyo-Hi) 91, Minshu Vol.63, No.8, p.1881, *Glaxo Kabushiki Kaisha v Director of Kojimachi Tax Office* (2009) 12 ITLR 644 (Sup Crt Japan).

²⁴¹ *Re Société Schneider Electric* (2002) 4 ITLR 1077 (Conseil d’État).

²⁴² *Eagle Distribuidora de Bebidas SA v Second Group of the Revenue Department in Brasilia*, 9 ITLR 627.

²⁴³ *Companhia Vale do Rio Doce v National Treasury*, 17 ITLR 643.

Postscript

Since this article was finalised the OECD have issued the draft contents of the 2017 Update to the OECD Model.²⁴⁴ This contains two items that were dealt with in the article without knowledge that they would be included in the Update: the deletion of the reference to partnerships in Article 10(2)(a)²⁴⁵; and the complete replacement of the existing Commentary to Article 1 on partnerships by the new Commentary on fiscally transparent entities.²⁴⁶ There is also more extensive Commentary on the application of Articles 23A and 23B²⁴⁷.[Ⓒ]

²⁴⁴ OECD, *Draft Contents of the 2017 Update to the OECD Model Tax Convention* (Paris: OECD, 11 July 2017).

²⁴⁵ Pt 1B para.14, and corresponding Commentary at Pt 1C para.40.

²⁴⁶ Pt 1C para.24, which essentially replicates the draft Commentary in the Hybrids Report, above fn.1.

²⁴⁷ Pt 1C para.47.

[Ⓒ] Base erosion and profit shifting; Double taxation; Hybrid mismatch agreements; Model laws; Multilateral instruments; OECD; Partnerships; Transparent entities