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DOUBLE NON-TAXATION AND THE USE OF HYBRID ENTITIES

Thesis in fulfillment of the requirements for the degree of Doctor in Laws

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To Marie-Antoinette

"No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it".

(OECD Action Plan on Base Erosion and Profit Shifting, Paris 2013).

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LIST OF ABBREVIATIONS

AEDAF	Asociación Española de Asesores Fiscales
AG	Attorney General
AOE	Apple Operations Europe
AOI	Apple Operations International
APAs	Advanced Pricing Agreements
ASI	Apple Sales International
ATAD	Anti-Tax Avoidance Directive
ATP	Aggressive Tax Planning
AU	Austria
AUS	Australia
BE	Belgium
BEPS	Base Erosion and Profit Shifting
BFH	Bundesfinanzhof
BGBl	Bundesgesetzblatt
BOE	Boletín Oficial del Estado (Spain)
BR	Brazil

BTR	British Tax Review
CA	Canada
CARF	Brazilian Administrative Council of Tax Appeals
CbC Reporting	Country-by-Country Reporting
CCCTB	Common Consolidated Corporate Tax Base
CEN	Capital Export Neutrality
CFC(s)	Controlled Foreign Companies
CH	Switzerland
CIN	Capital Import Neutrality
CIT	Corporate Income Tax
CJEU	Court of Justice of the European Union
CON	Capital Ownership Neutrality
CRS	Common Reporting Standard
CTB	Check-the-Box
DE	Germany
DD	Double Deduction
DGT	Dirección General de Tributos
DK	Denmark

DLP	Kommanditselskaber
DNT	Double Non-Taxation
D/NI	Deduction/Non-Inclusion
DTC(s)	Double Tax Convention(s)
EATLP	European Association of Tax Law Professors
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortization
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECOFIN	Economic and Financial Affairs Council
EEC	European Economic Community
EEA	European Economic Area
EEIG	European Economic Interest Grouping
E&P	Earnings and Profits
ES	Spain
EStG	Einkommensteuergesetz
EU	European Union
EUR	Euros
FATCA	Foreign Account Tax Compliance Act

FDI	Foreign Direct Investment
FE	Fundatio Europaea
FTC	Foreign Tax Credit
GAAP	Generally Accepted Accounting Principles
GAAR(s)	General Anti-Avoidance rule(s)
GmbH	Gesellschaft mit beschränkter Haftung
HMA	Hybrid Mismatch Arrangements
HMRC	Her Majesty's Revenue & Customs
IBFD	International Bureau of Fiscal Documentation
ICJ	International Court of Justice
IFA	International Fiscal Association
IFRS	International Financial Reporting Standards
IGA(s)	Intergovernmental Agreement(s)
IN	India
IP	Intellectual Property
I&R Directive	Interest and Royalty Directive
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service

JP	Japan
KStG	Körperschaftsteuergesetz
LLC(s)	Limited Liability Company(s)
LLP(s)	Limited Liability Partnership(s)
LOB	Limitation of Benefits
LU	Luxembourg
MAP	Mutual Agreement Procedure
MC	Model Convention
MCMAA	Multilateral Convention on Mutual Administrative Assistance in Tax Matters
MERCOSUR	Mercado Común del Sur
MLI	Multilateral Instrument
MNE(s)	Multinationals
MS	Member State(s)
NID	Notional Interest Deduction
NL	The Netherlands
NYU	New York University
OECD	Organization for Economic Co-operation and Development

OECD Model	Organization for Economic Co-operation and Development Model Convention
OJ	Official Journal
PCIJ	Permanent Court of International Justice
PE	Permanent Establishment
PL	Poland
PPT	Principal Purpose Test
PSD	Parent-Subsidiary Directive
R&D	Research and Development
SAAR(s)	Specific Anti-Avoidance rule(s)
Sàrl	Société `a responsabilité limitée
SAT	State Administration of Taxation
SCE	Societas Cooperativa Europaea
SE	Societas Europaea
Sec.	Section
SICAV	Société d'Investissement `a Capital Variable
Spanish NRITL	Spanish Non-Residents Income Tax Law
SPV	Special Purpose Vehicle
STR	Special Tax Regime

T.C.	Tax Court
TIEA(s)	Tax Information Exchange Agreement(s)
Treas. Regs.	Treasury Regulations
TFEU	Treaty on Functioning of the European Union
UK	United Kingdom
UN	United Nations
US	United States
USCo	United States Corporation
US Model	United States Model Convention
USP	United States Partnership
VAT	Value Added Tax
VCLT	Vienna Convention on the Law of Treaties
WHT	WHT
WTO	World Trade Organization

INTRODUCTION

The topics of double non-taxation (hereinafter, "DNT") and the use of hybrid entities have been in the agenda of the international tax community for a long time.[1] Nevertheless, their analysis acquires a particular importance in our days when transformations within the tax world have achieved a speed, and perhaps also an international commitment not witnessed before, being materialized in the OECD BEPS Project.[2]

The international tax community, or the majority of it, has been generally skeptic as regards to both the DNT outcome and the use of hybrid entities.

1 In 1999, e.g. the OECD launched the *Partnership Report*, which subsequently inspired the inclusion of Article 23(4) in the 2000 OECD Model. *See* OECD (1999), *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation No. 6, OECD Publishing, Paris. During 2010, the OECD also launched the *OECD Report on Addressing Task Risks Involving Bank Losses*, which paid special attention in the situations when the same tax loss is relieved in more than one country as a result of the differences in tax treatment between jurisdictions. Subsequently, in 2011, the OECD launched the *Report on Corporate Loss Utilization through Aggressive Tax Planning*, which recommended countries to consider introducing restrictions on the multiple uses of the same loss to the extent they are concerned with the results of DNT and tax deferral. *See* OECD (2011), *Corporate Loss Utilization through Aggressive Tax Planning*, OECD Publishing, Paris. Likewise, DNT was the central point of discussion in the International Fiscal Association (IFA) Congress in 2004 and hybrid entities was recently discussed in the version of the year 2014 of the same forum. *See* in this regard: Cahiers de droit fiscal international— Vol. 89a, *Double Non-Taxation,* (IFA 2004) and Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014).

2 *See* OECD (2013) *Addressing Base Erosion and Profit Shifting*, OECD Publishing, Paris and OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris.

The DNT outcome, on one hand, supposes the complete absence of taxation, and as such it seems to be as unfair or undesirable as its counterpart: double taxation. This idea has been largely reinforced under the academic postulate that income should be taxed at least once in any cross-border transaction.[3] Hybrid entities, on the other hand, have been criticized to be an open door for creating advantages with differences among country tax systems, which might be exploited in order to duplicate tax benefits and to minimize overall tax burdens.[4] Nonetheless, neither the international need of taxing every

[3] A further analysis at *infra* Chapter I, Section 3.

[4] For some authors this is a problem called *"cross-border tax arbitrage"* or *"international tax arbitrage"* and occurs when a taxpayer is involved in a transaction or set up a business structure in order to take advantage of differences among country tax systems with the goal of exploiting such differences in order to duplicate tax benefits and to minimize his overall tax burden. Therefore, inconsistent characterization of income or entities among the countries might, e.g. give rise to tax arbitrage opportunities. Supporting the academic concept of tax arbitrage *see*, e.g. L. Dell'Anese, *Tax Arbitrage and the Changing Structure of International Tax Law*, Egea, Milan, 2006. *See also* R. Avi-Yonah, Tax Competition, *Tax Arbitrage and the International Tax Regime*, 61 Bull. Int'l Taxn. 4 (2007), Journals IBFD; T. Rosembuj, *International Tax Arbitrage*, 39 Intertax 4 (2011); J. Prebble, *Exploiting Form in Avoidance by International Tax Arbitrage–Arguments Towards a Unifying Hypothesis of Taxation Law*, 17 Asia-Pac. Tax Bull. 1 (2011), Journals IBFD. Nevertheless, the concept of international tax arbitrage is arguable, mostly when dealing with situations when taxpayers legitimately arrange their affairs in order to achieve DNT, using the uncoordinated tax rules among jurisdictions. In this opinion *see*, e.g. H.D. Rosenbloom, *Cross-Border Arbitrage: The Good, The Bad and the Ugly*, Taxes—The Tax Magazine, Vol. 85 (2007), p. 116. Accordingly, the concept of tax arbitrage is still unable to explain how, e.g. differences in the characterization of entities or the corporate residence give rise to arbitrage, while differences in tax rates not. For a further analysis on this subject, *see* M. Kane, *Strategy and Cooperation in International Responses to International Tax Arbitrage*, 53 Emory L.J. 89 (2004). *See also*, J. Roin, *Taxation Without Coordination*, 31 The Journal of Legal Studies 1, Part 2 (2002); D. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 Boston College Law Review 1 (2002); T. Gresik, *The Taxing Task of Taxing Transnationals*, 39 Journal of Economic Literature 3 (2001); T. Edgar, *Corporate Income Tax Coordination*

single cross-border transaction at least once nor the differences in the tax characterization of entities have been proved to be *a priori* a true concern.[5] In spite of the above, the influence of the current international tax reforms, and perhaps also the simplification offered in the use of notions given by granted, has created the perfect scenario for the appearance of even more pragmatic approaches that simply combine both elements, i.e. DNT outcome and disparities in the tax characterization of entities, into one single target, which ought to be counteracted.[6] This idea seems to convince many and it is sometimes difficult to argue against due to its pragmatism and complex construction. Nonetheless, it should not be encased as unquestionable at all.

as a Response to International Tax Competition and International Tax Arbitrage, 51 Canadian Tax Journal 3 (2003).

5 For example, the OECD BEPS Action Plan states: "No or low taxation *is not per se a cause of concern*, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it". (Emphasis added). *See OECD (2013), supra n.* 2, p. 10. In contrast, Action 11 seems to get back to the original idea that DNT is indeed the evil, regardless of the element of artificiality in a cross-border transaction, when it says: "single taxation in cross-border transactions is indeed one of the principal aims of the project both in cases when the interaction of different tax rules leads to such an outcome or when the outcome arises from the shifting of profits from the jurisdictions where the activities creating that profits took place". Id. As regards to the disparities in the tax characterization of entities, they seem to be the result of sovereign tax policy decisions, representing the general rule and not the exception in the international tax practice. *Infra* Chapter III.

6 OECD (2015), *Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2-2015 Final Report*, OECD Publishing, Paris. In 2012, the OECD also produced a *Report on Hybrid Mismatch Arrangements*, which reviewed domestic anti-abuse norms responding to various potentially abusive practices and concluded that they were successful in combating such practices, recommending these solutions to the problem of hybrid mismatch arrangements from a unilateral perspective. OECD (2012), *Report on Hybrid Mismatch Arrangements,* OECD Publishing, Paris. The concept of HMA is analyzed in *infra* Chapter V.

In this vertiginous path of international tax changes, therefore, this work adopts a different approach, taking the time to discover to which extent the DNT outcome and the use of hybrid entities are (if they were once) interconnected elements that should serve each other in the design of domestic and tax treaty anti-hybrid provisions, or whether a re-orientated debate as regards to the use of hybrid entities might be proposed. This task is not superfluous, because only once these issues have been properly clarified, it will be possible to seriously determine whether or not the positions adopted and solutions proposed up to this date shall be supported, improved or simply discarded.

1. Object and Purpose

The object and purpose of this study is to analyze the interaction between the DNT outcome and the use of hybrid entities within the international context, including also the application of tax treaties. For this purpose, this work considers the following research questions:

1. Is there necessarily an interconnection between the use of hybrid and reverse hybrid entities and the DNT outcome? Should the rules targeting the use (or misuse) of hybrid and reverse hybrid entities be designed based exclusively on the DNT outcome?

2. Is there an alternative approach to deal more directly with the use (or misuse) of disparities in the characterization of entities for tax purposes, which does not consider the DNT outcome, or should the current *consequentialist approach* prevail?

Likewise, this work starts from the following hypotheses, which will be proved or disproved during the development of this work:

a. The sole result of a D/NI outcome, i.e. DNT, should not be considered *per se* a matter of concern in any cross-border transaction. Likewise, the use of the DNT outcome as an immediate proxy to determine the existence of practices that might be considered abusive when they derive exclusively from the use of hybrids or reverse hybrid entities should be prevented.

b. *Linking rules*, i.e. rules matching deductions with the respective inclusion of income in the other country, as the ones proposed within the OECD BEPS Action Plan 2, have the risk of setting up strong presumptions of abusive practices by the sole reason that the outcome of DNT has been achieved. Likewise, these rules are highly complex to administer and they do not target the core issue with respect to hybrids and reverse hybrid entities, i.e. the different tax characterization of entities. An alternative should thus be evaluated.

c. Rules regulating the use of *transparent entities* at the level of tax treaties in order to prevent the access to the benefits of a bilateral tax treaty by third countries out of that treaty are, in principle, recommendable. Nevertheless, the inclusion of an Article 1(2) within the OECD Model, resembling Article 1(6) US Model, might generate important issues with respect to developing countries, mostly considering that these countries generally rely on source taxation. Similar concerns are shared as regards to Article 3(1) MLI, which mirrors the OECD proposal of Article 1(2) OECD Model. Alternatives solutions, including domestic ones, should be analyzed.

2. Scope

This work refers exclusively to the study of the cases in which a DNT outcome derives exclusively from the different characterization of the same entity by two different jurisdictions, i.e. when a different characterization of the same entity results in a D/NI outcome. Therefore, this study will not refer to cases of "double deduction" (DD) included within the OECD BEPS Action Plan 2 and will not analyze the cases of "dual resident mismatches" either, as those cases refer neither to the characterization of entities, such as the case of dual resident mismatches, nor they involve the DNT outcome, such as in the case of hybrid and reverse hybrid structures whose outcome is a DD.

Accordingly, this study will exclude the cases of DNT derived from the use of hybrid financial instruments, i.e. when the same financial instrument is qualified differently by two jurisdictions: as debt in one jurisdiction while as equity in the other.[7] This exclusion is justified by two reasons. Firstly, hybrid entities and hybrid instruments are two different problems. Whilst the former supposes the different characterization of an entity by two different jurisdictions, the latter implies a different characterization of the payment (income) made by one taxpayer to the other. The above, however, does not mean to recognize that many transactions can, in practice, involve both a hybrid payment and a hybrid entity at the same time. Secondly, the exclusion has the purpose of simplifying the analysis of DNT as an outcome derived exclusively from the use of hybrid entities and to enable a better understanding of the nature of the issues involved. In the same order of ideas, the study will not refer to the cases concerning "hybrid transfers", namely, arrangements to transfer a financial instrument where the laws of two jurisdictions differ on whether the transferor or the transferee has got the ownership of the payments on the underlying asset, e.g. re-purchase (REPO) or securities lending transactions.[8]

Finally, this work will not include the cases of "hybrid PEs mismatches", i.e. when two jurisdictions disagree on whether a business activity is being carried out through a PE or not. The reasons for this last exclusion are

7 For a complete study about this specific topic, *see*, e.g. J. Bundgaard, *Hybrid Financial Instruments in International Tax Law*, Wolters Kluwer, BV, The Netherlands (2017).

8 OECD (2015), *supra* n. 6, p. 26.

certainly obvious. On the one hand, PEs are not strictly entities or separate entities, regardless that they can be part of an entity. On the other hand, the "mismatch" in this case arises with respect to the existence (or not) of a PE, i.e. a legal fiction in itself created to tax the profits of a business (branch) when there was enough economic presence in a territory, and not with respect to the existence or not of an "entity" due to its different characterization in two countries. This is also perhaps the reason why the OECD also opted for elaborating a separate report for this purpose.[9] As per the justification for the exclusion of "PE mismatches" from this work, any reference to the potential application of the proposed *reactive coordination rule* (Chapter VI) to these cases will also be omitted.

3. Methodology

This work has opted for an analysis not strictly linked to any specific tax jurisdiction, which, in principle, might not necessarily follow the traditional paths of a doctoral thesis in law that normally uses as a starting point the specific provisions of a jurisdiction. Nonetheless, the methodology chosen

9 As well confirmed by the OECD: "Branch mismatch arrangements are not 'hybrid' in the sense that they are not the result of differences in the tax treatment or characterization of an instrument or entity". *See* OECD (2016), *Public Discussion Draft: BEPS Action 2 Branch Mismatch Structures*, OECD Publishing, Paris. Accordingly, all of the examples involving hybrid entities and reverse hybrid entities within the OECD BEPS Action 2 assume that there is no PE in the country of establishment of the entity once this is considered as transparent in the country of the investors. *See also*, OECD (2017), *Neutralizing the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, OECD Publishing, Paris.

in this case finds its justification in two main reasons. On one hand, it is given by the nature of the concepts under analysis, i.e. DNT and hybrid entities. Both issues represents problems that involves the interaction of different jurisdictions, i.e. international tax law issues that are not limited to a particular State, and that many times also involve the application of supranational law, i.e. EU law, and tax treaties. To this extent, it results more accurate to situate all these issues under analysis within an international context, rather than to limit their scope to the laws of a given country, which might finally restrict the results of this work. On the other hand, a more agnostic analysis, i.e. not linked to the analysis of a specific jurisdiction, allows this author to carry out a deeper study into the foundations of the concepts in abstract, absent of the specific limitations of domestic tax legislation, which might finally allow elaborating solutions applicable to a generality of cases. As such, thefore, this research work might properly be considered as an *international tax law* thesis.

The above, however, does not mean to recognize that the author completely renounces referring to the laws of specific tax jurisdictions either as a way of example or as a way to support the analysis of the specific subjects treated during the development of this work. In this regard, it is important to note that the election of the countries whose domestic legislations, including also domestic jurisprudence, are used or analyzed has not been randomly made. On the contrary, it strictly follows the directions given by the nature of the general topics under analysis, i.e. DNT and hybrid entities, and the manner in which this research work has been finally structured. In this

sense, the author has chosen to carry out a more extensive analysis upon the rules of characterization of foreign entities for tax purposes in the United States of America (Check-the-box rules or CTB) in Chapter III. This analysis is justified in the importance of these rules as to originate hybrid and reverse hybrid entities in the international context, being also a unique example in the world of a system of characterization of foreign entities in which the taxpayer may choose the tax characterization of them. Likewise, the *Spanish Income Attribution Regime* is analyzed in Chapter III as a manner to provide a concrete example of coordination in the characterization of foreign entities, even though such a coordinated result is the result of an administrative practice of the Spanish tax authority (DGT), which does not necessarily have a proper foundation within the strict text of the law. Likewise, the Danish law is analyzed in Chapter III as another important example of coordination to solve issues as regards to hybrids and reverse hybrid entities. Indeed, the Danish rules appear as a reaction to the use (or misuse) of the CTB rules in the United States and have served as an orientation to the latest reforms within the EU ATAD II, delaing with HMA with third countries outside the EU. All the other references to speficic tax jurisdictions are used according to the specific subjects analyzed during the thesis. In this regard, e.g. Chapter I refers to the tax credit and LOB clause within the United States tax system as regards the discussion upon the existence of an international principle that would oblige to pay taxes in at least one State in cases of cross-border transactions, known as *single tax principle*. Both specific provisions are used as part of the pro and cons

arguments to prove or disprove its existence, and thus, they might rarely be omitted. Another example can be found in the use of the German tax law to exemplify the use of *switch-over clauses* within tax treaties or the reference to tax treaty override in Chapter II. Accordingly, some examples of solutions to deal with the dichotomy between Article 1(2) OECD Model and the *beneficial ownership* requirement of Articles 10, 11 and 12 OECD Model, are taken from the treaties between Poland/United States and Canada/United States as it can be noted in Chapter IV. All of the above ratifies the international tax law character of this research work and justifies the use of tax laws and jurisprudence of different countries as per the development of the work requires.

The apparent unsystematic analysis of EU tax law, on the other hand, might also be a cause of concern from a traditional point of view. Nevertheless, the use of EU tax law follows the whole methodlogy adopted for this thesis, i.e. EU tax law is analyzed as part of the whole international context appearing and disappearing during the thesis as per its development requires. That is the reason why some references to EU tax law firstly appear in Chapter I as part of the non-legal notion of *Aggressive Tax Planning* (ATP), in particular, because of the "EU notion" of ATP given by the EU Commission. Similarly, EU tax law is used as part of the analysis of the concept of *Special Tax Regimes* (STR), included as part of the OECD BEPS Action Plan 6, and analyzed in Chapter II, because it might indeed generate concerns under primary and secondary EU tax law. In Chapter III, appears again a reference to EU tax law as a manner to exemplify the evolution in

the treatment of HMA within the EU. This evolution is certainly interesting, because of the most recent developments within the EU to deal with HMA, in particular the launch of the EU ATAD I and II. Finally, it appears as part of the analysis of the OECD *linking rules* in Chapter V and its compatibility with EU primary and secondary law. The use of EU tax law to test the efficacy of *linking rules* finds its justification in two main reasons. On one hand, because the notion of *discrimination* elaborated within the CJEU when compared, e.g. to the one of Article 24 OECD Model, also analyzed in this Chapter, might drives to different results. On the other hand, because the EU has been particularly compromised in the implementation of the OECD BEPS measures, including HMA. This task has been materialized with the approval of the EU ATAD I, which opted for including the OECD *linking rules* to deal with hybrids (both as regards to entities and financial instruments), and the recent development included within the EU ATAD II, which covers HMA with third countries. All of the above sustains a methodological analysis of EU tax law as per the development of the research requires, certainly disclosing a sistematic treatment.

A more agnostic analysis not restricted to any specific jurisdiction has also special relevance with respect to the study of the concepts of DNT and the use of hybrid entities within the tax treaty context. Although tax treaties constitutes a singular world, the use of tax treaty models, specially the widespread use of the OECD Model, might be helpful to extract general conclusions applicable to the generality of tax treaties using similar

provisions. Chapter II, e.g. analyses some specific provisions of the OECD Model, which at first glance might be interpreted in a manner of preventing DNT. However, a closer look at them demonstrates that they are far from being interpreted in light of this broad tax policy goal. Similarly, Chapter IV deals with the analysis of Article 1(6) US Model, which regardless of not being included in all the treaties signed by the United States, may be compared with the proposed Article 1(2) OECD Model in order to extract general conclusions with respect to the use of hybrid entities and reverse hybrids within tax treaties. In particular, the use of study cases in Chapter IV, both to explain the consequences of the application of Article 1(6) US Model and 1(2) OECD Model, finds a proper justification in the subsequent analysis of the same cases within the proposal of Chapter VI, which creates an harmonic point of comparison, even though this latter proposal does not attempt to be implemented directly within tax treaties.

Finally, there is another important reason to prefer an analysis not restricted to any specific jurisdiction. This work proposes an alternative approach (i.e. the *reactive coordination rule*) to deal with hybrid entities and reverse hybrid entities, which does not only deviates from the the OECD *linking rules*, but also it has the characteristic of being designed without considering a specific jurisdiction in mind. The above has the advantage of being a rule that, in principle, might be implemented in any jurisdiction, keeping in mind that hybrid entities are an international concern not restricted to a specific State only. As regards to the proposal, this is based on some fundamental ideas. In first place, it attempts to be a simple rule that avoids the complex

set of OECD *linking rules*, and which might also serve as a valid and more administrable alternative to the above-mentioned domestic solution. In second place, it attempts to focus on the real issue involving the use of hybrid and reverse hybrid entities, i.e. the disparate characterization of entities by two or more jurisdictions, disregarding the outcomes of the transactions involving the use of hybrid entity structures, particularly the DNT outcome. Thirdly, it attempts to be a rule that might provide also more consistent results in the application of tax treaties, in particular as regards to Article 1(2) OECD Model and Article 3(1) MLI. The above might be intuitively understood since once coordination in the characterization of entities has been achieved, the conflicts within tax treaties disappear and the application of Article 1(2) OECD Model is restricted only to those cases in which the two Contracting States considers the entity as fiscally transparent, which will happen exclusively in those cases in which the entity was given a tax transparent treatment in its county of legal organization. All these outcomes are further on analyzed at Chapter VI.

4. Structure of the work

This work is divided in three parts.

Part One refers to the study of the DNT outcome. This part of the study includes two Chapters. Chapter I, on one hand, which attempts to demonstrate that the DNT outcome should not be considered *per se* as a

cause of concern in any cross-border transaction. This Chapter also includes the arguments against the supporters of the idea that an international tax law principle exists to obligate that income is taxed at least once in a cross-border transaction. Accordingly, by analyzing the traditional legal concepts of tax evasion and tax avoidance, the Chapter attempts to demonstrate that DNT should not be confused with these concepts that distorte its nature. The analysis in abstract of the notion of DNT will allow us to prevent an *a priori* negative perception of it, reinforcing its nature of a simple outcome. Chapter II, on the other hand, analyzes the concept of double non-taxation in light of the application of bilateral tax treaties. Taking some provisions of the OECD Model and some examples of tax treaty clauses, this Chapter aims to demonstrate that no provisions within tax treaties adopt the general tax policy goal of preventing DNT. The above does not mean to recognize that under some circumstances tax treaties might indeed prevent DNT, such as the case when *subject-to-tax* or *switch-over clauses* are expressly introduced within a tax treaty. However, these situations are as exceptional as when some provisions are introduced within tax treaties regardless the DNT outcome, e.g. *tax sparing* or *matching credits*.

Part Two turns the analysis into the second main subject of this work: *hybrid entities*. This part of the study also includes two Chapters. Chapter III, on one hand, refers to some key concepts that are necessary to circumscribe the subsequent analysis of the concepts of *hybrid entities* and *reverse hybrids*. This Chapter also includes a general analysis of the different existing methods to characterize foreign entities for tax purposes around the world,

i.e. the comparative approach; legal personality approach; overall approach and fixed approach, in order to demonstrate that no system prevails over the other and that there is no completely inviolable method of characterization of entities. Likewise, it provides a detailed analysis of the U.S. CTB system as the largest and most famous "elective system" to characterize entities for tax purposes, reserving the taxpayers the exclusive right to determine when a foreign entity will be taxable or not, addressing also the previous characterization system used in the United States, i.e. *Kintner* test. Accordingly, it analyzes the cases of tax planning opportunities derived from the CTB election, specifically with reference to the avoidance of Subpart F income (CFC rule) and the inappropriate use of foreign tax credit, demonstrating that the electivity of the CTB system is more apparent than real, and when compared, e.g. with a resemblance or comparable system, there is practicably no difference in terms of the possibilities to predict a desired characterization of entities. Finally, the Chapter addresses three concrete examples of coordination in the tax characterization of foreign entities around the world: Spain, Denmark and the attempted coordination within the Proposal for an EU ATAD and the inclusion of Article 9a EU ATAD II, dealing with cases of payments made to reverse hybrid entities. These examples attempt to demonstrate that coordination in the characterization of entities is not only a utopian academic idea, but it can also be an effective manner to deal with hybrids and reverse hybrid entities, serving also as an anteroom to the general proposal of this work. Chapter IV, on the other hand, deals with the use of hybrid entities and the

entitlement to tax treaty benefits. For this purpose, the Chapter briefly refers to the general rules regarding the entitlement to tax treaty benefits with respect to entities and analyses the principles established within the OECD Partnership Report as regards to conflicts of allocation of income. Accordingly, it provides a detailed analysis of Article 1(6) US Model, which is the first positive recognition of the principles settled within the OECD Partnership Report, and the immediate precedent of Article 1(2) OECD Model, which is subsequently analyzed in this Chapter. Despite a general analysis of the wording of these two provisions, the Chapter provides specific illustrations with respect to the application of both provisions, which are divided in two groups: (i) strict bilateral cases and (ii) triangular cases. Likewise, as regards to Article 1(6) US Model, it also provides some examples where the interplay between Article 1(6) US Model and other tax treaty and domestic provisions is either not entirely clear or they simply conflict with each other. The above includes the interplay with the concept of *beneficial owner* in Article 10, 11 and 12 US Model; the U.S. "*saving clause"*, the U.S. CTB regulations and I.R.C. Sec. 894(c). Similarly, as regards to Article 1(2) OECD Model, it also addresses some specific issues referred to its application, which include the interplay with the concept of *beneficial owner*, the *saving clause* and double taxation relief's issue (particularly considering the proposal of paragraph 64 of the OECD BEPS Action 6), and the negative impact that Article 1(2) OECD Model has with respect to developing countries. Finally, the analysis and conclusions referred to Article 1(2) OECD Model are extended to Article 3(1) of the MLI, which contains essentially the same text. Further analysis is also

provided as regards to Article 3(3) and Article 11 MLI, referred to the simplified and detailed *"saving clause"* version introduced within the MLI. Accordingly, this analysis is complemented with the study of Article 3(2) and Article 5–Option C MLI, dealing with the impact of the saving clause and the double taxation relief's issues.

Finally, Part Three analyzes how both the DNT outcome and hybrid entities, analyzed in Part One and Two of this work, interact together within the notion of *"hybrid mismatch arrangements"* (HMA). For this purpose, Chapter V firstly analyzes the notion of HMA and criticizes its confusing and limited construction. It is also argued in this Chapter that the attempt to connect disparities derived from different characterization of the same entity by two different jurisdictions and the DNT outcome might ultimately create presumptions of abusive practices. Likewise, this Chapter aims to demonstrate that the deficient construction of the notion of HMA is replicated in the elaboration of the remedies proposed to counteract them, i.e. *"linking rules"*. For this purpose, the Chapter reinforces some issues of compatibility between *linking rules* and tax treaties and EU Law, respectively. Against this attempted interconnection between the use of hybrid and reverse hybrid entities and the DNT outcome, which has derived in a complex set of rules to implement both at a domestic and tax treaty level and whose true efficacy is still an incognito, Chapter VI proposes a different alternative: a domestic *reactive coordination rule.* The proposal aims to be a domestic alternative to coordinate the characterization of

entities according to the legal characterization of the entity in the *home country*, i.e. the country where the entity, whose characterization is under debate, is formally and legally organized, and it is based in three main tax policy ideas: simplicity, coherence and administrability. The first part of the Chapter describes the mechanics of the proposal, including its scope of application and the policy objectives. Likewise, it explains the functioning of the proposal using specific illustrations in this regard, and detailing also its advantages and disadvantages. It finally provides a comparison between the proposed rule and other existing rules addressing the same path of coordination in order to clearly set up the common points and deviations that makes the proposed rule in this Chapter preferable. The second part of the Chapter analyzes the implications of the domestic *reactive coordination rule* within tax treaties. As recognized in Chapter IV, the inclusion of a new Article 1(2) OECD Model (and Article 3(1) MLI) solves many issues regarding the proper allocation of tax treaty benefits when tax transparent entities are involved. However, this article if far from being a fair solution for developing (source) countries. This issue could, nevertheless, be mitigated in the hypothetical that the domestic *reactive coordination rule* is applied worldwide. Indeed, if that occurs, the scope of application of Article 1(2) OECD Model will be automatically reduced, providing more consistent tax treaty outcomes, and indirectly enhancing the position of source countries in those cases where the pure application of Article 1(2) OECD Model originated unfair results. The proposal, however, does not attempt to be neither a perfect solution nor an improvable one, but rather to serve as a guide to re-orientate the discussion to what really matters in the debate

regarding hybrid entity mismatches, especially in this time where we have witnessed how issues are presented in a pragmatic costume, being sometimes very difficult to see beyond that or to argue against. Chapter VII finally summarizes the main findings of this work.

–PART ONE–

Double Non-Taxation: Delimiting the Boundaries of an Stigmatized Concept

I. CHAPTER

Double Non-Taxation: A Conceptual Analysis

1. Introduction

The use of the notion of DNT[10] has acquired considerable prominence during the last years. The appearance in the media of public tax cases concerning multinational corporations, such as Apple[11], Amazon[12], Fiat[13], Starbucks[14] and McDonalds[15], just to mention some of them, using

10 Some authors use the term *"white income"* as equivalent to DNT. Nevertheless, this term might create certain confusion with other new notions that have also recently appeared in the international tax arena, such as the notion of *"stateless income"*. This latter, however, is certainly not a synonymous of DNT. Therefore, for the sake of clarity, the author will only refer to the classic term of DNT as the complete absence of taxation in an international transaction. For the explanation of the term *"stateless income"*, see *infra* Section 2.2. As an example of authors referring to *"white income"* as an interchangeable concept of DNT *see*, e.g. W. Haslehner, *Double Taxation Relief, Transfer Pricing Adjustments and State Aid Law*, in: I. Richelle, W. Schön and E. Traversa (eds) *State Aid Law and Business Taxation*, Springer, Heidelberg, 2016.

11 *See*, e.g. US: US Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs, Hearing on Offshore Profit Shifting and the U.S. Tax Code – Part 2, Apple Inc. (2013). *See also*, e.g., A. Ting, *The Politics of BEPS – Apple's International Tax Structure and the US Attitude towards BEPS*, 69 Bull. Intl. Taxn. 6/7 (2015), Journals IBFD; L. Sheppard, *Apple's Tax Magic*, Worldwide Tax Daily (26 May 2013).

12 *See*, e.g. J. Martin, *Amazon Fighting IRS Over Cost-Sharing Agreements*, Tax Analyst, Featured Articles, posted online on 21 January 2013.

13 *See,* e.g. T. Ciro and B. Mascitelli, *Machinations in the Global Automotive Industry: The Fiat and Chrysler Deal Examined*, 12 Derivs. & Fin. Instrums. 2 (2010), Journals IBFD. *See also*, L. Ambagtsheer-Pakarinen, *Commission*, 56 Eur. Taxn. 1 (2016), Journals IBFD.

14 *See*, e.g. H. van den Hurk, *Starbucks versus the People*, 68 Bull. Intl. Taxn. 1 (2014), Journals IBFD. *See also*, C. Allison, *How Starbucks Lost its Social License—and Paid 20 Million pounds to Get it Back*, 71 Tax Notes Int'l 7 (2013), p. 637.

15 *See*, e.g. EU: European Commission Press Release, *State aid: Commission opens formal investigation into Luxembourg's tax treatment of McDonald's* (3 Dec. 2015).

sophisticated tax structures to reduce or to eliminate taxation, including the role of activists promoting "tax justice" and "fairness"[16], have certainly created an interesting scenario to debate or re-debate about a notion that seems to be understood *a priori* as something negative. The recent work of the OECD, the 2013 BEPS project, has not only reaffirmed this negative idea on what double non-taxation is, but it has gone further and provides specific measures that countries should follow in order to counteract its undesirable effects.[17]

Nevertheless, a proper debate could not start from the basis of notions given by granted. On the contrary, within the debate on DNT, it is important to go one step back and to ask whether we really have certainty on what are we debating on? Do we know what is DNT? Is it correct to use this notion as an interchangeable one with some illegal or undesirable concepts, such as tax evasion or tax avoidance? Where is the limit? Is there a general prohibition under international law by which taxpayers are not permitted to legitimately pursue a DNT outcome in cross-border transactions?

This Chapter provides an analysis in abstract of DNT aiming to answer those questions and to demonstrate that the notion of DNT should be neither

16 In this regard, one of the biggest "think tank" activists is the Tax Justice Network launched in 2003. The organization has a wide network around the world, including North America, Latin America, Asia and Europe. More information about the Tax Justice Network at www.taxjustice.net

17 OECD (2013), *supra* n. 2.

regarded *per se* as a cause of concern in any cross-border business nor confused with other illegal or undesirable activities, such as tax evasion or tax avoidance. Equally undesirable is the use of "non-legal notions" or pseudo-legal concepts created to justify international limits to cross-border tax planning. Particularly important is the notion of "*aggressive tax planning"* (ATP), whose *consequentialist approach*, i.e. based upon the outcome of DNT instead of traditional elements of economic substance or artificiality, may jeopardize even more the understanding of the notion of DNT. The Chapter also argues against the belief, supported by some international tax scholars and defended even as a an "international tax principle", that income should be taxed at least once in any cross-border transaction, as one of the main responsible for the ambiguity of a notion whose nature is that of a simple outcome. Section 2 summarizes the traditional understandings of the notion of DNT in the international tax doctrine. Section 3 analyzes the "*single tax principle"* (or the belief that income should be taxed at least once in cross-border transactions) and its negative influence upon the understanding of the notion of DNT. Section 4 analyses in brief the traditional concepts of tax evasion and tax avoidance, reinforcing the idea that DNT should not be assimilated to any of these undesirable activities, whose limits are normally set up by law. Section 5 attempts to demonstrate that the *consequentialist approach* adopted within the pseudo-category of ATP may also negatively influence the understanding of the notion of DNT, creating an artificial limit (not legal)

for those transactions on which a legitimate tax planning took place. Section 6 provides some final remarks.

2. The traditional attempts to explain an ambiguous concept

The several and traditional attempts to explain the notion of DNT are ambiguous. While some scholars have been inclined to describe it as the simple reverse effect of double taxation or the absence in exercising the sovereign taxing rights, others have included subjective elements, i.e. intentionality, to differentiate between objectionable and non-objectionable double non-taxation. There are also who have simply opted to consider it as a *per se* undesirable and illegitimate outcome. Following these ambiguous developments, the author revisits the main attempts to explain the notion and summarizes them as follows: 1) double non-taxation as the reverse side of double taxation; 2) double non-taxation; under-taxation and *stateless income*; 3) double non-taxation as an intended or unintended outcome, and 4) double non-taxation as a *per se* undesirable outcome.

2.1. Double Non-Taxation as the reverse side of Double Taxation

Strictly speaking, DNT arises exactly in the reverse situations of double taxation.[18] This is to say, while double taxation implies that income is taxed

[18] In this sense, e.g. S. Pulido, *Avoidance of Double Non-Taxation in Portugal,* in: M. Lang (ed.), *Avoidance of Double Non-Taxation*, Linde, Vienna, (2003), p. 284; M.

twice or multiple times in a cross-border taxation, double non-taxation supposes the complete absence of taxation in those similar scenarios. In other words, DNT is the result of an uncoordinated exercise of taxing powers by different tax authorities, each of whom provide different criteria, territorial, personal, material, to establish a link between the taxable base and the taxing authority and thus to justify the tax claim.[19]

Scholars have historically distinguished between two types of double taxation: juridical and economic. *Juridical double taxation* implies the imposition of identical or similar taxes in two (or more) states on the same

Ullah, *Avoidance of Double Non-Taxation in the United Kingdom,* in: M. Lang (ed.), *Avoidance of Double Non-Taxation*, Linde, Vienna, (2003), p. 427; A. Verstraeten, *Double (Non)Taxation in VAT and Direct Taxes: Which Tax is better for Developing Countries?,* in: M. Lang, P. Melz and E. Krostoffersson (eds.), *Value Added Tax and Direct Taxation: Similarities and Differences,* IBFD (2009), p. 374; G. Bizioli, *Comparative Analysis of the Causes of Double (Non-) Taxation in the Income and VAT/GST Contexts,* in: M. Lang, P. Melz and E. Krostoffersson (eds.), *Value Added Tax and Direct Taxation: Similarities and Differences,* IBFD (2009), p. 400. In the field of indirect taxation, specifically regarding VAT, some authors have considered that double non-taxation arises: " [W]hen no country has imposed the relevant tax on the relevant subject matter, which is therefore effectively 'tax-free' in the sense that there is no tax burden to pass on to consumers." *See*, e.g. R. Millar, *Intentional and Unintentional Double Non-Taxation*, in: M. Lang, P. Melz and E: Kristofferson (eds.), *Value Added Tax and Direct Taxation: Similarities and Differences,* IBFD (2009), p. 417. Also in this position *see,* e.g. S. Menuchin and N. Baram, *Israel,* in: Cahiers de droit fiscal international—Vol. 89a, *Double Non-Taxation* (IFA 2004), p. 439.

[19] E. Traversa and C. Hellepute, *Double (Non-) Taxation in VAT and Direct Taxes: How to Achieve Some Convergence within a Summa Divisio? A European Perspective,* in: M. Lang, P. Melz and E: Kristofferson (eds.), *Value Added Tax and Direct Taxation: Similarities and Differences,* IBFD (2009), p. 340. Double taxation normally occurs because most States tax their residents on their worldwide income irrespective of whether the income derives from their country of residence or from abroad. *See also*, M. Rasmussen, *International Double Taxation*, Wolters Kluwer, New York (2011).

taxpayer with respect to the same taxable income or capital or event.[20] For example, a dividend received by a shareholder who is non-resident in the State of the payer company will be normally subject to a WHT in the State of source and it will be also included as income in the State of residence of the shareholder. Accordingly, *economic double taxation* occurs where two different persons are taxable in respect of the same income or capital.[21] For instance, when income is received according to the law of one state by a partnership treated as a taxable entity in that state, while the other State considers the partnership as transparent and attributes the income directly to the partners liable to tax in its territory. In this order of ideas, if DNT is simply the reverse side of double taxation, then DNT will occur when a taxpayer engaged in an international transaction is not subject to any tax on behalf of the countries that have the right to tax.[22] In other words, as double taxation arises from the exercise of sovereign taxing rights of two or more countries, double non-taxation is a consequence of the opposite, and it occurs when no country exercises its sovereign taxing rights, either because the country of residence decides to exempt an item of foreign source income and the source country also decides not to tax such an income or because the

[20] A. Rust, in: Reimer and Rust (eds.), *Klaus Vogel on Double Taxation Conventions*, 4th edn (2015), Article 23 at m.no.1. For a deeper analysis of the phenomenon of juridical double taxation *see,* e.g. M. Pires, *International Juridical Double Taxation of Income*, Kluwer Law and Taxation Publishers, Boston (1989).

[21] Rust, *supra* n. 20, at m.no.2. *See also*, M. Lang, *Introduction to the Law of Double Taxation Conventions*, 2nd. Ed., Linde Vienna (2013), pp. 29-30.

[22] Verstraeten, *supra* n. 18.

DTC in force assigns taxing rights to either the source or resident country, but the assigned country simply not exercise these taxing rights.[23]

The understanding of DNT as the reverse effect of double taxation does not imply, however, to consider it immediately as an undesirable outcome. Indeed, neither the elimination of double taxation nor the avoidance of DNT are sacred principles of international tax law. On the one hand, the former idea confuses between how much taxes should be levied and how many times. From a legal point of view, however, both questions should not deserve the same attention. There should be concern about how much taxes are levied, mostly considering that taxes should at any case become confiscatory, but the same attention should not be paid on how many times these taxes are levied. [24] After all, many taxpayers should be indifferent if they are taxed once at a rate 35% than 35 times at a rate of 1%. On the other hand, the latter idea (the prevention of DNT) simply disregards the nature of the concept, whose desirability (or not) will depend exclusively upon the agreement of two jurisdictions. [25] In fact, there is actually no evidence that

[23] Id., p. 378.

[24] Accordingly, in some cases the relief of double taxation seems not to be a problem at all, as it happens with developing countries or transition economies. As residents of these countries are expected to receive less income from foreign sources, the relief of double taxation is, in fact, not a priority. *See* R. Vann, *Chapter 18: International Aspects of Income Tax,* in: V. Thuronyi (ed.), *Tax Law Design and Drafting*, Vol. II, International Monetary Fund (1998), p. 37.

[25] This can be easily seen in the case of countries that, e.g. within a tax treaty, include a *subject-to-tax* or *switch-over clause* in order to counteract the effects of DNT. In such cases, there is no doubt that the outcome of DNT is indeed an undesired outcome. *See* a further analysis on the use of *subject-to-tax* and *switch-over clauses* in *infra* Chapter II, Section 4.2.1 and 4.2.2.

the international law imposes any obligation on the countries to relief double taxation or to prevent DNT in absence of such agreements. As provided by Vogel: "Double taxation, resulting from the interaction of the domestic laws of two (or more) States, will be consistent with international law as long as each individual legislation is consistent with international law".[26] The above simply reinforces what the PCIJ stated in the *Lotus* case (1927), in terms that what it is not prohibited under international law, it is indeed permitted.[27] In other words, in the absence of an international norm prohibiting either double taxation or DNT, one should conclude that both are generally permitted or tolerated outcomes.

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26 K. Vogel and A. Rust, in: Reimer and Rust (eds), Reimer and Rust (eds.), *Klaus Vogel on Double Taxation Conventions*, 4th edn (2015), Introduction at m. no. 11.

27 The Lotus case of 1927 referred to a collision occurred in high seas between a French vessel (SS Lotus) and a Turkish vessel (Boz-Kourt) and which involved the application by Turkey of criminal law against both the French and Turkish officers on watch of the vessels. France alleged that the SS Lotus was using the French flag; therefore, it should be assimilated to French territory and thus Turkey had no jurisdiction to carry out criminal proceedings against the French captain of the SS Lotus. Accordingly, it alleged that it was a common practice on that time that countries would avoid to apply any of such criminal proceedings outside the territory. Denying the French request, the Permanent Court of International Justice, the judicial branch of the League of Nations, precedent of the United Nations, sustained: "Even if the rarity of the judicial decisions to be found among the reported cases were sufficient to prove in point of fact the circumstances alleged by the Agent for the French Government, it would merely show that States had often, in practice, abstained from instituting criminal proceedings, and not that they recognized themselves as being obliged to do so […]". International: *The case of the S.S. "Lotus",* Collection of Judgments, Publications of the Permanent Court of International Justice, Series A-No.10 , 7 September 1927, p. 28.

2.2. Double Non-Taxation; under-taxation and *Stateless Income*

In another attempt to explain the concept of DNT, some scholars have not only included the complete absence of taxation, but also the cases of low taxation or under-taxation, even achieved by a legitimate tax strategy.[28] However, putting in equal footing DNT and under-taxation deviates from the nature of the concept of DNT which is, in essence, the absolute absence of taxation either by the disparities in domestic laws, the application of a tax treaty provision or the simple decision of a State not to exercise its taxing rights.

The distinction between DNT and under-taxation can be easily illustrated using the Apple's international tax structure as example.[29] The tax structure of Apple is simple when compared with others international tax structures. Apple Inc., a US Corp, owns a 100% of the stock in Apple Operations International (AOI), which subsequently owns 100% of the stock in Apple Operations Europe (AOE) and which subsequently owns 100% of the stock in Apple Sales International (ASI).[30] These last three companies are incorporated in Ireland, however AOI and ASI have their effective management and control in the United States.[31] AOI basically acts as a holding company for many group companies involved in overseas

[28] Even though the ultimate goal of any tax planning is to legitimately achieve DNT. *Infra* Section 4.2.1.

[29] For a deeper analysis upon the Apple's tax structure, *see* A. Ting, *iTax–Apple's International Tax Structure and the Double Non-Taxation Issue,* BTR 1 (2014).

[30] Id., at 42-46.

[31] Id.

operations and receiving dividends from its subsidiaries.[32] ASI engages unrelated contract manufacturers in China to assemble the products and sells the final ones to distribution subsidiaries in Europe and Asia.[33] Consequently, ASI entered into a "cost sharing agreement" with the ultimate parent company, Apple Inc., under which it posses the economic rights to Apple's intellectual property, while the legal ownership of that property remains with Apple Inc. in the United States.[34] Finally, Apple derives over 60% of its income from foreign jurisdictions[35], paying an effective tax rate lower than the 12,5% of corporate tax rate in Ireland. As per the Apple's international tax structure, it is possible to figure out clearly that while that the outcome of DNT derives exclusively from the disparities in the domestic

[32] Id.

[33] Id.

[34] A *cost sharing agreement* is a regime introduced during the early 1990s and whose idea was that when a US multinational starts a new R&D project, it can enter into an agreement with its offshore subsidiaries in order to share the cost of development. If the project is finally a success, they also share the profits derived from it. Id., at 47. The primary tax benefit from entering into a cost sharing agreement is that all participants to such agreement will be considered the owner of their respective interest in the intangible created, thereby preluding the application of the general transfer pricing rules related to the transfer of intangible property. Accordingly, if the participants enter into a *qualified cost sharing agreement*, i.e. a written agreement under which the participants agree to share the costs of developing intangibles proportionally to their relative shares of reasonable benefits from the individual exploitation of their assigned interest in the intangibles, the IRS is precluded from making Section 482 adjustments (according to arm's length), unless it is strictly necessary to make each participant's share of intangible development costs equal to its share or reasonable anticipated benefits. *See* M. Levey and S. Wrappe, *Transfer Pricing: Rules, Compliance and Controversy*, 3th ed., Wolters Kluwer Business, Chicago, 2010, pp.137-138, para. 460.

[35] This issue does not necessarily mean profit shifting. On the contrary, it could perfectly represent the successful business position of the group overseas.

concepts of corporate tax residence,[36] the one of under-taxation derives from the legitimate use of a cost sharing agreement between Apple Inc. and its subsidiary ASI, a regime introduced in the early 1990s in the United States.

Finally, it is worth to refer to the cases where under-taxation or DNT might be achieved through the shifting of profits from high to low tax jurisdictions made by multinationals around the world. This phenomenon that involves the shifting of income within a multinational tax group in order to reduce or completely avoid taxation has been denominated by some authors as *"stateless income"*.[37] Kleinbard defines *stateless income* as "the income derived for tax purposes by a multinational group from business activities in a country other than the domicile of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers of the factors of the production though which the income was derived, and is not the domicile of the group's parent company".[38] In other words, *stateless income* implies "the movement of taxable income within a multinational group from high to low-taxed source countries without shifting the location of externally supplied capital or activities involving

[36] According to the U.S. tax law, a corporation is resident when it is incorporated in the United States. Conversely, in Ireland the residency of a corporation is determined in accordance to the place of effective management and control. Thus, AOI and ASI, both incorporated in Ireland and managed and controlled in the United States, were neither resident in the United States nor in Ireland, then there was no link to trigger taxation in any place.

[37] E. Kleinbard, *Stateless Income*, 11 Florida Tax Review 699 (2011).

[38] Id., p. 701.

third parties".[39] Therefore, it involves the application of a series of international tax norms, including e.g. the recognition of separate tax persons; transfer pricing rules; the treatment of income as debt or equity, etc., whose outcome might be or not non-taxation all-together. Hence, *stateless income* is a more complex construction whose treatment exceeds the purpose of this work; however, what it is interesting to point out here is that it that it does not necessarily mean to be a concept equivalent to DNT, despite the fact that such outcome might sometimes be achieved.[40]

2.3. Double Non-Taxation as an intended or unintended outcome

For a part of the international tax doctrine, DNT may also be divided into two sub-categories: intended (or voluntary) and unintended (or involuntary) DNT.[41] Intended DNT, on the one hand, would exist when every country

[39] Id., p. 703.

[40] For further references on this topic *see*, e.g. E. Kleinbard, *The Lessons of Stateless Income*, 65 Tax Law Review 99 (2011); E. Kleinbard, *Stateless Income's Challenge to Tax Policy*, USC Center in Law, Economics and Organization, Research Paper No. C11-8, USC Legal Studies Research Paper No. 11-13 (2011); E. Kleinbard, *Through a Latte, Darkly: Starbucks's Stateless Income Planning*, 139 Tax Notes 13 (2013), pp. 1515-1535; K. Carey, *Stateless Income's Agency Problem: Are Multinationals Acting in the Best Interest of Shareholders through the creation of Stateless Income?* (14 May 2012), full text available at SSRN.

[41] More recently, some authors have also made use of the notion of *"unintended double non-taxation"* to explain the modern pseudo-legal notion of *"aggressive tax planning"*(ATP). *See,* e.g. P. Pistone, *La Planificación Fiscal Agresiva y las Categorías Conceptuales del Derecho Tributario Global,* Revista Española de Derecho Financiero 170, Abril-Junio 2016, pp. 109-151. Pistone provides that *unintended double non-taxation* would be a constitutive element of this pseudo-legal notion of *aggressive tax planning*, jointly with the exploitation of disparities among jurisdictions to obtain a tax

that has the right to impose the relevant tax on a particular subject matter has agreed that no tax should be imposed upon that subject matter, or the countries have agreed on which of them should exercise the jurisdiction to tax a particular subject matter, but the relevant country has not exercised that jurisdiction, either because it has chosen not to impose a tax of that type or simply not to tax that subject matter, or because the country has no effective ways to enforce the tax.[42] Unintended DNT, on the other hand, would be represented by the cases in which "more than one country could impose the relevant tax on a particular subject matter but none of them has done so because each of them is of the view that another has the (or a superior) jurisdiction to impose the tax".[43] This could happen if the relevant countries disagree about the underlying principles that determine who has the jurisdiction to tax and they both take the position that they do not have it, or they agree in the underlying principles, but they interpret them differently, either in their laws or in the interpretations of the law made by courts, taxpayers and/or the tax administration.[44] In other words, unintended double non-taxation would be the case when the DNT outcome was not the result originally aimed by the States. Some authors have expressly reinforced the idea that the intentional element within the notion of

advantage and the desalination between the place of origin of the income and the place where taxes on that income are actually paid. For a further analysis on the concept of *aggressive tax planning* in connection with the DNT outcome, see *infra* Section 5.

42 Millar, *supra* n. 18, p. 418-419. The intentional DNT is normally related with the stimulation of certain activities in both countries, having usually an economic-political character. *See* Lang, *supra* n. 21. See also, Bizioli, *supra* n. 18. 402.

43 Millar, *supra* n. 18, p. 428.

44 Id.

unintended DNT refers exclusively to the "intention of the States",[45] rather than the intention of the taxpayers, regardless the ambiguity of the notion of intention of States itself. Yet, excluding from this intentionality element the taxpayers' intention makes sense since the taxpayers' intention in a cross-border transaction will be always to reduce their costs, i.e. taxes, if possible to zero.[46] An interpretation *a contrario sensu* will simply not recognize the reality of the cross-border transactions and the legitimate use of tax planning structures.[47]

[45] Pistone, e.g. when referring to *unintended double non-taxation* as an element of the notion of *aggressive tax planning*, clearly states that the former excludes the intention of the taxpayers. In the original Spanish text, it can be read as follows: *"En este sentido, este tercer elemento viene comúnmente definido como «doble no imposición involuntaria» sin que esta expresión implique una reconstrucción de los aspectos subjetivos relativos a la planificación fiscal agresiva realizada por el contribuyente"*. [In this regard, this third element comes normally defined as unintended «double non-taxation», but without implying that this expression means a subjective reconstruction of the subjective elements of aggressive tax planning made by the taxpayer] (author's translation). *See* Pistone, *supra* n. 41, p. 123.

[46] Some authors, however, state that unintended DNT would be the result of the improper use of domestic tax laws, tax treaty law or Community Law, being thus an undesirable effect in cross-border transactions. *See*, e.g. Bizioli, *supra* n. 19. In a similar position: J. Almudi, *Avoidance of Double Non-Taxation in Spain*, in: M. Lang (ed.), *Avoidance of Double Non-Taxation*, Linde, Vienna, (2003), p. 341; Ullah, *supra* n. 18; D. Gutmann, *Avoidance of Double Non-Taxation in France*, in: M. Lang (ed.), *Avoidance of Double Non-Taxation*, Linde, Vienna, (2003), p. 87. This notion becomes closer to the intention of the taxpayers, at least when referring to the "improper use" of the domestic laws, treaties or Community Law (EU Law). In these cases, the improper use of a tax treaty, for example, will be determined by objective and subjective factors, including the "purpose" or "principal purpose" of a transaction, which might be an indirect reference to the taxpayers' subjective intention.

[47] *Infra* Section 4.2.1.

The whole idea of using a subjective element, i.e. *intentionality*, to explain the notion of DNT is, however, not only debatable, but also very precarious. On the one hand, it might give rise to many *ad-hoc* interpretations upon what "intention of the States" actually means and how it should be expressed. For example, someone could argue that the intention of the States needs to be established literally within the domestic laws of the States or within specific bilateral tax treaty provisions. In other words, no interpretation of the reasoning of the policy-makers should be relevant to interpret whether two States intended or not to achieve DNT with respect to a certain item of income, being the express wording of the law the primary and unique source of intentionality.[48] However, others could legitimately argue that in the absence of a literal reference, the intention of the State could be tacitly obtained from somewhere else, e.g. legislation discussion meetings or treaty negotiation acts, opening the door for random tax policy interpretations that could finally jeopardize the taxpayers' legal certainty. On the other hand, and more importantly, the argument forgets the complex problems of political malfunction that involves the lawmaking process both in a domestic and in a global basis.[49] Indeed, the "intention of the law" (or

[48] Pistone seems to follow this path when he states that each limitation to the legitimate right to minimize the taxpayer's tax burden must be established within specific rules. Otherwise, the principle of legality (civil law countries) or the rule of law (common law) would be violated. *See* Pistone, *supra* n. 41, p.127 (footnote 43).

[49] A. Christians, *Avoidance, Evasion and Taxpayer Morality*, 44 Wash. U. J. L. & Pol'y 39 (2014), pp. 49-50. The UK Government, e.g. has criticized the role of the Big Four accounting firms for initially offer assistance to draft anti-avoidance legislation, and then abuse their position by finding ways to do exactly what the legislations intended to stop. *See also,* e.g. J. Martin, *UK Lawmakers Lambaste Big 4 Accounting Firms*, 69 Tax Notes Int'l 6 (2013), pp. 518-519. In this latter article is provided the example of how a

the politicians making the law) is most of the time influenced by external actors, e.g. multinationals, which directly or indirectly manipulate the final outcomes of a tax reform.[50] The above does not only include a direct lobby within the domestic lawmaking process, which is normally regulated and it is publicly known, but also an indirect influential participation of these actors within the various international tax networks, such as the same OECD forum.[51] In this order of ideas, framing DNT based on the legislators intend is incapable of truly controlling the taxpayers' behaviors, because it is indeed very difficult to distinguish a pure "intention of the States" in most of the cases, adding more difficulties to the always problematic holistic approach of determining legislative intends.

It is thus the author's opinion that the use of subjective elements, such as *intentionality*, to explain the outcome of double non-taxation should be simply discarded, or alternatively, be used only when such an "intention" is

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big four assisted in the drafting of the U.K patent box legislation to latter on advice clients on how to use the law to avoid tax. Similar examples are provided with the drafting of CFC rules. *See also*, J. Martin, *Lawmakers Seek New Code of Conduct for Tax Accountants*, 70 Tax Notes Int'l 6 (2013), pp. 519-520.

50 Christians, *supra* n. 49. In this opinion as well, Essers states: "The choices in the field of international tax law have to be made, explained and justified by responsible politicians and policymakers. But before those decisions are taken, many of these stakeholders in the international tax arena will do their best to influence and convince these politicians and policymakers". P. Essers, *International Tax Justice between Machiavelli and Habermas*, 68 Bull. Int'l Taxn. 2 (2014), Journals IBFD, p. 54.

51 Christians states that multinational companies play an important marketing role ("native advertising") presented as journalism, academic research or even the participation in international networks, being the most notably case the OECD where the access to lawmakers is perhaps held in an informal and unobservable way. Christians, *supra* n. 49.

no other result than the express wording of the domestic laws or tax treaties dealing specifically with cases of DNT.[52] In all of other cases, its use should be simply avoided for sake of clarity and legal certainty.

2.4. Double Non-Taxation as a *per se* undesirable outcome

There are finally who simply identify double non-taxation as an outcome *per se* negative, constituting a pervasive reality in the world of cross-border investment and commercial activity, whose opportunities can derive either

[52] For example, when tax treaties include either *subject-to-tax* or *switch-over clauses* to prevent DNT, or when they include *tax sparing* and *matching credit clauses* in a clear tolerance of the DNT outcome. For a further analysis *tax sparing* and *matching credit clauses* within tax treaties, *supra* Chapter II, Section 4.2. Taking also the "intentions" expressed within the wording of domestic laws or tax treaties, some authors have attempted to create new categories to explain the difference between intended and unintended DNT. In particular, Martinez Laguna distinguishes between *"proper DNT"* and *"twice non-taxation"*. The former notion, on one hand, would represent the agreement of the parties within a tax treaty, being intended DNT in this case, e.g. when tax sparing or matching credit clauses are included and unintended DNT when, e.g. subject-to-tax and switch-over clauses are introduced. The latter notion, on the other hand, relates to the parallel exercise of sovereignties by two States. In this case, Martinez Laguna argues that it is not possible to ascertain intentions in this context of uncoordinated exercises of sovereignty, being thus in his view, this one the notion used within the international debate referring to *"unintended DNT"*. F. Martinez Laguna, *Abuse and Aggressive Tax Planning: Between OECD and EU Initiatives–The Dividing Line between Intended and Unintended Double Non-Taxation*, 9 World Tax J. 2 (2017), Journals IBFD. In the author's view, however, the categorization proposed by Martinez Laguna is not only very complex, but also it seems to serve the simple purpose of justifying a notion that will be further analyzed in this work, and whose legal validity is more than arguable: the notion of ATP (*aggressive tax planning*). Indeed, it is Martinez Laguna himself who recognizes that when he says: "Unintended twice non-taxation is part of the concept of aggressive tax planning. Aggressive tax planning is reflected in all of the different measures implemented in domestic and treaty law tackling non-acceptable (unintended) outcomes from a state perspective in advance". Id., Sec. 6. For an analysis of the concept of ATP as regards to DNT, *infra* Section 5.

from tax treaties, the differences of domestic laws or the failure to report income to the appropriate jurisdiction.[53]

3. Double Non-Taxation and the *Single Tax Principle*

Perhaps one of the main reasons for the ambiguity in the concept of double non-taxation is derived from the influence of the so-called *single tax principle* or the assumption that income should be taxed once (and no more than once) in any cross-border transaction. This Section attempts to demonstrate that beyond the debate regarding the simplistic construction of the single tax principle,[54] its *downside* departure, as named by some scholars,[55] i.e. the avoidance of DNT, cannot be supported neither under the traditional argument of the use of the tax credit method to relieve double taxation nor under the more recent ones that involves a misinterpretation of the LOB provision within the US Model.

[53] *See*, e.g. D. Ring, *United States,* in: Cahiers de droit fiscal international—Vol. 89a, *Double Non-Taxation* (IFA 2004), p. 725.

[54] Shaviro, e.g. criticizes the simplistic construction of the *"single tax principle"* when he says: "Tax treaties generally require that the signatories eliminate "double taxation" […] The treaties also commonly seek to address "fiscal evasion"[understood by some commentators as the avoidance of "double non-taxation"] […] Put the two concern together and you arguably have a 'single tax principle' […]". D. Shaviro, *The Two Faces of the Single Tax Principle* , New York University Law and Economics Working Papers, Paper 419 (2015), p. 1.

[55] Id.

3.1. Historical Background

In 1998 H. D. Rosenbloom delivered an important lecture upon international tax arbitrage, i.e. whether exploiting differences between the tax systems of two jurisdictions to minimize the taxes paid could be considered a problem, and if so, whether something could be done without a centralized international tax organization.[56] Rosenbloom's thesis exposed by then was that international tax arbitrage would be the natural response of the taxpayers to the normal differences that exist between the tax systems around the world.[57] These differences would be the result of sovereign decisions that consider the legal, economic and political aims of a determined tax system. Therefore, they should not represent a problem, or at least an appropriate explanation for why they could be a problem should be given, other than appealing to the existence of an "international tax system".[58] Rosenbloom's reaction was motivated on a statement about international tax policy emanated from the U.S. Senate Finance Committee in 1986, in which the Committee, in reference to the discussion about dual

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[56] Unlike Avi-Yonah made a previous reference to the "international tax regime" in 1997, the academic debate regarding its existence started with the The David R. Tillinghast Lecture on International Tax Arbitrage and the 'International Tax Regime' held at N.Y.U. in 1998. *See*, H. D. Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the "International Tax System"*, 53 Tax L. Rev. 137 (2000). *See also*, R. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 Tax L. Rev. 507 (1997).

[57] Rosenbloom, *supra* n. 4, p. 116.

[58] Id., p. 166. Also in line with Rosenbloom's argument *see,* e.g. J. Roin, *Competition and Evasion: Another Perspective on International Tax Competition,* 89 Geo. L. J. 543 (2001); M. Graetz, *The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 54 Tax L. Rev. 261 (2001), M. Kane, *supra* n. 4.

residence companies, referred to the international tax system. The statement was as follows: "The committee does not believe that the United States Senate wittingly agreed to an international tax system where taxpayers making cross-border investments, and only those taxpayers, could reduce or eliminate their U.S. corporate tax through self-help and gain an advantage over U.S. persons who make similar investments".[59]

Contrary to Rosenbloom's position, Avi-Yonah supported the antagonist idea.[60] This is the existence of an international tax system (that he prefers to call an "international tax regime"), which would rest basically in the bilateral tax treaty network and in domestic tax laws of the major trading nations, and which would form part of customary international law.[61] The pillars of this regime would be two basic principles that underline it: the *single tax principle*, which implies that the income should be taxed once (no more and not less), and the *benefits principle* which means that active business income must be taxed primarily at source and passive investment

[59] S. Rep. No. 99-313, p 422 (1986), in: Rosenbloom, *supra* n. 56, p. 137.

[60] In support of his thesis, Avi-Yonah provides a question based upon the hypothetical case that a developing country or transition economy decided to adopt an income tax for first time: how free would this country be to write its international tax rules if it wishes to attract foreign investment? He argues that the freedom of this country and most of the countries around the world to adopt international tax rules is severely constrained, even before entering a tax treaty, by the need to adapt to generally accepted principles of international taxation. *See* R. Avi-Yonah, *International Tax as International Law: An analysis of the International Tax Regime*, Cambridge University Press, New York (2007), pp. 3-4. *See also* R. Avi-Yonah, *Commentary (Response to article by H. David Rosenbloom), 53* Tax L. Rev. 167 (2000).

[61] Avi-Yonah, *supra* n. 56.

income primarily at residence.[62] The comfortable idea of recognizing such a regime would directly imply that countries would not be free to adopt any international tax rules they please, but rather should operate under the rules of this regime, disregarding a basic premise in taxation, which is that taxing and spending is still a matter of domestic tax policy.[63] In particular, the recognition of a *single tax principle* would drive us to an early conclusion that both double taxation and DNT must be equally eliminated, mitigated or at least prevented.

3.2. The downside of the *Single Tax Principle*

As already stressed, the single tax principle states that cross-border income should be taxed once, i.e. not more and not less than once, at the rate

[62] The benefit principle provides that the residence jurisdiction would have the primary right to tax passive income (investment), while the source jurisdiction would have the primary right to tax active income (business). *See* Avi-Yonah (2007), *supra* n. 60, pp. 8-13. Although the benefit principle has been proved since long time not to explain in a good way the development of the modern digital economy, only recently Avi-Yonah has recognized its obsolescence arguing that, at least "temporarily", this principle (pillar of the "international tax regime") should be re-evaluated and be understood in a complete opposite way. As provided by Avi-Yonah: "Most of the current issues can be solved if we taxed passive income primarily at source and active income primarily at residence". *See* R. Avi-Yonah, *The International Tax Regime: A Centennial Reconsideration*, University of Michigan Public Law Research Paper No. 462 (2015), full text available at SSRN.

[63] Important international tax scholars have also supported the idea of the existence of an international tax regime. *See*, e.g., H. Ault, *The importance of International Cooperation in Forging Tax Policy*, 26 Brook. J. Int'l L. 1693 (2001); H. Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, 70 Tax Notes Int'l 12 (2013). Y. Brauner, *An International Tax Regime in Crystallization*, 56 Tax L. Rev. 259 (2003); Y. Brauner, *Integration in an Integrated World,* 2 N.Y.U. J. L. & Bus. 51 (2005); Dell' Anese, *supra* n. 4.

determined by the benefits principle.[64] Thus, the single tax principle would include both the traditional tax policy aim of avoiding double taxation as well as the avoidance of double non-taxation. Some tax scholars refer to these effects as the *"upside departure"* and *"downside departure"* of the single tax principle.[65] Both sides of the principle are built under the assumption that all the countries would like to maintain both a personal and a corporate income tax, justifying the single tax principle from a theoretical and from a practical point of view. [66] On the one hand, the upside departure of the single tax principle would help to avoid that income derived from cross-border transactions is taxed more heavily than domestically.[67] Indeed, double taxation leads to tax rates that can be extremely high and tend to disincentive international investment. The downside departure, on the other hand, would help to avoid that cross-border income is under-taxed or not taxed at all, violating both the horizontal and vertical equity when compared to the higher rates imposed at the domestic level, avoiding also an erosion of the national tax base.[68] In other words, both the outcomes of double taxation and DNT would be naturally forbidden by the existence of a supreme principle under international tax law that obliges to eliminate or mitigate these outcomes.

64 Avi-Yonah (2007), *supra* n. 60, p. 9.
65 Shaviro, *supra* n. 54.
66 Avi-Yonah (2007), *supra* n. 60.
67 Id.
68 Id.

Scholars supporting the existence of a principle of single taxation have traditionally argued based on the extended tax treaty network around the world, and specifically, the use of the tax credit method to relieve double taxation rather than the exemption method. More recently, however, some scholars have also come up with some new arguments involving the interpretation of the 1981 LOB provision in the US Model. All of these arguments are subsequently analyzed.

3.2.1. The Tax Credit Method to ensure Single Taxation

Countries around the world tend to relieve double taxation, either unilaterally or bilaterally, mainly by two different manners: granting an exemption upon the foreign income received by a resident taxpayer, no matter the taxation of that income in the other country, or granting a credit upon the foreign taxes paid in the foreign country.[69] In other words, unlike

[69] The use of credit or exemption is connected with the classic economic arguments regarding tax neutrality, which has been largely discussed in the literature, and which promote different forms of efficiency. On one hand, *capital export neutrality* (CEN) is an economic standard holding that taxation should be a neutral factor in a taxpayer's choice between carrying on economic activity in the taxpayer's residence country or in a foreign country. It is given effect in its purest form when the taxpayer's residence country taxes each resident's worldwide income as it is earned and provides the resident with an unlimited credit for foreign income taxes imposed on that income. In other words, it ensures that taxpayers face the same rate of tax on the return to capital irrespective of the country where the capital is deployed. On the other hand, *capital import neutrality* (CIN) ensures that taxpayers face the same rate of tax on the return to capital deployed in a given jurisdiction irrespective of the jurisdiction in which the taxpayer is resident. In other words, it ensures that local and foreign capital competes on equal foots in a determined country. Some authors also refer to a third type of neutrality called *national neutrality* (NN), which consists in providing relief of double taxation giving the taxpayer a deduction for the foreign taxes paid, the same way a deduction is

the exemption method, the focus of the credit is on the amount of taxes effectively paid in the other country.[70] Therefore, the credit method would implicitly pursue the object of ensuring that the income is taxed at least in

granted for other costs. This type of neutrality would make investors indifferent between the pre-tax return on domestic investments and the return on foreign investments after paying foreign taxes. *See* D. Weisbach, *The Use of Neutralities in International Tax Policy*, 68 Nat'l Tax J. 635 (2015). In addition to the traditional discussion between CEN and CIN, some authors have developed the concept of *capital ownership neutrality* (CON), which means, in simple terms, that the world welfare is maximized if the identities of capital owners are unaffected by tax rate differences. *See* M. Desai and J. Hines, Evaluating International Tax Reform, 56 Nat'l Tax J. 487 (2003). *See also*, M. Desai and J. Hines Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting,* 57 Nat'l Tax J. 937 (2004). The usual policy recommendation to achieve CON is for countries to adopt territorial tax systems, namely, not to tax business income earned in some countries. Indeed, the CON has been advanced as the basis of a policy reform in the United States to move toward a territorial tax system. For a critical analysis on the concept of CON, *see* Kleinbard (Tax Law Rev. 2011), *supra* n. 40. For Kleinbard, the CON principle assumes that the source country taxation is fully capitalized into prices of firms operating in that source country as well as they [MNEs] face a constant after-tax rate of return everywhere in the world, and suffer the same tax burden everywhere, when taxes include both implicit and explicit taxes. He argues that what he calls "stateless income tax planning" vitiates the plausibility of this assumption. Id., p. 100. As he provides: " Without the full capitalization of source country taxes in firms valuations, reliance on the CON principle to recommend that the United States adopt a territorial tax system reduces to a plea for a "competitive" international tax framework, by which is meant a system no less generous than those available to firms domiciled in other countries. But that plea, in turn, is little different in practice from a call for trade export subsidies or the like, and strangely ignores the competitiveness of domestic operations". Id., p. 101. Kleinbard's work is added to the existing work of Grubert and Altshuler, who have also criticized the economic efficiency arguments for territorial tax systems. *See,* e.g. H. Grubert and R. Altshuler, *Corporate Taxes in the World Economy: Reforming Taxation of Cross-Border Income*, Working Papers, Department of Economics, Rutgers, the State University of New Jersey No. 2006, 26 (2006).

[70] This is because, if taxes are not effectively paid in the other country, then no credit is granted. Perhaps the exception to that are the clauses of *tax sparing* introduced within some treaties. A further analysis is carried on at *infra* Chapter II, Sec. 4.1.1.

one country when a cross-border transaction takes place.[71] This assumption is, in principle, correct. As the foreign tax credit is granted in a dollar-by-dollar basis, no credit is allowed when there is no income taxes paid in the source country.[72] The above could drive us to preliminary conclude that income will be taxed at least once. However, there is no proof that the real aim of the tax credit method is indeed to ensure single taxation. On the contrary, historical arguments in the design of the tax credit method (specifically in the US) as well as examples of tax treaty practice should bring us to a totally different conclusion. Let me take the example of the US Foreign Tax Credit.[73]

The US Foreign Tax Credit proposal came into play right after the end of the World War I.[74] At that time, countries in Europe needed money for

[71] Avi-Yonah argues that T.S. Adams, the designer of the U.S. tax credit system, implicitly recognized the existence of a principle of single taxation when he stated as follows: "the state which with a fine regards for the rights if the taxpayers takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax". *See* T.S. Adams, *Interstate and International Double Taxation*, in Lectures on Taxation 101, (Roswell Magill ed., 1932), cited in: Avi-Yonah, *Who Invented the Single Tax Principle? An Essay on the History of U.S. Treaty Policy,* 59 N.Y.L. Sch. L. Rev. 309 (2014), p. 313.

[72] In contrast, the exemption method applies no matter what happens in the source country. Indeed, if the income is by any reason not taxed in the source country, the exemption is granted anyway in the residence country. *See*, e.g. the application of Article 23A of the OECD Model.

[73] This example is not random. The Unites States was indeed the pioneer country introducing a tax credit system to relieve double taxation. Likewise, it is the design of the US Foreign Tax Credit normally used by the supporters of the single tax principle to argue in its favor. For an analysis on the history of the U.S. FTC, *see* M. Graetz and M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke Law J. 1021 (1997).

[74] Id., p. 1051.

reconstruction and increased their tax rates accordingly.[75] This phenomenon was extended even beyond Europe and implied that American investors were inevitable subject to tax outside the United States. In other words, the original design of the foreign tax credit system in the United Stated did not consider whether the foreign countries would tax or not the income of American investors abroad, because in fact the historic context was completely the opposite: countries after the war wanted to get revenues through taxation, thus the main idea in designing the tax credit relief was to avoid the potential double or multiple taxation that American investors might suffer, which reveals that the original aim of the credit method was not ensuring single taxation, but rather simply avoiding double or multiple taxation.[76] The above brings us to the second important historical factor in the design of the US Foreign Tax Credit, which is related to the lack of competitiveness of the American businesses abroad precisely derived from the potential double or multiple taxation to which they were exposed to. As provided by Carroll: "The American credit system is ideal for a wealthy nation that desires to encourage the expansion of its foreign trade, and is willing to afford relief from double taxation to its citizens or residents […] The United States says, in effect, to its citizens—go abroad and trade. If you

[75] As provided by Graetz and O'Hear: "A variety of American economic and diplomatic interests required that a substantial quantity of American capital be channeled to rebuild post-war Europe. The United States was owed billion dollars by allied governments for wartime loans; somehow Europe would need access to American dollars to pay off this debt". Id.

[76] "Americans wanted smaller government, lower taes, and fewer international entanglements" Id., p. 1052.

have to pay tax on your earnings in foreign countries, show me your bill and I will give you relief […]".[77] This concern about competition was also presented by T.S. Adams into his tax treaty work: "[Legislation authorizing U.S. negotiation of tax treaties] will enable the businessmen [sic] of those foreign countries which have benefit of conventions or treaties of this kind protecting them from the burden of international double taxation". Therefore, unlike an instrument to ensure that income in a cross-border transaction must be taxed at least once, the history behind the U.S. foreign tax credit (1918) demonstrated us that it was primarily conceived as a tool to promote competitiveness of American businesses abroad avoiding the unfair result of taxing twice the income derived from these businesses. Then, the single and unavoidable taxation abroad was simply the result of the historic moment in which the foreign tax credit came into life, but it was neither a purpose nor a condition for the implementation of the foreign credit system. To think otherwise would simply distort the history behind the origin of the foreign tax credit.

There are also strong tax treaty practice arguments to reject the idea that the tax credit method to relieve double taxation would serve the purpose of ensuring single taxation. It is undeniable that in most of the cases the tax credit is granted in the resident country to the extent that taxes have been effectively paid in the source country. Nevertheless, this outcome is indeed

[77] M. Carroll, The Double Taxation Conference 28-29 (3 Sep. 1927), unpublished manuscript available at T.S. Adam Papers, Yale University, Box 16, Sep. 1927 folder, cited in: Id., p. 1050.

far from accomplishing with an international tax law principle. The above can be easily seen in the use of *tax sparing* and *matching credit clauses*. In these cases, the tax credit is granted regardless the amount of taxes paid in the source country, working indeed as a notional tax credit. Accordingly, and despite the rejection to these clauses at the OECD level and the US tax treaty practice, these clauses are negotiated and implanted by important economies in the world, e.g. Brazil, in order to safeguard their own tax incentives policies.[78]

Moreover, if single taxation is going to be ensured by the tax credit method, or whether this is a proof of the existence of the single tax principle, one should simply conclude that this is in fact a very inefficient system to achieve that purpose. Indeed, if income is not taxed in the source country and never repatriated to the resident country, it is clear that a DNT outcome will be achieved, being impossible under that scenario, to ensure single taxation.[79] In simple words, the tax credit method complies the primary role

78 See more about the discussion regarding tax sparing and matching credits at infra Chapter II, Sections 4.1.1 and 4.1.2.

79 The above can be illustrated in the following example: if a U.S. Corporation incorporates a subsidiary in a low-tax jurisdiction and it generates income exempted from taxation or taxed at a very low rate in that country, the result, i.e. deferral of U.S. taxation, will be an exemption or at least something very similar to an exemption at the residence country, because foreign subsidiaries are not taxed in the United States so long as they do not repatriate dividends to the U.S. parent company. A foreign subsidiary is not regarded as a U.S. person even if wholly owned by a U.S. person. *See* US: I.R.C. Section 7701(a)(5). When the subsidiary makes a distribution to the parent company, the parent will use the foreign income taxes the subsidiary paid to offset the tax liability imposed by repatriation. *See* US: I.R.C. Section 902(a).

of mitigating double taxation, and sometimes indirectly achieving the outcome of ensuring single taxation. However, this latter result will depend exclusively on the repatriation of the income to the resident country. In absence of the above, the argument that the tax credit method ensures single taxation seems to be more an altruistic idea rather than a real effect in practice.

3.2.2. The Agnosticism of the Exemption Method

As already stressed, the main difference between the exemption and credit method to relieve double taxation is that the former looks exclusively at the income, exempting foreign source income no matter the taxes paid abroad.[80] This special feature of the exemption method makes it completely ineffective to ensure single taxation, because unless countries decide to include specific provisions to maintain a single taxation status, i.e. either a

[80] This principle applies both in the case of *"full exemption"* and *"exemption with progression"* recognized in the OECD Model. In both cases the State of residence has the right to tax exclusively the amount of domestic source income, exempting the amount of foreign source income received. The only difference is that in the case of exemption with progression, the amount of foreign source income is considered in order to determine the tax rate applicable in the State of residence, which could finally imply a lower amount of taxes relieved in comparison with the full exemption. The above can be illustrated as follows: If a resident of State A has $100,000 of worldwide income ($80,000 domestic and $20,000 from country B), and country A normally taxes $100,000 at a rate of 35% and $80,000 at a rate of 30%, then applying the exemption with progression, the resident of State A will be subject to 35% on the amount of $80,000 of foreign source income ($28,000), while if the full exemption were applied, he would be subject to 30% on the same $80,000 ($24,000). There will be a difference of $4,000 in relief between both methods, although the principle of exempting the foreign source income always will apply. *See* OECD Commentary on Articles 23 A and 23 B concerning the methods for elimination of double taxation, para. 18 and 19.

subject-to-tax or a *switch-over clause*, the DNT outcome will inevitably arise.[81] In other words, the exemption method is totally agnostic with respect to the aim of ensuring single taxation, or which is the same, avoiding DNT.

The general agnosticism of the exemption method to prevent DNT is recognized at the OECD level as an efficient element when compared with the credit method, making thus the election of the former to prevail over the latter in relieving double taxation.[82] Indeed, as the exemption method does

[81] *Infra* Chapter II, Sections 4.2.1 and 4.2.2.

[82] This statement is only focused on the simplicity of the exemption method used to relieve double taxation and it avoids the economic discussion on why countries could choose one method instead of the other for economic efficiency or equity reasons. This discussion refers to the economic notions of CEN and CIN neutrality. As already stressed, the former means that the investor should pay the same total tax, whether he receives an investment income from foreign or domestic sources. The latter means that capital funds originated in various countries should compete in equal feet in the capital market of any country. K. Vogel, *Worldwide v. source taxation of income– A review and re-evaluation of arguments (Part II),* Intertax 10 (1988), pp. 310-311. Vogel observes that export neutrality thus supposes a worldwide taxation income with the use of foreign tax credit, while import neutrality implies a source-based taxation system with the use of the exemption method to relieve double taxation. Id. *See also*, Weisbach, *supra* n. 69. The literature has shown preference for capital-export neutrality. *See,* e.g. C. McLure Jr., *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm,* 45 National Tax Journal 145 (1992). Vogel also mentions Richard Musgrave and Bernard Snoy in this position. *See* R. Musgrave, *Criteria for Foreign Tax Credit, in: Taxation and Operations Abroad, Symposium* (1960), and B. Snoy, Taxes on Direct Investment Income in the EEC, A Legal and Economic Analysis (1975), both cited in: Vogel, Id. Nevertheless, this preference has also been challenged. *See*, e.g. L. Mutén, *Some Topical Issues Concerning International Double Taxation*, in: S. Cnossen (ed.) *Comparative Tax Studies. Essays in Honor of Richard Goode* (1983), cited in: K. Vogel, *Taxation of Cross-Border Income, Harmonization, and Tax Neutrality under European Law*, in: K. Vogel (ed.) *Taxation of Cross-Border Income, Harmonization, and Tax Neutrality under European Law* (1994), p. 24, and re-cited in: D. Pinto, *Exclusive Source or Residence-Based Taxation–Is a New and Simpler World Tax Order Possible?,* 61 Bull. Intl. Taxn. 7 (2007), Journals IBFD, p. 286 (footnote 77). It has also been

not require the State of residence to undertake investigations upon the actual taxation in the other State and whether or not the right to tax is in effect exercised by the other State, it is normally regarded as the most effective one.[83] This idea of absolute exemption is, nevertheless, partially mitigated when the outcome of DNT arises.[84] Paragraph 35 on the OECD Comm. on Article 23A and 23B OECD Model states: "Occasionally, negotiating States may find it reasonable in certain circumstances, in order to avoid double non-taxation, to make an exception to the absolute obligation on the State of residence to give exemption […] Such may be the case where no tax on specific items of income or capital is provided under the domestic laws of the State of source, or tax is not effectively collected owing to special circumstances such as the set-off of losses, a mistake, or the statutory time limit having expired".[85] Similar concerns on DNT actually motivated the modification of the OECD Commentaries on Article 23A OECD in 2000 and the 2008 update version of the OECD Model although, as we will see

argued that the debate about capital export or import neutrality is less relevant in a globalized world. *See*, e.g. D. Frisch, *The Economics of international Tax Policy: Some Old and New Approaches*, 47 Tax Notes 5 (1990). Similarly, analyzing both scenarios: an international world with exclusive residence-based taxation and source-based taxation, Pinto concludes that beyond the strong theoretical justifications of both approaches, none of them can be exclusively applied internationally. *See* Pinto, p. 291. For an interesting analysis about the notion of neutrality and EU Law, *see* W. Schön, *Neutrality and Territoriality–Competing or Converging Concepts in European Tax Law?*, 69 Bull Intl. Taxn. 4/5 (2015), Journals IBFD. For the alternative notion of *capital ownership neutrality* (CON), s*ee* Desai and Hines, *supra* n. 69. *See also*,. Desai and Hines Jr., *supra* n. 69.

[83] OECD Commentary on Articles 23 A and 23 B concerning the methods for elimination of double taxation, para. 34.

[84] OECD Commentary on Articles 23 A and 23 B concerning the methods for elimination of double taxation, para. 35.

[85] Id.

later on in this work, none of these modifications were enough to solve all the situations of DNT that they originally pretended.[86] Yet, and regardless these concerns, the OECD Commentaries recognizes that the faculty of implementing the exemption method remains still within the context of domestic laws.[87] The above implies that the obligation to give an exemption to relieve double taxation might still be absolute if the countries desire to, regardless the concerns about DNT above-explained. More importantly, the wording of the Article 23A OECD Model, still suggests that the residence State shall exempt the income or capital received by one of its residents to the extent that this income *"may be"* taxed in the State of source. In a nutshell, no effective or actual taxation is required in the source State in order to trigger the application of the exemption in the State of residence.[88]

Despite the agnosticism of the exemption method to prevent DNT, this is still the preferred method to relieve double taxation among many countries, including e.g. the whole continental Europe.[89] The above responds to a

[86] See *infra* Chapter II, Section 3.3 and 3.4.

[87] OECD Commentary on Articles 23 A and 23 B concerning the methods for elimination of double taxation, para. 35.

[88] This issue is further analyzed in this work, where some examples are provided in order to demonstrate the substantial difference when Contracting States actually desire that income "is taxed" or "subject-to-tax", and when this "may be taxed". See *infra* Chapter II, Section 4.2.1.

[89] The preference of the exemption method in Europe has been largely discussed in the European tax literature. *See*, e.g. W. Schön, *Tax Competition in Europe—The National Perspective*, 42 Eur. Taxn. 12 (2002), Journals IBFD, p. 495. *See also*, J. Avery Jones, *Avoiding Double Taxation: Credit versus Exemption – The Origins*, 66 Bull. Intl. Taxn. 2 (2012), Journals IBFD; M. Helminen, *The Problem of Double Non-Taxation in the European Union – To What Extent Could This Be Resolved through a Multilateral EU*

series of factors, e.g. the capital import neutrality tendency among European countries and the long-standing domestic tax law traditions giving preference to this method to relieve double taxation rather than the credit method. As well explained by Schön: "From an economic standpoint, both features of "tax neutrality" [capital import and capital export neutrality] have their merits. It is a long-standing tradition to which many European states have submitted and it is also sound fiscal policy to set up a tax system according to the ideal of 'capital import neutrality'".[90] Likewise, the European Commission's proposal for a CCCTB reinforces the primacy of the exemption method at the EU level. This proposal foresees unconditional exemption for distributions coming from companies outside the group, with the *switch-over clause* and a CFC rule only applying to distributions from subsidiaries that are resident outside the EU.[91]

Therefore, it results difficult for this author to perceive the presence of an international tax law principle that prevents DNT in cross-border situations, and which is reflected in the application of the credit method to relief double

Tax Treaty Based on the Nordic Convention?, 53 Eur. Taxn. 7 (2013), Journals IBFD, p. 309; G. Maisto, *Credit versus Exemption under Domestic Tax Law and Treaties*, in: M. Lang et al., *Tax Treaties: Building Bridges between Law and Economics*, (IBFD 2010), sec. 2.

90 Schön, *supra* n. 82.

91 *See* G. Kofler, *Indirect Credit versus Exemption: Double Taxation Relief for Intercompany Distributions*, 66 Bull. Intl. Taxn. 2 (2012), Journals IBFD, p. 89. For an analysis on the CCTB proposal *see*, e.g. L. Cerioni, *The Commission's Proposal for a CCCTB Directive: Analysis and Comment*, 65 Bull. Intl. Taxn. 9 (2011), Journals IBFD. *See also*, J. Barenfeld, *A Common Consolidated Corporate Tax Base in the European Union—A beauty or a beast in the quest for tax simplicity*, 61 Bull. Intl. Taxn. 7 (2007), Journals IBFD.

taxation, when indeed neither the credit nor the exemption methods are strictly effective to ensure single taxation. Whilst the effectiveness of the credit method to ensure single taxation will depend exclusively on the repatriation of profits, the exemption method is completely agnostic in preventing DNT. Accordingly, and when countries must decide among the methods to relieve double taxation, there is certain tendency to opt for the simplicity of the exemption method rather than the complexity of the credit method. The above, however, does not mean that countries might achieve an agreement to prevent double non-taxation introducing, e.g. *subject-to-tax* or *switch-over clauses* within their tax treaties. Nevertheless, this inclusion will be in any case a reflection of a tax law principle, but rather the result of an *ad-hoc* tax treaty negotiation.[92]

3.2.3. New voices in defense of the *Single Tax Principle*

The conceptual evidence presented so far does not give space for the recognition of the single tax principle as to prevent DNT. Nevertheless, new voices have arisen and have insisted in the defense of the downside departure of it. Specifically, some scholars have recently argued that the original introduction of a Limitation of Benefits (LOB) provision in the 1981 US Model would be an argument strong enough to sustain the recognition of a principle of single taxation in cross-border transactions. [93]

[92] A further analysis can be found at infra Chapter II, Sections 4.2.1 and 4.2.2.
[93] Avi-Yonah , *supra* n. 71, pp. 313-318.

3.2.3.1. The 1981 LOB provision– US Model

The original design of the LOB provision under the US Model provided that the benefits of a reduced WHT under a treaty would not be applicable to non-publicly traded corporations residing in the treaty partner, unless more than 75% of the shares of that corporation are owned by individual residents and the income is not paid out to residents of third countries.[94] In addition, paragraph 3 of the Article 16 of the 1981 Tax Treaty Model provided that treaty benefits would not apply to corporations subject to a significant lower tax in their country of residence.[95] The interpretation of paragraph 3 of Article 16 is that the reduction of WHT at source is contingent to the taxation at residence, regardless the ownership of the recipient of the income.[96]

Although the above interpretation is not completely wrong, it is certainly not based on the accomplishment of a principle of single taxation, but rather on the legitimate interest of the source country, which restricts its taxation rights granting a reduced WHT under a tax treaty, to coordinate this restriction with a similar taxation at the residence country. Otherwise, there would be no interest for the source country to restrict itself from taxing a

[94] US: United States Model Income Tax Convention of 16 June 1981, Article 16(1).

[95] Article 16(3) stated: "Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other Contracting State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State". US: United States Model Income Tax Convention of 16 June 1981, Article 16 (3).

[96] Avi-Yonah, *supra* n. 71, p. 317.

determined item of income. This also reaffirms the original intention of the LOB provisions, which is to limit the access of third parties to a treaty between two countries from which they are not residents[97] and not the avoidance of either double taxation or DNT.

Furthermore, there are others reasons that reinforce the idea that the contingency included in the original 1981 LOB provision had nothing to do with the recognition of a principle of single taxation. Firstly, the original LOB provision in the 1981 US Model was not applicable to partnerships, which are currently recognized as persons under the most recent US Models, and therefore, being able to receive the benefits of a treaty. Thus, it is difficult to conceive the application of a principle of single taxation applicable only to tax treaty cases in which a corporation or trust was involved.[98] Secondly, a tax treaty model is neither a negotiated treaty nor an

[97] *See*, e.g., N. Bammens and L. De Broe, *Treaty Shopping and Avoidance of Abuse in Tax Treaties: Building Bridges between Law and Economics* (M. Lang et al. eds., IBFD 2010), Online Books IBFD.

[98] This argument lacks importance today with the suggestion to include partnerships within the scope of the LOB made by Rosembloom in 1983 and further taken into account in the 1996 and 2006 United States Model Income Tax Conventions. As provided by Rosembloom: "Partnerships, on the other hand, are not themselves taxpayers in the United States or in many other countries, although they are generally regarded as 'persons' under recent U.S. tax treaties, with their residence dependent on that of the treaty partners. Because treaty benefits are thus available to partnerships as such, and because corporations and trusts can serve as partners, partnerships should be included within the limitation as well—if only to preclude their use to avoid a limitation of benefits applicable to corporations and trusts. Moreover, because there are numerous entities in the world whose statuses as corporations, trusts, or partnerships may not be so clear, treaty drafter may find it convenient to speak in terms of 'all persons other than individuals'. Use of this phrase will obviate interpretative problems, and it is difficult to

ideal world of taxation.[99] Indeed, LOB provisions are subject to several modifications during the negotiation process, and even sometimes not included.[100] Then, it would be difficult to recognize a principle of single taxation applicable only in those cases in which either the LOB provision was finally included in the negotiated treaty or it was included exactly as it was designed in the treaty model.

Moreover, the subsequent elimination of paragraph 3 and the inclusion of a "base erosion test" in the 1996 and 2006 model, reaffirms the idea that the LOB provisions have (and had) nothing to do with assuring single taxation. Article 22(2)(f)(ii) of the US Model establishes: "A resident of a Contracting State shall be entitled to all the benefits of this Convention if the resident is: […] (f) a person other than an individual, if: (ii) less than 50 percent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State (unless the payment is attributable to a permanent establishment

see how any possible over inclusion could be harmful". H. D. Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 Law & Pol'y Int'l Bus. 763 (1983), pp.811-812. *See* the reference to "persons other than individuals" included in Article 22(2)(f) of the United States Model Income Tax Convention of 20 Sept. 1996 and Article 22(2)(e) of the United States Model Income Tax Convention of 15 Nov. 2006.

99 As Rosenbloom explains: "[A] taxpayer may reject a treaty and its content and invoke its rights under domestic law […]". Rosembloom, *supra* n. 56, p. 164.

100 Although it is a policy of the United States to include a LOB provision into its tax treaties, there are cases in which this provision has not been included. For example, the treaties between the United States and Greece, Hungary, Pakistan, Philippines, Poland and Romania do not include a LOB provision. *See* R. Avi-Yonah and O. Halabi, *US Treaty Anti-Avoidance Rules: An Overview and Assessment*, 66 Bull. Intl. Taxn. 4/5 (2012), Journals IBFD, p. 238.

situated in either State), in the form of payments that are deductible for income tax purposes in the person's State of residence".[101] In other words, payments made to any resident of either Contracting State, as well as payments made to PEs, will not be considered base eroding payments.[102] Then, under the 1996 US Model it was perfectly possible that a US partnership pays a deductible payment to a resident of the other Contracting State, where that payment was not taxable, without considering that payment as base eroding.[103] Accordingly, Article 22(2)(f)(ii) of the 2006 US Model more or less maintained the wording of the 1996 version. This is to say, in case of a person other than an individual (a partnership) made deductible payments that represent less than 50% of its gross income to non-residents of either Contracting States, these payments would be considered as base eroding.[104] However, these payments do not include arm's length

[101] US: United States Model Income Tax Convention of 20 September 1996, Article 22(2)(f)(ii).

[102] US: Technical Explanation of the United States Model Income Tax Convention of 20 September 1996, Article 22.

[103] To the extent that the recipients do not themselves base erode to non-residents. Id.

[104] Article 22(2)(f)(ii) of the 2006 United States Model Income Tax Convention states: "A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:[…] (f) a person other than an individual, if: (ii) less than 50 percent of the person's gross income for the taxable year, as determined in the person's State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), subparagraph b), clause i) of subparagraph c), or subparagraph d) of this paragraph in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property)". *See* US: United States Model Income Tax Convention of 15 November 2006, Article 22(2)(f)(ii). *See also*, US: Technical Explanation of the United States Model Income Tax Convention of 15 November 2006, Article 22.

payments in the ordinary course of business for services or tangible property.[105] This last inclusion reduces the scope of application of the LOB provision, because it expressly excluded payments to non-residents of the treaty to the extent that these payments were made on arm's length in the ordinary course of business for services or tangibles, and increases the likelihood that certain arm's length deductible payments made from a treaty resident to another resident (or even a non-resident), are excluded from taxation in the hands of the recipient. This issue, however, would in any case demonstrate that the final target of the LOB provision is to ensure the single taxation of cross-border payments.

3.2.3.2. The 2016 LOB provision–US Model

A separate reference should be made with respect to the new Article 22 of the 2016 US Model.[106] The new base erosion test include deductible payments made to residents of either Contracting State that benefit from a *"Special Tax Regime"* (hereinafter, "STR") in their Contracting State of residence with respect to the deductible payments.[107] For this purpose, the new Article 3(1) will consider a STR as "any statute, legislation, or administrative practice in a Contracting State with respect to a tax described in Article 2 (Taxes Covered) that meet all of the following conditions:

105 Id.

106 US: United States Model Income Tax Convention of 17 February 2016, Article 22. *See also*, US: Proposed Limitation on Benefits Article, Select Draft Provisions of the U.S. Model Income Tax Convention of 20 May 2015.

107 Id.

[…]".[108] Likewise, the definition includes a list of cases where any legislation, regulation of administrative practice shall not be considered as a STR.[109] Conversely to the 1996 and 2006 US Model, the proposal of amendment includes deductible payments made to a treaty resident subject to a special tax regime in the hand of the recipient, including low or zero tax jurisdictions. Practically speaking, the wording of the 2015 proposal of amendment is quite similar to that one of paragraph 3, Article 16 of the 1981 US model. Thus, and even though the wording of the norm seems to be

[108] US: Proposed Treaty Rules Addressing *"Special Tax Regimes"*, Select Draft Provisions of the U.S. Model Income Tax Convention, 20 May 2015. It is also important to remark that the definition of STR includes as administrative practice a "ruling practice". This is to say, e.g. if a taxpayer obtains a ruling providing that its foreign source interest income will be subject to a low rate of taxation in the State of residence, and that rate is lower than the normal rate that applies to foreign source interest income received by residents of that State, the administrative practice under which the ruling is obtained will be considered a STR. *See* US: Technical Explanation for Definition of *"Special Tax Regime"*, Select Draft Provisions of the U.S. Model Income Tax Convention of 20 May 2015, p. 2. It is convenient to note that up to the date this work was concluded, no technical explanations of the 2016 US Model had been launched. However, it is expected that the Select Draft Provisions of the U.S. Model Income Tax Convention of 20 May 2015 be replicated in the final technical explanations.

[109] The draft of the new Article 3(1) of the US Model states: "[…] However, the term shall not include any legislation, regulation or administrative practice: i) the application of which does not disproportionately benefit interest, royalties or other income, or any combination thereof; ii) that, with regard to royalties, satisfies a substantial activity requirement; iii) that implements the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises); iv) that applies principally to persons that exclusively promote religious, charitable, scientific, artistic, cultural or educational activities; v) that applies principally to persons substantially all of the activity of which is to provide or administer pension or retirement benefits; vi) that facilitates investment in entities that are marketed primarily to retail investors, are widely-held, that hold real property (immovable property), a diversified portfolio of securities, or any combination thereof, and that are subject to investor-protection regulation in the Contracting State in which the investment entity is established; or vii) that the Contracting States have agreed shall not constitute a special tax regime because it does not result in a low effective rate of taxation;". Id.

exogenous to the original purpose of a LOB provision, this author sustains again that the source country has a legitimate interest to coordinate a restriction to tax an item of income, provided a treaty is in force, with the corresponding taxation of that income at residence. This legitimate interest to coherently accomplish with the allocation of taxing powers made by a tax treaty does not have anything to do with the accomplishment of a principle of single taxation that governs cross-border transactions, and rather responds to a rational concern of the source country that restrict its taxing powers when a tax treaty is negotiated and finally comes into play.

4. Double Non-Taxation and Tax Evasion/ Tax Avoidance

This Section turns now to briefly revisit both the legal concept of tax evasion and tax avoidance in order to demonstrate that DNT cannot be homologated (or confused) with any of those concepts. Likewise, it provides a critical analysis on the non-legal notion of "*aggressive tax planning*" (ATP), a modern pseudo-category used within the OECD BEPS Project[110] and analyzed by some scholar in equal footing with the legal concepts of tax evasion and tax avoidance.[111] This Section intends to demonstrate the

[110] The OECD refers 22 times to the concept of ATP just in the OECD BEPS Report from 2013. *See*, OECD (2013), *supra* n. 2. However, the OECD already referred to the concept of ATP in its 2011 report focused on transparency and the design of better tools for assessing tax compliance risks. *See* OECD (2011), *supra* n. 1.

[111] Pistone, even though recognizing the legal uncertainty behind the concept of ATP proposes a systematic analysis of this non-legal concept, referring to it as a "new conceptual category of global tax law". Pistone, *supra* n. 41, pp. 109-151.

negative impact of the use of non-legal concepts within the legal debate regarding DNT.

4.1. Tax Evasion in a nutshell

Tax evasion and tax avoidance are eminently domestic legal concepts[112], and beyond the linguistic differences in the use of the terms,[113] there is substantial consensus of their meanings.[114]

[112] The fact that they are domestic legal concepts does not prevent us to recognize that tax evasion and tax avoidance can have consequences beyond the domestic borders. Indeed, a major problem for domestic tax jurisdictions is the fact that taxpayers hide offshore assets, failing to declare them and in some cases failing to pay the taxes due on the income derived from those assets. Likewise, and although tax avoidance is not an international notion, it is worth to briefly refer to the concept of tax avoidance (or "tax abuse") elaborated by the jurisprudence of the CJEU in *Halifax* and *Cadbury Schweppes*, both case laws ruled in 2006. In *Halifax*, on one hand, and referred exclusively to indirect taxation, the CJEU provided that an abusive practice exists if certain transactions aimed to obtain a tax advantage contrary to the purpose of the law and this aim, i.e. obtaining the tax advantage, is indeed an essential aim. In *Cadbury Schweppes*, referred precisely to direct taxation, the CJEU set up the limits on what kind of anti-avoidance measures might be justified in order to restrict the fundamental freedoms within the European Union. In this regard, the CJEU was clear in providing that only "wholly artificial arrangements", which do not reflect economic reality, may be targeted. In both cases, the CJEU set up important boundaries of what should be a matter of concern and what should be not, preventing thus Member States to go beyond those limits in order to justify restrictive tax measures, which might finally affect the functioning of the European internal market. The above does not mean to recognize that a uniform concept of tax abuse exists with the EU, but some important patterns of a harmonized concept might be recognized. *See* EU: Judgment in *Halifax plc., Leeds Permanent Development Services Ltd., County Wide Property Investments Ltd. v. Commissioners of Custom and Excise,* C-255/02, ECLI:EU:C:2006:121, hereinafter "*Halifax* case" and EU: Judgment in *Cadbury Schweppes and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue,* C-196/04, EU:C:2006:544, hereinafter "*Cadbury Schweppes* case".

For the majority of the countries, tax evasion represents a fraudulent conduct from the taxpayer that it is aimed to cause an illegal reduction in the amount of taxes to be paid. It generally involves a willful conduct of the taxpayer and the respective lack of information by the authorities, which end up in a reduction of the final tax assessment. This conduct is normally described within law and it is sanctioned, although the effective sanctions will depend of the possibilities and the will of the specific government to prevent these patently illegal and objectionable behaviors. Therefore, tax evasion is no more than a question about governance failure in collecting taxes due to a lack of information. As well explained by Vann: "[T]he prevention of fiscal evasion primarily refers to cases where taxpayers fraudulently conceal income in an international setting and rely on the inability of tax administrations to obtain information from abroad".

The above means that tax evasion is a *per se* an illegal conduct, normally described and sanctioned by law, and which has to be with the intentions of a taxpayer to fraudulently hide his assets/income from the tax authorities, achieving in those cases, most probably, double or multiple non-taxation. This latter outcome, however, is not necessarily a precondition for the

[113] For example, in English the term "tax evasion" is synonymous of "tax fraud", and it can be translated into German as *"Steuerhinterziehung",* into French as *"fraude fiscal",* into Spanish as *"evasión fiscal"* and into Portuguese as *"evasao fiscal"*. Conversely, the term "tax avoidance" is translated into French as "évasion fiscale", into German as "Steuerumgehung", into Spanish as "elusión fiscal" and into Portuguese as "elusão fiscal". *See* C. Alves, *Preventing Tax Avoidance: Is There Convergence in the Way Countries Counter Tax Avoidance?*, 67 Bull. Intl. Taxn. 7 (2013), Journals IBFD, p. 348.

[114] Id.

existence of tax evasion situations. In other words, the fact that a taxpayer achieves DNT in a cross-border transaction is not a presumption that he is evading taxes. In most of the cases, this outcome will be certainly promoted or saved by the legislations involved in the transaction and it will respond to specific incentives aimed to promote the growth of a specific sector or the whole economy of a country.[115] Thus, what it is sanctioned in those cases of tax evasion is thus not that a taxpayer finally achieved non-taxation all together in a cross-border transaction, but rather that he unlawfully concealed assets from the tax authorities in order to reduce his final tax burden.

4.1.1. Tax Evasion versus Tax Fraud

Although the majority of the countries do not draw a line to separate both tax evasion and tax fraud, there are countries that clearly distinguish among them. Perhaps the most interesting example is Switzerland, where tax evasion constitutes a willful or negligent behavior of the taxpayer that causes a predisposition to improperly omit or to make an incomplete final assessment.[116] Thus, the offender, by action or omission, obtains an

[115] This can be seen in the offer of tax incentives around the world, especially with respect to the research and development of intangibles with the IP Boxes regimes and the like. Accordingly, within the tax treaty context, countries normally negotiate the inclusion of clauses that safeguard the success of those incentives, e.g. *tax sparing* clauses. *Infra* Chapter II, Section 4.1.1.

[116] CH: Article 175 of the DBG (Federal Law on Direct Federal Tax) of 14 December 1990 and Article 56 of the StHG (Federal Law on Harmonization of Direct Taxes of the Cantons and Municipalities) of 14 December 1990.

unjustified tax advantage causing a deficit to the community.[117] The causal connection between the behavior of the offender and the deficit in the community is necessary to consider the action or omission as tax evasion.[118] In contrast, tax fraud supposes that a person forges, fake or uses false certifications to deceive third persons for purposes of tax evasion.[119] Conversely to tax evasion, the deficit in the community is not required.[120] Thus, both behaviors are sanctioned, although in a different manner.

The distinction between tax fraud and tax evasion in Switzerland has important consequences at the tax treaty level as well.[121] For example, the 1996 tax treaty between Switzerland and the United States (currently in force) grants exchange of information under Article 26 only in case of "tax

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[117] Id.

[118] Id.

[119] CH: Article 186 of the DBG and Article 59 of the StHG.

[120] Id.

[121] *See*, e.g. CH: Decision of the Swiss Federal Administrative Court [Bundesverwaltungsgericht] A-737/2012 of 5 April 2012. In a more recent decision of 6 January 2014, the Swiss Federal Administrative Court [*Bundesverwaltungsgerich*t] overturned a previous decision of the Swiss Federal Tax Administration granting administrative assistance to the IRS in disclosing some bank account data of American clients. The distinction between tax fraud and tax evasion was one of the main reasons provided by the Court to explain the denial to exchange information in this case. For more information about this Court decision, *see* CH: Press release, Media Relations A-5390/2013 and A-5540/2013, Swiss Federal Administrative Court, St. Gallen (8 Jan. 2014). *See also* the official German text and an unofficial English translation in: CH: *X. vs. Federal Tax Administration, A-5390/2013, Swiss Federal Administrative Court* [Bundesverwaltungsgericht], 6 January 2014 (ed. P. Baker), 17 ITLR, Lexis Nexis, London (2014). *See* also, L. Parada, *Intergovernmental Agreements and the Implementation of FATCA in Europe*, 7 World Tax J. 2 (2015), Journals IBFD, pp. 232-235. *See also*, L. Parada, *Lessons Learned from the Swiss Julius Baer Case*, 74 Tax Notes Int'l 13 (2014); S. Ronco, *Scambio di informazioni tra Stati Uniti e Svizzera: il caso Julius Baer*, Rassegna Tributaria 6, (2014), pp. 1332-1353.

fraud or the like".[122] This is to say, according to paragraph 10 of the Protocol, when the taxpayer has engaged in fraudulent conduct that causes or it is intended to cause an illegal and substantial reduction in the amount of tax paid to a Contracting State.[123] In other words, exchange of information is not granted in cases of mere tax evasion. [124] Nevertheless, the above situation could change with the entry in force of the 2009 Protocol, which eliminates the reference to "tax fraud and the like" and introduces a major information clause. Once the Protocol is ratified, it will be applied retroactively since 23 September 2009, date of the signature of the Protocol.[125] However, the approval of the 2009 Protocol is still on hold in the U.S. Senate.[126]

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[122] CH/US: Convention between the United States of America and the Swiss Confederation for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed at Washington on 2 October 1996 as amended by the Protocol signed on 2 October 1996, Article 26(1).

[123] CH/US: Technical Explanations of the Convention between the United States of America and the Swiss Confederation for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed at Washington on 2 October 1996 as amended by the Protocol signed on 2 October 1996.

[124] For more information why Switzerland does not grant administrative assistance in a case of simple nondisclosure or tax evasion *see*, e.g. M. Desax, *The Swiss Perspective of Information Exchange*, 58 Tax Notes Int'l 12 (2010), pp. 955-957. For more information about the Swiss bank secrecy law and its coordination with tax treaties *see*, e.g. G. Braidi and L. Cousinou, *Swiss Banking Secrecy: A Heaven of Peace in Distress for US Taxpayers*, Quid? Fribourg Law Review 2, pp. 7-10 (2014).

[125] CH/US: Protocol 2009 amending the Convention between the United States and the Swiss Confederation for the avoidance of double taxation with respect to taxes on income signed at Washington on 2 October 1996, Swiss Federal Gazette (27 Nov. 2010), p. 224, Article 5 (2).

[126] The reason is that U.S. Senator Rand Paul argues that the Protocol gives the IRS too much power to investigate non-criminal behaviors. *See* L. Shepard, *Don't Ask, Don't Tell: Swiss Behavioral Patterns*, 66 Tax Notes Int'l 1 (2012), p. 8.

4.1.2. The reactions to Tax Evasion

As explained above, tax evasion is basically a lack of information problem,[127] and not a DNT problem. Governments, in cases of tax evasion, are unable to track taxpayers who intentionally hide their income, mostly offshore, resulting in a failure to collect taxes. That is why the natural reaction against tax evasion is exchange of information, namely, to extend the channels by which countries can cooperate in order to achieve appropriate levels of transparency that prevent taxpayers from hiding assets/income.

A global tendency towards tax transparency has been evidenced in the recent efforts made by countries to increase the levels of exchange of information, which is added to the old measures normally used to combat offshore tax evasion.[128] One major unilateral example is the 2010 FATCA legislation in the United States[129], which beyond the criticism of its

127 Vann, *supra* n. 24.

128 Countries also combat offshore tax evasion through voluntary disclosure amnesties. These initiatives are generally successful, but they have limitations. For example, taxpayers can perceive unfairness and anticipates further amnesties, reducing the level of revenues collected by the governments. *See* L. Lederman, *The Use of Voluntary Disclosure Initiatives in the Battles Against Offshore Tax Evasion*, 57 Vill. L. Rev. 499 (2012), p. 519. *See also*, C. Boise, *Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty*, 14 Geo. Mason L. Rev. 667 (2007), p. 707.

129 US: Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010). *See also*, US: Proposed FATCA Regulations (2012) and Final FATCA Regulations (2014), both available at www.irs.gov. For further information regarding the discussions about FATCA s*ee, e.g.* A Mahboob, *FATCA and the Fat Cats: Foreign Pass-through Payments and the Blocker Problem,* 71 Tax Notes Int'l 12 (2013); J. Arora et al., *U.S. releases Final FATCA Regs,* 69 Tax Notes Int'l 4 (2013); P. Carman, *Final*

extraterritoriality and the conflicts with other jurisdictions has opened the door to develop more effective international instruments to exchange information between jurisdictions. An example of the above is the OECD/G-20 Global Standard on Automatic Exchange of Financial Account Information released on February 2014 (Common Reporting Standard or CRS),[130] which is based on the FATCA Intergovernmental Agreement (IGA) Model 1A.[131] Other global efforts have attended more to the disclose of corporate taxpayers' information, such as the mandatory disclosure rules

FATCA Regulations Provide Certainty, Flexibility, 15 Derivs. & Fin. Instrums. 2 (2013), Journals IBFD; V. Hammer, *US Update*, 66 Bull. Intl. Taxn. 6 (2012), Journals IBFD; W. Cui, *Passthru Payments and the Fantastic World of FATCA,* 13 Derivs. & Fin. Instrums. 4 (2011), Journals IBFD; Parada, *supra* n.121.

130 OECD (2014), *Standard for Automatic Exchange of Financial Account Information: Common Reporting Standard,* OECD Publishing, Paris.

131 As provided in the OECD CRS: "The Common Reporting Standard, with a view to maximizing efficiency and reducing costs for financial institutions draws extensively on the intergovernmental approach to implementing FATCA". Id. *See also*, L. Sheppard, *Machiavellian Pragmatism in Tax Enforcement*, 77 Tax Notes Int'l 11 (2015), p. 927. See also, M. Stewart, *Transnational Tax Information Exchange Networks: Steps towards a Globalized, Legitimate Tax Administration*, 4 World Tax J. 2 (2012), Journals IBFD, p. 169. It is important to clarify that there are two versions of the Intergovernmental Agreement Model 1: (i) the reciprocal version (Model 1A), which provides for the United States to exchange information currently collected on accounts held in U.S. financial institutions by residents of treaty partner countries (either by bilateral tax treaties or TIEAs), and includes a policy commitment to pursue regulations and support legislation that would provide for equivalent levels of exchange by the United States; and (ii) the non-reciprocal version (Model 1B), where no reciprocal exchange of information takes place. *See* Parada, *supra* n. 121, p. 204. *See also*, F. A. García Prats, *Los Nuevos Estándares Internacionales de Intercambio de Información: FATCA o el fin del Secreto Bancario* in *Intercambio de Información, Blanqueo de Capitales y Lucha contra el Fraude Fiscal* (Dir. F.A. García Prats), Instituto de Estudios Fiscales, Madrid (2014), pp. 205-206.

under the OECD BEPS Action 12,[132] and the imposition on taxpayers to disclose their affairs before or after lodgment of tax returns.[133] Similarly, the issuance of the MCMAA[134] and the CbC Reporting,[135] have contributed to increase the power of the tax authorities to exchange information in a cooperative manner.[136]

This tax transparency path can also be found within the European Union since the establishment of the EU Saving Tax Directive (Council Directive 2003/48/EC).[137] This Directive obliges financial institutions to report the identity of the EU residents who receive interest payments and to exchange

[132] OECD (2015), *Mandatory Disclosure Rules, Action 12–2015 Final Report*, OECD Publishing, Paris.

[133] For example, in the case of disclose before lodgment of tax returns, through the issuance of rulings or voluntary administrative procedures, e.g. APAs. Accordingly, by exchanging information through DTCs or TIEAs after lodgment of tax returns.

[134] OECD/EU (2011): Convention on Mutual Administrative Assistance in Tax Matter of 1 June 2011.

[135] OECD (2015), *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13–2015 Final Report*, OECD Publishing, Paris.

[136] M. Dirkis, *The 'Lyon's Mouth' post-box: A Comparative Review of the Limitations on the use by Revenue Authorities of Leaked and Stolen Information*, Working Paper University of Sydney, presented at the Tax Research Conference organized by the Ross Parson Centre for Commercial, Corporate and Taxation Law (Sydney) and the Max Planck Institute for Tax Law and Public Finance (Munich), 28-29 Nov. 2016, p. 1.

[137] EU: Council Directive 2003/48/EC of 3 June 2003 on Taxation of Saving Income in the Form on Interest Payments, OJ L157 (2003) as amended through 2006. As FATCA, the EU Saving Tax Directive pursues the combat against tax evasion imposing due diligence requirements on financial institutions. However, and contrary to FATCA, it is limited only to private individual who receive interests (not including entities) and it concerns only financial institutions located in Europe. *See* L. Cavelti, *Automatic Information Exchange versus the WHT Regime Globalization and Increasing Sovereignty Conflicts in International Taxation*, 5 World Tax J. 2 (2013), Journals IBFD, p. 191 and I. Grinberg, *Taxing Capital Income in Emerging Countries: Will FATCA Open the Door?*, 5 World Tax J. 3 (2013), Journals IBFD, p. 337.

it in an annual basis with the respective residence country.[138] More recently, the adoption by the European Commission of the Council Directive 2014/107/EU[139], which amended the Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation[140] and extended the mandatory automatic exchange of information in accordance with the new OECD/G-20 global standards for automatic exchange of information added to the proposal of a Council Directive in order to repeal the EU Saving Tax Directive (Council Directive 2003/48/EC)[141], simply demonstrate that idea of setting up one unique standard for automatic exchange of information within the EU. Moreover, probably the most symbolic recent achievement at the EU level is the EU-Switzerland Tax Transparency Agreement of 2015.[142] The new EU-Switzerland tax transparency agreement is fully consistent with the OECD/G20 global standard for the automatic exchange of information and it should not only improve the Member States' abilities

[138] Among the characteristics of the EU Saving Tax Directive is that it provides a *"transitional WHT regime"* which works as a relief for those EU countries that still possess strict bank secrecy policies. Nonetheless, the effectiveness of the transitional WHT regime has been eliminated with the subsequent developments upon transparency. *See* Parada, *supra* n. 121, p. 218.

[139] EU: Council Directive 2014/107/EU of 9 Dec. 2014 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, OJ L359 (2014).

[140] EU: Council Directive 2011/16/EU of 15 Feb. 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L64 (2011).

[141] EU: Proposal for a Council Directive repealing Council Directive 2003/48/EC, COM (2015) 129 final, 18 March 2015.

[142] *See* EU: European Commission Press Release IP/15/5043, *Fighting tax evasion: EU and Switzerland sign historic tax transparency agreement*, 27 May 2015. *See also* R. Höltschi, *Automatischer Informationsaustausch, Schweiz und EU unterzeichnen AIA,* Neue Zürcher Zeitung (27 May 2015).

to track down and tackle tax evaders, but it should also act as a deterrent against hiding income and assets abroad to evade taxes.[143]

Despite the importance of these global achievements towards tax transparency and exchange of information, one should not forget the importance of maintaining a proper balance between the protection of taxpayers' rights and the public interest of combating tax evasion. This is to say, there is a natural limitation in the fight against tax evasion, which is the protection of taxpayers' rights.[144] The above is particularly relevant when referring on how to gather information to start, e.g. a civil or criminal proceeding against tax evasion and which type of information can be finally used in Court. Indeed, as we have witnessed during the last years, there are some publicly known cases in which information has been unlawfully obtained, either because it was leaked or stolen, and finally used by the tax authorities to start a tax evasion proceeding.[145] Unfortunately there is no a

143 Parada, *supra* n. 121, pp.219-220.

144 For different analyses upon the protection of taxpayers' rights in a world in which automatic exchange of information seems to be the final aim *see*, e.g. P. Baker, *Some Recent Decisions of the European Court of Human Rights in Tax Matters*, 55 Eur. Taxn. 2/3 (2015), Journals IBFD; J. Calderón Carrero and A. Quintas Seara, *The Taxpayer's Right of Defense in Cross-Border Exchange of Information Procedures*, 68 Bull. Int'l. Taxn. 9 (2014), Journals IBFD; R. Desax, *Practical Protection of Fundamental Rights of Taxpayers*, 69 Bull. Int'l Taxn. 4/5 (2015), Journals IBFD; N. Serim, *Taxpayers' Rights–The Turkish Model,* 48 Eur. Taxn. 4 (2008), Journals IBFD; R. Camacho Palma, *An Overview of the Protection of Taxpayer Rights in Portugal*, 50 Eur. Taxn. 1 (2010), Journals IBFD, and M. de Zeeuw, *The Formulation of Taxpayer Rights and Obligations in a Developing Country*, 14 Asia-Pacific Tax Bull. 1 (2008), Journals IBFD.

145 Perhaps the most famous cases of stolen information are: 1) the "LGT Kieber papers", where a former employee of the LGT Bank in Lichtenstein, stole information, putted into a CD, and subsequently sold it to the German tax authorities; 2) The "Falciani list",

unanimous position on this matter, and domestic Courts around the world have generated inconsistent precedents. In Germany, e.g. there is a tendency to accept the use of leaked and stolen information without limitations, which might certainly jeopardize basics taxpayers' rights, such as the right of defense.[146] This tendency, however, has been mitigated by recent decisions, at least with regards to criminal matters.[147] France, on the other hand, seems to adopt a more restrictive position regarding the use of this type of information in Court.[148] This position was strengthened in 2010 and 2011,

where Mr. Hervé Falciani, a former employee of the HSBC in Geneva, stole information of around 130,000 customers and sold it to different EU Governments. *See* Dirkis, *supra* n. 136, pp. 8-13.

[146] The German Federal Constitutional Court, in a case of stolen information by former employee of LGT Bank in Lichtenstein and subsequently sold to the German tax authorities, stated that it did not affect the fundamental right of privacy being thus not against the German Federal Constitution. *See* DE: BVerfG Beschl. v. 9 Nov. 2010 [2 BvR 2101/09] – DStR 2010, 2512. *See also*, S. Soong Johnston, *State Court Rejects Challenge Against Use of Stolen Bank Data*, 73 Tax Notes Int'l 9 (2014) and K. Parillo, *German Court Permit Used of Stolen Data in Tax Probes*, 60 Tax Notes Int'l 10 (2010), p. 725.

[147] DE: VGH Urteil v. 24 Feb. 2014 [VGH B 26/13] Steuk 2014, 106. In this case, the Land Constitutional Court of Rhineland-Palatinate [*Rheinlandpfalz*] ruled against the arguments of a taxpayer who was trying to prevent the access of the tax authorities to register his house in suspicion of tax evasion. The information was contained in a CD with stolen data and which was sold to five different Governments. The Court sustained that the informant acted at his own initiative; therefore, those acts were not attributable to the State and they did not infringed the right to a fair trial. However, what it is interesting to highlight is that the Court confirmed that the acquisition of data media for purposes of criminal prosecution is indeed admissible only insofar as the public authorities do not systematically encourage the committing of crimes. This position does not only differ from the one sustained by the German Federal Supreme Court in 2010, but also opens the door to provide certain limitations in the use of stolen data, at least with respect to criminal proceedings.

[148] For example, in 2011 the Court of Appeal in Paris [Court d'Appel de Paris] denied the French tax authorities the entrance in the house of a taxpayer to search for information regarding a potential tax fraud case. J. Delaurière and C. Prest, *French Tax Authorities*

when the Civil Supreme Court stated that it is fundamental that a judge verifies that the information provided to the tax authorities was lawfully obtained, without being distracted by economic considerations that prevent him to judge in accordance with the fundamental principles that govern the legitimacy of his actions.[149] Similarly, in Switzerland, the Federal Administrative Court has recently stated in a case regarding exchange of information under Article 28 of the Switzerland-France tax treaty (exchange of information), that Switzerland is not allowed to give any administrative assistance if the request for administrative assistance is based on stolen data.[150] Accordingly, the CJEU has recently confirmed, within the *Sabou case,* the domestic law monopoly in the protection of taxpayers' rights.[151] In this case, the Czech Supreme Court stopped the proceedings between the Czech tax authorities and Mr. Sabou and referred to the CJEU for a preliminary ruling. Among the inquiries, the Czech Supreme Court stated: "[A]re the tax authorities in the requested MS obliged, when providing

Lose Battle on Stolen Data, 62 Tax Notes Int'l 3 (2011), p. 176. At that time, the French authorities tried to get the authorization based on the information stolen by an employee of HSBC with respect to customers with bank accounts in Switzerland. See, Parada, *supra* n. 121, pp. 212-215. *See also*, Dirkis, *supra* n. 136, Sec. 2.2.2.

149 The Supreme Civil Court strengthened this position in 2011 arguing: "[I]I the economic considerations cannot be ignored by the judge, such considerations shall not distract the judge from his obligation to judge in accordance with the fundamental principles which govern the legitimacy of his action". Delaurière and Prest, *supra* n. 148. The considerations of the Court were made under the basis of art. 6(1) of the European Rights Convention and the duty of loyalty. Id. *See also*, Parada, *supra* n. 121, p. 213.

150 CH: Federal Administrative Court [*Bundesverwaltungsgericht*–BVGer], Urteil A-6843/2014 of 15 Sep. 2015. *See also*, CH: Bundesverwaltungsgericht: Medienmitteilung v. 24 Sep. 2015, *Keine Amtshilfe bei gestohlenen Daten,* Urteil A-6843/2014 v. 15 Sep. 2015.

151 EU: Judgment in *Sabou v. The Czech Republic*, Case C-276/12, ECLI:EU:C:2013:678.

information in accordance with the Directive 77/799/EEC (mutual assistance between MS), to observe a certain minimum content of their answer, so that it is clear from what sources and by what method the requested tax authorities have obtained the information provided? May the taxpayer challenge the correctness of the information thus provided, e.g. on grounds of procedural defects of the proceedings in the requested State? ".[152] The CJEU established that the Directive did not govern any of these questions and that they must be addressed only at a domestic level.[153] However, as per the AG's opinion was that in order to use the info in the requesting MS, the requested MS is obliged to provide "adequate statements" about the inquiries conducted and upon which the information is based. This statement, in the author's opinion, brings a small chance to further improve the protection of the taxpayers' right beyond MS's domestic laws.

To sum up, the reactions against tax evasion are given by the increase of the levels of transparency and cooperation in the exchange of information

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152 Id., para. 22.

153 The Court specifically stated: "It must be observed that Directive 77/799 does not address the taxpayer's right to challenge the accuracy of the information conveyed, and it does not impose any particular obligation with regard to the content of the information conveyed. In those circumstances, only national laws can lay down the relevant rules. The taxpayer may challenge the information concerning him conveyed to the tax authorities of the requesting Member State in accordance with the rules and procedures applicable in the Member State in question. The answer to the third question is therefore that Directive 77/799 does not govern the question of the circumstances in which the taxpayer may challenge the accuracy of the information conveyed by the requested Member State, and it does not impose any particular obligation with regard to the content of the information conveyed". Id., para. 48, 49 and 50.

among countries. These reactions, however, cannot be implemented at any cost and should not prevent Governments from providing the necessary safeguards for the fundamental taxpayers' rights, even beyond the national boundaries of domestic laws, as it has been done so far. This could be made through the use of tax treaties; TIEAs or any other international instrument that might serve this purpose.[154]

4.2. Tax Avoidance in a nutshell

Unlike tax evasion, tax avoidance has nothing to do with illegal or fraudulent behaviors aimed to hide assets/income.[155] On the contrary, tax avoidance seems to be more a natural taxpayer's reaction to the imperfect design of domestic tax rules, which are finally used by him to reduce his tax burden, if possible to zero. In this regard, tax avoidance is closer to be an issue of interpretation of the laws rather than an issue related to the lack of information. Indeed, in tax avoidance cases taxpayers will often refer to the literal wording of the law or a treaty to support certain tax arrangements. If the outcome of the arrangement is against the object and purpose of the law,

[154] The author has already argued in this regard when referring to the "Intergovernmental Agreements (IGAs)" to implement FATCA. Considering the nature of these agreements, they could also be utilized to regulate the use of information unlawfully obtained avoiding misinterpretations and contradictory results and contributing to the protection of the taxpayers' rights. *See* Parada, *supra* n. 121, pp. 212-215. In a similar direction with respect to the protection of taxpayers' rights, *see* Calderón Carrero and Quintas Seara, *supra* n. 144.

[155] "In the case of tax avoidance, all facts are disclosed: the taxpayer tries to take advantage of a legal rule by interpreting it in the most favorable way from his point of view". *See*, Essers, *supra* n. 50, p. 58.

and the taxpayer was mainly motivated by tax reasons to get involved in such an arrangement, the tax judge might deny the outcome of such arrangement.[156] The above does not mean that transparency might not contribute in solving tax avoidance problems, but it will not be enough because information is not the core of the issue.

Tax avoidance, unlike tax evasion is, however, not *a priori* objectionable.[157] This will depend exclusively upon the level of tolerance given in a specific jurisdiction, which is normally limited by the use of GAARs or SAARs at a domestic level.[158] In the United States, e.g. it has been largely accepted tax a taxpayer can arrange his businesses in order to pay as low taxes as possible or to defer their payment.[159] A similar doctrine of tolerance can be found under English common law.[160] The practical problem is, of course, that in

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156 Id.

157 The reproach in the case of tax evasion comes directly from the fact that this is indeed an illegal conduct.

158 *Infra* Section 4.2.2.

159 For example, in *Helvering v. Gregory*, it is stated that: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is no even a patriotic duty to increase one's taxes". US: *Helvering v. Gregory,* 69 F.2d 809, 810 (2d Cir. 1934). Another example is the well-known tolerance in the United States to accept the deferral on Subpart F income through the use of the "Check-the-box" (CTB) regulations that allow the taxpayer to choose the tax treatment for U.S. tax purposes of foreign entities not considered *per se* as Corporations. For a further analysis upon the U.S. CTB regulations, *see infra* Chapter III, Section 4.

160 In *Duke of Westminster v. IRC*, Baron Thomas Tomlin said: "Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers

many occasions it is difficult, if not impossible, to distinguish the line between what is objectionable and what is not. This difficulty, however, should not prevent Governments and policymakers from setting up the boundaries of tax avoidance, and the ones between this latter and tax evasion, strictly based upon the rule of law, avoiding the inclusion of non-legal standards to inflict legal sanctions.[161]

As to double non-taxation, it is not possible to argue that this outcome is a necessary condition for the occurrence of tax avoidance. In some cases, e.g. the reduction in the taxpayer's burden might be interpreted as the simple capacity to access at tax benefits not originally available or to simply improve a business position. An example of the above could be the case of a corporate taxpayer subject to an interest limitation rule that prevents him from borrowing enough money from a related lender outside his residence country. Let us also assume that the domestic interest limitation rule is designed in such a way that it leaves open the application of transfer pricing rules as a carve-out clause, although not expressly stated within the law. In this case, nothing would prevent the taxpayer to prove that its interest payments accomplishes with the arm's length standard in order to escape the application of the interest limitation rule. Therefore, the use of this gap has nothing to do with the achievement of DNT and responds to the simple desire of avoiding a rule that limits his capacity of borrowing money from

may be of his ingenuity, he cannot be compelled to pay an increased tax". UK: *Duke of Westminster v. IRC*, [1936] 19 D.T.C. 490, 520 (Can.)

161 *Infra* Section 4.2.2. See also, *infra* Section 5 as regards to the concept of ATP.

abroad. In other cases, even when the outcome of DNT is clearly the final aim, this aim is completely legitimated by law, such it is in the case of tax planning structures, which is in fact a non-objectionable type of tax avoidance. Thus, whatever the source of the non-taxation outcome is, i.e. legitimate or illegitimate tax avoidance, it remains as an outcome, not representing by itself a proxy or presumption of a reproachable taxpayer's conduct.

4.2.1. Tax Avoidance and International Tax Planning

As slightly pointed out before, international tax planning is no other thing that the natural behavior of an entrepreneur to optimize his costs,[162] being thus a type of tax avoidance, which is legitimated by law. The above could be argued at the individual level;[163] however, there is no doubt about it at the corporate level, where the persons called to manage a company are legally bound to involve in tax planning structures in order to minimize company's costs. This obligation might be well interpreted within the context of the duty of loyalty or the duty of care that directors of a company have with the

162 This is also a fact expressly recognized within the OECD. *See* OECD (1987), *International Tax Avoidance and Evasion, Double Taxation Conventions and the Use of Conduit Companies*, Issues in International Taxation No. 1, OECD Publishing, Paris, p. 11.

163 For example, there could be always exceptional cases of taxpayers whose level of social compromise brings them to pay as many taxes as possible, even twice. For an interesting economic analysis on how patriotism might moderate the incentives to avoid taxes, *see* B. Geys and K. Konrad, *Patriotism and Taxation*, Working Paper of the Max Planck Institute for Tax Law and Public Finance No. 2016-11 (2016).

shareholders or investors of the entity. As explained by Schön: "As dividends are paid out of profits, which have been subject to corporate income tax, the interest of the shareholders goes for the after-tax profit rather than for the pre-tax profit […] This makes the minimization of the corporate tax burden an integral part of the managers' duty of care […] Therefore, they – i.e. the directors themselves – are legally bound to engage in tax strategies".[164] Thus, and unlike an individual taxpayer, the manager body of a company must respond to the profits expectations of the shareholders and must fulfill this duty involving in tax strategies that allow the company to maximize its profits.[165]

The outcome of DNT is thus not only a possible and accepted one within the context of an international tax planning, it is indeed, in most of the cases, a demonstration of a successful tax strategy aimed to reduce company's costs. Since taxes are basically costs, any cross-border or international tax planning will be aimed at least to avoid double taxation, i.e. duplicated costs, and to achieve DNT, i.e. the optimization of the overall tax liability in order to maximize profits. In simple words, a taxpayer will always intend to avoid paying taxes twice and will always try paying as close as possible to zero.[166] This conclusion, however, does not mean to recognize that the

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[164] W. Schön, *Tax and Corporate Governance: A legal Approach* in: W. Schön (ed) *Tax and Corporate Governance*, MPI Studies on Intellectual Property, Competition and Tax Law, Springer, Heidelberg (2008), p.46.

[165] Id., p. 47.

[166] R. Eicke, *Tax Planning with Holding Companies—Repatriation of U.S. Profits from Europe,* Kluwer Law International, BV The Netherlands (2009), pp. 11-21.

boundaries of what is a legitimate tax planning today might vary as per the specific tax policies of a domestic jurisdiction in the future, eventually affecting the whole tax planning strategy, and indirectly the legitimacy of the DNT aim. This variation in the legal boundaries, however, will not imply that the DNT outcome will become in a presumption of illegal or illegitimate conducts, but it will certainly makes impossible its achievement within the new legal framework.[167]

4.2.2. The reactions to Tax Avoidance

Generally speaking, countries follow different approaches to draw the line between objectionable and non-objectionable tax avoidance, using in most of the cases the elements of economic substance and artificiality as a proxy to determine the presence of abusive transactions. As explained by Garcia Prats, it is possible to distinguish at least three main groups of anti-avoidance measures: a) countries that use a sham/simulation concept instead of specific or general anti-avoidance measures, either by statute or by Court; b) countries using GAARs, which may differ from country to country, or SAARs, e.g., CFC rules or the non-deductibility of certain foreign

[167] However, these new boundaries do not refer to the public perception of what is morally right or wrong, but rather to specific rules aimed to reduce the scope of tax planning strategies. The above reaffirms the idea of avoiding the use of non-legal notions to set up those boundaries, e.g. the notion of ATP. See *infra* Section 5.

payments, and c) countries using law theories elaborated by Courts.[168] Among this last group, it is also possible to distinguish three main theories: 1) Step transaction or *Ramsay* doctrine, which advocates for the recognition of series of transactions as a single one.[169] Then, the step transactions are disregarded for tax purposes and they are taxed as a unified transaction;[170] 2) Business purpose, according to which transactions should be characterized according to their substance.[171] This is to say, distinguishing between transactions with valid business purposes and artificial ones designed exclusively to avoid taxes,[172] and 3) Economic Substance, which does not relate to the purpose of the transaction but to its effects.[173] The basic premise of this theory is that a court may deny the tax benefits resulting from a transaction if this transaction itself lacks any economic benefit other than the tax saving.[174]

Whatever path is taken to draw the line between objectionable and non-objectionable (or legitimate or illegitimate) tax avoidance, it is important

[168] F. A. Garcia Prats, *The 'Abuse of Tax Law': Prospects and Analysis* in: G. Bizioli (ed.) *Essays in International and European Tax Law,* Jovene Editore, Napoli (2010), p. 58-61.

[169] Id.

[170] J. Soled, *Use of Judicial Doctrines in Resolving Transfer Tax Controversies*, 42 Bos. College L. Rev. 3 (2001), p. 587.

[171] Garcia Prats, *supra* n. 168.

[172] P. Lampreave, *An Assesment of the Anti-Tax Avoidance Doctrines in the United States and the European Union*, 66 Bull. Intl. Taxn. 3, p. 155 (2012), Journals IBFD.

[173] Garcia Prats, *supra* n. 168.

[174] Id., p 154.

that this is made from the rule of law,[175] excluding arguments of morality or justice.[176] Following this path will benefit both taxpayers and governments. On the one hand, taxpayers can certainly rely on the legal certainty required to carry out their businesses. This is to say, they can be aware before engaging in any tax avoidance scheme of the expected behaviors, and therefore, whether or not certain transactions can be disregarded. On the other hand, governments impose effective punishments for the cases in which the limits of legitimate tax avoidance are contravened, moving the tax system to a more coherent and consistent application.[177] More importantly, there will be a lower chance to confuse between tax evasion, and illegal behavior, tax avoidance, a legitimate or illegitimate conduct depending on the level of tolerance established by the law of a specific jurisdiction, and DNT, an always legitimate tax planning aim.

[175] Although this concept belongs specifically to the common law tradition, I use it also as a synonymous of the *principle of legality* used in many civil law countries. In simple words, law should provide the boundaries between legitimate and illegitimate tax avoidance.

[176] This issue is deeply analyzed by A. Christians, who states: "The idea that taxpayer behavior must be managed by law, rather than social sanction, rests fundamentally on the premise that tax policy can move toward greater coherence over time if the public persistently demands a means of monitoring lawmaking". *See* Christians, *supra* n. 49, p. 59. Christians also argues that the turn to morality, rather than law, to delineate what is legal or illegal is indeed counterproductive to pursue a coherent tax policy in the long term and it can also have grave consequences for the future of tax policy on a global scale. Id., pp. 39-40. *See also*, e.g., A. Christians, *Tax Activists and the Global Movement for Development through Transparency in Tax,* in: M. Stewart and Y. Brauner (eds.), *Law and Development*, Edward Elgar Publishing (2013), p. 288.

[177] Christians, *supra* n. 49*,* p. 55.

5. Double Non-Taxation and “*Aggressive Tax Panning”*

Contrary to the idea stressed in Section 4 that only law should set up the boundaries between legitimate and illegitimate tax planning (objectionable tax avoidance), we have recently witnessed the appearance of a non-legal category into the debate: the notion of “*Aggressive Tax Planning”* (ATP).[178] This Section aims only to emphasize how the *consequentialist approach* observed within the ambiguous notion of ATP, i.e. focusing in the results of the transaction–DNT or low taxation– might negatively impact the proper understanding of the DNT outcome, and indirectly affects the delineation of the traditional boundaries between legitimate and illegitimate tax avoidance, contributing thus to increase the level of legal uncertainty for taxpayers.[179]

[178] The expression ATP is, nevertheless, not new. It was originated in the United States, where it was used to refer to structures that were designed against the spirit or purpose of the regulations. *See* J. Calderón Carrero and A. Quintas Seara, *The Concept of ‘Aggressive Tax Planning’ Launched by the OECD and the EU Commission in the BEPS Era: Redefining the Border between Legitimate and Illegitimate Tax Planning*, 44 Intertax 3 (2016), p. 209.

[179] Therefore, this Section does not attempt to provide an exhaustive analysis of the notion of ATP. For this purpose, s*ee*, e.g. A. P. Dourado, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Action 2 and 6*, 43 Intertax 1 (2015); F. A. García Prats, *Los límities a la planificación fiscal agresiva y el abuso de las normas tributaries,* at AEDAF, X Congreso Tributario. La Justicia: ¿Garantía del Estado de Derecho? AEDAF, 2015; Pistone, *supra* n. 39; Calderón Carrero and Quintas Seara, *supra* n. 178; C. Fuest et al., *Profit Shifting and “Aggressive” Tax Planning by Multinationals Firms: Issues and Options for Reform*, 5 World Tax J. 3 (2013), Journals IBFD; P. Piantavigna, *Tax Abuse and Aggressive Tax Planning in the BEPS Era: How EU Law and the OECD are Establishing a Unifying Conceptual Framework in International Tax Law, Despite Linguistic Discrepancies*, 9 World Tax J. 1 (2017), Journals IBFD.

5.1. The notion of ATP in brief

ATP is a non-legal notion developed by the OECD within the context of the BEPS Project,[180] which, although lacking of a consistent definition, seems to have a very clear and instrumental purpose: to reduce the scope of (legal) tax planning and to set up new ethical standards for taxpayers in order to prevent abusive practices. The above can be noted, e.g. in Action 12 OECD BEPS Action Plan,[181] where the notion of ATP is used to recognize tax-planning structures that comply with the wording of the law, but not with its spirit.[182] In other words, the notion of ATP would attempt to explain the loopholes and inconsistencies in cross-border transactions that involve the application of different domestic tax systems aiming to create a more coherent framework. In this order of ideas, and at least *a priori*, this vague notion seems to serve more the purpose of being a guiding principle rather than a rule that should generally be applied.[183]

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180 However, the OECD already referred to the notion of aggressive tax planning in its 2011 Report. *See* OECD (2011), *supra* n. 1.

181 OECD (2015), *supra* n. 132.

182 Calderón Carrero and Quintas Seara, *supra* n. 178, p. 210.

183 This conclusion is important, because it allows us to argue that in any case the notion of ATP can be used as synonymous of tax avoidance, and reaffirms the idea that the notion of ATP is a non-legal category in itself. As provided by Calderón Carrero and Quintas Seara: “[T]he new concept of aggressive tax planning does not aim to be a type of overriding principle to be applied generally (like a ‘soft law GAAR’), nor does it aim to constitute a ‘rule of teleological interpretation’ of the regulatory language, but its purpose may lie more in bringing about a change in the way the new international taxation system is understood […]”. Id. On the other hand, if the final aim were to establish a general rule that contemplates the new ATP category, i.e. a positive rule (hard law), it would be practically impossible to distinguish between this ATP category

5.2. The EU notion of ATP: A *consequentialist approach*

A broader understanding of the notion of ATP can be, however, found in the EU Commission Recommendation on Aggressive Tax Planning launched in 2012.[184] According to the EU Commission "[a]ggressive tax planning consists of taking advantage of the technicalities of a tax system or of the mismatches between two or more tax systems for the purpose of reducing tax liability".[185] The EU Commission also establishes that the consequences of these ATP schemes normally include the outcome of double deduction, i.e. when the same loss is deducted both in the State of source and residence, and the outcome of DNT, i.e. when income that is not taxed in the source State is exempt in the State of residence.[186] Thus, as per the EU understanding, any operation whose purpose is to achieve DNT would be included within the notion of ATP, covering also, e.g. non-artificial transactions with a pure (legal) tax purpose.

This broader understanding of ATP is confirmed by some tax scholars who explain it as a "conceptual category of the global Tax Law, consisting in the exploitation of the disparities between tax systems with the purpose of obtaining tax advantages, which would have not been otherwise available", proposing a systematic study of the notion, as if we were referring to a pure

and a simple GAAR, generally applied by countries to counteract abusive practices. Id. On a different opinion: Piantavigna, *supra* n. 179.

184 EU: European Commission Recommendation of 6 Dec. 2012 on aggressive tax planning, COM (2012), 8806 final.

185 Id.

186 Id.

legal concept, which would include at least three elements: a) the exploitation of the legal disparities between tax systems in order to obtain a tax advantage; b) the desalination between the source of the income and where taxes are actually paid, and c) the DNT outcome as a result not originally intended by the States. Only the simultaneous concurrence of these elements would allow classifying a cross-border tax planning structure as ATP. [187]

The *"consequentialist approach"*[188], however, or the fact that a tax planning structure will be regarded as aggressive or not based on the results of the transaction (i.e. DNT or low taxation) adopted by the EU Commission and assumed also by some tax scholars, might have serious negative effects. The most evident one is that it might turn the understanding of the concept of tax avoidance, traditionally linked to the lack of economic substance or artificiality of a cross-border transaction, into the focus of eliminating DNT. This approach disregards all the other complexities that involve a cross-border transaction, including e.g. the legality and the methods used within the transaction, and contributes even more to the stigmatization of the DNT outcome. For some authors, however, these effects are mitigated since the DNT outcome is relevant only when the States did not originally 'intend' this outcome.[189] Nevertheless, as stated in Section 2.3 of this Chapter, to

[187] Pistone, *supra* n. 41, p. 117.
[188] Calderón Carrero and Quintas Seara, *supra* n. 178, p. 220. The authors refer indistinctly to "consequentialist standard" and "quantitative standard".
[189] Pistone, *supra* n. 41, pp. 123-125.

assume that the ‘intention of the States’ can be obtained purely without considering the influence of political malfunctions simply implies not to understand the reality in the lawmaking process. Indeed, the influence of external actors in the lawmaking process does not only consider the direct lobby of multinationals, but also the participation of these and other actors within international tax networks, such as the OECD.[190] Therefore, the ‘intention of the States’ as to aim or not the DNT outcome should only be relevant when is expressly stated in the wording of the law, or the treaty, not giving space to subjective interpretations. Unfortunately, a clear tendency on the contrary can be seen in the participation of the media into the debate regarding tax evasion and tax avoidance, providing a general confusion of legal concepts, which, of course, includes an *a priori* rejection of the double non-taxation outcome. In 2012, e.g. James Henry, an American tax justice activist, said: “Both evasion and avoidance have the same impact on the rest of us, which is, our tax burdens are greater because the truly rich are not paying their fair share: they are able to put their money abroad, *and basically are able to take advantage of a system that allows a double non-taxation. And that is a real problem* (emphasis added)”.[191] The above can riskily drives us to conceive the notion of DNT as a *per se* pervasive reality in the world of cross-border investments and commercial activity, disregarding its legal validity as part of a legitimate tax planning strategy. The consequentialist approach of the notion of ATP, therefore, starts from a

[190] Christians, *supra* n. 49.
[191] Id., p. 52.

wrong and not demonstrated premise, which is that income derived from a cross border transaction should be taxed somewhere. This idea, as already stressed in this Chapter, has validity neither as a principle of international tax law nor as customary law.[192]

Another effect, although not directly derived from the consequentialist approach, but from the 'academic construction' of the notion of ATP itself, is the assumption that 'disparities' among legislations used by taxpayers to reduce their tax burden is an *a priori* evil element of the international tax system, or at least a proxy to determine abusive practices. As noted before in this work, however, disparities in the design of domestic tax laws are indeed the general rule and not the exception, and when countries want to restrict the potential abuse of these disparities, they normally do that from the rule of law and not from grey non-legal categories.[193] Similarly, the desalination between the source of the income and where taxes are actually paid may be a valid element to consider with respect to the 'notion of ATP". However, its determination becomes sometimes very complex, if not impossible to

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192 Garcia Prats states that such a premise [single taxation] can be accepted only if a norm in each of the States (or at least one of them) establishes it. In absence of such a norm, the sole acceptance of the idea of single taxation would produce the nonsense result that States could unilaterally declare the exemption of some income, but when such an income had an international origin or destiny, this exemption would be nullified. *See* García Prats, *supra* n. 168, p. 125. The original Spanish text says: "*Dicha premisa solo puede resultar aceptable si existe una norma tributaria en cada una–o al menos en alguna– de las jurisdicciones afectadas que así lo establezca, de conformidad con los presupuestos de derecho interno que legitiman el nacimiento de la obligación tributaria respectiva"*.

193 As states by Rosenbloom: "Countries differ in regard to the many rules of law that make up any system of taxation". *See* Rosenbloom, *supra* n. 56, p. 140.

determine. A clear example of the above is the case of hybrid entities. In this situation, there is no such desalination between the source of the income or the place where activities are rendered and the place where taxes were paid (at least not that evident). The issue, in most of these cases as we will see further on in this work, is reduced to the uncoordinated rules to characterize foreign entities among various jurisdictions, which might derive in a DNT outcome. Thus, if all the elements of the notion of ATP might simultaneously concur to classify a transaction or tax structure as aggressive tax planning, the absence of the "desalination element" in the case of hybrid entities might drive us to conclude that these types of structures could not be regarded as ATP, at least not in a pure theoretical analysis.[194]

As a result, the notion of ATP seems to be not only unclear and consequentialist but also very risky to implement without negative legal and tax policy consequences. On the one hand, it puts at risk the principle of legality in international transactions, contributing to increase the level of uncertainty for taxpayers and situating the discussion on tax avoidance closer to moral arguments rather than legal ones. On the other hand, it negatively affects the proper understanding of the DNT outcome. Both consequences should definitely be avoided.

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194 According to Pistone, only the simultaneous concurrence of the three elements would allow classifying a cross-border transaction as ATP. Pistone, *supra* n. 41, p. 117. Thus, the absence of any of the elements would make the category useless in the case of hybrid entities.

6. Final Remarks

Double non-taxation is an outcome that implies the complete absence of taxation in two or more jurisdictions. This simple understanding is, however, normally tergiversated in different manners confusing the outcome of the transaction, i.e. DNT, with the intentions of the taxpayers or the intentions of the States, producing more confusing results that derives in an *a priori* negative perception of a notion that should, in principle, be understood as a simple outcome.

The negative perception of the DNT outcome, as already stressed in this Chapter, has its very first origin in the wrong belief that income should be taxed at least once in any cross-border transaction. Authors supporting this idea generally argue using the credit method to relieve double taxation as an example. However, as demonstrated in this Chapter, ensuring single taxation through the use of the credit method is very limited in practice, at least in order to conclude the existence of a general tax policy or even a tax principle aimed to ensure single taxation. Indeed, this outcome will always depend of the repatriation of income: if income is finally not repatriated, there is no single taxation to be ensured. Accordingly, the historic antecedents of the origin of the credit method failed to demonstrate that the method was created to ensure single taxation. Regardless the above, new voices still claim for the existence of such a tax principle based basically upon the wording of the US LOB provision (1981), interpreted in a manner

that the reduction of WHT at source is contingent to the taxation at residence. In the author's view, however, this rule has nothing to do with the application of any principle of taxation (or single taxation), but rather with the legitimate interest of the source country, which restricts its taxation rights through reduced WHT under a tax treaty, to coordinate this restriction with a similar taxation in the residence country.[195]

The idea of DNT as a simple outcome is not superfluous. Indeed, it is especially relevant with respect to the negative consequences that could arise from a tax policy perspective if the concept goes beyond that simple understanding. On one hand, they could increase the risk of homologating the DNT outcome with other traditional and undesired legal issues, such as tax evasion or tax avoidance, affecting thus, directly or indirectly, legitimate transactions whose outcome is precisely DNT. Likewise, it could give rise to the legal recognition of non-legal concepts used to set up the boundaries of what should be regarded as tax avoidance in a determined jurisdiction. This is particularly relevant with the concept of ATP, whose *consequentialist approach* has only contributed to increase the level of confusion, creating a scenario of uncertainty among taxpayers. The above does not mean to recognize that the DNT outcome may be achieved through tax evasion or tax avoidance. However, it does not mean that DNT can be regarded as a proxy of these actions. On the other hand, the understanding of DNT beyond

[195] A further analysis on the double non-taxation outcome and bilateral tax treaties can be seen in *infra* Chapter II.

a simple outcome might derive in the incoherent design of domestic rules, such as the case of domestic anti-hybrid rules, i.e. rules dealing with the improper use of hybrid entities, using as basis for their design the DNT outcome. The above has already been demonstrated in the OECD proposal on Action 2 and the *"linking rules"*, an issue that will be further analyzed in this work.

As a result, this Chapter concludes that the boundaries of the notion of DNT should remain within its nature of a simple outcome, absent of subjective interpretations, not being thus regarded *per se* as a cause of concern. This idea will at least govern the remaining part of this work.

II. CHAPTER

Double Non-Taxation and Bilateral Tax Treaties

1. Introduction

Tax treaties have historically been associated to the object and purpose of preventing or alleviating double taxation.[196] They also seek to address fiscal or tax evasion, a problem related with the asymmetries of information and the governance failure in collecting taxes,[197] but that some scholars have also interpreted as including a broader tax policy goal: the avoidance of

[196] Nevertheless, and although an analysis of double taxation as an object an purpose of the tax treaties is out of the scope of this work, it is important to highlight here that the capacity of the tax treaties to prevent or mitigate double taxation is also very limited. Under the OECD Model, e.g. only the persons *"liable to tax"* have access to the treaty relief of double taxation. Likewise, the relief is granted only regarding the taxes covered by the treaty, i.e. taxes on income and capital, and more rarely inheritance and gift taxes and it is only contemplated for the so-called "*juridical double taxation"*. However, *"economic double taxation"*, i.e. when a same element of income or the same economic transaction is subject to the same type of tax in the hands of two or more different taxpayers, is not included in the treaty relief. *See* M. Lang, *General Report,* in: Cahiers de droit fiscal international—Vol. 89a, *Double Non-Taxation* (IFA 2004), pp. 78-81. Likewise, other tax scholars have interestingly argued that the prevention of double taxation would be more an apparent objective of the tax treaties than a real one at the time countries sit down and negotiate them. *See* T. Dagan, *The Tax Treaty Myth*, 32 N.Y.U. J. Int'l L. Pol. 939 (2000). Dagan sustains that the idea that tax treaties exist primarily to alleviate double taxation would have its origin in a false premise that countries would not be able to do so in absence of them. However, most of the countries include in their domestic laws either the exemption or the credit method. Accordingly, in some cases the relief of double taxation seems not to be a problem at all, as it happens with developing countries or transition economies. As residents of these countries are expected to receive less income from foreign sources, the relief of double taxation is indeed not a priority. *See* Vann, *supra* n. 24. In a similar analysis, involving developing countries, *see* e.g. J. Braun and M. Zagler, *An Economic Perspective on Double Tax Treaties with(in) Developing Countries*, 6 World Tax J. (2014), Journals IBFD.

[197] *Supra* Chapter I, Section 4.1.

double non-taxation.[198] This tendency has become particularly evident after the 1999 OECD Partnership Report[199] and the inclusion of Article 23(4) in the 2000 OECD Model, achieving perhaps its maturity in the recent proposal of the OECD BEPS Action Plan 6.[200]

This Chapter attempts to demonstrate that the prevention of double non-taxation is still an exogenous element of tax treaties. This is to say, unless some specific provisions have been included within the tax treaties to ensure single taxation, these instruments should not be interpreted in light of the broad tax policy goal of avoiding DNT. This conclusion, however, should not be interpreted as if the outcome of DNT was a desired and general tax treaty outcome either. In fact, in the same order of ideas, and as it will be demonstrated further on, unless some specific provisions are directly introduced onto tax treaties, e.g. *tax sparing* or *matching credits*, the DNT outcome will be equally exceptional. The above simply reinforces the idea already stressed in Chapter I, which is that DNT is indeed a simple outcome, whose impact (negative or positive) will depend of the transaction and the countries involved. Section 2 of this Chapter analyses the rules of

198 *See*, e.g. Ault (2013), *supra* n. 63; Avi-Yonah, *supra* n. 71.

199 OECD (1999), *supra* n. 1.

200 For the specific proposal on Action 6: OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances,* Action 6—2015 Final Report, OECD Publishing, Paris. For the OECD “BEPS Project”, *see* OECD (2013), *supra* n. 2. For a preliminary evaluation of the OECD BEPS Project, *see,* e.g. Y. Brauner, *BEPS: An Interim Evaluation*, 6 World Tax J.1 (2014), Journals IBFD, p. 10.

interpretation of tax treaties contained in the VCLT[201] and the role that the OECD Model and its Commentaries have for interpretative purposes. Section 3 focuses in the analysis of specific provisions of the OECD Model, commonly included in tax treaties and which at first glance might be interpreted as ensuring single taxation. However, a closer look at them should drive us to a different conclusion. Section 4 studies specific provisions included within tax treaties that either directly tolerate the outcome of DNT, such as *tax sparing* and *matching credits*, or that prevent the concurrence of the outcome, such as the case of *subject-to-tax* and *switch-over clauses*. The above has the purpose of emphasizing the exceptionality of both the occurrence and the avoidance of DNT within tax treaties. Section 5 analyses the impact of some OECD proposal contained in Action 6 and referred to the outcome of DNT. These are: 1) a modification of the title of the OECD Model including a reference to tax evasion and tax avoidance; (2) a recommendation of a preamble, which includes that tax treaties cannot create opportunities for non-taxation or reduced taxation through tax evasion or tax avoidance, and 3) the inclusion of the concept of *"Special Tax Regimes"* (STR). Section 6 provides some final remarks.

2. Interpretation of Tax Treaties

There are two elements that should be considered when analyzing the interpretation of tax treaties. The first has to be with the object of

[201] UN: Vienna Convention on the Law of Treaties ["VCLT"] of 23 May 1969, United Nations, Treaty Series, Vol. 1155, I-18232, p. 331.

interpretation. In this regard, the interpretation of a tax treaty supposes the establishment of the true meaning of a validly concluded or negotiated treaty and not an abstract MC, regardless the practical importance that a MC can have in the interpretative process.[202] In this order of ideas, a tax treaty should be understood as a legal transaction, like a private contract under domestic law, by which the contracting parties establish mutual obligations and rights and whose law-creating character derives from the application of the international law rule of *pacta sunt servanda*.[203] The second element refers to the specific tools used to interpret a tax treaty. Indeed, tax treaties like domestic law are interpreted in accordance to specific rules provided for that reason and which are contained in Article 31, 32 and 33 of the VCLT. While Article 31 refers to the general rules of interpretation, Article 32 deals specifically with preparatory work, and Article 33 is concerned about the interpretation of the treaties in multiple languages.[204] As follows, the author will analyze each one of these rules separately.

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[202] G. Schwarzenberger, *A Manual of International Law*, 5th ed., Steven & Sons Limited, London (1967), p. 164.

[203] As provided by Kelsen: "[T]he treaty has a law-applying and at the same time a law-creating character. It has a law-applying character because every conclusion of a treaty is the application of the rule of general international law *pacta sunt servanda*; it has a law-creating function because every treaty constitutes obligations and rights that, prior to the conclusion of the treaty, had not yet existed, obligations and rights which come into existence by the treaty". H. Kelsen, Principles of International Tax Law, 2nd ed., Holt, Rinehart &Winston Inc., New York (1967), p. 456.

[204] The analysis of Article 33 of the VCLT is a matter that exceeds the concern of this Chapter. Therefore, the author will focus exclusively on Articles 31 and 32. However, for a full analysis of this topic, *see* G. Maisto (ed.), *Multilingual Texts and Interpretation of Tax Treaties and EC Tax Law*, Amsterdam, IBFD, 2005.

2.1. General Rule of Interpretation

While Article 31(1) of the VCLT establishes the general rule of interpretation, Articles 31(2), (3) and (4) elaborate on the general rule specifying what the context of a treaty is and which kind of materials should be considered along with the context, including the fact that, if appropriate, a term of the treaty may be given a special meaning rather than its ordinary one.[205] Article 31(1) of the VCLT states: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".[206] The above means that the text of the treaty, i.e. the "ordinary meaning" of the "terms", the wording of the entire agreement in its context, and the object and purpose of it, are relevant elements to consider for interpretative purposes.

The *ordinary meaning of the terms* of the treaty refers to the technical language internationally developed and used in certain specialized areas, such as tax law, and does not mean an everyday usage.[207] The text of the treaty is generally understood as an independent source of interpretation, which means that the text of the treaty prevails over other ways of interpretation (e.g. the context or the object and purpose), perhaps under the assumption that there is no better place to reflect the intention of the parties

205 B. Arnold, *The Interpretation of Tax Treaties: Myth and Reality*, 64 Bull Intl. Taxn. 1 (2010), Journals IBFD, p. 5.
206 Article 31(1) of the VCLT.
207 Vogel and Rust, *supra* n. 26, Introduction at m.no. 84.

than the text of the treaty itself. This position, whose target is to achieve certainty in the interpretation of tax treaties, reducing thus the scope of subjectivity, has been not only the position undertaken by the International Law Commission, the Institute of International Law and the jurisprudence of the International Court of Justice,[208] but also a common recognized practice among the States.[209]

Unlike the ordinary meaning of the terms of a treaty, the *object and purpose*, is an integral expression,[210] which does not refer to the intention of the Contracting States but to the objective aim of the treaty reflected by the treaty as a whole.[211] This does not imply that the intention of the Contracting States is absolutely useless, but it will only be relevant to the extent it has been expressed in the text of the treaty.[212] As provided by Article 31(4) VCLT, the parties may attribute a "special meaning" to a term of the treaty,

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[208] I. Brownlie, *Principles of Public International Law*, 4th Ed., Clarendon Press, Oxford, 1990, p. 627.

[209] In Germany, e.g. the Federal Fiscal Court [*Bundesfinanzhof*] did not allow an interpretation against the wording of the treaty. DE: 1965 BStBl III 258 (BFH 1965) cited in C. Heber and C. Sternberg, *Chapter 6: Germany* in: R. van Brederode and R. Krever (eds), *Legal Interpretation of Tax Law*, Kluwer Law International, BV the Netherlands (2014), p. 185. Accordingly, in France, e.g. the Conseil d' État does not only give more relevance to the literal interpretation, but in fact it provides that the result of the literal interpretation is absolutely irrelevant. This is to say, the literal interpretation should be applied even if it deprives the taxpayer from a legitimate advantage or if it grants an advantage to the taxpayer that was not foreseen by the negotiators of the treaty. *See* D. Gutmann, *Tax Treaty Interpretation in France* in: M. Lang (ed), *Tax Treaty Interpretation*, Linde, Vienna, 2001, p. 109.

[210] Vogel and Rust, *supra* n. 26, Introduction at m.no. 85.

[211] Id., Introduction at m.no.82.

[212] Id., Introduction at m. no. 83.

which will thus reflect the intention of the Contracting States.[213] However, what it is not acceptable is that an interpretation intends to presume what the parties wanted, even if the strict interpretation of the wording carries out a non-logical result.[214] In other words, the purpose shall influence the interpretation in a manner of giving light of the terms of the treaty, but it will be subordinated to the text of the treaty and it will not constitute and independent mean of interpretation.[215] This approach by which the text of the treaty must be the dominant consideration has been criticized by some authors, because indeed Article 31 of the VCLT does not establish any clear weight that should be given either to the text, the context or the purpose of a treaty.[216] In other words, nothing would prevent a judge or other interpreter, e.g. to conclude that a treaty provision is reasonably clear that it must be applied without regard to the context and purpose, or in contrast, that the purpose of a treaty justify an interpretation, stretching the words of a treaty or even ignoring them.[217] Arnold considers that this amplitude might not be

[213] Article 31(4) of the VCLT states: "A special meaning shall be given to a term if it is established that the parties so intended".

[214] In France, e.g. the Conseil d' État decided in 2000 to grant a French resident a tax credit with respect to the WHT paid on the interest derived from Italian State bonds. It turns out later that, derived from the literal interpretation of Article 22 of the 1958 France-Italian Income Tax Treaty, the tax credit granted was higher than the amount of foreign taxes effectively paid in Italy, contradicting the spirit of the convention. Regardless the above, the interpretation prevailed. *See* FR: CE, 3rd and 8th s.-s., 24 May 2000, req. no. 209 699 et rec. no. 209 891, CRCAM *Normand (Concl.), DF* no. 48, 2000, comm. 943, concl. Touvet cited in: Gutmann, *supra* n. 209, p. 110.

[215] Vogel and Rust, *supra* n. 26 , Introduction at m. no. 83.

[216] Arnold, *supra* n. 205, pp. 5-6.

[217] In *Thiel v. Federal Commissioner of Taxation,* the Australian Court clearly endorsed a "purposive" approach to the interpretation of the treaties. *See* AUS: *Thiel v. Federal Commissioner of Taxation* [1990] HCA 37; 171 CLR 338, cited in: R. Krever and P.

necessarily harmful and it could help the interpretative role of the judiciary.[218] After all, the work of the judges is essentially subjective and it could be improved if there are less strict rules of interpretation.[219] Likewise, he stresses that taxpayers and tax advisors generally prefer a literal interpretation due to a self-motivated interest, considering that they normally plan around or take undue advantage of rules read literally.[220] Nonetheless, Arnold does not offer sufficient argument neither to disregard certainty as a value itself in the interpretative process nor to assume that a literal interpretation must necessarily help a misconduct of taxpayers.

The mandate to interpret a tax treaty *in light of its object and purpose* also supposes that both authorities and courts of the Contracting States apply a consistent interpretation. This is to say both Contracting States should seek the treaty interpretation that is most likely to be accepted in both States, also

Mellor, *Chapter 2: Australia,* in: R. van Brederode and R. Krever (eds), *Legal Interpretation of Tax Law*, Kluwer Law International, BV the Netherlands (2014), p. 42. Similarly, in the famous *Glaxo case* in Japan, the Supreme Court did not only attend the text of Article 7 of the Japan-Singapore Income Tax Treaty to consider that the application of the Japan's CFC rules were not prohibited or restricted, but included a whole examination of the CFC rules and their compatibility with the object and purpose of the treaty. The Court found that the CFC contained various exemptions for genuine activities and also a tax credit if the CFC rule was triggered. As the Japan's CFC rule was regarded as reasonable as a while, the Court concluded that it did not impede Singapore's taxation according to Article 7 of the Japan-Singapore Income Tax Treaty. *See* JP: Supreme Court, 29 October 2009, Glaxo, Minshu, Vol. 63 No. 8, 1881 cited in: Y. Masui, *Chapter 9: Japan,* in: R. van Brederode and R. Krever R. van Brederode and R. Krever (eds), *Legal Interpretation of Tax Law*, Kluwer Law International, BV the Netherlands (2014), p. 257.

218 Arnold, *supra* n. 205, pp. 5-6.

219 Id.

220 Id., p. 7.

known as "common interpretation".[221] This does not mean that a State must simply accept the case law of the other State without reviewing it, but to research and evaluate his reasoning.[222] This reasoning has been taken to the extreme of considering that a common interpretation means to achieve a similar result using a similar method of interpretation. The aim seems to be that both countries give the same meaning to a tax treaty, avoiding a different interpretation that could lead to situations of double taxation or DNT. Nevertheless, it is obvious that the common interpretation is concerned with the result of the interpretation and not with the method of interpretation used.[223] Accordingly, nothing can guarantee that the use of the same method of interpretation will produce the same result.[224]

With respect to the *context* of the treaties, it should be noted that it includes any related completed document made in connection to the treaty, including notes and letters exchanged when the treaty was signed.[225] It also includes the preamble of the treaty. However, any "accompanying materials", i.e.

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221 Vogel and Rust, *supra* n. 26, Introduction at m. no. 90 and m.no. 92.

222 Id. Introduction at m no. 90. Likewise, Masui recognizes the influence that foreign court cases had in the *Glaxo case* in Japan (e.g. the *Schneider Electric* case decided by the French Conseil d' État), regardless none of these cases were formally cited in the decision of the Supreme Court of Japan, which is nevertheless a generalized practice: Courts in Japan never cite foreign tax cases in tax decisions. *See* Masui, *supra* n. 217, p. 258. *See also*, FR: Conseil d' État, 28 June 2002, Case No. 232276, *Schneider Electric*, RJF 10/02, no. 1080. For an analysis of the case, *see* e.g. P. Dibout, *L'inapplicabilité de l'article 209 B du CGI face à la convention fiscal franco-suisse du septembre 1966*, 36 Revue de Droit Fiscal (2000), p. 1133-1141.

223 Arnold, *supra* n. 205, p. 11.

224 Id.

225 Vogel and Rust, *supra* n. 26, Introduction at m.no. 85.

materials created during the negotiation of a treaty, supporting documents, position papers, etc. may only be referred to as a supplementary source and inasmuch they confirm the interpretation made under Article 31 of the VCLT or in case of doubts.[226] Nevertheless, "technical explanations", like the ones normally released by the US Treasury Department after the negotiation of a tax treaty by the United States, or any other type of explanation post-negotiation is regarded neither as part of the context of the treaty nor as accompanying materials, and they thus cannot be used for interpretation purposes.[227]

Let me finally make some brief remarks regarding the term *good faith*, which is normally read in conjunction with the rest of Article 31(1) of the VCLT without any special connotation,[228] although it is one of the cornerstones of public international law.[229]

Article 31(1) VCLT mandates that a tax treaty shall be interpreted in *good faith* according to the ordinary meaning, the context and the object and purpose of a treaty. This Article does not give any hints to what *good faith*

[226] Id. Introduction at m.no. 86.

[227] Id.

[228] *See*, e.g. K. Vogel and R. Prokisch, *General Report* in: Cahiers de droit fiscal international—Vol. LXXVIIa, *Interpretation of Double Taxation Conventions* (IFA 1993), pp. 55-85.

[229] *See* L. De Broe, *International Tax Planning and Prevention of Abuse*, Doctoral Series IBFD, Vol. 14, Amsterdam (2008), p. 240. *See also,* K. Olenik, *Tax Treaties and the Recourse to Historical Interpretation under the Vienna Convention on the Law of Treaties*, in: T. Ecker and G. Ressler (eds.), *History of Tax Treaties. The Relevance of the OECD Documents for the Interpretation of Tax Treaties,* Linde, Vienna (2011), p. 69.

means.[230] However, for the majority of the scholars, *good faith* in the interpretation of tax treaties means that a treaty must be interpreted honestly, fairly and reasonably and in accordance with the common interpretation of the parties as expressed or implied in the tax treaty.[231] The most important manifestation of the good faith is in fact the general rule of international law *"pacta sunt servanda"* codified in Article 26 VCLT,[232] an interpretation that it is reaffirmed by the jurisprudence of the ICJ[233] This element of "reasonableness" applies to the entire process of interpretation, although it finds its limitations in the creation of new obligations which are no longer covered either by the wording of the treaty or the intention of the parties.[234] Therefore, the principle should act only in a way to clear up ambiguous wording in a treaty, and not to create new obligations. In other words, it works only as a principle lending contours.[235]

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[230] N. Shelton, *Interpretation and Application of Tax Treaties*, Lexis Nexis, London (2004), p. 167.

[231] Id., p. 242. *See also*, F. Engelen, *Interpretation of Tax Treaties under International Law,* Doctoral Series No. 7, IBFD (2005), pp.131-132.

[232] Article 26 of the VCLT states: "Every treaty in force is binding upon the parties to it and must be performed by them in *good faith* (emphasis added)".

[233] In the 1997 *Gabcikovo-Nagymaros case*, the ICJ stated: "This latter element [good faith], in the Court's view, implies that […]it is the purpose of the Treaty, and the intention of the parties concluding it, which should prevail over its literal application. The principle of good faith obliges the parties to apply it in a reasonable way and in such a manner that its purpose can be realized". *See* International: *Case Concerning the Gabcikovo-Nagymaros Project (Hungary/Slovakia)*, Judgment of 25 September 1997, I.C.J. Reports 1997, p. 76. *See also* a reference to the case in: De Broe, *supra* n. 229, p. 241. The Commentary on Article 31 of the VCLT also sustains that good faith "flows directly from the rule *pacta sunt servanda*". *See* United Nations, *Yearbook of the International Law Commission*, *Vol.* II, New York, 1967, p. 221-§12.

[234] S. Reinhold, *Good Faith in International Law*, Bonn Research Paper on International Law, Paper No. 2 (2013), p. 20.

[235] Id.

2.2. Supplementary Means of Interpretation

Article 32 of the VCLT represents an attempt to limit the use or influence of supplementary materials, specially *preparatory work*, that are considered less authentic than the one provided in Article 31.[236] In fact, at the Vienna Convention's conclusion the United States proposed to remove the apparent hierarchy of sources between Article 31 and 32 and proposed to combine both articles, giving therefore more scope to preparatory work and the circumstances in which the treaty was concluded.[237] This proposal received little support.[238] In contrast, the distinction was justified since the elements of interpretation in Article 31 relate to an agreement between the parties at the time when or after it receives authentic expression in the text, while preparatory work, e.g. did not have the same authentic character.[239]

According to Article 32 of the VCLT, supplementary materials can be considered basically in three circumstances: a) to confirm the meaning resulting from the application of Article 31; b) where, after applying Article 31, the meaning of the provisions at issue is still ambiguous or obscure, and c) where the application of Article 31 leads to a result which is manifestly absurd or unreasonable.[240] Nevertheless, the structure of Article 32 is not exempt from criticism. First, unless the interpretation of Article 31 leads to

[236] Arnold, *supra* n. 205, p. 7.
[237] Brownlie, *supra* n. 208, p. 628.
[238] Id.
[239] Id.
[240] Article 32 of the VCLT.

an ambiguous, obscure, absurd or unreasonable result, the application of Article 32 will be generally dismissed. This is because the remaining alternative would be to use the supplementary material to confirm the interpretation of Article 31, but what if that interpretation is not confirmed? There is no manner to resort to Article 32, unless there is an ambiguous, obscure, absurd or unreasonable interpretation under Article 31. Therefore, an unambiguous, clear, not absurd and reasonable interpretation of a provision of a tax treaty according to Article 31, which is not confirmed under the preparatory work of Article 32, will be anyway acceptable. Second, the distinction between supplementary materials and other more authentic materials is not always clear. This is especially relevant in the case of the OECD Commentaries on the OECD Model and its value as preliminary work, an issue that will be analyzed in more details in the subsequent Section of this Chapter.

2.3. The interpretative role of the OECD Model and its Commentaries

The legal basis for reference to the OECD Model and its Commentaries as an aid to interpret a specific tax treaty is far from being settled. If we strictly analyze the rules of interpretation of Article 31 of the VCLT explained in the Section above, we might conclude that the Commentaries do not fit into any of these categories. After all, Commentaries on a MC are not made in connection with a negotiated tax treaty, which is indeed a unique

instrument.[241] Likewise, it is arguable if they could be considered as supplementary means of interpretation under Article 32 of the VCLT, because the OECD Model and its Commentaries are neither an instrument made in connection with the conclusion of a treaty nor *preparatory work* used or produced in preparing an individual treaty.[242] An alternative, however, to overcome these formal constrains and the bridge created between Article 31 and 32 of the VCLT could be through the use of Article 31(4) of the VCLT.[243] As proposed by Ault, the terms contained in the OECD Commentaries could be regarded as a special meaning when interpreting the provisions of a tax treaty, which can be especially relevant in the case of OECD member countries.[244] Then, the OECD Commentaries would represent a sort of "default rule", which would reflect the intention of the Contracting States.[245] In accordance to this interpretation, it would be presumed that OECD member countries wanted to convey the meaning

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241 *See*, P. Baker, *Double Taxation Conventions*, Sweet & Maxwell, London (2014), p. E-13. *See also*, H. D. Rosenbloom, *Current Developments in regard to Tax Treaties*, 40 N.Y.U. Inst. on Fed. Tax'n §31 (1982).

242 Supporting the view that the OECD Commentaries cannot be regarded as preparatory work, *see* e.g. E. Reimer, *Tax Treaty Interpretation in Germany,* in: M. Lang (ed.), *Tax Treaty Interpretation*, Linde, Vienna, 2001, p. 135. Reimer sustains that German case law and legal theory do not consider the OECD Commentaries neither as a genuine source of international law (thus being regarded as not binding documents) nor as preparatory work as per Article 32 of the VCLT. Conversely, in *Thiel v. Federal Commissioner of Taxation* in Australia, there is a clear reference to the OECD Commentaries as "supplementary means of interpretation" for the purposes of Article 32 of the VCLT. *See* Krever and Mellor, *supra* n. 217, p. 42.

243 For the complete analysis, *see* H. Ault, *The Role of the OECD Commentaries in the Interpretation of Tax Treaties*, Intertax 4 (1994), pp. 144-148.

244 Id., p. 147.

245 Id.

intended in the OECD Model and its Commentaries,[246] being such a meaning a *special meaning* according to Article 31(4) of the VCLT.[247] This conclusion should not discard the possibility of the States to make reservations or observations to the Commentaries.[248] A similar presumption would arise if the text of the OECD Model is not adopted literally, but a formulation is chosen that permits an interpretation according to the OECD Model or if the text of the provision is identical to the OECD Model, but a related provision that differs from it suggest a different interpretation.[249]

Giving the OECD Commentaries a special meaning carries out two important consequences. On one hand, it is the possibility of relying on the OECD Commentaries as a sort of "official interpretation" (OECD countries) or at least as an important official guidance of interpretation (non-OECD members). On the other hand, it is the possibility of recognizing the OECD Commentaries a certain binding character, mostly for OECD members. Let me refer to both issues in a separate manner.

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[246] Id.

[247] Id., p. 146. *See also*, Vogel and Rust, *supra* n. 26, Introduction at m.no. 101.

[248] Vogel and Rust, *supra* n. 26, Introduction at m.no. 103. Reimer, on the contrary, is very critic on this matter, because he considers that the ordinary meaning under Article 31(1) of the VCLT cannot depend on the lack of such observations. Thus, the issue is to understand that the ordinary terms of a treaty, as the terms used by the OECD, would imply a sort of pre-legal understanding, i.e. some sort of everyday meaning of the words used by a treaty. Likewise, Article 31(4) of the VCLT (special meaning) is not a reliable source either. It requires a consensus between the Contracting parties and a mere observation (unilateral act) would not qualify for that. *See* Reimer, *supra* n. 242.

[249] Vogel and Rust, *supra* n. 26, Introduction at m.no. 101. *See also*, Ault, *supra* n. 243.

With respect to the first consequence, there are almost no doubts regarding to the important guidance that the OECD Commentaries have in solving tax treaty cases in practice for both OECD and non-OECD members. An interesting example from non-OECD members can be found in the famous cases of *Eagle I* (2006) and *Eagle II* (2008), regarding the application of Brazilian CFC rules and the compatibility with Article 7 and 10 of the Brazil-Spain Income Tax Treaty.[250] In this case law, the Brazilian Courts emphasized the role of the OECD Commentaries as a "useful tool to help in the interpretation [of tax treaties]" and of "great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes".[251] This issue has special importance considering that Brazilian Courts normally refer neither to the VCLT nor to the OECD Commentaries when solving tax treaty cases.[252] Also one should consider that Brazil has been trough a long process to become a member of the

[250] Brazil: Brazilian Administrative Council of Tax Appeals, Judgment No. 101-95.802 – *Eagle I*– and Brazilian Administrative Council of Tax Appeals, Judgment No. 101-97.070 – *Eagle II*–. For a further reference to *Eagle I* case law *see,* e.g. A. Júnior, *Caso Eagle 1: Interpretação das Normas Brasileiras de Tributação de Lucros e Rendimentos oriundos do exterior pelo CARF,* in: L. Freitas de Moraes e Castro and A. Ribeiro (eds.) *Tributação Internacional: análise de casos*, MP Editora, São Paulo (2010), pp. 259-278. For a further reference to the *Eagle II* case law in Brazil *see,* e.g. L. Freitas de Moraes e Castro, *Brazilian CFC Rules: Background and Status After Eagle II Case*, 18 Latin America Law & Business Report 3 (2010); R. Da Silveira, *Case Eagle II: Tributação de auferidos no exterior em virtude de participação societária*, in: L. Freitas de Moraes e Castro and A. Ribeiro (eds.), *Tributação Internacional: análise de casos*, MP Editora, São Paulo (2010), pp. 279-304. *See also*, L. Parada, *A Comparative Analysis of CFC Regimes in Latin America*, 68 Tax Notes Int'l 10 (2012), pp. 968-971.

[251] L. Schoueri, *Chapter 3: Brazil*, in: R. van Brederode and R. Krever (eds.), *Legal Interpretation of Tax Law*, Kluwer Law International, BV the Netherlands (2014), p. 69.

[252] Id.

OECD. The above, however, does not imply that the OECD Model and its Commentaries have a very limited importance with respect to non-OECD countries.[253] The weight given to the Commentaries will, nevertheless, depend on a case-by-case analysis.[254]

Nevertheless, the practical value that the OECD Commentaries can have for interpretative purposes should not drive us, at least not immediately, to conclude that they must be regarded as legally binding documents. In other words, the presumption that OECD countries wanted to convey the meaning of the OECD Model, being that meaning either ordinary or special, does not grant *per se* a binding character to the OECD Commentaries. [255] There is no doubt that a binding character of the OECD Commentaries might positively help in providing a coherent and perhaps more uniform interpretation of tax treaties, mostly among OECD members; however, there is no evidence that prove their binding nature neither upon OECD members States nor upon non-OECD members States.[256] On the contrary, the non-binding character of

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253 Vogel and Rust state that the OECD Model and its commentaries are less important, although not irrelevant. The above can be seen, e.g. in the similitude between the UN Model used by developing countries and the OECD Model. Vogel and Rust, *supra* n. 26, Introduction at m.no. 104.

254 Id.

255 R. Prokisch, *Fragen der Auslegung von Doppelbesteuerungsabkommen*, 4 SWI 52 (1994).

256 D. Ward et al. state: "There is no consensus concerning the application of Articles 31 and 32 of the VCLT as regards to the OECD commentaries. This undoubtedly arises because the commentaries in the OECD Model are, as we discuss below, not intended to be binding and are unique as they do not relate to an actual treaty but to a Model treaty, which also is non-binding". D. Ward et al., *The Interpretation of Income Tax Treaties with Particular Reference to the commentaries on the OECD Model*, IBFD, Amsterdam (2005), p. 18. Likewise, e.g. Pijl states: "The Commentary cannot be considered to be a

the OECD Commentaries is specifically ratified within the text of the OECD Model, when Paragraph 3 of its introductory chapter provides: "Member countries, when concluding or revising bilateral conventions ***should*** conform to this Model Convention as interpreted by the Commentaries […]" (emphasis added).[257] Accordingly, Paragraph 29 remarks the auxiliary character of the commentaries and its non-binding nature when it establishes: "Although the Commentaries are not designed to be annexed in any manner to the conventions signed by the Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of

binding source of international law. It is a legally non-binding document, which has no bearing on the State as a whole, and only creates a moral obligation for the executive". *See* H. Pijl, *The OECD Commentary as a Source of International Law and the Role of the Judiciary*, 46 Eur. Taxn. 5 (2006), Journals IBFD, p. 224. Also, Engelen, although supporting a theory that the OECD members and parties of a treaty would be bound by conduct to interpret and apply a treaty in accordance with the commentaries, recognizes that the commentaries "as such" are not binding on the OECD member countries when he says: "[W]hether the Commentaries *as such* are legally binding on the OECD members countries, I fully endorse Mr. Ward's view that it should be answered in the negative". F. Engelen, *Some Observations on the Legal Status of the Commentaries on the OECD Model*, 60 Bull. Intl. Taxn. 3 (2006), Journals IBFD, p. 105. Regarding non-OECD members, it is evident that the commentaries are "less important". *See* Vogel and Rust, *supra* n. 26, Introduction at m. no. 104. Conversely, Baker considers that the OECD commentaries can be relevant, even for non-OECD members, when it is clear that the specific treaty has been concluded based on the OECD Model. *See* P. Baker, *supra* n. 241, p. E-19. In a recent article, West analyses the relevance of the OECD Commentaries in those cases in which a treaty or a protocol expressly referred to them as an interpretational rule. Although he recognizes that this would not change the non-binding nature of the Commentaries, it could certainly help as a "soft law" tool to resolve constitutional conflicts that can appear in case the Commentaries are used as an ambulatory interpretation rule. For a further analysis, *see* C. West, *References to the OECD Commentaries in Tax Treaties: A Steady March from "Soft" Law to "Hard" Law?*, 9 World Tax J. 1 (2017), Journals IBFD.

[257] OECD Model Tax Convention and Commentaries (2014), Para. 3, Introductory Chapter.

the conventions and, in particular, in the settlement of any disputes".[258] Likewise, the Recommendation of the OECD Council concerning the MC (1997), simply provided a "recommendation" to the members countries to conform to the MC and that the tax administrations follow the commentaries when interpreting the OECD Model, but in any case it settle an obligation to do so. Therefore, the OECD Commentaries can create only a moral or "soft" obligation for these countries in order to follow them for interpretative reasons, but in any case they are bound to do so.[259] This conclusion has also special relevance to discard the idea that due to the widespread acceptance of the OECD Model and its Commentaries, they can constitute a sort of customary international tax law.[260]

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[258] Id., para. 29, Introductory Chapter.

[259] The interpretational use of the OECD commentaries cannot be considered as State practice either. They could constitute State practice in one moment, but this issue will depend of the subsequent judicial practice. *See* Pijl, *supra* n. 256, p. 220.

[260] A full analysis on this matter certainly exceeds the purpose of this Chapter. However, it is worth to mention that the formation of customary law implies the concurrence of two constitutive elements: State practice or *usus* and *opinion juris*. Whilst the first implies that a number of States contribute, actively or passively towards the customary international rules, the latter supposes the conviction of a State that is following certain practice accepted as law. *See* International: Statute of the International Court of Justice, Article 38(1)(b). Therefore, even if the OECD Commentaries are generally used and accepted for interpretation purposes, their non-binding nature would imply the absence of *opinion juris,* i.e. a necessary element for the formation of customary law. The importance of the *opinio juris* in the formation of customary law has been widely recognized by the international public law doctrines as well as for the jurisprudence of the International Court of Justice (ICJ). *See*, e.g. Brownlie, *supra* n. 208; B. Lepard, *The Necessecity of Opinio Juris in the Formation of Customary International Law*, Discussion Paper for Panel on "Does Customary International Law Need *Opinio Juris?"*, pp.2-4; M. Mendelson, *The Subjective Element in Customary International Law*, 66 British Yearbook of International Law1 (1995), p. 208; F. Parisi, *The Formation of Customary Law*, George Mason Law & Economics Research Paper No. 01-06, p. 5 available at SSRN. Conversely, however, in 2000 the International Law Association (ILA) elaborated a concept of customary international law excluding the

Some authors have, however, insisted in supporting the binding nature of the OECD Commentaries and their interpretative value based on the international public law doctrines of acquiescence and estoppel.[261] The Encyclopedia of Public International Law defines *acquiescence* as "the proposition of binding effect resulting from passivity and inaction with respect to foreign claims which, according to the general practice of States, usually call for protest in order to assert, preserve of safeguard rights".[262] Thus, acquiescence, which finds expression in the adage "*qui tacet consentire videtur si loqui debuisset ac potuisset",* means the act of implying consent to a certain fact by remaining silent.[263] By other side, the principle of *estoppel*, very similar to the Roman law principles of *non licet venire contra factum proprium* and *allegans contraria non audiendus est,* attends to the effect that a person who represents a fact to another who in turns alters his position in reasonable reliance on such representation may

element *opinio juris*. The report declared that a rule of customary law "is one which is created and sustained by the constant and uniform practice of States and other subjects of international law in or impinging upon their international legal relations, in circumstances which give rise to a legitimate expectation of similar conduct in the future". *See* International Law Association, *Statement of Principles Applicable to the Formation of General Customary International Law,* adopted by Resolution No. 16/2000, London Conference, 2000, Section 1(i), p. 8.

261 Engelen, *supra* n. 256.

262 J. P. Müller & T. Cottier, *Aquiescence*, in: R. Bernhardt (ed.), Encyclopedia of Public International Law, Volume I (1992), p. 14.

263 Id, p.106. The I.C.J. has recognized the principle of acquiescence in, e.g. International: *Case Concerning the Delimitation of the Maritime Boundary in the Gulf of Maine Area (Canada v United States of America)* (Merits), Judgment of 12 October 1984, I.C.J. Rep 305.

not deny that the fact exists.[264] In other words, under the principle of estoppel a party is not permitted to take up a legal position that is in contradiction with its own previous representations or conduct, when another party has been led to assume obligations towards, or attribute rights to the former party in reliance upon such representations or conducts. For example, if State A relies on the conduct of State B, this latter State is precluded to act contrary to its representation. If State B acts contrary to this representation, it is acting without good faith and contrary to international law.[265] Thus, both acquiescence and estoppel are principles based in *good faith*,[266] although differing in the components of time and reliance.[267] While acquiescence is that passivity in relation to a right of another State to the extent that good faith affords the passivity the character of consent, estoppel hinges on previous presentations.[268] In this order of ideas, if OECD (and non-OECD) countries have not made an observation on the interpretation of the provisions of the OECD Model as set out in the commentaries, when concluding or revising a tax treaty, it would mean that the countries have acquiesced in that interpretation and it becomes legally binding, being a sort of tacit agreement to interpret the provisions of the treaty as per the OECD Model and its Commentaries.[269]Accordingly, if there are any doubts as to the parties' acceptance of the OECD Commentaries, the countries are

[264] Engelen, *supra* n. 256, p. 106.
[265] Reinhold, *supra* n. 234, pp. 13-14.
[266] *Supra* Section 2.1.
[267] Id.
[268] Id.
[269] Engelen, *supra* n. 256, p. 109.

estopped or precluded from denying such acceptance.[270]

The application of the doctrines of acquiescence and estoppel, as explained above, seem to be inappropriate to justify a binding character of the OECD Commentaries, mostly considering their contradictory results.[271] Indeed, if the principle of acquiescence were applied, it would force countries that did not make observations to the Commentaries to tacitly accept the effects of their interpretation, recognizing a sort of official interpretation that might in fact jeopardize the rule of *pacta sunt servanda*. This conclusion would contradict the international tax treaty practice, which demonstrates that OECD members not always enter an observation when they disagree with the OECD Commentaries,[272] but sometimes these observations are simply not required. The latter situation can be easily demonstrated through the history of the MCs and its Commentaries. In fact, many times the OECD Commentaries have been modified in order to include the predominant opinion of the OECD members, which means that in those cases the OECD

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270 Engelen, *supra* n. 256, p. 106.

271 This issue has been extensively analyzed somewhere else. For this purpose, *see* Pijl, *supra* n. 256.

272 Ward et. al. provides the example of paragraph 7 of Article 1 of the 1977 OECD Model. The text of paragraph 7 which, although recognizing that taxpayers have the possibility of exploiting tax differences between States, left the door open to include domestic laws in order to counteract potential abusive situations, i.e. anti-abuse rules. Despite the dissenting views regarding the fact that anti-abuse rules should be confirmed in the treaty texts (the majority opinion argued that no reference in the treaty should be made), no observations were made after the 1992 OECD Commentaries that expressly recognized the majority opinion in paragraph 24 of Article 1. Ward et al., *supra* n. 256, pp. 49-50.

members departed from the Commentaries, but no observation was needed.[273] The above conclusion does not diminish the value of the OECD Commentaries in the interpretative process, but simply reaffirm that they cannot be considered as legal binding documents.[274]

Similar concerns should exist with respect to the application of the principle of estoppel to justify the binding character of the OECD Commentaries. If two countries agree on a tax treaty based on the OECD Model and its Commentaries, which both have accepted, they would be precluded from denying such acceptance, even if such acceptance comes in a tacit manner, e.g. if the tax treaty follows exactly the provisions of the Model Convention. Nevertheless, one should not confuse the existence of a soft obligation derived from the OECD Commentaries as an interpretation of the OECD Model with the real rights and obligation derived from the negotiated tax treaty itself and based in the international law rule of *pacta sunt servanda*. Could the parties be really precluded of denying the acceptance of the OECD Commentaries when, in fact, this document never created legal rights or obligations to the parties? To justify the binding character of the OECD Commentaries based on the principle of estoppel seems to go to far, mostly considering its restrictive application in the field of international public law.
Few words should be finally said regarding the different versions in time of the OECD Commentaries and their use for interpretation purposes. The

[273] Id., p. 51.
[274] Id.

majority of the international tax scholars agree that the version of the OECD Model and its Commentaries at the time of the conclusion of a tax treaty is the only one that can be considered for interpretation purposes.[275] This implies that further changes[276] to the OECD Commentaries should not affect the interpretation of a specific tax treaty concluded before those changes entered into force. This approach is particularly relevant considering that the OECD Commentaries can represent the ordinary meaning of a treaty between two OECD members under Article 31(1) of the VCLT or, at least, they could convey a special meaning under Article 31(4) of the VCLT.[277] This conclusion has logic since the only version to which the negotiator of a tax treaty had access was the one existing at the time of the conclusion of a treaty.

[275] Vogel and Rust, *supra* n. 26, Introduction at m.no. 105. *See also*, M. Lang, *supra* n. 21, p. 50.

[276] But not all changes of the OECD Commentaries will have legal effects. For example, a change in the language to make the English or French more alike will have no legal significance. *See* Vogel and Rust, *supra* n. 26, Introduction at m. no. 106

[277] Ault also coincides with this static view when he says: “A later-arising special meaning would be hard to conceive. Thus at least with respect to some terms, if the Commentaries are to be used, it must be on a static basis”. Ault, *supra* n. 243, p. 148.

2.4. The reference to Domestic Law: Article 3(2) of the OECD Model

Article 3(2) of the OECD Model provides a general rule of interpretation that allows referring to domestic law in case any *term*[278] is not defined in a tax treaty, unless the context otherwise requires.[279] The reference to domestic law of the Contracting States (known as *lex fori*) has logic since a tax treaty is negotiated with the domestic laws of the Contracting States in mind and tax treaties exist in order to coordinate these two tax jurisdictions, limiting their taxing powers by the treaty.[280] Accordingly, it also provides practical advantages, because it prevents the overloading of tax treaties with definitions that would render its application difficult,[281] as well as it increases legal certainty.[282] However, one should also recognize that Article

278 The use of "term" should be interpreted in a manner wider than just "words". At least this should be justified in the fact that many times the governing language of a treaty is not the one of the domestic law, and even in some cases it is a third language, commonly English, that takes precedent. In this latter case, as provided by Avery Jones, "a third language will never be found in either State's domestic laws, and so the "term" must be wider than just words. *See* J. Avery Jones, *The Interaction between Tax Treaty Provisions and Domestic Law*, in: G. Maisto, *Tax Treaties and Domestic Law*, EC and International Tax Law Series Vol. 2, IBFD (2006), p. 134.

279 Article 3(2) of the 2014 OECD MODEL was modified in 1995 and according to the 2014 OECD Model, it provides: "As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State".

280 Arnold, *supra* n. 205, p. 9.

281 Instead, taxpayers, administrative authorities and courts can keep the meaning of a term as it is already known in domestic law. *See* Vogel and Prokisch, *supra* n. 228, p. 77

282 As provided by Avery Jones: "Article 3(2) was a brilliant solution. The result is that in any case where the treaty relieves a category of income from tax, the relief corresponds

3(2) contradicts the primary goal of a "common interpretation" of tax treaties, increasing also the possibilities of different interpretations and qualification conflicts.

Generally speaking, Article 3(2) of the OECD Model is applied with certain limitations. Firstly, it only covers the interpretation of the *terms* used in a tax treaty. [283] Therefore, the provision does not apply to use principles of domestic law in the interpretation of tax treaties or to clarify unclear passages of a treaty itself.[284] Furthermore, Article 3(2) of the OECD Model it is possible to conclude that if the terms of the treaty have no particular or established legal meaning under domestic laws, or a term is used in private law only, then the resort to domestic law would not be possible.[285] It is also important to note that Article 3(2) of the OECD Model refers exclusively to

exactly with the internal law taxing provision. This is far more important than that the treaty category of income has the same scope in each State; the internal law charging provisions are most unlikely to be the same either. Indeed, the result of relying on internal law definitions is superior to the treaty containing a definition of a type of income, which may well be different from the internal law definition used for taxing the income". *See* Avery Jones, *supra* n. 278, p. 125.

283 A. Rust, in: Reimer and Rust (eds.), *Klaus Vogel on Double Taxation Conventions*, 4th edn (2015), Article 3(2) at m.no. 111.

284 Id.

285 In *Thiel v. Federal Commissioner of Taxation*, e.g. the High Court of Australia rejected an interpretation of the terms "enterprise" and "profits", because these terms did not have any particular or established meaning under Australian domestic law. See *Thiel v. Federal Commissioner of Taxation,* cited in: Krever and Mellor, *supra* n. 217. A similar reasoning can be found in the Dutch case *Hoge Raad*, where the Supreme Court said that Article 3(2) of the OECD Model could not be applied to interpret a term that is not used in a similar context under the domestic law. *See* NL: Decision of the Dutch Supreme Court *Hoge Raad,* 1 Dec. 2006, BNB 2007/75-79 cited in: A. Bosman, *Casualty under Tax Treaties*, 44 Intertax 5 (2016), p. 393.

the meaning of the terms that the Contracting State applying the treaty give at the moment the treaty is applied and not when this is concluded.[286] Secondly, the provision only refers to the law of those taxes covered by the convention, excluding thus any reference to private or tax law regarding taxes not included, e.g. VAT. Likewise, it is clear that when a term has a meaning for tax law purposes, while a different one for another field of law, the former prevails.[287]

The reference to domestic law is conditioned by the expression *unless the context otherwise requires* used in Article 3(2) of the OECD Model, which means that the *renvoir* to the domestic law under Article 3(2) is limited by the interpretation derived from the context of the treaty. In this regard, one should not consider the term *context* in the same manner as it is used for purposes of Article 31(2) of the VCLT. Indeed, the function of the term *context* is completely different in both provisions.[288] For many authors the use of *context* under Article 3(2) of the OECD Model has a wider meaning than the one in Article 31(2) of the VCLT, which helps in avoiding the inappropriate use of domestic law definitions.[289] As provided by Helminen, the context under Article 3(2) of the OECD Model is clearly indicating situations in which the contextual meaning should prevail over the *lex fori*

[286] Rust, *supra* n. 283.
[287] Id.
[288] Vogel and Prokisch, *supra* n. 228, p. 82.
[289] J. Avery Jones, *United Kingdom*, in: Cahiers de droit fiscal international–Vol. LXXVIIa, Interpretation of Double Taxation Conventions (IFA 1993), p. 610.

meaning as per Article 3(2) of the OECD Model,[290] even though one should stress that it is not possible to extract from the reading of the Article 3(2) any kind of preference or hierarchy for interpretation from the context.[291] Thus, the term context should be widely interpreted to include any materials that indicate that the *lex fori* meaning is not consistent.[292] The case law *Padmore v. IRC* in the United Kingdom is a good example of the application of the above.[293] The issue in this case was that the treaty between UK and Jersey defined the term "person" including any "body of persons, corporate or not corporate". However, English law expressly excluded Partnerships from the concept of "body of persons". The Court concluded that the context required that the internal law be not used, because the context required otherwise.[294] Likewise, in *Estate of Burghardt v. Commissioner*, regarding the US-Italy Estate Tax Treaty, the Court ruled that as neither the IRC nor the Treasury Regulations use the term "specific exemption" in the Estate Tax Area, the term should be interpreted in the context of the treaty and not by other rules of domestic law.[295]

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[290] M. Helminen, *Tax Treaty Interpretation in Finland*, in: M. Lang (ed.), *Tax Treaty Interpretation*, Linde, Vienna (2001), pp. 84-86.

[291] Rust, *supra* n. 283, Article 3(2) at m. no. 121.

[292] Id. *See also*, Helminen, *supra* n. 290.

[293] UK: *Padmore v. IRC* [1989] STC 493.

[294] J. Avery Jones, *Tax Treaty Interpretation in the United Kingdom*, in: M. Lang (ed.), *Tax Treaty Interpretation*, Linde, Vienna (2001), p. 369.

[295] US: US Tax Court of 11 April 1983, No. 20766-81, *Estate of Burghardt v. Commissioner*, 80 T.C. 705 (1983).

Some tax scholars have interpreted Article 3(2) of the OECD Model in a way by which this provision should be applied only to the extent that no other solution can be derived from the tax treaty itself.[296] Lang explains this restrictive interpretation with the example of the concept of "business profits" under Article 7 of the OECD Model. He states that the fact this term is not defined anywhere in the OECD Model does not mean that one should resort immediately to domestic law in order to get the answer.[297] On the contrary, based on the systematic, theological and historical factors of the treaty, one should arrive to the conclusion that the concept of business profits applies to income from activities that are not services of where there is a significant capital expenditure.[298] Nevertheless, Lang's arguments seem to be not that convincing, mostly considering the wording of Article 3(2) of the OECD Model. Indeed, as noted already, the reference to domestic law is limited by the expression *"unless the context otherwise requires"* and not *"unless the context yields no other, or absolutely no other, interpretation"*.[299] Therefore, no every single interpretation from the context should give rise to a divergence with Article 3(2) of the OECD Model, but only those based on relatively strong arguments.[300] This also confirms what the author already stressed, which is that there is no priority for

[296] Rust disagrees with this conclusion when he states in reference to Article 3(2) OECD Model: "It is, on the other hand, itself a special rule of interpretation in relation to the general rules contained in the VCLT governing the interpretation of DTCs, as such, it takes precedence over those general rules". Rust, *supra* n. 283.
[297] Lang, *supra* n. 21, p 45.
[298] Id.
[299] Rust, *supra* n. 283, Article 3(2) at m.no. 122.
[300] Id.

interpretation from the context, at least not one that can be inferred from the wording of Article 3(2). Yet, one should recognize that the fewer the cases where domestic law is used to interpret treaty terms, the greater the probability that both States will try hard to interpret the treaty in its context trying to achieve a common understanding, which could also reduce the chances, e.g. for qualification conflicts.[301]

To sum up the preceding, Article 3(2) of the OECD Model sets up the following order for interpretation of terms used in the tax treaties: 1) a special definition in the tax treaty will be applied; 2) if no special definition exists, then the domestic law of the Contracting State applying the treaty (*lex fori*) must be applied to the extent it relates to the taxes covered by the treaty and only if the context otherwise requires; 3) if the interpretation from the context is strong enough, this should be used instead, although the resorting to the context is not automatic and it should be measured among with the alternatives interpretations; 4) if the context does not provide for a different interpretation, the general rules of interpretation should be applied.[302]

[301] M. Lang, *2008 OECD Model: Conflicts of Qualification and Double Non-Taxation*, 63 Bull. Intl. Taxn. 5 (2009), Journals IBFD, p. 206.

[302] Rust, *supra* n. 283, Article 3(2) at m.no. 125 and 126.

3. Double Non-Taxation and the OECD Model and its Commentaries

As already noted, the OECD Model is not an object of interpretation itself.[303] Nevertheless, it might be useful to analyze some of its provisions, normally included in tax treaties, and which at first glance might be interpreted in a manner of preventing DNT. This perception, however, may easily disappear when a closer look at these provisions is taken and an interpretation, as per the rules analyzed in Section 2, is applied. As follows, the author analyzes the following OECD Model provisions: a) The term *"liable to tax"* of Article 4 (1) OECD Model; b) the concept of *beneficial owner*; c) the Article 23A (1), and d) the Article 23A (4) OECD Model.

3.1. The interpretation of the term *"Liable to Tax"*

Article 4(1) OECD Model establishes that a resident, for purposes of a tax treaty, means any person who, under the law of that State, is "*liable to tax"* therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.[304] The meaning of the term *liable to tax* is, however, highly disputed. By one side, tax scholars interpret the term as including a person who is subject to actual taxation in the State of residence. This idea would support the assumption that tax treaties actually ensure single taxation or, which is the same, that they aim to avoid DNT. By the other side, commentators attribute to it the meaning of a person who is just

303 *Supra* Section 2.
304 Article 4 of the OECD Model Convention.

subject to full taxation (i.e. worldwide taxation), despite the fact that taxes might be effectively applied or not in that State. This latter interpretation, in the author's view, seems to be more in accordance with both the wording of the OECD Commentaries and the tax treaty practice. Some observations can be made in supporting this idea.

At first glance, the basic function of tax treaties is to allocate taxing rights and not to ensure that those rights are effectively exercised.[305] Indeed, there are no mechanisms within the OECD Model to carry out such a task, unless specific provisions have been included during the bilateral negotiation of a tax treaty.[306] In other words, once the treaty has allocated the exclusive right to tax certain item of income or capital to a Contracting State, that State keeps the right to exercise or not such right, not being even necessary the concurrence of double taxation for residents to claim treaty benefits. Such interpretation could, e.g. lead to an acceptable outcome of DNT, because it is a conscious decision of the Contracting State whether or not they enter

305 The above position has been repeatedly supported by the international jurisprudence. For example, in 2001, a decision of the *Cour Administrative in Luxembourg* sustained that: "[A] tax treaty is a bilateral instrument limiting each contracting state's right to tax by attributing the taxation right to one of the two contracting states. This limitation is, in principle, permanent and cannot be changed by one of the contracting states on the basis of the argument that the other contracting state does not make use of its taxation right". *See* LU: Cour adm., 27 juillet 2011, n°28115C du role.

306 Article 4(1)(b) of the 1989 tax treaty between India and the United States establishes, e.g. that the residence of partnerships, estates and trusts depends on their being *subject to tax* (actual taxation) either in their hands or in the hands of their partners. *See* Tax Convention between the Government of the United States of America and the Government of the Republic of India of 1 January 1991, Article 4 (1)(b).

into a tax treaty that leaves open the possibility of DNT.[307] In an example of the tax treaty practice, e.g. it is well known that Belgium does not tax capital gains realized neither by individuals nor upon shares realized by corporations.[308] If a State decides to enter into a tax treaty with Belgium, or any other country having a similar practice, and includes a provision such as Article 13(5) OECD Model, it is reasonable to expect that that State has examined or has at least been informed regarding this domestic practice.[309] Yet, if that State pursues in concluding the treaty, without any reservation that allows him to preserve its taxing rights in case income is not effectively taxed in Belgium, or both countries do not include any specific provision to ensure single taxation, one should simply conclude that DNT is a tolerated outcome. This fact does not contradict the object and purpose of the negotiated tax treaty. On the contrary, States normally enter into tax treaties with other States reputed as low-tax countries and they still decide to unconditionally forgive their taxing rights over income not taxed or low-taxed in those States.[310]

Accordingly, it is often understood that a person *liable to tax* is that who, by reason of various criteria (i.e. residence; domicile, etc.), is subject to

[307] R. Ismer and K. Riemer, in: Reimer and Rust (eds.), *Klaus Vogel on Double Taxation Conventions*, 4th edn (2015), Article 4 at m. no. 19.
[308] De Broe, *supra* n. 229, p. 359.
[309] Id.
[310] *See*, e.g. A. Martin Jiménez, *Domestic-Anti Abuse Rules and Double Taxation Treaties: A Spanish Perspective–Part I*, 56 Bull. Intl. Taxn.11 (2002), pp. 542-553.

"comprehensive taxation".[311] Although the OECD Commentaries do not provide a definition of what *comprehensive taxation* means, they recognize that in many States a person is considered liable to comprehensive taxation even if that State does not impose effectively a tax.[312] This would be the case of, e.g. pension funds, charity and other organizations that might be exempted from taxation if they meet all the requirements of the specific domestic law for that purposes, but who are still subject to tax laws in that Contracting State.[313] It can also be the case of any person whose income is below the taxable minimum or who make use of losses or allowances to reduce its tax assessment.[314] If one interprets the term *liable to tax* in a way to ensure effective or single taxation, all those persons would be immediately excluded from the treaty protection.[315] Thus, being subject to *comprehensive taxation* does not mean to be subject to taxes in the other country. This conclusion is indeed supported in the wording of Article 4(1) OECD Model, which requires that a person is "liable" and not "subject" to tax.[316] While the first expression is commonly used to refer to potential taxation, the latter is used to ensure actual taxation.[317] Explained in a different manner, the concept of "*liable to tax"* comprehends taxation and exemption, whilst the concept of *"subject to tax"* does not include

311 OECD Commentary on Article 4 concerning the definition of resident, para. 8 and 8.6.
312 OECD Commentary on Article 4 concerning the definition of resident, para. 8.6.
313 Id.
314 De Broe, *supra* n. 229, p. 358.
315 Id.
316 Ismer and Riemer, *supra* n. 307, Article 4 at m.no.26.
317 Id.

exemption, but only situation of effective taxation and others in which there is no effective taxation due to deductions and reductions in the calculation of the tax liabilities.[318]

The distinction between the concepts of *"liable to tax"* and *"subject to tax"* is well illustrated in the "*Weiser* case" that involved the application of the UK-Israel tax treaty.[319] In brief, the case referred to a resident of Israel who received pension income from the UK. He claimed that this pension income was exempt from taxes in the UK, because the income was derived by a resident of Israel, subject thus to tax in that country. After the taxpayer's claim was refused by the HMRC on the ground that the pensions were not *"subject to tax"* in Israel, he appealed to the First-tier Tribunal, who not only confirmed the position of the HMRC, but also reaffirmed the clear distinction between both expressions.[320] The First-tier Tribunal sustained that the taxpayer confused the expressions *"subject to tax"* and *"liable to tax"* as employed in tax treaties.[321] *"Liable to tax"*, on the one hand,

318 Pulido, *supra* n. 18, p. 291.

319 UK: FTT, 10 Aug. 2012, *Paul Weiser v. Commissioner for Her Majesty's Revenue and Customs,* [2012] UKFTT 501 (TC), [2012] SFTD 1381, Tax Treaty Case Law IBFD. S*ee also*, B. Cleave, *The Weiser Case: UK Pension Income Not Subject to Tax in Israel under the Israel-United Kingdom Income Tax Treaty (1962)*, 67 Bull. Intl. Taxn. 6 (2013), Journals IBFD.

320 Id., p. 280.

321 Judge Berner referred to the emblematic cases of *Bayfine UK* (2011) and *Smallwood* (2010) for the principles to be applied in this case. Id. For the full text of the cases*, see* UK: CA, 23 Mar. 2011, *Bayfine UK v. Commissioner for H M Revenue and Customs*, [2011] EWCA Civ 304, Tax Treaty Case Law IBFD and UK: CA, 8 July 2010, *Smallwood (Trevor Smallwood and Mary Caroline Smallwood, Trustees of the Trevor Smallwood Trust) v. Commissioners for the H M Revenue and Customs*, [2010] EWCA Civ 778, Tax Treaty Case Law IBFD. *See also*, B. Cleave, *The Bayfine Case,*

requires only an abstract liability to taxation, namely, a Contracting State might exercise its right to tax the income in question, being irrelevant whether or not that State finally exercises its right to tax and whether or not an amount of tax becomes payable. *"Subject to tax",* on the other hand, requires income being actually included in the computation of the individual's taxable income, resulting in a tax payable subject to deductions for allowances, reliefs, etc. This clear distinction has also been repeated in the tax treaty practice of other countries. In China, e.g. the term "*liable to tax"* is interpreted by the SAT, who has the general power to interpret tax legislation and tax treaties and which are rarely contradicted by courts, as having the legal obligation to pay tax on a comprehensive basis, but not actual payment of tax.[322]

Another issue that it is normally disregarded in the analysis of the expression *"liable tax"* refers to the fact that it is up to the Contracting States, according to their domestic laws, to determine the connecting factors that will trigger taxation and the requirements under which these factors (i.e. domicile; residence; place of management, etc.) will be applied.[323] In other words, it finally depends on each Contracting State to lay down the

Elaborate Tax Avoidance Scheme Using Tax Treaty Fails in Court of Appeal of England and Wales, 65 Bull. Intl. Taxn. 11 (2011), Journals IBFD, and B. Cleave, *The Smallwood Case: Dual Residence of Trustees*, 65 Bull. Intl. Taxn. 8 (2011), Journals IBFD.

322 J. Li, *The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base*, 66 Bull. Intl. Taxn. 9 (2012), Journals IBFD, pp. 455-456.

323 OECD Commentary on Article 4 concerning the definition of resident, para. 4.

conditions under which a person will be regarded as "resident" for purposes of a tax treaty, and therefore, subject to comprehensive taxation. The above can certainly derive in different results. In France, e.g. the definition of residence is exceptionally modified in certain cases to ensure single taxation. Under Article 4B(2) of the French Tax Code, civil servants who perform their duties abroad are deemed to have their domicile in France, despite they are not residents, to the extent they are not subject to unlimited liability in the foreign country where they perform their activities.[324] In the United States, some deviations from the OECD Model can be recognized, such as the inclusion of "citizenship" as one of the factor to determine residence in the case of individuals, or the "place of incorporation" as a residence determination factor in the case of corporations. Accordingly, and perhaps the most notably extension of the concept of residence, is the inclusion of a LOB provision, which basically limits the benefits of the treaty to *bona fide* residents, namely, taxpayers with strong connections with the treaty partner and not only residents as per the domestic law of that State.[325] Since the concept of resident for tax treaty purpose might thus be restricted or extended as per the countries' domestic laws desire, it is incorrect to sustain that always the avoidance of DNT is safeguarded.

[324] Gutmann, *supra* n. 209, p. 97.

[325] Y. Brauner, *Chapter 23: United States*, in: G. Maisto (ed), *Residence of Companies under Tax Treaties and EC Law*, EC and International Tax Law Series Vol. 5, IBFD, Amsterdam (2009), p. 876-877.

3.2. The concept of *Beneficial Owner* as a meaning to prevent DNT

Like the concept of *"liable to tax"* analyzed before, there is an easy temptation to interpret the concept of "*beneficial owner"* used in articles 10, 11 and 12 OECD Model in a manner of preventing DNT. Although this concept has been profoundly studied in the international tax literature,[326] and it is certainly not the intention of this author to emulate the results of those studies here, some brief observations regarding its interpretation are still required.

The concept of "*beneficial owner"* or *"bénéficiare effectif"* (French translation)[327] was firstly and officially introduced in the 1977 OECD

326 As regards to the literature about the meaning of the concept of *beneficial owner*, *see*, e.g. C. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties*, IBFD, Amsterdam (1999); R. Fraser and J. Oliver, *Beneficial Ownership: HMRC's draft guidance on interpretation of the Indofood decision*, BTR 1 (2007); J. Bernstein, *Beneficial Ownership: An International Perspective*, 45 Tax Notes Int'l 12 (2007); P. Baker, *The United Nations Model Double Taxation Convention between Developed and Developing Countries: Possible Extension of the Beneficial Owner Concept,* in: Committee of Experts on International Cooperation in Tax Matters: Fourth Session, Geneva, 20-24 October 2008; A. Martín Jiménez, *Beneficial Ownership: Current Trends*, 2 World Tax J. (2010), Journals IBFD; M. Lang et. al. (eds), *Beneficial Ownership: Recent Trends*, IBFD, Amsterdam (2013). For a recent compilation work regarding the historic evolution and academic discussions regarding the concept of *beneficial owner* in different jurisdictions, *see also* A. Meindl-Ringler, *Beneficial Owner in International Tax Law*, Kluwer Law International, Alphen aan den Rijn, 2016.

327 Some authors argue that the French official translation of the term is more accurate than the English expression, because the emphasis is not putted on the person's ownership of the income, but rather on whether this person really benefits from the income. *See*, e.g. P. Pistone, *Italy: Beneficial Ownership as Anti-Abuse Provision in International Taxation*, in: M. Lang et.al. (eds), *Beneficial Ownership: Recent Trends*, IBFD, Amsterdam (2013), p. 184. The above, in view of others, could also be an indication that civil law countries represented at the OECD did not want to use the common law

Model[328] and makes reference to the limitation that payments of dividends, interests or royalties (Articles 10, 11 and 12 OECD Model), normally subject to a reduced WHT at source, must be "beneficially owned" by a resident of the other State.[329] The historic reason behind this concept is to prevent treaty shopping through the imposition of conduit companies by third-State residents in order to claim treaty benefits not otherwise available to them,[330] and it was included for the very first time in the 1966 Protocol of the 1945 US-UK tax treaty.[331] The original intent of this provision, according to its design under English law, was actually to distinguish between the legal owner and the non-beneficial owner for the title given on

concept of *beneficial ownership* when they negotiate tax treaties, because this concept is indeed more referred to the person's ownership of the income. *See*, De Broe, *supra* n. 229, p. 680.

[328] However, the first time that was introduced in an OECD draft was in 1974. *See* R. Ng, *The Concept of Beneficial Owner*, in: T. Ecker and G. Ressler (eds.) *History of Tax Treaties. The Relevance of the OECD Documents for the Interpretation of Tax Treaties,* Linde, Viena (2011), p. 514. Ng also provides some other examples of tax treaties that included the term *"beneficial owner"* even before its official introduction in the OECD Model. In this regard, e.g. the 1968 UK-the Netherlands treaty; the1968 Ireland-France treaty; the1969 Australia-Japan treaty and the1975 UK-Spain treaty. Id., p. 515.

[329] R. Vann, *Beneficial Ownership: What Does History (and Maybe Policy) Tell Us*, in: M. Lang et.al. (eds.), *Beneficial Ownership: Recent Trends*, IBFD, Amsterdam (2013), p. 281.

[330] De Broe explains that both the 1977 OECD Model Commentaries and the 1986 OECD Conduit Companies Report indicate that the term is used as an anti-avoidance device against treaty shopping carried out through the use of conduit companies by third-States residents. *See* De Broe, *supra n*. 229, p. 654 and 664. *See also*, OECD (1987), *supra* n. 162. *See also*, E. Kemmeren, in: Reimer & Rust (eds), *Klaus Vogel on Double Taxation Conventions*, 4th edn (2015), Pre Articles 10-12 at m.no. 21.

[331] For a complete historic analysis, *see* R. Vann, *supra* n. 329, p. 275. *See also*, Ng, *supra* n. 328.

the sale of a land.[332] A same distinction was made in the law of equity between legal ownership of the trustee and the equitable, or beneficial, ownership of the beneficiary.[333] Not surprisingly, however, the term has not equivalence in most civil law countries, where a split of ownership is not known, at least not to the extent recognized in common law countries.[334] Indeed, civil law countries, apart from few exceptions,[335] do not use the term *"beneficial owner"* in their domestic laws.[336] The interpretation of the term *"beneficial owner"* presents many troubles, because it is not a defined concept at the tax treaty level, unless some references in the OECD

332 J. Avery Jones et. al., *The Origin of the Concepts and Expressions used in the OECD Model and their adoption by States*, 60 Bull. Int'l. Taxn. 6 (2006), Journals IBFD, p. 246.

333 Id.

334 De Broe, *supra* n. 229, p. 663.

335 The Netherland is, for example, an exception. Article 4(3) of the 1965 Dividend WHT Act; Article 25 of the 1969 Corporate Income Tax Act and Article 9.2 of the 2001 Individual Income Tax Act define the concept in a negative manner. In this regard, *see* H. Pijl, *Beneficial Ownership and Second Tier Beneficial Owners in Tax Treaties of the Netherlands,* 31 Intertax 10 (2003), p. 353. By other side, there are also common law countries in which, even though including reference to the term *beneficial owner* in their domestic laws, it lacks of importance at least in light of its main purpose, which is to combat treaty shopping. This is the case, e.g. of the United States where the courts have somehow abandoned the concept as a meaningful weapon against treaty shopping. This is especially evident in the *Aiken Industries* case (1971). *See* US: USTC, 5 August 1971, *Aiken Industries Inc. v. Commissioner of Internal Revenue*, 56 T.C. 925. In this case, the US court was able to deny treaty relief in absence of a *beneficial owner* provision. For a complete analysis of the case, *see* Y. Brauner, *Beneficial Owner in and outside US Tax Treaties,* in: M. Lang et.al. (eds), *Beneficial Ownership: Recent Trends*, IBFD, Amsterdam (2013), pp. 143-166. *See also*, De Broe, *supra* n. 229, pp. 423-430.

336 *See*, W. Eynatten, K. De Haen and N. Hostyn, *The Concept of 'Beneficial Owner' under Belgian Tax Law: Legal Interpretation is Maintained*, 31 Intertax 12 (2003), p. 523. *See also*, De Broe, *supra* n. 229, p. 663.

Commentaries on Articles 10, 11 and 12 OECD Model are made.[337] The interpretation thus could take actually two routes: (i) a domestic interpretation, derived by the application of Article 3(2) OECD Model, or (ii) an autonomous interpretation, derived by the tax treaties themselves.

The interpretation according to Article 3(2) OECD Model, on the one hand, and as already stressed somewhere else in this work, allows resorting to domestic law in case any term is not defined in a tax treaty, unless the context of the treaty otherwise requires.[338] But even if the context requires otherwise, there is no rule in Article 3(2) OECD Model that allows us to conclude *a priori* that the interpretation based in the context of the treaty should have priority.[339] However, one should bear in mind that the fewer the application of Article 3(2) OECD Model, the greater the probability that both States achieve a common interpretation, which is one of the final aims

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337 Most of the references in the 2014 OECD Commentaries intend to clarify the interaction between a reduced WHT in the State of source, granted by a tax treaty, and the income derived from dividend, interest or royalties, which is received by intermediaries in the State of residence. In this sense, e.g. paragraph 12 of the 2014 Commentaries on Article 10 states: "The requirement of beneficial ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words 'paid…to a resident' as they are used in paragraph 1 of the Article". Likewise, paragraph 4 of the 2014 Commentaries on Article 12 provides: "The requirement of beneficial owner was introduced in paragraph 1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries". Indeed, since 1977 that this requirement was introduced to make clear that agents and nominees are not to be regarded as beneficial owners. *See* De Broe, *supra* n. 229, p. 656. However, none of these references are indeed a definition of the concept. *See* Eynatten, De Haen and Hostyn, *supra* n. 336. In fact, the information why the OECD introduced the *beneficial owner* requirement is still confidential. *See*, du Toit, *supra* n. 326, p. 179.

338 *Supra* Section 2.4.

339 Rust, *supra* n. 283, Article 3(2) at m. no. 121.

of the interpretation of tax treaties.[340] There are, however, additional reasons to support this line of argumentation. In first place, the concept of "*beneficial owner"* has no counterpart in civil law countries.[341] The above makes difficult for those countries to come up with an interpretation based on a concept that does not exist under their legislations.[342] In second place, the history behind the notion of "*beneficial owner"* tells us that this was introduced to avoid treaty shopping; therefore, a uniform interpretation seems to be more in line with this aim. Otherwise, there would be a clear risk that its ordinary meaning goes beyond its tax treaty use, ending up perhaps in cases of treaty override, which is especially clear in the case of countries that use the term *beneficial owner* as an anti-avoidance provision.[343] Furthermore, a domestic interpretation of the concept could also lead to inappropriate results, suggesting that an autonomous treaty meaning makes more sense. De Broe explains well this situation under the

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[340] Vogel and Rust, *supra* n. 26, Introduction at m. no. 90 and 92.

[341] Civil law countries do not split ownership, at least not to the extent recognized in common law countries. De Broe, *supra* n. 229, p. 663.

[342] Even though in those cases in which there is no meaning for the term under income tax law, but under other domestic laws, such meaning should only be used in those cases in which this is relevant for tax purposes. This has been widely recognized in the comparative jurisprudence. *See*, e.g. the cases of *Thiel v. Federal Commissioner of Taxation* (Australia) and *Hoge Raad* (The Netherlands), referred at *supra* n. 217 and *supra* n. 285, respectively.

[343] The U.S. rules on conduits entities are an example of the above. *See* US: Treas. Reg. Sec. 1.881-3 et seq. These regulations empower the district director to disregard the participation of a conduit entity in a conduit financing arrangement if the taxpayer engages in such an arrangement pursuant to a tax avoidance plan. There is no reference to *beneficial owner* in the regulations, which rely more in domestic anti-abuse doctrines, such as *substance over form*, rather than the treaty concept. De Broe, *supra* n. 229, p. 670. Nevertheless, this is not surprising considering the little relevance of the concept of *beneficial owner* in the United States. Brauner, *supra* n. 335.

perspective of Belgian law, although its implications can also be extrapolated to any other civil law countries. The term "beneficial owner" is recognized neither under Belgian private law nor under Belgian tax law. Thus, many authors simply apply the equivalent concept of *"legal ownership"* under the Belgian Civil Code. In simple words, the *"beneficial owner"* would be either the person holding the legal title or another right in rem, e.g. *usufruct*.[344] Such interpretation, as expected, leads to the inappropriate result that a fiduciary owner or a nominee holding the legal title to the assets and collecting income from such property in his own name, but on behalf of the principal, is characterized as the beneficial owner, and thus, is entitled to tax treaty benefits.[345] Similar inappropriate tax treaty results have been produced in the past due to the absence of equivalent concepts in common and civil law countries.[346] Yet, for some authors it is

344 The legal concept of "*usufructus"*(from Latin "usus fructus"), recognized in civil law countries, grants a person a limited right in rem to use something (usufruct holder); however, the full ownership remains in the hands of another person who has the legal title. Id.

345 De Broe, *supra* n. 229, pp. 668-669.

346 An example is the civil law concept of "Commissionaire", which is recognized in civil law countries, but interpreted as if it were a simple "undisclosed agency" (common law concept) for purposes of the application of Article 5(6) of the OECD Model. As the "indirect representation" does not have counterpart in common law countries, all the commissionaires are treated as binding the principal in common law countries. However, in civil law countries, the commissionaire acts on behalf of the principal, but in his own name. Thus, the principal is not a party in the contracts with the customers and only relates to the commissionaire being therefore not bound, unless specific domestic law provisions provide the opposite. For tax treaty purposes, the above means that a "commissionaire" will be always regarded as a PE in a common law country, whilst it will not be such in civil law countries, unless provided otherwise. The interpretation of the concepts of Commissionaire lead in the past to contradictory results in the famous *Zimmer* and *Dell* cases in France and Norway respectively. For a deeper analysis on this topic, *see* J. Avery Jones and D. Ward, *Agents as Permanent*

unobjectionably today that the term "beneficial owner" is an international term and a domestic meaning is only relevant inasmuch this is consistent with the OECD Commentaries. That would be confirmed in the 2011 and 2012 OECD discussion draft papers on the concept of *"beneficial owner"* and the wording of the 2014 OECD Model, which suggests a contextual meaning without reference to any "technical meaning that it could have had under the domestic law of the specific country […]".[347]

The treaty meaning of the term *"beneficial owner",* on the other hand, could be understood in three different manners: (i) the domestic meaning in common law jurisdictions imported to the OECD Model;[348] (ii) the meaning

Establishments Under the OECD Model Tax Convention, 1 BTR 346 (1993). *See also*, e.g. L. Parada, *Agents v. Commissionaires: A Comparison in light of the OECD Model Convention*, 72 Tax Notes Int'l 1 (2013).

[347] *See* Kemmeren, *supra* n. 330, Pre Articles 10-12 at m.no. 31. *See also*, OECD (2011), *Clarification of the Meaning of 'Beneficial Owner' in the OECD Model Convention. Discussion Draft*, OECD Publishing, Paris; OECD (2012), *OECD Model Tax Convention: Revised Proposals Concerning the Meaning of 'Beneficial Owner' in Art. 10, 11 and 12*, OECD Publishing, Paris.

[348] In this opinion, C. du Toit argues that there is a strong presumption that the term *"beneficial owner"* would have been included within the OECD Model adopting its meaning from domestic common law countries. C. du Toit' s argument is sustained in two main precedents. First, the drafter of the OECD Model opted for this term instead of alternatives, such as *"final recipient"*, "*economic owner"* or *"beneficially entitled".* Second, the term was used before its introduction within the OECD Model, and even after that there were no observations to the term, as it would have been expected from civil law countries. *See* du Toit, *supra* n. 326, pp. 178-179. In a critical opinion on this theory, De Broe argues that it is unrealistic to think in two civil law countries negotiating a treaty and intending to incorporate a common law concept, which is indeed exogenous to their legislations. Accordingly, De Broe states that there is no evidence in the OECD materials suggesting that the drafters wanted to incorporate the common law the meaning of the concept of beneficial owner. De Broe, *supra* n. 229, pp.676-680.

of the OECD Commentaries,[349] or (iii) the *"beneficial owner"* considered as the person to whom the income is attributed under the tax law of the residence and/or source State. This last alternative deserves special attention, because the idea of considering the term "*beneficial owner"* as the person to whom income is attributed sets up a meaning of the concept beyond of a simple anti-avoidance device,[350] driving some scholars to sustain that the concept of "*beneficial owner"* would actually ensure that income is *"subject to tax"* in the State of residence, underlying the idea that the term *"beneficial owner"* would, in the end, help in preventing the outcome of DNT.[351]

The interpretation of the term *"beneficial owner"* as the person to whom income is attributed makes sense. Juridical double taxation, the main object and purpose of tax treaties,[352] could only arise if the income is attributed to a "taxpayer" of the other Contracting State. Thus, the fact that the source State

[349] On this matter, it is publicly known that the OECD Commentaries only describe in a negative fashion manner the persons who are not going to be considered as beneficial owners. Such a description comes from the 1977 OECD Model and it is reinforced in the 1986 OECD Conduit Companies Report. De Broe, *supra* n. 229, pp. 680-690.

[350] In this opinion *see*, e.g. B. Arnold, *Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model*, 58 Bull. Intl. Taxn. 6, (2004), Journals IBFD. Arnold states that the beneficial ownership requirement in the Articles 10, 11 and 12 is more a fundamental rule of taxation rather than an anti-avoidance rule.

[351] Oliver, e.g. explains his position as follows: "The question that arises for purposes of defining the beneficial owner of the payment is whether the recipient of the payment is subject to tax on that payment in the resident country, not simply subject to tax or liable to tax generally, but subject to tax on that payment". *See* J.D. Oliver et al., *Beneficial Owner,* 54 Bull. Int. Taxn. 7 (2000), Journals IBFD, p. 322.

[352] With respect to the limitation of tax treaties to relief all cases of juridical double taxation and economic double taxation, see the references in *supra* n. 196.

gives relief from double taxation only in those cases in which the income is attributed to a person who is a resident in the other State is certainly convincing. Similar suggestions might be extracted from the 1999 OECD Partnership Report with respect to transparent entities and the access to treaty benefits, when it states that the determination of the *beneficial owner* will be made by looking at the treatment of the entity in the country of residence of the taxpayer claiming the treaty benefits.[353] Nevertheless, there are several reasons to discard that such an interpretation necessarily means that the person to whom the income is attributed must be the person *"subject to tax"* in the State of residence, or which is the same, that the terms *"beneficial owner"* and "*subject to tax"* are equivalent ones. On one hand, and as it has been already stressed, the term was officially introduced in the 1966 Protocol of the 1945 US-UK tax treaty with the idea of replacing the *"subject-to-tax"* clause contained in that specific treaty, under which the source country would deny benefits under Articles 10, 11 and 12 if the recipient of the income was not subject to tax in the residence country.[354] Thus, it would be at least contradictory to interpret the term *"beneficial owner"* in a manner of ensuring single taxation, through a "*subject-to-tax"* requirement in the State of residence, when the concept precisely replaced an original specific provision aiming to accomplish with that target.

[353] However, neither the OECD Partnership Report nor Article 1(2) OECD Model properly considers the interplay with the concept of *beneficial owner*. This issue is specifically analyzed in *infra* Chapter IV, Section 3.3.2.3, as regards to the OECD Partnership Report and Section 5.3.1, as regards to Article 1(2) OECD Model.

[354] *See* Vann, supra n. 329, and Ng, *supra* n. 328.

Likewise, the original provision implied to exclude, e.g. charities and pension funds from the reduced WHT granted by the treaty, because they were actually exempt from taxation in the country of residence. However, this exclusion could only be regarded as a *"subjective subject-to-tax criterion"*, as some authors refer to,[355] but in any case it implies the requirement of an effective taxation, i.e. an *"objective subject-to-tax criterion"*.[356]

On the other hand, when revisiting the process of review of the 1963 OECD Model, it is possible to see that the OECD began asking delegates to identify some problems in the draft document.[357] The UK delegation proposed the inclusion of a *"subject to tax"* clause as a way to solve the defective drafting of article 10, 11 and 12. The UK delegates observed: "If a 'subject to tax' test is not included in these Articles we think that the drafting is defective […]".[358] However, in 1967, the Fiscal Committee created the

355 *See*, e.g. M. Distaso and R. Russo, *The EC Interest and Royalty Directive- A Comment,* 44 Eur. Taxn. 4 (2004), Journals IBFD. *See also*, B. Terra and P. Wattel, *European Tax Law*, 6th ed., Kluwer Law International, BV The Netherlands, 2012.

356 A similar requirement is found, e.g. in the definition of qualified companies in the EU Interest and Royalty Directive, where a company must be *"subject"* to one of the specific listed corporate taxes, without being exempt. This requirement, however, seems to be rather clear in excluding companies that are *"subjectively exempt"* and does not mean any form of effective taxation of the interest or royalty income. *See* J. López Roriguez and G. Kofler, *Beneficial Ownership and EU Law*, in: M. Lang et.al. (eds.), *Beneficial Ownership: Recent Trends*, IBFD, Amsterdam (2013), p. 223.

357 OECD (1967), *Observations of Member Countries on Difficulties Raised by the OECD Draft Convention on Income and Capital*, Fiscal Committee TFD/FC/216, Paris, available at www.taxtreatieshistory.org.

358 Vann, *supra* n. 329, p. 282. *See also*, OECD (1967), *supra* n. 357, p. 14. According to Avery Jones, the uncertainty created by the United Kingdom, suggesting that a *"subject-*

Working Party No. 27 consisting of Luxembourg, France and the Netherlands, dealing with the redrafting of the interest and royalties articles, who rapidly clarified that the real UK intent was indeed to propose either a *"subject to tax clause",* under which the source country would renounce its taxing rights inasmuch the resident country taxed the income, or that Articles 10, 11 and 12 were to be applied only if they were paid to the *"beneficial owner"* of the income.[359] The above emphasizes the different meaning of both concepts, a fact that was reaffirmed in the Working Party No. 1 of the Committee on Fiscal Affairs on Double Taxation, Working Group No. 23 (Germany-Belgium), where referring to Article 10 OECD Model, it recommended the second solution, i.e. the inclusion of the *beneficial owner's* concept rather than a *"subject-to-tax"* requirement.[360]

to-tax" test was required, or alternatively that there should be a beneficial owner requirement, attended to the interpretation of specific domestic rules which existed during the time of the discussion draft in 1967, but that no longer existed at the implementation of the *"beneficial owner"* provision in the 1977 OECD Model. In other words, the inclusion of the provision was indeed not really necessary. For a full analysis, *see* Avery Jones, *supra* n. 294, pp. 333-339.

359 "The United Kingdom Delegation considers that as they stand Articles 10, 11 and 12 are defective in that they would apply to dividends, interests and royalties paid to an agent or a nominee with a legal right to the income. To remedy this situation, it proposes either that a 'subject to tax clause' be introduced, under which the country of source would give up its right to tax only if the country of residence taxed the income, or else that these Articles be made to apply only to income paid to the 'beneficial owner' ". *See* OECD (1970), *Working Party No. 27 of the Fiscal Committee (Luxembourg-France-The Netherlands), Report on suggested amendments to Articles 11 and 12 of the Draft Convention, relating to interest and royalties respectively*, FC/WP27(70)1, Paris, p. 13, available at www.taxtreatieshistory.org.

360 OECD (1973), *Working Party No. 1 of the Committee on Fiscal Affairs on Double Taxation, Working Group No. 23 (Germany-Belgium), Revision of Article 10 of the 1963 Model Convention and Commentary Thereon*, CFA/WP1(73)2, Paris, available at www.taxtreatieshistory.org. *See also*, Ng, *supra* n. 328, p. 523.

Furthermore, the absence of correlation between the terms *"beneficial owner"* and *"subject-to-tax"* is also reaffirmed in the 2014 Commentaries on Article 12 OECD Model. The Commentaries emphasize that it is not specified whether the application or not of the exemption in the State of source should be conditional upon the royalties being subject to tax in the State of residence.[361] In fact, they provide that those issues could be settled during the bilateral negotiation.[362] Thus, it is possible that the Contracting States agree during the negotiation of a tax treaty the specific inclusion of a *"subject-to-tax clause"* within the treaty, but in any case the requirement of subjecting to (effective) tax the income in the State of residence should be considered as an ordinary interpretation of the concept of *"beneficial owner"*.

3.3. Conflicts of Qualification and DNT: The new interpretation of Article 23A(1) OECD Model

A third provision that might be interpreted as preventing DNT is related to what is known in doctrine as *conflicts of qualification*. A *conflict of qualification* arises when a tax treaty contains terms from domestic law that are understood in their respective meanings by the residence or source State or that can be interpreted in an independent or autonomous manner.[363] These *qualification conflicts* are originated, *inter alia*, due to the interaction of

[361] OECD Commentary on Article 12 concerning the taxation of royalties, para.6.
[362] Id.
[363] Vogel and Prokisch, *supra* n. 228, p. 82

Article 3(2) OECD Model and the normal disparities between the domestic systems of the Contracting States, and they can derive either in double taxation or DNT.[364] For example, in the case two States characterize differently the same item of income or the same entity.[365] As regard to DNT, it might arise because of the application of Article 23A OECD Model (exemption method) when two Contracting States, due to differences in their domestic laws, apply different provisions of the tax treaty in such a way that the source State considers itself prevented from taxing the income at issue whilst the residence State, in application of another distributive rule, considers that the source State has the right to tax the income and therefore exempts the income under Article 23A(1) OECD Model.[366] The OECD Model and its Commentaries deal specifically with these cases in paragraph 32 et seq. of the OECD Commentary on Articles 23A and 23B of the OECD Model.

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364 Id. *See also*, C. Marchgraber, *Conflicts of Qualification and Interpretation: How Should Developing Countries React?*, 44 Intertax 4 (2016), p. 307.

365 *See*, e.g. the example of paragraph 32.4 of the OECD Commentary on Article 23 A and Article 23 B concerning the methods for elimination of double taxation, referred to the conflict derived from the different qualification of the same entity for tax purposes. These conflicts, however, are not strictly related to the different characterization of entities (like conflicts of allocation of income), but rather to the discrepancies as regards to the nature of an item of income. For the analysis of hybrid entities and the entitlement to tax treaty benefits, see *infra* Chapter IV.

366 OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 32.6. *See also*, R. Sudoczky, *Double Taxation Relief, Transfer Pricing Adjustments and State Aid Law: Comments*, in: I. Richelle, E. Traversa and W. Schön (eds), *State Aid Law and Business Taxation*, Springer, Heidelberg (2016), p. 169.

The OECD approach, originated in the Partnership Report of 1999[367] and included in the 2000 OECD Commentaries (updated in 2008) on Article 23A and 23B OECD Model, suggests that the phrase *"in accordance with the provisions of this Convention, may be taxed",* included in those Articles, should also be interpreted in relation to possible cases of DNT arisen due to the application of Article 23A.[368] This is to say, the OECD proposes that the State of residence is not obliged to exempt an item of income or capital if the source State considers itself prevented from taxing that item of income or capital, which would otherwise *have had the right to tax,* if the State of residence consider, in application of another distributive rule, that the source State *has the right to tax* the income and therefore exempts the income as per Article 23A OECD Model.[369] Thus, DNT might be avoided by means of the interpretation of Articles 23A(1) and 23B(1) OECD Model.[370] The 2008 update of the OECD Model extends this approach even to the cases where

367 Article 23A(1) OECD Model states: "Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, *may be taxed* in the other Contracting States […]".

368 OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 32.6. With respect to the avoidance of double taxation, the phrase *"in accordance with the provisions of this Convention"* is interpreted by the OECD Commentaries as requiring the State of residence to grant relief from double taxation (through exemption or credit) in case of conflicts of qualification resulting from differences in domestic law. In these cases, the State of residence is bound by the qualification of the State or source. OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 32.3. *See also,* Lang, *supra* n. 301, p. 204.

369 A. Rust, *The new Approach to Qualification Conflicts has its Limits*, 57 Bull. Intl. Taxn. 2 (2003), Journals IBFD, p. 45. The original 2000 version used the phrase "have taxed" instead of "have had the right to tax" and the phrase "to tax" instead of "to have the right to tax". *See* Lang, s*upra* n. 301.

370 Marchgraber, *supra* n. 364, p. 309.

the State of source refrains from levying tax under its domestic law, but would have been prevented anyway by the treaty, understood in light of its domestic law.[371] In simple words, the application of the OECD approach would go beyond the different qualification of the same treaty rule.[372]

The conclusion that the new OECD interpretation of Article 23A(1) OECD Model effectively counteracts cases of DNT when a conflict of qualification is involved, *ergo* constituting a sort of indication that the avoidance of DNT might be regarded as an object and purpose of the tax treaties, is certainly not precise and it can be subject to a serious criticism. Firstly, Article 23A(1) OECD Model is applicable only if the income *"may be taxed"* in the State of source.[373] A person *"may be taxed"* in the State or source *"in accordance with the provisions of this Convention"* only if the tax treaty does not prevent the State from doing so.[374] Therefore, whether or not the tax was indeed levied in the source state is absolutely irrelevant.[375] A different interpretation should simply derive in absurd results. As accurately explained by Lang: "[…] the same approach should be followed in the mirror situation [the exercise of taxing rights]. If the source state, under its domestic interpretation of the treaty terms, is able to exercise taxing rights but refrain from doing so domestically, the income still 'may be taxed' in

[371] Lang, *supra* n. 301.
[372] Id.
[373] Id.
[374] Id.
[375] Id.

'accordance with the provisions of the Convention'. Thus, a resident state that, under its domestic law interpretation, takes the position that the income falls under a different allocation rule and that therefore it may also exercise taxing rights should be prevented from doing so since the income "may be taxed" in the other state".[376] Secondly, there are qualification conflicts to which Article 23A(1) OECD Model is simply not applicable; therefore, in those cases DNT should be a tolerated outcome. Vogel explains that tax treaties contain two types of distributive rules: complete and open.[377] Complete distributive rules are those that while maintaining the taxation by one of the Contracting States, they exclude the other Contracting States from taxing the item of income in question. They can be normally distinguished by the use of the words *"shall be taxable only",* e.g. Article 7(1) when it provides that the profits of an enterprise that it is not regarded as a PE in the State of source shall be taxable only in the State of residence; or Article 8(1) OECD Model that provides that the profits from the operation of ships or aircraft in international traffic shall be taxable only in the State where the place of effective management of the enterprise is situated;[378] or Article 19(1)(a) when, according to the interpretation of the State of residence, the taxpayer receives a salary from the other Contracting State and become a resident solely for the purpose of rendering a service.[379]

376 Id.

377 K. Vogel, *Conflicts of Qualification: The Discussion is not Finished*, 57 Bull. Intl. Taxn. 2 (2003), Journals IBFD, p. 43.

378 Id.

379 Rust, *supra* n. 369, p. 49. Also Article 20 OECD Model can be a good example when a student or business apprentice becomes a resident of the State in which he is studying or

The distributive rules might be considered as a *lex specialis* to Article 23 and be applicable at least side-by-side.[380] On the other hand, open distributive rules are those who maintain the taxation by one of the Contracting States; however, they do not determine whether and how the income in question will be taxed by the taxpayer's State of residence. They normally use the words *"may be taxed"*, e.g. Article 7(1) when it provides that income received through a PE in the State of source *may be* taxed by that State. Contrary to the complete distributive rules, these rules must be completed by Article 23 OECD Model. Furthermore, the distinction between *"shall be taxable only"* and *"may be taxed"* is not accidental and it is indeed a standard pattern of tax treaties, observed by the OECD Model and by all the treaties following it.[381]

Following Vogel's classification of the tax treaty provisions, one could conclude that Article 23A(1) OECD Model is not effective to solve cases of DNT in cases where the State of residence applies a complete distributive rule that allows only the State of source to tax the income.[382] Indeed, Article 23A(1) OECD Model does not impose an additional obligation on the State of residence to exempt the income (article 23 OECD Model might be

training. *See* J. Avery Jones, *Conflicts of Qualification: Comments on Prof. Vogel's and Alexander Rust's Articles*, 57 Bull. Intl. Taxn. 5 (2003), Journals IBFD, p. 184.

380 Rust, *supra* n. 379.

381 Id.

382 Vogel, *supra* n. 377, pp. 42-43.

applied).[383] Likewise, the obligation to exempt the income contained in the distributive rule is still in force, because Article 23A(1) cannot lift the State of residence from that obligation. In other words, the source's State qualification is not binding on the State of residence.[384] Thus, if the State of source believes that it is prevented from taxing the income, this income remains untaxed in both residence and source States and Article 23A(1) will not help otherwise.[385]

Moreover, tax treaties not only contain distributives rules, they also have non-distributive rules, e.g. rules determining the territorial and personal scope of the treaty; or the taxes to which it applies; definition of treaty terms, etc. All these provisions use terms taken from domestic laws of the Contracting States; therefore, conflicts of qualification might also arise.[386] Vogel explains how "unsolved" DNT also remains in the case of non-distributives rules, despite the new interpretation of Article 23A and 23B OECD Model, in the following example: "An independent singer who is citizen of Austria alternates between performing in Austria and in Germany. He has a permanent contract with an opera company in Germany, committing him to a certain number of appearances each year. During the

[383] Id.
[384] Id, p. 50.
[385] This does not mean that a different solution can be followed, e.g. the application of Article 25 OECD Model (Mutual Agreement Procedure). *See* OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 32.5. In this opinion: Avery Jones, *supra* n. 379.
[386] Although Vogel recognizes that, as these conflicts do not refer to types of income, a varying qualification does not lead to double taxation and very rarely to DNT. Vogel, *supra* n. 277, pp. 42-43.

taxable year in question, he had, in addition, some separate engagements in Austria. In both states, he lives in hotels. On several occasions, he stayed part of the day in Austria and part in Germany. Therefore, the aggregate of his stays in each of the two states was more than six months. He received dividends and interest from portfolios in a third country. Both Austria and Germany want to tax these receipts".[387] The issue in this case is that both countries would allege unlimited tax liability (worldwide taxation). Germany would argue that the stay more than six months constitute a *habitual abode,* whilst Austria, would say that under Austrian law he is a resident, although he does not have a habitual abode. Austria and Germany will prefer to exclude the application and articles 10 and 11 of the OECD Model and to apply Article 21 (other income), which grant exclusive taxation to the resident state. For that purpose, however, the singer should also be considered a resident for tax treaty purposes. The tie-breaker rule of Article 4(2)(b) OECD Model establishes that if the taxpayer does not have a permanent home available in either State (he was living in hotels), the residency will be that of his *habitual abode*, a term that should be interpreted in accordance with the domestic laws.[388] Article 4(2)(b) OECD Model does not contemplate the time necessary to be considered *habitua*l, and it just says that the time must be *sufficient.* Thus, a resort to domestic law in accordance to Article 3(2) OECD Model is needed. For Austrian law

387 Id., p. 42 at "Case 2".

388 Vogel, however, recognizes that this is controversial and there are tax scholars who consider that the term *habitual abode* has an autonomous interpretation. Id.

purposes, there was no habitual abode; therefore, his habitual abode would be in Germany. For German tax purposes, however, the habitual abode implies the fact of staying more than six months, which means that under German domestic law, the singer has habitual abode in both countries. This would imply that, according to the tie-breaker rule of Article 4(2) OECD Model, the citizenship of the singer would prevail (he is Austrian). Germany thus cannot tax either, being the result no other than DNT. Vogel's example can be criticized because it does not include the possibility of a MAP to resolve the dual residency problem.[389] However, beyond this legitimate criticism, the example illustrates very well that when a term exists in domestic law and it is used in a tax treaty context, qualification conflicts might arise and they cannot be solved by application of Article 23A(1) or 23B(1) OECD Model, at least not in cases of non-distributive rules.

Some final words should be said regarding the tax policy implications of the new interpretation of Article 23A(1) OECD Model upon developing countries or emergent economies. Despite the fact that Article 23 UN Model recently included the OECD Commentaries of paragraph 32.1 to 32.7, it is still not clear why developing countries should agree in accepting that OECD's interpretation that the State of residence always tax in the case of a conflict of qualification leading to DNT (or low taxation as well).[390] More important is the wording of the updated 2008 OECD Model, which states

389 Avery Jones, *supra* n. 379, p. 186.
390 For an extended analysis: Marchgraber, *supra* n. 364.

that the State of residence should not be obliged to apply the exemption method if the State of source, in light of its domestic law, interpret the provision of the treaty as precluding it from taxing an item of income or capital, which would have not taxed under its domestic law anyway. If such an interpretation is adopted, the tax incentive normally granted by developing countries to attract FDI might be totally offset if the exemption method is finally not applied in the State of residence.[391]

3.4. Conflicts of Interpretation and DNT: Article 23A(4) OECD Model

As noted before, the OECD interpretation of Article 23A(1) OECD Model does not mitigate all the cases of DNT, being its effects rather limited to the qualifications resulting from disparities between the domestic tax systems of the Contracting States. Indeed, if, e.g. DNT arises from the varying evaluation of the facts or the diverging interpretation of a treaty provision (known as "conflicts of interpretation"), Article 23A(1) OECD Model is absolutely ineffective to ensure single taxation.[392] Considering the above, the OECD included Article 23A(4) in the OECD Model in order to deal specifically with those cases of DNT resulting from the different

[391] Developing countries have similar incentives to negotiate "tax sparing" clauses with tax credit countries, because despite of the tax incentive in the host country, if a credit is not granted in home country (investor), the incentive can be nullified. *See* a further analysis on *tax sparing clauses* at *infra* Section 4.1.1.

[392] Marhgraber, *supra* n. 364, p. 312.

interpretation of a provision of the Model Convention or the facts of a case.[393]

As per Article 23A(4) "[t]he provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income". Therefore, under the OECD approach, the residence state shall not be obliged to grant an exemption if the source state interprets the facts of a case or the provisions of the Convention in such a way that it consider itself fully or partially restricted from taxing an item of income or capital, whilst the residence state adopts a different interpretation of the facts or the provisions of the Convention, considering that the same item of income or capital should be taxed in the State of source, which thus would lead to apply the exemption.[394] In this order of ideas, the effect of Article 23A(4) OECD Model is identical to a "switch-over clause".[395] The OECD also emphasizes that these cases where Article 23A (4) OECD Model applies should be distinguished from those "where the qualification of an item of income under the domestic law of the State of source interacts with the provisions of the Convention to preclude that State from taxing an item of income or

393 OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 56.1.

394 OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 56.1.

395 *Infra* Section 4.2.2.

capital in circumstances where the qualification of an item under domestic law of the State of residence would not have had the same result".[396]

Regardless the above, the truth is that Article 23A(4) OECD Model is not completely effective to solve all the cases of DNT derived from a conflict of interpretation. According to the OECD Commentaries, if the State of source considers that it *may tax* an item of income or capital in accordance with the OECD Model, but no tax is actually payable on that income or capital because of the domestic law, DNT shall be an unavoidable outcome.[397] In such a case, the State of residence must apply the exemption method, because the exemption at source does not result from the Convention, but rather from the domestic law of the State of source and a tax treaty cannot take away that domestic exemption.[398] This conclusion is also corroborated by paragraph 34 of the Commentary on Article 23A and 23B OECD Model, which establishes that the State of residence must exempt the item of income or capital which, in accordance with the Convention, *may be taxed* by the State of source, regardless whether or not the right to tax is in effect exercised by the State of source.[399]

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396 OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 56.3

397 OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 56.2

398 Id.

399 OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 34.

4. Double Non-Taxation and Specific Tax Treaty Provisions

This Section now turns to study some examples of the tax treaty practice in which, through the inclusion of specific provisions within the tax treaties, the outcome of DNT is either tolerated or otherwise prevented. Nevertheless, and whatever path is followed, it is worth to highlight that the use of these provisions is exceptional and it responds to specific tax policy reasons. The above simply emphasizes that neither the outcome of DNT nor its avoidance are indeed an object and purpose of the tax treaties, unless the Contracting States have expressly decided otherwise.

4.1. DNT as an outcome tolerated by Tax Treaties

There can be many examples in which tax treaties tolerate the outcome of DNT.[400] However, I hereby will refer exclusively to the cases of *tax sparing* and *matching credit* clauses, commonly used by developing countries or emergent economies to attract FDI. In these cases, and due to more important policy reasons, countries are simply indifferent when facing the outcome of DNT.

[400] In some cases it would be even possible to affirm that the outcome of DNT is directly pursued, e.g. in the case of income derived from research activities from teachers or professors. An example is the Article 21 of the 1971 France-Portugal Tax Treaty, which exempts in both Contracting States the income received by a professor or a teacher who is resident of a Contracting State and who is moving to the other states for a maximum of two years. *See* Gutmann, *supra* n. 46, p. 90.

4.1.1. Tax Sparing

Many countries, especially developing countries, provide a series of tax incentives, including e.g. tax holidays or reduced corporate tax rates in order to attract FDI.[401] The success of these tax incentives, however, does not depend entirely from the exclusive policy in the country hosting the investment. In fact, in most of the cases, the success of the tax incentive will also depend upon the taxation of the income derived from that investment in the investors' home country and the subsequent relief of the potential double taxation generated. In this regard, if the investors' home country uses the exemption method to relieve double taxation, there will generally be no effects upon the tax incentive provided by the host country inasmuch the exemption method applies disregarding the amount of taxes paid in the investment's host country, which is indeed the general rule.[402] However, if

[401] One reasonable explanation as regards to the importance of attracting FDI in developing countries can be found in the change of paradigm of many countries of Central and Eastern Europe and Latin America after the 1970s. The political movement from socialism to market economy, followed by the trend towards a freer flow or investment capital, and specially, the process of privatizations can be seen a clear reasons of that. Indeed, previously many of these countries were very suspicious regarding FDI, which was seen as a form of post-colonialism or dollar-imperialism. *See* A. Easson, *Tax Incentives for Foreign Direct Investment, Part I: Recent Trends and Countertrends*, 55 Bull. Intl. Taxn. 7 (2001), Journals IBFD, p. 267.

[402] Generally the exemption method should apply in this manner, without paying attention to the taxes paid in the other country, contrary to the tax credit that is generally granted in a "dollar-by-dollar" basis. For a comparative analysis between the credit and exemption methods as international mechanisms used to relief double taxation *see*, e.g., G. Maisto, *supra* n. 89. *See also*, G. Kofler, *supra* n. 91. The simplicity of the exemption method, when compared to the credit method, have made it the preferred method to relieve double taxation among continental European countries, fitting better the

the home country applies the exemption only to the extent the source State has a minimum level of taxation, then the tax incentive is neutralized.[403] Similarly, if the home country applies the tax credit method to relieve double taxation, the effect of the tax incentive is again nullified.[404] This is because the tax credit method generally applies only with respect to the taxes effectively paid in the foreign country. In order to avoid such a result, host countries normally negotiate the inclusion of *tax sparing clauses* that enable the investors to obtain a tax credit in their home country upon the taxes that they should have paid in the host country in absence of the tax incentive. As expected, in some cases the absence of taxation in the host country due to a specific tax incentive added to the application on the credit method upon a statutory tax (not effectively paid) in the home country may derive in DNT.[405] The result of DNT in this case is an accepted outcome that guarantees the success of the tax incentive in the host country, and ultimately, helps to promote investment and economic growth in developing countries.[406]

objectives of the internal market. In this regard, *see*, e.g. W. Schön, *supra* n. 82. *See also*, M. Helminen, *supra* n. 89.

403 Although the OECD Commentaries uses a different expression: "[…] the incentive granted by a State of source *may be* reduced […] (emphasis added)". *See* OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 72.

404 Id.

405 Although this is only true in those cases in which the tax incentive attends to a reduction in the tax rates that affect the investment or simply in a tax holiday. Other tax incentives do not attend to the direct payment of taxes, e.g. in the case of an accelerated depreciation granted.

406 L. Schoueri, *Tax Sparing: uma reconsideração da reconsideração* in: R. Mariz de Oliveira at al. (eds.), *Direito Tributário Atual*, Dialética/IBDT (2011), pp. 93-108. *See also*, e.g. A. Celine, R. Desbordes and J. Mucchielli, *Do Tax Sparing Agreements*

Some tax scholars have, nevertheless, openly criticized the exaggerated importance given to *tax sparing clauses*.[407] They basically argue that tax sparing is a problem only when the investor invests through a branch in the host country, because if he does it through a subsidiary, the residence country (home country) will generally not impose taxes on the profits generated by the subsidiary and the dividends received from the subsidiary will be exempted in the home country, normally because of the application of the participation exemption.[408] Then, if the developed country also exempts the profits of the foreign branch, there would not be a problem at all.[409] Accordingly, others scholars sustain that tax sparing clauses can

Contribute to the Attraction of FDI in Developing Countries, 14 Intl. Tax and Pub. Fin. 5 (2007); J. Amico, *Brazil: Developing and Implementing Tax Treaty Policy: The Tax Sparing Clause*, 43 Bull. Intl. Fisc. Doc. 8/9 (1989).

407 In a complete analysis regarding base erosion in developing countries, *see* H. Ault and B. Arnold, *Protecting the Tax Base of Developing Countries: An Overview*, Paper on Selected Topics in Protecting the Tax Base of Developing Countries (UN), Draft Paper No. 1, United Nations, New York (2013), p. 32.

408 Id. The statement of these authors is correct, although it disregards that one of the major capital exporter countries in the world, i.e. the United States, does not apply the participation exemption, but rather the tax credit upon profits repatriated. Thus, it could rarely be argued that a developing country, which has important tax incentives to attract FDI, is indifferent in the negotiation of a treaty with the United States. Accordingly, the United States has also firmly rejected the inclusion of tax sparing clauses within its tax treaties, despite the fact that the tax treaty between the United States and Pakistan was indeed the first one to include such a provision in 1957, although finally rejected by the US Senate. Previously, in 1953, it was also discussed in the report of the British Royal Commission, which recommended the adoption of tax sparing clauses as a way to aid British investment abroad. The proposal was finally rejected in 1957. *See* OECD (1997), *Tax Sparing–A Reconsideration,* OECD Publishing, Paris, p. R (14)-10 and 11.

409 This critic, however, is not entirely precise, because it does not consider the role of CFC rules around the world, and whose strength is recommended in the latest OECD BEPS Action 3, as an effective manner to tax the of a subsidiary established in the host

constitute a clear infringement to the non-discrimination principle recognized in Article 24 OECD Model and other supranational legislation, such as EU Law.[410] A similar criticism can be found in the *OECD Report on Tax Sparing*, which also makes equal the concepts of tax sparing and matching credits.[411] The main point of criticism was stated in the report was that tax sparing and matching credit clauses had a very limited influence upon foreign investors decisions, opening new possibilities for tax evasion and other types of abuse.[412] Likewise, the OECD Commentaries on Articles 23A and 23B, concerning the methods for elimination of double taxation, sustain that tax sparing provisions constitute a departure from those Articles,[413] being thus a reproduction of the principles summarized the OECD Report on Tax Sparing, which remain unchanged until today.[414]

Nonetheless, and beyond the criticism that can exist with respect to the effectiveness and efficiency of tax sparing clauses, it is undeniable that they

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country. This can be especially true when CFC rules apply to both active and passive income, e.g. in Brazil. See references at *supra* n. 250.

410 This is because *tax-sparing* clauses involve a worse treatment for residents' domestic investors than foreign investors. Likewise, it could also be argued that they infringe the principle of tax neutrality (CEN), although it is not less valid to consider that the different treatment between residents and non-residents is justified by the public policy goal of encouraging investment in lesser-developed countries. For a further analysis, *see* R. Mason, *Tax Discrimination and Capital Neutrality*, 2 World Tax J. 2 (2010), Journals IBFD, p. 136.

411 For a critical analysis on this matter, *see* V. Arruda and A. Trindade, *Tax Sparing and Matching Credit: From an Unclear Concept to an Uncertain Regime*, 67 Bull. Intl. Taxn. 8 (2013), Journals IBFD.

412 OECD (1997), *supra* n. 408, p. R(14)-19 to 24.

413 OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 74.

414 Arruda and Trindade, *supra* n. 411, p. 399.

still represent an important tax policy tool for developing countries and only few countries are prepared to take the risk of unilaterally withdrawing these clauses from their tax treaties.[415] In a nutshell, unless all developing countries decide to withdraw these provisions at once, the incentive to keep them is still higher.[416] The outcome of DNT will thus remain as an acceptable one in those treaties which, although exceptionally, still include *tax sparing clauses.*

4.1.2. Matching Tax Credits

Unlike the similitude with *tax sparing clauses*, the matching credit clauses have nothing to do with tax incentives or any other kind of subsidy provided by the source country.[417]

Generally speaking, a *matching credit* provision implies that the residence State will credit a fixed amount of tax on certain items of income ("notional tax") derived from the source State, regardless whether or not those items

[415] Easson, *supra* n. 401, p. 273. However, from a practical point of view, as many *tax sparing* provisions are subject to a limited period of time, most of them have already elapsed. This implies that the practical significance of the provisions has decreased. Nevertheless, this does mean that developing countries stop using them as a tool to attract investment, as it is the case of many countries part of the MERCOSUR. For an analysis on the economic influence of tax sparing and matching credits *see*, e.g C. Forcada, *The Economic Effect of Taxation on the Flow of Software Copyright Royalties in MERCOSUR*, 65 Bull. Intl. Taxn. 7 (2011), Journals IBFD.

[416] This is illustrated as the classic economic theory known as the "prisoner's dilemma". *See* Easson, *supra* n. 401.

[417] The OECD, however, mixes both the concepts of tax sparing and matching credits in its Report on Tax Sparing. *See* OECD (1997), *supra* n. 408.

were subject to effective taxation in that State.[418] The tax credit granted will be normally higher than the one actually paid or withheld in the source country, even higher than the one provided by the specific tax treaty. If the notional tax allowed as a credit is equal to the tax at residence, then a full exemption will be granted. In other words, the outcome of DNT will be again an inevitable consequence of the *matching credit* provision in the tax treaty.

4.2. DNT as an outcome specifically avoided by Tax Treaties

Contrary to the cases of *tax sparing* and *matching credits* where the countries directly tolerate the outcome of DNT, sometimes tax treaties attempt to prevent that an item of income remains untaxed in both the residence and source State, affecting thus the country which, due to the tax treaty, limited its rights to tax a specific income. For this purpose, the Contracting States normally negotiate the inclusion within their tax treaties of either a *subject-to-tax* or *switch-over* provision. Nevertheless, the use of these provisions is very exceptional and sometimes is subject to a justified

[418] The predetermination in the tax treaty of the exact amount of credit to be granted by the State of residence makes the difference between a *matching credit* and a *tax sparing* provision, because while the former contains this predetermination, the latter responds exclusively to a specific tax incentive in the source country which, due to this fact, does not exercise its taxing rights. *See* Arruda and Trindade, *supra* n. 411, p. 400. *See also*, L. Freitas de Moraes e Castro, *Brazil's Anti-Treaty Shopping Measures: Current and Future Developments regarding Beneficial Ownership and Limitation on Benefits Clauses in Tax Treaties*, 65 Bull. Intl. Taxn. 12 (2011), Journals IBFD, p. 662 (footnote 6).

criticism, both derived from their ambiguous interpretation and some tax policy concerns.

4.2.1. *Subject-to-tax* clauses

As noted already, one of the option for those countries that decide to grant tax treaty benefits only in those situations where the item of income in question is taxed in the other Contracting State is through the inclusion within their tax treaties of specific provisions known as *"subject to tax clauses"*. Although the wording of *subject to tax clauses* can vary from country to country, and sometimes from tax treaty to tax treaty within the same country, they all have the same aim in common: to ensure single taxation either in the residence or source State.[419]

[419] In Austria, e.g. some tax treaties include a *subject-to-tax* clause in order to ensure the taxation of Austria as the source country. An example of the above can be found in the Article 15(2) of the Australia-Austria tax treaty, where besides the requirement of the 183 days, the country of employment (source State) is prevented from exercising its taxing rights with respect to income from dependent services only to the extent the income is or will be subject to tax in the State of residence. Similar provisions can be found in the Article 20(1) of the tax treaty Austria-Malaysia*,* the Article 12(3) of the former tax treaty Canada-Austria, or Article 13 of the treaty Austria-UK and Austria Switzerland. *See* M. Achatz; B. Gröhs and R. Weninger, *Taxation of non-resident individuals in Austria*, 58 Bull. Intl. Taxn. 11 (2004), Journals IBFD, p. 529. Germany also includes these clauses in some of its treaties. For example, Article 23(3) of the German-New Zealand tax treaty (1978) and Article 23(1) of the German-UK tax treaty (2010). However, the inclusion of *subject to tax clauses* should not be considered as a general German treaty policy. *See* J. Lüdicke, *Exemption and Tax Credit in German Tax Treaties–Policy and Reality*, in: P. Baker and C. Bobbett (eds), *Tax Policy Math*, Essays in honor of John F. Avery Jones, (IBFD 2010), p. 292.

The OECD Commentaries recognize the possibility of including *subject-to-tax* provisions within tax treaties as an exception to the absolute obligation in the State of residence to relieve double taxation through the exemption method in cases where the other Contracting State does not tax the respective item of income.[420] Those cases could arise when no taxes are applied in the State of source with respect to the specific item of income or capital, or the taxes are not effectively collected due to, e.g. a set-off of losses, an expiration of the statutory time limit or a simple mistake.[421] Nevertheless, the application of *subject-to-tax clauses* is not absent of interpretation problems, mostly derived from their varied wording in different countries and the absence of common rules at the level of the OECD Model. For example, while some countries might consider that "subject to tax" is equivalent to "liable to tax" (i.e. being subject to taxation in a jurisdiction, regardless whether or not taxes were finally paid), other countries could simply consider that "subject to tax" is indeed a synonym of "effective taxation". However, "effective taxation" does not always imply "to be taxed", but sometimes could be regarded as the simple act of "being subject to a tax regime". In most of the cases, the absence of domestic jurisprudence increases the uncertain results. The above can be seen, e.g. in the case of the *subject-to-tax provision* contained in Article 22(1)(a) of the

[420] OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 35.

[421] Id.

German-Luxembourg tax treaty.[422] This clause targets situations in which income remains wholly or partially untaxed in Luxembourg, as Luxembourg does not or cannot exercise its taxing rights under the tax treaty due to its domestic rules.[423] The treaty, therefore, grants the exemption to relieve double taxation in Germany only in those cases of income sourced in Luxembourg, which is "effectively taxed" *("tatsächlich besteuert")* in Luxembourg.[424] Nevertheless, it is not entire clear in Luxembourg what "effective taxation" means for purposes of the tax treaty, as there is no administrative guidance or case law that might help in clarifying this term. Another practical application of the above can be found, e.g. in the Belgian tax treaty practice.[425] Belgian tax treaties generally include in Article 23 the exemption method as a relief of double taxation. In the case of some tax treaties,[426] however, the expression "may be taxed", normally used in Article 23 OECD Model, is substituted by the expression "is taxed".[427] In parallel, when interpreting the treaty relief provision and the expression "is taxed",

[422] Convention between the Federal Republic of Germany and The Gran Duchy of Luxembourg for the avoidance of double taxation of 23 April 2012 (which replaced the treaty of 1958), Article 22(1)(a).

[423] F. Jacob and A. Hagena, *The Germany-Luxembourg Income and Capital Tax Treaty (2012)*, 66 Bull. Intl. Taxn.10 (2012), Journals IBFD, p. 537.

[424] Id.

[425] N. Bammens, *Subject-to-Tax Clauses in Belgian Tax Treaties–"Exemption Vaut Impôt" Doctrine Rejected Again in Case Law,* 68 Bull. Intl. Taxn. 8 (2014), Journals IBFD, p. 432. *See also*, L. De Broe and N. Bammens, *Interpretation of subject-to-tax clauses in Belgium's tax treaties: critical analysis of the "exemption vaut impôt" doctrine,* 63 Bull. Intl. Taxn. 2 (2009), Journals IBFD.

[426] For example, the treaties with Estonia, Greece, Latvia, Lithuania and the United States. *See* De Broe and Bammens, *supra* n. 425, p. 69.

[427] Bammens, *supra* n. 425.

the Belgian tax authority has been inclined to apply a domestic doctrine known as "*exemption vaut impôt"*, which means that the wording "is taxed" is interpreted as being *"subject to a tax regime in the source country"* and not necessarily *"to be subject to effective taxation"* in the source State.[428] The Belgian jurisprudence has been quite contradictory on this matter. The Brussels Court of Appeal, e.g. in the *Sidro* case in 1970 ruled that the condition of Article 23 of the Belgian-Canada tax treaty should be interpreted as "effective taxation".[429] However, the Belgian Supreme Court ruled later on in favor of the taxpayer and provided that the requirement of being taxed abroad is not subject to any condition based on the nature, form or amount of the foreign tax.[430] In other words, it is enough to be subject to a tax regime in the source State, even though no taxes are finally assessed. In a recent decision ("*Mons Court* case") of 2014,[431] however, the *Tribunal de Première Instance de Mons*, turned back and reaffirmed that the expression "is taxed" should be interpreted as requiring effective taxation in the source State and denying the application of the "*exemption vaut impôt"* doctrine.[432]

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428 Id.

429 The case concerned *Sidro*, a Belgian company, was the majority shareholder of a Canadian company. During the 1960s, *Sidro* sold its shares in the Canadian subsidiary, realizing a capital gain. However, no taxes were charged on that capital gain in Canada. Accordingly, Belgium's unilateral relief provided for a reduced tax rate on income earned and taxed abroad. The Court of Appeals in Brussels held that the reduced rate could not be applied, because the capital gains were not "effectively taxed abroad". *See* De Broe and Bammens, *supra* n. 425, p. 68. *See also*, Belgium: Brussels Court of Appeals, 28 May 1969, *Rev. Fisc*. 81 (1970).

430 Id.

431 Belgium: Mons., 11 Sep. 2013, No. 11/1078/A.

432 The case, referred to the application of Article 23(2)(a) of the Belgium-Lithuania tax treaty (1998), concerned a Belgian resident who worked as a consultant in Lithuania for the EBRD. According to Lithuanian domestic law, the remuneration received by the

As per the *Tribunal de Première Instance de Mons'* s decision, the First-tier Tribunal (Tax Chamber) in the UK, during the *Weiser* case in 2012, set up a clear distinction between *"liable to tax"* and *"subject to tax"*.[433] In the decision was stated that while *"liable to tax"* is a term normally used to refer a taxpayer that falls within the scope of a State's taxation in general, *"subject to tax"* is used in relation to the chargeability of a specific item of income.[434] In other words, the term *"subject to tax"* requires that income be actually within the charge to tax in the sense of being included in the computation of the taxpayer's taxable income, with the result of a tax being paid.[435] In other cases, it is doubtful whether or not a *subject-to-tax provision* is indeed a "subject-to-tax requirement". Such is the case of Germany, which includes a *"general subject to tax clause"* in some of its tax treaties, known as "*Regress clauses* or *Rückfallklauses"*.[436] An example can be found in the wording of Article 23(3) of the 1981 German-Canada tax treaty, which reads as follows: "For purposes of this Article, profits, income or gains of a resident of a Contracting State shall be deemed to arise from sources in the other Contracting State if they are taxed in that other

Belgian resident was taxable in Lithuania, but the Framework Agreement between Lithuania and the EBRD required Lithuania to exempt it. The taxpayer, relying in the "*exemption vaut impôt"* doctrine, argued that Belgium should exempt the remuneration even though this has not been subject to tax in Lithuania, because of the Framework Agreement. *See* Bammens, *supra* n.425, pp. 432-433.

433 *See* the reference to the *Weiser* case law at *supra* n. 319.

434 Cleave, *supra* n. 319, p. 282.

435 Id., p. 281.

436 H. Chen, *Interpretation of Subject-to-Tax Clauses,* in: M. Schilcher and P. Weninger (eds), *Fundamental Issues and Practical Problems in Tax Treaty Interpretation*, Linde, Vienna (2008), pp. 379-380.

Contracting State in accordance with this Agreement".[437] The BFH, however, has been clear in sustaining that such clauses do not constitute a *subject to tax clauses.*[438]

Other problems associated to the use of *subject-to-tax* clauses refer to the evident contradiction between *subject to tax clauses* and the pure application of the exemption method to relieve double taxation.[439] As the author has sustained before in this work, the exemption method, unlike the credit method to relieve double taxation, should be applied regardless the consideration upon the taxation of the income in the other country.[440] This simplicity is in fact one of the main reasons for countries to opt for the exemption rather than the credit method to relieve double taxation, and it is also one of the reasons of its justified success in continental Europe where it is the preferred method.[441] This is why some authors have recommended that, unless some particular reasons inspired in the other Contracting States'

[437] Agreement between Canada and the Federal Republic of Germany for the avoidance of Double Taxation with respect to Taxes on Income and certain others of 17 July 1981 (also "German-Canada Tax Treaty"), Article 23(3)

[438] DE: BFH 17.02.2003. 1 R 14/02. BStBl II 2004, referred to Article 23(3) of the German-Canada Tax Treaty.

[439] Likewise, one could also argue that the economic idea behind the application of the exemption method (CIN) is violated through the use of these subject-to-tax clauses. Nevertheless, this analysis certainly exceeds the purpose of this Chapter and this whole work.

[440] OECD Commentary on Articles 23 A and 23 B concerning the methods for elimination of double taxation, para. 34.

[441] *See,* e.g. Schön*, supra* n. 89.

tax system motivate the inclusion of *subject-to-tax clauses*, a good tax treaty policy should indeed refrain of doing that.[442]

An issue of particular interest in the whole study of *subject-to-tax clauses* is how some countries have opted for introducing these clauses onto domestic laws, overriding the tax treaty provisions that refer to the application of the exemption method. This is the case of Germany, e.g. who in 2004 introduced a treaty override provision under which income from employment is only treaty exempt insofar the taxpayer gives evidence that this has been taxed or that the other State waived its right to tax.[443] Subsequently, in 2007, it introduced a second domestic rule by which the tax treaty exemption is denied if the income is not taxed in the other country by reason of a domestic law that forbids that State to tax the income for the sole reason that the taxpayer is not liable to unlimited taxation, because of his residence, habitual abode (domicile), place of management, seat or any other similar criterion.[444] In parallel, and most importantly, a further treaty

442 *See* Lüdicke, *supra* n. 419, p. 296.

443 DE: Sec. 50d(8) of the Income Tax Act ["*Einkommensteutergesetz*–EStG"]. According to Lüdicke, this provision is also inconsistent with a long-standing unilateral exemption policy of certain employee income derived from Germany's non-tax treaty partners. *See* Lüdicke, *supra* n. 419, p. 294. Interestingly, however, in a decision of 15 December 2015, the Federal Constitutional Court (BVerfG–*Bundesverfasungsgericht*) held that Sec. 50d(8) of the Income Tax Act is absoulutelty compatible with the German Constitution, despite the fact of overriding tax treaty law. *See* DE: BVerfG, Beschl. 15.12.2015 – 2 BvL 1/2, URL: http://www.bverfg.de/e/ls20151215_2bvl000112.html

444 DE: Sec. 50d(9), No. 2 of the Income Tax Act ["*Einkommensteutergesetz*–EStG"]. This domestic rule was introduced as a reaction to the jurisprudence of the German Federal Tax Court [*Bundesfinanzhof* (BFH)], specifically to the landmark decision of 17 December 2003 regarding the application of the 1981 Canada-Germany tax treaty,

override provision was introduced within German law, with retroactive effect in this case, according to which a treaty exemption is not granted inasmuch the other State applies the treaty in a way that income is not taxed or it is taxed at a very reduced rate.[445] For some authors, however, this latter provision works in practice more as a *switch-over clause* rather than *subject-to-tax clause.*[446] Needless to say is that the tax treaty override represents a real threat to legal certainty.[447]

Last but not least, it worth to assume the question whether a *general subject-to-tax clause* to prevent double non-taxation shall be included in the OECD Model. Such type of provision can be found, e.g. in Article 26(2) of the Nordic Tax Convention, although its application is limited. According to Article 26(2), if the treaty attributes the right to tax to any income or property to the source State, and that State, according to its domestic law,

according to which relevant provisions contained in the treaty should not be interpreted such that they allow Germany to tax only items of income that are not subject to tax in the other Sate. This provision is triggered in cases where income that would be taxed in the hands of residents of the source State, it is exempt for non-residents, either by application of a treaty or domestic law. However, it excludes general domestic tax exemptions applicable to both residents and non-residents. *See* R. Resch, *The New German Unilateral Switch-Over and Subject-to-Tax Rule*, 47 Eur. Taxn. 10 (2007), Journals IBFD, p. 480.

445 DE: Sec. 50d(9), No. 1 of the Income Tax Act ["*Einkommensteutergesetz*–EStG"]. This provision only applies in a tax treaty context. Therefore, it is not triggered because of any tax exemption of the domestic laws of the Contracting States. Id.

446 Id.

447 The OECD addressed the problem of treaty override in its 1989 report, in which it recommended member countries to avoid enacting any legislation that is intended to have effects that contradict international treaty obligations. *See* OECD (1989), *Tax Treaty Override*, OECD Publishing, Paris. For an analysis on the debate with respect to treaty override in Germany *see*, e.g. A. Perdelwitz, *Treaty Override–Revival of the Debate over the Constitutionality of Domestic Treaty Override Provisions in Germany*, 53 Eur. Taxn. 9/Special Issue (2013), Journals IBFD, p. 445.

does not subject entirely such income or property to tax liability, that income not included in the tax liability shall be taxable only in the residence State. This provision, however, does not apply to qualification or interpretation conflicts. It does not apply in case of disagreements between the Contracting States on the facts and circumstances of a case or on the interpretation of the Convention. In other words, it deals very good with cases of DNT caused by national laws, but it does not, however, for cases of DNT derived by the treaty itself in a classification conflict situation. It is undeniable that such a clause could make things easier in terms of avoiding ambiguous interpretations of tax treaties, at least with respect to the avoidance of DNT.[448] However, it is not surprising that no discussion was carried out during (or after) the major tax revolution started with the BEPS Project in 2013. It is, thus, the author's view that inasmuch no general *subject-to-tax provision* comes into play, the use of *subject-to-tax-clauses*, and subsequently the ensuring of single taxation as a tax treaty aim, will remain exceptional.

4.2.2. ***Switch-over*** **clauses**

Switch-over clauses is another tax treaty manner in which countries may ensure that income does not remain untaxed, preventing thus that DNT arises. Specifically, these clauses allow a State to switch from the exemption

[448] Chen, *supra* n. 436, pp. 383-384.

method to the credit method in cases where DNT arises.[449] As per the *subject-to-tax clauses*, the design and use of the *switch-over clauses* vary from country to country, although they all have in common the aim of avoiding that income remains untaxed because of the application of the exemption method to relieve double taxation.[450]

The inclusion of *switch-over clauses* within tax treaties is, however, not always an acceptable tax policy and it can become irrelevant under certain circumstances. Thus is especially true if the same "switch-over" effect can be achieved under other provisions in the OECD Model, e.g. under the OECD interpretation of Article 23A(4) OECD Model. As already stressed during this Chapter, the OECD approach on this matter is that the residence State shall not be obliged to grant the exemption method if the source State interprets the facts of a case or the provisions of the Convention in such a way that it consider itself fully or partially restricted from taxing an specific

[449] Lang, *supra* n. 21, p. 129.

[450] Germany, e.g. has used *switch-over clauses* in its tax treaties since the 1980s. The original intention of them was to avoid double taxation and DNT, although later on the clauses were restricted to eliminating DNT. The switch from the exemption to the credit method applies if in the Contracting States items of income or capital are placed under different provisions or attributed to different persons, and inasmuch the conflict cannot be solved before through a MAP and if as a result of the difference in placement or attribution, the relevance income or capital would remain untaxed or taxed lower than without this conflict. Thus, in theory, the application of the clause depends of the (un)successful prior MAP, although this requirement has been overridden by the application of domestic provisions included in 2007, which made the MAP requirement useless. S*ee* Lüdicke, *supra* n. 419, p. 291. For an example of the German tax treaty practice of including switch-over clauses, *see*, e.g. Article 23(1)(e)(aa) of the Germany-United Kingdom tax treaty (2010) or Article 24(1) of the Germany-Singapore tax treaty (2004).

item of income or capital.[451] This is exactly the same effect that could be achieved through a *switch-over provision*. Likewise, the use of switch-over clauses is redundant in cases where a *subject-to-tax clause* was already included within the same tax treaty. Having in mind the aim of preventing DNT, it is certainly impossible to imagine the practical function of a *switch-over clause* when an item of income was already taxed due to the proper application of a *subject-to-tax clause.*

The spread use of switch over clauses can also generate special tax treaty concerns when domestic *switch-over clauses* are introduced within domestic laws overriding tax treaty obligations.[452] This problem could be even exacerbated if a massive treaty override practice is implicitly encouraged by specific legislative projects in a supranational level. An example of the above can be materially found in the original text of the proposal for an Anti-Tax Avoidance Directive (ATAD) in Europe, which was issued in the beginning of 2016. In brief, the proposed European Directive was part of a whole Anti-Tax Avoidance Package that intended to address a number of issues connected to the implementation of the OECD BEPS Project. Among the provisions proposed, there was the inclusion of a *switch-over clause*

[451] *Infra* Section 3.4. *See also*, OECD Commentary on Article 23A and Article 23B concerning the methods for elimination of double taxation, para. 56.1.

[452] The issue of tax treaty override and the Constitutional concerns derived from it has been largely discussed in Germany. *See*, e.g. Lüdicke, *supra* n. 419; Perdelwitz, *supra* n. 447.

(Article 6)[453] that would allow a MS not to apply the exemption system to relieve double taxation in cases where the taxpayer receives a profit distribution or proceeds from a disposal of shares held in an entity located in a third country (not MS) regarded as low tax jurisdiction.[454] Beyond the criticisms stressed somewhere else by this and other authors regarding the limitation in the use of the exemption method to relive double taxation and the comparison between statutory corporate tax rates to trigger the application of this Article,[455] the promotion of a massive treaty override was indeed a major fact, specially because of the prevalence of EU Law over treaty commitments, at least regarding tax treaties signed after 1 January 1958.[456] Fortunately, the final text of the Directive has been modified and it does not currently include a *switch-over* provision anymore, a decision that seems to be more in line with the whole OECD BEPS project, which has

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[453] The original text of Article 6(1) reads as follows: "Member States shall not exempt a taxpayer from tax on foreign income which the taxpayer received as a profit distribution from an equity in a third country or as proceeds from the disposal of shares held in an entity in a third country or as income from a permanent establishment situated in a third country […]".

[454] The determination of a low tax jurisdiction criterion is made based on a comparison between both the corporate statutory tax rates of the State of the subsidiary and the State of the taxpayer. If the profits or proceeds were subject to a statutory corporate tax rate lower than 40% of the statutory tax rate that would have been charged under the applicable corporate tax system in the MS of the taxpayer. Id.

[455] *See* A. Navarro, L. Parada & P. Schwarz, *The Proposal for an EU Anti-avoidance Directive: Some Preliminary Thoughts*, 25 EC Tax Rev. 3 (2016).

[456] Because of Article 351 TFEU, tax treaties signed before 1 January 1958 would prevail over EU Law. For the prevalence of EU Law over tax treaty commitments, *see* EU: Judgment in *Costa v. E.N.E.L.*, C-6/64, EU:C:1964:66.

never included a literal *switch-over clause* [457] and which finally aims to tax income where profits are sourced or the value is created.[458]

It is interesting to note that even considering the undesirable effects of *switch-over clauses* described above, and regardless the inclusion of Article 23A(4) in the OECD Model, some countries insist in the use of these clauses to avoid DNT. The above, in the author's view, is not only a recognition that Article 23A(4) OECD Model is not completely effective to solve all situations of DNT derived from conflicts of interpretation, but also a demonstration that countries understand that without the explicit inclusion of these type of clauses, DNT cannot be implicitly understood as an aim or *per se* object of the tax treaties themselves, remaining thus as an exception within the tax treaty practice.

5. The impact of the OECD BEPS Action 6 proposal

The OECD has recently proposed a modification of the OECD Model, which might include expressly the avoidance of DNT as an object and

[457] Indirectly, however, we could argue that the defensive rule promoted under the OECD BEPS Action 2 has a similar effect than a *switch-over clause*. Indeed, as we will see further on in this work, this rule obligates a country to deny an exemption in the receiving country of the payment if the income received was deducted in the payor country. See *infra* Chapter V.

[458] The concept of "value creation" has been, however, subject to criticism by important scholars, basically because of its lack of consistency with the traditional application of the arm's length standard without renouncing to the old belief. *See*, e.g. W. Schön, *Transfer Pricing Issues of BEPS in the light of EU Law*, 3 British Tax Rev. 417 (2015) and Y. Brauner, *supra* n. 200.

purpose of the tax treaties. This proposal has been issued through the 2013 OECD BEPS Action Plan 6[459] and it is ratified and explained in detail in the subsequent 2014 deliverables[460] as well as in the 2015 final report.[461] It is also ratified in the wording of the recently relseased draft of the 2017 update to the OECD Model.[462] When finally introduced, these changes might direct impact in the interpretation of tax treaties as per the rules of Article 31 of the VCLT already analyzed in Section 2 of this Chapter.

The OECD proposal can be divided in three main amendments concerning the outcome of DNT: (1) a modification of the title of the OECD Model including a reference to tax evasion and tax avoidance; (2) a recommendation of a preamble, which includes that tax treaties cannot create opportunities for non-taxation or reduced taxation through tax evasion or tax avoidance, and 3) the inclusion of the concept of *"special tax regimes"* (STR). All of them are separately analyzed in the following subsections.

[459] Id.
[460] OECD (2014), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
[461] OECD (2015), *supra* n. 200.
[462] OECD (2017), *Draft Contents of the 2017 Update to the OECD Model Convention*, OECD Publishing, Paris. *See also*, OECD (2017a), *Draft Contents of the 2017 Update to the OECD Model Convention, Comments received on the 11 July public release,* OECD Publishing, Paris.

5.1. Modification of the title of the OECD Model

The first of the modification introduced by the OECD BEPS Action Plan 6 is to replace the current title of the OECD Model by the following: “Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance”.[463]

Although this modification is part of 2013 OECD BEPS Action Plan, it is in fact not a novel feature in the OECD Model. Specifically speaking, in 2003, paragraph 7 of the OECD Commentaries on Article 1 was already modified in order to include such a reference to tax evasion and tax avoidance. Paragraph 7 reads now as follows: “[…] It is also a purpose of tax conventions to prevent tax avoidance and evasion”.[464] Accordingly, the OECD Model 2014 provides that States that wish to include in the title a reference to either the avoidance of double taxation or both the avoidance of double taxation and the prevention of fiscal evasion may do so.[465] Therefore, the real impact of this modification as regards to the question whether tax treaties aim or not to prevent DNT is practically zero. Firstly, because it

[463] Id., p. 91. The current title of the OECD Model 2014 says: “Convention between (State A) and (State B) with respect to taxes on income and capital”, without any reference to double non-taxation. The wording is ratified in the draft contents of the 2017 update to the OECD Model. OECD (2017), *supra* n. 462.

[464] OECD Commentary on Article 1 concerning the persons covered by the Convention, para. 7.

[465] Title of the 2014 OECD Model Tax Convention, footnote 1.

refers to two concepts (tax evasion and tax avoidance) not equivalent to the outcome of DNT and whose scope is already included within Article 26 (new Article 27) OECD Model.[466] As this author has repeatedly sustained, fiscal or tax evasion is in fact an aim of tax treaties recognized in Article 26 of the OECD Model (new Article 27), regarding to exchange of information, and which refers to problems of governance failure in collecting taxes due to a lack of information.[467] However, tax evasion has nothing to do with ensuring single taxation or avoiding DNT. Likewise, tax avoidance supposes that a taxpayer can use legal alternatives available or can create new ones in order to reduce its tax burden as low as possible, not being an illegal behavior. Therefore, this behavior of the taxpayer will be considered objectionable or not depending of the level of tolerance in a determined jurisdiction and the effect in the public revenues.[468] Secondly, the absence of a direct reference to DNT in the title allows this author to conclude that an interpretation that tax treaties aim to prevent DNT should be simply discarded.

5.2. The inclusion of a recommended Preamble in the OECD Model

Jointly with a modification in the title of the OECD Model, it is proposed that the OECD Model recommends a preamble that include expressly that the tax treaties, are not intended to "create opportunities for non-taxation or

466 *Supra* Chapter I, Section 4.
467 Id.
468 *Supra* Chapter I, Section 4.2.

reduced taxation through tax evasion or tax avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)".[469] The modification of the preamble is accompanied by an inclusion of a paragraph 16.1 in the Introduction, which says: "The changes made expressly recognize that the purpose of the Convention are not limited to the elimination of double taxation and that the Contracting States do not intend the provisions of the Convention to create opportunities for non-taxation or reduced taxation through tax evasion and avoidance".[470] The above, if finally included within a negotiated treaty,[471] might have an immediate

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469 OECD (2015), *supra* n. 200, p. 92. A similar wording was included in the revised preamble of the 2016 US Model, which states: "The Government of the United States of America and the Government of […], intending to conclude a Convention for the elimination of double taxation with respect to taxes on income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed to obtain reliefs provided in this Convention for the indirect benefit of residents of third states), have agreed as follows:". United States Model Income Tax Convention (2016), front page. *See also* the same wording in the recently released draft contents of the 2017 update to the OECD Model. OECD (2017), *supra* n. 462.

470 OECD (2015), *supra* n. 200, p. 93.

471 The literal wording of this proposed preamble (and title) has already been used in the new tax treaty between Germany and Australia, which says: "Australia and the Federal Republic of Germany, Desiring to further develop their economic relationship and to enhance their cooperation in tax matters, Intending to conclude an Agreement for the elimination of double taxation with respect to taxes on income and on capital *without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Agreeemnt for the indirect benefit of residents of third States* […]" (emphasis added). *See* 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 of 11 Nov. 2015, p. 2.

impact in the interpretation of tax treaties, since the preamble of tax treaties is part of their context, and thus a fundamental part of their interpretation.[472] Nevertheless, the wording of the preamble at stake is open to criticism both in form and in substance. Firstly, the proposed preamble includes not only cases of DNT, but also cases of "reduced taxation", whatever reduced taxation means for this purpose. The above might create serious problems of interpretation. On one hand, because it is not clear which references should be used to compare between tax systems in order to determine that a level of "reduced taxation" has been achieved. For example, one might compare using statutory tax rates, or "effective tax rates" or, perhaps a pre-elaborated OECD table might determine the "minimum" of taxation required by country. On the other hand, and as it has been stressed before in this work, DNT and reduced taxation (under-taxation) should not be regarded as equivalent concepts, because in fact they represent two different outcomes.[473] While the former implies a complete absence of taxation, the latter supposes that at least a minimum level of taxation was achieved. Thus, the item of income in question was taxed at least once. However, when putted together (non-taxation and reduced taxation), we confuse again the nature of DNT, creating an *a priori* negative idea upon it.[474]

Secondly, it has been intrinsically suggested in the wording of the proposed preamble that only the cases of DNT derived strictly from cases of tax

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472 Article 31(1) of the VCLT.
473 *Supra* Chapter I, Section 2.2.
474 Id.

evasion or tax avoidance should be a matter of concern.[475] Hence, one should conclude thus that in all of those cases in which the outcome of DNT has been generated neither through a fraudulent conduct from the taxpayer that it is aimed to cause an illegal reduction in the amount of tax to be paid nor through an objectionable, but not illegal conduct aimed to reduce the taxpayer's tax burden, the outcome of DNT is not be regarded as a cause of concern at all. This intrinsic limitation is remarkable because it recognizes that DNT is indeed not *per se* a problem. Nevertheless, it might generate new problems of interpretation, because both the concept of tax evasion and tax avoidance are eminently domestic concepts, and thus, their boundaries are not homogeneous for all countries.[476] As already stressed in Chapter I, tax evasion is generally an illegal conduct around the world. However, tax avoidance is not. Therefore, the level of tolerance to tax avoidance in each country will certainly determine the extension to which the preamble of the treaty contributes to the interpretation of the treaty. In other words, the concept of tax avoidance can in any case be interpreted autonomously and it will always require a reference to domestic law.

Thirdly, and finally, this author considers that the wording of the proposed preamble certainly exceeds the mandate of the G-20 when the BEPS Project

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475 The use of the word "through" instead of "for example" or "among others" in the proposed Preamble clearly suggests a narrow interpretation. The preamble states that tax treaties are not intended "to create opportunities for non-taxation or reduced taxation *through* tax evasion or tax avoidance […]". *See* OECD (2015), *supra* n. 200.

476 *Supra* Chapter I, Section 4.

was launched. If recalled, the BEPS Action Plan stated: "No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it".[477] This is to say, tax treaty entitlement is conditioned to substance and economic functionality, i.e. activities that contribute to value creation or active trade or business, etc. Therefore, taxpayers should not be seen as abusing a treaty where genuine businesses are set up, even if non-taxation derived from the application of that treaty is the result of those businesses. As already stressed in this work, DNT can be indeed an acceptable result within a tax treaty context, provided that non-artificial arrangements are observed.[478]

5.3. The new concept of *"Special Tax Regime (STR)"*

Action 6 also includes a proposal, not originally introduced in the 2014 draft,[479] addressing what is called *"special tax regimes"* (STR).[480] Under the proposal, the treaty benefits related to interest (Article 11 OECD Model), royalties (Article 12 OECD Model) and other income (Article 21 OECD Model) would be denied in case of persons that are subject to a STR with

477 OECD (2013), *supra* n. 2, p. 10.
478 A similar view was provided in the Revised Public Discussion Draft on Action 6. *See* OECD (2015), *Comments Received on Revised Public Discussion Draft, Follow-up Work on BEPS Action 6: Prevent Treaty Abuse*, OECD Publishing, Paris, p. 100-101.
479 OECD (2014), *supra* n. 460.
480 OECD (2015), *supra* n. 200, pp. 96-98.

respect to these particular items of income.[481] For this purpose, a STR with respect to an item of income or profits "means any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit, including through reductions in the tax rate or the tax base […]".[482] Several exclusion from the special tax regime status are also provided for any legislation, regulation or administrative practice that, e.g. is designed to prevent double taxation or that implement the principles of Article 7 or Article 9 OECD Model, among others.[483] The proposal also includes the respective modification in Articles 11, 12 and 21 OECD Model in order to entitle the source State to tax these types of income, beneficially owned by a resident of the other Contracting State, if such resident is subject to a STR at any time during the taxable period in which the income is paid,

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481 Id.

482 Id., p. 96.

483 The 2015 Final Draft states: "However, the term shall not include any legislation, regulation or administrative practice: (i) the application of which does not disproportionately benefit interest, royalties or other income, or any combination thereof; (ii) except with regard to financing income, that satisfies a substantial activity requirement; (iii) that is designed to prevent double taxation; (iv) that implements the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises); (v) that applies to persons which exclusively promote religious, charitable, scientific, artistic, cultural or educational activities; (vi) that applies to persons substantially all of the activity of which is to provide or administer pension or retirement benefits; (vii) that facilitates investment in widely-held entities that hold real property (immovable property), a diversified portfolio of securities, or any combination thereof, and that are subject to investor-protection regulation in the Contracting State in which the investment entity is established; or (viii) that the Contracting States have agreed shall not constitute a special tax regime because it does not result in a low effective rate of taxation;". Id., p. 97.

as well as a treaty rule to deal with the future changes in Contracting States' domestic laws.[484]

Unsurprisingly, the STR proposal of Action 6, originally tabled by the U.S. delegate to the Working Party, mirrors the draft of the 2016 US Model, which includes a similar concept in Article 3(1).[485] Unlike the OECD proposal, however, the draft of the US Model is accompanied by a more detailed Technical Explanation draft, from which is possible to determine that the tax policy behind its introduction is no other than to mitigate the generation of DNT in instances where tax treaties are abused in combination with tax regimes that offer specially beneficial tax status. As provided in the Preamble of the of the 2016 US Model: "Consistent with the G20-OECD Base Erosion and Profit Shifting (BEPS) initiative, the STR provisions are intended to mitigate instances of double non-taxation whereby a taxpayer uses provisions in the tax treaty, combined with special tax regimes, to pay no or very low tax in either treaty country".[486] This intention is later on reaffirmed in the same text when it states: "It is inappropriate for tax treaties to reduce U.S. statutory withholding rates on deductible U.S. source payments when the related income is subject to no or very little tax".[487] Nevertheless, and although not expressly recognized in the 2015 Final Report on Action 6, it was perhaps the existence of specific tax regimes

484 Id., p. 98.
485 U.S. Model Tax Convention (2016), Article 3(1).
486 Preamble to U.S. Model Income Tax Convention of 17 February 2016, p. 2.
487 Id.

related to the transfer of intellectual property rights from one country to a lower-tax jurisdiction and the resulting of granting treaty benefits to base-eroding payments (i.e. "IP Boxes"), the real aim behind this proposal.[488]

5.3.1. A critical view upon the concept of STR

There is no doubt about the aim of the new concept of STR rule: the prevention of double non-taxation when it derives from the use of STR. Some deficiencies in the design of the rule, however, leave still serious doubts regarding the capability of it to achieve its aim and open the door for criticism. In this order of ideas, it can be firstly argued that the scope of application of the STR rule is very broad and subjective. On one hand, it is broad if we consider that under the OECD proposal, the STR rule applies to both related and unrelated transactions, even though the information available as to whether a tax regime is special or not is not equally available

[488] The analysis of the "IP Box regimes" certainly exceeds the purpose of this work. However, for further and detailed analysis on this subject *see*, e.g. R. Danon, *General Report*, in: Cahiers de droit fiscal international Vol. 100A– *Tax Incentives for R&D* (IFA 2015), p. 17-56; E. Traversa, *Tax Incentives and Territoriality within the European Union: balancing the internal market with the tax sovereignty of member states*, 6 World Tax J. 3 (2014), Journals IBFD; P. Palazzi, *Taxation and Innovation*, OECD Taxation Working Paper No. 9, OECD Publishing, Paris (2011); I. Zammit, *Centralized Intellectual Property Business Models–Tax Implications of EU Patent Box Regimes*, 69 Bull Intl. Taxn. 9 (2015), Journals IBFD; Å. Hansson and C. Brokelind, *Tax Incentives, tax expenditures theories in R&D: the case of Sweden*, 6 World Tax J. 2 (2014), Journals IBFD; R. Matteotti and P. Roth, *Tax Incentives on research and development*, Archives de droit fiscal Suisse May/June 2015, Special issue IFA Basel 2015, available at www.asa.online, acceded on 11 Jan. 2017; M. Soler and E. Gil, *Encouraging Research and Development (and Innovation) in the Spanish Tax System*, 70 Bull. Intl. Taxn. 8 (2016), Journals IBFD.

in both situations. For example, it is expected that both taxpayers and tax authorities will require detailed information about a taxpayer in the other Contracting States. This information can easily be obtained in case of related-parties; however, it is possible to imagine some important limitations in the case of unrelated ones. Likewise, it is more likely that loan or royalty transactions made with the purpose of wrongfully acceding to the benefits of a treaty be carried out between related than unrelated parties. Hence, this author does not see any strong reason to extent the application of the STR rule to unrelated-parties.[489] On the other hand, it is subjective since there is no objective benchmark as to what a tax regime should be compared. For example, should a tax regime be regarded special with respect to another just because the former contains different tax depreciation rules, or different rules for claiming financial expense? What if a tax regime contains special features included in a comprehensive way within the tax regime as a whole? Is that also "special" for purposes of the STR rule? The proposed paragraph 15.2 of the introduction of the OECD Model is unfortunately helpless in providing some clarity in this regard. This paragraph only contains a general statement which provides as follows: "States should also consider whether there are elements of another State's tax system that could increase the risk of non-taxation, which may include tax advantages that are ring-fenced from

[489] Id. The scope of the STR was already narrowed in the 2016 US Model, where the rule applies only to related-party interest payments, royalty payments and guarantee fee payments within the scope of Article 21 US Model. A similar modification should be made with respect to the OECD proposal.

the domestic economy".[490] Nevertheless, it is still unclear what a "tax advantage" means for this purpose. A reference could be made, however, to the US Model, which provides some more objectives criteria. One of the requirements for a statute, regulation or administrative practice to be regarded as a STR is that "is generally expected to result in a *rate of taxation* that is less than the lesser of: A) 15%; or B) 60% of the general statutory rate of company tax applicable in the other Contracting State".[491] This objective criterion can certainly help in improving the design of the STR rule, but more importantly in avoiding that taxpayers and tax authorities adopt conflicting position with respect to the concept of STR.

Accordingly, it is not entirely clear to which extent an "administrative practice" can become a STR. This is to say, it is clear that the term STR includes the ruling practice of a State (perhaps the only real motive of this rule), although a ruling practice can vary a lot from country to country. Some insights might, however, be extracted again from the US Model Technical Explanation's draft, which provides an illustrative example on this matter. The example states as follows: "[I]f a taxpayer obtains a ruling providing that its foreign source interest income will be subject to a low rate of taxation in the residence State, and that rate is lower than the rate that generally would apply to foreign source interest income received by residents of that State, the administrative practice under which the ruling is

[490] Paragraph 15.2 of the introduction of the OECD MODEL. *See* OECD (2015), *supra* n. 200, pp. 94-95.

[491] U.S. Model Income Tax Convention (2016), Article 3(1)(iii).

obtained is a special tax regime".[492] Although the example is clear in providing that a ruling will be included as administrative practice, it is still not clear from that example if both private and public rulings will be equally included.

Moreover, within the list of exceptions of legislations, regulations or administrative practices that should not be regarded as STR, there is an exception by which any legislation, regulation or administrative practice "designed to prevent double taxation" is not considered a STR. Following this order of ideas, if a taxpayer obtains a ruling in State X, which grants the application of a domestic exemption to relieve double taxation with respect to foreign sourced interest coming from State Z, and which are beneficially owned by a resident in country Y, that ruling should not be regarded as a STR, for purposes of the application of the treaty between State Y and State X, because it aims to prevent double taxation. Subsequently, if State Y does not tax the interest either,[493] the DNT outcome remains as an acceptable one. A similar conclusion can be achieved if that rule is introduced by statute or any other regulation. This effect could, however, be neutralized by the parallel proposal in Action 6 that intends to make a tax treaty responsive to certain future changes in a country's domestic tax laws.[494] Under this proposal if at any time after signing the Convention, either of the

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492 New Article 3 Paragraph 1(l) definition of *"Special Tax Regime"*, Select Draft Provisions of the U.S. Model Income Tax Convention of 20 may 2015, p. 3.

493 The fact that the interest payments are beneficially owned by a resident of State Y in this case does not mean that State Y must subject to tax those interest payments.

494 OECD (2015), *supra* n. 200, p. 98.

Contracting State provides an exemption from the taxation to resident companies or resident individuals for substantially all foreign source income (including interest and royalties), the provisions of Article 10, 11, 12 and 21 OECD Model may cease to have effect.[495] For this purpose, a Contracting State may notify the other Contracting State through diplomatic channel that it will cease to apply the above-mentioned provisions, which will have effect for both Contracting States.[496]

Finally, it is important to highlight that under the application of the STR rule with respect to Article 11, 12 and 21 OECD Model, it is still up to the source State, to which the final taxing rights are assigned in those cases, to decide whether or not to tax those items of income. As provided, e.g. in the modification of Article 11 OECD Model, and repeated in the proposed modifications of Articles 12 and 21 OECD Model: "Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State **may be** taxed in the first-mentioned Contracting State […]" (emphasis added).[497] In simple words, the application of the new STR rule should not be interpreted as a *"subject-to-tax"* provision or the like.[498] On the contrary, considering the limitation of tax treaties to assign taxing rights and not to enforce them, the literal wording of the STR rule only

495 Id.
496 Id.
497 OECD (2015), *supra* n. 200.
498 *Supra* Section 4.2.1.

suggests an obvious conclusion, which is that tax treaties "may", but not "must" prevent DNT.

5.3.2. The STR rule and EU Law

The practical application of a rule such as the one proposed under Action 6 (STR) can have some inconveniences at the level of primary and secondary EU Law. With respect to EU primary law, the CJEU stated clearly in the *SIAT case* (2012), that domestic tax rules cannot determine the tax treatment of a payment made in one MS by reference to the characteristic of the tax system of another MS.[499] In brief, the case referred to the application of a domestic Belgian law that limited the deductibility of the payments for some services received by a Belgian resident company (SIAT). The justification of the Belgian Government to deny the deduction was the application of Article 54 of the 1992 Belgian Income Tax Code that provides that the payments for supply or services, among other kind of payments, e.g. interest, shall not be regarded as business expenses where they are made to a non-resident taxpayer,[500] if that payment is not subject there to a tax or is subject to a *"tax regime which is appreciable more advantageous than the applicable tax regime in Belgium"* (emphasis added).[501] The taxpayer alleged that this domestic rule would infringe his freedom to provide

499 EU: Judgment in *Société d´investissement pour l´agriculture tropicale S.A. (SIAT) v. Belgian State*, C-318/10, EU:C:2012:415.

500 BE: Under Article 227(2) of the 1992 Belgian Income Tax Code, foreign companies that do not have their seat, principal place of business or centre of management or administration in Belgium are among the entities that are subject to tax on non-residents.

501 BE: Article 54 of the 1992 Belgian Income Tax Code.

services.[502]The CJEU finally ruled in favor of the taxpayer arguing that it was not clear what a "tax regime which is appreciable more advantageous than the applicable tax regime in Belgium" means for purposes of application of the rule, creating a level of uncertainty which can only be solved in a case-by-case basis.[503] Accordingly, it sustained that the special rule of Article 54 was liable both to dissuade Belgian taxpayers from exercising their right to the freedom to provide services and from other to offer their services to recipients in Belgium.[504] It follows thus that such a special requirement constitutes a restriction on the freedom to provide services.[505]

In an analogy between the Belgian rule (Article 54) and the STR rule proposed under Action 6, mostly considering the uncertainty of the term STR, which in certain manner coincides with the undefined term "tax regime appreciable more advantageous" under Belgian domestic law, it may be recommendable, at least from a policy perspective, to consider the position of the CJEU in cases like the one described above. Likewise, and although just some few services could be included under Article 21 OECD Model, there could be other fundamental freedoms jeopardized by the

[502] The CJEU has consistently sustained that Article 49 EC precludes the application of any domestic rules, which have the effect of making the provision of services between MS more difficult. *See*, e.g. EU: Joined Judgments *X and Passenheim-van Schoot*, C-155/08 and C-157/08 [2009], ECLI:EU:C:2009:368.

[503] C-318/10, EU:C:2012:415, *supra* n. 487, para. 26 and 27.

[504] Id., para. 28.

[505] Id., para. 29.

application of the STR rule, e.g. the freedom of capital derived by the limitation of deductibility of interest in case those interest are not subject to tax in the other Contracting State. Nothing would prevent the CJEU to apply a similar reasoning in such cases. Some could also argue in contrast that a restriction of the fundamental freedoms could be anyway justified under the aim of combating tax evasion or tax avoidance. However, it is worth to recall in this regard that, as sustained by the CJEU in the past, a restriction to the fundamental freedoms could be justified in the need to combat tax evasion or tax avoidance only if the specific objective of such a restriction is to prevent a conduct consisting in the creation of "wholly artificial arrangements" which do not reflect economic reality and with the view of escaping the taxes normally due on the profits or activities.[506]

Regarding EU secondary law, one should bear in mind that Article 1(1) of the EU Interest and Royalty Directive provides a general mandate that interest or royalty payments arising in a MS shall be exempted from taxes impose in that MS (source State), provided that the beneficial owner of the interest or royalties is a company of a MS, or a PE of a MS's company situated also in a MS.[507] Contrary to this general prohibition, however, the application of the STR rule would imply that a source MS, which paid interest or royalties to the beneficial owner of the other MS (resident) where

506 EU: *Cadbury Schweppes* case and *Halifax* case, *supra* n. 112.

507 Article 1(1) of the Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157/49 (2003), hereinafter "Council Directive 2003/49/EC of 3 June 2003".

those items of income were subject to a STR, “may tax” them. Thus, a potential violation of the Interest and Royalty Directive could arise if the source MS finally decides to exercise its right.[508]

The prohibition of Article 1(1) of the Interest and Royalty Directive can be, however, released in case it precludes domestic or agreement-based provisions required for the prevention of fraud or abuse.[509] Likewise, a MS may refrain to apply the Directive or withdraw its benefits in cases where the principal motive or one of the principal motives of the transactions is tax evasion, tax avoidance or abuse.[510] Therefore, if by application of Article 5(1) or (2) of the EU Interest and Royalty Directive the general prohibition of is released, the STR might be applicable. Nevertheless, the above should not prevent us to recognize that the limited wording of the rule –which opts for using the expression “may tax”, giving the source State the final decision of taxing or not– still leaves a high degree of uncertainty with respect to its practical application in these cases where the general prohibition of the Directive does not apply.

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508 As already stressed in this work, the STR rule uses the wording “may tax”, instead of, e.g. “must tax” or “shall be taxed”. Therefore, it leaves up to the State of source to finally exercise the assigned taxing right.

509 Article 5(1) of the Council Directive 2003/49/EC of 3 June 2003.

510 Article 5(2) of the Council Directive 2003/49/EC of 3 June 2003. This provision is similar to Article 15(1a) of the Council Directive 2009/133/EC of 19 Oct. 2009 on the common system of taxation applicable to mergers, divisions, transfer of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States.

6. Final Remarks

When answering the core question of this Chapter, which is whether tax treaties aim or not to prevent DNT as a broad tax policy goal, our answer should be clear and sound: No. As demonstrated during this Chapter, Tax treaties may certainly aim to counteract tax evasion and even sometimes tax avoidance. This has been since ever established through the inclusion of Article 26 (new Article 27) regarding exchange of information. However, and recalling what was explained already in Chapter I, none of those issues are necessarily equivalent concepts to DNT.[511] The above does not mean, however, that tax treaties might under certain circumstances be interpreted as aiming to prevent DNT. Indeed, this aim is especially evident when countries decide to include *subject-to-tax* or *switch-over clauses*, mostly to limit the pure application of the exemption method to relieve double taxation and in a clear attempt to avoid that a specific item of income, in a cross-border transaction, remains untaxed. This aim is, nevertheless, as exceptional as when tax treaties directly pursue the outcome of DNT when, e.g. when *tax sparing* or *matching credit clauses* are included within tax treaties.

The above puts on evidence some important conclusions. On one hand, DNT in a tax treaty context should also be regarded as a simple outcome, whose occurrence can be or not desirable depending upon the specific

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[511] *Supra* Chapter I, Section 4.

circumstances surrounding a specific tax treaty. However, it is impossible to extract a general tax policy behind bilateral tax treaties that allows us to affirm that they, as a general rule, aim to prevent the concurrence of DNT. This conclusion remains valid even after the implementation of the new OECD interpretation of Articles 23A and 23 B OECD Model in the OECD Commentaries and the inclusion of a new Article 23A(4) OECD Model. None of the above mentioned Articles are effective enough to solve all the situations of DNT derived from either conflicts of qualification or interpretation. On the other hand, even when the prevention of DNT is included within some tax treaties either through a *subject-to-tax* or a *switch-over clause*, the scope of these clauses is very limited, not being able to apply to the generality of situations of double non-taxation. This conclusion should not vary with the inclusion of a *"general subject-to-tax clauses"* resembling, e.g. the one included under Article 26(2) of the Nordic Tax Agreement. In simple words, no general tax policy aim of avoiding DNT might be concluded neither from the wording of the OECD Model nor from the tax treaty practice.

Special attention should, however, be paid on the proposals included within the BEPS Action 6 (i.e. modification of the title and preamble of the OECD Model and the inclusion of the STR rule) and their impact in the interpretation of double tax treaties with respect to the aim of avoiding DNT. Such proposals, riskily ignored by commentators in favor of perhaps other more important provisions of Action 6, such as PPT or LOB clauses,

might suggest an interpretation of the tax treaties not only as avoiding double taxation, but also as preventing DNT. Nevertheless, this suggestion, under the author's view, should rapidly be discarded due to various reasons. First, the unhappy wording of the modified OECD Model preamble, if finally introduced within tax treaties, could only suggest that these latter aim to prevent DNT exclusively in the cases where this outcome is the result of tax evasion or tax avoidance. However, the inhomogeneous construction of these concepts, eminently domestic ones, added to the imprecise equivalence given to the concepts of "DNT" and "reduced taxation" might create new and serious problems of interpretation. Needless to say is that the proposed wording certainly extend the mandate given by the G-20 when the BEPS Project was released. Second, the STR rule in case of Articles 11, 12 and 21 OECD Model do not suggest any obligation to the source State to tax the item of income. On the contrary, it is still facultative to this State to exercise or not its taxing right assigned, as demonstrated in the use of the word "may be" instead of "is" or "must be", which could suggest otherwise. Therefore, to interpret the rule as generally preventing that interest, royalties or other income, remain untaxed because of being subject to a STR, would be at least imprecise.

Last but not least, the application of such a rule could face some problems within the EU, mostly derived from the current scope of the Interest and Royalty Directive. The implicit obligation to tax assigned to the source State within the STR rule could be impracticable with respect to transactions between MS within the EU. To do otherwise would imply a violation of EU Law.

–PART TWO–

Hybrid Entities:

A Domestic Decision with International Consequences

III. CHAPTER

The Hybrid Entities' Conundrum: A (Simple) Tax Characterization Issue

1. Introduction

Chapter II and I have been so far devoted to establish the boundaries of what DNT is, including its implications within bilateral tax treaties. This Chapter turns now to analyze the second main element of this study: *hybrid entities*. For this purpose, the Chapter attempts to answer two simple questions: why hybrid entities (and reverse hybrid entities) exist and why one should care about them. The answer to these simple queries is, however, crucial for the further development of this study, especially when the interaction between hybrid entities and DNT is analyzed in further Chapters.[512]

Section 2 refers to some key concepts that are necessary to circumscribe the subsequent analysis on hybrids and reverse hybrid entities. The above includes the distinction between legal and business entities, the difference between domestic and foreign entities, and the taxable and non-taxable status of entities from a domestic perspective. Section 3 turns the analysis into the concepts of *hybrid entities* and *reverse hybrids*, delimiting their terminology and subsequently analyzing in a systematic manner the different existing manners to characterize foreign entities for tax purposes.

[512] I*nfra* Chapters V, VI and VII.

This analysis includes the positive and negative different characteristics of the comparative approach; legal personality approach; overall approach and fixed approach with the purpose of demonstrating, on one hand, that no system prevails over the other, and on the other hand, that there is no completely inviolable system of characterization of foreign entities for tax purposes, being them therefore the result of specific domestic and sovereign tax policy decisions. Section 4, provides a detailed analysis of the U.S. CTB system as the largest and most famous "elective system" to characterize entities for tax purposes, reserving the taxpayers the exclusive right to determine when a foreign entity will be taxable or not. It also provides a reference to the previous characterization system used in the United States (i.e. *Kintner test*) as well as it analyzes the cases of tax planning opportunities derived from the CTB election, specifically with reference to the avoidance of Subpart F income (CFC rule) and the inappropriate use of foreign tax credit. This Section also demonstrates that the electivity of the CTB system is more apparent than real, and when compared, e.g. with a resemblance or comparable system, there is practicably no difference in terms of the possibilities to predict a desired characterization of entities. Section 5 provides three concrete examples of different degrees of coordination in the characterization of foreign entities: Spain, Denmark and the attempted coordination within the Proposal for an EU ATAD and the inclusion of Article 9a EU ATAD II, dealing with cases of payments made to reverse hybrid entities. These examples attempt to demonstrate that coordination in the characterization of entities is not only a utopian

academic idea, but it can also be an effective manner to deal with hybrids and reverse hybrid entities. Section 6 finally provides some final remarks.

2. Key Concepts

There are basically three previous and necessary distinctions to make before going into the conceptual study of hybrid entities: the distinction between legal and business entities, the difference between domestic and foreign entities, and the issue regarding taxable and non-taxable entities. I will briefly refer to them during the subsequent subsections.

2.1. Legal Entities and Business Entities

As expected, there is no straightforward and uniform definition of legal entities. Indeed, the concept necessarily varies from country to country according to the different civil and company law traditions. Nevertheless, a *legal entity* can generally be understood as "a body having legal existence separate from its owners or participants […], such that is capable of having its own rights and incurring its own liabilities."[513] This separate existence is normally recognized in civil law countries as "separate legal personality", and sometimes supposes also an important factor to determine the taxable

[513] IBFD Glossary, available online at the IBFD Tax Research Platform, accessed on 24 Jan. 2017.

status of entities.[514] In common law countries, however, where the concept of legal personality is not generally recognized, other elements can be considered.[515] For example, in the United States whether an organization is an entity separate from its owners for federal tax purposes is a matter or federal tax law and it does not depend whether the organization is recognized as an entity under state law.[516] For example, a joint venture or other contractual arrangements may create a separate entity if the participant carry on a trade, business or financial operation, or venture and divide the profits therefrom. On the contrary, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.[517]

514 In Belgium, e.g. all entities that are residents for tax purposes, have legal personality, and are engaged in profit-making activities, are generally considered subject to corporate income tax. On the contrary, legal entities with no legal personality, such as partnerships, are considered as tax transparent. P. Vanhaute, *Belgium in International Tax Planning*, 2nd revised ed., IBFD, Amsterdam (2008), Chapter 7.10, Online Books IBFD. In contrast, there are countries like Italy where, even though recognizing the concept of legal personality, this is indeed completely irrelevant for purposes of applying the Corporate Income Tax. M. Grandinetti, *Italy*, in: D. Gutmann (ed.) *Corporate Income Tax Subjects,* EATLP International Tax Series, Vol. 12, IBFD, Amsterdam (2015), p. 342.

515 This is arguable, however, in the case of the UK where the jurisprudence has clearly recognized that Limited Partnerships have no separate legal personality, while e.g. LLPs and Scottish Partnerships have. *See*, e.g. U.K.: CA, 9 June 1998, M*emec Plc. v. Commissionaire of Inland Revenue*, Tax Treaty Case Law IBFD.

516 US: Treas. Reg. Sec. 301.7701-1(a)(1).

517 US: Treas. Reg. Sec. 301.7701-1(a)(2).

Nonetheless, legal entities will not necessarily be considered as business entities. Business entities will generally include a type o legal entity whose purpose is to carry on businesses. In civil law countries, the distinction is normally made between civil law and company law companies, distinguishing among them with respect to the existence of commercial reasons that justifies their existence.[518] In common law countries, however, the distinction tends to be more straightforward and provided directly by statute. For example, in the United States the IRC states that a business entity is basically any entity recognized for federal tax purposes, including a disregarded entity with a single owner that is not properly classified as a Trust or otherwise subject to special treatment under the Internal Revenue Code.[519] This is why in the United States and many other countries, the concept of business entities is necessarily reduced to Corporations and Partnerships.

Although the determination of legal and business entities seems to be *a priori* a matter of domestic law, it is interesting to note that it is also possible to find legal entities organized at a supranational level. Examples of the above are the European Company (SE),[520] the European Cooperative

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518 In Spain, e.g. as per the administrative practice of the DGT, a civil law entity might have a commercial object when it exercises an economic activity of production, exchange or services within the market. ES: DGT, Consulta Vinculante V2378-15 of 28 July 2015.

519 US: Treas. Reg. Sec. 301.7701-2(a) for the concept of business entities. *See also*, US: Treas. Reg. sec. 301.7701-4 for Trusts.

520 EU: EC Regulation 2157/2001, Official Journal L 204/01.

Society (SCE)[521], the European Economic Interest Grouping (EEIG),[522] which are legal forms to a large extent governed by uniform EU law, but which are still partly regulated by the national provisions of the MS of incorporation.[523]

In spite of the above, this work will use the term *entity* as including any other arrangement as well, regardless the legal position taken by a country on who derives the income from that entity or arrangement and on whether this has or not legal personality in a specific jurisdiction.

2.2. Domestic Entities and Foreign Entities

As a general rule, countries have a clear understanding of what is a domestic entity, while such an understanding is not that clear when we talk about foreign entities. The reason seems to be obvious: each country decides sovereignly about their own legal forms. That is why countries generally opt to see foreign entities as the opposite of domestic ones, relying in the interpretation of the available legislation instead of providing a clear

[521] EU: EC Regulation 1435/2003, Official Journal L 207/03.

[522] EU: EEC Regulation 2137/1985.

[523] L. Cerioni, *Cross-Border Mobility of Companies in the European Union: Tax Competition and Increased Scope for the CCCTB following Cartesio*, 64 Bull. Intl. Taxn. 12 (2010), Journals IBFD, P. 636. In 2012, the European Commission presented also the final proposal for a Council Regulation on the Statute for a European Foundation (FE). *See* EU: Proposal for a Council Regulation on the Statute for a European Foundation (FE),COM(2012) 35 final, 2012/0022 (AP), 8 Feb. 2012, EU law IBFD. For further analysis on this proposal, *see,* e.g. J.J.A.M. Korving and L.W.D. Wijtvliet, *A Consideration of the European Foundation: Alle Menschen werden Spender,* 67 Bull. Intl. Taxn. 9 (2013), Journals IBFD.

definition of them, or simply using single criteria to determine the distinction between domestic and foreign entities.[524] An example of the above is the worldwide extended use of the concept of *place of incorporation* and *place of central management and control*, which also normally coincide with the criterion to distinguish whether a company is tax resident or not in a specific jurisdiction. In the United States, e.g. the Treasury Regulations consider an entity as domestic if it is incorporated or organized in the United States or under the law of the United State or the law of any state or the District of Columbia.[525] If an entity is organized in both a foreign country and in the United States, then it is also considered to be a domestic entity. All of the other entities are considered as foreign entities.[526] Similarly, in the Netherlands an entity organized under Dutch law is considered as a resident taxpayer or domestic entity.[527] Conversely, e.g. Ireland traditionally used the place of central management and control as a single criterion to determine whether an entity is domestic or foreign.[528] Other countries opt for using multiple choices to distinguish between domestic and foreign entities, recognizing both the place of incorporation and the place of management and control as determine factors. In the United

[524] This makes the concept of foreign entities a residual (or default) one. *See* M. Lang and C. Staringer, *General Report*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 34.

[525] US: I.R.C Sec. 7701(a)(4) and Sec. 7701(a)(5).

[526] *See* the exception for domestic corporations with a wholly owned Mexican or Canadian subsidiary, which may elect to be treated as a domestic corporation under certain circumstances. US: Sec. 1504(d).

[527] NL: Article 2(4) of the Corporate Income Tax Act 1969.

[528] A. Moore, *Ireland-Corporate Taxation* sec. 1, Country Analyses IBFD (accessed 1 Feb. 2017).

Kingdom, e.g. it is considered that if a company is incorporated in the country, it is thus resident for tax purposes. However, if an entity is incorporated abroad, but centrally managed and controlled in the United Kingdom, it is also regarded as a domestic resident company.[529]

It is difficult to argue which one of the criteria, i.e. the place of incorporation or the place of central management and control, is the less easy to manipulate.[530] Indeed, e.g. if Ireland would use the place of central management and control as a single criterion with respect to other countries using the place of incorporation as a single criterion, some unsound outcomes might arise. For example, a company incorporated in Ireland before October 2013 and centrally managed and controlled somewhere else, e.g. the United States, could have been considered tax resident nowhere, because while Ireland understood that the company was centrally managed in the United States, this latter country considered it incorporated there,

529 The only caveat is the case of an entity treated as resident in a territory outside the UK and not resident in the UK for tax treaty purposes. In such a case, the entity will be regarded as non-UK resident. *See* M. Baldwin and T. Kiranoglu, *United Kingdom*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p.838. *See also*, e.g. S. Oliver, *The Parent-Subsidiary o 23 July 1990: A United Kingdom Perspective*, 10 EC Tax Rev. 211 (2001).

530 In reference to the place of incorporation test used in the United States, Bittker and Lokken state that: "[A] place of management test is less arbitrary than the present U.S. rule [place of incorporation] only if that place is identified by factors that are not easily manipulated. For example, if the place of management is considered to be where the board of directors meets, a place-of-management test is even more pliable than the present U.S. rule". B. Bittker and L. Lokken, *Fundamentals of International Taxation, US Taxation of Foreign Income and Foreign Taxpayers*, Thomson Reuters, Valhala NY (2011), p. 65-43.

therefore, it was not regarded as a domestic corporation. [531] After October 2013, however, these kinds of outcomes are no longer possible and an Irish incorporated company cannot be regarded as tax resident nowhere for tax purposes.[532]

2.3. Taxable and Non-Taxable Legal Entities

As well as the distinction between domestic and foreign entities, the distinction between taxable and non-taxable entities at a domestic level is not homogenous around the globe, because it responds to specific and sovereign domestic tax policy decisions. Some countries, determine whether an entity is taxable or not with reference to its corporate or private law status, e.g. using the legal personality of the entity as a factor to determines its tax status. Nonetheless, not always the legal personality is decisive in determining the tax status of an entity at a domestic level. In the case of *partnerships*, e.g. many countries recognizes them as legal entities, subject to rights and obligations and able to appear in Court (i.e. having a separate legal personality), but they treat them for tax purposes as transparent

[531] This was the situation with AOI, AOE and ASI, the three Irish subsidiaries of Apple Inc. that originated a sound and public debate, because these three entities, due to the combination of the domestic rules in the United States and in Ireland, were regarded as tax residents nowhere. *See* Ting, *supra* n. 29, pp. 4-45.

[532] Indeed, since 24 October 2013 where an Irish incorporated company is managed and controlled in a tax treaty country but is not resident there under that country's law, and it is not normally regarded as resident in Ireland because it is not managed and controlled in Ireland, it will be nevertheless regarded as resident in Ireland for tax purposes. This change is effective from 1 January 2015 as regards companies incorporated before 24 October 2013. *See* Moore, *supra* n. 528. *See also*, D. Stewart, *Ireland Targets 'Stateless' Companies in 2014 Budget*, 72 Tax Notes Int'l 3 (2013).

entities, not able to assume tax obligations, such as the payment of taxes.[533] The advantage of relying in the corporate or private law status of an entity is, however, clear: there is no need to look at the structural substance of the entities.[534] That is why many countries follow this criterion.[535] In contrast, there are countries that simply separate between the corporate and the tax law status. In the United States, e.g. there is no immediate recognition of some legal forms as taxable entities at a federal level.[536] A U.S. LLC e.g. is treated as a corporation at the corporate state level, while it is treated as a disregarded entity for federal tax purposes.[537]

Although the domestic taxable status seems to be applicable without middle points, i.e. the entity is regarded as a separate taxable entity or not, there are some exceptions in which it is possible to distinguish "semi-transparent" entities or entities subject to a partial tax transparency regime. An interesting example of the above is the case of the French Limited Partnership (*societies en commandite simple*), which is regarded as a taxable entity, subject to corporate income tax with respect to the share of the profits of the limited partners, while it is regarded as a transparent entity with respect to the share of the profit of the general partners, unless elected

[533] In the United States, e.g., a partnership must file an income tax return even though it does not have to pay taxes. US: IRC Sec. 701 and Sec. 6031.
[534] Lang and Staringer, *supra* n. 524, p. 27.
[535] Id.
[536] *Infra* Section 4.1.
[537] However, LLCs with publicly traded interests are treated as corporations for federal tax purposes. *See* I.R.C. Sec. 7704. *See also*, P. McDaniel, M. McMahon, Jr. and D. Simmons, *Federal Income Taxation of Partnerships and S Corporations*, 4th Ed., Foundation Press, New York (2006), p. 2.

otherwise.[538] Similarly, the general partners of a Limited Partnership in Czech Republic are taxed at the level of the partners, while the limited partners are taxed at the level of the entity.[539] Likewise, as per the treatment of Trusts in Italy, certain beneficiaries are known, while others remain unknown.[540] A Trust will be transparent only in the part of the income attributed to the known beneficiaries, while it will remain opaque for the rest.[541] This partial or semi-taxable status, however, should not be confused with the situation in which an entity is granted a tax exemption that allows this entity not to be taxed on certain items of income or when certain activities are exempted of taxation, e.g. in the case of a non-profit organization. In general terms, a specific tax exemption or a full tax exemption will not change the taxable status of an entity, which will continue to be treated as a taxable entity even though is exempted from

[538] A. Coustel, *France*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), pp. 340-341. Indeed, the only entity treated as fully transparent under French domestic law is the real property co-ownership partnership, as defined by Article 1655 ter of the General Tax Code. *See* J. Benamran, *France-Corporate Taxation* sec. 11, Country Analyses (accessed 1 Feb. 2017).

[539] T. Balco and H. Skalicka, *Czech Republic*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 260.

[540] A. Bavila, *Taxation of Trusts in Italy: Capital Gains on Trust Assets and Transparent Trusts*, 64 Bull. Intl. Taxn. 8/9 (2010), Journals IBFD, p. 482.

[541] A. Crazzolara, *Italy*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 445. It is interesting to note that "trusts" were recognized only after Italy ratified the Hague Convention of 1 July 1985, which entered into force on 1 January 1992. The above created a lot of issues for practitioners, public officers and judges to understand a concept that comes from common law countries, e.g. the United Kingdom or Bermuda. For further analysis, *see* L. Corsini, *The Taxation of Trusts in Italy*, 53 Bull. Intl. Taxn. 3 (1999), Journals IBFD, p. 21. Specific provisions on trusts were not issued until the Law 296 of 27 Dec. 2006, which entered in force on 1 Jan. 2007. Bavila, *supra* n. 540.

Corporate Income Tax in a specific jurisdiction. Indeed, in the majority of the cases the entity will continue to comply with some obligations inherent to taxable entities, such as filing tax returns or other tax formalities.[542] In other cases, the taxable status of an entity might certainly guarantee its entitlement to get a tax exemption. In Germany, e.g. only taxable entities are entitled to tax exemptions.[543]

Finally, it should be highlighted that the tax status of an entity should not vary just because it becomes part of a tax group regime. Indeed, and although this will depend exclusively upon the tax regime under analysis, it seems to be generally accepted that the tax status granted to a single entity is respected once it is part of a tax group.[544]

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542 Spain is an exemption, because totally tax exempted entities do not have to file tax returns and they are also excluded from all other tax formalities. *See* M. Villar, *Spain*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 743.

543 DE: Section 5 of the German Corporate Income Tax.

544 In Germany, e.g. the effects of the tax group regime only extend to the transfer of the income from the subsidiary to the parent of the group, but it does not affect the taxability of the entities among the group. P. Dorfmüller, *Germany*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 359. *See also*, DE: BFH of 29 October 1974, I R 240/72, BStBl. 1975 II, 126 and BFH of 7 Dec. 1994, I K 1/93,BStBl. 1995 II, 175. Similarly, in Spain although the tax group is regarded as a taxpayer, the members of the group remain subject to the entire obligations in their individual capacity, except with respect the payment of the corporate income tax of the group. *See* ES: Article 56(2) and (3) of the of the Corporate Income Tax Law [*Ley del Impuesto sobre las Sociedades*], Law 27/2014 (consolidated text) of 27 Nov. 2014, BOE No. 288 of 28 Nov. 2014. An exception of the above, however, could be the case of the Polish tax group regime. A tax corporation group may be formed under Polish tax law by an agreement between two or more *Spzoos* or SAs that have their registered office in Poland and it must exist for at least three tax years. Once the tax corporation group is formed, the income and losses of all the companies of the group is aggregated, having also the advantage that no transfer pricing rules are applied to the intra-group transactions, and the group members cannot linger file

3. Hybrid Entities and Reverse Hybrids

Having already stressed some key concepts regarding legal entities in general, this Section turns now to properly study the origin and existence of *hybrids* and *reserve hybrids entities*. This includes, specifically, the study of the different systems to characterize entities for tax purposes, which is indeed the core issue regarding hybrid and reverse hybrid entities.

3.1. Terminology

Generally speaking a *hybrid entity* is an entity considered as a taxable or opaque entity in the country of its establishment,[545] i.e. an entity different from its owners and subject to corporate income taxation in its country of organization, while in the other country, the same entity will be regarded as tax transparent,[546] namely, there will be no taxation at the level of the entity,

separate tax returns. In simple words, the tax group is technically a single taxpayer and the members cease to be regarded as separate entities. Nonetheless, this interpretation is not entirely clear as exposed by the Directors of the Tax Chambers in Warsaw in different tax rulings, tax scholars and tax authorities. *See* P. Gozdziowska, B. Kuzniacki and T. Wickel, *Poland*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), pp. 638-639.

545 The terms *"taxable entity"* and *"opaque entity"* are used Iin an interchangeable manner and during this work. Likewise, the term "tax transparent" and "fiscally transparent" entities are used in the same manner.

546 The OECD Glossary of Tax Terms states that a *hybrid entity* is "an entity that is characterized differently in two or more jurisdictions, for example, an entity that is treated as a partnership in one jurisdiction and as a corporation in another". OECD, Glossary of Tax Terms, available at www.oecd.org, accessed on 24 Jan. 2017. Likewise, the IBFD Tax Glossary states that a *hybrid entity* is "generally, an entity that is characterized as transparent for tax purposes (e.g. as a partnership) in one jurisdiction and non-transparent (e.g. as a corporation) in another jurisdiction. An entity that is

but rather at the level of the partners.[547] Let us assume the following simple example: XCo is a corporation incorporated in country X, which has a wholly owned subsidiary in country Y (YSub). For country Y tax purposes, YSub is recognized as a taxable entity, namely, is it a separate legal entity subject to corporate income tax. Accordingly, the sole owner of YSub, i.e. XCo, will pay taxes only on the distribution received as dividend from YSub. On the contrary, for Country X tax purposes, the same YSub entity is considered as tax transparent. In simple terms, YSub is deemed not to exist for Country X tax purposes. Therefore, all the income, credit and expenses will flow through YSub to its sole owner, XCo. YSub is thus a hybrid entity.

treated, from the point of view of a particular jurisdiction, as transparent in that jurisdiction and as non-transparent in the other jurisdiction is sometimes referred to as "regular hybrid". IBFD Glossary, available online at the IBFD Tax Research Platform, accessed on 24 Jan. 2017.

547 Although this explanation coincides with the traditional tax treatment of 'Partnerships' as conduit entities where the various items of income and losses flow to the individual partners, its use is not limited exclusively to those entities in this work, and it may also include, e.g. single ownership entities not taxed at the level of the entity, but rather at the level of the single owner, such as the case of a Limited Liability Company (LLC) in the United States. *See*, e.g. L. Cunningham and N. Cunningham, *The logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships*, 4th Ed., West, United States, 2011, p. 1, with respect to the tax treatment of U.S. partnerships. *See also*, McDaniel, McMahon, Jr. and Simmons, *supra* n. 537, p. 1. Likewise, Australia, Germany and Sweden are also examples of countries that follow a tax transparency treatment for partnerships, similar to the one applied in the United States. However, there are some countries in which partnerships are, nevertheless, subject to tax at the entity level. For example, Belgium and Hungary. *See* J. Barenfeld, *Taxation of Cross-Border Partnerships, Double Tax Relief in Hybrid and Reserve Hybrid Situations,* Vol. 9 IBFD Doctoral Series, Amsterdam (2005), Sec. 2.3.2.2, Online Books IBFD.

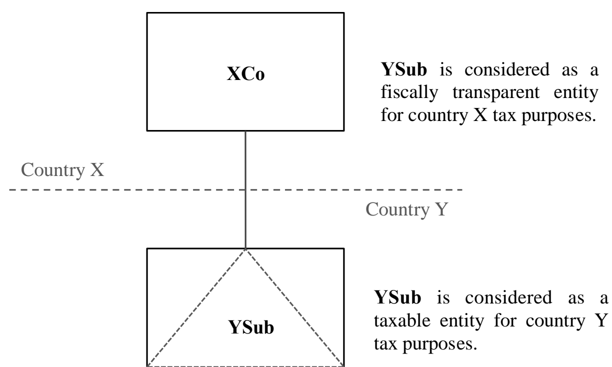

Figure 1: Hybrid Entity

Accordingly, the same phenomenon of "hybridity" can also be found in the opposite direction. This is to say an entity treated as tax transparent in the country of its establishment, but considered as a taxable entity in the other country. These entities are known in doctrine as "reserve hybrids".[548] Taking the same example as above, YSub is regarded as a tax transparent entity in its country of organization, i.e. country Y, while as a taxable entity in the country of its sole owner (XCo), i.e. country X. Thus, while country Y will not subject YCo to taxation at the level of the entity, considering for this purpose that all income, credits and expenses will flow-through YCo until its owner (XCo), country X will consider rather the opposite, i.e. it will subject XCo to taxation only to the extent of the distributions made from

[548] With respect to the concept of *"reserve hybrid",* the Glossary of the IBFD states that: "[A]n entity is a reverse hybrid when it is treated from the point of view of a particular jurisdiction as non-transparent and as transparent in the other. A hybrid entity is, therefore, also always a reverse hybrid, the difference depending on whether the classification is being made from the point of view of the jurisdiction treating the entity as transparent (hybrid) or non-transparent (reverse hybrid)". *See* IBFD Glossary, s*upra* n. 546.

YSub. In other words, YSub is under the eyes of country X as taxable or tax opaque entity.

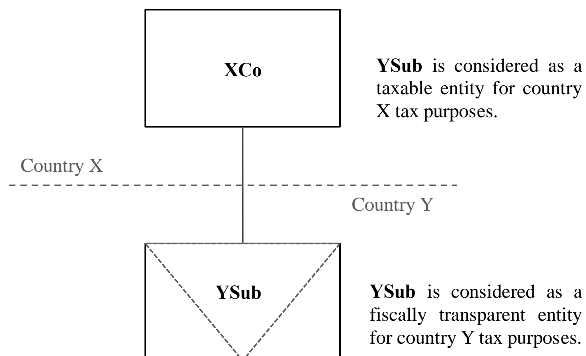

Figure 2: Reverse Hybrid

The core issue within the existence of hybrid and reverse hybrid entities remains thus in the different characterization of an entity made by two or more jurisdictions, which can have an impact both with respect to the amount of taxes paid as well as to which country taxes should be paid. For this reason, the next Sections of this Chapter will be dealing in detail with this issue.

3.2. The Characterization of Foreign Entities for Tax Purposes

As already stressed, the whole issue with respect to hybrids and reverse hybrid entities refers to the rules used to determine the tax status that a foreign entity will have in a specific jurisdiction, i.e. taxation at the level of the entity or at the level of the owners. Although the characterization of foreign entities is made as per the specific domestic rules adopted in each

country, which also depends exclusively of the specific domestic and sovereign tax policies, they can be divided as follows: 1) comparative approach; 2) legal personality approach; 3) overall approach; 4) fixed approach and 6) elective approach. All of them will be further on explained.

3.2.1. Comparative Approach

The majority of the countries opt for a comparative approach or "resemblance test" to characterize foreign entities for tax purposes. For this purpose, a foreign entity is recognized as a taxable entity or not considering certain degree of comparability or equivalence to domestic taxable entities, and in some cases also considering the characteristic of the entity under foreign law. Germany, e.g. applies a resemblance test *(Rechtstypen-vergleich*) in a two level manner. On the one hand, the foreign entity is evaluated in abstract according to the applicable foreign corporate law.[549] The reason for that is to distinguish the legal characteristic of the foreign entity from those domestic entity types in order to rule out non-applicable comparisons.[550] In other words, it seeks to determine whether the foreign entity matches a German domestic one based on its functions and economic activity. For example, a French SICAV is, from a German perspective, considered equivalent to a German investment company by virtue of its

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[549] The Foreign law is determinative and particular attention is given to the conditions under civil law. C. Kahlenberg, *Classification of Foreign Entities for German Tax Purposes*, 54 Eur. Taxn. 4 (2014), Journals IBFD, p. 152. *See also*, U. Henkel, *Subjektfähigkeit grenzüberschreitender Kapitalgesellschaften*, RIW 7 (1991), p. 567.

[550] Kahlenberg, *supra* n. 549, p. 153.

economic activity and functions.[551] On the other hand, and once this abstract-evaluation is made, a specific legal comparison between the foreign and the domestic corporate characteristic is made.[552] If there is no German entity to compare, the classification is made by way of an abstract structural comparison.[553] Therefore, while the general-abstract approach applied in the first level evaluate the applicable foreign corporate law, without, e.g. considering any potential design flexibility in the corporate governance documents, the second level or individual-concrete approach includes an evaluation of the specific characteristic of the entity.[554]

In 2004, however, and referred specifically to the characterization of a U.S. LLC, it was issue the "LLC letter",[555] which enumerated some criteria that should be considered when applying the comparison. These factors are as follows: (a) centralized management and representation; (b) limited liability; (c) free transferability of interests; (d) allocation of profits; (e) provision of capital; (f) perpetual duration of the entity; (g) profit distribution; (h) formal requirements for organization[556] and (i) other factors.[557] Nevertheless, it is

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[551] Id. *See also*, J. Staigner and V. Köth, *Abkommensberechtigung einer französischen SICAV sowie des deutschen REIT*, BB 47 (2012), p. 2916.

[552] Kahlenberg, *supra* n. 549, p. 153.

[553] Id.

[554] Id.

[555] DE: Federal Ministry of Finance [*Bundesfinanzministerium*], 19 Mar. 2004, IV B4-S1301 USA- 22/04, *Schreiben betr. steuerliche Einordnung der nach dem Recht der Bundesstaaten der USA gegründeten Limited Liability Company*, BStBl I 2004, pp. 411-412.

[556] While the entry into the local German commercial register is a mandatory condition for the existence of stock corporations, partnerships limited by shares and limited liability companies (LLCs), it is not mandatory for the existence of commercial partnerships. In

still unclear whether the application of these criteria might be extended beyond the characterization of an U.S. LLC.[558]

Similarly, the Netherlands uses a resemblance test[559] that relies on the company law features of an entity determined according to its foreign incorporation statutes or contracts.[560] The test in based on the following four

such a case, the registration in the local German commercial register will be only relevant with respect to third parties. DE: BFH of 13 June 1992, IX R 182/87, BStBl. 1992 II, 972.

557 For example, whether the foreign entity has legal personality can be also considered, although it does not play a decisive role for classification purposes. Accordingly, the number of investors is not a suitable criterion for distinguishing between corporation and partnerships. Dorfmüller, *supra* n. 544, p. 367.

558 Kahlenberg, *supra* n. 549.

559 The test is currently reflected in a degree published by the Dutch Minister of Finance dated on 11 December 2009. *See* NL: Decree of the State Secretary of Finance, CPP2009/519M of 11 Dec. 2009. The decree has no legal binding power; however, as it is the interpretation made by the State Secretary of Finance, taxpayers can rely on it based on the principle of "legitimate expectations" [*vertrouwensbeginsel*]. *See* M. De Graaf and J. Gooijer, *Netherlands*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 563.

560 Id. Originally, however, the test was issued in the end of 2004, when the Ministry of Finance issued two decrees addressing the classification of foreign entities. The first of these decrees dealt with the classification of foreign entities in the context of the amended EC-Parent Subsidiary Directive. The second one attempted to clarify the Dutch approach to the classification of foreign entities for purposes of the Dutch participation exemption. *See* NL: Decrees of 18 December 2004, Nos. CPP 2004/2730M and CPP 2004/1304M. *See* S. Laghmouchi, *Netherlands: Issues Arising under the Decrees on the Tax Treatment of Foreign (Hybrid) Entities*, 60 Bull. Intl. Taxn. 2 (2006), Journals IBFD, pp. 81-82. The test in 2004 was based on similar questions: "1) Can the entity hold legal title to the assets and liabilities used to carry out its activities?; 2) Is there at least one participant that has unlimited liability for debts and other obligations of the entity?; 3) Does the entity have a capital divided into shares?; 4) Is the admission or replacement of participants, other than by reason of inheritance or legacy, possible without the consent of all other participants? […]. If test 1 was answered affirmative and test 2 negative, the foreign entity was classified as non-transparent. If test 1 was answered affirmative or negative and test 2 was answered affirmative, test 3 and 4 had to be taken into account. If test 3 and 4 were answered affirmative, the foreign entity was

questions: a) is it possible for an entity to legally own the assets with which it performs its activities? ; b) Are all the participants in the entity legally liable only to a limited extent, i.e. liable only for the amount of their capital contributions?; c) Does the entity have capital divided into shares for company law purposes, or can the capital be regarded as having been into shares?, and d) is the entry of new, or the replacement of existing, participants possible without the consent of all participants, except in cases of inheritance or legacy? If the answer to three of the four questions is positive, then the foreign entity is considered as a taxable entity.[561] The Dutch resemblance test is, however, not the only test used in the

non-transparent. If test 3 or 4 was answered negative, the foreign entity was transparent. If the foreign entity was comparable to a Dutch limited partnership (*'commanditaire vennootschap'*), only the fourth test had to be applied. If the foreign entity was comparable to a Dutch limited partnership and the fourth test was answered affirmative, the entity was non-transparent according to the 2004 Decree". *See* A.W.G. Lamers, *Classification of Foreign Entities in the Netherlands: Recent Developments*, 38 Intertax 12 (2010), p. 682.

[561] Prior to this four-question test, the characterization system consisted in a six-criteria test contained within the Decree of 18 September 1997, No. DGO 97-00417, which stated the following questions: (1) Is a (formal) decision required to distribute the entity's profits to its participants? (2) Do the participants in the entity have limited liability? (3) Does the entity have legal title to the assets used in carrying on its activities? (4) Can the participants be replaced or admitted without the consent of all the other participants (i.e. is there free transferability of interests)? (5) Is the entity's capital divided into shares? (6) Is the entity subject to tax on its profits? An affirmative answer to all six precedent questions resulted in a foreign entity characterized an opaque entity and eligible for the Dutch participation exemption. On the contrary, if one of the questions was answered in the negative, the foreign entity resulted to be regarded as a transparent entity for Dutch tax purposes. This 1997 decree was a reaction to a decision of the Amsterdam Tax Court of Appeal dealing with the classification of a French *société en nom collectif* (SNC). An SNC has legal personality in France, its participants are liable for the SNC's debts, and the entity does not have capital divided into shares. The Amsterdam Tax Court of Appeal held thus that, under Dutch civil law, an SNC should be considered to be similar to a Dutch "*vennootschap onder firma",* namely, a transparent entity. Id. *See also*, NL: Decision of Amsterdam Tax Court of Appeal of 4 January 1995, No. 93/1467, Infobulletin, 95/315.

Netherlands to characterize foreign entities as taxable or non-taxable. Indeed, the Dutch Supreme Court applies a slightly different test. The Supreme Court arises the question of who owns the rights and obligations from the conduct of the business and, hence is entitled to the profits. For this purposes, it considers the following factors: 1) the liability of the participants is limited to their contribution in the entity; 2) if the business is legally owned by the entity, and 3) if it is not actually being conducted on the account and at the risk of the participants in any other way.[562] If based on these factors, it can be concluded that the rights and obligations from the conduct of a business are owned by the entity, this will be classified as a body corporate for Dutch tax purposes.[563] Thus, a body corporate is considered non-taxable if the capital is wholly or partially divided by shares.[564] Nevertheless, if the partners are directly entitled to the profits of the entity, a second test is applied through which it is assessed whether the internal regulations imposed on the relationship between the entity and the partners resemble those of an open Dutch limited partnership or a partnership divided by shares.[565] In addition, although not officially recognized, there is also the possibility of obtaining an advance ruling with respect to the tax status of a foreign entity.[566]

[562] De Graaf and Gooijer, *supra* n. 559, p. 564.

[563] Id.

[564] Id. *See also,* NL: Supreme Court 16 March 1994, no. 27.764, BNB 1994/191.

[565] The distinctive criterion is whether the participations in the entity are freely transferable. Id.

[566] As provided by De Graaf and Gooijer: “What most commonly happens in Dutch practice is that, in bona fide situations, the tax inspector will be willing to give advance certainty depending on whether a specific foreign entity is considered to be transparent

In abstract therefore a resemblance or comparative test seems to be the simplest manner to characterize foreign entities for tax purposes. After all, the determination on whether a foreign entity is taxable or not for tax purposes is left exclusively to the domestic characteristics of the taxable entities compared to the foreign entity under analysis. Nevertheless, these types of tests or comparative approaches normally fail in different manners. Firstly, they are unable to deal with the problem that other country's entities may be inherently different to the own ones.[567] Secondly, they require a high level of technical preparation within domestic tax authorities as well important costs, mostly related to hiring foreign tax lawyers who can confirm the analysis of the corporate characteristics of the entity under scrutiny.[568] Thirdly, and even in those cases in which all these costs are assumed, there is no hundred-percent of certainty that the system will not be manipulated at all.[569] Indeed, it is a question of time that taxpayers get used to understand how to manipulate the factors or questions that the resemblance test involve in order to obtain the desired characterization,

or non-transparent for domestic tax purposes. In fact, there is an experienced coordinating team within the Dutch tax administration that functions as a back office handling questions such as these that are submitted to individual tax inspectors all over the country". Id.

567 Avery Jones stresses the example of the Lichtenstein *"Anstalt",* which is not clear whether it is a foundation or a trust. However, he also agrees that similar problems exist with respect to the different treatment of partnerships in civil and common law countries. *See* J. Avery Jones et al., *Characterization of Other Sates' Partnerships for Income Tax*, 56 Bull. Intl. Fisc. Doc. 7 (2001), Journals IBFD, p. 289. For a reference to the "*Anstalt", see* M. Selig, *Half Trust, Half Company, All Anstalt: The History and Possible Tax Consequences of the Liechtenstein Anstalt Down Under,* 53 Intl. Fisc. Docn. 8/9 (1999), Journals IBFD.

568 *See*, e.g. the Dutch tax administration and test already explained in this Section.

569 *See*, e.g. the "*Kintner test"* in the United States before the implementation of the CTB Regulations. *Infra* Section 4.2.

transforming the comparative system in a *de facto* elective system.[570] The above is not only a negative consequence for the tax administration making the comparative analysis, but it is also tremendously unfair result for the taxpayers who cannot access to sophisticated tax advisors in order to obtain a determined characterization of an entity. Finally, one should also consider that an autonomous characterization of entities might necessarily generate inconsistent results. In other words, there is no guarantee that a similar foreign entity is characterized twice in inconsistent manners, e.g. once as a taxable entity and the other as tax transparent, increasing thus the probabilities of generating hybrid and reverse hybrid entities.[571]

3.2.2. Legal Personality Approach

Conversely to the comparative approach, there are countries that prefer to look at the 'legal personality' of the foreign entity and essentially grant the taxable status to those entities that are considered as legal entities, namely, entities separated from their owners.[572] In Belgium, e.g. the concept of legal personality serves as the main nexus to classify a foreign entity as taxable or not and it is governed under Belgian international private law.[573] As a starting point, the place of principal establishment of the entity, i.e. where the company is effectively managed or the "real seat", will be the primary conflict of law rule under Belgian international private law to be

[570] Id.
[571] *Supra* Section 3.1.
[572] *Supra* Section 2.1.
[573] De Broe, *supra* n. 229, p. 67.

considered.[574] If the foreign entity has legal personality and it is treated as a taxable entity under the private law rules of the foreign jurisdiction, then Belgian law will recognize *de plano* that foreign entity as a separate taxable entity.[575] If the foreign entity lacks of legal personality under the laws of the foreign jurisdiction, it will be regarded as a transparent entity in Belgium, regardless of how the foreign jurisdiction treats that entity.[576] Similarly, in Switzerland the determination of the foreign entity's legal personality in its country of organization is considered.[577]

Nevertheless, the legal personality is rarely applied as an isolated factor to determine the characterization of foreign entities. Indeed, this factor is normally used as a first-level test and it is later on combined with a resemblance or comparable test in a second-level. In Belgium, e.g. if a foreign jurisdiction from which the foreign entity derives does not recognize the concept of legal personality, e.g. the United States, the characteristics of this entity are compared against the characteristics of the legal entities under

574 Id.

575 Indeed, the fact that a taxpayer incorporates a foreign company to avoid or reduce tax liability is not enough to disregard the foreign entity for tax purposes. Id.

576 This may result in double taxation, e.g. if the foreign entity is treated as fiscally transparent and this country considers that the non-resident owners have a permanent establishment. The same situation could occur if the entity is regarded, even in absence of legal personality, as a taxable entity. P. Faes, *Belgium*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), pp. 151-152.

577 CH: Article 49(3) of the Federal Direct Tax Act [Bundesgesetz vom 18. Dezember 1987 über das international Privatrecht, SR 291], original text: *„Ausländische juristische Personen sowie nach Artikel 11 steuerpflichtige, ausländische Handelsgesellschaft und andere ausländische Personengesamtheiten ohne juristische Persönlichkeit werden den inländische juristischen Personen gleichgestellt, denen sie rechtlich oder tatsächlich am ähnlichen sind"*.

Belgium law in order to determine whether or not that entity is taxable in Belgium.[578] In other words, a resemblance test is applied as a second-level test to that of legal personality.[579]

Most of the difficulties to conceive the legal personality as a unique proxy to determine the characterization of a foreign entity are derived exclusively from the own nature of this concept. As noted Avery Jones et al.: "Legal

578 In 1998, the Court of Appeal of Brussels classified a U.S. general partnership as fiscally transparent entity, even though the concept of legal personality does not exist under U.S. law. For this purpose, the Court took the features of the U.S. general partnership and tested against those that would be attributed to a Belgian legal entity, arriving to the conclusion that the U.S. partnership had no legal personality because all profits and losses were directly allocated to the partners; the partners were personally liable for the debts of the partnership; the partnership entered into dissolution in case of death, serious illness, bankruptcy or incapacity of one of the partners, and a partner could not withdraw from the partnership prior to its dissolution. *See* BE: Court of Appeals of Brussels, 30 Apr. 1998, AFT, 1999, 119-125, cited in: Faes, *supra* n. 558, p. 157.

579 Similarly, in Switzerland, the legal or factual features of the foreign entity, e.g. by-laws and internal decisions that evidence how the entity is effectively organized, are compared to the Swiss entity to which it comes closest. There is, however, no uniform list of criteria provided by statute for this purposes. For further analysis, *see* S. Oesterhelt and S. Schreiber, in: Zweifel/Beusch (Eds.), Art. 49 of the Swiss Federal Law on Direct Taxation [Bundesgesetz über die direkte Bundessteuer], 3r ed., Helbling Lichtenhahn, Basel (2017), n. 42 et seq. However, e.g. the Swiss Tax Conference, an association of the Swiss federal and cantonal administrations, published in 2011 some guidelines or recommendations with respect to the treatment of a U.S. LLC. In this regard, it was possible to circumscribe some factors normally considered to grant taxable status, which included: (a) whether or not the foreign entity has legal personality and (b) whether or not the partners' liabilities are restricted. *See* J. Salom and H. Salomé, *Switzerland*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 801. In the past, it was uncertain whether the participation in a U.S. LLC was regarded as a participation in a Partnership or a Corporation for Swiss tax purposes. Nevertheless, these guidelines clarified that a U.S. LLC was equal to a Swiss GmbH/Sàrl (*Gesellschaft mit beschränkter Haftung/société à responsabilité limitée*), namely, a Swiss Corporation. *See* P. Hongler, *Swiss Tax Authorities Clarify Treatment of a Shareholding in a U.S. LLC*, 65 Tax Notes Int'l 8 (2012), pp. 595-596.

person […] is a concept that each country understands within its own legal system, and one tends to assume, wrongly, that it means much the same everywhere".[580] An example of the above is the case of the EEIG in Europe, which is considered to have legal personality in most of the European countries, less in Germany and Italy, where it does not fit the concept of legal persons.[581] In case of Germany, this is due to the German legal tradition. As regards to Italy, this is because under Italian law there is a strict separation between the entity and its owners, which results in the fact that the owners cannot be personable liable for the entity's liabilities.[582] On the contrary, the members of an EEIG are so liable.[583]

3.2.3. Overall Approach

Other countries, instead of applying isolated criteria to qualify foreign entities for tax purposes, prefer to apply an overall approach in order to classify foreign entities for tax purposes.[584] The U.K. is a good example of the above, because the U.K. does not apply fixed labels on foreign entities, i.e. opaque or transparent, but rather it applies its tax legislation to determine the tax status of a particular entity for a particular tax situation.[585] The above

580 Avery Jones et al., *supra* n. 567, p. 297.
581 Id.
582 Id.
583 Id.
584 Lang and Staringer, *supra* n. 524, p. 35. The report refers to "overall" or "more comprehensive" approach in comparison to the reliance in single criteria.
585 Baldwin and Kiranoglu, *supra* n. 529, pp. 835-836.

also implies, e.g. that a partnership is considered as a fiscally transparent entity but not for all tax purposes.[586]

The overall approach is thus very uncertain for taxpayers, because it depends specifically of the particular entity and tax situation analyzed. This level of uncertainty, created mostly by inconsistent rules based on case law, can be illustrated in a couple of paradigmatic Court decisions. On one hand, it is *Memec Plc v. IRC* (1998) case law.[587] This case law referred to Memec, a parent company, which entered into a silent partnership agreement under German law [*stille Gesellschaft*]. The other partner was a German GmbH, which was wholly owned by Memec. Accordingly, the partnership had no separate legal personality, but there was a contractual arrangement under which Memec had the right to receive a share of the profits of the business carried on by the other partner, in return for a capital payment.[588] The German GmbH had also other subsidiaries from which it received dividends, which where also the main source of income of the German silent partnership, and thus shared between the partners as per the arrangement. Memec argued the profits received by the German GmbH were indeed

[586] For this purpose, Baldwin and Kiranoglu provide the example of foreign private foundations and state: "These are vehicles which are essentially corporate in nature, but with have some of the characteristics of settlement or trust. Because of the different definitions used in particular pieces of legislation, the same foundation may be both a close company for certain inheritance tax (IHT) purposes and also a 'settlement' for other IHT purposes. Give the broad range of terms and conditions on which foundations are established, the constitution of the particular foundation in question and the effect of its local governing law need to be considered in order to determine how the foundation affects the UK tax analysis". Id.

[587] U.K.: M*emec Plc. v. Commissionaire of Inland Revenue* (1998), *supra* n. 515.

[588] Baldwin and Kiranoglu, s*upra* n. 529, p. 848.

received by Memec, which was able to claim tax treaty relief of double taxation.[589] Memec stated that the German silent partnership did not create a new source of income under the arrangement, because the arrangement was indeed transparent for tax purposes in the U.K.[590] These arguments were originally rejected by the High Court judge, who considered that the question was not on the transparency or not of the German silent partnership, but rather on the arrangement. In this regard, it considered that Memec had no rights in the shares of the subsidiaries and the distribution made to them. However, it did not refer to the main issue, which was whether or not the German silent partnership could be regarded as fiscally transparent under English law. Later on, nevertheless, when the case was appealed, the Court of Appeal referred specifically to the nature of the German silent partnership and to which extent the characteristic of the German silent partnership was shared by an English or Scottish partnership. This decision was the basis for the guidelines of the HMRC International Manual INTM 180010, which listed six factors to consider whether an entity was treated as transparent or opaque for U.K. tax law purposes, including e.g. references to the separate legal existence of the foreign entity and the level of responsibility on entity's liabilities, i.e. if they are assumed by the entity of personally by the owners of the entity.[591]

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[589] Id.

[590] Id.

[591] UK: HMRC, INTM 180010. All the factors included are: a) whether the foreign entity has a legal existence separate from that of the persons who have an interest in it; (b)whether the entity issues share capital or something else which serves the same function as share capital; (c) whether the business is carried on by the entity itself or jointly by the persons who have an interest in it that is separate and distinct from the

The factors published in the INTM 180010 governed the characterization of entities at least until 1 July 2015, where the decision upon *Anson v. Commissioner for HMRC*[592] came into play.[593] In brief, the *Anson* case law referred to Mr. Anson, a resident individual for U.K. tax a law purposes that owned a U.S. LLC in Delaware.[594] This entity was dedicated to manage various profitable venture capital funds.[595] A U.S. LLC is for U.S. tax purposes treated as a disregarded entity (fiscally transparent), while in the U.K. was historically treated as a taxable entity.[596] The issues in question were to determine whether the profit remitted from the U.S. were the same Mr. Anson was taxed in the U.S. or not and whether he was finally entitled

entity; (d) whether the persons who have an interest in the entity are entitled to share in its profits as they arise; or whether the amount of profits to which they are entitled depends on a decision of the entity or its members, after the period in which the profits have arisen, to make a distribution of its profits; (e) who is responsible for debts incurred as a result of the carrying on of the business: the entity or the persons who have an interest in it; and (f) whether the assets used for carrying on the business belong beneficially to the entity or to the persons who have an interest in it. *See* M. Lemos, '*Non-Transparent': The Court of Appeal's Decision on the Delaware LLC in HMRC v. Anson*, XII GITC Review 2 (2014), p. 46.

592 UK: *Anson (Apellant) v. Commissioners for Her Majesty's Revenue and Customs (Respondent)* [2015] UKSC 44 on appeal from [2013] EWCA Civ 63, 1 July 2015.

593 Even up to that date the interpretation of the factors was debatable. *See*, e.g. O. Popa, *UK Investors in US LLCs Exposed to Double Taxation–Is This the End of the Story?*, 53 Eur. Taxn. 6 (2013), Journals IBFD, p. 299.

594 Lemos, *supra* n. 591, p. 48. I will refer broadly to "U.S. LLC", although the term is not precise because indeed every single State of the United States establishes different rules as regards to the organization of LLCs. Nevertheless, the tax status is matter of federal tax law. *Infra* Section 4.

595 Id.

596 In fact, it is included as such in the list of classifications of foreign entities for U.K. tax purposes published by the HMRC. *See* UK: HMRC, INTM 180030—*Foreign entity classification for UK tax purposes: List of Classifications of Foreign Entities for UK tax purposes*.

to tax treaty relief.[597] The HMRC argued that the profit derived from the LLC and taxed in the U.S. were not the same income subject to tax in the U.K.[598] In other words, the HMRC considered the U.S. LLC as a taxable entity, and thus Mr. Anson could not credit the taxes already paid in the U.S. on the share of profits in the LLC.[599]

The First-tier Tribunal ruled in 2010[600] in favor of the taxpayer, allowing double taxation relief under the treaty.[601] The tribunal emphasized that the partners were entitled to profits as they arose, and thus Mr. Anson was taxed on the same income in both countries, being entitled to tax treaty relief.[602] The Upper-Tribunal, however, did not agree with this decision. Indeed, it considered that the First-tier Tribunal had erred in law in holding that the members of the U.S. LLC had not merely a contractual but a proprietary entitlement to profits, although no evidence supported that conclusion.[603] In

597 Mr. Anson paid taxes in the U.S. on his share on the LLC's profits at a rate of 45%. Accordingly, he also paid taxes in the U.K. on his after tax amount remitted to the U.K. at a rate of 22%. He was thus subject to double taxation. Popa, *supra* n. 593.

598 Id., p. 300.

599 Id.

600 The case was anonymized as *Swift v. Commissioners for HM Revenue and Customs*. *See* UK: First-tier Tribunal, 22 Feb. 2010, Case TC00399, Appeal No. SC/3106/08, *Swift v. Commissioners for HM Revenue and Customs,* Tax Treaty Case Law IBFD.

601 Popa, *supra* n. 593.

602 The Tribunal used the M*emec Plc'*s approach to determine whether the LLC was transparent or not for U.K. tax purposes. Id. This also coincides with the majority opinion of practitioners in the U.K., who have stated that what makes an entity transparent for U.K. tax purposes is the ability of the members to remove profits from the organization, without there being any person who can restrict that ability. Lemos, *supra* n. 591, p. 51.

603 Id., p. 52. *Also*, UK: Upper Tribunal, 3 Aug. 2011, FTC/39/2010, [2011] UKUT 318 (TCC), Tax Treaty Case Law IBFD; B. Arnold, *Tax Treaty Case Law News*, 66 Bull. Intl. Taxn. 1 (2012), Journals IBFD.

simple words, it considered the U.S. LLC as a taxable entity, and thus that Mr. Anson was taxed in the U.K. on a distribution and not on the same profits taxed in the U.S., not granting the tax treaty relief.[604] Similarly, the Court of Appeal considered the U.S. LLC as a taxable entity and did not grant the FTC to Mr. Anson.[605] In the decision of 1 July 2015, however, the U.K. Supreme Court interpreted that a U.K. resident individual, member of a US Delaware LLC, treated as fiscally transparent for US tax purposes, was entitled to a FTC under the treaty with the U.S. for the amount of foreign taxes paid and calculated on the profits of the LLC.[606] In other words, it considered the U.S. LLC in the *Anson*'s case law as fiscally transparent. The UK Supreme Court therefore declined to apply the traditional position of considering a U.S. LLC as a taxable entity and focused instead in the language of Article 23(2)(a) of the 1975 US/UK DTC (currently 24(4)(a) of the 2001 UK/US DTC) in terms of determining whether or not the UK tax was computed by reference to the same profits or income by reference to which the US tax is computed, granting finally the FTC. As provided by the Court: "When UK tax is payable on a dividend received from a US Corporation, and US tax has been paid by the corporation on the profits out of which the dividend was paid, there can be no question of the UK tax

[604] Popa, *supra* n. 593.

[605] The arguments of the Court of Appeal, however, were slightly different and focused more in the source of the income. In fact, the Court held that the relevant test for determining whether a person is taxed on the same profits is whether the source is the same. Lemos, *supra* n. 591, p. 52. Using *Memec Plc's* approach, the Court determined that the profit of the LLC did not belong to its members as they arose; therefore, the sources of Mr. Anson's income were different. Popa, *supra* n. 593.

[606] UK: *Anson v. Commissioners for Her Majesty's Revenue and Customs* (2015), *supra* n. 592.

being 'computed by reference to the same profits or income' as the profits of the corporation, if the source of the income is identified on the basis of UK (or, indeed, US) tax law".[607] The above confirms the finding of the First-tier Tribunal, which stated that: "[I]n light of the of the terms of the LLC operating agreement and the views of experts is that the members of [the LLC] have an interest in the profits of [the LLC] as they arise".[608] Therefore, in the same order of ideas, the Court states: "If, then, Mr. Anson was entitled to the share of the profits allocated to him, rather than receiving a transfer of profits previously vested (in some sense) in the LLC, it follows that his 'income arising' in the US was his share of the profits. That is therefore the income liable to tax under UK law, to the extent that it is remitted to the UK. There is no dispute as to the income which was taxed in the US: that was Mr. Anson's share of the profits of the LLC. Mr. Anson's liability to UK tax is therefore computed by reference to the same income as was taxed in the US. He accordingly qualifies for relief […]".[609]

Two important conclusions arise from the *Anson* case law with respect to the characterization of foreign entities.[610] On the one hand, it is the level of uncertainty in the U.K. rules of characterization of foreign entities. As noted already, the HMRC recently stated in a list that a U.S. LLC is treated as taxable entity. This certainly contradicts the U.K. Supreme Court's decision

[607] Id., para. 92.
[608] Id., para. 119.
[609] Id., para. 121.
[610] Other important conclusions that arise from *Anson* are related to the use of transparent entities and the access to tax treaty benefits, mostly in light of the proposed Article 1(2) OECD Model. However, this issue will be further analyzed in *infra* Chapter IV.

in *Anson*, providing again a broader level of uncertainty for all other forthcoming cases.[611] This issue is in part solved since the HMRC has made public in September 2015 that it will continue to apply the practice of treating U.S. LLCs as taxable entities, regardless the outcome in *Anson*.[612] This is, however, not necessarily an auspicious result for taxpayers, because it implies that future potential cases of double taxation may occur. On the other hand, *Anson* has already set up the discussion with respect to the "U.K. system" to characterize foreign entities, including those who, based on simplicity, claim for a system similar to that existing in the United States, i.e. CTB election.[613] As we will see further on in this work, one of the reasons the United States moved from a resemblance test, i.e. *Kintner* test, to an elective system was indeed the level of complexity in the old rules determining the tax status of entities, mostly from the tax authorities' point of view.[614] Under this assumption, it would not be a complete surprise that this discussion turns into a more serious debate in the near future.

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611 *See,* e.g. S. Rogers, D. Cassidy and J. Mace, *U.K. Tax Treatment of U.S. LLCs Post-Anson*, 82 Tax Notes Int'l 4 (2016).

612 The document issued by the HMRC confirmed the following: "(i) when U.S. LLCs have already been treated as companies or corporations, HMRC will not challenge this view; (ii) the *Anson* ruling was specific to the facts and circumstances of that case, particularly Delaware law, and did not herald a wholesale shift in interpretation in this area; (iii) individual claims for double tax relief in reliance on Anson will be considered on a case-by-case basis; and (iv) HMRC proposes to continue in its existing approach to determine whether a foreign entity has 'ordinary share capital' for the purpose of various important corporate tax reliefs (including the substantial shareholding exemption)". Id., pp. 367-368.

613 Lemos, *supra* n. 591, p. 57.

614 *Infra* Section 4.3.

3.2.4. Fixed Approach

Tax scholars refer to "fixed approach" to those cases in which all foreign entities are characterized in the same way, i.e. either fiscally transparent or opaque.[615] This labeled characterization can be done in many manners. Italy, e.g. openly considers all foreign entities as taxable entities.[616] Other countries prefer to provide lists of taxable and non-taxable entities, such as the case of Luxembourg.[617] In other cases, e.g. Greece, the taxable status of foreign entities is given based on arguments of neutrality or non-discrimination. [618] In other words, as all domestic entities are regarded as taxable entities, similarly all foreign entities should be also treated like that.[619] There also situations in which the absence of specific rules permits to interpret that all foreign entities are, e.g. regarded as taxable entities.[620]

At first glance, the fixed approach is less costly for the tax administrations, which do not have to determine the tax status of foreign entities. Likewise, it

615 *See*, e.g. Avery Jones et al., *supra* n. 567. *See also*, V. Kumar, *Conflicts of Qualification and Conflicts of Allocation of Income,* in: E. Burgstaller and K. Haslinger (eds.), *Conflicts of Qualification in Tax Treaty Law*, Linde (2007), p. 39. Countries like Greece, Italy and Portugal follows this approach. *See* Lang and Staringer, *supra* n. 524, p. 35.

616 A. Crazzolara, *supra* n. 541,p. 447.

617 "The opaque entities are listed in article 159 LIR, while the tax transparent entities are listed in article 175(1) LIR and §11bis StAnpG". *See* P. Berna, P. Mischo and F. van Kuij, *Luxembourg*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 516.

618 A. Kardachaki and S. Psaroulis, *Greece*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 392.

619 Id.

620 *See*, e.g. M. Texeira De Abreu, Portugal in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 651; F. Yañez, Chile, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 197.

contributes to predictability for taxpayers who know in advance how some foreign entities will be treated for domestic tax purposes and it is less subject to abusive practices since taxpayers must rely completely in the knowledge on foreign law to plan a tax structure in order to reduce taxation. Nevertheless, and as well as the approaches already mentioned, it does not entirely avoid the generation of hybrid and reverse hybrid entities and their potential misuse. For example, if Italy considers all the foreign entities as taxable entities, [621] the probability of generating cases of reverse hybrids are indeed high, because of the amount of businesses around the world using fiscally transparent structures, such as Partnerships.

3.2.5. Elective Approach

Finally, there is an approach under which the taxpayer can elect the tax status of a determined foreign entity. The majority of the countries, with some exceptions, do not follow this approach,[622] and at this moment the only

[621] A. Crazzolara, *supra* n. 541, p. 447.

[622] In 2013, the Special Tax Treatment Control Act in South Korea allowed certain qualified foreign entities to opt to be treated as fiscally transparent in the same manner as domestic companies. Under the new rule, a foreign entity is qualified to make the election if it meets all the following criteria: (i) the foreign entity has certain similarities to the domestic entities which are allowed to make the election; (ii) the foreign entity has a PE in Korea; (iii) the foreign entity is treated as fiscally transparent in its country of organization. S. Kim and J. Yoon, *Republic of Korea*, in: Cahiers de droit fiscal international Vol. 99B, *Qualification of Taxable Entities and Tax Treaty Protection* (IFA 2014), p. 485. In contrast to the U.S. CTB election, the South Korean rule seems to have the purpose of avoiding characterization conflicts, mostly when there is a potential PE with potentially significant income. *See* Lang and Staringer, *supra* n. 524, p. 38. Other countries have recently introduced electivity exclusively within the domestic context, i.e. not applicable to foreign entities. This is the case of Italy, where since 1 January 2017 there is the possibility to elect the tax treatment of Corporation and other

example is given by the "CTB regulations" in the United States, which due to its special characteristics and complexities will be separately analyzed.

4. The U.S. Elective System: The 'Stone Guest' in a Worldwide Waltz

The United States represents the largest and most famous "elective system" to characterize entities for tax purposes, reserving the taxpayers the exclusive rights to determine when a foreign entity will be taxable or not for U.S. tax purposes. However, when comparing the previous experience based on a resemblance test, i.e. *Kintner* test, it is possible to realize that the current system is indeed not less elective than the previous one, at least in practice. The above, however, does not mean to recognize that the CTB system represents an important source of disparities with respect to the characterization of entities, and therefore, opportunities for tax planning, which can be mostly seen in the circumvention of Subpart F income (CFC rules in the United States) and FTC rules. Nonetheless, and as it will be demonstrated further on in this Section, not always the circumvention of those rules attend to the CTB election, but rather to the poor design of those rules, being therefore the election completely irrelevant.

entities (e.g. Partnerships) either as tax transparent or taxable entities, as the the taxpayers decide. The election can take five taxable periods and it is renewable. *See* IT: Article 55 bis Corporate Income Tax Act [*Imposta sul reddito d'impresa*], Official Journal [*Gazzetta Ufficiale*] No. 301 of 31 Dec. 1986.

4.1. Introductory issues: Domestic/Foreign and Taxable/Non-Taxable Entities

When analyzing the characterization of entities for U.S. tax purposes, it is important to clarify two previous issues: the distinction between domestic and foreign entities, and the determination on whether an entity is taxable or not for U.S. tax purposes.

Generally speaking, the distinction between domestic and foreign entities in the United States is very straightforward: entities organized under U.S. Law are domestic entities while the others are foreign.[623] On the other hand, the determination on whether a domestic entity is taxable or not for U.S. tax purposes is made as follows: firstly, it is determined whether an organization is recognized as a separate entity or not, i.e. an entity separate from its owners;[624] secondly, it is determined whether the entity is a "business entity", which is basically any entity recognized for federal tax purposes, including a disregarded entity with a single owner, that is not

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[623] US: IRS Sec. 7701(a)(4)-(5); US: Treas. Reg. Sec. 301.7701-5. There is one exception, however, which is the case of a domestic Corporation that may elect to have a Canadian or Mexican subsidiary treated as a domestic Corporation for U.S. tax purposes if the subsidiary is organized and "maintained solely for the purpose of complying with the laws [Canada or Mexico] as to the title and operation of property". US: IRC Sec. 1504(d). *See also*, US: IRS Notice 2000-7, 2000-4 IRB 49 regarding the effect of repeal of certain Canadian Banking Legislation on Section 1504(d) elections. The US jurisprudence has also been clear that a when the solely purpose was not to comply with Canadian Law, the election is not allowed. *See*, e.g. US: *Kholer Co. v. US*, 124 F3d 1451 (Fed. Cir. 1997).

[624] A "cost sharing arrangement", e.g. is not recognized as a separate entity for federal tax purposes. *See* US: Treas. Reg. Sec. 301.7701-1(c). *See also*, US: Treas. Reg. Sec. 301.7701-1(a)(1) and Treas. Reg. Sec. 301.7701-1(a)(2), and the references to legal separate entities in the United States in *supra* Section 2.1.

properly classified as a Trust or otherwise subject to special treatment under the Internal Revenue Code.[625] A business entity with two or more owner is thus classified either as a Corporation,[626] subject to Corporate Income Tax at the level of the entity, or as a Partnership,[627] not subject to taxation at the level of the entity, but rather at the level of the partners.[628] Accordingly, a business entity with one single owner is classified either as a Corporation or a disregarded entity.[629] This distinction is crucial, because all business entities not recognized as *per se* Corporations are regarded as "eligible

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625 US: Treas. Reg. Sec. 301.7701-2(a) for the concept of "business entities", and US: Treas. Reg. sec. 301.7701-4 for the concept of "trusts".

626 The term "Corporation" is defined by statute to include: "associations, joint stock companies, and insurance companies". US: IRC Sec. 7701(a)(3). There are domestic entities that must be considered as such for US tax purposes, e.g. Banks, insurance companies. *See* US: Treas. Reg. Sec. 301.7701(2)(b). Accordingly, there are foreign entities that are listed as *per se* Corporations. US: Treas. Reg. Sec. 301.7701(2)(b)(8).

627 Partnerships include: "a syndicate group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or state or a corporation […]". US: IRC Sec. 7701(a)(2). Likewise, a "partner" is defined as: "a member in such a syndicate group, pool, joint venture, or organization". US: IRC Sec. 7701(a)(2).

628 The pattern of taxation of partnerships (pass-through entities), specially referred to the avoidance of economic double taxation has certainly encouraged its use in the United States. McDaniel et al. explains it as follows: "Since the partnership is treated as a conduit for tax purposes, profits are taxed only once, in contrast to the taxation of corporate profits, first when earned by the corporation, and again, when distributed to shareholders". McDaniel, McMahon and Simmons, *supra* n. 537,p. 1. Likewise, the use of losses makes a difference when electing between forming a Corporation or a Partnership. As McDaniel et al. state: "In addition, when the enterprise realizes losses, the partners may deduct the losses currently on their own tax returns, while losses at the corporate level may not be deducted by shareholders". Id. In addition to Partnerships, Limited Liability Companies (LLCs) are taxed either as Corporations or Partnerships. There is no single systematic treatment of LLCs for US federal tax purposes; however, most of LLCs are treated as Partnerships. Id., pp. 1-2.

629 A disregarded entity is an organization with a single owner, which can be recognized as an entity separate from its owner. US: Treas. Reg. Sec. 301.7701-3.

entities"[630], which means that they can elect to be classified either as a Corporation (taxable entity), a Partnership (non-taxable) or a disregarded entity, which is known as the "Check-the-box" (CTB) system or CTB regulations.

As noted, therefore, the CTB regulations apply primarily with respect to the characterization of domestic entities, not being exclusively designed to characterize foreign entities for U.S. tax purposes. The above has to be with the fact that in the United States entities are formed according to state laws (and not according to federal law), which indeed creates lot of problems with respect to the legal characteristics of entities.[631] For that reason, and since its very beginning, federal income tax developed its own system of characterization for corporation, partnerships, trusts and states.[632] Regardless, the above, this work will subsequently refer exclusively to the rules of characterization of foreign entities for U.S. tax purposes.

4.2. The 1954 *Kintner* test

Before the implementation of the CTB regulations in 1996, the United States characterized foreign entities for tax purposes based on the

630 *"Eligible entities"* are business entities not classified as a Corporation under Treas. Regs. Sec. 301.7701-1(b)(1), (3),(4),(5),(6),(7), or (8). US: Treas. Reg. Sec. 301.7701-3(a).

631 *See*, e.g. P. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 Cath. U.L. Rev. 437 (1995).

632 US: Section II.D. of the Revenue Act of 1913, ch. 16, 38 Stat. 114, cited in: Dell'Anese, *supra* n. 4, p. 217.

concurrence of four corporate features which included: limited liability; continuity of life; centralized management, and free transferability of interests.[633] Hence, an entity with more than one owner was classified as an association, taxable as a corporation, if it possessed at least three of these characteristics.[634] If it possessed fewer than three, then it was classified as a partnership for U.S. tax purposes.[635] The treatment of entities with a sole proprietorship was not included under the *Kintner* resemblance test.[636]

The *Kintner* test, however, was not always easy to apply and let open a lot of possible outcomes, even when similar facts and foreign laws were under analysis. An example of the above can be found in the Rev. Rul. 77-214

633 US: *United States v. Kintner*, 216 F2d 418 (9th Cir. 1954). Subsequent Treasury regulations were issued as a result of this case law. *See* US: Treas. Reg. Sec. 301.7701-1 to 11, T.D. 6503, 1960-2 C.B. 409. Nevertheless, in 1935 the U.S. Supreme Court already stated a sort of previous resemblance test. *See* US: *Morrissey v. Commissioner*, 296 U.S. 344 (1935). This decision upholds both the Treasury's regulatory authority in the area of entity classification and the government's position concerning business trust. The decision described the corporate features that a trust should meet to be considered analogous to a Corporation, including: ability to hold title to property; centralized management; continuity of life upon death of an owner; a structure that facilitates the transferability of beneficial interest and limited liability. *See* Dell'Anese, *supra* n. 4, p. 218. The above responded to a reaction during the early 1930s, where many professionals, especially doctors, began abandoning their solo practice in favor of large unincorporated groups in the form of trust or partnership agreements. *See* Hobbs, *supra* n. 631, p. 481. This issue was even more important after *Pelton v. Commissioner* (1937), where these types of organizations received the treatment of associations, taxed as Corporation, which allowed them, e.g. to adopt tax-favored pension plans in comparison to those applicable to individuals. Sooner taxpayers started exploiting the corporate status. Id., p. 482. *See also,* US: *Pelton v. Commisioner*, 82 F. 2d 473 (7th Cir. 1937).

634 Bittker and Lokken, *supra* n. 530, p. 65-66. *See also*, M. Gianni, *International Tax Planning After Check-the-Box*, 2 J. Passthrough Entities 39 (1999), p. 9-10.

635 Id.

636 Id.

(1977)[637] and Rev. Rul. 93-4 (1993), [638] both referred to the application of the *Kinstner* test to a German GmbH [*Gesellschaft mit beschrankter Haftung*], owned by two subsidiaries subsequently owned by a U.S. Parent Corporation. In the case of the Rev. Rul. 77-214, on one hand, the IRS stated that a German GmbH always possesses the corporate characteristics of limited liability[639] and centralized management.[640] By other side, the presence of continuity of life[641] and free transferability of interest[642] would also exist unless separate interests exist to compel dissolution or to enforce transfer restrictions.[643] The GmbH's memorandum of association contained that the GmbH would be dissolved in case of death, insanity or bankruptcy of one of the shareholders [*Gesellschafter*] and any transfer of the GmbH's shares [*Geschäftsanteile*] would require the prior written approval of all the other shareholders. Because the GmbH was owned by two subsidiaries wholly owned by a U.S. parent, the IRS ignored the provisions of the GmbH's memorandum of association and considered that the GmbH possessed both free transferability of interest and continuity of life, being recognized as a Corporation for U.S. tax purposes.[644] In the Rev. Rul. 93-4, on the other hand, the IRS examined the same facts and foreign laws,

[637] US: IRS Rev. Rul. 77-214, 1977-1 C.B. 408.

[638] US: IRS Rev. Rul. 93-4, 1993-1 C.B. 225.

[639] DE: Sec. 13 GmbHG –Limited Liability Company Act– [limited liability].

[640] DE: Sec. 35 GmbHG –Limited Liability Company Act– [management].

[641] DE: Sec. 60 GmbHG –Limited Liability Company Act– [dissolution of a GmbH].

[642] DE: Sec. 15 GmbHG –Limited Liability Company Act– [transferability of interest in the GmbH].

[643] B. Spudis and M. Wilczynski, *Entity Classification Update: Rev. Rul. 93-4*, 71 Taxes 164 (1993), p. 165.

[644] This is known as the "single interest theory" applied by the IRS to justify the existence of free transferability of interest and continuity of life. Id.

arriving to the same conclusion, i.e. a GmbH is a Corporation for U.S. tax purposes, although letting open some possibilities for achieving the opposite outcome: the tax treatment of partnerships.[645] Although the IRS concluded that a German GmbH always possesses the characteristics of limited liability and centralized management, coinciding with its previous Rev. Rul. 77-214, it modified its previous position regarding continuity of life, stating that the presence or absence of separate interests is not relevant to the determination of whether an entity possesses continuity of life.[646] As the GmbH's memorandum of association requires dissolution upon bankruptcy of any shareholder, the GmbH lacks of continuity of life, "without further action", the Rev. Rul. 93-4 removes thus the need for any shareholder to compel dissolution.[647] With respect to the characteristic of free transferability, however, the Rev. Rul. 93-4 stated that because the two shareholders of the GmbH were subsidiaries of the same parent company, all decisions were subject to the influence of the parent company, applying the single interest theory.[648] This conclusion is nonetheless arguable, because it is not clear that the single interest theory applies also to domestic entities.[649] Accordingly, no reference was made within the Rev. Rul. 93-4 to the specific characteristic of the subsidiaries involved, when in fact according to that

645 Id., p. 169.

646 As provided by Spudis and Wilczynski: "[…] the Service appears to be announcing that the single interest theory, as described in Rev. Rul. 77-214, is inapplicable to the corporate characteristic of continuity of life. In so ruling, the Service corrects its prior statement that dissolution must be compelled". Id., p. 166.

647 Id.

648 Id.

649 Spudis and Wilczynski state that Rev. Rul. 93-4 and Rev. Rul. 88-8 suggest that the single interest theory should be applied to both domestic and foreign entities. Id., p. 168.

some limitations to transfer interest may still exist depending of the entity involved.[650]

The *Kintner* test, on the other hand, although being the official manner to characterize foreign entities for tax purposes, was not always strictly followed. The above is demonstrated, e.g. in the General Counsel Memorandum 34.376 (1970), where the IRS determined that an entity incorporated under the law of Nigeria had also to be treated as a Corporation for U.S. federal tax purposes, considering that the concept of incorporation was similar to the U.S. concept, regardless the application of the *Kintner* test.[651] Similarly, in the General Counsel Memorandum 35.294 (1973), the IRS concluded that a Colombian company had to be recognized as a Corporation for U.S. tax purposes, because it was a separate juridical person under Colombian Law, regardless the analysis of the factors under the *Kintner* test.[652] Later on, the IRS would issue the General Counsel Memorandum 36.910 (1976) revoking the General Counsel Memorandum

[650] Certainly less influence from the US Parent Company could exist if both subsidiaries owning the GmbH were German stock corporations [*Aktiengesellschaft*] rather than GmbH. *See* Sec. 76, subsec. 1 and sec. 117 AktG. This latter provides a responsibility of the directors of the company in case decisions where influenced, e.g. by shareholders. Nevertheless, Sec. 291 AktG [controlling company] can restrict the effects of Sec. 76, subsec. 1 AktG. Compare with: Sec. 35; Sec. 45 and Sec. 47 GmbHG.

[651] US: IRS General Counsel Memorandum 34.376 of 13 Nov. 1970, cited in: A. Gomez, *Rationalizing the Taxation of Business Entities*, 49 Tax Lawyer 2 (1995), p. 301. *See also*, Dell'Anese, *supra* n. 4, p. 220.

[652] This position was subsequently limited by Rev. Rul. 73-254, by which the IRS clarified that the characterization of the a foreign unincorporated entity should be carry on through the *Kintner* test, regardless that this entity was recognized as a separate juridical person in its country of formation. *See* US: Rev. Rul. 73-254, 1973-1 C.B. 613. Id. *See also,* US: IRS General Counsel Memorandum 35.294 of 6 April 1973.

35.294, by which it stated that all foreign entities should be characterize according to the *Kintner* test, unless incorporated under common law principles.[653] This issue should be finally settled in the IRS Rev. Rul. 88-8 (1976), where the IRS opted for considering all foreign entities as unincorporated, and thus, subject to the *Kintner* test in order to determine their characterization for U.S. tax purposes.[654]

The use of the *Kintner* test thus puts on evidence some important consequences. On one hand, the complexity and the level of legal uncertainty a resemblance test may represent for taxpayers. Indeed, under a resemblance test, tax authorities really need to get involved onto foreign laws in order to understand the proper characteristics of an entity. The above does not necessarily guarantee the same outcome, not even when the same entities and the same laws are under analysis, increasing thus the levels of uncertainty for taxpayers. On the other hand, and even when such analysis is accurate, although most of the time costly, the opportunities of planning will nevertheless exist since taxpayers can always access to a careful consulting with local counsels in order to obtain the characterization desired.[655] In other words, nothing prevents taxpayers to use drafting techniques advices made by specialized attorneys to predetermine the classification type desired. This

653 US: IRS General Counsel Memorandum 39.610 of 4 Nov. 1976, cited in: Gomez, *supra* n. 651.

654 Id.

655 Gianni, *supra* n. 634, p. 10. *See also,* S. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 35 Hofstra L. Rev. 405 (2005), pp. 430-431, who observed that well-advised taxpayers under the *Kintner* test could certainly avoid the application of corporate income tax.

is exactly why the *Kinstner* test remained in practice as a residual test applied mostly to unsophisticated taxpayers who were unable to pay the professional fees required circumventing its rules,[656] being not less elective than its successor: the CTB regulations.[657] The above, however, does not mean to categorize the *Kintner* test as better or worse than the subsequent elective system, but simply to emphasize that it proved at that time to be inadequate to serve its purpose, mostly after the appearance of small form of business with characteristic of both Corporations and partnerships.[658]

4.3. The 1996 CTB Regulations

In 1996 the IRS issued the final regulations that simplified of the old system of characterization of foreign entities in the United States.[659] Generally speaking, the system allowed certain foreign business entities to be classified in a manner different from that provided in their countries of incorporation so long they were not regarded as *per se* Corporations for U.S.

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656 Dell'Anese, *supra* n. 4, p. 222.

657 In the same opinion, Sicular states: "Over time, of course, practitioners became increasingly adept at manipulating the four factors [*Kintner* test] to change the tax result, even for entities that were clearly corporations […]. Getting there, of course took some amount of costly […], but the U.S. tax saving frequently justified the cost. Entity classification thus was often effectively elective […]". D. Sicular, *The New Look-Through Rule: W(h)ither Subpart F?,* 46 Tax Notes In'l 6 (2007), p. 601.

658 This is clearly explained by Hobbs, who states before the implementation of the CTB system: " […] the resemblance test remains the methodology for entity classification today. However, it has not become cemented into the foundation of accepted tax doctrine. Indeed, given its history of inadequacy, it is remarkable that the resemblance test has survived". Hobbs, *supra* n. 631, p. 519. And he continues: "The resemblance test has proven inadequate because its underlying assumption is that all corporations resemble each other and that other organizations resemble corporations". Id.

659 US: T.D. 8697, 61 Fed. Reg. 66584 of 18 Dec. 1996.

tax purposes.[660] These foreign entities able to elect their tax treatment for U.S. tax purposes are recognized as "eligible entities".[661]

Under the CTB system, an eligible foreign entity can elect to be classified either as an association, which is taxable as a corporation in the United States, or as a partnership, which is taxable only at the level of the partners.[662] Accordingly, if an eligible foreign entity has only one member, it can choose to be classified either as an association or as a disregarded entity.[663] The election can be made at any time and it must accomplish with the formal requirements established by law.[664] Accordingly, the effective day of the election will normally be that one specified in the respective election form, although it also is possible to provide a specific date different from the one on which the election is filed, having even the chance of giving the election a retroactive effect.[665] Once the election has been made, it

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660 US: Treas. Reg. Sec. 301.7701-2(b)(8) states the list of *per se* Corporations.

661 US: Treas. Reg. Sec. 301.7701-3(a).

662 Id.

663 Id.

664 An eligible entity is required to attach a Form 8832 ("Entity Classification Election") jointly with its Federal tax or information return of the taxable year in which the election is made. If the entity is not required to file a return for that year, a copy of the Form 8832 must be attached to the federal tax or information return of any direct or indirect owner of the entity for the taxable year in which the election is made. US: Treas. Reg. Sec 301.7701-3(c)(1)(ii).

665 The effective date cannot be more than 75 days prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date of more than 75 days prior to the date the election if filed, it will be effective only 75 days prior to the date it was filed. Likewise, if the effective date exceeded 12 months after the date on which the election is filed, it will be effective 12 months after the date is filed. US: Treas. Reg. Sec. 301.7701-3 c)(1)(iii). Accordingly, US: IRS Rev. Proc. 2009-41 extended the time for filing the election to 3 years and 75 days prior to the date on which the lection is filed. Entities that satisfy the

cannot be changed for a period of sixty months succeeding the date of the election.[666]

In absence of an election, the tax status of a foreign business is settled by default rules attending to the limited liability and the number of owners of the foreign entity.[667] According to these rules, a foreign eligible entity will be considered a Partnership if it has two or more members and at least one of them does not have limited liability.[668] On the contrary, it will be classified as an association taxable as a corporation, if all members have limited liability[669] and as a disregarded entity if an eligible entity has a single owner who does not have limited liability.[670] Likewise, a foreign eligible entity is considered to have "limited liability" if the member has no personal liability for the debts of or claims against the entity, by reason of being a member, based solely on the statute or law pursuant to which the entity is organized.[671] Conversely, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such.[672] The determination

requirements set out in Rev. Proc. 2009-41 must follow the prescribed procedures for obtaining relief for a late election. *See* US: IRS Rev. Proc. 2009-41 of 28 Sep. 2009.

666 US: Treas. Reg. Sec. 301.7701-3 c)(1)(iv).

667 US: Treas. Reg. Sec. 301.7701-3(b)(2) that refers to the classification of foreign eligible entities that do not file an election. The default rules, however, do not apply with respect to the classification of entities made before 31 Dec. 1996. These entities maintain their characterization according to the *Kintner* test. US: Treas. Reg. Sec. 301.7701-3(b)(3)(ii).

668 US: Treas. Reg. Sec. 301.7701-3(b)(2)(1)(A).

669 US: Treas. Reg. Sec. 301.7701-3(b)(2)(1)(B).

670 US: Treas. Reg. Sec. 301.7701-3(b)(2)(1)(C).

671 US: Treas. Reg. Sec. 301.7701-3(b)(2)(ii).

672 Id.

thus is left to the statute or law in the foreign country where the entity is organized, except when a country allows the entity to specify in its organizational documents whether its members will have limited liability.[673] In such a case, these organizational documents turn also to be relevant.

As per all the rules described above, it is possible to extract some preliminary conclusions. On one hand, although the CTB system is known for being elective, this election is subject to important limitations, which allow arguing that, indeed, it is just partially elective. The above can be seen, e.g. in the fact that the election is relegated only to certain entities recognized as eligible entities and based also on limitations of time once the election is made. This issue was also recognized within the Joint Committee on Taxation (1997) reviewing the U.S. elective system adopted and which stated: "[I]t could be said that the regime established under the check-the-box regulations is not completely elective, because entities eligible to elect either corporate or partnership under the regulations generally are unincorporated domestic entities".[674] Accordingly, the default characterization rules reduces the practical application of the election only to those situations on which an entity wishes to have a characterization other than that provided by statute or in cases it decides to change a previous election. In all the other cases thus the foreign entities will have a characterization for U.S. tax purposes regardless any election made by the

673 Id.
674 US: Staff of the Joint Committee on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues*, U.S. Government Printing Office, Washington D.C. (1997), p. 16.

taxpayer. On the other hand, and in comparison with the previous *Kintner* test, the CTB system represents an important contribution to simplicity and legal certainty in the characterization of foreign and domestic entities for tax purposes.[675] By one side, it eliminates the factual and legal comparisons established under the *Kintner* test, reducing also the costs for the tax administration.[676] By other side, it represents a proof of 'fairness' or equal treatment of taxpayers, since after the CTB regulations the election in the classification of entities is available to all types of taxpayers and not only those well-advised ones.[677] Indeed, as recognized within the US Joint Committee of Taxation (2010): "The Check-the-box regulations were intended to relieve both taxpayers and the IRS from the need to expend considerable resources in determining the proper classification of unincorporated entities, when classification was effectively elected for well-advised taxpayers".[678] As such, it is possible to affirm that the CTB

675 Indeed, it also allowed taxpayers to avoid domestic corporate status, and therefore, economic double taxation of income. In words of the Joint Committee on Taxation (1997): "The principal impact is that taxpayers may now choose with greater simplicity and lower compliance costs whether they will pay two levels of tax on business income under the corporate tax rules, or whether they will pay only one level of tax under the partnership tax rules (or as a disregarded single-member entity)". Id., p. 17. In the same opinion regarding simplicity and legal certainty for taxpayers, Mullis states: "The criteria required to qualify to make a CTB election are simple and explicit. Once a classification election is made, it continues until an entity elects for a different classification". K. Mullis, *Check-the-Box and Hybrids: A Second Look at Elective U.S. Tax Classification for Foreign Entities*, 64 Tax Notes Int'l 5 (2011), p. 373. This is in fact represented in the succeeding sixty months limitation in which the election cannot be changed. US: Treas. Reg. Sec. 301.7701-3 c)(1)(iv).

676 Mullis, *supra* n. 675. *See also*, Dell'Anese, *supra* n. 4, p. 223; Gianni, *supra* n. 634.

677 Id.

678 US: US Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, p. 48

regulations were not the result of isolated or random tax policy issues, disconnected with reality of business in the United States, but rather a positive (written) legal response to classification rules that were becoming elective, and which could also involve other similar rules within the tax system.[679]

4.4. The CTB and tax planning opportunities

The CTB regulations have not only improved in simplicity and fairness for taxpayers, but have also created important new opportunities for planning through the use of hybrid entities in order to circumvent other domestic tax rules.[680] This is especially evident with respect to the avoidance of anti-deferral rules (CFC rules) and the use of foreign tax credits not originally intended under U.S. tax law.[681] The above, however, does not mean to recognize neither that the existence of hybrid entities and reverse hybrids is a problem *per se* nor that coordinated international measures should necessarily be adopted. Indeed, most of these issues still remain as domestic concerns than could be (and in some case are) solved in a unilateral level.[682]

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679 As stated by the Joint Committee (1997): "The check-the-box regulations could have the long-term effect of drawing attention to rules that may have become elective (whether under new regulations or under prior law) and of sparking a re-thinking of the rationale for such rules in some cases". US: Joint Committee of Taxation (1997), *supra* n. 674, p. 18.

680 However, as this author has argued somewhere else in this work, tax planning is not an *a priori* illegitimate activity. On the contrary, it becomes so depending of the level of tolerance in a determined country. *Supra* Chapter I, Section 4.2.1.

681 US: Staff of Joint Committee of Taxation (1997), *supra* n. 674, pp. 19-21.

682 *See*, e.g. Denmark and the domestic anti-hybrid and anti-reverse hybrid rules discussed in *infra* Section 5.2.

Yet, and as this author will argue later on, the coordination in the characterization of entities seems to be a better manner to deal with the issue, at least better than attempting to match tax outcomes as proposed by the OECD.[683]

4.4.1. Avoidance of Subpart F Income

Under U.S. tax law, a "CFC" is a foreign corporation in which more than 50% of the total combined voting power of all classes of stock[684] or the total value of all stock, whichever is higher,[685] is owned by "U.S. shareholders", i.e. U.S. persons owning directly, indirectly[686] or constructively[687] 10% or

683 *Infra* Section 5. OECD (2013), *supra* n. 2.

684 US: Treas. Reg. Sec. 1.951-1(g)(2) refers to the meaning of "voting power".

685 For example, if a domestic corporation owns exactly 50 percent of a foreign corporation's voting common stock (class A) and nonvoting preferred stock (class B). A foreign person owns the remaining stock, class A and B, in the same percentage. If at the beginning of the next year, the domestic corporation buys one shares class B from the foreign person, the foreign corporation will be considered a CFC. US: Treas. Reg. Sec. 1.957-1(c), Example 8. Prior to 1987, the control was measure only by voting power. The alternative of total value was added to avoid manipulation. *See* Staff of Joint Committee on Taxation, 99th Cong., 2nd Sess., General Explanation of the Tax Reform Act of 1989, p. 988, cited in: Bittker and Lokken, *supra* n. 530, p. 69-8.

686 "Indirect ownership" consists of stock beneficially owned by a U.S. person through a foreign corporation, partnership, trust or state. In other words, the stock held by foreign entities is considered as indirectly owned proportionally by its shareholders or partners. US: IRC sec. 958(a)(2). For example, if P (domestic corporation) owns 80% of F1 (foreign corporation), and F1 owns 80% of F2 (foreign corporation), and F2 owns 90% of F3 (foreign corporation), P is indirectly owner of 64% (0.80*0.80) of F2 and 57.6% (0.80*0.80*0.90) of F3. *See* example in Bitter and Lokken, *supra* n. 530, p. 69-10. However, if P was a wholly owned subsidiary of another domestic corporation (e.g. U Corp.), there is no attribution of stock to it. Id.

687 Under U.S. tax law, the concept used is *"constructive ownership"* and refers, in general terms, to the attribution rules of IRC sec. 318, with some modifications. For example, under sec. 318 a person is regarded to be the owner of stock owned by certain relatives (e.g. spouse), by his 50 percent controlled corporation, or by a partnership or trust in

more of the total voting stock of that foreign corporation.[688] In such a case, all those U.S. shareholders owning 10% or more of the voting stock must include each year their *pro rata* share of certain CFC income, known as "Subpart F" income, which is generally passive income, regardless whether or not earnings are distributed from the subsidiary to the shareholders.[689] Thus, CFC rules have the purpose of avoiding tax deferral through the incorporation of subsidiaries abroad, accelerating thus the taxation of certain income.

As per to the CFC rules explained above, it is clear that what makes a foreign entity to be considered a CFC is the fact of being characterized as a Corporation for U.S. tax purposes, i.e. a taxable entity. Hence, partnerships for U.S. tax purposes (i.e. tax transparent entities) will, in principle, not be subject to anti-deferral rules. However, since the CTB system is in essence elective, giving the taxpayer the possibility of changing the tax characterization of an entity,[690] the possibilities to circumvent the U.S. CFC thus rules increases. A classic example of the use of hybrid entities to

which he participates. For purposes of Subpart F rules, however, the percentage of stock ownership deemed to be controlling is reduced from 50 to 10 percent.

688 US: IRC Sec. 951(a). *See also*, P. McDaniel, H. Ault and J. Repetti, *Introduction to United States International Taxation*, 5th Ed., Wolters and Kluwer, New York (2005), p. 115.

689 *"Subpart F income"* as defined in IRC sec. 952 consists of two principal categories of income: 1) insurance income, and 2) foreign base company income. This latter, as per the definition in IRC sec. 954, includes: a) foreign personal holding company income, b) foreign base company sales income, c) foreign base company service income and d) foreign base company oil related income. *See*, McDaniel, Ault and Repetti, *supra* n. 688, pp. 116-119. Generally speaking, Subpart F income is income that the Congress found subject to tax haven manipulation. *See* Bittker and Lokken, *supra* n. 530, p. 69-4.

690 Subject to the limitations stated in *supra* Section 4.3.

circumvent Subpart F Income is earnings stripping through a disregarded loan.[691] Let us assume that a domestic corporation is the wholly owner of a foreign entity (F1), organized as a corporation in country A and listed as a *per se* Corporation for U.S. tax purposes. F1 subsequently owns 100% of another foreign entity (F2), organized in country B, a low tax jurisdiction, where the entity is also a taxable entity for country B tax purposes. Let us also assume that F2 grants a loan to F1, and therefore, F1 pays back interest associated to that loan.

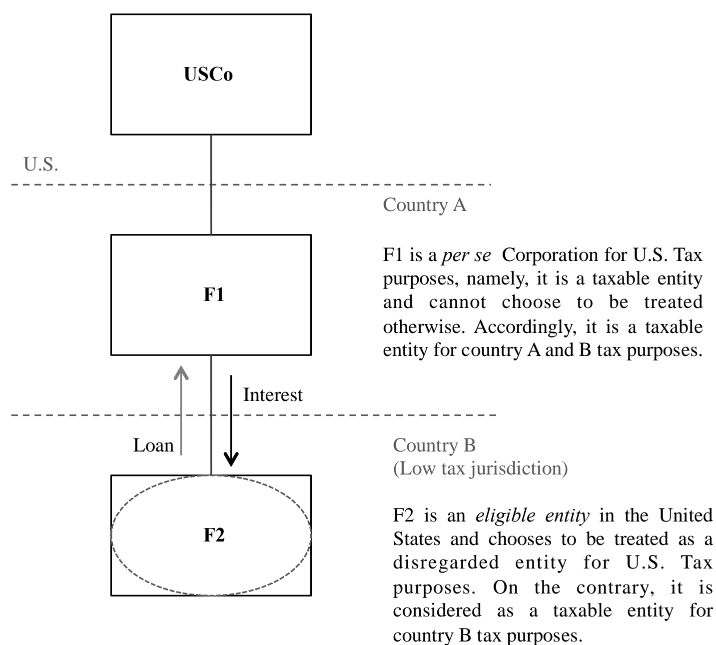

Figure 3: Hybrid Entities and Subpart F Income

691 Mullis, *supra* n. 675, pp. 375-376.

F2 is an eligible entity for U.S. tax purposes and it can elect to be treated either as a Corporation or as a disregarded entity. If F2 elects to be disregarded for U.S. tax purposes; therefore, the loan and the interest are also disregarded for U.S. tax purposes. This is to say, no interest income is recognized in the United States as Subpart F income. Accordingly, as F2 is a taxable entity in country B and F1 is also a taxable entity in country A, the interest paid from F1 to F2 is deductible at the level of F1, and most probably, not taxed in country B. This latter outcome (non-taxation in country B) is, however, irrelevant for U.S. tax purposes, because the fact that the income was taxed or not in country B would not change the erosion of the domestic tax base due to the circumvention of CFC rules in the United States. This is at least the original concern expressed by the Staff of the Joint Committee on Taxation (1997) as follows: "Under subpart F rules, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include in income currently their shares of certain earnings of the controlled foreign corporation, whether or not the earnings are distributed to the shareholders […] were the subsidiary to qualify as a partnership or a 'nothing', its earning may not be included income currently by the U.S. owner, making current inclusion, or not, a matter of choice".[692] No reference is made with respect to the taxation or not in the other country.

[692] US: Joint Committee of Taxation (1997), *supra* n. 674, p. 19. Similarly, it was addressed by the Staff of the Joint Committee on Taxation (2010), which stated: "[…] Treasury and the IRS recognized that such increased flexibility in entity classification in the foreign context could provide greater opportunities than under existing regulations for inconsistent, or hybrid, entity classification in which an entity is treated as a taxable

Another way to circumvent Subpart F income through the use of hybrid entities is given by a specific provision within the CFC rules, known as *“same-country exception”*.[693]

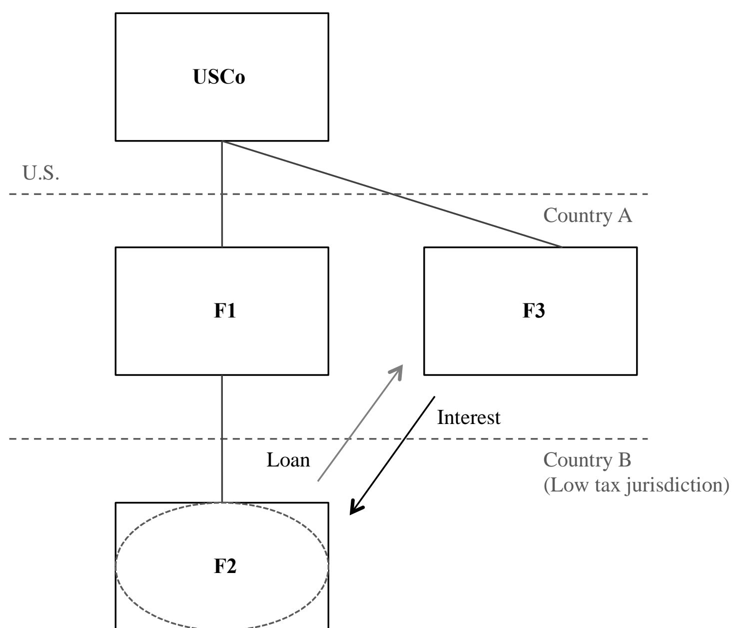

Figure 4: "Same-country" exception

This exception states that Subpart F income will not include dividends, interest, rents and royalties received by a related corporation organized under the same laws of the CFC and which has a substantial part of its assets

entity in one country but as a flow-through entity in another country”. US: Joint Committee on Taxation (2010), *supra* n. 678, p. 48.

693 US: IRC Sec. 954(c)(3).

used in its trade or business located in that country.[694] As noted above (Fig. 4), we are assuming the same structure than in Fig. 3, with the difference that a second foreign corporation (F3), wholly owned by a the same domestic corporation that owns F1, is organized in country A. Likewise, let us assume that F2 grants a loan to F3 and receives interest back. Therefore, considering that F2 chose to be treated as a disregarded entity, the loan and interest between F3 and F2 is disregarded for U.S. tax purposes. Accordingly, the fact that F2 is a disregarded entity implies that F3 is paying the interest "directly" to F1, which is indeed organized in the same country. Thus, the "same-country" exception applies and the interest paid to F2 is not included as Subpart F income of F1, which is clearly a CFC.

Unlike the example in Fig. 3, however, where it is clear that the circumvention of CFC rules came up due to the tax characterization of F2, in this second example (Fig. 4) is not entirely clear that the characterization of the foreign entity (F2) is properly the cause of the circumvention of the CFC rules. Indeed, as it can be seen in Fig. 5 below, the avoidance of Subpart F income might be perfectly achieved if F1 granted the loan directly to F3, being thus the characterization of F2 completely anecdotic. Therefore, the issue in this case attends more to a deficient design of CFC rules, rather than the use of the CTB election.

[694] Id.

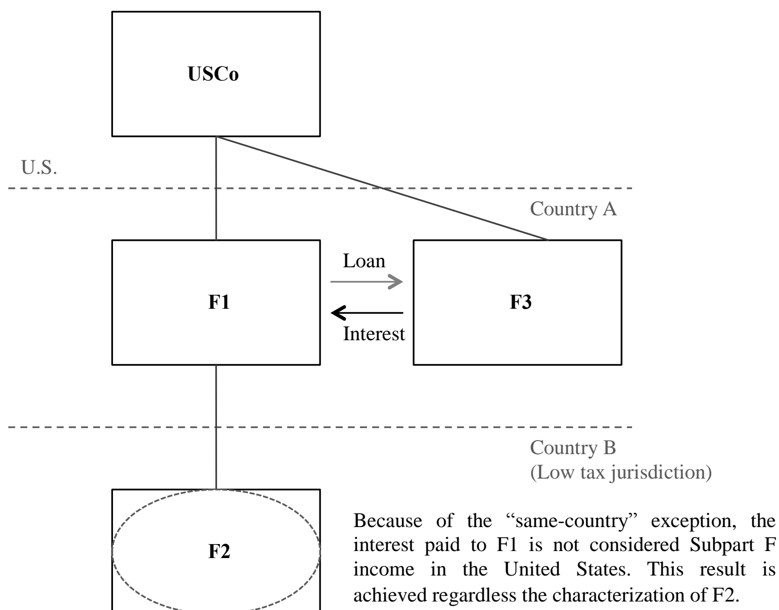

Figure 5: Same-country exception and the irrelevancy of the CTB election

A similar situation occurs, e.g. with the *“manufacturing exception”* with respect to the generation of foreign base company sales income (FBC sales income).[695] As a general rule, FBC sales income is income from transactions in personal property (goods) where a related person is either the buyer or the seller.[696] However, if CFC’s income is derived in connection with the sale of personal property manufactured, produced or constructed by a CFC, that

[695] FBC sales income is part of subpart F income, see *supra* n. 689.

[696] US: Sec. 954(d)(1). *See also*, Bittker and Lokken, *supra* n. 530, p. 69-51. For example, A CFC’s gross profits on a sale of goods are thus usually FBC sales income. Likewise, if a CFC acts as an agent for a related person in a transaction in goods, its commission fee is normally FBC sales income.

income is not considered FBC sales income.[697] In other words, income from manufacturing activities is not Subpart F income and it should not be taxed as such in the United Sates. Although the exception makes sense since a CFC regime should not discourage the expansion of manufacturing operations carried on by MNEs in foreign countries, the relaxation of the text in 2008 certainly helped to extent the scope of the exception.[698] Indeed, after the modification of the statute in 2008, any CFC that makes a "substantial contribution" through the activities of its employees, even though the foreign company itself it is not a manufacturer is considered as being included within the manufacturing exception.[699] This issue was also discussed during the hearing before the Permanent Subcommittee on Investigations of the Committee of Homeland Security and Governmental Affairs of the United States Senate, referred to the Apple Inc.'s offshore profit shifting.[700] Recalling what was referred in Chapter I regarding the Apple Inc. case, the Apple's tax structure is as follows:

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697 US: Treas. Reg. Sec. 1.954-3(a)(4)(i).

698 Ting, *supra* n. 29, p. 50.

699 US: Treas. Reg. Sec. 1.954-3(a)(4)(iv)(a). For this purpose, the participation of the CFC employees is crucial. Accordingly, even though the determination of whether the employees of the CFC made a substantial contribution depends on all relevant facts and circumstances, the regulations provides a non-exclusive list of activities of CFC employees, including, among others: the oversight and direction of the activities or process by which the good are produced; material selection, vendor selection, or control of the raw materials, work-in-process or finished goods; management of manufacturing costs or capacities; quality control, etc. US: Treas. Reg. Sec. 1.954-3(a)(4)(iv)(b), from (1) to (7). *See also*, Bittker and Lokken, *supra* n. 530, p. 69-59.

700 US: Permanent Subcommittee on Investigations of the Committee of Homeland Security and Governmental Affairs of the United States Senate, *Offshore Profit Shifting and the U. S. Tax Code—Part 2 (Apple Inc.)*, S. Hrg.113-90, U.S. Government Printing Office, Washington (2013), hereinafter also "U.S: Apple's Hearing Report (2013)".

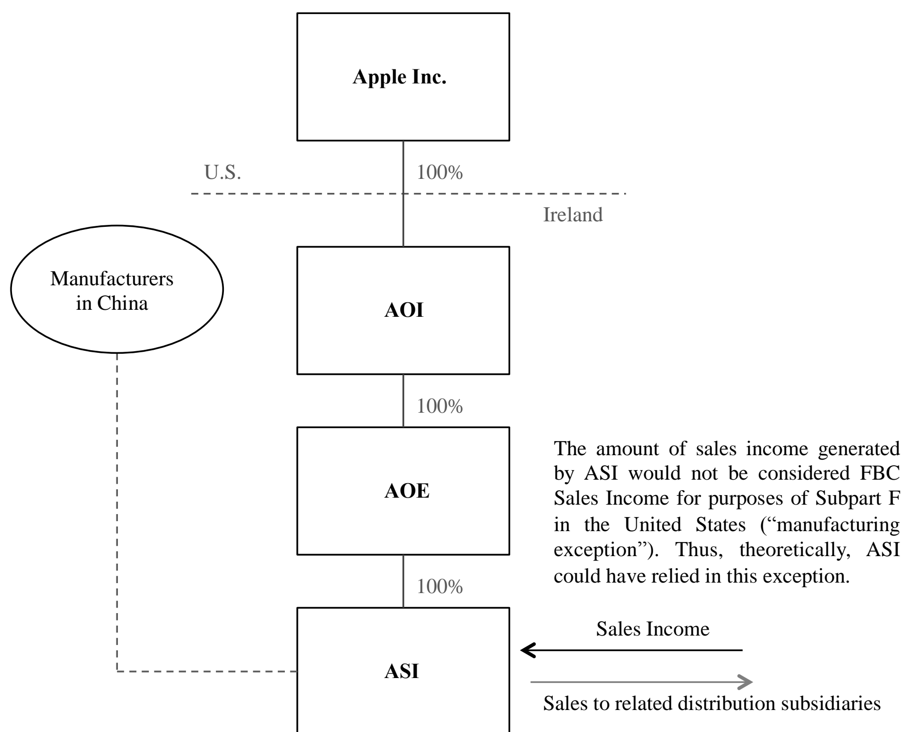

Figure 6: Apple's Tax Structure

Apple Inc., a US Corporation, owns a 100% of the stock in Apple Operations International (AOI), which subsequently owns 100% of the stock in Apple Operations Europe (AOE) and which subsequently owns 100% of the stock in Apple Sales International (ASI). This latter ASI engaged in unrelated contract manufacturers in China to assemble the products, and subsequently sell them to distribution subsidiaries in Asia and Europe.[701] Therefore, theoretically, ASI could have relied in this exception, although

[701] Ting, *supra* n. 29, p. 44.

that was not necessary because of the CTB election. ASI indeed avoided to be regarded as a CFC though the CTB election. However, what it is interesting to stress here is that, even in the absence of the CTB election, ASI could have made used only of the manufacturing exception to obtain a similar result (i.e. the avoidance of potential FBC sales income), which demonstrates again that the electivity in the treatment of foreign entities for tax purposes is just a piece of the whole puzzle.[702]

There are cases, however, in which the CTB election is completely irrelevant to circumvent Subpart F income. This is the case, e.g. of multiple chain structures. [703] Let us assume the following hypothetical. A domestic corporation owns two CFCs: F1 incorporated in country A and FF1 incorporated in country C. Accordingly, F1 has a wholly owned subsidiary in country B (F2) and FF1 has also a wholly owned subsidiary in country D (FF2). F1 and FF1 are *per se* corporations; therefore, not entitled to the CTB election. However, F2 and FF2 are eligible entities and they elect to be treated as disregarded entities. Likewise, FF2 grants a loan to F2 and receives interest back.

[702] In this regard, Ting states that this is a demonstration that "the U.S. tax law provides multiple shields to protect ASI's income from U.S. taxation". Id., p. 51.

[703] "Check-the-box planning also cannot work if, for whatever reason, a corporation's foreign subsidiaries are in multiple chains, rather than being consolidated under a single foreign holding company". Sicular, *supra* n. 657, p. 606.

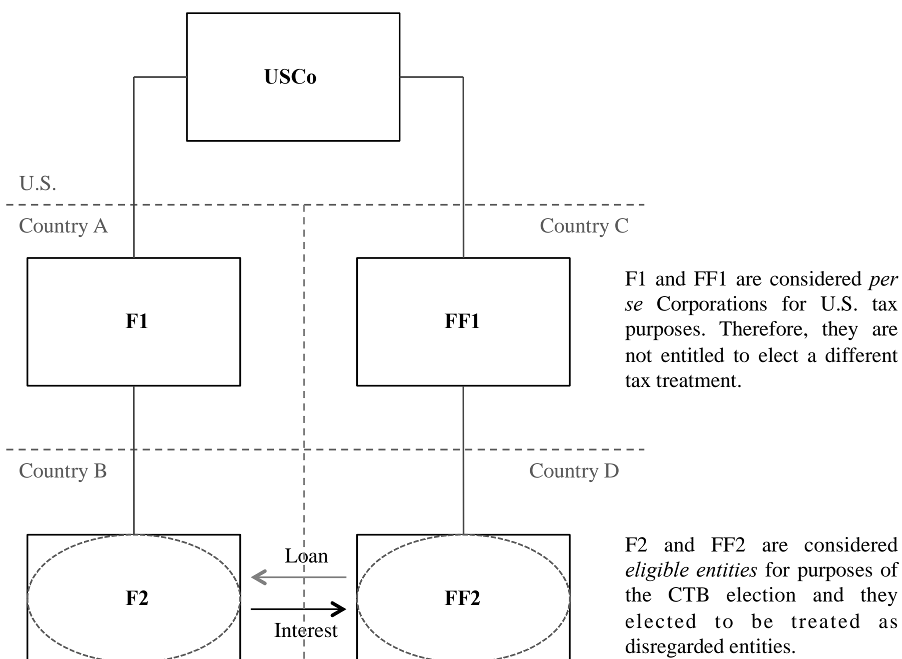

Figure 7: Multiple chain structures and the circumvention of Subpart F Income

As per the example above (Fig. 7), the interest payments will be recognized as payments between FF1 and F1, and thus Subpart F income. The *“same country exception”* does not apply in this case. Likewise, there will be Subpart F income, regardless the election via CTB.

In addition, a more extreme interpretation could even lead the conclusion that in some cases the CTB election might create Subpart F income that would not otherwise existed in absence of the election.[704]

[704] Id.

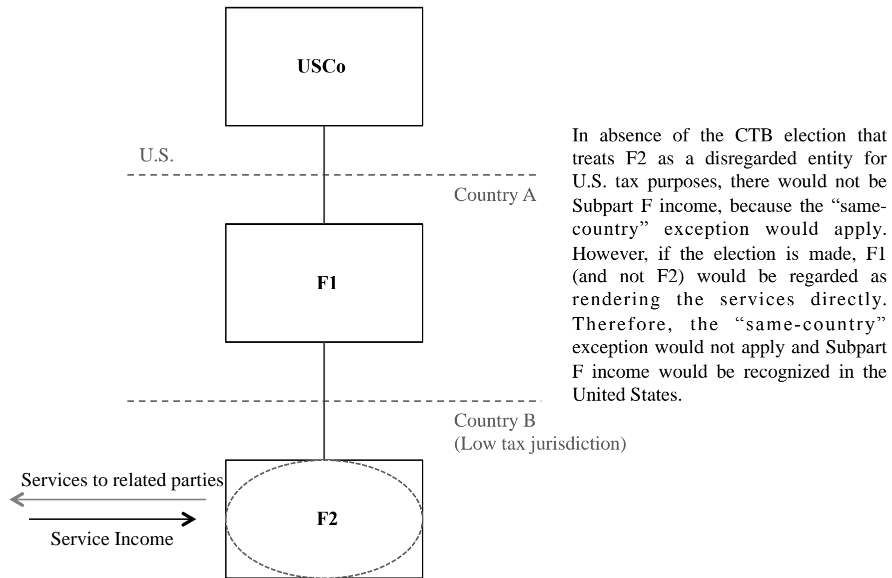

Figure 8: CTB election and the creation of Subpart F Income

Taking the original example in Fig. 3, where a domestic corporation owing F1, organized as a corporation in country A and listed as a *per se* Corporation for U.S. tax purposes, which subsequently wholly owns another foreign entity (F2), organized in country B, with the sole difference that F2 performs services for a related party in country B, i.e. same country of incorporation and receives income accordingly. In absence of the CTB election, the services performed by F2 are not considered foreign base company sale and services income, because they are rendered in the same country of incorporation: country B. Nevertheless, if F2 elects to be treated as transparent entity to circumvent other items of Subpart F income, it could risk the creation of a different type: service income. Indeed, in this case, the

services would be rendered by F1, incorporated in country A, but rendered in a different country: country B. The same country exception would thus not be applicable and the income should be recognized in the United States as CFC income. This result would not exist in absence of the CTB election.

4.4.2. Reaction from U.S. Tax Law

The formal reaction of the United States to the circumvention of Subpart F rules through the use of hybrid entities came first with the Notice 98-11, right after the implementation of the CTB regulations.[705] The Notice attempted to tackle the situations in which a "hybrid branch", namely, an entity with a single owner that is treated as a separate entity under foreign tax law and as a branch of a CFC that is its sole owner for U.S. tax purposes, was used to make deductible interest payments that reduced the CFC's foreign tax liability, and created low-taxed interest income in another entity, without creating subpart F income.[706] The IRS and the Treasury stated that regulations would be issued to prevent that such hybrid branch arrangements are undertaken, and when that happens, the branch and the CFC will be treated as separate corporations for purposes of Subpart F.[707] Despite the fact that those regulations came in force in the form of temporary regulations, including e.g. rules providing that the "same-country exception" applied to payments by a CFC to a branch of a related CFC only if the

705 US: Notice 98-11, 1998-6 I.R.B. 18.
706 US: Joint Committee on Taxation (2010), *supra* n. 678, p. 48.
707 US: Notice 98-11, 1998-6 I.R.B. 18. *See also*, US: T.D. 8767, 63 Fed. Reg. 14613, 26 March 1998.

payment would have qualified for the exception if the hybrid branch had been a separate CFC incorporated in the jurisdiction in which the payment is subject to tax (other than a WHT),[708] the IRS rapidly issued Notice 98-35[709] withdrawing Notice 98-11 and later on the temporary regulations in force. Notice 98-35, however, maintained the re-characterization of the hybrid branch as a separate Corporation in case of hybrid branch payments.[710] For this purpose, three conditions should be met: a) the hybrid branch payment must reduce the foreign tax of the payer; b) the hybrid branch payment would have been Subpart F income if the transaction were between two CFCs,[711] and c) there must be a disparity between the effective rate of tax on the payment in the hands of the payee and the hypothetical rate of tax that would have applied if the income had been taxed in the hands of the payer. For all other purposes, the hybrid branch is not treated as a separate entity.[712] None of these initiatives, however, finally achieved a permanent status.

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708 US: Joint Committee on Taxation (2010), *supra* n. 678, p. 49. This rule interestingly focuses upon the taxation (or not) of the income in the foreign country, an issue that should be irrelevant if this income is finally included as Subpart F income in the United States. Similarly, Notice 98-11 stated: "Treasury and the Service believe that it is appropriate to prevent taxpayers from using these types of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of Subpart F income". US: Notice 98-11, 1998-6 I.R.B. 34.

709 US: Notice 98-35, 1998-27 I.R.B.

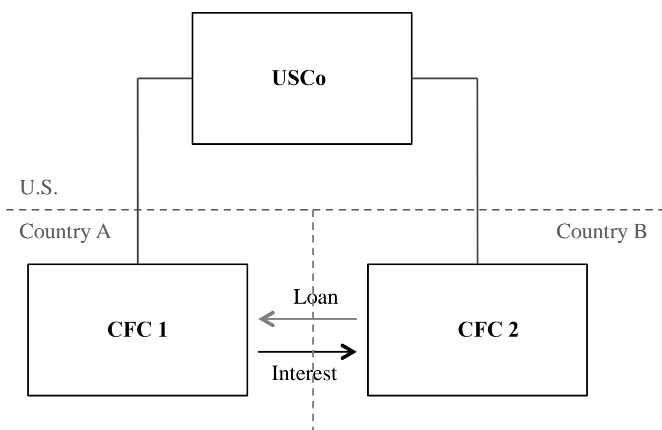
710 Id.

711 Specifically, the Notice refers to *"foreign personal holding company income"*, which includes: (a) dividends, interest, rents and royalties; (b) net gains from the sale or exchange of property which gives rise to the income described in (a); (c) gain from certain commodities transactions; (d) gains from certain foreign currency transactions, and (e) income which is the equivalent of interest. *See* McDaniel, Ault and Repetti, *supra* n. 688, pp. 117-118.

712 US: Notice 98-35, 1998-27 I.R.B.

Contrary to the above tendency, in 2006, and although inspired in the arguments of Notice 98-11, section 954(c)(6) was introduced within the Internal Revenue Code. This section states a "look-through" rule by which dividends, interest, rents and royalties received or accrued by a CFC, which is a related person, shall not be treated as Subpart F income to the extent attributable to income of the related person that it is neither Subpart F income nor income effectively connected with the conduct of a trade or business in the United States.[713] In other words, if e.g. CFC1, organized in country A, and CFC2, organized in country B, are both wholly owned by a U.S. corporation, and CFC1 grants a loan to CFC2, and therefore, CFC2 pays interests back, those interests will not be included as Subpart F income of CFC1 to the extent they were not attributable to Subpart F income.

[713] US: IRC Sec. 954(c)(6)(A).



The interest paid by CFC2 will not be recognized as Subpart F income to the extent attributable to income of the related person (CFC1) that it is neither Subpart F income nor income effectively connected with the conduct of a trade or business in the United States.

Figure 9: "Look-Through rule" –IRC Sec. 954(c)(6)

This provision is particularly interesting, because it relaxes the position previously adopted with respect to hybrid branch arrangement and Subpart F income and it represents to certain extent an extension of the "same-country exception".[714] The above does not only highlight the contradictory nature of the CFC rules in the United States since they were issued,[715] but also ratifies

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714 Ironically also, the provision was very important in the case of Apple to avoid Subpart F income. As stated within the Apple's case hearing: "Apple avoided them [Subpart F income] mostly through check-the-box regulations and the controlled foreign corporation (CFC) look-through rule". US: Apple's Hearing Report (2013), *supra* n. 700, p. 15.

715 As stated by Sicular: "The legislature's original intent in enacting Subpart F was to impose some constrains on the offshore movement of American capital, both to limit undue advantages enjoyed by investing abroad and to prevent tax avoidance through the use of offshore heavens and shelters. As originally enacted, Subpart F reflected a compromise between the two conflicting goals of capital export neutrality […] and

by statute a "look-through" practice achieved already through the CTB election.[716]

4.4.3. Use of Foreign Tax Credit

The U.S. FTC is the method used to relive juridical double taxation at a domestic level.[717] As such, the FTC allows U.S. taxpayers to credit the payment of foreign taxes against their domestic tax liabilities, having as

"competitiveness" or capital import neutrality […] The last 45 years have not resolved the conflict, and that long-running tug-of-war is one of the reasons why Subpart F has always been unpredictable and confusing". Sicular, *supra* n. 657, p. 590.

[716] "[S]ince 1997 there has been a de facto look-through treatment in many cases through the use of the check-the-box rules to achieve. The use of the check-the-box rule to achieve look-through treatment in the international context was initially controversial and, while Treasury backed down from its initial attack on the technique, it was never quite given up. Section 954(c)(6) resolves the controversy, at least for a while; by providing an explicit, and broader, look-through rule, which is a logical next step". Id.

[717] U.S. citizens, resident aliens and domestic corporations can elect annually if they want to deduct the foreign taxes paid or to use a credit against its U.S. income tax liability instead. *See* McDaniel, Ault and Repetti, *supra* n. 688, p. 87. *See also*, US: IRC Sec. 901-908 and 960. This foreign tax credit is known as "direct tax credit" as makes reference to the credit against foreign taxes paid directly by a U.S. taxpayer to a foreign country. There is, however, under U.S. tax law, also a so-called "indirect foreign tax credit", which is the credit granted to U.S. Corporations that directly own at least 10-percent or more of the voting stock in a foreign corporation from which it receives dividends. It is thus a legal fiction by which the U.S. Corporation is deemed to pay the taxes paid by the subsidiary in the foreign country attributable to those dividends. The indirect credit is also extended until the sixth tier subsidiary to the extent that each parent owns directly at least the 10-percent voting requirement. After the third tier, it is necessary that the U.S. parent have at least a 5-percent indirect ownership. *See* McDaniel, Ault and Repetti, *supra* n. 688, pp. 93-96. For a detailed explanation with respect to the different rules and calculation of the indirect foreign tax credit, *see* Bittker and Lokken, *supra* n. 530, pp. 72-189 to 72-243. Rules about indirect foreign tax credit: US: IRC Sec. 902 and correspondent Treasury Regulations. For the reference to indirect ownership, *supra* n. 686. For a brief historical reference of the U.S. foreign tax credit, see *supra* Chapter I, Section 3.2.1. For purposes of this Section and the subsequent of this Chapter, we will refer to FTC as "direct foreign tax credit", unless otherwise provided.

fundamental characteristic that the entity that bears the legal liability, and not necessarily the one that remits the payment of foreign taxes, is entitled to claim the credit.[718] The above can be seen, e.g. in the case that a foreign entity is required by law to withhold and remit the tax to the IRS in the case of interest paid to a non-resident. In this situation, the legal liability remains in the recipient of the interest paid and not in the entity in charge of the withholding of the tax, which is indeed a mere intermediary or "withholding agent".[719] The determination on the taxpayer on whom legal liability is placed is made according to foreign law.[720]

Hybrid entities can be used in this case to modify the person entitled to the FTC according to U.S. tax law in a manner in which the FTC is claimed, although there is no a corresponding income inclusion by the entity claiming the credit on foreign taxes.[721] This is known in doctrine as "tax credit splitting". Let us assume the following example: A domestic corporation is the wholly owner of F1, a foreign corporation organized in country A, treated for U.S. tax purposes as a disregarded entity, while as a corporation for country A tax purposes. Likewise, F1 is the wholly owner of F2, also

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[718] US: Treas. Reg. Sec. 1.901-2(f)(1) and 1.901-2(g)(1).

[719] US: Treas. Reg. Sec. 1.901-2(f)(2)(ii), Ex. 1.

[720] Whether a particular foreign income tax is paid or accrued is sometimes an extremely difficult task. For example, a U.S. parent Corporation may be liable for the taxes paid by a tax group in Luxembourg, even though the majority of the income of the group is not subject to tax in the United States. This is because, under Luxembourg law, the parent of the group was exclusively liable for the group's Luxembourg income tax. This was precisely the result in *Guardian Industries Corp v. Unites States* (2005), which is discussed later on in this Section. *See* Bittker and Lokken, *supra* n. 530, p. 72-10 and 72-11. *See also*, US: *Guardian Industries Corp v. Unites States,* 477 f. 3d 1368, 1371 (Fed. Cir. 2007).

[721] Mullis, *supra* n. 675, p. 377.

organized in country A and treated as a transparent entity for country A tax purposes, although elected to be treated as a Corporation for U.S. tax purposes.

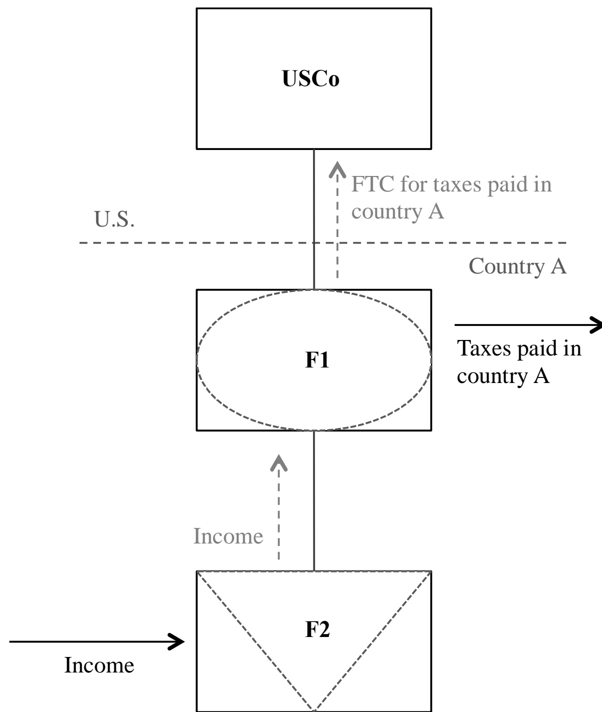

Figure 10: Foreign Tax Credit Splitting

If income is earned by F2, the United States will consider that this income is attributable to F2, because this is regarded as a Corporation for U.S. tax purposes. However, on the other hand, country A will consider that income is attributable to F1, who is also legally liable for the payment of taxes in country A. Nevertheless, as the United States disregards F1 as an entity, it

considers that the legal liability upon the foreign taxes paid is attributable to the U.S. domestic corporation, who is finally entitled to claim the FTC, regardless that no income was included at the level of the domestic parent company.[722]

Although with some minimal differences on the facts, this was the main issue discussed in *Guardian Industries Corp v. Unites States* in 2005.[723]

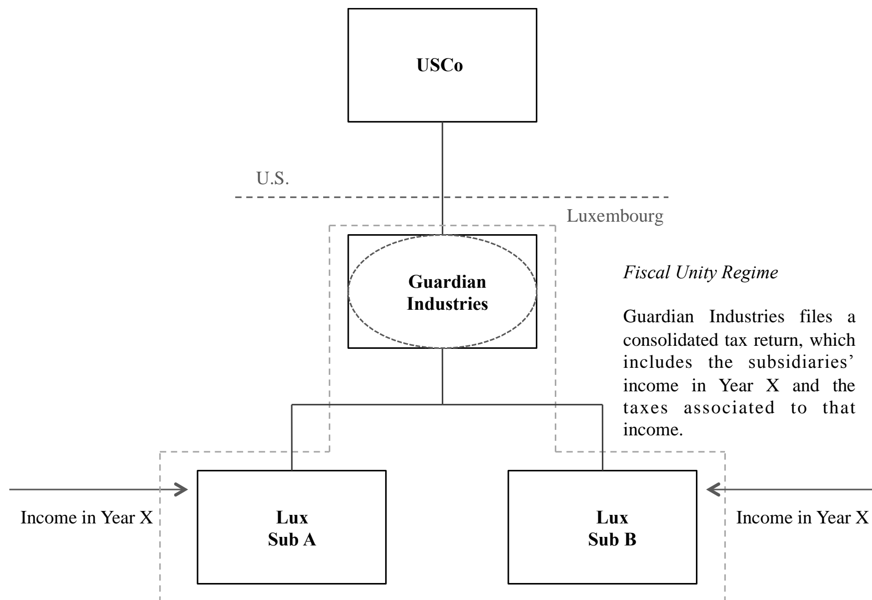

Figure 11: Tax structure in Guardian Industries Corp. v. United States (2005)

[722] Income was not included at the level of the domestic parent company, because the United States considers that income never flew from F2 to F1, because F2 is regarded as a Corporation for U.S. tax purposes. However, income actually flew from F2 to F1, because as per the rules of country A, F2 is a transparent entity.

[723] US: *Guardian Industries Corp v. Unites States* at *supra* n. 720.

In *Guardian Industries*, the taxpayer, a U.S. Corporation, indirectly owned a hundred percent of the stock in Guardian Industries S.a.r.l. (“Guardian Industries”), which was an entity organized under the laws of Luxembourg.[724] Guardian Industries was a corporation for purposes of Luxembourg corporate income tax and a disregarded entity for U.S. tax purposes.[725] Guardian Industries also owned stock in several subsidiaries in Luxembourg, all treated as Corporations for U.S. tax purposes.[726] Guardian Industries and the subsidiaries were also part of the same fiscal unity regime under the laws of Luxembourg.[727] Therefore, Guardian Industries reported income and paid taxes on the combined amount, i.e. including the subsidiaries’ income.[728] Likewise, the taxpayer in the United States claimed a FTC for the foreign taxes paid by Guardian Industries, even though no income was reported in the United States.[729] The IRS argued that Guardian Industries and the subsidiaries had joint and severally liable for the Luxembourg corporate income tax; therefore, the tax paid should be allocated among the subsidiaries.[730] The trial court, however, concluded that

[724] J. Riedy, *IRS Uses Voluntary Payment Rule to Challenge Foreign Tax Credits Separated from the Income Base*, 34 Int’l. Tax J. 3 (2008), pp. 11-12.
[725] Id.
[726] In the example in Fig. 11, they are represented by Lux SubA and Lux SubB, as a simplification.
[727] Riedy, *supra* n. 724.
[728] Id.
[729] Id.
[730] US: Treas. Reg. Sec. 1.901-2(f)(3). This regulation states that if foreign income tax is imposed on the combined income of two or more related persons and they are jointly and severally liable for the income tax under foreign law, then the foreign law is considered to impose a legal liability on each person as per the amount of the foreign income tax attributable to its portion of the base for the tax. For example, following the hypothetical of Bittker and Lokken: “[I]f a domestic corporation’s subsidiaries in

Guardian Industries was not joint and severally liable for the taxes paid in Luxembourg. The Federal Circuit confirmed that finding and affirmed that, under the Luxembourg consolidated return, Guardian Industries bore the legal liability for the consolidated group's taxes, which added to the fact that Guardian Industries was treated as a disregarded entity for U.S. tax purposes, allowed the domestic parent company in the United States to claim the hundred-percent of the FTC, regardless that no income was associated to those foreign taxes paid.[731] This decision would pavement the origin of the U.S. rules regulating tax credit splitting events discussed below.

4.4.4. Reaction from U.S. Tax Law

Perhaps the first attempt to regulate in positive law the results achieved in *Guardian Industries* and the issues with respect to foreign tax credit splitting was through the proposed regulations under Treas. Reg. Sec. 1.901-2(f).[732] The proposed regulations essentially attempted to provide rules that match

country X file a consolidated tax return and the members of the country X are jointly and severally liable for the tax on the group's income, each subsidiary is the taxpayer with respect to the country X tax on its portion of the consolidated income. In contrast, if the country X parent is exclusively liable for the country X tax on all income of the country X group, the parent is deemed to have paid all of the group's country X tax, and other members of the group are deemed to have paid none of the tax". *See* Bittker and Lokken, *supra* n. 530, p. 72-11.

731 Riedy, *supra* n. 724.

732 Id. Also, as provided by Rosenberg: "The general theory behind matching (as a big picture concept) is that the FTC is intended to reduce double taxation on foreign-source income, which is only achieved if the credit is given to the same person who recognizes the foreign-source income for U.S. tax purposes". R. Rosenberg, *New Foreign Tax Credit Anti-Splitting Rule*, 129 Tax Notes 6 (2007), p. 701.

the results when FTC was separated from the income on which the tax provided through the use of disregarded entities. In this order of ideas, the proposed regulations stated, on one hand, that if an entity is a reverse hybrid, i.e. considered as a Corporation in the U.S. and a fiscally transparent entity in its country of incorporation, the tax imposed on the owner's share of income from each reverse hybrid and the tax imposed by the foreign country on other income of the owner, is considered to be imposed on the combined income of each reverse hybrid and the owner, being thus allocated between the owner and the reverse hybrid in a *pro rata* basis.[733] Let us assume the following simplified example: A and B are domestic Corporations, owners of 95% and 5% of C, a Partnership organized under the laws of country X. This Partnership, however, elected to be treated as a Corporation for U.S. tax purposes. In year X, C has income of 500i, and was subject to a CIT of 30% in country X. The partners A and B must pay taxes in country X for the amount of 142.5i and 7.5i, respectively.[734] Under the matching rule, however, if an owner's share in a reverse hybrid's income has no other income taxable by the foreign country where the reverse hybrid is organized, all of the foreign tax is allocated to and considered paid by the reverse hybrid.[735] In our case thus C is liable for the whole amounts of taxes that A and B paid, because A and B did not have other income in country X.

733 US: Proposed Treas. Reg. Sec. 1.901-2(f)(2)(iii).
734 US: Proposed Treas. Reg. Sec. 1.901-2(f)(6) Ex. 7.
735 US: Proposed Treas. Reg. Sec. 1.901-2(f)(2)(iii).

The payments are indeed treated as capital contributions to C.[736] (See below).

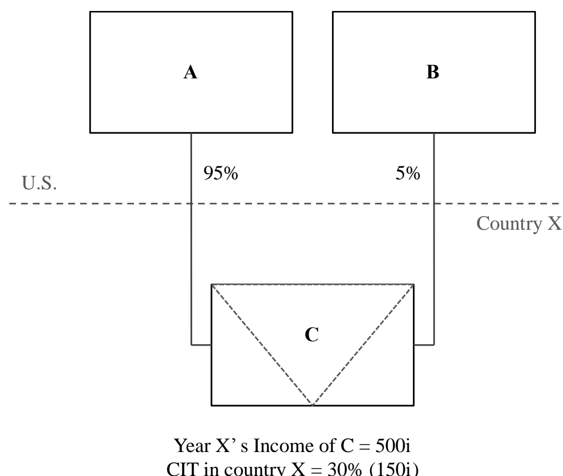

Figure 12: Proposed Treas. Reg. sec. 1.901-2(f) and reverse hybrids

Accordingly, if foreign taxes are imposed on a hybrid entity, i.e. a taxable foreign entity regarded as fiscally transparent for U.S. tax purposes, the hybrid entity is considered to be legally liable for such tax under foreign tax law, and therefore, deemed, for U.S. tax purposes, to pay the foreign taxes.[737] In other words, the foreign taxes are allocated among the partners.[738] Assuming the same facts of the hypothetical above, with the

[736] US: Proposed Treas. Reg. Sec. 1.901-2(f)(2)(v).
[737] US: Proposed Treas. Reg. Sec. 1.901-2(f)(3).
[738] Bittker and Lokken, *supra* n. 530, p. 72-19.

only difference that C is an entity regarded as opaque for country X tax purposes, while as fiscally transparent for U.S. tax purposes, the outcome is that A is entitled to a FTC of 142.5i and B on the amount of 7.5i, which is calculated in proportion to the income attributable to them: 475i are allocable to A, while 25i are allocable to B.[739]

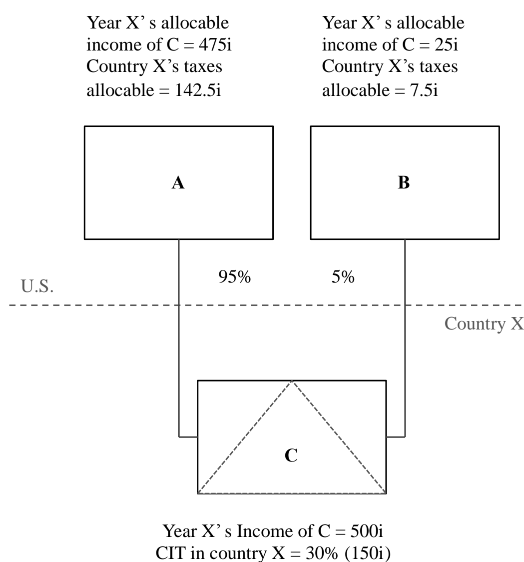

Figure 13: Proposed Treas. Reg. sec. 1.901-2(f) and hybrid entities

[739] For some authors, however, this does not appear to change the results under the existing rules. *See*, e.g. J. Riedy, *Proposed Code Sec. 901 Regulations Revise the Technical Taxpayer Rule*, 6 J. Tax'n Global Transactions 19 (2006), p. 22. Indeed, the proposed regulations did not change the rule by which income tax is considered paid, for U.S. income tax purposes, by the foreign person on whom foreign law imposes legal liability for such tax, and presented the regulations as a clarification of that general rule. For a critical analysis in this regard, *see*, e.g. H. Levine and M. Miller, *Proposed Regulations "Clarifying" the Technical Taxpayer Rule Don't Pass the Giggle Test*, 33 Int'l Tax J. 5 (2007).

On the other hand, the proposed regulations modified the results achieved in *Guardian Industries* since foreign income tax must be allocated to all members of the group in proportion to the income of each member.[740] Indeed, as per the proposed regulations, if foreign law imposes tax on the combined income of two or more persons, it is deemed that the legal liability is imposed on each of these persons for the amount of the foreign tax that it is attributable to such person's portion of the tax base.[741] Taking the example on Fig. 11, let us assume that the gross income of the tax group in year X is 200i, which is subject to a 30% of CIT in Luxembourg. We will also assume that under the laws in Luxembourg the loss of Lux Sub B is allocated to Guardian Industries and Lux Sub A according to their income.

Guardian Industries	100i [742]
Lux Sub A	100i
Lux Sub B	(60)i
Net Group Income	140i
Assumed Luxembourg taxes (30%)	42i

Figure 14: Income of the group– Prop. Treas. Reg. sec. 1.901-2(f)

As noted, therefore, Guardian Industries and Lux Sub A had both 70i of net income, the taxes paid in Luxembourg by the group are allocated as follows: 21i on Guardian Industries; 21i on Lux Sub A and 0i on Lux Sub B. The above means that Guardian Industries would have declared its correspondent

[740] US: Treas. Reg. Sec. 1.901-2(f)(2)(i).
[741] Bittker and Lokken, *supra* n. 530, p. 72-15.
[742] "i" represents a foreign currency.

income in the United States and would have claimed a FTC of 21i, instead of 42i paid by the whole group. Similarly, if no income were allocated to Guardian Industries, no foreign taxes would be allocated either, regardless of which person actually remits the taxes, or which person of the foreign country could proceed against to collect the taxes if they were not paid.[743] These regulations, however, never achieved the status of final regulations.[744]

In 2010, nonetheless, the United States adopted a new matching rule with the purpose of preventing the separation of creditable foreign taxes from the associated foreign income that originated them.[745] Under this new rule, if a foreign tax credit splitting event occurs with respect to a foreign income tax, this tax will not be taken into account for U.S. tax purposes before the taxable year in which the "related income" is also taken into account by the taxpayer.[746] The term "related income" is referred in the statute as to any income, or earnings and profits, to which such portion of foreign income

743 The term "person" includes a disregarded entity. Bittker and Lokken, *supra* n. 530, p. 72-15. *See also*, Riedy, *supra* n. 724.

744 *See*, e.g. D. Forst, *Recently Enacted Code Sec. 909 Targets "Splitter" Transactions (Part 1)*, 14 J. Passthrough Entities 1 (2011). The proposed regulations also addressed an amendment to the voluntary payment rule in Proposed Treas. Reg. Sec. 1.901-2(e)(5). Under the proposed regulation, all foreign entities in which the same U.S. person has a direct or indirect interest of 80% or more would be treated as a single taxpayer. For a further analysis, *see* Riedy, *supra* n. 724, pp. 11-12 and 69-71.

745 US: Staff of the Joint Committee on Taxation, *Technical Explanations of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to the H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010*, (JCX-46-10), 10 August 2010, p. 4.

746 US: IRC Sec. 909(a). Nevertheless, the key is on the person. For example, if the same person has both the foreign taxes and the related income, and no covered person takes the income into account, the failure in recognizing the income in the same year does not delay the use of the FTC. *See* Rosenberg, *supra* n. 732, p. 702. *See also*, Forst, *supra* n. 744, p. 12.

taxes relates.[747] Accordingly, it is understood that there is a "foreign tax credit splitting event"[748] with respect to foreign income taxes if the related income is or will be taken into account by a "covered person", which is, with respect to any person who pays or accrues the foreign income taxes: a) any entity in which the payer holds, directly or indirectly, at least 10 % ownership by vote or value;[749] b) any person which holds, directly or indirectly, at least 10 % ownership by vote or value in the payer,[750] and c) any person which bears a relationship with the payer according to IRC Sec. 267(b) or 707(b).[751] Therefore, a splitting event will take place when foreign taxes and related income are allocated to different but related persons for U.S. tax purposes, being a related person technically called "covered person" for this purposes.[752] In addition, and contrary to the proposed regulations under Treas. Reg. Sec. 1.901-2(f), the rules on foreign tax credit splitting event (Sec. 909), do not disallow the use of the FTC, but rather they suspend its use until the entity claiming the credit takes into account the related income.

The application of the new IRC Sec. 909 can be illustrated as follows: let us assume a simplified structure based on *Guardian Industries* by which a domestic Corporation, USCo, wholly owns LuxCo, a Luxemburgish Corporation acting as holding, which subsequently wholly owns OpCo, an

[747] US: IRC Sec. 909(d)(3).
[748] US: IRC Sec. 909(d)(4).
[749] US: IRC Sec. 909(d)(4)(A).
[750] US: IRC Sec. 909(d)(4)(B).
[751] US: IRC Sec. 909(d)(4)(C). Letter (D) of Sec. 909(d)(4) also includes: "any other person specified by the Secretary", which may certainly expand the list of covered persons.
[752] Rosenberg, *supra* n. 732.

operational subsidiary of LuxCo.[753] Both entities situated in Luxembourg are part of a single tax group. LuxCo is solely liable to file the tax returns of the group and to pay the CIT tax at a rate of 30% on the amount of 100i of income that OpCo generated in Year X. Accordingly, while OpCo remains treated as a Corporation for U.S. tax purposes, LuxCo elects to be treated as a disregarded entity. No dividends are distributed from OpCo to LuxCo in year X.

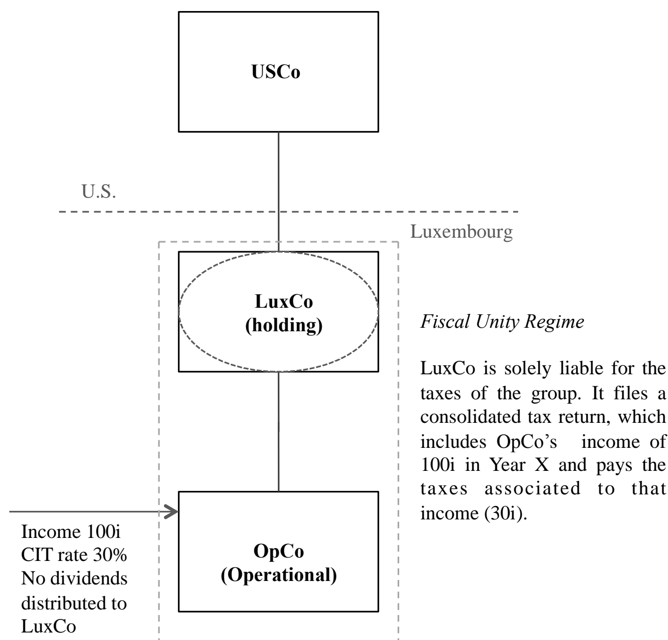

Figure 15: Application of IRC Sec. 909 "FTC splitting event"

[753] This example is taken from Bittker and Lokken, Section 72.5A: "Deferral of foreign income tax on Income not currently recognized", with some modifications. *See* Bittker and Lokken, *supra* n. 530, p. 72-87.

In absence of IRC section 909, LuxCo would be regarded, for U.S. tax purposes, as solely liable for the taxes of the group. Accordingly, as LuxCo is a disregarded entity for U.S. tax purposes, USCo could claim a FTC in the amount of 30i, regardless that this latter in the United States recognizes no income, because indeed OpCo did not distribute dividends to LuxCo in Year X. Nevertheless, under IRC section 909, OpCo would be regarded as a "covered person" with respect to USCo, because this latter through LuxCo (disregarded as an entity in the U.S.) owns at least 10% of OpCo. In addition, the amount of 100i, from which LuxCo paid 30i of taxes in Luxembourg, would be considered as "related income", and there would be a FTC splitting event with respect to the taxes paid by LuxCo because, for U.S. tax purposes, the related income of 100i is included only in the E&P of a covered person (OpCo).[754]

Despite the importance of IRC section 909 to counteract situations in which due to hybrid entities a FTC is improperly granted, they are not exempt of criticism. On one hand, it is argued that the definition of 'related income' is not as precise as it should be in order to determine when a foreign tax credit splitting event occurs. Indeed, it is undeniable that the definition of 'related income' is circular: it refers to income to which foreign taxes relates.[755] One should argue, on the contrary, that similar matching rules exist with respect to the allocation of foreign taxes to income divided in two baskets (general active income and passive income) for determining the FTC for U.S. tax

754 Id.
755 US: IRC Sec. 909(d)(3).

purposes.[756] Nevertheless, such regulations attempt to match foreign taxes with income according to the foreign law’s perception of the tax base, whilst the FTC splitting rules attempt to do the same, but according to U.S. tax law.[757] For example, under these latter rules no consideration is made with respect to the share of losses or whether a payment is debt or equity for foreign tax purposes.[758] The above makes the task of matching foreign taxes with related income an extremely difficult one.[759] Similarly, on the second hand, the focus upon the person who takes the income into account for U.S. tax purposes seems to deviate from the historic approach adopted by the IRS.[760] As noted, IRC Section 909 attempts to grant the FTC to the person who takes into account the related income for U.S. tax purposes, rather than for foreign tax purposes. This approach seems to deviate from the previous regulations that intended to match the FTC with the related income for foreign tax purposes.[761] Finally, although the concept of ‘covered persons’ includes only related persons, limiting thus the application of section 909 to the cases in which FTC and related income is split, the statute gives the IRS

[756] According to U.S. tax law, the credit for the amount of foreign taxes may not exceed the U.S. tax, before the credit, on income from foreign sources. This is known as FTC limitation. US: IRC Sec. 904(a). The FTC limitation must be determined separately for foreign taxes on each the two baskets: passive category and general category. US: IRC Sec. 904(d). *See also*, Bittker and Lokken, *supra* n. 530, pp. 72-93 and 72-123.

[757] Rosenberg, *supra* n. 732, p 703.

[758] Id.

[759] Id. *See also*, J. Bates, *Nature Abhors a Splitter: The FTC Splitter and Indirect FTC Rules*, 61 Tax Notes Int’l 7 (2011), p. 517.

[760] Rosenberg, *supra* n. 732.

[761] As provided in Treas. Reg. Sec. 1.901-2(f)(1): “The person by whom tax is considered paid for purposes of section 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax”. US: Treas. Reg. Sec. 1.901-2(f)(1).

the possibility of extending the concept of covered persons to "any person that the Treasury specifies".[762] In other words, cases in which the splitting of FTC and related income is made between unrelated person are also hypothetically possible.

5. Coordination in an Uncoordinated World

As it can be noted so far, the whole issue regarding hybrid and reverse hybrid entities responds to the domestic characterization of foreign entities for tax purposes. Thus, it seems to be legitimate to ask at this point whether or not coordination might be indeed a more accurate approach in order to avoid the misuse of these structures.[763]

This Section provides three examples of different degrees of coordination in the characterization of foreign entities: Spain, Denmark and the attempted coordination rule within the Proposal for a EU ATAD and the recent Article 9a of the EU ATAD II. These examples demonstrate that coordination in the characterization of entities is beyond being a utopian academic idea and it might be a very effective manner to deal with hybrids and reverse hybrid entities.

762 US: IRC Sec. 909(d)(4)(D).

763 Coordination, however, must not be understood as synonymous of harmonization. As it will be detailed in *infra* Chapter VI, this author proposes a rule ("*reactive coordination rule*"), which, on one hand, helps eliminating the hybrid mismatch itself, and, on the other hand, can be applied in a simpler and more coherent manner.

5.1. The Spanish Experience: An example of coordination in the home country?

The Spanish characterization system of foreign entities for tax purposes is an interesting case of analysis. Originally designed as a resemblance test by statute, its practical application by the Spanish Tax Administration (DGT) considers specially the tax treatment given to the entity in its own jurisdiction, i.e. where the entity is established, reducing thus the possibilities of disparities in the characterization of foreign entities practically to zero in all cases in which Spain is the country classifying a foreign entity in a different manner. Disparities in the characterization of Spanish entities will, however, still exist with respect to Spanish domestic entities characterized by a foreign country. In such a case, Spain does not change the domestic characterization of its own entities in order to coordinate them with a foreign characterization of them.[764]

5.1.1. Spanish Legal Entities in brief

Article 1665 of the Spanish Civil Code defines a 'legal entity' [Spanish: *sociedad*] as "a contract by which two or more persons agree to put in common money, goods or industry, with the aim of distributing the benefits among them".[765] A similar definition is held in Article 166 of the Spanish

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[764] This latter situation occurs, nevertheless, in the case of specific Danish provision dealing with the U.S. CTB Regulations. *Infra* Section 5.2.

[765] ES: Article 1165 of the Royal Decree of 24 July 1889 that publishes the Civil Code (hereinafter, "Spanish Civil Code).

Commercial Code, which provides that an entity is: "a contract by which two or more persons agree to put in common money, goods, industry or any of these in a common fund, to obtain profits, will have commercial nature, whatever the type, as far as it has been incorporated according to this Code".[766] Therefore, 'legal entities' [or *sociedades*] can be regarded as civil or commercial [or business] law entities under Spanish Law.[767]

The distinction between civil and business entities is crucial under Spanish law since, as a general rule, only business entities are subject to the Corporate Income Tax Law.[768] All civil law entities, on the contrary, are subject to a special regime called "Income Attribution Regime" or *[Regimén de Atribución de Rentas]*, which in simple words means that these legal entities will not be taxable, but rather their income and the respective taxes will be attributed to their partners who will suffer the final tax burden.[769]

766 ES: Article 166 of the Royal Decree of 22 Aug. 1885 that publishes the Commercial Code (hereinafter, "Spanish Commercial Code"). Articles 166 to 168 of the Spanish Commercial Code are currently repealed by the Law No. 19/1989 of 25 July 1989 on partial reform and adaptation of the commercial law to the Directives of the European Community with respect to legal entities [B.O.E. 27 July 1989].

767 Other distinctions can be made, e.g. between public and private entities. *See* ES: Article 35 of the Spanish Civil Code.

768 Since 2014, however, civil law entities with a commercial object will be subject to Corporate Income Tax. *See* ES: Article 7(a) of the Corporate Income Tax Law [*Ley del Impuesto sobre las Sociedades*], Law 27/2014 (consolidated text) of 27 Nov. 2014, BOE No. 288 of 28 Nov. 2014.

769 ES: Article 8.3 of the Personal Income Tax Law, Law 35/2006 of 28 Nov. 2006 [*Ley de Impuesto a la Renta sobre las Personas Físicas (LIRPF)*]. Original Spanish text: *"No tendrán la consideración de contribuyentes las sociedades civiles no sujetas al Impuesto de Sociedades, herencias yacentes, comunidades de bienes y demás entidades a que se refiere el artículo 35.4 de la Ley 58/2003, de 17 de diciembre, General Tributaria. Las rentas correspondientes a las mismas se atribuirán a los socios, herederos, comuneros o partícipes, respectivamente, de acuerdo a lo establecido en la Sección 2ª del Titulo X de esta Ley".* Articles 86 and 90 of the LIRPF regulate the "Income Attribution Regime".

The above, however, does not mean Spain makes a systematic distinction between Corporations and Partnerships or opaque and transparent entities in its internal legislation, at least not as it can be seen in common law countries such as the US or the UK, but it provides a very close distinction when separates between civil and business entities for purposes of the application of the Corporate Income Tax.[770]

5.1.2. The *"Income Attribution Regime"* of the Spanish NRITL

The special "Income Attribution Regime" can also be applicable to foreign entities whose juridical nature is similar or identical to the Spanish entities. Indeed, according to Article 37 of the Spanish NRITL states: "Those entities incorporated abroad and whose juridical nature is identical or analogous to those of the entities subject to the income attribution regime, which are incorporated according to the Spanish Law, shall also be considered as entities subject to attribution of income regime".[771] Thus, in simple words, non-resident or foreign entities having an identical or analogous legal nature to "Spanish transparent entities", i.e. entities subject to the Spanish income attribution regime, will also be considered transparent. This analysis of

[770] Considering the transposition of EU law into Spanish law, several legal entities subject to tax transparency treatment have arisen. This is the case, e.g. of the Spanish Economic Interest Groups, the European Economic Interest Group and the Temporary Business Association [*Union Temporal de Empresas*]. *See* ES: Law No. 12/1991 of 29 April 1991 on Economics Interest Groups, and Law No. 18/1982 of 26 May 1982 on Temporary Business Associations. *See also*, EU: Council Regulation (EEC) No. 2137/85 of 25 July 1985 on the European Economic Interest Grouping–EEIG– (OJ L 199, 31.7.1985).

[771] ES: Article 37 of the Spanish Non-Resident Income Tax Law–NRITL, Royal Legislative Decree No. 5/2004 of 5 March 2004.

equivalence or resemblance test includes several factors, such as the legal form of the foreign entity; legal personality; capital divided or not by shares, etc.

5.1.3. The Spanish Characterization Test in Practice

Despite the textual wording of Article 37 Spanish NRIT, which can be read as a simple resemblance test,[772] Spanish tax scholars coincide that when this test is applicable by the DGT, i.e. Spanish tax authority, the tax treatment given in the foreign country is the central element to determine the legal characterization of the foreign entity.[773] In simple words, the administrative practice of the DGT seems to settle a unique example of coordination in the characterization of foreign entities that reduces practically to zero the possibilities of disparities in the characterization of foreign entities, at least in all the cases in which Spain is the country classifying a foreign entity for domestic tax purposes.[774]

The above has been ratified in several binding rulings issued by the DGT up to this date. For example, a recent consultation of 2015[775] referred to the

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772 *See*, e.g. the cases of Germany and the Netherlands, *supra* Section 3.2.1.

773 *See*, e.g., D. Jiménez-Valladolid de L'Hotellerie-Fallois and F. Vega Borrego, *Chapter 29: Spain* in *Corporate Income Tax Subjects* (ed. D. Gutmann), EATLP International Tax Series, Vol. 12 (2016), pp. 460-464. *See also* A. Mosquera Mouriño, *Régimen de atribución de rentas: especial referencia a las actividades económicas*, Carta Tributaria 4 (2012), pp. 3-16.

774 It is, however, always possible to get a ruling clarifying the tax status of an entity liable (or potentially liable) to tax in Spain. *See* ES: Articles 88 and 89 of the General Taxation Law [*Ley General Tributaria*], Law No. 58/2003 of 17 Dec. 2003.

775 ES: DGT, Consulta Vinculante No. V3836-15 of 2 Dec. 2015.

juridical nature of a "German *Kommanditgesellschaft"* (German KG)[776] owned by some Spanish residents. As per the German tax law, a KG, independently of its legal personality, is subject to tax regime in Germany by which the income of the entity is not subject to tax at the level of the entity, but rather at the level of the partners. The DGT considered that the German KG had a similar or identical nature than the Spanish entities subject to the income attribution regime.[777] Thus, for purposes of Spanish Income Tax Law, such German KG will have the same tax treatment in Spain, which means that the Spanish partners should recognize the income of the KG according to their participation in the entity. Likewise, the DGT clarified that if dividends were distributed from the German KG to the Spanish partners, which were attributed to previous tax years in which the Spanish partners included their respective income attribution, will not be subject to tax again in Spain.[778] This opinion with respect to the German KG resemblances a previous binding ruling issued by the DGT in 2014.[779] Similarly, the DGT stated in a general ruling of 2005, with respect to the consultation regarding a Scottish General Partnership, that this entity has a nature similar or identical to the Spanish entities subject to the income attribution regime.[780] One of the element considered in this consultation was the fact the General Partnership, according to Scottish tax law, was regarded

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776 This could be equivalent to the concept of *"Limited Partnership*" used in common law countries.
777 ES: DGT, *supra* n. 775.
778 Id.
779 ES: DGT, Consulta Vinculante No. V1631-14 of 25 June 2014.
780 ES: DGT, Consulta General No. 0196-05 of 1 June 2005.

as transparent for Scottish tax purposes.[781] In 2007, in another general ruling, the DTG stated that a British partnership rendering legal services in Spain through an office should be regarded to have a nature similar or identical to the Spanish entities subject to the income attribution regime.[782] This conclusion was achieved bearing in mind specially the "legal regime applicable to partnerships in the UK".[783] On the contrary, when the tax transparency treatment of the entity is not clear at all, either because of the foreign legislation of for the lack of information when the taxpayer submitted the consultation, the DGT has considered the tax treatment of the entity as opaque. For example, in the binding ruling No. 0012-11 of 11 January 2011,[784] referred to the legal nature of some international funds of capital risk using the form of limited partnerships, the DGT analyzed the concurrence of several factors, including limited liability of the limited partners, the administration of the fund by a third party and the existence of an agreement to distribute profits in which the limited partners have no influence. However, the taxpayer submitting the consultation in this case did not provide enough information regarding where exactly these funds were incorporated,[785] which, under the author's view, influenced the final decision of the DGT to consider these funds as opaque entities. Someone could also argue that the limited liability of the partners as well as the other

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781 Id.

782 ES: DGT, Consulta General No. 0024-07 of 1 July 2007.

783 Id. *See also*, ES: DGT, Consulta General No. 2110-04 of 30 Dec. 2004, with respect to tax treatment given to a British partnership in Spain.

784 ES: DGT, Consulta Vinculante No. V0012-11 of 11 January 2011.

785 In this case the taxpayer limited to inform that such funds where incorporated in the form of limited partnerships (LP), similar to the ones of Anglo-Saxons countries. Id.

factors analyzed by the DGT were information enough to achieve the same conclusion. Nevertheless, the DGT has opted clearly in other rulings to treat a LP or LLP as transparent entities when such a treatment is clearly stated in the country of incorporation.[786]

Although it is arguable to affirm that Spain completely deviates from the resemblance test established by statute, it is evident from the administrative practice of the DGT that there is at least a tendency, when applying the resemblance analysis, to respect the characterization of the foreign entity given in its country of incorporation, having thus this feature a decisive weight in the final characterization of the foreign entity.[787] This tendency can be seen, e.g. in a very recent binding ruling No. 3319-16 of 14 July 2016,[788] referred to a Spanish entity owned 100% by a German KG, which is subsequently owned by two partners: a general partner in Germany and a limited partner in the UK. The question referred exclusively to the potential application of the tax treaty between Spain and the UK with respect to the

786 E.g., ES: DGT, Consulta Vinculante No. V1398-16 of 5 April 2016, referred to the nature of a LLP incorporated in the UK. In a similar response regarding the treatment of a British LLP, *see* ES: DGT, Consulta Vinculante No. V036-14 of 10 February 2014.

787 For example, other factors considered in the DGT Consulta General No. 0196-05 of 1 June 2005, were that, according to the UK tax law: 1) the general partnership had legal personality, although its capital was not divided in shares; 2) the unlimited liability of the partners; 3) the management if the entity is made by each of the members who act as agents of the entity and the rest of the members; 4) the partnership is not obligated to deposit annual accounts in the UK; 4) the partners are entitled to the profits without need of a decision or agreement at the entity level. None of these factors, however, were as relevant as the fact that the entity was not subject to tax in the UK at the level of the entity, but rather at the level of the partners. *See* ES: DGT, Consulta General No. 0196-05 of 1 June 2005.

788 ES: DGT, Consulta Vinculante No. V3319-16 of 17 July 2016.

limited partner of the German KG in the UK. Even though the DGT pronounced already with respect to the legal nature of the German KG for Spanish tax purposes, considering it as fiscally transparent, the DGT repeated in several passages of this recent ruling that the fact that the KG is regarded as transparent in Germany, and in this case also in the UK, permits to treat it also as transparent in Spain (subject to the "Income Attribution Regime"), and making also applicable the Spain-UK tax treaty.

By other side, it is the author opinion that the level of coordination achieved with respect to the characterization of foreign entities for tax purposes has to be specifically with the similitude between the Spanish "Income Attribution Regime" and the concept of "transparent entities" mostly used, but not exclusively, in common law countries. Indeed, while a transparent entity will be an entity not subject to tax at the level of the entity, but at the level of the partners, e.g. a partnership, an entity subject to the "Income Attribution Regime" will be an entity whose income is attributed directly to the partners. In other words: a fiscally transparent entity. In the same order of ideas, if a foreign entity is taxable at the level of the entity (i.e. it is a opaque entity), it will also be considered as such for Spanish tax purposes. This coordinated outcome thus nullifies all the possibilities of disparities in the characterization of foreign entities for Spanish tax purposes, i.e. when Spain classifies foreign entities, reducing also the complexity of the Spanish

resemblance test and increasing the levels of legal certainty for taxpayers involved in legitimate tax planning structures through foreign entities.[789]

Finally, it is interesting to highlight that the Spanish solution provides to certain extent a degree of coordination in the characterization of the entity at source. Indeed, and contrary to other solutions that will be analyzed further on in this work,[790] it is not the country receiving a hybrid payment who states the characterization to be followed, but rather the country where this payment is sourced. This solution seems to be, in principle, fairer with developing countries and interesting it was also proposed within the original text of the EU ATA Directive in 2016.[791]

789 On the contrary, Villar argues that the question of characterizing foreign entities in Spain is highly an individual task, which is very time consuming and lead to legal uncertainty. *See* Villar, *supra* n. 542. This author does not disagree that the factors to be considered in the characterization of a foreign entity are several, and as any other resemblance test, it is costly. However, the author estimates that the Spanish IFA report does not properly evaluate the extensive Spanish tax administrative practice, which clearly shows a tendency to recognize the tax treatment of the foreign entity in its country of organization, which should certainly reduces the time consuming cost, at least in part. Accordingly, if a taxpayer asking the DGT regarding the tax treatment of an entity, e.g. a US LLC, whose tax treatment in the United States is clear will, on the contrary, experience a higher degree of certainty with respect to the DGT's answer.

790 Especially the one proposed within the OECD Partnership Report, which attempts coordination in the characterization of entities in the residence country. *Infra* Chapter IV Section 3.

791 *Infra* Section 5.3. There is no doubt, however, that the deviation from the textual wording of the law made by the Spanish Tax Administration as to interpret the Income Attribution Regime affects the principle of legality and it might thus be considered undesarible. However, it is undeniable that from a pragmatic point of view, the interpretation of the Spanish Tax Administration provides an interesting solution of coordination as regard to the issue of hybrid entities.

5.2. The Danish Experience: Re-characterization of its own entities

Unlike the Spanish example above, Denmark has some specific rules providing for a certain degree of coordination in the characterization of its own domestic entities with the one provided by a foreign country, under certain circumstances.[792] In other words, if certain requirements are met, a domestic Danish taxable entity, considered tax transparent by a foreign country, can be re-characterized also as a transparent entity in Denmark. Likewise, a Danish transparent entity can be re-characterized as taxable entity if the foreign country considers it also as taxable entity. Both rules are indeed a targeted reaction to the characterization of entities derived specifically from a potential electivity in the characterization of Danish entities by a foreign country (i.e. the U.S. Check-the-box rules), rather than a general rules attempting to coordinate the characterization of foreign entities for Danish tax purposes at any level.[793] The above, however, does not rest merits to this interesting example of coordination in the characterization rules in order to deal with both hybrid entities and reverse hybrids.

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[792] This can also be referred as "coordination at residence", considering that Danish entities are re-characterized as per the tax treatment given in the place where the parent company or investors are residents.

[793] In this opinion, e.g. Dell'Anese, *supra* n. 4, p. 254. *See also*, A. Møllin Ottosen and M. Nørremark, *New Anti-Avoidance Rules in Denmark Targets Reverse Hybrids and Convertible Bonds*, 68 Bull. Intl. Taxn. 11 (2008), Journals IFBD, p. 513; J. Bundgaard, *Coordination Rules as a Weapon in the War against Cross-Border Tax Arbitrage–The Case of Hybrid Entities and Hybrid Financial Instruments,* 67 Bull. Intl. Taxn. 4/5 (2013), Journals IBFD, pp. 200-201. All these authors coincide that the target of the 2004 and 2008 rules were exclusively the negative impact of the U.S. CTB regulations.

5.2.1. Danish Reaction to Hybrid Entities

In 2004, Denmark adopted a rule by which a Danish taxable entity may be re-characterize as tax transparent if certain requirements are met:[794] i) the taxable entity is a Danish resident entity or a PE of a foreign resident company; ii) the Danish taxable entity is disregarded for foreign tax purposes; iii) the income of the Danish company is included in the taxable income of the "controlled foreign legal entity", i.e. an entity that owns more than 50% of the Danish company or holds more than 50% of the voting rights, and iv) the foreign country is a member of the EEA or a tax treaty partner with Denmark.[795] If all the requirements are met, the Danish entity will be treated as a branch of the controlled foreign legal entity.[796]

As repeatedly argued by some authors, the reasons of these rules seem to be settled specifically to counteract some commonly used transactions in the

[794] DK: Section 2A of the Corporate Income Tax Law [SEL–*Selskabsskatteloven*]. This rule was adopted by the Bill 119 of 17 Dec. 2003. *See*, J. Wittendorff, *Denmark's Hovmand Clarifies Pending Transparent Entities Legislation*, 33 Tax Notes Int'l 9 (2004), p. 758. *See also*, Dell'Anese, *supra* n. 4, p. 254.

[795] Wittendorff, *supra* n. 794. J. Wittendorff, *Danish Parliament Enacts Transparent Entity Legislation*, 34 Tax Notes Int'l 1 (2004).

[796] The fact that a Danish companies is regarded as a branch, does not entitle the company to take a deduction for payments made to the foreign parent company or to the group-related entities, which are also treated as fiscally transparent under laws of the residence State of the foreign company. The payments are indeed considered made within the same legal entity. Accordingly, dividends paid from the Danish entity to the foreign controlled legal entity are not subject to WHT. *See* A. Riis and P.E. Lytken, *Denmark-Corporate Taxation* sec. 10, Country Analyses IBFD (accessed 6 Feb. 2017). Nevertheless, "if there is a direct link between external borrowings by the foreign parent company and the loan granted to the transparent entity, the interest paid by the foreign parent should be allocable to the transparent entity in accordance with ordinary principles of PE taxation". Wittendorff, *supra* n. 794. *See also*, Dell'Anese, *supra* n. 4, pp. 254-255.

past, which involved a Danish SPV financed with debt and owned by U.S. persons, who has always the chance to elect how to treat the Danish company for tax purposes.[797] Therefore, since a SPV is a taxable entity for Danish tax purposes, the Danish company was able to deduct interest payments made to its U.S. parent, although the interest income was never included in the United States due to the CTB election, treating the SPV as tax transparent for U.S. tax purposes.[798] Interestingly, however, this domestic rule does not provide for a denial in the deduction made at the level of the SPV, but rather it targets the real issue here, which is the different characterization of the same entity by Denmark and the United States. [799] Since the SPV will, after the application of the rule, be considered also as tax transparent, the payment of interest will not be deductible any

[797] *See*, e.g. N. Bjørnholm and A. Obery Hansen, *Denmark in International Tax Planning*, Online Books IBFD, 2005, p. 41–sec. 4.16.2. Also, as provided by Bundgaard: "Despite the general wording of the provision [Section 2A SEL], the practical scope appear to be Danish entities that are eligible for the U.S. check-the-box election. As a practical issue, this [application of the rule] includes primarily Danish companies organized in the form of a private limited company (*Anpartsselskab*–ApS). If an election is made according to US law to treat a Danish ApS as a transparent entity for US tax purposes, this may invoke this provision". Bundgaard, *supra* n. 793, p. 201. Accordingly, Møllin Ottosen and Nørremark state: "Different classifications of entities have been considered a problem mainly in relation to Danish limited partnerships whose direct owners are tax resident in the United States". Møllin Ottosen and Nørremark, *supra* n. 793.

[798] We are assuming, of course, that the Danish SPV is an eligible entity for purposes of the CTB election. *Supra* Section 4.3.

[799] Indirectly, however, the deduction is denied since it is disregarded for Danish tax purposes after the re-characterization. *Infra* Chapter V refers specifically to this solution, proposed by the OECD within the BEPS Action Plan 2, and known as "primary response".

longer, although without the need of introducing a new domestic rule that denies the deduction.[800]

The application of the Danish anti-hybrids rule seems to be very straightforward; however, there are still some doubts about its real effectiveness. For example, the Danish rule requires for re-characterizing a domestic taxable entity as transparent that the income of the Danish SPV is included in the taxable income of the U.S. parent, which is assumed to be a controlled foreign entity. The above represents, on one hand, an important practical limitation of the rule, since no re-characterization will occur in all those cases in which the Danish company has indeed no operating income in a specific taxable year. On the other hand, the fact that Denmark treats a domestic taxable entity as tax transparent does not change the fact that the United States disregards the payments of the interests and any other transactions between the Danish company and the U.S. parent. Therefore, the interests will not be subject to tax anywhere and no matter what, because they will be disregarded for all tax purposes. Likewise, the rules are not entirely clear whether they apply in cases of a U.S. taxpayer treats a Danish entity as transparent, without making use of the CTB election, but rather due to the default rules of classification in the United States.[801] Is in this case the

800 A Danish company, which has been re-characterized as fiscally transparent, is also not considered as a Danish tax resident and thus is not subject to the benefits of the EU Directives and tax treaties signed by Denmark. Riis and Lytken, *supra* n. 796. Accordingly, the Danish company will no longer be subject to full-Danish corporate taxation. Wittendorff, *supra* n. 794.

801 US: Treas. Reg. Sec. 301.7701-3(b)(3)(ii), with respect to the U.S. default rule of characterization of entities. See also, *supra* Section 4.3. for a further analysis.

Danish anti-hybrids rule applicable? If not, there would certainly be a range of situations that would not be covered under the rule, allowing a circumvention of it.[802] If yes, it would make more sense, because in such a case the rule would counteract both the effect of the election and the default rules, coordinating completely the characterization of entities. Indeed, as stressed already in this Chapter, the CTB system is indeed just partially elective and this is an issue that should not be underestimated.[803]

Another example of the limited application of the rules is the case of group-related entities.[804] Let us assume a U.S. corporation directly owns a holding company (Holding 1), incorporated in country X and this latter owns another holding company (Holding 2), incorporated in country Y, which finally owns a Danish company (DCo). Let us also assume that Holding 2 grants a loan to DCo and that this latter pays back interests associated to that loan.

802 This will certainly depends on the Danish law. If Danish law, e.g. allows to modify the responsibility of a Danish entity with two or more members (e.g. SPV, ApS, etc.), and one of these members becomes unlimited liable for the responsibilities of the entity, the Danish entity will be considered by default as a tax transparent entity for U.S. tax purposes. US: Treas. Reg. Sec. 301.7701-3(b)(2)(1)(A).

803 *Supra* Section 4.3.

804 "Unless the Danish subsidiary is held by the US parent company through one of more intermediate holding companies, which are not treated as fiscally transparent for US tax purposes, the Danish subsidiary is reclassified as a branch under section 2A". *See* Riis and Lytken, *supra* n. 796.

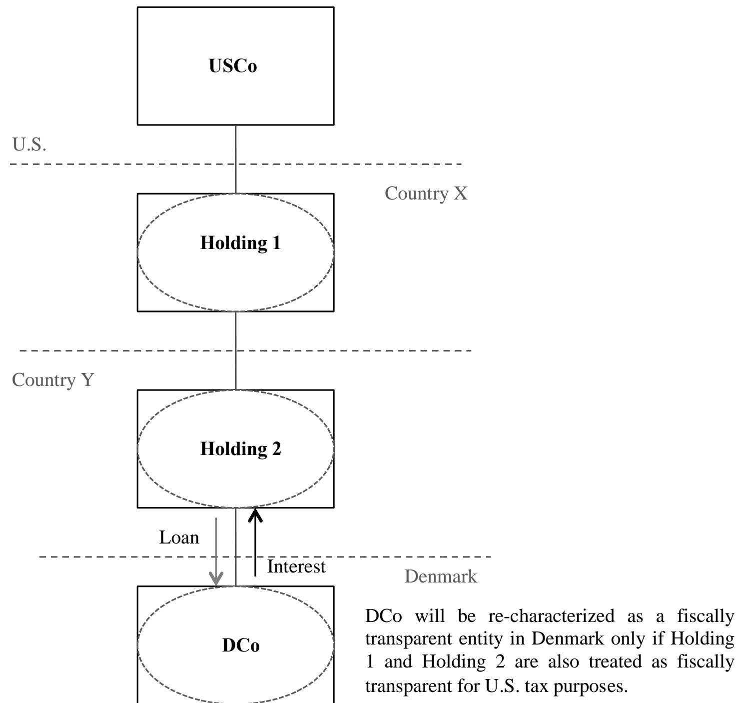

Figure 16: Danish anti-hybrid rule and group related entities

In this case, the Danish rule applies only to the extent that DCo and all the holding companies are treated as fiscally transparent under the tax rules of the foreign parent company, i.e. under the tax rules in the United States.[805] If the above does not happen, the interest will still be tax-deductible, although subject to the Danish thin capitalization rules.[806]

[805] Id.
[806] Wittendorff, *supra* n. 794, p. 759.

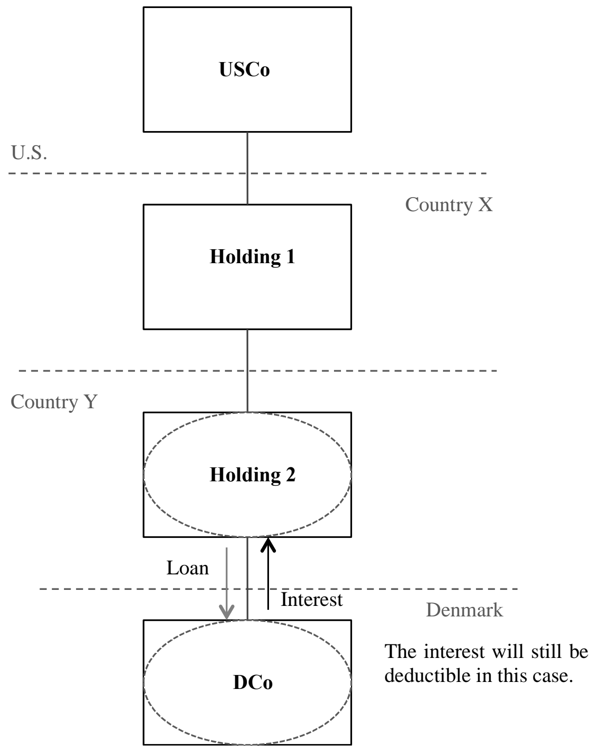

Figure 17: Danish anti-hybrid rule and group related entities (second assumption)

In the example above, if Holding 1 is considered opaque for U.S. tax purposes, while Holding 2 and DCo are regarded as tax transparent, the interest paid by DCo will still be deductible, but subject to the Danish thin capitalization rules, assuming also that the income of the foreign creditor company is not included in the taxable income of the parent company in the United States.[807]

[807] Id., Ex. 3, Chart 2.

Let us now assume that Holding 2 does not exist anymore and that the structure only contemplates the U.S. parent, Holding 1 and the Danish subsidiary, DCo.

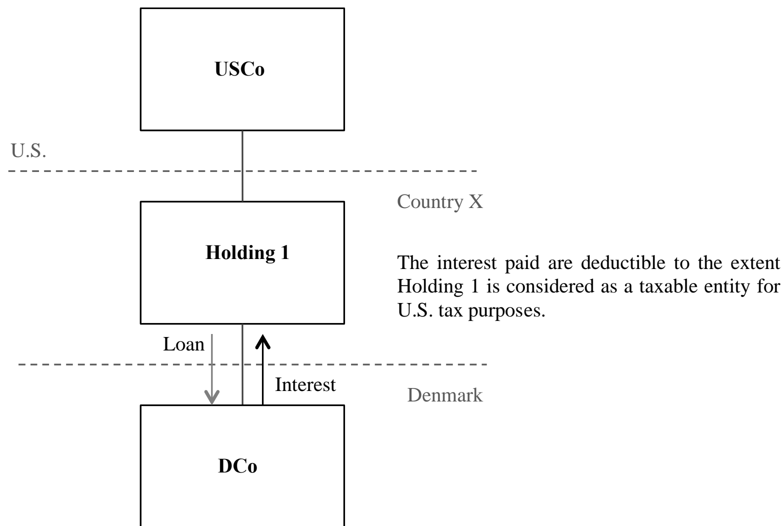

Figure 18: Danish anti-hybrid rule and group related entities (third assumption)

In such a case, the interest paid from DCo to Holding 1 would be also deductible to the extent that Holding 1 is considered as taxable entity for U.S. tax purposes.[808]

Although it is undeniable from all the assumptions above that the elective characteristic of the CTB rules certainly helps in circumventing the application of the Danish anti-hybrid rule when intermediary holding

[808] Id., Ex. 1, Chart 2.

companies are involved,[809] one should also consider that in all those cases where the U.S. parent decides to treat Holding 1 and 2 as taxable entities in order to avoid the Danish anti-hybrids rule, they would most probably remain subject to CFC rules in the United States to the extent that Subpart F income is generated.[810] The above could perhaps not eliminate completely the abusive use of the CTB election, but at least increases the alternative costs for taxpayers when deciding about tax planning strategies involving holding companies in Denmark.[811]

Finally, it is interesting to note the rational behind the Danish anti-hybrids rule, especially with respect to the collection of taxes and the intention that income is taxed somewhere, but not in Denmark. On one hand, if e.g. a country wanted as a general rule to keep its taxing rights, collecting thus revenues, the Danish rule produces exactly the opposite effect, encouraging the collection of taxes in the other country. Indeed, since the moment that all requirements are met, a Danish company will be re-characterized as tax transparent, therefore, not being subject to tax in Denmark anymore to the extent the income of the Danish company is recognized in the other country. This situation can be compared with the Spanish coordination in the characterization of a foreign entity, which is made under a completely

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809 *Supra* Section 4.3.

810 Nonetheless, one should also consider that Subpart F income can be easily avoided in the United States without necessarily making use of the CTB election, e.g. through the "same country exception". *Supra* Section 4.4.1.

811 Although recognizing that this is a very difficult issue to measure, Bundgaard states, from a practical experience, the following: "[T]he provision has had a significant effect on the structuring of the investments of US multinationals enterprises (MNEs) in Denmark". *See* Bundgaard, *supra* n. 793, p. 201.

opposite rational: to follow the domestic treatment of a foreign entity in its country of organization.[812] In this latter case, however, the possibilities of revenue losses are lower.[813] On the other hand, and with respect to the aim of taxing the income somewhere, i.e. requesting that income of the Danish company is recognized in the other country, one should consider that this aim could be easily avoided in case the parent company is not necessarily located in the United States and rather in a low tax jurisdiction. This issue could occur in theory since the Danish rule is written to be generally applied to all situations in which a Danish company is treated as tax transparent, and so long all the other requirements are met, and not only in those cases in which the parent company is organized in the United States.[814] Likewise, the re-characterization of a Danish entity as a tax transparent entity does not change the characterization made in the United States. This means, a payment of interest from the Danish company to its parent will be completely disregarded in both countries. The above solves the hybrid

[812] *Supra* Section 5.1.3.

[813] For example, in a simple structure in which a Spanish company wholly owns a subsidiary in country X, and this country treats the entity as opaque, Spain will also follow this characterization. Therefore, income will be taxed in country X. However, Spain could also tax the income by application of the CFC rules, decreasing the risk of tax deferral in Spain. Likewise, if the tax treatment of the subsidiary in its country of organization were as fiscally transparent, Spain would follow that treatment and would again collect the taxes in the hands of the Spanish company (income is considered flowing-through directly to the shareholders). In both cases thus the revenue loss risk would be minimal.

[814] Bundgaard, *supra* n. 793. Nevertheless, this rule would have any impact when applied to Spain. In such a case, as Spain will follow the Danish characterization of the entity, there will be no space for the application of the Danish anti-hybrid rule. *Supra* Section 5.1.

disparity, although strictly speaking keeps the interest income untaxed, i.e. disregarded as income.[815]

5.2.2. Danish Reaction to Reverse Hybrids

As per the case of hybrid entities, in 2008 the Danish Parliament adopted the Bill No. L181, which contained measures to counteract the effects of cross-border structures involving *reverse hybrids*,[816] namely, Danish entities considered as tax transparent in Denmark, whilst as taxable entities in the other country part of the transaction.[817] For this purposes, the rule provides that certain entities normally treated as fiscally transparent in Denmark, e.g. limited partnerships [*kommanditselskaber*], partnerships limited by shares [*partnerselskaber*] and branches of non-Danish entities, must be re-characterized as taxable entities if: (i) the direct owners/partners holding more than 50% of the capital or voting rights are tax residents in one or more foreign jurisdictions, the Faroe Islands or Greenland,[818] and (ii) the

815 This proves again the inconsistent logic behind the single taxation ideal. In contrast, however, Dell'Anese states: "[T]he tax policy significance of the Danish initiative is clear: developed countries are beginning to take notice of U.S. entity classification rules […]. They are also beginning to react, applying the single tax principle logic, to the U.S. inaction in the outbound area, reaping this way all the tax advantage, as typical for first-movers in arbitrage situations". Dell'Anese, *supra* n. 4, p. 256. *See also* the discussion about the single tax principle and the DNT outcome at *supra* Chapter I, Section 3.

816 It also containes measures to counteract convertible bonds. However, this topic will not be analyzed here. For a reference, *see* Møllin Ottosen and Nørremark, *supra* n. 793. The rule is contained in DK: Section 2C of the Corporate Income Tax Law [SEL– *Selskabsskatteloven*].

817 *Supra* Section 3.1.

818 The "direct owners/partners" do not need to be affiliated parties. Indeed, they can be separated companies or individuals that reside in foreign countries and that together hold more than 50% of the capital or voting powers. *See* Møllin Ottosen and Nørremark,

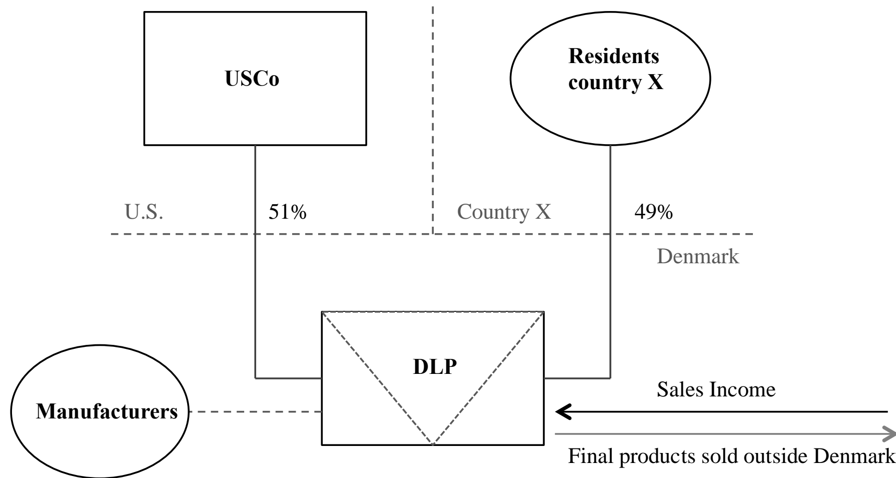
jurisdiction where the owners are tax resident either considers the Danish entity to be a separate taxable entity, or it does not exchange information with the Danish tax authorities.[819] Accordingly, if the re-characterization applies, it affects not only those who belong to the countries treating the Danish entity as taxable entity or who do not exchange information with Denmark, but also the other owners residents in countries treating the entity as tax transparent or those who indeed exchange information with Denmark.[820] Let us assume the following example where a U.S. parent company has 51% of the voting rights in a Danish limited partnership [*kommanditselskaber*]–DLP–, which is regarded as fiscally transparent entity in Denmark. The remaining 49% belongs to owners resident in country X. While the U.S. owners elect to treat the DLP as a taxable entity, the owners in country X treat the DLP also as fiscally transparent. Let us also assume that the DLP enters into a manufacturing agreement according to which a third party manufactures a product on behalf of the limited partner. According to this agreement, the DLP maintains the ownership of

supra n. 793, p. 514. Accordingly, non-Danish entities and branches, which are deemed to be fiscally transparent in their country of organization, are disregarded fur purposes of determining who are the direct owners/partners. The above is relevant, e.g. in the case a taxpayer decides to use an intermediary company (e.g. organized in country Y) between the U.S. owners and the Danish transparent entity, which is deemed to be transparent in country Y, but as a taxable entity in the United States. In such a case, the entity in country Y is disregarded for purposes of determining who is the direct owner of the Danish entity. Id.

[819] An exception to this anti-reverse hybrid rule applies for venture funds investing in medium and small-sized companies if certain conditions are met. The reason for exempting venture funds is the desire to continue to encourage the start-up and growth of these types of businesses. Bundgaard, *supra* n. 793, p. 202.

[820] Møllin Ottosen and Nørremark, *supra* n. 793, p. 514.

the IP, raw materials and final products. These latter are sold by DLP to unrelated parties outside Denmark.



DLP is a fiscally transparent entity in Denmark. Likewise, country X treats it as fiscally transparent. The U.S. owners, however, elected to treat it as a taxable entity.

Figure 19: Danish anti-reverse hybrid rule

In absence of the Danish anti-reverse hybrids rule, the DLP is regarded as fiscally transparent in Denmark, and if there is no a Danish PE either, the income derived from the sales is disregarded for tax purposes in Denmark. This is to say, it flows through the owners in the United States and country X. Likewise, and because the U.S. owners elected to treat the Danish entity as a taxable entity, the income is not taxed in the United States either, at least until dividends are distributed to the United States. Moreover, as income from manufacturing activities is not considered as Subpart F income (“manufacturing exception”) in the United States, the application of the U.S.

CFC rules is also nullified.[821] Accordingly, as in this case USCo owns more than 50% of the voting rights in DLP and they elected to treat it as taxable entity for U.S. tax purposes, the DLP is re-characterized as a taxable entity in Denmark, affecting also those owners/partners who are not U.S. residents.[822] In other words, the characterization of the Danish entity is coordinated with the characterization of the other country where the parent company is resident, i.e. the United States in this case. Thus, the DLP will be taxed in Denmark at a normal corporate tax rate of 25% on the income generated.[823]

Interestingly, the Danish anti-reverse hybrid rule deviates from the recent OECD proposal in Action 2 of the BEPS Action Plan.[824] In brief, Action 2 provides for introducing a domestic rule denying a deduction at the level of the payer with respect to a payment made to a reverse hybrid (primary

[821] US: Treas. Reg. Sec. 1.954-3(a)(4)(i). See also, *supra* Section 4.4.1.

[822] Møllin Ottosen and Nørremark, *supra* n. 793, p. 514.

[823] Other effects following the re-characterization will include: 1) contrary to the normal rule that the owner of a fiscally transparent entity is deemed to own a proportionate part of the entity's assets and liabilities, this will be deemed to have an ownership in a separate entity. The above mans that any disposal of interest in the Danish entity will be regarded as a sale of shares, whose capital gains are not taxed in the hands of non-Danish residents; 2) a "rollover principle" at the level of the owners of the entity, which ensures that they are generally not taxed on any gains on the assets held by the entity as a consequence of the re-characterization. On the contrary, the owners or participants of the re-characterized Danish entity are deemed to have acquired their ownership interest in the entity at a price equal to the tax value of the assets and liabilities held by the entity at the time of the re-characterization; 3) assets and liabilities held by an entity that is re-characterized will be deemed to be acquired at the same time as the participant acquired the and at a similar price ("rollover principle" at the entity level); 4) dividends distributions from the re-characterized entity might be subject to WHT in Denmark. Id., pp. 514-515.

[824] OECD (2015), *supra* n. 6. A further analysis will conducted at *infra* Chapter V.

response), attempting finally to match outcomes. The Danish anti-reverse hybrid, on the contrary, attempts to match the characterization of the entities, which is indeed the core of the issue with respect to reverse hybrids. Yet, it is interesting to note that even when the final target were to match outcomes in order to tax income somewhere, the Danish rule seems to be more effective, because it does not require determining when a deduction has been taken in the third country payer (an issue normally difficult to determine in a big scale). In contrast, the re-characterization of the domestic entity as a taxable entity guarantees that the income will be subject to tax in Denmark, regardless of the deduction in the third country. Thus, at least in principle, the Danish rule would accomplish with the target of ensuring taxation in a simpler manner than calling for denying a deduction at the level of the payer and relying in the application of CFC rules at the level of the parent company, as proposed by the OECD in Action 2 of the BEPS Action Plan.[825]

In spite of the above, there are still some features of the Danish anti-reverse hybrid rule that are not completely convincing in order to apply as a solution in an international level. On the one hand, it is the one referred to the effect of the re-characterization. It seems, at least *a priori*, unfair that the re-characterization of a fiscally transparent entity as a taxable entity is applied

825 Indeed, if the OECD proposed rule (*primary response*) is applied in case a deductible payment is made to a reverse hybrid, the denial of the payment does not change the fact that the country of organization considers the entity as fiscally transparent while the country where the parent company is located considers it as a taxable entity. In other words, the reverse hybrid issue will remain and the income will be recognized neither in the country of organization of the entity nor in the country of the parent company.

to all partners, letting the interest of minority shareholders subject to the tax treatment of the entity in the countries where the majority shareholders reside. Such a rule seems to be not only disproportionate and very disadvantageous for minority shareholders, but also it could give rise to important internal conflicts and negative consequences for the normal functioning of a business. Indeed, in the worse scenario, it could influence the decisions of domestic investors to carry out businesses based on the residents of the foreign investors and the tax treatment given to the entity in their country. The above result is not only absurd, but it could generate important limitations to the economic development. On the other hand, although connected with the above, it is the author's view that the Danish anti-reverse hybrid rule relies too much in foreign law, i.e. with respect to the tax treatment of a domestic entity, which could finally increase the level of uncertainty for taxpayers, even violating domestic basic legal principles, such as legal certainly.

5.3. From the EU ATAD I to EU ATAD II: A frustrated example of supranational coordination

In January 2016 the European Commission issued a proposal for a Council Directive laying down rules against tax avoidance practices that might affect the functioning of the internal market.[826] The proposal for a Directive

[826] EU: Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, COM (2016) 26 final, hereinafter "Proposal for EU ATAD". The proposal for Directive was only a part of a

contained a very interesting rule attempting to coordinate the characterization of entities according to the characterization given in the source MS. This rule, unfortunately, did not see the light, most probably attending to the global influence (and why not to say it, the political pressure) of the OECD proposal, i.e. *linking rules*.[827] On 12 July 2016, therefore, a final text of the Directive ("EU ATAD I")[828] came up with rules resembling the above-mentioned OECD *linking rules,* which have been recently (29 May 2017) also been extended to deal with hybrid entity mismatches involving third countries, i.e. outside the EU ("EU ATAD II").[829]

full Commission's Anti-Tax Avoidance Package that also included other initiatives at a regional level. Other initiatives included in the package are, e.g. a recommendation on tax treaties; a revision of the Administrative Cooperation Directive; a Communication on an external Strategy for Effective Taxation and a Chapeau Communication and Staff Working Document, explaining the political and economic rationale behind the individual measures that intends to address a number of issues in response to the 2013 BEPS project and which is also in line with some previous work in the area at the European level. *See* EU: Report of the Code of Conduct Group (Business Taxation), 16553/114 Rev. 1, FISC 225, ECOFIN 1166, Brussels (11 Dec. 2014). *See also*, EU: Commission Communication, A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, COM (2015) 302 final, 17/6/2015. For an analysis of this Action Plan *see*, e.g., S. Krauß, *EU-BEPS? Aktionsplan für eine faire und effiziente Unternehmensbesteuerung in der EU*, Internationales Steuerrecht 2 (2016), p. 45 et seq.

[827] *Infra* Chapter V, Section 3.

[828] EU: Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L193, (2016), hereinafter "Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I)".

[829] EU: Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, OJ L144/1 (2017), hereinafter "Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II)".

Nevertheless, and despite the frustrated process of coordination in the characterization of entities within the EU, the recent EU ATAD II seems to retake the original approach proposed by the European Commission, at least with respect to issues involving reverse hybrid entities, proposing a rule that has nothing to do with the OECD BEPS approach, and which attempts to solve the issue of reverse hybrids through a re-characterization rule triggered in the country where the reverse hybrid is established.[830]

The above-mentioned process of coordination, or attempted coordination, since the proposal for an EU ATAD until its final text (EU ATAD I) and the launch of the EU ATAD II, dealing with mismatches with third countries, is subsequently analyzed.

5.3.1. The EU ATAD I (original text): A coordination at source

The proposal for EU ATAD contained a specific provision dealing with hybrid entities: Article 10 of the original text of the proposal for Directive. This article stated as follows: "Where two Member States give a different legal characterization to the same taxpayer (hybrid entity), including its permanent establishments in one or more Member State, and this leads to either a situation where a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State

[830] EU: Article 9a of the Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II).

or a situation where there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion of the same payment in the other Member State, the legal characterization given to the hybrid entity by the Member State in which the payment has its source, the expenses are incurred or the losses are suffered shall be followed by the other Member State".[831]

Leaving aside for a moment the analysis of the connection between hybrid entities and the outcome of D/NI (DNT), which will be assumed in detail further on in this work,[832] the Proposal for EU ATAD provided a very interesting solution to deal with cases in which a different characterization of the same entity is given by two MS. The solution, unlike other proposals launched at that time, especially the OECD *linking rules*, attempted to coordinate the characterization of the entity as per the one given in the source country, countering thus the true reason of hybrid and reverse hybrid entities, rather than only alleviating the symptoms derived from the main issue.[833]

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831 EU: Article 10(1) of the Proposal for EU ATAD.

832 The article refers to DD and D/NI. While the former is excluded from the analysis of this work, the latter will be further on analyzed. *Infra* Chapter V.

833 Navarro, Parada and Schwarz, *supra* n. 455, p. 129. The solution proposed is partially in line with the recommendation of the European Parliament of December 2015, where the Parliament calls the European Commission for a proposal "to either harmonize national definitions of debt, equity, opaque and transparent entities […]; or prevent double non-taxation, in the event of a mismatch". *See* EU: Recommendation C6 'Hybrid Mismatches' of the Resolution of the European Parliament with recommendations to the Commission on bringing transparency, coordination and convergence to corporate tax policies in the Union, 16 Dec., (2015/2010 (INL)), cited in: G. Fibbe and A.J.A. Stevens, *Hybrid Mismatches Under the ATAD I and ATAD II*, 26 EC Tax Rev. 3 (2017),

Let us assume the following simple example: X, an entity organized in MS1 has a subsidiary, Y, in MS2. For purposes of MS1, Y is not recognized for tax purposes (tax transparent), while for MS2's tax purposes, this is indeed a taxable entity subject to corporate income tax. Likewise, X grants a loan to Y and it receives interest back accordingly.

p. 155, footnote 19. A harmonized solution, i.e. harmonization in the rules characterizing entities for tax purposes within the EU has also been proposed somewhere else. In particular, Fibbe proposed a uniform classification method within the EU by mutually recognizing the tax classification in the host country. This mutual classification method is based in the principle of mutual recognition of entities and it would be materialized in a EU Directive. For further details on Fibbe's proposal, *see* G. Fibbe, *EC Law Aspects of Hybrid Entities*, Vol. 15, Doctoral Series IBFD, Amsterdam (2009), pp. 293-384. *See also*, EU: Judgment in *Columbus Container Services BVBA & Co. v Finanzamt Bielefeld-Innenstadt*, C-298/05, ECLI:EU:C:2007:754, where the CJEU argued that a disparity derived from the autonomous classification of entities within EU MS was an issue beyond the fundamental rights and freedoms. Fibbe, based in the outcome in *Columbus Container Services,* reinforces the idea of introducing a Directive on Mutual Recognition of Entities within the EU. As stated by Fibbe: "If the ECJ did not consider in the *Columbus* case that the consequence of a classification conflict is a forbidden restriction […] Therefore, the new directive introduces a better system than the current tax classification methods that are applied autonomously […]" Fibbe, Id., p. 378. In spite of the fact that I agree that the EU is a better place for achieving harmonized or coordinated results, harmonization in the characterization of entities would still be a utopic idea to implement in a global scale. Likewise, if only implemented within the EU, it would still leave open issues of disparate characterization of entities between MS and non-MS. For that reason, this author is more inclined to propose a *reactive coordination rule*, which, unlike a full harmonization, it provides for coordination in the rules characterizing entities. For the proposal, see *infra* Chapter VI.

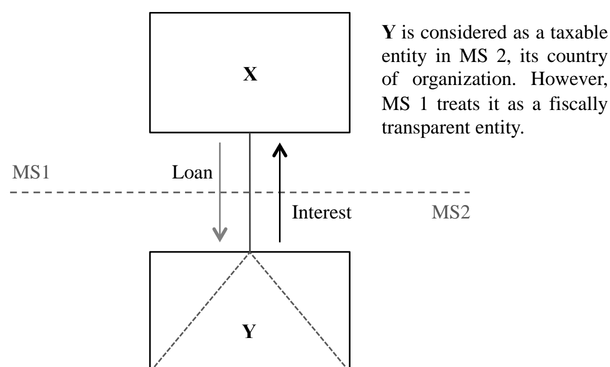

Figure 20: Article 10 EU ATA Directive (original text)

Therefore, any transactionS between X and Y would be disregarded for MS1's purposes, while the same transactions would be recognized in MS2. In other words, the interest payments will be deductible in MS2, while not recognized as income in MS1, giving rise to a D/NI outcome.

The proposed Article 10, however, instead of opting for a rule matching the outcomes, i.e. denying a deduction in the country of the payer to the extent that income is not included as such in the country of the payee, or letting this latter country to defensively react recognizing the transaction between X and Y, follows a different path.[834] It provides that as MS1 and MS2 do not agree in the characterization of the entity Y, established in MS2, and this disagreement results in a D/NI outcome, MS1 should follow the characterization of entity Y in MS2, i.e. the source country of the payment.

[834] For a further analysis on the OECD *linking rules*, infra Chapter V, Section 3.

In other words, MS1 should align its characterization of entity Y with the one provided in MS2, which is not only the country where the entity is established, but also the source of the interest payments. The above does not only avoid the D/NI outcome, which is arguably the true reason of the mismatch, but also directly solve the disparity in the characterization of the entity Y, which is indeed the core of the issue at stake.

The solution proposed by Article 10 EU ATAD does not only differ from the one proposed by the OECD within the BEPS Action Plan 2, but also makes more sense in a regional-coordinated context such as the EU,[835] where similar domestic measures have been adopted, or they operate at least in practice.[836] Likewise, coordinating the characterization at source may, on one hand, avoid implementing more invasive measures, such as obligating a MS to deny a deduction when a correspondent inclusion of income is not made in the other MS, or to force a MS to tax a payment received by an entity, even though this MS decided sovereignly to exempt it. On the other hand, it attends specifically to the core issue regarding hybrid entities: the different characterization of the same entity by two countries, avoiding complexities and consequentialist approaches that might finally affect legitimate transactions.[837]

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[835] The author has already argued in this sense. *See* Navarro, Parada and Schwarz, *supra* n. 455, p. 129.
[836] For example, Spain. *Supra* Section 5.1.
[837] I*nfra* Chapter V, Section 5.

Regardless the above, one could still argue that a similar regional-coordination could be also achieved following the characterization of the entity given in the residence country.[838] What are thus the reasons to give preference to the characterization of the entity in the country where the payment is sourced rather than the country where the investors are residents? Both tax policy and practical reason might justify the preference for the source country.[839] On one hand, as the country producing the hybrid entity mismatch is precisely the country of the investors, there are strong tax policy reasons to argue that a coordination in the characterization of entities should be settled following the characterization of the entity as per the rules of the country where this is established, and not in the other way around. In other words, the country that is primarily called to react in case of a mismatch is the country producing such mismatch, i.e. the country of residence of the investors.[840] On the other hand, there are also practical

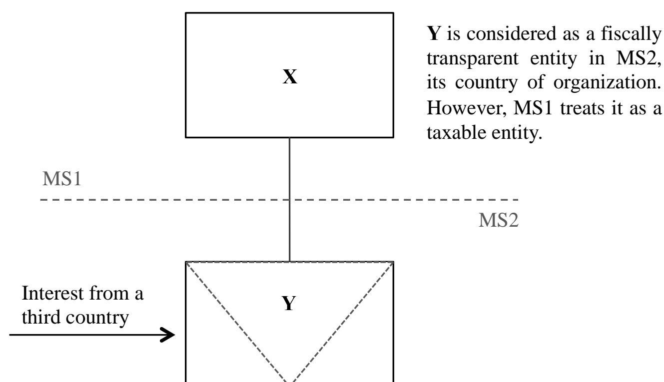
[838] This is indeed the solution proposed within the 1999 OECD Partnership Report with respect to transparent entities and the access to tax treaty benefits. *Infra* Chapter IV, Section 3.1.

[839] The Proposal for EU ATAD refers to "source country". However, as it will be explained later on in this work, this author is more inclined for using the term "home country" (i.e. where the entity is established or incorporated) in order to create a coordinated solution in the characterization of entities. This is because the use of the concept "source country" might not always coincide with the "home country" of the entity, e.g. in case of payments made to a hybrid entity in a triangular situation). Moreover, this author believes that the pretended wording of Article 10 of the Proposal for EU ATAD when it says "source country" is indeed "home country". The reason of using finally "source country" has to be with the fact that the Proposal for EU ATAD is only covering payments made by a hybrid entity and which derive in a D/NI outcome. Therefore, in such cases, the source and home country will always coincide. For the proposal or reactive coordination rule, which explains the use of "home country" rather than "source country", *infra* Chapter VI, Section 2.1.

[840] J. Lüdicke, *"Tax Arbitrage" with Hybrid Entities: Challenges and Responses*, 68 Bull. Intl. Taxn. 6/7 (2014), Journals IBFD, p. 317.

reasons, e.g. following the characterization at source might be an easier way to deal with reverse hybrid entity mismatches in cases where the reverse hybrid entity receives payments. Indeed, up to now a reverse hybrid entity mismatches of this type is mostly counteracted either denying a deduction in the country where the payment is made o relying on the use of CFC rules in the country of the investors.[841] Nevertheless, this situation could be simply solved making the country of the investors to follow the classification of the entity in its country of establishment. This is to say, considering also the entity as tax transparent. Let me illustrate the above as follows: X, a corporation incorporated in MS1 has a subsidiary, Y, in MS2. This latter considers the entity as transparent, while the former as a taxable entity. Y receives interest income from a third country. If Y, therefore, receives interest from a third country, MS2 will not tax that item of income, because it considers that Y is a non-taxable entity. MS1, on the other hand, considers that the entity exists, and thus will not consider that the income flows through Y, being finally allocated in X.

[841] However, the OECD also proposes limiting the tax transparency in the country where the reverse hybrid entity in organized. *See* OECD (2015), *supra* n. 6, p. 64, Recommendation 5.2.



For MS2 tax purposes, the interest should flow through and be allocated to X. They are thus not taxed at the level of Y. On the contrary, MS1 considers that the interest are allocated in Y and no income arises until dividends are distributed.

Figure 21: Article 10 EU ATA Directive (original text) and reverse hybrids

In absence of Article 10 of the EU ATAD this reverse hybrid case would be left exclusively to the capacity of MS1 to use its CFC rules in order to recognize the interest income in MS1.[842] Nevertheless, if Article 10 were applied, MS1 should also consider Y as a transparent entity, and thus it would tax the interest in the hand of X, without having to rely exclusively on its CFC legislation. Thus, in principle, the solution proposed by the EU ATAD seems to drive us to a simpler manner to deal with these cases, solving also the problem in its core, i.e. eliminating the disparate tax treatment of the entity.

[842] *See*, however, *supra* n. 841.

In spite of the above, the application of the proposed Article 10 had also important limitations, mostly derived from its restricted regional scope.[843] Indeed, the rule was created to apply only to hybrid and reverse hybrid entity mismatches within the EU. In other words, assuming any of the examples mentioned above, with the only difference that the residence country's entity (MS1) is the United States, the results would evidently change to the extent that Y in both examples is an eligible entity for purposes of the CTB election.[844] The above could raise serious issues regarding competition between EU and U.S. investors willing to invest within Europe, resulting in the latters to have a competitive advantage in comparison with the formers.[845] This issue is, however, (partially) solved with the extension of the rule to cases involving hybrid entity mismatches outside the EU according to the amendments in the EU ATAD II. [846]

843 Navarro, Parada and Schwarz, *supra* n. 455, p. 130.

844 *Supra* Section 4.3.

845 The author has also proposed somewhere else that, considering the unlikeliness that the United States decides to amend its characterization system when applied to EU entities, this issue should simply assumed as a stranded cost in the implementation of the proposal. *See* Navarro, Parada and Schwarz, *supra* n. 455, p. 130.

846 However, there are still doubts with respect to certain transactions included within the scope of the EU ATAD II. For example, payments made to a reverse hybrid entity in case the reverse hybrid entity is not organized within the EU. The wording of Article 9a suggests that those cases would not be within the scope of the Directive. However, some authors disagree on this statement. *See*, e.g. Fibbe and Stevens, *supra* n. 833, p. 165. *See also* a further analysis of the EU ATAD II in *infra* Section 5.3.3. The other limitation, in the author's view, is the link to specific outcomes (DD and D/NI). This issue will, however, analyzed in *infra* Chapter V.

5.3.2. The EU ATAD I (final text): When political pressure comes first

Despite the potential positive outcome that the original text of the EU ATAD proposal could have achieved, i.e. an unprecedented regional-coordination in the characterization of foreign entities for tax purposes within the European internal market, the final text included within the Directive substantially deviates from its original draft. As provided in the final Article 9 (Hybrid Mismatches) of the EU ATAD I, with respect to D/NI outcomes: "2. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment".[847]

Interestingly, the core issue regarding hybrid and reverse hybrid entities, i.e. the characterization of entities, is relegated to the backyard in the final text of the EU ATAD I, giving again priority to the artificial matching of tax outcomes.[848] This result can only be explained due to political reasons. Since the modification of the PSD in 2014,[849] which included a rule by which a parent company is refrained from taxing profits distributed by qualifying subsidiaries of another Member State only to the extent that the distributions

847 Article 9 of the Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I).

848 The arguments on why the author sustains that matching outcomes, i.e. DD and D/NI, is an artificial construction will be further analyzed in connection with the concept of hybrid mismatch arrangement in *infra* Chapter V. However, this analysis excludes the cases of DD.

849 EU: Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 219/40 (2014), hereinafter "Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU".

are not tax deductible in the Member State of the subsidiary,[850] there was no equivalent rule at the EU law level denying a deduction if a correspondent inclusion of income did not take place.[851] While the former rule included within the PSD corresponds to the so-called "defensive rule", the latter one included in the EU ATAD I corresponds to what is known as "primary response", both measures designed and proposed within the OECD BEPS Action Plan 2 in order to deal with "hybrid mismatches".[852] In other words, if the text would have been approved in its original wording, we would have two incompatible rules solving the same issue at a EU level. On one hand, the PSD providing for a compulsory taxation when income was deducted in the MS of the payer, i.e. the OECD "defensive rule"; on the other hand, a rule attempting to solve the problem through the coordination in the characterization of entities at source, i.e. a completely different solution to the one proposed by the OECD. As this latter rule is contained in a wider and ex-post Directive, it might have implied a tacit derogation of the former, or which is the same, it could repeal the legal basis created to implement the OECD solutions on hybrids mismatches, unless of course a modification in the PSD came also into play.[853] Therefore, in the author's view, it is evident

850 If the profit distributions are tax deductible in the Member State of the subsidiary, then the parent company's Member State will be obliged to tax them. Id.

851 C. Marchgraber, *Tackling Deduction and Non-Inclusion Schemes–The Proposal of the European Commission*, 54 Eur. Taxn. 4 (2014), Journals IBFD, p. 142. *See also*, Navarro, Parada and Schwarz, *supra* n. 455, p. 128.

852 A further analysis on *linking rules* will be made in *infra* Chapter V.

853 As this author has argued somewhere else with respect to the Proposal for EU ATAD: "[…] a positive immediate result can be concluded: there will be no need to force a sovereign Member State to deny a deduction or to tax an in tem of income to counteract

that the turn over from a rule coordinating the characterization of entities among MS to one denying a deduction when income is not correspondently included in the other MS, or allowing a deduction only in the MS where the payment has its source, represents a surrender to the political pressure at the OECD level in terms of aligning the rules to the proposal launched by the OECD, missing perhaps the chance of providing a rule more in line with the idea of a European internal market, and more directly targeting the core of the issue with respect to hybrid entity mismatches.[854]

5.3.3. The EU ATAD II: Confirming (but no exclusively) the OECD standards

As stressed already, on 29 May 2017, it was published the final text of the ATAD II.[855] This EU Directive attempts to extend the scope of application

a hybrid mismatch. The above however will require a modification in the current Parent-Subsidiary Directive". Navarro, Parada and Schwarz, supra n. 455, p. 129.

854 As Fibbe and Stevens also argue as regards to the EU ATAD I and II: "[…] the approach chosen by the Council does seem to close many of the existing loopholes were hybrid mismatches are used. Main remaining question is whether all twenty-seven Member States will be able to consistently implement the complex anti-mismatch rules. *The authors see it as a missed chance that in the ATAD it has not been decided to address the very cause of hybrid mismatches*" (emphasis added). Fibbe and Stevens, *supra* n. 833, p. 153.

855 The first proposal came up, however, on 25 October 2016, which subsequently derived in a second draft published on 2 December 2016. *See* EU: Proposal for a Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, COM (2016) 687 final, 25 Oct. 2016, hereinafter "Proposal ATAD II (25 Oct. 2017)". Later on, a text was made public on 17 February 2017, which was accepted by the European Council during the ECOFIN meeting of 21 February 2017. *See* EU: Proposal for a Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, 6333/17 FISC 46 ECOFIN 95, 17 Feb. 2017, Article 9(2), hereinafter, "Proposal ATAD II (17 Feb. 2017)". The final text approved and released on 29 May 2017 has, nevertheless, no variations in comparison with the latest

of the proposed rules to mismatches with third countries, confirming, on one hand, the OECD recommendations established in Action 2 of the BEPS Action Plan through a modification of Article 9 EU ATAD I, and, on the other hand, introducing also a very interesting rule to deal with payments made to reverse hybrid entities, which is perhaps more in line with the original intention of the EU ATAD.[856]

5.3.3.1. Article 9(2) EU ATAD II: The OECD Approach

With respect to Article 9 EU ATAD, referred to D/NI outcome, it reads now as follows: "To the extent that a hybrid mismatch results in a deduction without inclusion:(a) the deduction shall be denied in the Member State that is the payer jurisdiction; and (b) where the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome shall be included in income in the Member State that is the payee jurisdiction". [857] The wording is not a surprise, because it simply

one of February 2017. EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II).

856 The ATAD II also includes measures related to dual inclusion of income and hybrid transfers, which will not be treated in this work. The rules related to imported mismatches will be mentioned further on in this work, *infra* Chapter V, Section 2.4.3.

857 Article 9(2) of the Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II). A mirror Article can be found in the launched proposal of 17 Feb. 2017. See EU: Proposal ATAD II (17 Feb. 2017). The wording of the Article was slightly different in the draft of 25 October 2016. However, the idea remained the same: the inclusion of a *primary response* and a *defensive rule* to counteract hybrid mismatches. As provided in Article 9(2) of this draft: "To the extent that a hybrid mismatch involving a third country results in a deduction without inclusion: (i) if the payment has its source in a Member State, that Member State shall deny the deduction, or (ii) if the payment has its source in a third country, the Member State concerned shall require the taxpayer to include such payment in the taxable base, unless the third country has already denied the deduction or

aligns, or attempts to align, the EU proposal on hybrid mismatches with the OECD proposal.[858] This intention is indeed interpreted from the wording used in the preamble of the Directive, which provides: "In response to the need for fairer taxation and, in particular, to follow up on the OECD BEPS conclusions, the Commission presented its Anti-Tax Avoidance Package […]".[859] Likewise, it states: "Directive (EU) 2016/1164 includes rules on hybrid mismatches between Member States and should thus also include rules on hybrid mismatches with third countries […]".[860] The aligning intention can also be seen in the modification of certain specific requirements related to the scope of the proposed rules in order to make them closer to the OECD proposal.[861] For example, the EU ATAD I contained a more restricted definition of "associated enterprises" [862], when

has required that payment to be included". *See* Article 9(2) of the Proposal ATAD II (25 Oct. 2017). MS have until 31 DEC. 2019 to publish the adopt the measure into domestic laws, which should also come into force from 1 Jan. 2020, with the exception of new Article 9a ("tax residency mismatches"), whose text can be communicated to the Commission until 31 Dec. 2021 and comes into force from 1 Jan. 2022. *See* Article 2 of the Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II). *See also,* EU: European Commission Press release, *Fair Taxation: Commission welcomes new rules to prevent tax avoidance through non-EU countries*, 21 Feb. 2017.

858 Also in this opinion: Fibbe and Stevens, *supra* n. 833, p. 156.

859 EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II), rec. 3.

860 Id., rec. 8.

861 The OECD BEPS Action Plan 2 limits the application of the proposed *linking rules* to *"control groups"* (and structured arrangements). *Infra* Chapter V, Section 3.3.1 and 3.3.2. The EU ATAD refers instead to *"associated enterprises"*, although in practice both concepts, after the modifications introduced by the EU ATAD II, include the same assumptions.

862 Article 2(4) of the Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I) provides that: " 'associated enterprises' means: (a) an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25 percent or more or is entitled to receive 25 percent or more of the profits of that entity; (b) an individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership of 25 percent or more or is entitled to receive 25

compared to the definition included within the EU ATAD II.[863] Indeed, this latter measure includes within the concept of "associated enterprises" also the cases of persons being part of the same consolidated group; a person "acting together" with another person with respect to the voting rights or capital ownership of an entity, or an enterprise in which the taxpayer has a significant influence in the management, or the other way around, when an enterprise has a significant influence in the management of the taxpayer, which are concepts expressly included within the OECD BEPS Action 2. [864] Once again, however, it would have been more interesting to see an approach more in line with the idea of a European internal market, although still in line with the OECD BEPS Action 2, but addressing directly the core of the hybrid entity mismatches. The European Union is indeed the best scenario to achieve this aim.[865]

percent or more of the profits of the taxpayer […] For the purposes of Article 9 [hybrid mismatches] and where the mismatch involves a hybrid entity, this definition is modified so that the 25 percent requirement is replaced by a 50 percent requirement".

863 EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II), rec. 13 and 14.

864 To compare, *see* the concepts of *"control group"* and *"acting together"* under the OECD BEPS Action Plan 2 in *infra* Chapter V, Section 3.3.1.

865 Fibbe and Stevens share this critic and refer to a more "principled based EU approach" in terms of "introducing either a consistent system of anti-abuse rules whereby always the same country (source country or investor country; from an EU policy perspective the source country seems preferable) should make the adjustments or by implementing a uniform classification method [of entities] between Member States". Fibbe and Stevens, supra n. 833, p. 156, footnote 22.

5.3.3.2. Article 9a EU ATAD II: The characterization of entities is back on the scene

Regardless, the tendency to align the EU proposals on hybrid entity mismatches with the one proposed by the OECD, it is interesting to highlight a small deviation of this tendency which can be found in Article 9a EU ATAD II dealing with payment received by reverse hybrid entities established in a MS.

Article 9a EU ATAD II reads as follows: "Where one or more associated non-resident entities holding in aggregate a direct or indirect interest in 50% or more of the voting rights, capital interests or rights to a share of profit in a hybrid entity that is incorporated or established in a Member State, are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person, the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that this income is not otherwise taxed under the laws of the Member State or any other jurisdiction". [866] As per the wording of the Article, it is possible to affirm that it attempts (to certain extent) to coordinate the characterization of entities as a solution to the reverse hybrid mismatch, rather than constructing a rule focused exclusively on the tax outcomes in a transaction.[867] The above can be seen in the wording of the Article, when it says: "[…] the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that this income is not otherwise

866 Article 9a(1) of the Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II).
867 In this opinion, *see also* Fibbe and Stevens, *supra* n. 833, p. 164.

taxed under the laws of the Member State or any other jurisdiction". [868] Thus, in other words, the Article is providing for a re-characterization of the entity at the level of the MS where this is organized, which at least gets closer to the true issue regarding reverse hybrid entities: the disparate characterization for tax purposes.[869]

The rule on Article 9a EU ATAD II seems also to apply with priority over the rule contained in Article 9(2) (*linking rules*). The above seems to be confirmed in the recital 29 of the preamble of the Directive, which says: "The hybrid mismatch rules in Article 9(1) and (2) only apply to the extent that the situation involving a taxpayer gives rise to a mismatch outcome. No mismatch outcome should arise when an arrangement is subject to adjustments under Article 9(5) or 9a and, accordingly, arrangements that are subject to adjustment under those parts of this Directive should not be subject to any further adjustment under the hybrid mismatch rules".[870] In simple words, to the extent that Article 9a has solved the reverse hybrid entity mismatch, there is no need to apply the rules of Article 9(2) EU ATAD II. The above seems also to be the rule when CFC rules, contained

[868] Id. Despite the confusion that the reference to a "*hybrid entity"*, it is clear that the article refers to the case of a *"reverse hybrid"*, i.e. an entity considered as tax transparent in its country of organization, while as non-tax transparent in the country of the investors.

[869] The reverse entity mismatch rule resemblances what we have already study with respect to the Danish anti-reverse hybrid provisions. Briefly recalling, the Danish rule provides that certain entities normally treated as fiscally transparent in Denmark must be re-characterized as taxable entities if the direct owners/partners holding more than 50% of the capital or voting rights are tax residents in one or more foreign jurisdictions, and these jurisdictions considers the Danish entity to be a separate taxable entity. *Supra* Section 5.2.2.

[870] EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II), rec. 29.

within the EU ATAD I, might solve the reverse hybrid entity mismatch first. According to the recital 30 EU ATAD II: " Where the provisions of another directive, such as those in Council Directive 2011/96/EU [EU ATAD I], lead to the neutralization of the mismatch in tax outcomes, there should be no scope for the application of the hybrid mismatch rules provided for in this Directive".[871] A similar priority to CFC rules is confirmed under the OECD BEPS Action Plan 2.[872]

The rule in Article 9a EU ATAD II is, however, still ineffective to target payments made to a reverse hybrid entity in all those cases when the reverse hybrid is incorporated in a third country, outside the EU. Let us assume the following hypothetical: MS1 is a corporation incorporated in a MS, which has a subsidiary in a third country, outside the EU. This latter (Sub) has subsequently a subsidiary in a MS (MS2). Sub and MS2 engaged in a loan agreement through which MS2 pays interest payments to Sub. Sub is tax transparent entity in its country of establishment, although both MS consider it as an opaque entity.

[871] EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II), rec. 30.

[872] OECD (2015), *supra* n. 6, p. 64. See also, *infra* Chapter V, Section 4.2 referred to the interaction between CFC rules and *linking rules.* In addition, it is interesting to remark that the rule in Article 9a EU ATAD II seems to be, in principle, in contradiction to Article 62 of the CCTB proposal, which provides that where an entity is treated as transparent in a MS where it is established, a taxpayer holding an interest in the entity shall include in his tax base his share in the income of the entity. *See* EU: Proposal for a Council Directive (EU) 2016/0337 of 25 Oct. 2016 on a Common Corporate Tax Base, COM (2016) 685 final, Article 62(1) on allocation of the income of transparent entities to taxpayers holding an interest. *See also,* Fibbe and Stevens, *supra* n. 833, p. 164.

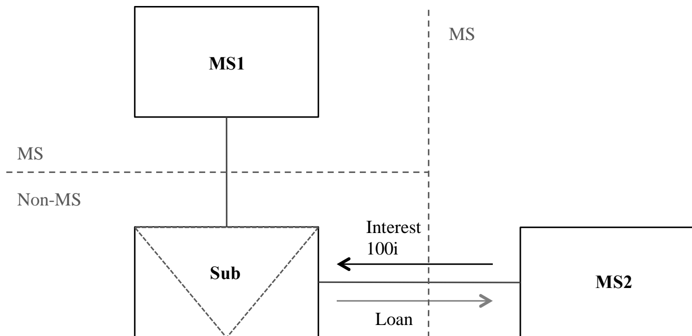


Figure 22: Article 9a EU ATAD II

In such case, Article 9a EU ATAD II is inapplicable. However, Article 9(2) may still apply, obligating MS2 to deny the deduction of the interest payments in that MS. Nevertheless, if MS2 is also located in a non-EU MS, both Article 9(2) and 9a EU ATAD II are inapplicable, i.e. those mismatches would be out of the scope of the EU ATAD I and II rules.

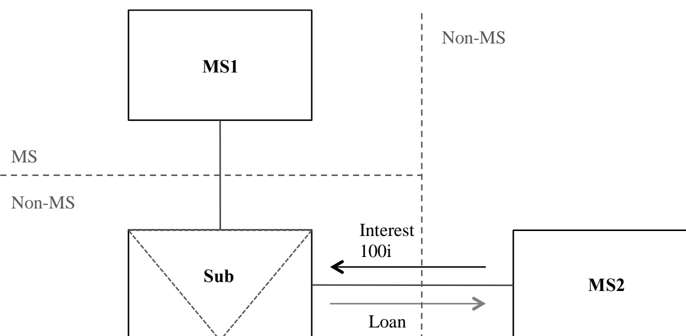


Figure 23: Article 9a EU ATAD II

In this scenario, therefore, the only option to solve the reverse hybrid entity mismatch would be to attend to the possibility that the third countries, i.e.

where Sub and MS2 are organized, introduced the OECD recommendations (i.e. either *linking rules* or that the non-MS country where the reverse hybrid is organized denies the tax transparency), or that the CFC in MS1 are effective enough to accomplish such an aim.

Yet, this author still argues that these types of rules, i.e. rules attempting to coordinate the characterization of the entities, makes more sense than those constructed based exclusively on the matching of tax outcomes. On one hand, and as repeatedly stressed in this work, they focus on the core of the issue regarding hybrid and reverse hybrid entities: the different characterization of the entity. On the other hand, they are simple to administer both for taxpayers and tax administrations. After all, matching the characterization of the entities is easier than determining whether a deduction was or not taken in the other State or whether income was or not included. Nonetheless, this author considers that some questions remain still unsolved. Firstly, there is still not enough justification to provide rules matching the characterization of the entity as per the one provided in the residence country of the majority controlling partner, rather than the characterization given in the MS where the entity is organized.[873] Of course the immediate consequence of this rule is that the revenues are maintained within the EU, which could be enough justification for many.[874] However, re-characterizing an entity in the MS where the entity is organized may also

[873] *Supra Figure **19**: Danish anti-reverse hybrid rule*.

[874] Revenues will be maintained within the EU, because the entity will be treated as a taxable entity, being thus subject to corporate income tax in the MS where it is organized (EU MS).

create uncertainty for those taxpayers who originally decided to carry on business using these types of organizations rather than tax opaque ones.[875] Secondly, there are still some doubts regarding the effect that the re-characterization might have for those minority shareholders or partners who reside in countries where the entity is considered fiscally transparent. Will the re-characterization proposed also affect those shareholders? The intuitive answer should be no. However, the experience of other countries, like Denmark, which offer similar solutions as the one proposed in the EU ATAD II, demonstrates that they will finally affect those shareholders who originally did not have any mismatch.[876] Thirdly, one should also consider the potential double taxation if the entity in the MS is re-characterized as taxable entity. In such a case the income received by the entity will be subject to tax in the MS where the entity is organized and might also be subject to taxation in the country of the majority of owners/partners treating the entity as a taxable entity, because of the application of CFC rules. The priority operation of CFC rules granted in the EU ATAD II seems, however, to be dealing correctly with this issue, because it switches off the application

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875 As noted already, in some cases the decision to opt for a traditional transparent entity, such a Partnership, rather than a Corporation attend to the simple fact of avoiding economic double taxation. This pattern is evident, e.g. in the case of the United States, where the use of partnerships was basically because of the avoidance of double taxation. *See* the explanation of McDaniel, McMahon and Simmons at *supra* n. 628.

876 Møllin Ottosen and Nørremark, *supra* n. 793, p. 514.

of Article 9a EU ATAD II in case the mismatch was already solved through the CFC legislation in MS1.[877]

All in all, this author is still of the idea that a *reactive coordination rule*, which respects the characterization of the entity given in the country of establishment (i.e. home country) might still bring better results. This idea will be elaborated in details further on in this work.[878]

6. Final Remarks

When answering the questions why hybrid entities (and reverse hybrids) exist and why we should be concerned about them, this Chapter has left us important conclusions. On one hand, hybrid entities and reverse hybrids are the result of domestic and sovereign tax policy decisions that determine the tax treatment that a foreign entity will have for domestic tax purposes. This result should not be surprising at all considering that tax systems around the world are neither uniform nor consistent in their tax policies and they normally differ with each other in many aspects. On the other hand, and derived from the above, one should note that there is no entities' characterization rules that fit all the requirements to be completely inviolable. Indeed, and contrary to the doctrine that tends to blame elective systems as a major source of hybrid and reverse hybrids, this Chapter has demonstrated that this result is not less likely to occur with other

[877] This outcome could be avoided granting an indirect FTC, although in this is not something that can be guaranteed in all cases.

[878] *Infra* Chapter VI.

characterization rules, e.g. resemblance tests. Indeed, resemblance or comparative tests normally fail in creating consistent characterizations of foreign entities due, most of the time, to the incompatible characteristics between foreign and domestic entities. Likewise, these tests tend to be generally not less elective than a formally elective system that relies completely in a taxpayer's election. A good example of the above is the *Kintner* test in the United States, which was in force before the issuance of the CTB regulations. Under this system, a sophisticated taxpayer could, after a proper legal advice, set up the structures that most accurately fit his pretentions, predicting thus in advance the desired tax treatment of those entities. The above, however, does not mean to recognize the influence of the CTB system to circumvent Subpart F Income and to inappropriately claim a FTC. However, and as demonstrated already, some of these circumventions did not attend exclusively to the CTB election, but rather to the poor design of domestic anti-deferral and FTC rules. The above therefore reinforces the idea that determining whether a characterization system is more or less elective is certainly not the true path to solve the issues on hybrids and reverse hybrid entities. In other words, the analysis of the existing systems to characterize foreign entities for tax purposes cannot be made in isolation, disregarding e.g. the design of other rules within the tax system, e.g. anti-deferral rules, and how they interact with the characterization rules within the global economy.

In the same order of ideas, this Chapter has attempted to demonstrate how the coordination in the characterization of foreign entities, i.e. the real issue regarding hybrids and reverse hybrid entities, is far from being just a utopian academic idea and could become indeed relevant to properly deal with the issue of hybrids and reverse hybrid entities. This tendency can indeed be seen already materialized in different countries and to different extents of development, including supranational law. For example, in Spain, unlike being a casual practice rather than an intended law rule, it results in an effective coordination in the characterization of entities, nullifying the appearance of hybrid entities and reverse hybrid entities in all those cases in which Spain is the country characterizing a foreign entity located in a country from where Spanish residents receives income. This idea was also recently included within the Proposal for an EU ATAD (2016), which provided that in all those cases in which different characterization of entities by two MS existed, and it derived in certain outcomes, the resident MS should follow the characterization of the source MS in order to solve the dichotomy. Unfortunately, this rule was not longer included in the final text of the EU ATAD I (2016), which opted for following the recommendations made by the OECD on this matter, i.e. a domestic implementation of a *primary response* and a *defensive rule*. In spite of the above, the recent EU ATAD II (2017) included a rule dealing with reverse hybrid entities and third countries, which provides for a re-characterization of a fiscally transparent entity when the entity is regarded by the majority of the shareholders, residents in a third country, as a taxable entity. This rule resemblances the approach already adopted by Denmark with respect to

hybrid and reverse hybrid entities, which attempts to coordinate the characterization of entities through a re-characterization of its own domestic entities, producing interesting results. This approach, however, has still the disadvantage of relying excessively in foreign law, increasing also the levels of uncertainty for taxpayers. Yet, it is the author's opinion that rules aimed to match the characterization of entities are indeed more effective manner to deal with hybrids and reverse hybrids entities, than attempting to create an artificial match of tax outcomes, as proposed by the OECD and the BEPS Action Plan 2. After all, hybrids and reverse hybrid entities exist exclusively because of the different characterization of the same entity by two jurisdictions. This idea will be reinforced further on in this work.[879]

[879] *Infra* Chapter VI.

IV. CHAPTER

Hybrid Entities and the Entitlement to Tax Treaty Benefits

1. Introduction

Tax treaties have the purpose of allocating taxing rights between the source and residence jurisdiction in order to avoid double taxation.[880] This division of taxing rights implies that either of these countries will give up part of their sovereignty to tax an item of income when two persons, considered residents for purposes of the treaty, are subject to taxation in both countries on the same income.[881]

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[880] On the other hand, as stressed in Chapter II, the aim of avoiding DNT as a general tax policy goal of tax treaties is rather arguable. This conclusion remains valid even after the implementation of the new OECD interpretation of Articles 23A and 23B OECD Model within the OECD Commentaries and the inclusion of a new Article 23A(4) OECD Model, because none of these articles are effective enough to solve all the situations of DNT derived from either conflicts of qualification or interpretation. *Supra* Chapter II, Section 3.4. The above can also be concluded after the recent proposal to modify the title and preamble of the OECD Model in order to include a reference to the avoidance of DNT and the inclusion of a *STR rule* under Action 6 of the BEPS project. *Supra* Chapter II, Section 5.3 and 6. On the one hand, the unhappy wording of the modified OECD Model preamble could only suggest that the prevention of DNT is exclusively relegated to the cases where this outcome is the result of tax evasion or tax avoidance. *Supra* Chapter II, Section 5.1 and 5.2. Likewise, the *STR rule* does not suggest any obligation to the source State to exercise its taxing rights as demonstrated in the use of the word “may be” instead of “is” or “must be”. *Supra* Chapter II, Section 5.3. In spite of the above, nothing prevents that some specific tax treaties might include provisions aiming to prevent DNT, e.g. *subject-to-tax* or *switch-over clauses*. *Supra* Chapter II, 4.2.1 and 4.2.2.

[881] However, as already stressed in Chapter II, the relief of double taxation is also limited to the cases of juridical double taxation. Economic double taxation, on the other hand, i.e. when a same element of income or the same economic transaction is subject to the same type of tax in the hands of two or more different taxpayers, is not included in the treaty relief. *See* references to this discussion in *supra* Chapter II, *supra* n. 196.

Although the determination of persons and residents for tax treaty purposes is rather clear in the case of individuals, it can be quite problematic when referring to entities, mostly when those entities are treated differently for tax purposes by the Contracting States. Accordingly, this disparity in the characterization of entities may give rise to conflicts *of allocation of income, i.e.* where the same income is attributed to different taxpayers in the source and residence States within the tax treaty context.[882]

[882] The disparities in the characterization of entities might also give rise to what is known in doctrine as *"conflicts of qualification"*. Nevertheless, as these conflicts depend on the nature of an item of income, rather than exclusively on the discrepancies as regards to the characterization of an entity either as fiscally transparent or tax opaque, they will not be included in the analysis of this work. In this opinion *also*, e.g. Fibbe, s*upra* n. 833, p. 216 and p. 219. However, a good example illustrating a conflict of qualification derived from the different characterization of entities can be found in the OECD Commentary on Article 23A OECD Model. The example consists of a partnership organized in State A, which has a PE in State E. Accordingly, its owner, who is a resident of State R alienates its interest in the partnership. While State E considers the partnership as tax transparent, State R, the State of the partner, considers it as a taxable entity. Derived from the different characterization of the partnership thus State R and State E apply a different provision of the treaty. In other words, they apply a disparate characterization of the *income* influenced by the different tax treatment of the entity. State R, on one hand, considers that the alienation of the interest corresponds to the alienation of the shares in a company, and thus, it is regulated under Article 13(5) OECD Model (which exempts the owner from taxation). State E, on the other hand, considers the owner to be alienating the underlying assets of the business in State E (PE), and thus, it might tax the income according to Article 13(1) or (2) OECD Model. The solution provided by the OECD in this case, and which derives from the 1999 OECD Partnership Report is that the State of residence (State R) should apply either the exemption or credit method to relief double taxation, following thus the characterization of the income in the State of source. This line of reasoning is founded in the wording of Article 23A and 23B OECD Model, which require the State of residence to check whether the income may be taxed in the State of source "in accordance with the provisions of the Convention". R. Danon, *Qualification of Taxable Entities and Treaty Protection*, 68 Bull. Intl. Taxn. 4/5 (2014), IBFD Journals, p. 200. A further discussion on the interpretation of the phrase *"in accordance with the provisions of this Convention, may be taxed",* referred to conflicts of qualification and DNT can be found at *supra* Chapter II, Section 3.3.

The concern regarding conflicts of allocation of income was originally assumed in the 1999 when the OECD issued a report referred specifically to the case of partnerships. In this report, the OECD suggested that a residence-source conflict of allocation of income (or attribution conflict) might be solved if the State of source relies on the attribution principles of the State of residence. This idea was later on recognized as positive law in Article 1(6) US Model, which also included cases of tax transparent entities that were not necessarily partnerships, and it is today part of the OECD recommendation on treaty issues in the Action 2 of OECD BEPS project, which proposes a new Article 1(2) OECD Model, whose text mirrors the US Model provision, and which is also replicated within Article 3(1) of the MLI.[883] This Chapter analyzes these provisions and raises some concerns with respect to their application.

Section 2 briefly refers to the general rules regarding the entitlement to tax treaties benefits with respect to entities. Section 3 analyses the principles established within the OECD Partnership Report as regards to conflicts of allocation of income. For this purpose, it analyzes the general principles settled within the report, its exceptions and the formal and substantial critics raised with respect to the position adopted. Section 4 analyzes Article 1(6) US Model, which is the first positive recognition of the principle settled within the OECD Partnership Report, and the immediate precedent of

[883] The proposal of including Article 1(2) OECD Model is already ratified in the text of the recently releseased draft contents of the 2017 update to the OECD Model. *See* OECD (2017) and OECD (2017a), *supra* n. 462.

Article 1(2) OECD Model. This Section firstly provides a general interpretation of the wording of this provision. Secondly, it illustrates the application of Article 1(6) US Model through seven examples, which are divided in two groups: (i) strict bilateral cases and (ii) triangular cases. Finally, this Section provides some examples where the interplay between Article 1(6) US Model and other tax treaty and domestic provisions is either not entirely clear or they simply conflict with each other. The above includes the interplay with the concept of *beneficial owner* in Article 10, 11 and 12 US Model; the *saving clause* of Article 1(4) US Model; the U.S. CTB regulations and I.R.C. Sec. 894(c). Section 5 follows a similar path. It firstly provides a general interpretation of the wording of Article 1(2) OECD Model. Later on, it analyzes seven illustrations explaining the application of Article 1(2) OECD Model, which are also divided in two groups: (i) strict bilateral cases and (ii) triangular cases. Finally, it addresses some specific issues referred to its application, which includes the interplay with the concept of *beneficial owner*, the *saving clause* and double taxation relief, and the negative impact that Article 1(2) OECD Model has with respect to developing countries. Section 6, briefly addresses Article 3(1) MLI concluding that the analysis as regards to the interpretation and application of Article 1(2) OECD Model can also be extended to this mirror provision introduced within the MLI. Accordingly, this Section analyzes Article 11 and Article 3(3) MLI, as two *saving clause*'s options expressly included within the text of the Convention as well as Article 3(2) and Article 5–Option C as regards to the interplay between the *saving clause* and the

obligations to relief double taxation within tax treaties. Section 7 provides some final remarks.

2. The General Application of Tax Treaties to Entities

As a general rule, a double tax treaty applies only to persons who are residents of one or both of the Contracting States. Therefore, in order to determine the application of a tax treaty to any entity, i.e. corporate or non-corporate entity, one should primarily consider two basic questions: (i) is the entity a person as per the definition of the OECD Model?, and subsequently, (ii) is this person a resident of a Contracting State as defined in the OECD Model?[884]

As regards to the first question, Article 3(1) a) OECD Model defines a *person*, for purposes of the Convention, as any "individual, company and any other body of persons".[885] In principle, the reference to "any body of persons" generated some questions as to whether partnerships and other non-corporate entities were considered persons for tax treaty purposes. This conflict, however, was solved in the 1999 OECD Partnership Report, which stated: "While the practices of Member countries are not entirely uniform in this respect, the Committee has determined that partnerships should be considered to be "persons" within the meaning of the definition found in

884 P. Baker, *The Application of the Convention to Partnerships, Trusts and Other, Non-Corporate Entities*, 2 GITC Rev. 1 (2002), pp. 1-2.

885 Article 3(1) OECD Model Tax Convention.

Article 3".[886] Subsequently, the last sentence of paragraph 2 on the Commentary on Article 3 was replaced by the following: "Partnerships will also be considered to be 'persons' either because they fall within the definition of 'company' or, where this is not the case, because they constitute other bodies of persons".[887] At present thus there is no doubt that partnerships are regarded persons for tax treaty purposes.

Article 4(1) OECD Model, on the other hand, states that a *resident* for purposes of the treaty is "any person who, under the law of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature […]".[888] As discussed already in Chapter II,[889] the view of the term "*liable to tax"* is that of a person who, by reason of various criteria, e.g. residence; domicile, etc., is subject to *"comprehensive taxation"*.[890] The OECD Commentaries do not define *"comprehensive taxation"* in a systematic manner. However, it is widely recognized and accepted in doctrine and in the tax treaty practice that a person is considered liable to comprehensive taxation even if a State does not impose effectively a tax.[891] For example, an entity enjoying a complete

886 OECD (1999), *supra* n. 1, para. 30.
887 OECD Commentary on Article 3 concerning general definitions, para. 2.
888 Article 4(1) OECD Model.
889 S*upra* Chapter II, Section 3.1.
890 OECD Commentary on Article 4 concerning the definition of resident, para. 8 and 8.6.
891 OECD Commentary on Article 4 concerning the definition of resident, para. 8.6. This is also the main reason why to put the terms "liable to tax" and "subject to tax" in equal footing is incorrect. While the former supposes full tax liability, which is provided even in the absence of an effective taxation, the latter necessarily assumes the effective payment of taxes. The requirement provided by Article 4(1) OECD Model certainly does not request effective taxation. See the full discussion at *supra* Chapter II, Section

exemption from tax is still regarded as resident for purposes of the tax treaty to the extent that the State of residence asserts jurisdiction to tax the entity on its worldwide income in accordance with one of the internationally accepted bases to full liability, i.e. place of incorporation or place of management of the entity.[892] *Prima facie*, therefore, both corporate and non-corporate entities would be regarded as residents for purposes of the treaty to the extent they are fully liable to tax. Nevertheless, the issue is precisely that most of the non-corporate entities, e.g. partnerships and disregarded entities with a sole owner, are granted full tax transparency, which is indeed inconsistent with the assertion of full tax liability based on worldwide taxation.[893] This is perhaps the reason why the 1999 OECD Partnership Report concluded that partnerships are not residents for purposed of Article 4(1) OECD Model.[894] In such a case, however, the partners are the ones who

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3.1. *See also* the reference to the case law UK: *Paul Weiser v. Commissioner for Her Majesty's Revenue and Customs* (2012), which finely illustrates the distinction between "liable to tax" and "subject to tax" at *supra* n. 319. Also in position that "liable to tax" does not correspond to "subject to tax", *see* e.g. De Broe, *supra* n. 229. *See also*, Ismer and Riemer, *supra* n. 307, Article 4 at m.no.26. See also the analysis at *supra* Chapter II, Section 3.1 as regards to the interpretation of the term "liable to tax" and DNT.

892 Baker, *supra* n. 884. Similarly, paragraph 8 of the Commentary on Article 4 provides the example of pension funds, charities and other organizations that may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws [i.e. if they are fully liable to tax]. The Commentary recognizes that "most States would view such entities as residents for purposes of the Convention". OECD Commentary on Article 4 concerning the definition of resident, para. 8.6.

893 As well explained by Baker: "[T]he problem with many non-corporate entities is that they are partially or fully transparent for tax purposes in their state of establishment or management. It would be entirely inconsistent for a state to accord full fiscal transparency to an entity and yet assert jurisdiction to tax that entity on its worldwide income". Baker, *supra* n. 884, p. 3.

894 Paragraph 34 of the OECD Partnership Report states: "If the State in which the partnership has been organized treats that partnership as fiscally transparent, then the

should be entitled to the benefits provided by a tax treaty to the extent that they are *liable to tax* on their share of the partnership income in those countries.[895]

Let us assume a basic illustration to explain the above: R is an entity organized in State R, which has two partners, A and B, who are residents of State R. Likewise, entity R receives interest payment from an independent debtor in State P. We will also assume that both State R and State P consider entity P as tax transparent, and that the general WHT on interest paid abroad in State P is 30%.

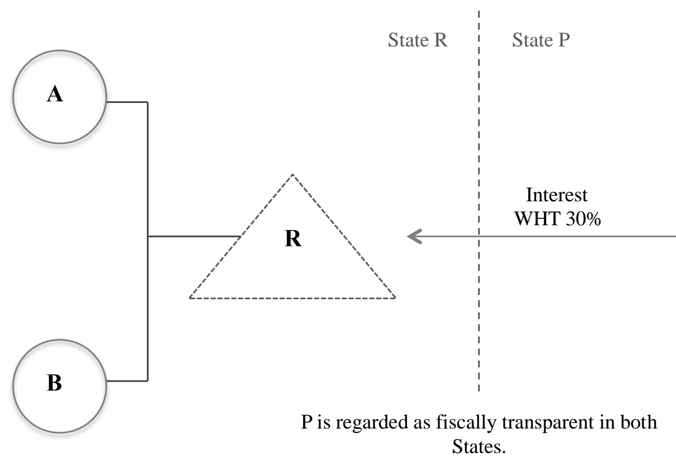

Figure 24: Entitlement to Tax Treaty Benefits/Transparent entities

partnership is not "liable to tax" in that State within the meaning of Article 4, and so cannot be a resident for purposes of the Convention […]". OECD (1999), *supra* n. 1, para. 34, p. 14.

[895] Id., para 47, p. 17. *See also*, OECD Commentary on Article 8 concerning the definition of resident, para. 8.8.

In such a case, and as per Article 11(2) of the treaty R-P, State P should apply a reduced WHT of 10% if the interest payments are paid to the beneficial owners of the other Contracting State, which in this case would most probably be A and B.[896] Likewise, according to Article 11(1) of the treaty R-P, State R should grant a relief from double taxation to partners A and B. In simple words, entity P is neither regarded as receiving the interest payments nor granted thus any benefits of the treaty. The treaty R-P is thus applicable as regards to A and B, who are residents of State R receiving interest from State P.

3. The 1999 OECD Partnership Report

In 1999 the OECD issued the Partnership Report, which provided some important conclusions with respect to the application of the OECD Model to partnerships and to other non-corporate entities.[897] Jointly with recognizing that partnerships can be regarded as persons for purposes of Article 3(1) OECD Model,[898] although not considered as residents for purposes of Article 4(1) OECD Model,[899] it provided important conclusions with respect

[896] State P also considers entity P as tax transparent; therefore, it will recognize that income is allocated to the partners, who should coincide with the beneficial owners.

[897] The Report adopted a case-study approach under different hypotheticals. The individual study of all those hypotheticals certainly exceeds the purpose of this Chapter. Nevertheless, some of them are considered later on in this work for purposes of stressing some fundamental ideas.

[898] OECD (1999), *supra* n. 1, para. 30, p. 12

[899] Id., para 47, p. 17.

to the cases of different characterization of the same entity in the country of residence and the country of source, giving rise to issues with respect to the allocation of income and the entitlement to tax treaty benefits.[900]

3.1. General Principle

As a general rule, the OECD suggests that when applying a tax treaty the State of source should rely on the attribution principles of the State of residence and attribute the income accordingly.[901] In other words, the State of source should take into consideration the way in which income arising in its jurisdiction is treated in the jurisdiction of the resident taxpayer.[902] Thus, if the State of residence follows a non-transparent approach with respect to

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[900] This Section does not deal with qualification conflicts, i.e. where the residence and source State apply different articles of the tax treaty on the basis of differences in their domestic laws. This issue was already analyzed in *supra* Chapter II, Section 3.3, referred specifically to cases of DNT and the new interpretation of Article 24A(1) OECD Model. *See also* on this topic: F. Engelen and P. Pötgens, *Report on "The Application of the OECD Model Tax Convention to Partnerships" and the Interpretation of Tax Treaties*, 40 Eur. Taxn. 7 (2000), Journals IBFD; A Lamers and J. Stevens, *Classification Conflicts: The Cross-Border Tax Treatment of the Profit Share of Limited Partners*, 44 Eur. Taxn. 4 (2004), Journals IBFD.

[901] H. Ault, *Issues Related to the Identification and Characteristics of the Taxpayer*, 56 Bull. Intl. Taxn. 6 (2002), Journals IBFD, p. 264. As provided in the OECD Commentaries on Article 1, modified after the OECD Partnership Report: "[…] 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". OECD Commentary on Article 1 concerning the persons covered by the convention, para. 6.3. This approach, according to Wheeler, was anticipated by Hugh Ault during the IFA Meeting in London on the concept of beneficial owner. J. Wheeler, *The Attribution of Income to a Person for Tax Treaty Purposes*, 59 Bull. Intl. Fisc. Doc. 11 (2005), Journals IBFD, p. 488.

[902] M. Steindl and M. Stiastny, *The Impact of the OECD Partnership Report (1999) on Tax Avoidance in Outbound Cases*, 68 Bull. Int'l. Taxn. 2 (2014), Journals IBFD, p. 112.

the entity through which income is received, the entity will be regarded as liable to tax and thus entitled to the benefits of the treaty.[903] On the contrary, if the resident State considers the entity as tax transparent, income will be allocated to its partners to the extent they are considered also as residents of that State.[904]

The application of the principles stated within the 1999 OECD Partnership Report can be illustrated through Example 4 of the Report, which provides the following hypothetical: P is Partnership established in State P. A and B are P's partners who reside in State P. State P treats P as a transparent entity while States S treats it as a taxable entity. P derives royalty income from State S that is not attributable to a PE in State S.[905]

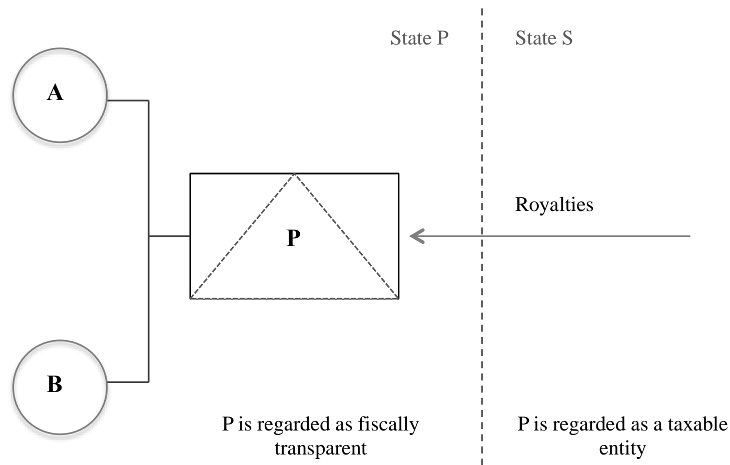


Figure 25: OECD Partnership Report, Example 4.

[903] Id.
[904] Id.
[905] OECD (1999), *supra* n. 1, Ex. 4, p. 23.

In this hypothetical, State S shall follow the characterization of entity P given in the State of residence in order to consider to whom the income is attributed. As A and B are residents of State P, the royalty income is considered to be paid to A and B, who are entitled to the treaty benefits.[906] On the contrary, however, i.e. without applying the principle of the OECD Partnership Report, one should consider that entity P is not a resident for purposes of Article 4(1) OECD Model; therefore, the treaty S-P might not be applicable, at least from the perspective of State P.[907] In other words, the royalties might be subject to double taxation, because country S would not limit its taxing rights in favor of the resident country.

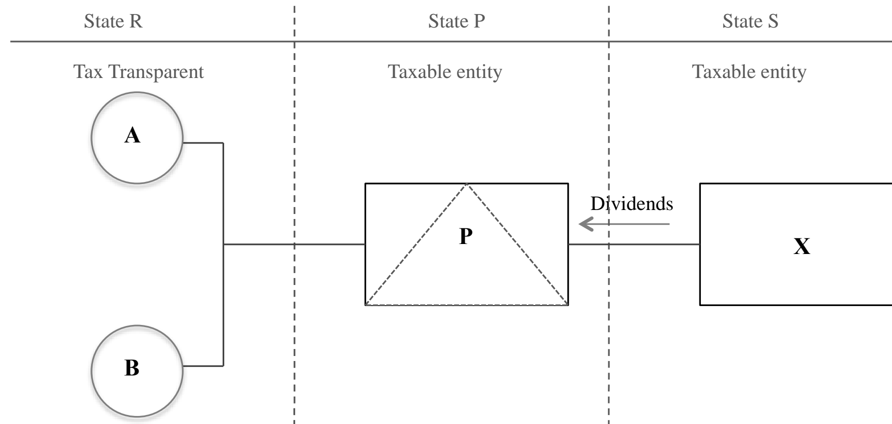
Similarly, in triangular cases the State of source is bound not only by the tax characterization of the entity in the State of residence of the partnership, but also by the tax treatment in the State of residence of the partners.[908] Once again, the characterization of the entity given in the State of source is completely irrelevant. Let us take the example 9 of the OECD Partnership Report, which provides as follows: entity P is established in State P. A and B are P's partners who resides in State R. P owns shares in X, company

[906] The above means that, in principle, State S should reduce its WHT and State R would grant a relief in case of double taxation. However, it is arguable that State S considers A and B as the beneficial owners for purposes of Article 12 OECD Model, and finally apply a reduced WHT. Thus issue is further on analyzed at *infra* Section 3.3.2.3.

[907] For State S, on the contrary, the treaty P-S is applicable with or without the considerations on the principles of the OECD Partnership Report, because State S considers entity P as a taxable entity.

[908] Steindl and Stiastny, *supra* n. 902.

resident in State S. X pays dividends to P. States P and S treats the partnerships as a taxable entity while State R treats as fiscally transparent.[909]



As noted, State S is bound not only by the characterization of entity P in country P, but also by the characterization of State R, where the partners of P reside. The double entitlement to treaty benefits is solved in a pragmatic manner providing that State S should apply the lowest WHT resulting from the application of the treaty P-S and R-S.

Figure 26: OECD Partnership Report, Example 9.

The OECD Partnership Report states that in this case the tax treatment given to entity P in State S is irrelevant for purposes of determining the to whom the income is attributed.[910] State S, however, will consider the tax treatment given in both State P and in State R. In this regard, the tax treaty between States P-S is applicable since P is considered as resident of State P by this State. A and B, on the other hand, are potentially liable to tax as residents of State R. Therefore, State S should, in principle, limit its taxing rights as regards to the treaty R-S. In other words, State S should be limited in its

[909] OECD (1999), *supra* n. 1, Ex. 9, p. 29.
[910] Id.

taxing rights by the tax treatment in State R and State P, providing a double entitlement to tax treaty benefits, i.e. to the entity P and to its partners, although by application of two different treaties. The solution proposed by the OECD in the Partnership Report in this case is, however, that State S applies the lowest WHT resulting from those two treaties to both applicable treaties.[911] For example, if the treaty P-S provides for 10% WHT and the one between R-S provides for 15% WHT, State S should tax the dividends at a rate of 10% WHT to satisfy both treaty obligations. The above, however, does not prevent the double taxation that might arise because of the non-application of the treaty R-P.[912]

3.2. Exception

The OECD contemplates an exception to the general recommendation: the general rule will not apply to restrict the source State's right to tax its own residents. As provided in the OECD Commentary on Article 1, updated as per the recommendations of the Report: "Where a partnership is treated as a resident of a Contracting State, 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

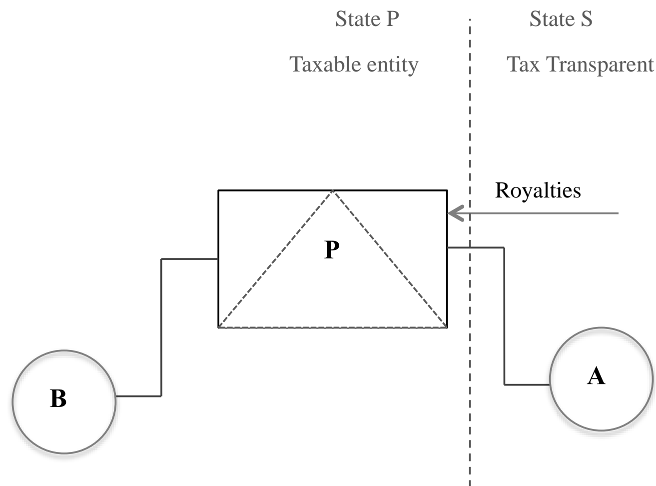
911 Id., Ex. 9, para. 74, pp. 29-30.

912 There is no relationship residence-source between R and P. Thus, there is no treaty applicable, assuming also that P is not regarded as a PE, because in such a case, the treaty R-P would be applicable and State R should grant double taxation relief. *See* a further analysis in *infra* Section 3.3.2.1.

residents on their share of the income of the partnership".[913] In other words, if the State of residence of the partnership treats it as a taxable entity and the source State considers it as transparent, the source State would not be limited to tax its own residents, partners of the Partnership, on the ground that the State of residence does not allocate the income to the partners. Let us assume the following hypothetical: P is a Partnership established in country P and has two partners: A and B. While B is resident of country P, A is resident in country S, the State of source. P receives royalties from country S. P is considered as a taxable entity in country P, while as fiscally transparent in country S.[914]

[913] OECD Commentary on Article 1 concerning the persons covered by the convention, para. 6.1.

[914] This example is inspired on Ex. 16 of the OECD Partnership Report. *See* OECD (1999), *supra* n. 1, p. 45.



State S is not restricted to tax its own resident, i.e. partner A, regardless the characterization of entity P given in the State of residence in this case.

Figure 27: Example inspired in Ex. 16, OECD Partnership Report

As per to Article 12 OECD Model, the royalties arising in a Contracting State and beneficially owned in the other Contracting State should be taxable only in this latter State, i.e. the State of residence.[915] Therefore, since P is a taxable entity in State P, this State has the exclusive right to tax those royalties, unless specifically prevented by a provision within the treaty or the application of CFC rules.[916] Nevertheless, the exception to the general

[915] Article 12(1) OECD Model Tax Convention.

[916] This was indeed the minority opinion sustained by the OECD delegates. As stated within the OECD Partnership Report: "The delegates who adopted that interpretation therefore concluded that unless the case fell under the application of CFC rules or the Convention included a special provision allowing State R [State S in our example] to tax its residents in such circumstances (e.g. a specific provision applicable to partnerships or a so-called "saving clause" such as is found in Conventions concluded by the United States), the Convention would prevent State R [State S in our example] on taxing partner

recommendation of the Report provides that in this case, State S would not be limited by Article 12 OECD Model and could also tax partner A on its share on the royalties, i.e. partnership's income. Indeed, as provided in the Report: "Article 12 of the Convention does not affect taxation that is based on residence but only taxation that is based on source".[917] In other words, Article 12 would not apply in this case, because the royalties would have not been paid from a Contracting State (State S) to the other Contracting State (State P). On the contrary, under State S's perspective, partner A and not P received the royalties, and partner A is a resident of State S.[918]

This position, agreed by the majority of the OECD delegates, could certainly drive to double taxation unless State S consider that partner A has a PE in State P, and thus, State S is obligated to provide double tax relief under the tax treaty.[919] The above, however, seemed not to be a reason enough to prevent State S from taxing partner A.[920] Yet, the double tax issue may become even permanent in cases involving other types of transparent entities rather than partnerships. As well explained by Danon, this could be perfectly possible in a similar situation involving a trust rather than a

B [A in our example] on his share of the royalties". OECD (1999), *supra* n. 1, Part III para. 126, p. 46.

917 OECD (1999), *supra* n. 1, Part III para. 127, p. 46.

918 Id.

919 Although minimized, double taxation would still exist in the cases where there is no PE in State P.

920 As provided by the OECD Partnership Report: "The fact that double taxation results because of the differing income allocations of State R and P [S and P in our example] is not a reason to limit its right to tax its residents". OECD (1999), *supra* n. 1, Part III para. 127, p. 47.

partnership.[921] Following the reasoning of Danon, let us assume the following hypothetical: State P is the country where a trust (T) is established. The settlor of the of trust is a resident of this State, while the beneficiary is a resident of State S, from where the trust receives annual royalties. The trust is regarded as fiscally transparent in both States.

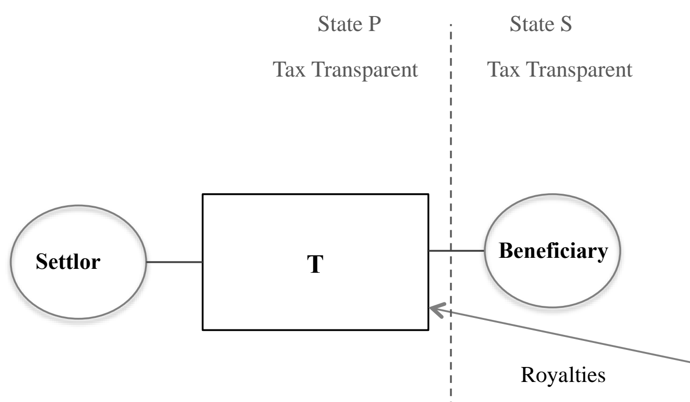


Figure 28: Example with Trust

In this hypothetical, and following the exception to the general recommendation of the Report, Article 12 OECD Model would not be applicable to limit the taxation rights of the source country S to tax the beneficiary, who is also resident of this country. State P, on the contrary, would tax the same income in the hands of the settlor, who is resident of State P. The difference is that the beneficiary, unlike partner A in the previous example, does not maintain a PE in State P. In this situation, therefore, the avoidance of double taxation becomes actually impossible.[922]

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[921] Danon, *supra* n. 882, p. 197.

[922] Danon argues that this solution is inconsistent. He sustains that "the only reason why the OECD arrives at this result is precisely because, without any sound argument, it

3.3. Critics

Critics upon the general recommendations of the OECD Partnership Report have been elaborated both in form and in substance.

3.3.1. Formal critics

Formally speaking, the Report is criticized for its case-by-case approach rather than a more general and theoretical one. Indeed, it is undeniable that a case-by-case approach is more practical and illustrative. However, it also creates a lot of uncertainty, because it is impossible to cover all the potential issues that may arise in every single situation using just few hypotheticals.[923] Similarly, the Report is criticized for limiting its analysis to the case of Partnerships, without including the case of other non-corporate entities, such as trusts or LLCs.[924] Although there are no doubts that the same criteria used for Partnership may also be used for other non-corporate entities.

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suddenly implicitly applies the internal attribution rules of the source state, thereby causing the income to be allocated to one of its residents […] More generally, what the OECD Partnership Report is doing is erroneously turning a source-residence into a residence-residence conflict of attribution". Although he argues "[…] the real and unresolved residence-residence conflict of attribution comes into play where income sourced in a third state is allocated to residents of two different resident states". Id., p. 198. See also *infra* Section 3.3.2.1, referring to "residence-residence" and "source-source" conflicts.

923 One of the major criticisms to the 1999 OECD Partnership Report came from Prof. M. Lang. *See* M. Lang, *The Application of the OECD Model Tax Convention to Partnerships, A Critical Analysis of the Report Prepared by the OECD*, Wolters Kluwer, Alphen aan den Rijn (2000). *See also*, e.g. Danon, *supra* n. 882, p. 199.

924 This is, however, clarified in the OECD proposal on Article 1(2) OECD Model. *See* the analysis in infra Section 5.

3.3.2. Substantial critics

Substantially speaking, the Report left also important gaps for criticism, which can be summarized in three main areas: (i) unresolved conflicts of attribution; (ii) a preference for a solution favoring residence States, and (iii) the interplay with other attribution rules, especially with the concept of *beneficial ownership* of Articles 10, 11 and 12 OECD Model.

3.3.2.1. Unresolved conflicts of attribution

As regard to the unresolved conflicts of attribution, these may arise either in the form of "residence-residence" conflicts or "source-source" conflicts.[925] The "residence-residence" conflicts, on the one hand, can be illustrated using the following hypothetical: P is a partnership organized in State P, which has two partners, A and B, who are residents of State R. Accordingly, P receives interest and royalties from State S. While State P and S treat the partnership as a taxable entity, State R, the residence' State of the partners A and B, considers it as fiscally transparent, although it does not constitute a PE.

[925] This terminology is indeed used by Danon. *See* Danon, *supra* n. 882, pp. 198-200.

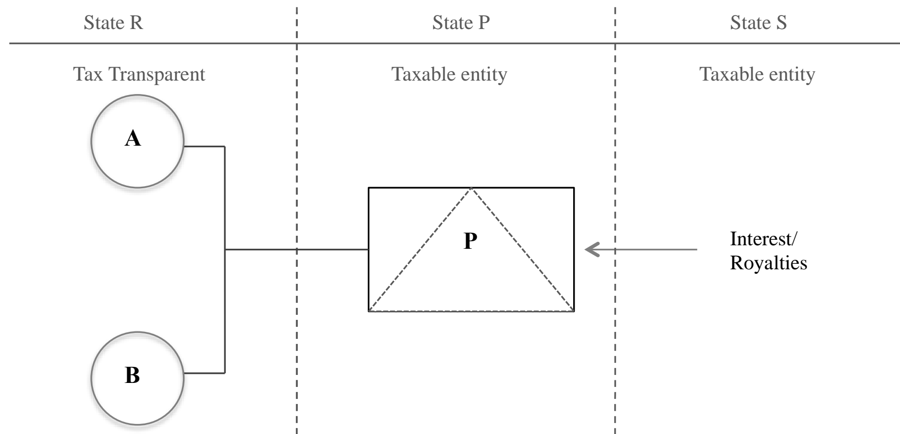

Figure 29: Triangular case illustrating a "residence-residence" conflict

As per the recommendation of the OECD Partnership Report, if State S has a treaty with both P and R, then both treaties would be applicable and State S would be obliged to impose the lowest rate upon interest and royalties.[926] On the other hand, State R and State P will impose taxation.[927] Nevertheless, State R will not be able to grant double taxation relief under a treaty with P, because the relationship between both is not as residence-source countries, but rather as residence-residence. In other words, the interest and royalties will be subject to double taxation.[928]

926 OECD Commentary on Article 1 concerning the persons covered by the convention, para. 6.5. *See also*, OECD (1999), supra n. 1, Part II.4, para. 74, Ex.9., p. 30,

927 If the income is royalties, they [State R and State P] will indeed have the exclusive right to tax as per Article 12 OECD Model.

928 The double taxation issue would be minimized if P were a considered a PE. In such a case, State R should grant a double taxation relief on the interest and royalties attributed to the PE. S*ee* Danon, *supra* n. 882, pp. 198-199.

Similarly, "source-source" conflicts of allocation may arise without a proper solution when a payment derived from an entity considered opaque in its country of organization while fiscally transparent in the country of residence of its partners and the country where the recipient of the income is located, giving rise therefore to an item of income sourced twice.[929] The above can be illustrated in the following hypothetical: P is a partnership organized in State P and with partners A and B, residents of State R. Partnership P pays interest to C, a company organized in State S. Whilst States R and S treat P as fiscally transparent, State P considers it as a taxable entity.

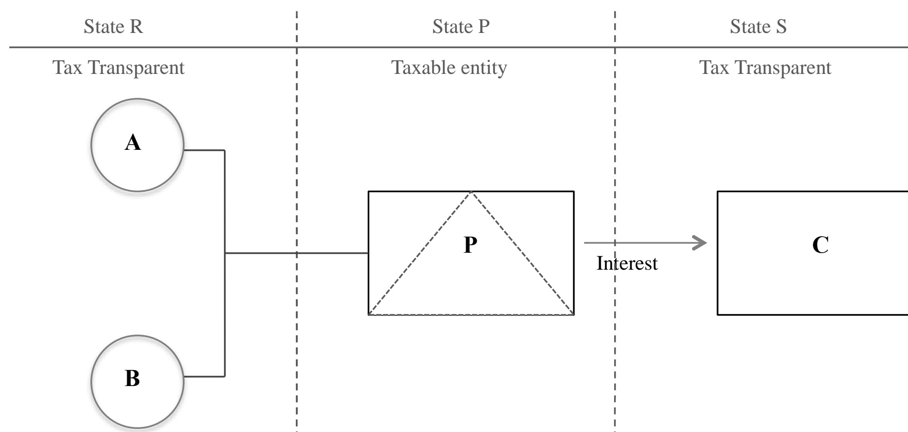

Figure 30: Triangular case illustrating a "source-source" conflict

As per Article 11(5) OECD Model, the interests are deemed to be paid both from country R and P. Therefore, State S should provide double taxation relief with respect to the treaty with R and P. Nevertheless, it is possible that

929 Id., p. 199

the total WHT levied in State R [930]and P is not fully creditable in State C, originating an unsatisfactory result of double taxation.

3.3.2.2. Preference for the State of Residence

Another sound critic against the principles stated within the OECD Partnership Report is its remarked preference for the State of residence rather than the State of source.[931] Indeed, as already stressed, the OECD Partnership Report provides that it is the State of residence that decides, in case of conflicts of allocation of income, whether the tax liability is imposed on the partnership or the partners and the source State applies then the tax treaty accordingly.[932]

This preference for the State of residence, as explained by Wheeler, does not consider the cases in which the State of source might consider that attribution unacceptable.[933] Indeed, the principle stated within the OECD Partnership Report is built on the grounds that income is attributed to a person, either the partners or the partnership, who carries out the business or

930 Id.

931 In 2005, and with respect to the OECD Partnership Report, Wheeler argued: "A more serious problem with this approach is that it does not take sufficient account of the concerns of the source state about income conduits". Wheeler, supra n. 901, p. 488.

932 J. Wheeler, Th*e Missing Keystone of Income Tax Treaties*, 3 World Tax J. (2011), Journals IBFD, p. 260. However, "[…] determining the direction taken by the income flow is a prior stage that should not be determined by one state alone. It is not satisfactory to give the initiative in this respect to the residence state, leaving the source state to combat an attribution that it finds unacceptable by using a concept as problematic as beneficial owner". Id., p. 261.

933 Id. For example, if the State of source considers that a payment of interest is not paid to the *beneficial owner* of the interest payments, it might in theory deny the reduced WHT under Article 11. *See also* the further analysis at *infra* Section 3.3.2.3.

makes the investment. Nevertheless, States sometimes go beyond these paths and attribute income based on less direct connections with the income.[934] In a similar view, Lang provides: "[I]t makes sense to assume that it is not up to the residence State to decide who shall be entitled to the treaty benefits in the source State. It is the source State that decides on the taxpayer status".[935] Wassermeyer also stresses that the domestic law of the state granting the tax benefits [source State] is crucial for purposes of the tax liability and income allocation.[936] The approach argued by these two authors, i.e. favoring the position of the State of source, has been confirmed by a case law decision of the Austrian Supreme Court [*Verwaltungsgerichthof*] in 2006.[937] In a complementary approach, Wheeler also proposed in 2005 that the law of the State where the intermediary company is located, in case of conduits, should also be decisive. This option has been, however, criticized for encouraging taxpayers to shift income to jurisdictions with a tax treaty providing for zero source taxation.[938]

934 Id.

935 Lang, *supra* n. 923, p. 38.

936 F. Wassermeyer, *Doppelbesteuerung (OECD-Musterabkommen* 2010 *Kommentar)* in: F. Wassermeyer, C. Kaeser, M. Lang and J. Schuch (eds.), Linde, Vienna, 2015, Article 12, m.no. 33.

937 AT: VwGH, 18 Oct. 2006, case 2003/13/0052, and an analysis of the case in: M. Lang, *Tendenzen in der Rechtsprechung des österreichischen Verwaltungsgerichtshofs zu den Doppelbesteuerungsabkomme,* IFF Forum für Steuerrecht 2012, pp. 27-29. *See also*, Steindl and Stiastny, *supra* n. 902, p. 114.

938 Steindl and Stiastny, *supra* n. 902, p. 114.

3.3.2.3. The (original missed) interplay with the concept of *beneficial owner*

The principle stated within the OECD Partnership Report seem not to be completely in line with the mechanic of tax treaties, especially when referred to the interplay between this principle and the concept of *beneficial owner* in Article 10, 11 and 12 OECD Model.[939]

Let me illustrate the above using a previous example with some additional information. Let us assume that entity P is established in State P. A and B are P's partners who resides in State R. P owns shares in X, company resident in State S. X pays dividends to P. States P and S treats entity P as a taxable entity while State R treats as fiscally transparent. Likewise, while the treaty P-S provides for a WHT of 10%, the treaty between R-S provides for a WHT of 5%.

[939] For the discussion regarding the meaning of *beneficial owner*, see the references at *supra* n. 326.

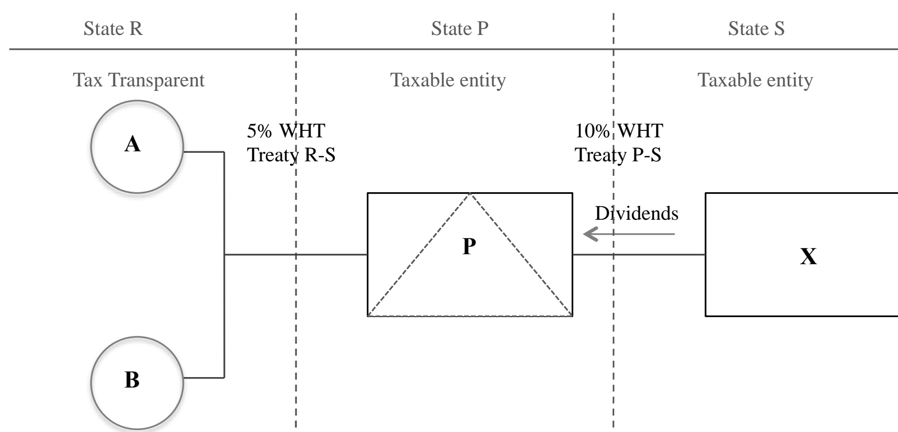

Figure 31: The OECD Partnership Report and the beneficial ownership requirement

If we consider the solution stated within the OECD Partnership Report and reproduced in the OECD Commentaries, we should say that this situation is solved if State S taxes the dividend at the lowest WHT rate between the two applicable treaties in this case, i.e. 5% WHT within the treaty R-S. However, the wording of Article 10(2) OECD Model provides for a reduced WHT to the extent the *beneficial owner* of the dividends is a resident of the other Contracting State. In this case, however, the solution provided within the OECD Partnership Report, and reproduced in the OECD Commentaries, seems to disregard the interplay between the benefits of the treaty and the special requirement of the *beneficial owner* of Article 10(2) OECD Model.

The OECD Partnership Report assumes that there is only one beneficial owner, i.e. partnership P. This is correct from the perspective of State S (State of source), who sees P as a taxable entity. However, in the same logic, State S should not restrict its taxing rights as regard to the A and B, who are

not the *beneficial owners* of the same dividends. In simple words, to solve the conflict just providing that the source State should apply the lowest WHT rate when comparing the treaties with the partnership and the partners seems to be at least awkward. Unfortunately, the proposed OECD Commentaries on Article 1(2) OECD Model leaves still open the discussion as regards to the beneficial ownership's requirement in Articles 10, 11 and 12 OECD Model. Indeed, the proposed OECD Commentaries on Article 1(2) OECD Model simply provide that nothing prevent the State of source to determine in this case that a different person may be regarded as the beneficial owner.[940]

4. The US Model: The legal precedent for the OECD Proposal

Although there are no doubts that the principles settled in the 1999 OECD Partnership Report are reproduced within Article 1(6) of the US Model, this provision can also be found within tax treaties concluded by the United States since 1996, and even older ones.[941] Accordingly, the formal inclusion within the US Model came only in its 2006 version,[942] applying indistinctly both to partnerships and other kind of entities, including e.g. trusts and LLCs.[943] This provision is analyzed in the subsequent subsections.

940 A further analysis at *infra* Section 5.3.1.

941 Biitker and Lokken, *supra* n. 530, p. 65-59.

942 R. Avi-Yonah and M. Tittle, *The United States Model Income Tax Convention*, Bull. Int'l Taxn., Vol. 61, p. 224 (2007), Journals IBFD.

943 US: United States Model Technical Explanation accompanying the United States Model Income Tax Convention of 15 November 2006, p. 7. The inclusion of trusts and LLCs is

4.1. General Interpretation of Article 1(6) US Model

Article 1(6) US Model (2016) states that: "For purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated 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".[944] A slightly similar wording was used in the previous US Model (2006), which provides: "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 income, profit or gain of a resident".[945]

Regardless the slightly different wording, the provision rules the same: if an item of income is received by a fiscally transparent entity, considered as such by any of the Contracting States, it shall be regarded as received by the residents of the State considering the entity as transparent, so long as the item of income is subject to tax at the partners' level in that State. This is to say, the benefits derived from a tax treaty can be claimed only by the partners of the transparent entity to the extent these are also regarded as

important, because it was in fact one of the concerns arose in the Partnership Report in 1999. *See* OECD (1999), *supra* n.1.

944 US: 2016 United States Model Income Tax Convention of 17 Feb. 2016, Article 1(6).

945 US: 2006 United States Model Income Tax Convention of 15 November 2006, Article 1(6).

residents in the State characterizing the entity as fiscally transparent. In other words, Article 1(6) US Model obliges the State of source to grant treaty benefits by the sole fact that the State of residence attributes the income, derived through a fiscally transparent entity, to one of its residents.[946]

Nevertheless, Article 1(6) US Model is not designed as an *"anti-hybrid entity"* rule, but rather as a rule that clarifies to whom income is being allocated, and thus, the benefits of a treaty are being granted when income is received through transparent entities. For example, it applies even if both Contracting States treat the entity as fiscally transparent.[947] The above, however, does not prevent the author to recognize its particular importance in cases where *hybrid entities* or *reverse hybrid entities* are involved.[948] Likewise, as per the technical explanations of the 2006 U.S. Tax Treaty Model, Article 1(6) has basically two main purposes.[949] On one hand, it aims to eliminate the technical problems that investors would have prevented using transparent entities to claim treaty benefits, even though such investors would be subject to tax on the income derived through such

[946] R. Doernberg and K. van Raad, *Hybrid Entities and the U.S. Model Income Tax Treaty*, 19 Tax Notes Int'l 8 (1999), p. 746.

[947] The reference to *"either Contracting State"* in the wording suggests that at least one Contracting State should treat the entity as fiscally transparent, but it does not restrict its application if both States do that. This is, e.g. stated clearly in the OECD proposal, which mirrors Article 1(6) US Model. *Infra* Section 5.

[948] As stressed in Chapter III, the U.S. Check-the-box regulations are indeed an important source of hybrid and reverse hybrid entities. *See* the analysis of the U.S. Check-the-box system at *supra* Chapter III, Section 4.

[949] Id.

entities.[950] On the other hand, it attempts to directly prevent the use of transparent entities to claim treaty benefits in circumstances where the person investing through such an entity is not subject to tax on the income in its State of residence.[951] Article 1(6) US Model involves thus a series of preconditions within its wording, which are analyzed as follows.

4.1.1. The reference to *"income, profit or gain"*

Article 1(6) US Model refers to *"income, profit or gain"* received by a fiscally transparent entity. Therefore, the provision includes several numbers of items of income, such as business profits, income from services, dividends, royalties, rental income and gains derived from the sale of property.[952] All of these items of income correspond to the substantive rules of Article 6 through 21 US Model.[953] Likewise, there is no reference to "capital", because there is no provision on taxation of capital within the US

[950] Id. The reference to *"subject to tax"* made in the 2006 Technical Explanation of the U.S. Tax Treaty Model could mislead to the wrong idea that Article 1(6) of the U.S. Tax Treaty Model is avoiding the result of DNT. However, this interpretation is incorrect. If we analyze the use of the term "subject to tax" in a treaty context, we immediately realize that it refers to the definition of residents or people liable to tax by reason of their domiciles, residence or citizenship. In simple words, and as we will see later on in this Chapter, the Article is trying to ensure that the tax treaty benefits arrive to a resident of any of the treaty partners and not to a third person, who is not part of the bilateral treaty.

[951] Id.

[952] US: Technical Explanation of the 2006 United States Model Income Tax Convention, of 15 November 2006, p. 5.

[953] Id.

Model.[954] Finally, it is also clear that the determinations of income should be made on an "item by item" and not "entity-by-entity" basis.[955]

4.1.2. Income, profit and gain derived *"by or through"*

The wording of the 2016 US Model refers also to income derived *"by or through"* an entity. This wording certainly differs from the wording of the 2006 US Model, which only referred to income *"derived through"*.[956]

When analyzing the 2006 Technical Explanation of the US Model, it seems to be clear that the terms *"by"* and *"through"* are used in an interchangeable manner. For example, the Technical Explanations state: "Under paragraph 6, an item of income, profit or gain *derived by* such a fiscal transparent entity will be considered to be derived by a resident of a Contracting State […]" (emphasis added).[957] Likewise, they provide: "In the case of a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom U.S. tax laws would treat as deriving

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954 J. Kollmann, A. Roncarati and C. Staringer, *Treaty Entitlement for Fiscally Transparent Entities: Article 1(2) of the OECD Model Convention*, in: M. Lang, P. Pistone, S. Staringer (eds.), *Base Erosion and Profit Shifting (BEPS). The Proposal to revise the OECD Model Convention*, Linde, Vienna, 2016, p. 21

955 A. Nikolakakis et al., *Some Reflections on the Proposed Revision to the OECD Model and Commentaries, and on the Multilateral Instrument, with respect to Fiscally Transparent Entities*, BTR 3 (2017), p. 311. See also, *infra* Section 5.1.1. as regards to the OECD Model.

956 Compare the wordings in *supra* Section 4.1.

957 US: Technical Explanation of the 2006 United States Model Income Tax Convention of 15 November 2006, p. 6.

the interest income *through* the partnership".[958] Yet, what seems to be clear is that, depending of the perspective, i.e. residence or source State, income might be considered derived by or through an entity, although this does not affect the fact that the country treating the entity as fiscally transparent should assign the benefits of the treaty to the owners of that entity only to the extent that they are also residents in that State. However, the above might be interpreted from Article 1(6) US Model without need of modifying its wording.

Although the real practical reasons for a change in the wording of the provision are still doubtful, mostly in the absence of technical explanations for the new 2016 US Model, some hints might be found within the OECD proposal of Article 1(2) OECD Model, which uses a similar wording.[959] In this case, the wording *"derived by or through"* seems to be interpreted as ensuring the application of the provision to cases where the source State treats the entity X as transparent, and thus, that the income is *derived through* the fiscally transparent entity and the cases where the source State treats the entity X as non-transparent (being regarded as transparent by the State of residence), and thus, that the income is *derived by* such entity.[960] The reference to income derived *"by or through"* seems thus to have a broad meaning, and is applied "regardless of the view taken by each Contracting State as to who derives that income for domestic purposes and

[958] Id.
[959] *Infra* Section 5.1.2.
[960] Id.

regardless of whether or not that entity or arrangement has legal personality or constitutes a person as defined in subparagraph 1 a) of Article 3".[961] In simple terms, this wording would reinforce the two functions of the provision, i.e. as to grant and to deny treaty benefits, from the perspective of the State of source.[962]

4.1.3. The reference to *"entities"* (and not *arrangements*)

The exclusive reference to *"entities"* within the wording of Article 1(6) US Model seems to be very clear and straightforward: the provision only applies to legal entities that qualify as a person as per the definition of Article 3(1) US Model, which are treated as fiscally transparent at least by one of the Contracting States.[963] Unlike the OECD Model, the US Model definition of person includes specifically partnerships, trusts, estates, companies and any other body of persons.[964] Therefore, the status as person of partnerships and other transparent entities was never an issue. In contrast, the definition of persons within the OECD Model generated some questions before 1999 as

[961] OECD (2015), *supra* n. 6, p, 141, Proposed Commentary on Article 1, para. 26.8.

[962] This is, however, evident from the wording within the 2006 US Model, which refers to the source State attribution "to the extent" of residence State attribution. *See* Nikolakakis et al., *supra* n. 955, p. 311.

[963] The 2006 Technical Explanation of the US Model states: "Entities falling under this description in the United States include partnerships, common investment trusts under section 584 and grantor trusts. This paragraph also applies to U.S. limited liability companies ("LLCs") that are treated as partnerships or disregarded entities for U.S. tax purposes". US: Technical Explanation of the 2006 United States Model Income Tax Convention, of 15 November 2006, p. 6.

[964] US: 2006 United States Model Income Tax Convention of 15 November 2006, Article 3(1).

to whether the wording "any body of persons" would also include partnerships and other non-corporate entities.[965] This discussion was, however, settled after the issuance of the OECD Partnership Report and the modification of the OECD Commentaries, which includes that: "Partnerships will also be considered to be 'persons' either because they fall within the definition of 'company' or, where this is not the case, because they constitute other bodies of persons".[966] All in all, the scope of application of Article 1(6) US Model seems to be rather clear, including within the notion of *"entities"* both corporate and non-corporate ones.

4.1.4. *"Wholly or partial"* fiscal transparency

Finally, the wording of the 2016 US Model refers to entities that are *"wholly or partially transparent"*. This wording, however, does not make much sense, because it was clear since the 2006 US Model that Article 1(6) was applicable not only to partnerships, but also to others transparent entities in general, including common investment trusts under I.R.C. Section 584 and grantor trust and LLCs.[967] Thus, the change in the wording seems to have more a practical reason, which is to align the wording with the OECD proposal of Article 1(2) OECD Model, facilitating thus the negotiations of treaties.[968]

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965 OECD Model Convention, Article 3; OECD Commentary on Article 3 concerning general definitions, para. 2. See also the discussion at *supra* Section 2.

966 Id.

967 US: Technical Explanation of the 2006 United States Model Income Tax Convention of 15 November 2006, p. 6.

968 *Infra* Section 5.1.4.

4.2. Illustrations as regards to the application of Article 1(6) US Model

The application of Article 1(6) US Model is illustrated below through a series of examples. All these examples assume the United States either being the resident or source State and are divided in two groups: (i) strict bilateral cases and (ii) triangular cases. Likewise, all the examples assume that no PE is constituted in the State of source and all treaties include Article 1(6) US Model. Finally, all the examples also assume that all anti-abuse restrictions within domestic laws and tax treaties are accomplished in order to apply Article 1(6) US Model.[969]

4.2.1. Application of Article 1(6) US Model in strict bilateral cases

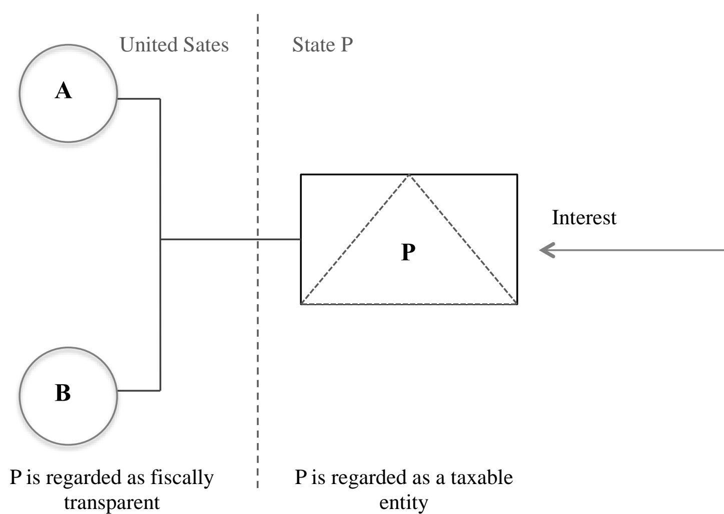
This Section contains four illustrations of strict bilateral situations analyzing the implication of Article 1(6) US Model. Whilst example 1 and 2 refer to income received by or through a hybrid entity, example 3 and 4 refer to income received through a reverse hybrid entity.

4.2.1.1. Example 1: Foreign entity with U.S. owners

Let us assume a foreign entity P, which is organized and resident in State P and has two owners: A and B, who are, nevertheless, U.S. citizens.

[969] This includes, e.g. substance over form doctrine or LOB provisions within U.S. tax treaties. For a brief reference about the LOB provision in the new 2016 US Model and its interpretation as regards to pursue single taxation, see *supra* Chapter I, Section 3.2.3.2.

Accordingly, entity P receives interest payments from a debtor in the foreign State P. While State P considers the entity as a taxable entity, the partners A and B in the United States have elected to treat the entity as tax transparent for U.S. tax purposes.[970] Thus, from a U.S. perspective, the income is allocated to the partners A and B instead. State P has also a general WHT on interest paid abroad of 30%, which is calculated on the gross amount of interest payments.



As foreign entity P is an eligible entity, partners A and B decided to file the election to treat foreign entity P as tax transparent for U.S. tax purposes.

Figure 32: Example 1–Foreign entity with U.S. owners

970 For a detailed analysis with respect to the election under the CTB regulations, see *supra* Chapter III, Section 4.3.

While, on one hand, for State P this is strictly a domestic situation, partners A and B, on the other hand, would like to claim the benefits of the treaty between the United States and State P, because from a U.S. perspective, income is allocated and taxed at the level of A and B. The conflict is thus given by the different tax characterization of entity P.

If we take a look at the application of Article 1(6) US Model, all the preconditions are met. There is indeed interest income being derived through an entity that one of the Contracting States (i.e. the United States in this case) considers as tax transparent, and the income is allocated to A and B, who are also U.S. citizens, i.e. residents for purposes of the treaty. The above implies that State P will limit its taxing rights and will apply now a reduced WHT of 15% according to Article 11 of the United States/State P tax treaty. Likewise, the owners A and B may claim a tax credit as per Article 23 of the United States/State P tax treaty.

The solution of Article 1(6) US Model in this case works certainly in favor of the United States, i.e. the State of residence in this bilateral case. The State of source (State P) should limit its taxing rights just because the partners of the entity are U.S. citizens and decided to file the election to treat the foreign entity P as tax transparent. In other words, the CTB rules seem to

be the real reason for the application of Article 1(6) US model to a situation that, in principle, might be perfectly treated as a domestic one.[971]

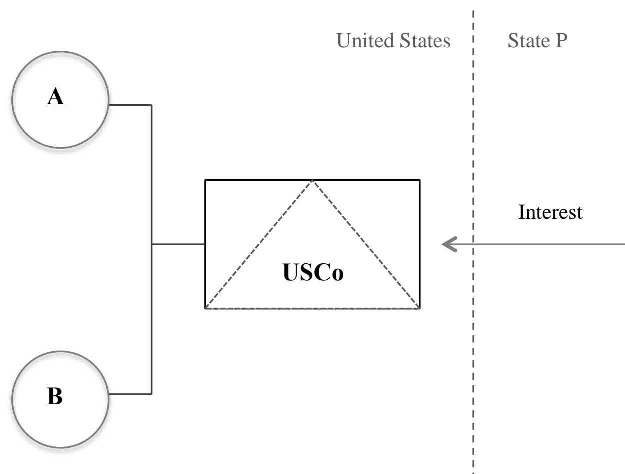
Likewise, the solution given by Article 1(6) US Model presents problem both from a State of source and residence perspective. From the State of source's perspective, it does not consider the proper interplay with the concept of *beneficial owner* under Article 11 of the United State/State P tax treaty. Indeed, for State P, partners A and B will be rarely considered as the beneficial owners of the interest under the rules of this State.[972] On the other hand, from the State of residence's perspective, it results arguable that Article 23 of the United States/State P tax treaty be interpreted so extensively as to provide relief to A and B, when technically there is no a direct payment of taxes. In other words, entity P will be subject to tax in State P, because it is a resident of that State. However, and unless Article 23 is interpreted as providing an indirect tax credit, A and B should not be relieved from double taxation.[973]

4.2.1.2. Example 2: U.S. Corporation with U.S. owners

Let us assume now that a U.S. Corporation (USCo) [*per se* Corporation][974] has two owners, A and B, who are also U.S. citizens, which receives interest payments from State P. While for U.S. tax purposes a U.S. Corporation is indeed a taxable entity, for State P tax purposes, this is a tax transparent

[971] Nonetheless, it is important to remember that even if this situation were treated as a domestic one, the United State could tax A and B (U.S. citizens) by reason of Article 1(4) US Model, i.e. the "saving clause".

entity. State P generally applies a WHT on interest paid abroad of 30%, which is calculated on the gross amount of payments.



USCo is a *per se* Corporation. Therefore, USCo is a taxable entity in the United States. Accordingly, this characterization cannot be changed using the CTB election at a domestic level. State P, on the other hand, considers USCo as a fiscally transparent entity.

Figure 33: Example 2–U.S. Corporation with U.S. owners

[972] *See* a further analysis in *infra* Section 4.3.1.

[973] The interpretation of Article 23 US Model as to provide an indirect tax credit should be, nevertheless, arguable. For a comparison with the solution proposed within the OECD Model, see *infra* Section 5.3.2. The solution to the interpretation of Article 23 in a similar case provides that, unless the relief refers to taxes applied according to the treaty, no relief should be given to A and B. In other words, if the taxation imposed to entity P is derived exclusively by the fact of being a resident of State P, there is no obligation to relief of double taxation in the other State. *See* OECD (2015), *supra* n. 200, para. 64 (replacement of Article 23B OECD Model), p. 88.

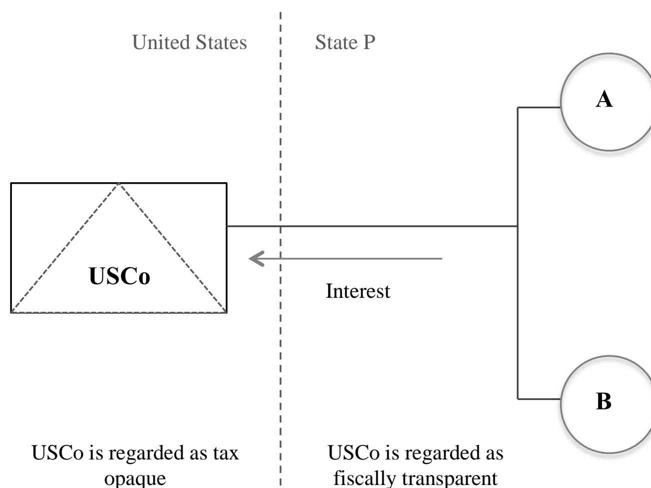
[974] For the implications regarding being considered a *per se* Corporation and the application of the CTB election, see *supra* Chapter III, Section 4.3.

The conflict in this case is thus due to the fact that while the United States considers that USCo is a taxable entity and resident for treaty purposes, State P considers that USCo is indeed a tax transparent entity. Therefore, for the United States USCo is the resident for treaty purposes receiving the interest payments form State P, and thus being entitled to claim the benefits of the treaty between the United States and State P, while for State P are the owners A and B the ones receiving the payments, and the beneficial owners of them, being them thus entitled to claim the benefits of the treaty between the two countries.

The preconditions of Article 1(6) US Model to grant the benefits of the treaty to A and B are, nevertheless, not met because A and B are not considered residents of State P. Therefore, Article 1(6) US Model acts in this case as to deny the benefits of the treaty to A and B and to ensure that they are granted to USCo. In other words, Article 1(6) US Model makes the characterization of USCo in the United States to prevail.

Yet, it is interesting to note that for the State of source (State P), it would be irrelevant whether the income is allocated to A and B or to USCo, because in both cases it would apply the treaty between the United States and State P, reducing its WHT to 15% according to Article 11 of the United States/State P tax treaty. In other words, Article 1(6) US Model is relevant in this case only as regards to whom in the State of residence might claim the relief of double taxation as per Article 23 of the United States/State P tax treaty. Likewise, as noted below, if A and B were residents of State P, the application of Article 1(6) US Model would be redundant, because the

preconditions of Article 11 US Model would not be met anyway, i.e. there would not be interest payments arising in a Contracting State and beneficially owned in the other Contracting State. The interest payments in this case would arise in the same State where the beneficial owners of the payments are residents; therefore, it would not go beyond of being a domestic situation. However, nothing would prevent the United States to tax USCo (a taxable entity) as a resident. Thus, double taxation might arise.[975]



Article 1(6) US Model is irrelevant in this case, because the preconditions for application of Article 11 US Model are not met. Likewise, interest will be taxed both in the United States, at the level of USCo, and in State P, as the share of income in the "foreign partnership".

Figure 34: Ex. 2 (variation)–U.S. Corporation with resident's owners in the State of source

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975 *See* the interplay between Article 1(6) US Model and Article 1(4) US Model ("saving clause") at *infra* Section 4.3.2.

4.2.1.3. Example 3: Foreign partnership with U.S. owners

Let us now assume that a foreign partnership P is organized and it is resident in State P. It has two owners, partners A and B, who are both U.S. citizens. Accordingly, foreign partnership P receives interest payments from a debtor in State P. The U.S. partners, A and B, elected to treat the foreign partnership P as a taxable entity in the United States, while this is indeed a tax transparent entity under the domestic laws of State P. Likewise, State P applies a general WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

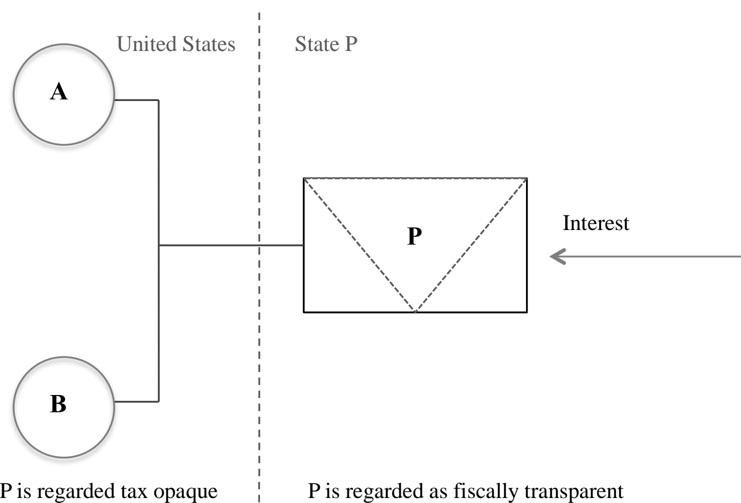


Figure 35: Example 3–Foreign partnership with U.S. owners

As well as in the previous cases, the conflict is given by the fact that State P considers the partnership as a tax transparent entity, namely, that the interest payments are allocated to A and B, residents of the United States. On the

contrary, the United States considers that the treaty with State P is not applicable at all, because in fact the partnership P is, for U.S. tax purposes, a taxable entity. The whole transaction raises no treaty concerns for the United States.

As regards to the application of Article 1(6) US Model, the income is received through partnership P, considered as fiscally transparent in State P, but it is, however, not allocated to residents of this State. On the contrary, A and B are U.S. citizens and residents in the United States. Therefore, Article 1(6) US Model applies in this case as to deny the benefits of the treaty to A and B, and to confirm that the payments of interest in this case is a mere domestic situation.[976] Yet, nothing prevents the United States to also tax the interest through the application of CFC rules, which might trigger double taxation. Double taxation, however, might be avoided in this case through the application of the domestic U.S. tax credit system.[977]

4.2.1.4. Example 4: Domestic partnership with U.S. owners

Let us assume now that a U.S. partnership (USP) has two owners, A and B, who are both U.S. citizens. Accordingly, some interest payments are paid

[976] The denial of the benefits of the treaty includes also the possibility that A and B claim the reduced WHT at source. In other words, it could not be argued that the source State should still reduce its WHT as per Article 11 US Model and that the benefits of the treaty to A and B are limited only to the double taxation relief of Article 23 US Model.

[977] US: I.R.C. Sec. 960 provides for a FTC with respect to the taxes paid at the level of the foreign subsidiaries. If a Corporation calims the credit (not as in the example above), the applicable provision is I.R.C. Sec. 902. Likewise, the deemed FTC under Sec. 960 is available for taxes paid by subsidiaries until the sixth tier. *See* McDaniel, Ault and Repetti, *supra* n. 688, p.121.

from State P. While USP is indeed tax transparent for U.S. tax purposes, State P considers it as a taxable entity. State P applies a general WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

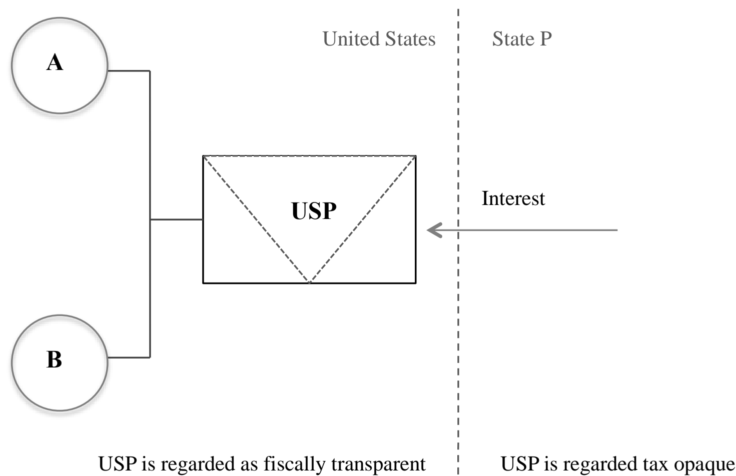


Figure 36: Example 4– Domestic partnership with U.S. owners

As well as in the other cases before, the issue here is given by the different characterization of USP, which is a tax transparent entity in the United States while it is considered a taxable entity in State P. Likewise, the solution given by Article 1(6) US Model to this case is simple: USP is a pass-through entity receiving interest from the other Contracting State. Thus, the income is allocated to the partners A and B, who are also U.S. citizens. Therefore Article 1(6) US Model acts clarifying that these persons are the ones who should claim the relief of double taxation under Article 23 of the United States/State P tax treaty and who could also enjoy the reduced

WHT at source. The solution seems to be satisfactory from the point of view of the State of residence, i.e. the United States.

From the point of view of the State of source, however, the application of Article 1(6) US Model might not solve all the conflicts as regards to the application of the treaty. Indeed, the fact that Article 1(6) US Model clarifies that A and B should be granted the benefit of the treaty, does not change the fact that State P still considers USP, and not partners A and B, as the *beneficial owner* of the interest income.[978] In other words, the reduced WHT at source as per Article 11 of the United States/State P tax treaty could still not be granted if State P considers that A and B are not the beneficial owners of the interest. The above might also generate conflicts as regards to the application of Article 23 of the United States/State P tax treaty, because the double taxation relief might in that case cover only the amount of reduced WHT and not the full amount of WHT, if State P decides not to apply the reduced WHT at source.

4.2.2. Application of Article 1(6) US Model in triangular situations

This Section turns now to analyze the application of Article 1(6) US Model to specific triangular situations. It is assumed in all cases that the intermediary entity is not a conduit company, agent or nominee. All the remaining assumptions used in the bilateral cases above, i.e. that no PE is constituted in the State of source, that all treaties include Article 1(6) US

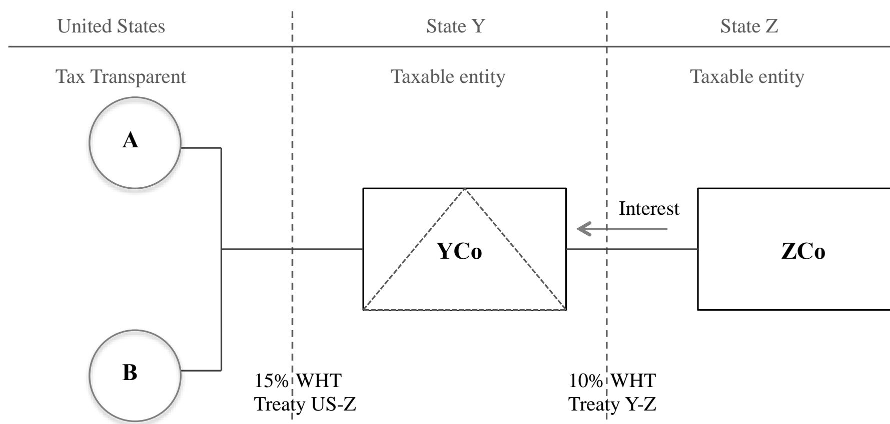
[978] See also, *infra* Section 4.3.1.

Model and in all cases the anti-abuse restrictions within domestic law and tax treaties are accomplished in order to apply Article 1(6) US Model, remain the same.

4.2.2.1. Example 5: Foreign intermediary entity with U.S. owners

Let us assume that YCo is an entity incorporated in State Y, which has two partners, A and B, who are U.S. citizens. Accordingly, YCo has a subsidiary in State Z, ZCo, which is financed by a loan granted by YCo and because of which it receives interest payments back from State Z.[979] YCo is considered as a taxable entity in State Y and in State Z. However, the U.S. partners A and B have elected to treat YCo as a fiscally transparent entity. Country Z applies a general WHT on interest paid abroad of 30% of the gross amount paid. It is also assumed that the treaty United States/State Z provides a reduced WHT of 15% while the treaty State Y/State Z provide for a reduced WHT of 10%.

[979] The example assumes that the loan and interest are arm's length.



While for U.S. tax purposes Yco is tax transparent, State Y and Z consider it as tax opaque. Likewise, State Z applies a general WHT of 30% on the payments of interest abroad. Likewise, the treaty United States/ State Z provides for a reduced WHT of 15% while the treaty State Y/State Z provide for a reduced WHT of 10%.

Figure 37: Example 5–Foreign intermediary entity with U.S. owners

According to the treaty between State Y and State Z, which it is assumed it follows the OECD Model; State Z should reduce its WHT to 10% as per Article 11 of the State Y/State Z tax treaty. Likewise, State Y should grant a relief of double taxation as per Article 23 of the State Y/State Z tax treaty. This result is achieved by the sole fact that both States coincide in characterizing YCo as a taxable entity. Therefore, the income and the benefits of the treaty are allocated to YCo.[980]

980 Even in the case State Y/State Z tax treaty would include a provision similar to Article 1(6) US Model (e.g. Article 1(2) OECD Model), it would not apply, because none of the Contracting States treat YCo as a fiscally transparent entity.

As regards to the treaty between the United States and State Z, and in particular with respect to Article 1(6) of the United Sates/State Z tax treaty, there is income received through an entity considered as tax transparent by one of the Contracting States, and which allocated to the partners A and B, who are U.S. citizens. Therefore, in principle, State Z (State of source) should accomplish with both treaties, which under the principles of the OECD Partnership Report would mean that State Z must apply the lower WHT rate (10%) as regards to both treaties. This solution would be, however, not only misaligned with the concept of *beneficial owner*,[981] but also it would leave open a potential double taxation issue.[982]

[981] The application of Article 1(6) US Model in this case would not change the fact that the source State still considers YCo as a taxable entity, and thus, as the *beneficial owner* of the interest payments. Thus, for purposes of applying Article 11 United States/State Z tax treaty, State Z could still argue that the interest are not beneficially owned by A and B in the United States.

[982] If the United States does not have a treaty with State Y, or if having a treaty, YCo is not regarded as a PE, there will be no double taxation relief for the taxes imposed at the level of YCo in State Y. A similar example was discussed at *supra* Section 3.3.2.1, referred to the unresolved conflicts of allocations under the principles of the OECD Partnership Report. Likewise, as well explained by Danon, if the same situation is analyzed as regards to a trust, being the trust and the settlor residents in State Y (using our example) and the beneficiary being resident in the United States, and having both the United States and State Y treating the trust as transparent, the relief of double taxation becomes impossible. *See* Danon, *supra* n. 882, pp. 198-199, Diagram 7. Yet, it is interesting to note, e.g. that the exchange of notes of 24 July 2011 as regards to the treaty between the United States and the United Kingdom expressly provides double tax relief in such a situation. As stated in the exchange of notes: "In the case the same item of income, profit or gain derived through a trust is treated by each Contracting State as derived by different persons resident in either State, and a) the person taxed by one State is the settlor or grantor of a trust; and b) the person taxed by the other State is a beneficiary of that trust, the tax paid or accrued by the beneficiary shall be treated as if it were paid or accrued by the settlor or grantor for the purposes of determining the relief from double taxation to be allowed by the State of which that settlor or grantor is a resident (or, in the case of the United States, a citizen) […]". US: United States response

4.2.2.2. Example 6: Foreign entity receiving U.S sourced income

Let us assume the same basic facts than in the example 5, with the difference that the United States is now the State where the interest are sourced and State X is the residence State of the partners A and B. Likewise, let us assume that YCo is treated as fiscally transparent for U.S. tax purposes while it is regarded as a taxable entity in State Y and State X. Finally, we will assume that all applicable treaties provide similar reductions of WHT of 15% at source.

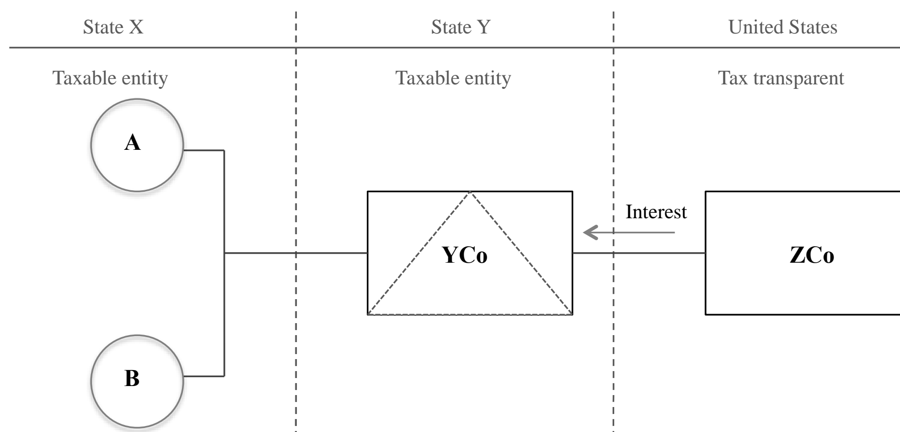


Figure 38: Example 6–Foreign entity receiving U.S. sourced income

If we first analyze the treaty between the United States and State Y, it is easy to figure out that Article 1(6) of the State Y/United States tax treaty applies as to deny A and B the benefits of the treaty. In other words, as there

to United Kingdom note setting forth additional agreements regarding the U.S.-U.K Double Taxation Convention, signed July 24, 2001, London.

is an item of income received through an entity considered in this case tax transparent in the United States (State of source), but the income is not allocated to U.S. residents, Article 1(6) of the State Y/United States ensures that the benefits are not allocated to A and B, but rather to YCo. This is to say, it is YCo, which may claim the reduced WHT under Article 11 of the State Y/United States and the relief from double taxation under Article 23. However, there is still an issue, because the application of Article 1(6) US Model in this case does not prevent the fact that, from a U.S. perspective, the *beneficial owner* of the interest might be A and B and not YCo, which is still a tax transparent entity from a U.S. perspective. In simple words, it could still be arguable that the United States limits its taxing rights and reduces its WHT to 15%, because for the United States the preconditions of Article 11 of the State Y/United States would not be met.[983]

State X, on the other hand, i.e. the State where the partners of YCo are residents, has also a treaty with the United States. In this case, Article 1(6) of the treaty State X/United States applies also as to deny the benefits of that treaty to A and B, because these two are not residents of the State treating the entity a tax transparent, i.e. the United States. The application of Article 1(6) of the State X/United States, however, does not solve the question as regards to who is the *beneficial owner* of the interest. In this case, it seems to be clear that the United States will still consider A and B as the beneficial owners of the interest and not YCo. Thus, the United States might still decide to apply Article 11 of the State X/United States as regards to A and

[983] See also *infra* Section 4.3.1.

B, even though by application of Article 1(6) of the State X/United States, these two are not entitled to the benefits of the treaty.[984]

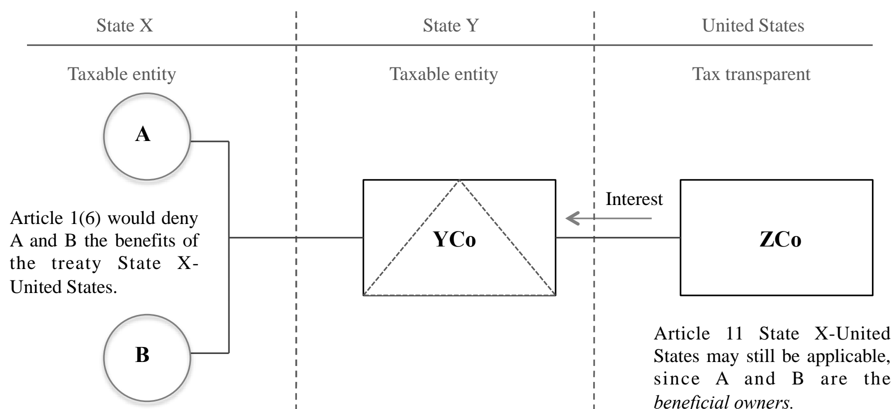


Figure 39: Ex. 6 – Art. 1(6) v. Beneficial Owner (Art. 11)

By other side, even in the hypothetical that A and B were U.S. residents, the preconditions of Article 11 of the State X/United States would not be met, i.e. there would not be a payment of interest arising in a Contracting State and being beneficially owned in the other Contracting State.[985] On the contrary, in this case, interest would arise and would be paid to residents of the same State. This situation would be thus a mere domestic one.

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984 Id.

985 Article 11(1) of the US Model states: "Interest arising in a Contracting State and *beneficially owned* by a resident of the other Contracting State may be taxed only in that other State" (emphasis added). US: 2006 United States Model Income Tax Convention of 15 November 2006, Article 11(1).

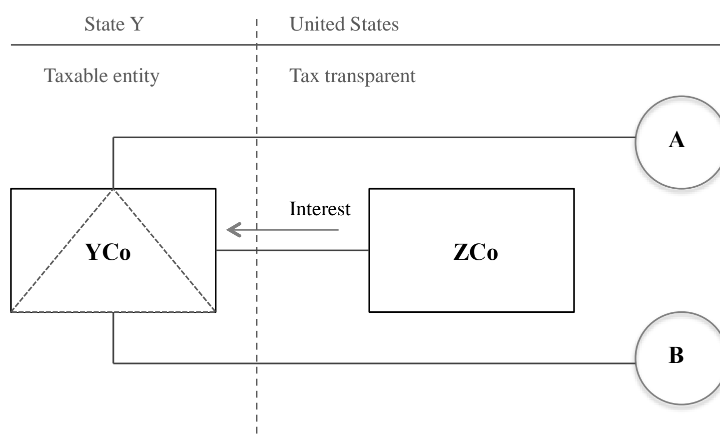

Figure 40: Ex. 6– Variation: A and B are U.S. owners

4.2.2.3. Example 7: U.S. intermediary partnership

Let us assume now that a U.S. partnership P has two foreign owners, A and B, who are residents of State X. Accordingly, it receives interest payments from ZCo, an entity organized in State Z. While the U.S. partnership P is fiscally transparent in the United States, it is considered as a taxable entity in both State X and State Z. Country Z has a general WHT on interest paid abroad of 30% of the gross amount paid. It is also assumed that both the treaty United States/State Z and the treaty X- Z provide for a similar reduced WHT of 10%.

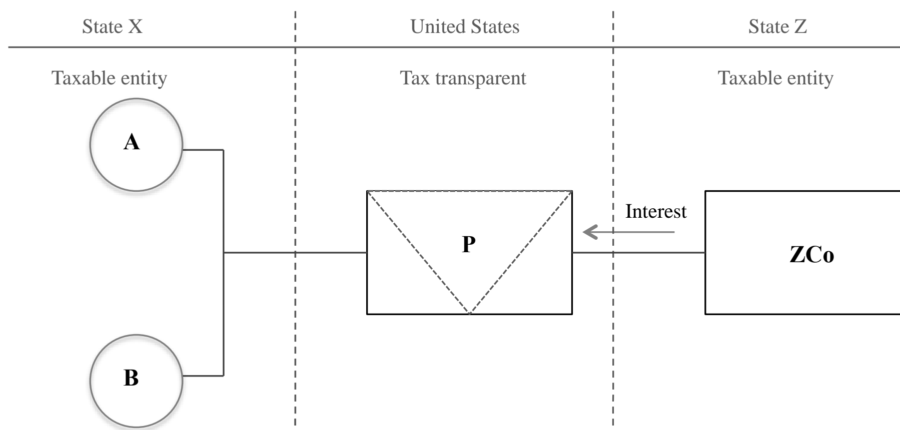

Figure 41: Example 7–U.S. intermediary partnership

Article 1(6) US Model works in this case as denying A and B the access to the benefits of the treaty United States/State Z. Indeed, only to the extent A and B were U.S. residents or citizens could access to the benefits of such treaty as per Article 1(6) of the United States/State Z tax treaty. Nevertheless, as the tax characterization of U.S. partnership P in the United States has not changed, the treaty is not applicable from a U.S. perspective anyway, because P is not a resident for purposes of the treaty.[986] From State Z's perspective, however, the treaty might still perfectly applicable, because P is for its tax purposes a taxable entity. The tax characterization of YCo has not changed by reason of Article 1(6) of the United States/State Z tax treaty. Therefore, it might be that State Z still decides to limit its taxing rights and reduces its WHT to 10%. This would not be, however, an optimal result for State Z.

[986] Article 4 of the 2016 US Model.

The treaty X-Z, on the other hand, is clearly not applicable in this case, because both Contracting States consider P as a taxable entity. This is to say, neither of them consider that the interest payments are being paid to A and B. This conclusion does not change at all if a provision similar to Article 1(6) US Model is introduced within the treaty State X/State Z, because in such a case the precondition for the application of the provision that income is received through a fiscally transparent entity, regarded as such by at least for one of the Contracting States, is not met.[987]

4.3. The interplay of Article 1(6) US Model with other tax treaty and domestic provisions

As noted in the illustrations above, Article 1(6) US Model provides a practical solution as regards to the question of who should be granted the benefits of a treaty when income is received through a transparent entity. Nevertheless, this provision cannot be analyzed in isolation.

This Section provides some examples where the interplay between Article 1(6) US Model and other tax treaty and domestic provisions are either not entirely clear or they simply conflict with each other.[988]

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[987] Compare the analysis at *infra* Section 5.2.2.3 (Example 7) as regards to Article 1(2) OECD Model.

[988] Although some of these issues have been already mentioned in the illustrations of *supra* Sections 4.2.1 and 4.2.2 (e.g. the interplay with the concept of *beneficial owner*) they are systematically analyzed in this Section.

4.3.1. The (still missed) interplay with the concept of *Beneficial Owner*

As stressed already, the solution provided by Article 1(6) US Model as regards to who should enjoy the benefits of a tax treaty when income is received through an entity considered as tax transparent at least for one of the Contracting States, is not always aligned with the requirement of Articles 10, 11 and 12 US Model, that income should be *beneficially owned* by a resident of the other Contracting State.[989]

Although the concept of beneficial owner is not defined within the US Model, it is stated that its determination is made under the law of the State imposing the tax, i.e. the State of source.[990] For example, as provided in the Technical Explanations regarding Article 11 US Model used in the illustrations above:“[t]he *beneficial owner* of the interest for purposes of Article 11 is the person to which the income is attributable under the laws of the source State”.[991] Thus, if a person receiving the interest is acting as an agent or nominee, regardless of being resident, it will not be considered the

[989] Although the author recognizes that the concept of *beneficial owner* is indeed conflictive, it is not the intention of this work to provide an exhaustive analysis of it. That would certainly exceed the purpose of this work. For a further study of the concept, however, *see* the references at *supra* n. 326. Likewise, the analysis of the concept of *beneficial owner* as regards to its interpretation as avoiding DNT within the OECD Model can be found at *supra* Chapter II, Section 3.2.

[990] US: Technical Explanation of the United States Model Income Tax Convention of 15 November 2006, p. 33 referred to paragraph 3, Article 10 US Model (Dividends) and p. 42 referred to paragraph 1, Article 12 (Royalties).

[991] Id., p.39 referred to paragraph 1, Article 11 (Interest).

beneficial owner of them.[992] Therefore, the *beneficial ownership* requirement should still be relevant as to determine the application of Article 11 US Model, regardless the results achieved of Article 1(6) US Model.

The conflictive interplay between the results of Article 1(6) US Model and the *beneficial ownership* requirement was illustrated in some examples analyzed in the previous Section of this Chapter.[993] For instance, in Example 4 above, it is evident that the solution of Article 1(6) US Model in order to grant the benefit of the treaty United States/State P to A and B, the partners of USP (a U.S. partnership), does not prevent the State of source (State P) to consider USP (a taxable entity under the domestic laws of State P) as the beneficial owner of the interest.[994] In other words, State P could perfectly deny the reduced WHT to A and B, who are residents but not beneficial owners as per the rule of the State of source.[995] Similarly, e.g. the strict application of Article 1(6) US Model in example 5 reveals again the misalignment between the provision and the *beneficial owner* requirement of Article 11 US Model.[996] In this case, the entity receiving the interest is considered a taxable entity both in the State of source (State Z) and the State of organization of the entity (State Y).[997] Thus, A and B, U.S. partners, obtain the benefits of the treaty United States/State Z, even with a more

[992] Id.
[993] *Supra* Section 4.2.
[994] *Supra* Section 4.2.1.4.
[995] Id.
[996] *Supra* Section 4.2.2.1.
[997] Id.

reduced WHT of 10% because of the application of the OECD partnership solution when the two applicable treaties provide for different rates of reductions of WHT, regardless the fact that the State of source might still consider YCo as the *beneficial owner.*

The US Model does not provide any hints as to solve this conflictive position between the solution of Article 1(6) US Model and the concept of *beneficial owner* in Articles 10, 11 and 12 US Model.

4.3.1.1. Alternatives approaches within the U.S. tax treaty practice

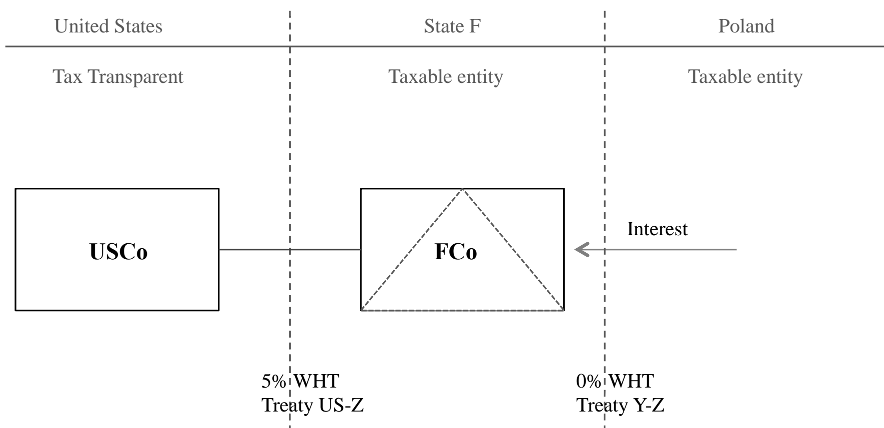
Despite the US Model does not directly assume the interplay between Article 1(6) and the concept of *beneficial owner* in Article 10, 11 and 12 US Model, some solutions to this conflictive position between the two provisions might be found within the U.S. tax treaty practice. As follows the author stresses two different solutions. The first one is found within the Poland/United States Tax Treaty (2013) and implies the non-application of Article 1(6) under some circumstances. Although this rule seems to be oriented for a different purpose, it indirectly helps solving the conflictive position between Article 1(6) and the *beneficial ownership*'s requirement. The second one is found within the Canada/United States Tax Treaty (1980 as amended in 2007), and attempts directly to solve the conflict through a rule that deems who should be the *beneficial owner*.

4.3.1.1.1. Poland/United States Tax Treaty

The treaty between the United States and Poland contains a provision, which provides that Article 1(6) US Model is not applicable if certain conditions are met. As stated in Article 1(6)(b) of the treaty United States-Poland: "Subparagraph a) shall not apply to an item of income, profit or gain if the entity described in subparagraph a) is not fiscally transparent under the laws of the State in which the income, profit or gain arises, is organized in a third state, and is eligible for benefits under a convention for the avoidance of double taxation between the third state and the State in which the income, profit or gain arises with respect to that item of income, profit or gain that are more favorable than the benefits provided by the provisions of this Convention with respect to that item".[998] Therefore, at least three preconditions should be met in order to disallow the application of the general rule contained in Article 1(6)(a) US-Poland treaty: (i) that the entity is considered as tax opaque under the law of the State where the interest payments are sourced; (ii) that the entity receiving the interest payments is organized in a third State (i.e. neither the United States nor Poland), and (iii) that the entity in this third State is eligible for the benefits of a treaty with the State of source, and which are more favorable than the benefits provided by the United States-Poland tax treaty.

[998] US/PL: Article 1(6)((b) of the Convention between the United States of America and the Republic of Poland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of 13 Feb. 2013.

Let me illustrate the application of this rule using an example similar than Example 5 above, although with some modifications.[999] Let us assume that a U.S. Corporation (USCo), resident in the United States, is the sole owner of FCo, an entity organized in State F. Accordingly, FCo receives interest payments from Poland. While for U.S. tax purposes, FCo is regarded as a tax transparent entity, for Polish and State F tax purposes is considered as a tax opaque entity. Likewise, while the treaty State F/Poland provides for a reduced WHT of 0%, the treaty United States/Poland provides for a reduced WHT of 5%.



The preconditions of Article 1(6)(b) US-Poland tax treaty are met. Thus, Article 1(6)(a) US-Poland tax treaty [Article 1(6) US Model] does not apply in this case. In other words, USCo is not deemed as deriving the interest payments.

999 This example is inspired in the one used within the Technical Explanations of the treaty United States/Poland. US/PL: Department of the Treasury Technical Explanation of the Convention Between the United States of America and the Republic of Poland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of 13 Feb. 2013, pp. 6-7. For example 5, *supra* Section 4.2.2.1.

Figure 42: Article 1(6)(b) United States/Poland double tax treaty

All the preconditions for the non-application of Article 1(6) US Model are thus met, i.e. FCo is considered by Poland as a taxable entity; FCo is organized in State F (a third State), and FCo, as a taxable entity in State F, is eligible to the benefits of the treaty between State F and Poland, which also provides for a more beneficial reduction of WHT when compared with the treaty United States/Poland. In this case, therefore, USCo is not deemed as deriving the interest payments, and thus, it is not entitled to the benefits of the treaty United States/Poland.

The solution given within the United States/Poland tax treaty is unique, since it is not included in other tax treaties signed by the United States, which also include Article 1(6) US Model within their texts.[1000] Likewise, the solution aligns in a better manner the allocation of the benefits of the treaty and the concept of *beneficial owner*, since it is evident that for the State of source (Poland), the beneficial owner of the interest payments is FCo and not USCo, since FCo is regarded in this country as a taxable entity.[1001] Therefore, if the application of Article 1(6) of the United States/Poland tax treaty would imply that a reduced WHT is also granted to USCo, this would most probably conflict with the fact that Poland would not consider USCo as the beneficial owner of the interest. Accordingly, and to certain extent, the solution seems to be more beneficial for the State of

[1000] Nevertheless, one should bear in mind that this provision seems to be the result of a bilateral negotiation and it is not included within the US Model.

[1001] Although it is arguable to say that this solution was created for that exclusive purpose. In fact, it seems to be more connected with the idea of avoiding double benefits obtained from treaties in triangular cases.

source, which must not limit its taxing rights just because of a different characterization of an entity given in the State of residence of the partners of that entity, when the entity is considered as a taxable entity by the State of source.[1002]

4.3.1.1.2. Canada/United States Tax Treaty

Another solution can be found within the Technical Explanations to the Protocol 2008, referred to the 2007 amendment to the Canada/United States tax treaty (1980), which specifically clarifies the interaction between Article IV(6) and IV(7) of the Canada/United States tax treaty [Article 1(6) US Model] and the concept of *beneficial owner* in Articles 10, 11 and 12 of the same treaty.[1003] According to the Technical Explanations to the Protocol 2008: "Special rules apply in the case of income, profits or gains derived through a fiscally transparent entity, as described in new paragraph 6 of Article IV. Residence State principles determine who derives the income, profits or gains, to assure that the income, profits or gains for which the source State grants benefits of the Convention will be taken into account for tax purposes by a resident of the residence State. Source country principles of beneficial ownership apply to determine whether the person who derives the income, profits or gains, or another resident of the other Contracting

[1002] The characterization of the entity in State F seems to be completely irrelevant, as it is also confirmed today within the U.S. Technical Explanations of the 2006 U.S. Model. US: Technical Explanation of the United States Model Income Tax Convention of 15 November 2006, p. 6.

[1003] US/CA: Convention between Canada and the United States of America with respect to Taxes on Income and on Capital of 26 Sep. 1980 (As amended through 2007), Articles IV (6) and IV (7).

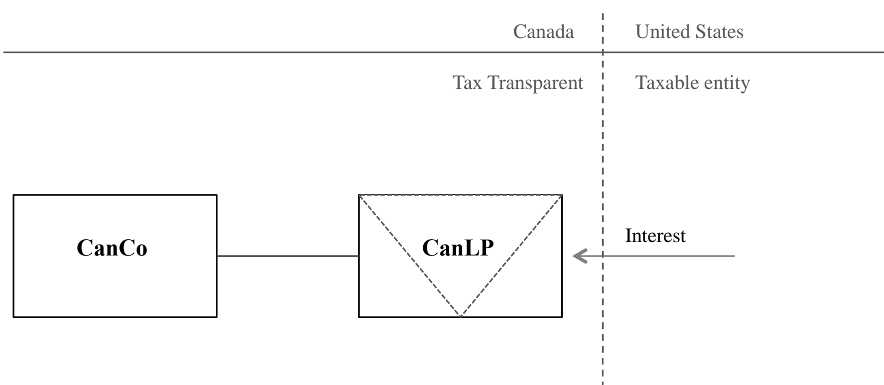
State, is the beneficial owner of the income, profits or gains. The source State may conclude that the person who derives the income, profits or gains in the residence State is a mere nominee, agent, conduit, etc., for a third country resident and deny benefits of the Convention. If the person who derives the income, profits or gains under paragraph 6 of Article IV would not be treated under the source State's principles for determining beneficial ownership as a nominee, agent, custodian, conduit, etc., that person will be treated as the beneficial owner of the income, profits or gains for purposes of the Convention".[1004] In simple words, the State of source should determine whether the partner(s) of a fiscally transparent entity, considered as such by the State of residence, is an agent, nominee, custodian or conduit or not, i.e. whether this is or not the *beneficial owner*. If the State of source considers that the partner deriving the income under Article IV (6) of the Canada/United States tax treaty is indeed an agent, nominee, custodian or conduit for a non-resident of the other Contracting State, then it may deny the benefits of Article 11 Canada/United States tax treaty. However, if the State of source still considers that the partner deriving the income under Article 1(6) is indeed an agent, nominee, custodian or conduit, but for a resident of the other Contracting State, then it should grant the benefits of the treaty anyway.[1005] The solution seems thus to assimilate the concept of

[1004] US/CA: Technical Explanation of the Protocol done at Chelsea on September 26, 2007 amending the Convention between the United States of America and Canada with respect to Taxes on Income and on Capital done at Washington on September 26, 1980, as amended by the Protocols of June 14, 1983, March 28, 1994, March 17, 1995 and July 29, 1997, p. 9.

[1005] Id.

resident and *beneficial owner*, at least for purposes of application of Article 1(6) US Model.

The above might be illustrated using the same example provided within the Technical Explanations.[1006] Let us assume a Canadian entity CanLP, which is considered as fiscally transparent in Canada, but as a taxable entity in the United States, and which receives interest payments sourced in the United States. Accordingly, CanCo, a company resident in Canada, wholly owns CanLP.



Even if the United States considers CanCo to be a nominee, agent, custodian or conduit, i.e. not a *beneficial owner*, it should allocate the benefits of Article 11 of the Canada/United States tax treaty if CanCo is a nominee, agent, custodian or conduit of a *Canadian resident*.

Figure 43: Example from the Technical Explanations to the Protocol 2008

According to Article IV (6) of the Canada/United States tax treaty [Article 1(6) US Model], it is CanCo which derives the interest payments and which should enjoy the reduced WHT of Article 11 of the Canada/United States

[1006] Id.

tax treaty.[1007] Likewise, the United States, the source State in this case, should consider CanCo as the *beneficial owner* of the interest, unless this is found to be a nominee, agent, custodian or conduit for a person who is not a resident of Canada.[1008] However, and even if the United States considers CanCo to be a nominee, agent, custodian or conduit, i.e. not a *beneficial owner*, it should allocate the benefits of Article 11 of the Canada/United States tax treaty if CanCo is a nominee, agent, custodian or conduit of a Canadian resident.[1009]

Even though this author recognizes that the solution given by the Canada/United States treaty is practical and solves the conflictive position between the two provisions under analysis, it might rarely be used within the US Model as a standard solution, because in fact it represents an exception to the rule that the *beneficial owner* is determined exclusively under the domestic laws of the State of source. Indeed, nothing within Article 1(6) US Model provides that the characterization of the entity by the State of source should be changed by application of this provision. Thus, it is still expected that the State of source (in absence of the explanation included within the Technical Explanations above) keeps considering a tax opaque entity as the *beneficial owner* of the interest paid. The success of the solution provided is thus tied to the commercial relations between the States negotiating the treaty, i.e. the United States and the other Contracting State. A solution such as the one found within the Canada/United States tax treaty certainly

[1007] Id.
[1008] Id.
[1009] Id.

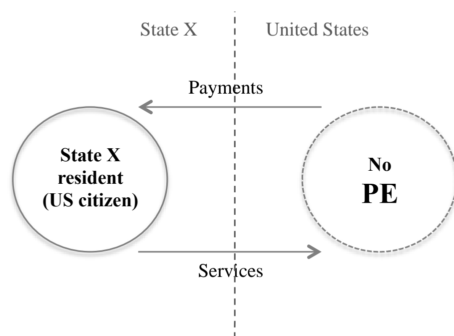
responds to that pattern of close economic connections. In spite of the above, this rule has been recently proposed as a solution that might be applicable within the OECD Model as regards to the conflict between Article 1(2) OECD Model and the beneficial ownership's requirement of Articles 10, 11 and 12 OECD Model. [1010]

4.3.2. The interplay with the *"saving clause"* [Article 1(4) US Model]

Article 1(6) US Model must also be analyzed as regards to its interplay with Article 1(4) US Model. This provision contains the traditional *"saving clause"* found in all the tax treaties signed by the United States, which basically establishes that the Contracting States reserve their rights to tax their residents and citizens as provided in the internal laws, notwithstanding any tax treaty provision to the contrary.[1011] As provided within paragraph 4, Article 1 US Model: "Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, for the period of ten years following the loss of such status, be taxed in accordance with the laws of that Contracting State". [1012] A simple example of the saving clause's

[1010] This proposal is analyzed at *infra* Sections 5.3.1.1; 5.3.1.2 and 5.3.1.3.
[1011] McDaniel, Ault and Repetti, *supra* n. 688, p. 181.
[1012] Article 1(4) of the 2016 U.S. Tax Treaty Model.

application would be a person resident in the other Contracting State, and also U.S. citizen, who renders services in the United States without constituting a PE. Under normal circumstances, and in application of Article 7 of the US Model, the United States would be prevented from taxing this income, because in fact there is no PE in the United States. However, as the resident of the Contracting States is also a U.S. citizen, the United States reserves the right to tax this citizens and resident on his worldwide income, overriding the application of the treaty. [1013]



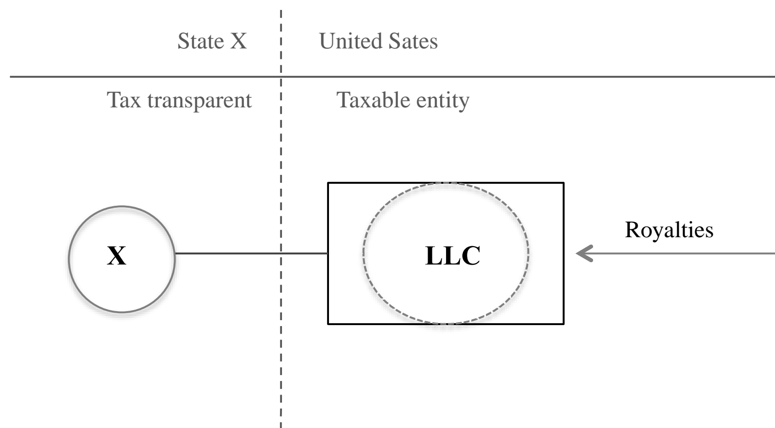
In principle, there are a no profits attributable to a PE in the United State. Thus, the United States should refrain from taxing the payment from services. However, as the State X resident is also a U.S. citizen, Article 1(4) US Model applies disregarding the treaty.

Figure 44: Example of the saving clause's application

[1013] Example taken from the US: Technical Explanation of the United States Model Income Tax Convention of 15 November 2006, p. 3. The application of the saving clause was also a key issue in: UK: CA, 23 Mar. 2011, *Bayfine UK v. Commissioner for H M Revenue and Customs*, [2011] EWCA Civ 304, Tax Treaty Case Law IBFD. In this case, while the United Kingdom claimed exclusive rights to tax since no PE was constituted in the United States, the United States applied taxation according to Article 1(3) of the U.K-U.S. tax treaty [*saving clause*]. For a more detailed analysis, considering all the other factors involved within the case, *see* B. Arnold, Tax Treaty News, 64 Bull. Intl. Taxn. 10 (2010), Journals IBFD, pp. 495-496. *See also*, Cleave, *supra* n. 321.

With respect to the specific interplay between Article 1(4) US Model [*saving clause*] and Article 1(6) US Model [*transparent entities*], it might be illustrated as follows. Let us assume the case of a U.S. LLC owned by a resident of State X and receiving royalties sourced in the United States. The sole owner of the LLC decides to treat the LLC as a U.S. Corporation according to the CTB election, although this is still considered as fiscally transparent in State X.[1014] In this scenario, the United States will tax the LLC on its worldwide income on a net basis, regardless of whether the other Contracting State (State X) views the LLC as fiscally transparent. In other words, under a strict application of Article 12 US Model, the royalties should be taxed exclusively in State X, at the level of resident X, who is the sole owner of the LLC receiving the income and being entitled to the benefits of the treaty United States/State X according to Article 1(6) US Model. Nonetheless, the United States reserves its right to tax the LLC on its worldwide income, which includes the royalties sourced in the United States.

[1014] The example is inspired in the explanation of the interplay in the US: United States Model Technical Explanation accompanying the United States Model Income Tax Convention of 15 November 2006, p.7. The example also mirrors example 17 of the OECD Partnership Report. *See* OECD (1999), *supra* n. 1, p. 47.



Regardless that Article 1(6) US Model grants the benefits of the treaty to Resident X, as the LLC is treated as non-fiscally transparent in the United States, the United States reserves its right to tax the LLC on its worldwide income, because of Article 1(4) US Model.

Figure 45: Saving clause and Article 1(6) US Model

The application of the saving clause, therefore, raises concern as regard to the double taxation relief in State X (Article 23), because unless an indirect tax credit is provided, the partner X will be taxed in State X on the same income already taxed in the United States, but with no double taxation relief under the treaty.[1015] Yet, the interpretation of Article 23 US Model as to grant an indirect tax credit is still arguable.[1016]

[1015] In practice some countries grant an indirect tax credit. *See* J. Lüdicke, *Exemption and Tax Credit in German Tax Treaties: Policy and Reality*, 64 Bull. Intl. Taxn. 12 (2010), Journals IBFD, p. 615; W. Schön, *International Tax Coordination for a Second-Best World (Part II)*, 2 World Tax J. 1(2010), Journals IBFD, p. 67. *See also*, Kollmann, Roncarati and Staringer, *supra* n. 954, p. 24.

[1016] In contrast, if e.g. a USCo is the sole owner of a foreign entity receiving royalties from the same State where this is a resident, and considered as tax transparent for U.S. tax purposes, an indirect tax credit would be granted to the extent the USCo owns at least 10% of the foreign subsidiary and receives dividends from this latter. US: IRC Sec. 902. This indirect tax credit is, nonetheless, granted under domestic law and it does not imply

4.3.3. Article 1(6) US Model and the CTB regulations

As already analyzed in Chapter III, the CTB regulations allow certain foreign business entities to be classified in a manner different from that provided in their countries of incorporation so long they are not regarded as *per se* Corporations for U.S. tax purposes.[1017] These entities, denominated *eligible entities*, may elect their tax treatment for U.S. tax purposes.[1018] Therefore, if a U.S. LLC is generally consider as a disregarded entity, the foreign owner may elect to treat it as a taxable entity for U.S. tax purposes. Accordingly, if a foreign partnership is regarded in its country of organization as fiscally transparent, the U.S. partners might elect to treat it as a taxable entity for U.S. tax purposes.[1019]

The possibility to re-characterize foreign entities for U.S. tax purposes does not only increase the number of possible disparities in the tax characterization of entities, giving rise to *hybrid* and *reverse hybrid entities*, but also it might condition, to certain extent, the application of Article 1(6) US Model. For example, in Example 1 above, the CTB election seems to be the true reason to trigger the application of Article 1(6) US model.[1020] Indeed, in absence of the election, the treaty between the United States and State P should not be applicable at all and the interest payment received by

to interpret Article 23 US Model as to granting an indirect tax credit. This interpretation of the Article 23 would be certainly very extensive.

1017 US: Treas. Reg. Sec. 301.7701-2(b)(8) states the list of *per se* Corporations.

1018 *Supra* Chapter III, Section 4.3.

1019 Id.

1020 *Supra* Section 4.2.1.1.

entity P should not go beyond of being a domestic concern.[1021] Thus, the domestic CTB election in this case is the cause of the application of the treaty and the allocation of the benefits to A and B, U.S. owners of entity P.[1022] The same situation might occur in the other way around. As noted in Example 3 above, it is the election to treat entity P, a foreign fiscally transparent entity, as tax opaque for U.S. tax purposes, which conditions the application of Article 1(6) US Model, in this case as to deny the benefits of the treaty to A and B and ensures the non-application of the treaty.[1023]

In some triangular situations, the benefits of treating a foreign entity as tax transparent might give rise to the application of a more beneficial tax treaty under Article 1(6) US Model. Let me recall Example 5 above, where by the sole fact that A and B, U.S. owners of a foreign entity organized in a third country and treated as fiscally transparent under the CTB election in the United States, might benefit from a reduced WHT under a tax treaty different from that between the United States and the State of source of the income.[1024] This situation, however, as already stressed, is elegantly solved within the U.S. treaty practice, making a "switch-off" in the application of Article 1(6) US Model where the entity receiving the interest is considered as tax opaque under the law of the State of source; the entity is organized in a third State and it is eligible for the benefits of a treaty with the State of

[1021] Id.
[1022] Id.
[1023] *Supra* Section 4.2.1.3.
[1024] *Supra* Section 4.2.2.1.

source, which are more favorable than the benefits provided by the treaty between the United States and the State of source.[1025]

All in all, the possibility of electing the tax treatment of a given entity organized within or outside the United States, should be considered as an important tool to determine the application of Article 1(6) US Model, and thus, the application or not of the benefits of a tax treaty to certain residents. In this case, unlike the tax planning opportunities analyzed in Chapter III with respect to the application of CFC rules or the use of a FTC,[1026] which also depend on the design features of these domestic rules (i.e. CFC rules and FTC), the CTB election seems to play a more direct role when analyzing the application of Article 1(6) US Model and the access or not to the benefits of a tax treaty.

4.3.4. Article 1(6) US Model and I.R.C. Sec. 894(c)

As well as Article 1(6) US Model, domestic I.R.C. Section 894(c) addresses the issue of hybrid entities, and thus, should be considered when analyzing the scope of application of Article 1(6) US Model. This domestic provision specifically states that a foreign person shall not be entitled to a reduced WHT granted by a treaty to the extent income is not attributed to that

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[1025] US/PL: Article 1(6)(b) of the Convention between the United States of America and the Republic of Poland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of 13 Feb. 2013. *See also* the analysis at *supra* Section 4.3.1.1.1.

[1026] *Supra* Chapter III, Section 4.4.

foreign person in the foreign country, the treaty does not contain a provision addressing the cases of income received through a transparent entity, and the foreign country does not impose a tax on the distribution of that income from the entity to such person.[1027]

The U.S. Treasury Regulations under Section 894(c) adopt different approaches depending on whether there is a *"domestic reverse hybrid"* involved or not.[1028] As per the definition in the Treasury Regulations, a *domestic reverse hybrid* entity is a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the person holding the interest in the entity in the other State.[1029] For example, a U.S. LLC whose non-resident sole proprietorship elected to treat as a Corporation in the United Sates (i.e. a taxable entity), while it is considered as fiscally transparent in his State of residence.[1030] A "*non-reverse domestic hybrid"* entity is exactly the opposite, i.e. an entity considered as fiscally transparent in the United States and/or any other jurisdiction. The rules under Section 894(c) apply differently in one case and the other.[1031]

[1027] US: I.R.C. Sec. 894(c)

[1028] McDaniel, Ault and Repetti, *supra* n. 688, p. 85.

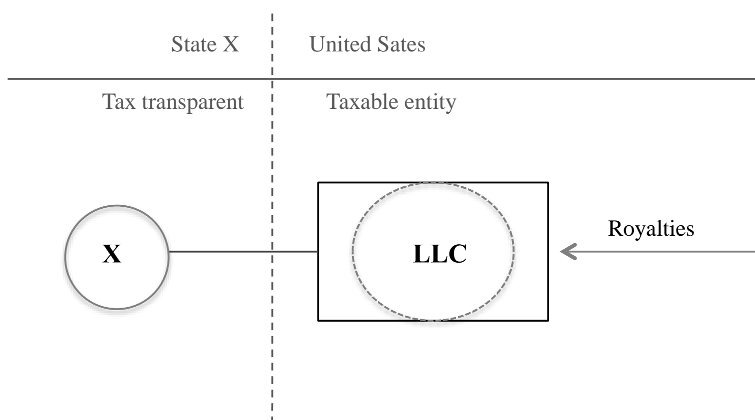
[1029] US: Treas. Reg. Sec. 1.894-1(d)(2)(i). The reference to "reverse hybrid entity" should not be thus confused with the traditional distinction between hybrids and reverse hybrid entities. *Supra* Chapter III, Section 3.

[1030] *See* example at *supra* Section 3.2.3.2.

[1031] US: Treas. Reg. Sec. 1.894-1(d)(2)(i).

As regards to *domestic reverse hybrid entities*, a distinction must be made with respect to payments received by a domestic hybrid entity or payments made by a domestic hybrid entity.[1032] With respect to payments received by a domestic hybrid entity, a tax treaty cannot reduce the tax applied to such payments that are from U.S. sources.[1033] Thus, even though another country might tax a foreign holder of interest in the entity as regards to the US sourced income; the United States will not apply the tax treaty rates to such person.[1034] In simple words, the foreign interest holders of a domestic reverse hybrid entity are not entitled to the benefits of a reduction of U.S. income tax according to a tax treaty in which the United States is part, when items of income received by such entity and sourced in the United States. Let me illustrate the above with the example from the Section 4.3.2 above assuming the case of a U.S. LLC owned by a resident of State X and receiving royalties sourced in the United States. The sole owner of the LLC decides to treat the LLC as a U.S. Corporation according to the CTB election, although this is still considered as fiscally transparent in State X. We will also assume that there is no Article 1(6) US Model included within the treaty United States/State X.

[1032] US: Treas. Reg. Sec. 1.894-1(d)(2)(ii)(A) and Treas. Reg. Sec. 1.894-1(d)(2)(ii)(B).
[1033] US: Treas. Reg. Sec. 1.894-1(d)(2)(i).
[1034] McDaniel, Ault and Repetti, *supra* n. 688, p. 85.



I.R.C. Section 894(c) provides that the interest holder X will not enjoy a reduced WHT, regardless that according to State X, the royalties are received by him.

Figure 46: I.R.C. Sec. 894(c)'s illustration

In this case, I.R.C. Section 894(c) provides that the interest holder X will not enjoy a reduced WHT, regardless that according to State X, the royalties are received by him. This provision might thus be interpreted as a protection of the base erosion at source and acts indeed as a complementary rule when Article 1(6) US Model has not been included within a tax treaty signed by the United States.[1035] Nonetheless, from a point of view of treaty obligations, the provision is indeed arguable, since basically operate as a treaty override.[1036] For example, if we assume that State X does not include

[1035] This is interpreted from the wording of I.R.C. Sec. 894(c), which requires that "the treaty does not contain a provision addressing the cases of income received through a transparent entity […]". US: I.R.C. Sec. 894(c).

[1036] The above practice should not be, however, a surprise since Article VI of the United States Constitution provides that international treaties and domestic legislation are in equal footing. Therefore, where tax treaties and legislative provisions conflict with each other, domestic legislation prevails. *See* McDaniel, Ault and Repetti, *supra* n. 688, p.

Article 1(6) US Model, but it recognizes strictly the principles of the OECD Partnership Report, introduced within the OECD Commentaries, the result should be the same as if the provision were introduced within the tax treaty with the United States. In such a case, however, this domestic provision will apply as denying the treaty benefits to a resident of the other Contracting State.[1037]

As regards to payments made *from* a domestic reverse hybrid entity, these payments will be characterized for tax treaty purposes as being paid by a non-transparent entity.[1038] Therefore, in the example above, if a payment is made from the U.S. LLC to its sole proprietorship in State X, it will be considered as a payment made from a tax opaque entity in order to apply the

178. However, the courts in the United States have also been clear that when legislative provisions override tax treaty obligations, this must be expressly stated within the domestic provision. *See*, e.g. US: *Cook v. United States*, 288 US 102 (1933). *See also*, US: Restatement (Third) of Foreign Relations Law of the United States (1987), Sec. 114(1). The issue as regards to the relation between treaties and domestic legislation was expressly addressed in US: I.R.C. Sec. 7852(d)(1), which provides: “For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law”. Likewise, US: I.R.C. Sec. 894(a) states: “The provisions of this title shall be applied to any taxpayer with *due regard* to any treaty obligation of the United States which applies to such taxpayer” (emphasis added). Yet, as provided by McDaniel et al.: “The extent to which these legislative changes will in fact affect the relation between treaties and statutes remains for the courts to decide in the context of particular situations of conflict that may arise in the future”. McDaniel, Ault and Repetti, *supra* n. 688, p. 179.

[1037] Thus, the application of this domestic provision as to deny the benefits of a treaty for certain payment received through hybrid entities will be prevented only to the extent that the other Contracting State agrees in introducing Article 1(6) US Model within its treaty with the United States and accomplishes also with the other preconditions of US: I.R.C. Sec. 894(c).

[1038] US: Treas. Reg. Sec. 1.894-1(d)(2)(ii)(A).

United States/State X tax treaty.[1039] Likewise, the Treasury Regulations provide special rules when the domestic reverse hybrid entity has received a tax-free dividend from a domestic subsidiary.[1040] In such a case, the payment from the domestic reverse hybrid to its interest holder abroad is considered as non-deductible dividend, regardless that it is in fact an interest payment.[1041]

On the other hand, the Treasury Regulations provide that in case of a "*non-reverse domestic hybrid"* entity, i.e. an entity considered as fiscally transparent in the United States and/or any other jurisdiction, an item of income shall be eligible for a reduced WHT under the treaty in which the United States is part of, only to the extent that an item of income is considered as derived by a resident for purposes of the treaty.[1042] Thus, the income might be derived by an entity receiving the income if this is considered as tax opaque in its jurisdiction, or if the entity is considered as fiscally transparent, it will be considered derived by the persons holding an interest in that entity to the extent the interest holder is not considered as fiscally transparent in its jurisdiction.[1043] Thus, it is possible to conclude that the taxing jurisdiction exercised over the item of income controls the

1039 Id.
1040 US: Treas. Reg. Sec. 1.894-1(d)(2)(ii)(B).
1041 Id.
1042 US: Treas. Reg. Sec. 1.894-1(d)(1).
1043 Id.

application of the treaty benefits as regards to *"non-reverse domestic hybrids".*[1044]

Yet, if all countries around the world decided to implement, bilaterally or multilaterally, Article 1(2) OECD Model, it seems to be, in principle, unnecessary that a domestic provision such as I.R.C Sec. 894(c) exists. Indeed, because of Article 1(2) OECD Model income would be attributed to a foreign person in the foreign country, because of a specific treaty provision addressing the cases of income received through a transparent entity, and the foreign country would most probably impose a tax on the distribution of that income from the entity to such person. Nevertheless, the wording of I.R.C. Sec. 894(c) seems to requires not only a provision similar to Article 1(6) US Model as to grant a reduced WHT, but also that income received by a foreign person through a tax transparent entity is allocated to that person and taxed there.[1045] This latter requirement leaves open the possibility that in absence of effective taxation, I.R.C. Sec. 894(c) might still be applicable. Paradoxically, however, if all countries around the world start introducing similar domestic provisions to protect their tax bases at source, Article 1(2) OECD Model (or similar provisions), might become completely irrelevant.

[1044] McDaniel, Ault and Repetti, *supra* n. 688, p. 85.
[1045] US: I.R.C. Sec. 894(c)(1)(C).

5. The OECD Model's proposal: A Residence State's perspective

Chapter 14 of the OECD BEPS Action Plan 2 contains a detailed proposal based on the conclusions achieved within the 1999 OECD Partnership Report, and which calls for the inclusion of a positive norm within the OECD Model dealing with cases in which one or two of the Contracting States treat an entity or arrangement as fiscally transparent.[1046] Unlike the OECD Partnership Report, however, the proposed Article 1(2) OECD Model addresses not only cases of partnerships, but also any other entities considered as fiscally transparent.[1047] Likewise, and as provided within the proposal, it attempts to ensure not only that the benefits of tax treaty are granted in appropriate cases, but also that these are not granted in cases where neither Contracting State treats the income received through a fiscally transparent entity as the income of one of its residents.[1048] This provision is analyzed as follows.

[1046] OECD (2015), *supra* n. 6, p. 139 et seq. *See also* the recently released draft contents of the 2017 update to the OECD Model and the public comments received as regards to the draft. *See* OECD (2017) and OECD (2017a), *supra* n. 462.

[1047] As provided by the OECD: "The Partnership Report (OECD, 1999), however, did not expressly address the application of tax treaties to entities other than partnerships. In order to address that issue, as well as the fact that some countries have found difficult to apply the conclusions of the Partnership Report, it was decided to include in the OECD Model Tax Convention (OECD, 2014), the following provision, which will ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership report". Id., p. 139.

[1048] Id. This reference would also clarify that Article 1(2) OECD Model may also be aimed as denying treaty benefits. *See also* in this opinion: Kollman, Roncarati and Staringer, *supra* n. 954, pp. 23-24; A. Schnitger and M. Oskamp, *Empfehlungen der OECD zur Neutralisierung von "Hybrid Mismatches" auf Abkommensebene*, 23 IStR 11 (2014), p. 390.

5.1. General Interpretation of Article 1(2) OECD Model

The proposal establishes the inclusion of a new paragraph 2 of Article 1 of the OECD Model Tax Convention, which reads as follows: "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 taxation 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 the taxation by that State, as income of a resident of that State".[1049] Unsurprisingly, the wording used in the OECD proposal is very similar to that one already utilized in the 2006 US Model and it is almost identical to the 2016 US Model.[1050] The wording of the OECD provision, and the preconditions for its application are subsequently analyzed.

5.1.1. The reference to ***"income"*** (only)

The proposed paragraph 26.9 of the Commentary on Article 1 states: "The word 'income' must be given the wide meaning that it has for the purposes of the Convention and therefore applies to various items of income that are covered by Chapter III of the Convention (Taxation of Income), including, for example, profits of an enterprise and capital gains".[1051] Therefore, it is

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[1049] OECD (2015), *supra* n. 6, p. 139. This wording is ratified in the recently released draft of the 2017 update to the OECD Model. *See* OECD (2017), *supra* n. 462.

[1050] *Supra* Section 4.1.

[1051] OECD (2015), *supra* n. 6, p, 141, Proposed Commentary on Article 1(2), para. 26.9.

clear that all the range of income between Article 6 and 21 OECD Model are included within the meaning of "*income"*, including profits business profits, income from services, dividends, royalties, rental income, etc.[1052] Likewise, the proposed wording of the Commentaries allows us to conclude that "capital" (Article 22 OECD Model) is not included within the scope of Article 1(2) OECD Model.[1053] In the same order of ideas, it is possible to sustain that the reference to *"income"* and not to *"income, profit or gain"* within Article 1(6) US Model does not represent thus a substantial difference, because in both cases it is clear that the provision applies only as regards to taxes on income.[1054]

Another important issue is that Article 1(2) OECD Model applies separately to each item of income. As provided within the proposed Commentaries: "As with other provisions of the Convention, the provision applies separately to each item of income of the entity or arrangement".[1055] The above is connected with the partial transparency treatment that some entities receive at a domestic level.[1056] Using the example of trusts, the proposed

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1052 Id. This argument is based on the idea that the term *"income"* within the OECD Model should have an autonomous interpretation. In this sense, the allocation rules of Articles 6 to 21 OECD Model should govern the taxation of income and should provide guidance as regards to the meaning of the term "income". *See* Ismer/A. Blank, in: Reimer & Rust (eds.), *Klaus Vogel on Double Taxation Conventions,* Article 2 at m.no. 36.

1053 Kollmann, Roncarati and Staringer, supra n. 954, p. 19. Also in this opinion: E. Schaffer, *Chapter 5: Implications of BEPS Action 2 and its Relevance for the Application of Article 17 of the OECD Model* in: *Domestic Attribution of Income and Taxation of International Entertainers and Sportspersons: Theory and Practice of Art. 17 OECD Model Convention* (M. Lang ed., IBFD 2017), Online Books IBFD.

1054 *Supra* Section 4.1.1. *See also*, Schaffer, *supra* n. 1053.

1055 Id. 142, Proposed Commentary on Article 1(2), para. 26.12.

1056 *Infra* Section 5.1.4.

Commentaries state that, e.g. if within a trust it is established that all dividends received by the trust will go directly to the beneficiaries during the lifetime, but they will be accumulated afterwards. If one of the Contracting States considers that the beneficiary is taxable on the distributed dividends that will be accumulated, Article 1(2) OECD will apply then to the dividends as to different categories, independently that they were received in the same month.[1057]

5.1.2. Income derived *"by or through"*

Article 1(2) OECD Model requires that income is derived *"by or through"* an entity or arrangement. However, there are no hints within the proposed Commentaries as regards to the distinction that the wording of the Article attempts. Indeed proposed Commentaries on Article 1(2) OECD Model simply state: "The reference to 'income derived by or through an entity or arrangement' has a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State as to who derives that income for domestic tax purposes and regardless of whether or not that entity or arrangement has legal personality or constitutes a person as defined in subparagraph 1 a) of Article 3".[1058] In principle therefore the wording seems to be redundant.[1059]

[1057] *Supra* n. 1055.

[1058] OECD (2015), *supra* n. 6, p, 141, Proposed Commentary on Article 1(2), para. 26.8.

[1059] In the case of the wording of Article 1(6) US Model 2016, the reference to "by or through" seems to be also irrelevant since the 2006 US Model only refers to "income

Regardless the above, some authors have suggested that the reference to *"by or through"* would have the purpose of ensuring the application of Article 1(2) OECD Model, on one hand, in cases where the source State treats the entity X as transparent, and thus, considers that the income is "*derived through"* that entity, and, on the other hand, in cases where the source State treats the entity X as non-transparent (being regarded as transparent by the State of residence), and thus, that the income is "*derived by"* such entity.[1060] This interpretation has logic if one considers that Article 1(2) OECD Model does not attempt to affect the determination of persons or events in the State of source.[1061] Therefore, in other words, the wording of Article 1(2) OECD attempts to ensure that the State of source grants the benefits of a treaty to the partners of an entity (to the extent they are residents of the other State) that this State considers as tax opaque, and which in absence of this provision, would not be granted. Likewise, if the State of source sees the entity as tax transparent, it would grant the benefits of the treaty to the partners of it (in absence of Article 1(2) OECD Model). Thus, Article 1(2) OECD Model in this case ensures that these benefits, which would otherwise be granted, are denied. The wording "derived by or through" would thus reinforce the two functions as regards to the application of the provision.[1062]

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through" (not "by") and the 2006 Technical Explanations uses the terms in an interchangeable manner. *Infra* Section 4.1.2.

1060 Nikolakakis et al., *supra* n. 955, p. 303. *See also*, Schaffer, *supra* n. 1053.

1061 Nikolakakis et al., *supra* n. 955, p.303.

1062 These two functions are separately stated within the United States/Canada Tax Treaty, Articles IV(6) and IV(7). *See* United States-Canada Income and Capital Tax Treaty (as

5.1.3. The reference to *"entities or arrangements"*

The inclusion of the term *"arrangements"* within the wording of Article 1(2) OECD Model, which is not part of the wording of Article 1(6) US Model, is one of the most evident differences between from two provisions that, in principle, seem to mirror each other, also with respect to their personal scopes. Nevertheless, the absence of a clear definition of the term *"arrangements"* has left a wide shadow of uncertainty as regards to what the proper the interpretation of the OECD provision should be, and therefore, to which extent the scope of Article 1(2) OECD Model is indeed wider than the correspondent provision in the US Model.

The reference to *"arrangements"* might be interpreted, on one hand, as covering all those cases of transparent vehicles other than partnerships. As stressed already, one of the main limitations of the 1999 OECD Partnership Report was the impossibility to extent the application of the conclusions achieved to entities other than partnerships.[1063] Therefore, the reference to *"arrangements"* would attempt to cover all those alternatives businesses

amended through 2007), Tax Treaties IBFD. This distinction is, nevertheless, unusual. Nikolakakis et al., *supra* n. 1060, p. 304. Although the justification above is convincing, one should not forget that the problem with the use of the expression *"derived by"* within the OECD Model is that normally other attributive rules using similar expressions, require a connection between the income and the taxpayer receiving the income, which might be misinterpreted as regards to *"income derive by a fiscally transparent entity"*. Regardless the above, the author agrees that the clarification as regard to the two functions of Article 1(2) OECD Model is appropriate.

[1063] *Supra* Section 3.

beyond the concept of partnerships, including e.g. CIVs and trusts.[1064] Although this interpretation seems to be logic since the OECD recognizes that the Partnership Report did not properly address the application of tax treaties to entities other than partnerships, it is evident that non-corporate entities in general, and the only two examples of vehicles used within the proposed Commentaries on Article 1(2) OECD Model, might be perfectly fitted within the term *"entities"* without need of referring to *"arrangements".*[1065] Therefore, the intention of the OECD proposal seems still to be different.

As argued somewhere else already, the inclusion of the term *"arrangements"* reveals, to certain extent, the intention to set up a flexible concept that anticipates the appearance of future vehicles treated as fiscally transparent and to which income is allocated, but which are not regarded as entities.[1066] In other words, there is an intention to extent the personal scope of Article 1(2) OECD Model beyond Article 1(6) US Model. This exercise is, however, very risky. On one hand, it affects the certainty required within a treaty provision that should be very clear as regards to whom a treaty benefit is being granted. On the other hand, it leaves a wide shadow over the interpretation of a notion that lacks of a clear explanation within the Commentaries. In this regard, and to the extent no specific examples of "arrangements" are provided, or a definition of the term is included within

1064 OECD (2015), *supra* n. 6, p. 140, Proposed Commentary on Article 1(2), para. 26.4 and 26.5

1065 Schaffer, *supra* n. 1053.

1066 Id.

the Commentaries, this author agrees with the conclusion that the interpretation of the personal scope of the provision remains exactly as it is with respect to Article 1(6) US Model.[1067]

5.1.4. *"Wholly and partial"* fiscal transparency

Another precondition for the application of Article 1(2) OECD Model is that the entity or arrangement be considered *"wholly or partly"* as fiscally transparent. The above involves, on one hand, the issue of determining what is a *"fiscally transparent entity",* and, on the other hand, what are the cases of *"partial fiscal transparency"* that the provision refers to.

As regards to *"fiscal transparency"*, the proposed Commentaries offer the following definition: "The concept of 'fiscally transparent' used in the paragraph 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 arrangement but at the level of the persons who have an interest in that entity or arrangement".[1068] The OECD provides an example within the proposed Commentaries, which covers the situation in which the amount of taxes payable is determined separately at the level of the entity, but with respect to the personal characteristics of the persons liable to tax. As regards to this example, it states: "The fact that the income

[1067] Also in this opinion: Nikolakakis et al., *supra* n. 955, p. 335. For the authors, the reference to *"arrangements"* should also be clarified.

[1068] Proposed Commentary on Article 1(2), para. 26.10 in: OECD (2015), *supra* n. 6, p, 141.

is computed at the level of the entity or arrangement before the share is allocated to the person will not affect that result".[1069] In addition, the proposed Commentaries state that countries are, nevertheless, free to clarify this definition of *"fiscally transparent"* within their bilateral conventions. Although this latter solution is indeed valuable since bilateral tax treaties are the best place where countries might clarify the doubts as regards to specific transparent forms existing in each of the Contracting State, it might also be risky to have so many different definitions of *"fiscal transparency"*, which might derive in ambiguous interpretations of the term, deteriorating the required legal certainty as regards to allocation conflicts, and thus, affecting both taxpayers and tax administrations.[1070]

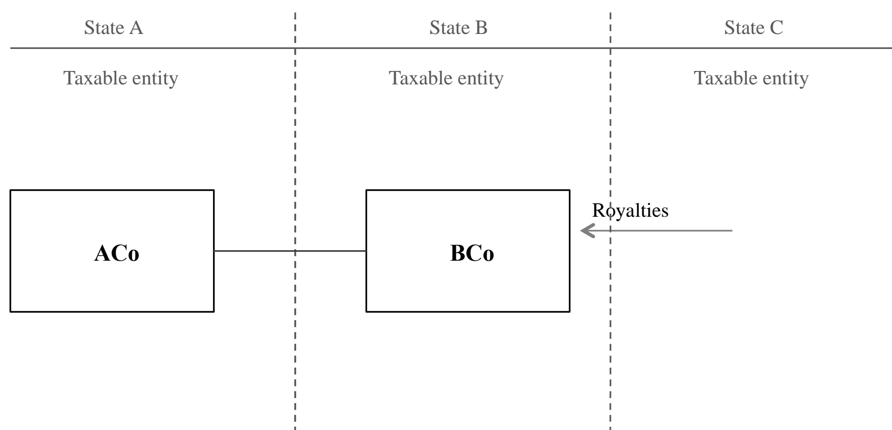
Despite the fact that the concept of *"fiscal transparency"* clearly refers to cases in which an entity is not taxable at its level, but rather the owners of that entity, regardless in which levels the taxes where calculated, some authors have suggested a broader interpretation of the concept, and thus, a potential broader application of Article 1(2) OECD Model due to these other potential conflicts of transparency.[1071] These authors have illustrated the above through the following example involving CFC rules. Let us imagine a company (ACo) incorporated in State A, which has 100% of the ownership of another company incorporated in State B (BCo). This latter company

[1069] Id.

[1070] M. Lang, *Dreifache Nichtbesteuerung als Ergebnis der Anwendung von Doppelbesteuerungsabkommen,* 25 SWI 5 (2015), pp. 198-208.

[1071] *See* Kollmann, Roncarati and Staringer, *supra* n. 954, pp. 17-18.

receives royalties from State C. Likewise all of the States consider BCo as a taxable entity.[1072]



Because of the application of Article 12 treaty B-C, the royalties are taxed in State B exclusively. State A also taxes the royalties as "deemed dividends", because of the application of CFC rules. However, the treaty A-C is not applicable, because the royalties are not attributed to ACo. Indeed, State A considers BCo as a taxable entity as well.

Figure 47: Illustration using CFC rules

For these authors, this case might imply a "conflict of transparency", even though all countries agree that BCo is a taxable entity.[1073] In other words, CFC rules would deem BCo to be transparent, and thus, attribute the undistributed profits to ACo. It is evident, however, that Article 1(2) OECD Model does not apply in this case, because none of the countries involved consider BCo as "tax transparent".

[1072] Id.
[1073] Id.

This author certainly disagrees with this interpretation. On one hand, this case does not represent a conflict of attribution of income for tax treaty purposes, because the royalties, for purposes of the treaty B-C, are clearly attributed to BCo, who is most probably also the beneficial owner according to the application of Article 12 OECD Model. State B, therefore, has the exclusive right to tax those royalties. The treaty A-C, on the other hand, is not applicable at all since State A considers BCo as tax opaque. Therefore, the second attribution, i.e. the “deemed dividend” by which State A also taxes the undistributed profits of BCo is due to a different legal fiction, which has nothing to o with the characterization of BCo. On the contrary, this legal fiction operates by the sole fact that ACo controls BCo and this latter receives passive income (royalties). In simple words, there is no “deemed transparency” as regards to this second attribution, but rather a different legal fiction that allows exceptionally taxing non-residents (BCo) on foreign source income in order to avoid tax deferral. To sum up, Article 1(2) OECD Model has nothing to do with this potential case of double taxation, which could (and perhaps should) be solved strictly at a domestic level.[1074] Moreover, it would be completely unfair for the State of source in this case (State C) to apply the treaty A-C, by extending the interpretation of the concept of *fiscal transparency* under Article 1(2) OECD Model, which would also oblige this State to limit its taxing rights as regards to State A.

[1074] Another option would be modifying Article 23 OECD Model to exceptionally grant relief of double taxation at the level of State A under the treaty A-C. However, this could imply also that State C has also to limit its taxing rights due to the application of the treaty, and solely because of the CFC rule in State A.

By other side, it is also interesting to note that the precondition that the entity or arrangement is considered as fiscally transparent applies not only with respect of cases of full transparency, but also to cases of *"partial transparency"*. The concerns about *"partial transparency"* are, nevertheless, not novel. They were indeed originally raised within the 1999 OECD Partnership Report, which stated: "The Committee first discussed cases where domestic tax laws create intermediary situations where a partnership is partly treated as a taxable unit and partly disregarded for tax purposes. While this may create practical difficulties with respect to a very limited number of partnerships, it is a more important problem in the case of other entities such as trusts. For this reason, the Committee decided to deal with this issue in the context of follow-up work to this report".[1075] Likewise, the proposed Commentaries on Article 1(2) OECD Model specifically addresses the issue establishing that: "In case of an entity or arrangement which is treated as partly fiscally transparent under the domestic laws 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".[1076] As noted within the Commentaries, this is particularly the case of LLPs and trusts. The above reinforces the idea that the personal scope of Article 1(2) OECD Model is indeed not different from Article 1(6) US Model, which although in its 2016 Model includes the wording *"partially transparent",* it

[1075] OECD (1999), *supra* n. 1 , para. 37.
[1076] OECD (2015), *supra* n. 6, p, 141, Proposed Commentary on Article 1(2), para. 26.11.

was clear since 2006 that the provision was applicable not only to partnerships, but also to others transparent entities in general, including common investment trusts under I.R.C. Section 584 and grantor trust and LLCs.[1077]

5.2. Illustrations as regards to the application of Article 1(2) OECD Model

The application of Article 1(2) OECD Model is illustrated through a series of examples that are divided in two groups: (i) strict bilateral cases and (ii) triangular cases. All the examples follow more or less the same facts used in the examples that analyzed the application of Article 1(6) US Model both referred to bilateral and triangular situations. The above allows us to compare results and to analyze the differences and similitudes between the two provisions. Likewise, and as well as in the examples regarding Article 1(6) US Model, all the examples below assume that no PE is constituted in the State of source and all treaties include Article 1(2) OECD Model. Accordingly, all the examples also assume that all the anti-abuse restrictions within domestic law and tax treaties are accomplished in order to apply Article 1(2) OECD Model.

[1077] US: Technical Explanation of the United States Model Income Tax Convention of 15 November 2006, p. 5.

5.2.1. Application of Article 1(2) OECD Model in strict bilateral situations

This Section contains four illustrations of strict bilateral situations analyzing the implication of Article 1(2) OECD Model. Whilst example 1 and 2 refer to income received by or through a hybrid entity, example 3 and 4 refer to income received through a reverse hybrid entity.

5.2.1.1. Example 1

Entity P is organized and resident in State P and has two owners: A and B, who are residents of State R. Accordingly, Entity P receives interest payments from a debtor in State P. While State P considers the entity as a taxable entity, State R considers the same entity as tax transparent, and thus, that the income is allocated to the partners A and B. State P applies a general WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

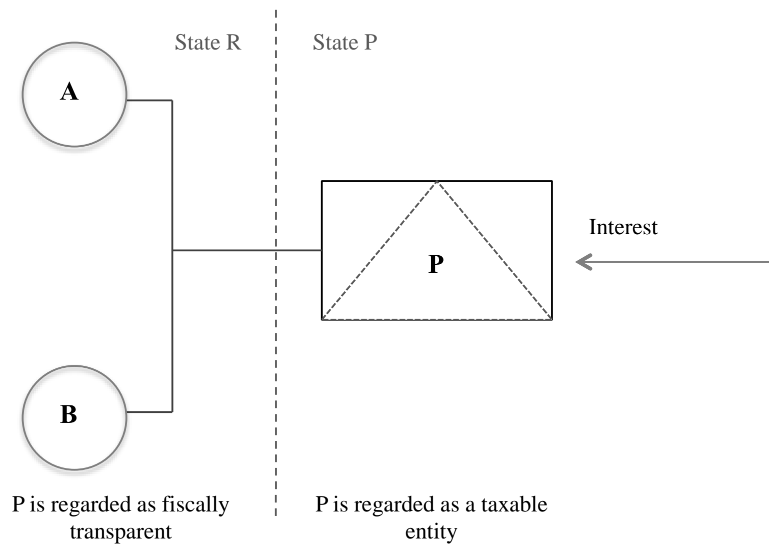


Figure 48: Article 1(2) OECD Model–Ex. 1

Unlike this is a pure domestic situation from the perspective of State P (State of source), Article 1(2) of the treaty R-P allows the application of the treaty between the two countries, granting to A and B the benefits of that treaty. In other words, the preconditions of Article 1(2) OECD Model are met, since there is an entity considered as fiscally transparent by one of the Contracting State, which is receiving income from the other Contracting State and that income is allocated to the partners, who are residents of the State considering the entity as tax transparent.

Although the solution is practical, it might be arguable since the point of view of the State of source (State P). Indeed, Article 1(2) of the treaty R-P makes the treaty applicable by the sole fact that entity P is characterized as

fiscally transparent in the State of residence, obliging the State of source to apply the treaty, and thus, to limit its taxing rights. Likewise, the solution does not consider the proper interplay with the concept of beneficial owner required in Article 11 of the treaty R-P to apply the reduction in the WHT at source. Indeed, it might be very difficult for the State of source to consider A and B as the beneficial owners of the interest paid in this case.[1078]

From the perspective of the State of residence, the solution also presents some problems. If entity P is subject to taxation in State P due to the rights that State P reserves to tax its own residents, it is arguable that State R grants a relief from double taxation under Article 23B OECD Model when A and B have paid no taxes in State P. This is to say, granting a relief in this case might be interpreted as if Article 23 may provide for an indirect tax credit, which, in the opinion of some commentators, it is indeed a very extensive interpretation of this provision. This issue is further on analyzed in this Chapter.[1079]

5.2.1.2. Example 2

Let us assume now that Entity R is organized in State R and has two owners, A and B, who are also residents of State R. Accordingly, some interest payments are paid from State P. While State R considers entity R as tax opaque, State P considers it as tax transparent. State P has also a general

[1078] This issue is further on analyzed in this Chapter at *infra* Section 5.3.1.
[1079] *Infra* Section 5.3.2.

WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

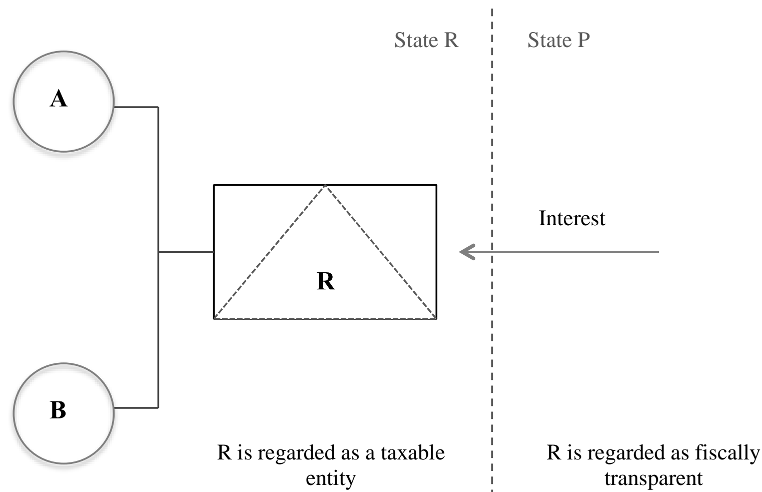


Figure 49: Article 1(2) OECD Model–Ex. 2

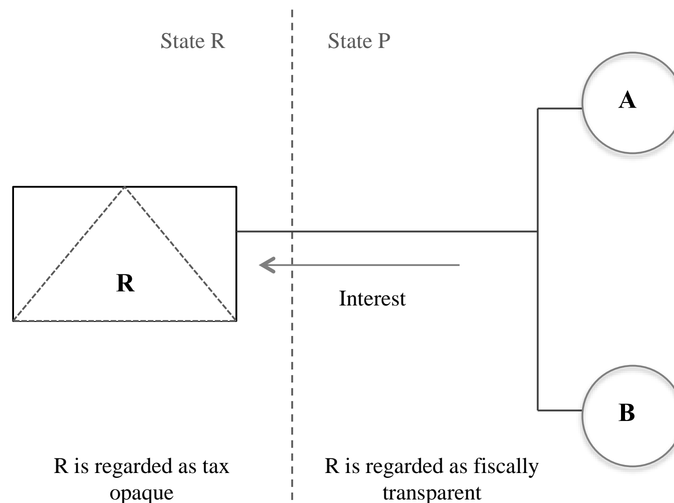
As per Article 1(2) OECD Model, there are interest payments received through an entity that one of the Contracting States considers as tax transparent. However, the income is not allocated to the partners of that entity who are also residents in the State treating the entity as tax transparent. Therefore, Article 1(2) of the treaty R-P acts in this case as denying A and B the benefits of the treaty and ensuring that the benefits of this are allocated to entity R.

In the same order of ideas, Article 1(2) of the treaty R-P clarifies who is entitled to claim the double tax relief in the State of residence under Article 23 of the same treaty. However, the solution of Article 1(2) of the treaty R-P

possesses a bit more uncertainty as regards to the proper application of Article 11, because it is doubtful that State P considers entity R as the beneficial owner of the interest payments, and thus, decides to reduce its WHT at source.

By other side, if A and B were residents of State P, the application of Article 1(2) of the treaty R-P would be redundant, because the preconditions of Article 11 would not be met anyway, i.e. there would not be interest payments arising in a Contracting State and paid to residents in the other Contracting State. The interest payments in this case would arise in the same State where the recipients of the payments are residents; therefore, it would not go beyond of being a domestic situation. However, nothing would prevent State R to tax entity R, which is, in its perspective, a taxable entity. Thus, double taxation might arise and be unavoidable in this case.[1080]

[1080] Unless a double taxation relief is provided domestically, i.e. in State P.



Article 1(2) OECD Model is irrelevant in this case, because the preconditions for application of Article 11 OECD Model are not met. Likewise, interest will be taxed both in State R, at the level of entity R, and in State P, at the level of A and B as the share of income in the foreign partnership. Double taxation might thus arise.

Figure 50: Article 1(2) OECD Model–Ex. 2 (variation)

5.2.1.3. Example 3

Let us assume now that entity P is organized and is resident in State P and has two owners: A and B, who are residents of State R. Accordingly, Entity P receives interest payments from a debtor in State P. State R considers the entity as tax opaque while State P considers the same entity as fiscally transparent. Entity P is thus a reverse hybrid entity. State P applies a general WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

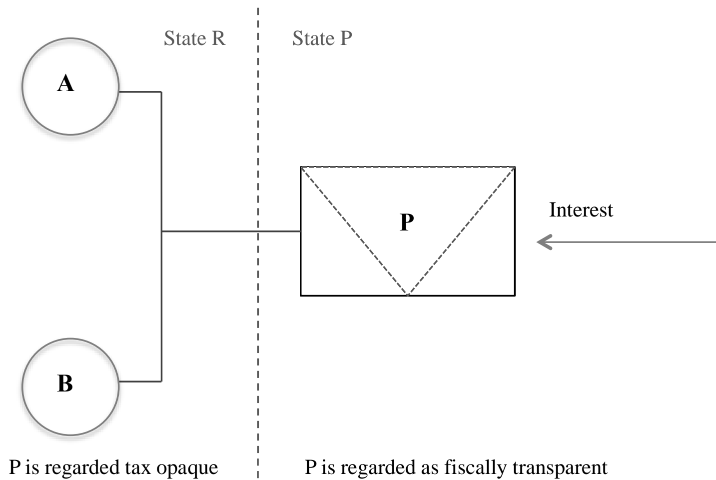


Figure 51: Article 1(2) OECD Model–Ex. 3

As regards to the application of Article 1(2) of the treaty R-P, the interest income is received through an entity (P) considered as fiscally transparent in State P, but it is not allocated to residents of this State. Therefore, Article 1(2) OECD Model applies in this case as to deny the benefits of the treaty to A and B and to confirm that the payments of interest in this case is a mere domestic situation. Yet, nothing prevents State R to also tax the interest through the application of CFC rules. Double taxation might be avoided in this case only to the extent a domestic relief is granted in State R.[1081]

[1081] This is the case, e.g. of the United States. US: I.R.C. Sec. 960 and 902. *See* the explanation in a similar example referred to the US Model provision at *supra* Section 4.2.1.3.

Likewise, the solution of Article 1(2) does not prevent that State P still considers A and B as the beneficial owners of the income.

5.2.1.4. Example 4

Let us assume now that entity R is organized and is resident in State R. Entity R has two owners, A and B, who are also residents of State R. Accordingly, interest payments are paid from State P. While State R considers entity R as tax transparent, State P considers it as a taxable entity. State P applies a general WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

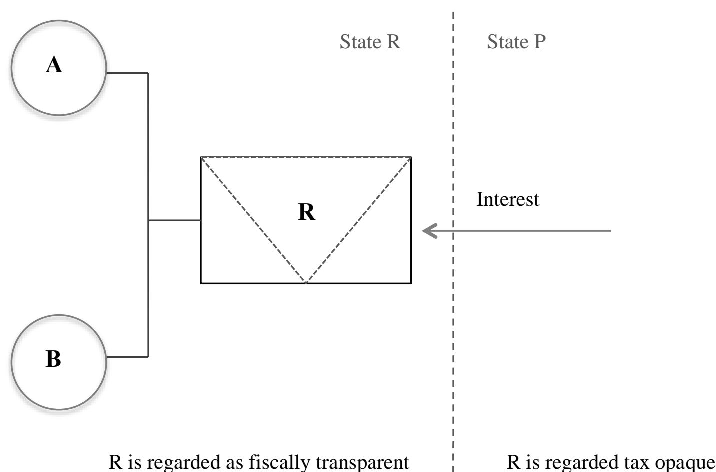


Figure 52: Article 1(2) OECD Model–Ex. 4

According to Article 1(2) of the treaty R-P, entity R is a fiscally transparent entity receiving interest from State P, which are allocated to the partners A and B, who are also residents of State R. Therefore, Article 1(2) of the treaty

R-P clarifies that the partners A and B are the ones who should claim the benefits of the treaty between State R and State P. This solution seems to be satisfactory from the point of view of the State of residence.

From the State of source's perspective, however, the application of Article 1(2) of the treaty R-P might still leave open some uncertainty as regards to the application of the treaty between State R and State P. Indeed, the fact that Article 1(2) clarifies that A and B should be granted the benefit of the treaty, does not change the fact that State P still considers entity R, and not A and B, as the beneficial owner of the interest income. In other words, State P might still deny the reduced WHT at source, because A and B are not the beneficial owners of the interest. The above might also generate conflicts as regards to the application of Article 23, because the double taxation relief might cover only the amount of reduced WHT under the treaty and not the full amount of WHT, if the State of source does not reduce its WHT under Article 11.

5.2.2. Application of Article 1(2) OECD Model in triangular situations

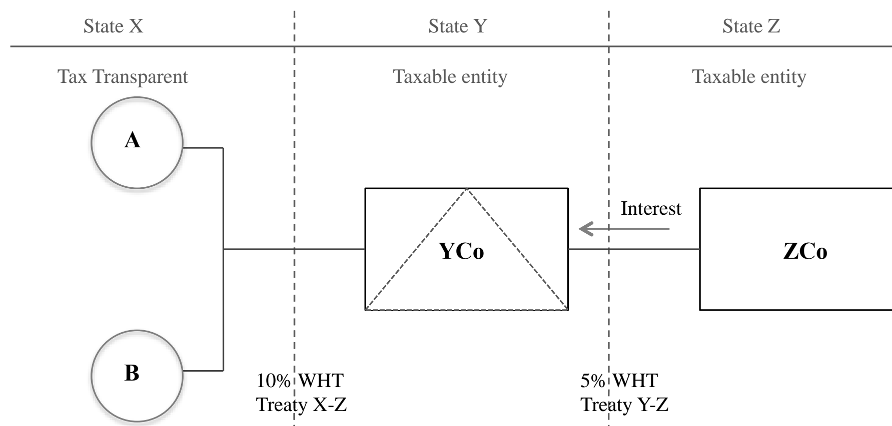
This Section turns now to analyze the application of Article 1(2) OECD Model to specific triangular situations. For this purpose, the previous assumptions that no PE is constituted in the State of source and all treaties include Article 1(2) OECD Model remain the same. Likewise, in all cases is

assumed that the intermediary entity is not a conduit company, agent or nominee.

5.2.2.1. Example 5

Let us assume that YCo is an entity incorporated in State Y, which has two partners, A and B, who are residents of State X. Accordingly, YCo has a subsidiary in State Z, i.e. ZCo, which is financed by a loan granted by YCo and because of which it receives interest payments back from State Z.[1082] YCo is considered as a taxable entity in State Y and in State Z. However, it is regarded as a fiscally transparent entity in State X. Likewise, although Country Z applies a general WHT on interest paid abroad of 30% of the gross amount paid, the treaty State X/State Z provides for a reduced WHT of 10% while the treaty State Y/State Z provides for a reduced WHT of 5%.

[1082] The example assumes that the loan and interest are arm's length.



While Yco is regarded as tax transparent in State X, State Y and Z consider it as tax opaque. Likewise, State Z applies a general WHT of 30% on the payments of interest abroad, although the treaty State X/State Z provides for a reduced WHT of 10% while the treaty State Y/State Z provide for a reduced WHT of 5%.

Figure 53: Article 1(2) OECD Model–Ex. 5

According to the treaty Y-Z, State Z should reduce its WHT to 5% according to Article 11 and State Y should grant a relief of double taxation as per Article 23. It is clear that the income and the benefits of the treaty are allocated to YCo. Likewise, Article 1(2) treaty Y-Z does not apply, because YCo is considered as a taxable entity in both Contracting States.

The treaty X-Z is, nevertheless, also applicable. According to Article 1(2) treaty X-Z, there is income received by or through an entity or arrangement considered as fiscally transparent by one of the Contracting States, and which is allocated to the partners A and B, who are also residents of the State treating the entity as tax transparent, i.e. State X. Therefore, in principle, State Z should accomplish with both treaties, which under the

principles of the OECD Partnership Report would mean that State Z must apply the lower WHT rate (5%) as regards to both treaties.[1083] This solution is, however, not only misaligned with the concept of beneficial owner,[1084] but also it would leave open a potential double taxation issue.[1085]

5.2.2.2. Example 6

Let us assume the same basic facts than in the example 5, with the sole difference that YCo is treated as fiscally transparent in State Z while it is regarded as a taxable entity in State X and Y. Likewise, this hypothetical also assumes that all applicable treaties provide similar reductions of WHT of 10% at source.

[1083] OECD Commentary on Article 1 concerning the persons covered by the Convention, para. 6.5.

[1084] *Infra* Section 5.3.1.

[1085] If State X does not have a treaty with State Y, or if having a treaty, YCo is not regarded as a PE, there will be no double taxation relief for the taxes imposed at the level of YCo in State Y. For an alternative manner to solve this issue, see the explanation regarding the treaty between the United States and Poland, which provides for the non-application of Article 1(6) US Model if certain requirements are met. *Supra* Section 4.3.1.1.1.

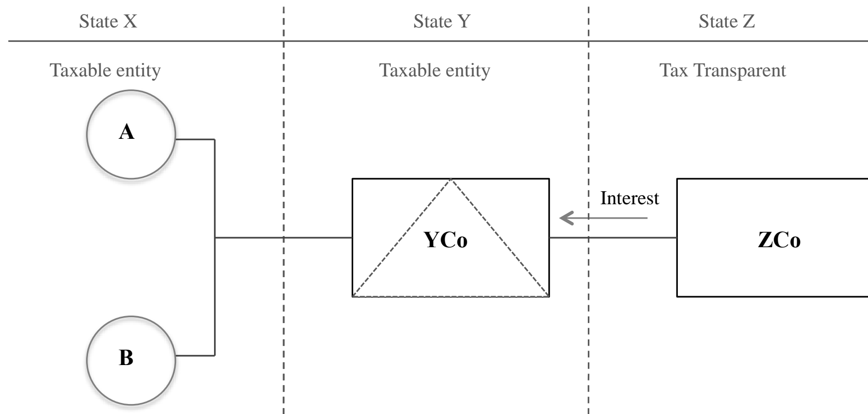


Figure 54: Article 1(2) OECD Model–Ex. 6

If we first consider the treaty Y-Z, it is easy to figure out that Article 1(2) treaty Y-Z applies in this case as to deny A and B the benefits of the treaty and to ensure that these benefits are allocated to YCo. In other words, as there is an item of income received through an entity considered in this case tax transparent in State Z, but the income is not allocated to residents of that State, Article 1(2) treaty Y-Z ensures that the benefits are not allocated to A and B, but rather to YCo. The application of Article 1(2) OECD Model, however, does not prevent the fact that State Z still considers A and B, and not YCo, as the beneficial owners of the interest. In other words, the reduced WHT of 10% at source could still be arguable under State Z's perspective, because the preconditions of Article 11 treaty Y-Z would not be met.

As regards to the treaty X-Z, Article 1(2) treaty X-Z also applies as to deny the benefits of that treaty to A and B, because these two are not residents of the State treating the entity a tax transparent, i.e. State Z. Thus, A and B could get neither the reduced WHT at source under Article 11 nor the double taxation relief under Article 23 of the treaty X-Z.

The application of Article 1(2) of the treaty X-Z, however, does not solve the question as regards to who is the beneficial owner of the interest. In this case, it seems to be clear that State Z will still consider A and B as the beneficial owners of the interest and not YCo. Thus, State Z might still consider applying Article 11 as regards to A and B, although by application of Article 1(2), these two are not entitled to the benefits of the treaty.

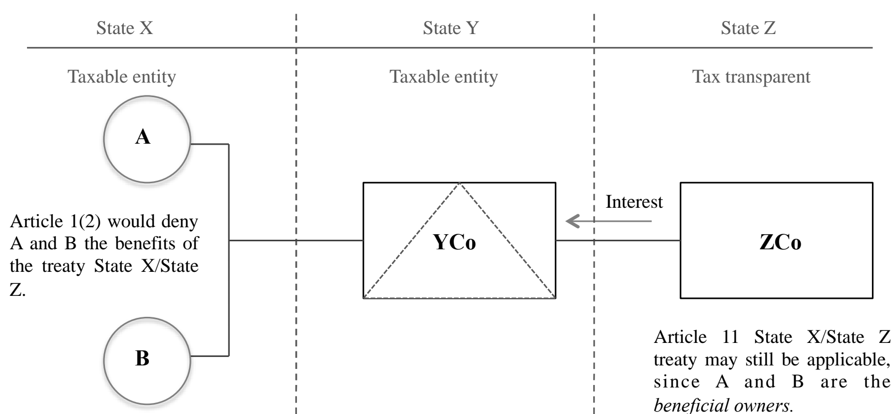


Figure 55: Article 1(2) v. Article 11 (beneficial owner)

On the other hand, even in the hypothetical that A and B were residents of State Z, the preconditions of Article 11 of the treaty X-Z would not be met,

i.e. there would not be a payment of interest arising in a Contracting State and being paid to residents in the other Contracting State. In contrast, in this case, interest would arise and would be paid to residents of the same State. This situation would thus remain as a domestic one.

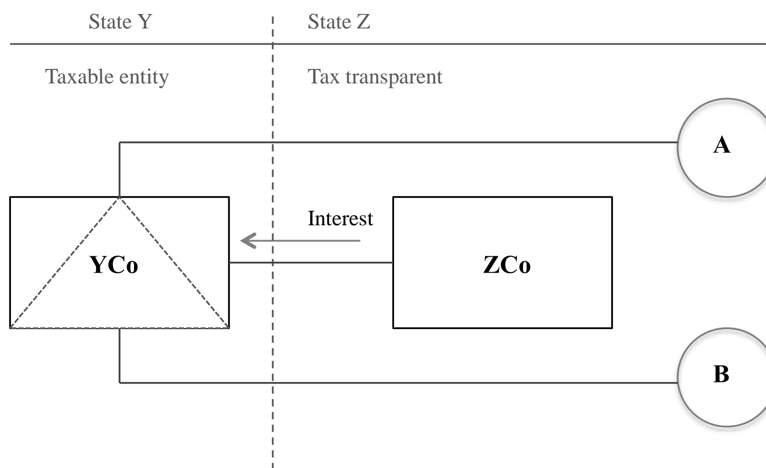


Figure 56: Ex. 6 (variation)

5.2.2.3. Example 7

Let us consider the same facts as example 6 above, with the sole difference that YCo is considered as fiscally transparent in State Y while as a taxable entity in State X and State Z.

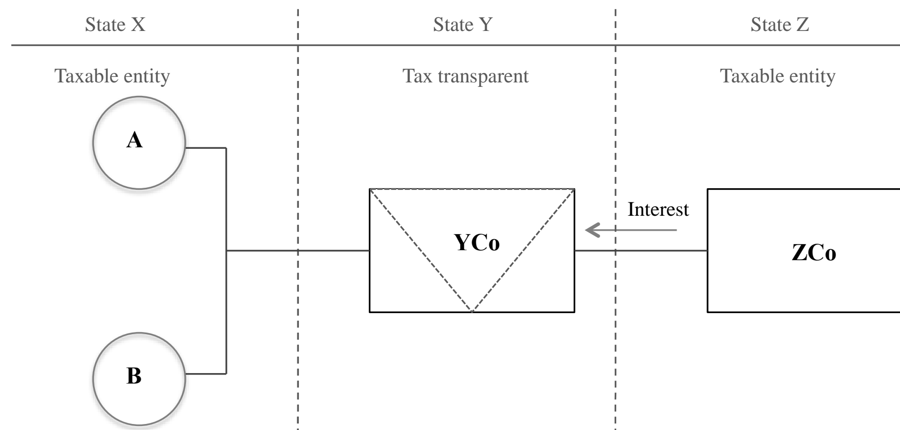


Figure 57: Article 1(2) OECD Model–Ex. 7

As regards to the treaty Y-Z, Article 1(2) works denying the benefits of the treaty to A and B, which are not considered residents of the State regarding YCo as tax transparent, i.e. State Y. This solution, however, does not prevent that State Y still considers YCo as tax transparent. In other words, Article 1(2) of the treaty Y-Z does change the characterization of the entity receiving the income, neither at the State source nor at the State of residence. Therefore, from the strict perspective of State Y, the treaty Y-Z is not applicable, because YCo is not a resident for purposes of the treaty. Nonetheless, State Z might still apply a reduced WHT under Article 11 of the treaty Y-Z, because State Z considers YCo as a taxable entity. This would not be, however, a desirable outcome from State Z's perspective.

As regards to the treaty X-Z, on the other hand, this is evidently not applicable. Since neither State X nor State Z considers that the income is paid to and received by A and B, the preconditions of Article 11 of the

treaty X-Z are not met. Accordingly, both States agree that YCo is a taxable entity. Therefore, the introduction of Article 1(2) within the treaty State X-Z does not change the result, because the precondition of having at least one Contracting State treating the entity as fiscally transparent would not be met.

5.3. Other Issues as regards to the application Article 1(2) OECD Model

As noted in the illustrations above, Article 1(2) OECD Model might solve many issues as regards to whom income, for purpose of a tax treaty, should be (or should not be) allocated, and thus, the benefits of the treaty should be granted (or not). This is especially troubling in cases where Contracting States do not agree on how to treat an entity for tax purposes. Nevertheless, the solutions provided by Article 1(2) OECD Model are not always desirable. The above is especially evident in cases where the application of Article 1(2) OECD Model puts the State of source in an unfavorable position as regards to the State of residence, or when the application of this provision conflicts with other attribution rules within tax treaties, in particular, with the concept of beneficial owner of Articles 10, 11 and 12 OECD Model. These issues are analyzed in the subsequent subsections.

5.3.1. The (repeated missed) interplay with the concept of ***Beneficial Owner***

As stressed already, the principles of the OECD Partnership Report are not necessarily aligned with the special requirement of Article 10, 11 and 12 OECD Model, which states that for purposes of the State of source to reduce its WHT, the income should be "paid to" the *beneficial owner* of the income.[1086]

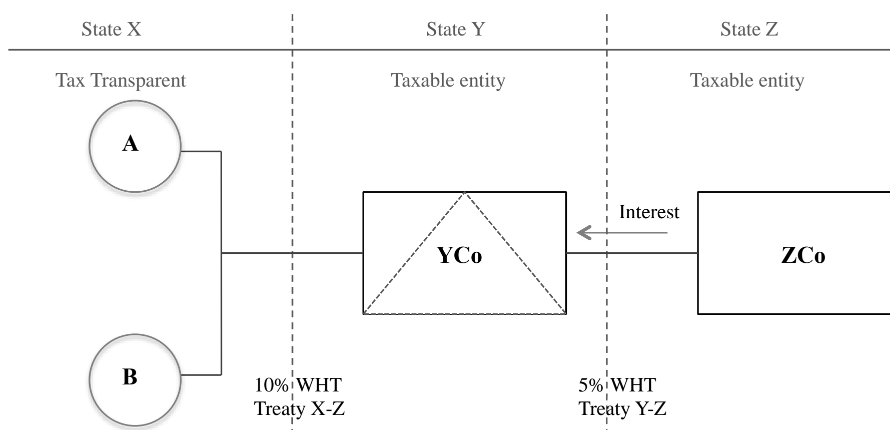
The proposed OECD Commentaries on Article 1(2) OECD Model seem to partially address the issue when states in paragraph 22.14: "Whilst the paragraph ensures that the various allocation rules of the Convention are applied to the extent that income of fiscally transparent entities is treated, under domestic law, as income of a resident of a Contracting State, *the paragraph does not prejudge the issue of whether the recipient is the beneficial owner of the relevant income*". (Emphasis added).[1087] Nevertheless, a closer look at the Commentary brings us a different insight.

Let us take Example 5 used in *supra* Section 5.2.2.1 above and assume that YCo is an entity incorporated in State Y, which has two partners, A and B, who are residents of State X. Accordingly, YCo has a subsidiary in State Z, i.e. ZCo, which is financed by a loan granted by YCo and because of which

[1086] *Supra* Section 3.1.3.2.3. This was also discussed as regards to Article 1(6) US Model and that is why the author refers to it as the "repeated missed" interplay with the concept of *beneficial owner*. See *supra* Section 3.2.3.1.

[1087] Proposed Commentary on Article 1, para. 26.14 in: OECD (2015), *supra* n. 6, p, 142.

it receives interest payments back from State Z.[1088] YCo is considered as a taxable entity in State Y and in State Z. However, it is regarded as a fiscally transparent entity in State X. Likewise, although Country Z applies a general WHT on interest paid abroad of 30% of the gross amount paid, the treaty State X/State Z provides for a reduced WHT of 10% while the treaty State Y/State Z provides for a reduced WHT of 5%.



While Yco is regarded as tax transparent in State X, State Y and Z consider it as tax opaque. Likewise, State Z applies a general WHT of 30% on the payments of interest abroad, although the treaty State X/State Z provides for a reduced WHT of 10% while the treaty State Y/State Z provide for a reduced WHT of 5%.

Figure 58: The interplay between Article 1(2) OECD Model and the beneficial owner

Following the proposed OECD Commentaries in this case, Article 1(2) OECD Model should not prejudge the issue of whether or not YCo is the beneficial owner of the dividends paid.[1089] Although the term *'beneficial*

[1088] The example assumes that the loan and interest are arm's length.

[1089] Proposed Commentary on Article 1(2), para. 26.14 in: OECD (2015), *supra* n. 6, p, 142.

owner' is indeed obscure and elusive,[1090] it is clear in this case that State Z will consider YCo, a taxable entity, as the beneficial owner of the dividends.[1091] In other words, State Z could still deny the application of the lowest WHT of 5% (treaty Y-Z) to A and B, because in fact A and B are not the beneficial owners of the interest. Nevertheless, according to the principles of the OECD Partnership Report, recognized within the OECD Commentaries, State Z should indeed accomplish with both treaties (Y-Z

1090 *See* the references at *supra* n. 326 as regards to the discussion about the meaning of *beneficial owner.*

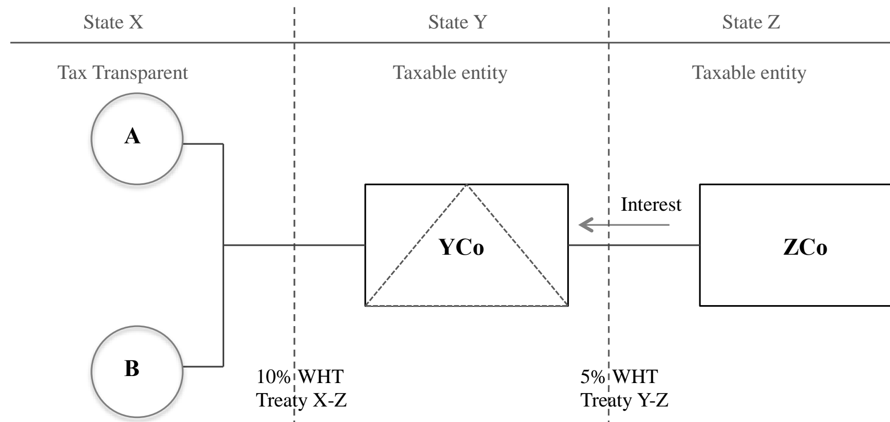
1091 The debate regarding which State, residence or source, should determine the beneficial owner, seems to be redundant in this case. On one hand, both countries consider YCo as a taxable entity, i.e. as a taxpayer and resident in State Y. On the other hand, the example assumes that YCo is not a conduit company, agent or nominee, that might affect its consideration as the beneficial owner. Therefore, either from the point of view of the State of source or the State of residence, it is expectable that the YCo is regarded as the beneficial owner of the interest. The above would indeed accomplish with the OECD Commentaries on Article 11 OECD Model, which states: "The requirement of beneficial owner was introduced in paragraph 2 of Article 11 to clarify the meaning of the words "paid to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over interest income merely because that income was immediately received by a resident of a State with which the State of source had concluded a Convention". OECD Commentary on Article 11 concerning the taxation of interest, para. 9. Accordingly, it states: "The term 'beneficial owner' is not used in narrow technical sense, rather, it should be understood in its context and in light of the object and purpose of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance". Id. In a similar triangular example, Sanghavi arrives to the same conclusion. His example considers a company SCo, resident in State S, which pays dividends to HCo, resident of State H. HCo is wholly owned by RCo, a company established in State R. While State S and H consider HCo as a taxable entity, State R considers it as a fiscally transparent entity, because of an option given in State R. As stated by Sanghavi: "However, article 10(2) restricts the source state's taxing rights only if the beneficial owner of the dividends is a resident of the other contracting states […] it is clear that the 'beneficial owner' generally refers to a singular entity [HCo]". D. Sanghavi, *BEPS Hybrid Entities Proposal: A Slippery Slope, Especially for Developing Countries*, 85 Tax Notes Int'l 4 (2017), p. 360, Fig. 1.

and X-Z), applying the lower WHT rate (5%) to both treaties.[1092] This solution is certainly not aligned with the concept of beneficial owner,[1093] and might also contradict the purpose of the treaty itself leaving open a potential double taxation issue as well.[1094]

[1092] OECD Commentary on Article 1 concerning the persons covered by the Convention, para. 6.5. However, if YCo is regarded as tax transparent in State Y, it is obvious that State Z must not grant any benefit of the treaty to State Y. For an alternative solution, *see* the treaty United States/Poland, analyzed in *supra* Sections 3.2.2.2.1 and 3.2.3.1.

[1093] The application of Article 1(2) OECD Model in this case would not solve the conflict that YCo might still be the beneficial owner of the interest payments. Thus, for purposes of applying Article 11 OECD Model, State Z could still argue that the interest are not beneficially owned by A and B in State X.

[1094] For example, if State X does not have a treaty with State Y, or if having a treaty, YCo is not regarded as a PE, there will be no double taxation relief for the taxes imposed at the level of YCo in State Y. Moreover, if the same situation is analyzed as regards to a trust, being the trust and the settlor residents in State Y (using our example) and the beneficiary being resident in State X, and having both State X and State Y treated the trust as tax transparent, the relief of double taxation becomes impossible. *See* Danon, *supra* n. 882, pp. 198-199, Diagram 7.



While Article 1(2) OECD Model provides that the recipient of the interest, and thus who gets the benefits of the treaty X-Z, are the partners A and B, this solution does not coincide with the fact that for State Z, Yco is the *beneficial owner* of the interest payments. Therefore, there would not be reasons for State Z to apply a reduced WHT of 5% at source as per the treaty X-Z.

Figure 59: Solution as per the Commentaries on Article 1(2) OECD Model

The second part of the Commentary does not help to clarify the interplay either. As provided in the second part of paragraph 24.16: "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*" (emphasis added).[1095] The example is straightforward and clear in terms that no nominee or agent, partnership or partner of it, is indeed the beneficial owner of the dividends. However, it does not clarify which of the

[1095] Proposed Commentary on Article 1(2), para. 26.14, in: OECD (2015), *supra* n.6, p, 142.

two, i.e. partners or partnership, should be considered as *beneficial owners.* Interestingly, nevertheless, is that the paragraph emphasizes that it is in accordance to the domestic laws of the State of source, how the determination of who is the *beneficial owner* should be made.[1096] Although some commentators might criticize this statement,[1097] the author agrees with the fact that, by logic, it is the State of source, i.e. the State whose taxing rights are limited by a tax treaty, who should determine to whom interest, dividends or royalties are *"paid to"*, independently of the residence Status as per the domestic laws of the State of residence. Of course this idea does

[1096] Id.

[1097] For example, Sanghavi states as regards to this second part of paragraph 26.14 of the Commentary on Article 1: "It is also strange that the commentary suggests that the beneficial owner should be determined exclusively in accordance with the tax principles of the source state. A situation in which the source state considers a partnership to be the beneficial owner of dividends, but the other state treats that partnership as transparent would, absent unilateral relief, likely result in unrelieved double taxation because the partnership will not qualify as a treaty resident". Sanghavi, *supra* n. 1091, p. 361. This author disagrees with Sanghavi's statement in the sense that, in practice, the partnership will not be subject to tax in the State of residence, but rather its partners, but only to the extent they are also residents in that State. If they were residents of a third State, there should be analyzed what is the tax treatment that this State gives to the partnership and whether this tax treatment coincide or not with the one given in the State of source. Thus, if this third country, i.e. where the partners are residents, treats the partnership as a taxable entity, there will be no double taxation issue, because the partners will not be allocated the income derived through the partnership. However, if this State considers the partnership as fiscally transparent, the State of residence of the partners will exercise its taxing rights. In this case, double taxation will arise, but only to the extent the State of residence does not grant double taxation relief under Article 23 OECD Model at all, or it grants double taxation relief, but only up to the amount of taxes at source limited by the treaty. The above, however, does not mean to proceed again with ad-hoc solutions giving also the State of residence the possibility to determine who is the beneficial owner of the income, or to establish exception as regards to the determination of the beneficial owner by the State of source. Instead, it is perhaps the design or the scope of Article 1(2) OECD Model, which should be questioned. This is indeed what this author assumes in the proposal at *infra* Chapter VI.

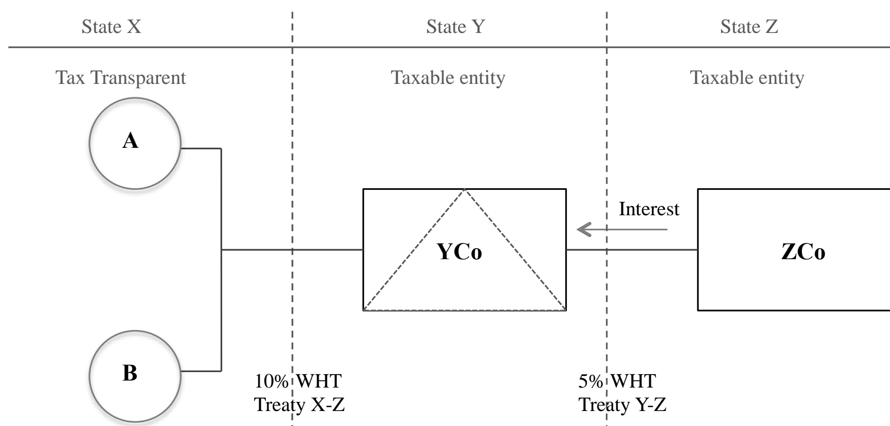
not solve the dichotomy between beneficial owner and the persons who benefit from a treaty as per Article 1(2) OECD Model either.

The issue is slightly differently addressed within the proposed UN Commentary on Article 1(2) UN Model, addressing the application of tax treaties to payments made through hybrid entities.[1098] The UN Commentary in this case states: "As first step in applying the benefits of the Convention, paragraph 2 identifies the resident of a Contracting State that derives an item of income for which treaty benefits are sought. In order to be entitled to such benefits, *such resident must also satisfy any additional requirements that are set forth in the applicable treaty, such as beneficially owning the item if income under the tax principles of the source State*, any applicable requisite ownership thresholds (such as those found in subparagraph 2(a) of Article 10 (Dividends), and either a principle purpose test or a limitation on benefits provision". (Emphasis added).[1099] Although in this case it is clearer that in order to obtain the benefits of the treaty, it is not only necessary to be a resident for purposes of the treaty, but also to accomplish with the beneficial ownership requirement of Article 10, 11 and 12 UN Model, the solution again crushes with Article 1(2) UN Model. Using the same example as

[1098] UN: Committee of Experts on International Cooperation in Tax Matters, 11th session, Item 3 (a)(i) of the provisional agenda, Application of treaty rules to hybrid entities, New provision for the United Nations Model Double Taxation Convention between Developed and Developing Countries to address the application of tax treaties to payments made through hybrid entities, Geneva 11-14 October 2016, Annex I: United Nations Model Double Taxation Convention between Developed and Developing Countries: proposed changes to address the application of tax treaties to payments made through hybrid entities, pp. 4 et seq.

[1099] UN: Proposed Commentary on Article 1(2) UN Model, para. 6. Id., p. 5.

above, we would conclude that State Z would consider YCo as the beneficial owner. Indeed, in this case there is no doubt that this determination is made exclusively "*under the tax principles of the source State"* (emphasis added), which considers YCo as a taxable entity. On the other hand, however, Article 1(2) UN Model will consider A and B as the person receiving the dividends and who benefit from the treaty X-Z, but who, nevertheless, are not the beneficial owners of the dividends according to State S. Once again thus the solution of Article 1(2) UN Model crushes with the beneficial ownership requirement, providing an inconsistent outcome.



While Article 1(2) UN Model provides that partners A and B are granted the benefits of the treaty X-Z, this solution does not coincide with the fact that for State Z, YCo is the *beneficial owner* of the interest payments, and not A and B. Once again, the solution of Article 1(2) UN Model crushes with the beneficial owner requirement of Article 10, 11 and 12 UN Model.

Figure 60: Solution under the Commentaries on Article 1(2) UN Model

5.3.1.1. A "deemed" ***Beneficial Owner***: An alternative solution

It results evident from the examples above that the dichotomy between the solution provided by Article 1(2) OECD Model as regards to whom should enjoy the benefits of a tax treaty when income is received by or through an entity (or arrangement, whatever that means) and the concept of *beneficial owner* in Article 10, 11 and 12 OECD Model, is very difficult to solve.[1100] Indeed, if one gives priority to the *beneficial owner*'s determination by the State of source, the Article 1(2) OECD Model remains ineffective in many cases. On the contrary, if one gives priority to the determination of who should get the benefits of a treaty when income is received by or through a fiscally transparent entity under Article 1(2) OECD Model, the *beneficial ownership*'s requirement crushes again and might deny those benefits. In simple terms, one remains in the circular effect created by the incompatibility of the two provisions.

In light of the above, a recognized bunch of academics have recently proposed an alternative to solve this dichotomy between Article 1(2) OECD Model and the *beneficial ownership* requirement, which is based on the common agreement of these authors that, beyond the discussion on prevalence between one provision and the other, all agree that the benefits of a treaty should not fail to be granted where the application of a provision such as Article 1(2) OECD Model would result in income being attributed to

[1100] Nikolakakis et al., *supra* n. 955, pp. 333-334. These academics include: A. Nikolakakis, S. Austry, J. Avery Jones, P. Baker, P. Blessing, R. Danon, S. Goradia, J. Hattingh, K. Inoue, J. Lüdicke, G. Maisto, T. Miyatake, K. van Raad, R. Vann and B. Wiman.

a resident of the other Contracting State, assuming no relevant party is acting as an agent or nominee or other intermediary for a third party from the source State's perspective.[1101] Having this in mind, the proposal is divided in two steps.

The first step suggests that the State of source should determine if the entity is an agent, nominee or other intermediary. If so, the Source State should skip the entity and go to the next person, i.e. the member(s) of the entity. If this person (or entity) for which the entity is a nominee, agent or other intermediary is considered as tax opaque,[1102] then Article 1(2) OECD Model is not in play.[1103] If this person (or entity) is a nominee, agent or other intermediary for another fiscally transparent entity, then Article 1(2) OECD Model is in play as regards to that other fiscally transparent entity.[1104]

[1101] Id.

[1102] It is not specified in the proposal, but this author assumes that the consideration of tax opaque or fiscally transparent refers to the consideration of the State of residence, even though the determination of nominee, agent or other intermediary is done from the perspective of the State of source.

[1103] Nikolakakis et al., *supra* n. 955, p. 336.

[1104] Id. The wording is confusing, but it seems to state that Step 2 of the proposal must be applied.

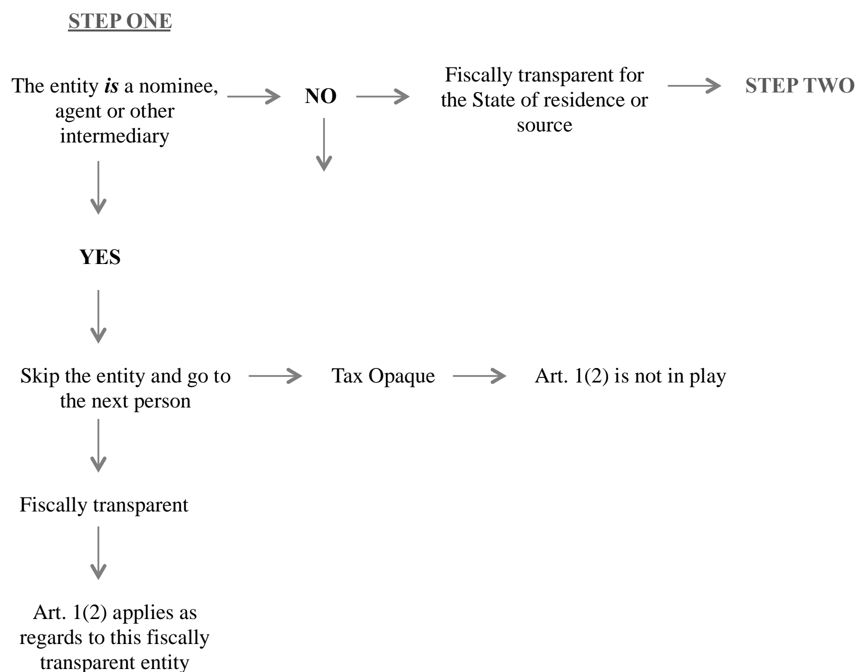


Figure 61: Step One –"Deemed" Beneficial Owner's proposal

The second step applies only to the extent that the entity is considered as a fiscally transparent entity and it is not a nominee, agent or other intermediary, or where it is a nominee, agent or other intermediary for another fiscally transparent entity.[1105] For this purposes, we must distinguish if the entity is considered as fiscally transparent from the perspective of the State of source or from the perspective of the State of residence. If the entity is regarded as fiscally transparent from the State of source perspective, but it is considered as opaque by the State of residence, then the State of source

[1105] Id.

must consider the entity as the *beneficial owner*.[1106] On the other hand, if the State of residence also considers the entity as fiscally transparent, then one should take a look at the members of the entity. If the members are residents of the State of residence, then the Source State must consider those residents as the *beneficial owners*, unless the resident is considered a nominee, agent or other intermediary.[1107] If the resident is indeed a nominee, agent or other intermediary, then the step calls to look at the principal. If the principal is a resident of the State of residence and also an opaque entity [it seems to be also from the State of residence's perspective], then the State of source should consider satisfied the *beneficial owner* requirement. On the contrary, if the principal is not a resident of the State of residence and considered as tax opaque [from the State of residence's perspective], then the *beneficial owner* requirement is not satisfied.[1108]

[1106] "[…] 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 in the source state's normal application of the beneficial owner principles". Id. It is thus clear that a "deemed" beneficial owner has been created in order to solve the discrepancies with Article 1(2) OECD Model Tax Convention.

[1107] It is correct to affirm in this case that if the resident is not regarded as a nominee, agent or other intermediary, it will coincide with the State of source's determination of the beneficial owner. However, this is the result of the tax characterization of the entity by both States as fiscally transparent. If residence and source treat the entity as fiscally transparent, it is almost impossible that they conflict as regards to who is the beneficial owner and also the person being entitled to the benefits of the treaty.

[1108] This is exactly the same solution within the treaty Canada/ United States analyzed some Sections above. *Supra* Section 4.3.1.1.2. In that treaty it is provided that if State of source considers that the partner deriving the income under Article IV (6) of the Canada/United States tax treaty [Article 1(6) US Model] is an agent, nominee, custodian or conduit for a *non-resident* of the other Contracting State, then the State of source may deny the benefits of Article 11 Canada/United States tax treaty. However, if the State of source still considers that the partner deriving the income is an agent, nominee,

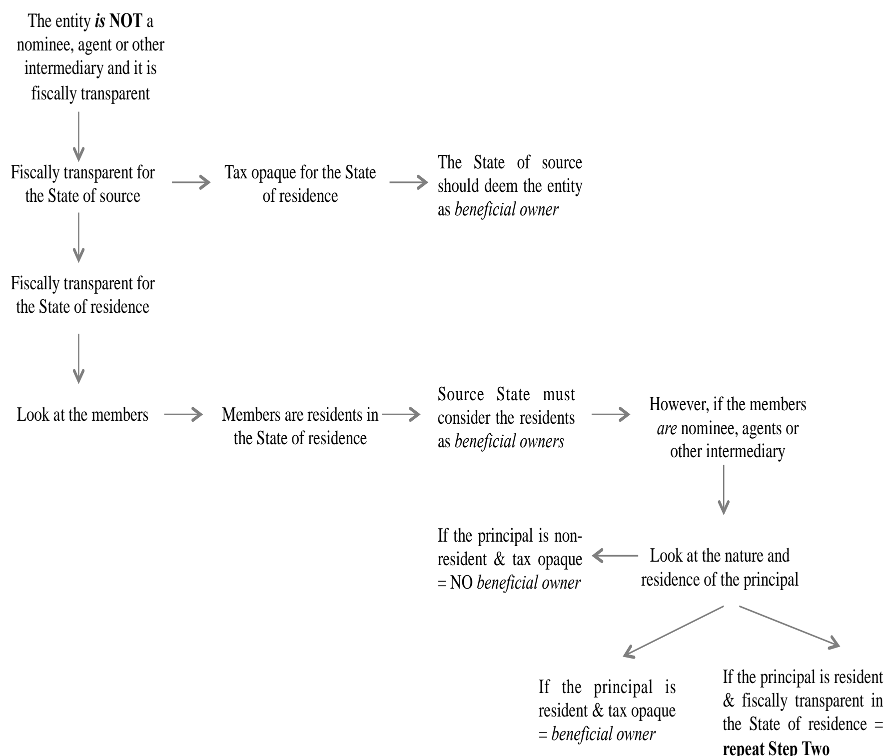


Figure 62: Step Two–"Deemed" Beneficial Owner's proposal

In the same order of ideas, if the entity were not considered as a nominee, agent or other intermediary and the State of source considers the entity as tax opaque, this step two would apply as follows.[1109] If the State of residence

custodian or conduit, but for a *resident* of the other Contracting State, then it should granted the benefits of the treaty anyway. The concepts of *residence* and *beneficial ownership* are merged in order to get a practical solution.

[1109] Nikolakakis et al., *supra* n. 955, p. 337.

also considers the entity as opaque, Article 1(2) OECD Model does not apply.[1110] On the contrary, if the State of residence considers the entity as fiscally transparent, then the State of source must apply the treaty as if the *beneficial owner* were the entity's member, unless they are regarded as nominee, agent or other intermediary by the State of source.[1111] If the members are considered as nominee, agent or other intermediary, then one should look at the residence of the principal. If the principal is a resident in the State of residence and a tax opaque entity, then it should be considered as the *beneficial owner* for purposes of the treaty. On the contrary, if the principal is a residence in the State of residence, but fiscally transparent, then step two is repeated. If the principal is not a resident in the State of residence, then it is not regarded as the *beneficial owner* for purposes of the treaty.[1112]

1110 Id. It is clear that the precondition of having at least one of the Contracting States treating the entity as fiscally transparent would not be met in order to apply Article 1(2) OECD Model.

1111 Id.

1112 Id.

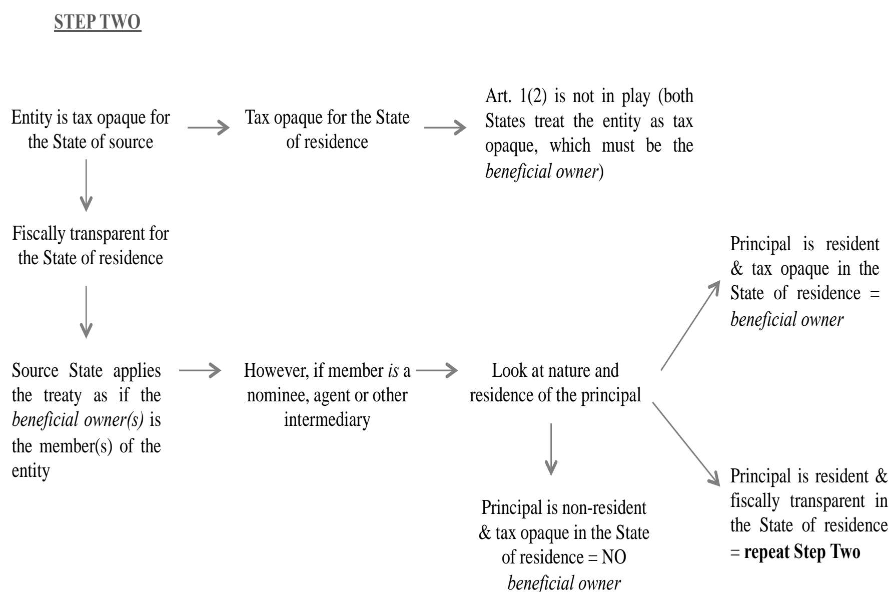


Figure 63: Step Two –"Deemed" Beneficial Owner's proposal

5.3.1.2. Testing the Proposal for a "deemed" *Beneficial Owner*

If we test the proposed solution with the illustrations given in *supra* Sections 5.2.1 and 5.2.2, the results would be as follows:[1113]

[1113] This is an interpretation of this author and might not necessarily coincide with the one sustained by the authors of the proposal.

Example 1:[1114]

In this example, Article 1(2) of the treaty R-P makes the treaty between these two States applicable by the sole characterization of entity P in State R, i.e. the State of residence, generating a conflict with the concept of beneficial owner in Article 11 of the treaty R-P. Let us thus apply now the proposed solution.

If entity P *is not* a nominee, agent or other intermediary under State P's perspective, but State R considers the entity as fiscally transparent, the solution would be that State P should apply the treaty R-P, granting a reduced WHT under Article 11, deeming A and B as the beneficial owners. Although the proposed alternative solves the dichotomy between Article 1(2) and Article 11 (beneficial owner) in a pragmatic way, the question why the State of source (State P) should apply the treaty R-P by the sole characterization of the entity in State R remains unanswered.

On the contrary, if entity P *is* as a nominee, agent or other intermediary (i.e. not the beneficial owner), State P should skip the entity and look at the members, i.e. A and B. In such a case, Article 1(2) is not in play, because partners A and B are not tax transparent (they are individuals). In other word, A and B are now deemed to be the beneficial owner by State P and they are also the persons receiving the benefits of the treaty under State R's perspective, which considers the entity as fiscally transparent. Although the

[1114] *Supra* Section 5.2.1.1.

solution completely disregards the tax characterization of the entity in the State of source, this seems to be irrelevant since the State of source considers the entity as a nominee, agent or other intermediary, i.e. not as the beneficial owner.

Example 2:[1115]

In this example, Article 11 of the treaty R-P applies as to reduce the WHT at source. However, Article 1(2) OECD Model denies the benefits of the treaty to A and B (beneficial owners under the State P's perspective) and provides that the benefits of the treaty should be allocated to entity R. Once again, State P might not agree in reducing its WHT with respect to entity R, but rather with respect to A and B, who are the beneficial owners. Let us thus apply now the proposed solution.

If entity R *is not* a nominee, agent or other intermediary under State P's perspective, and this State treats the entity as fiscally transparent, being rather opaque for the State of residence (State R), the proposed solution provides that State P should deem entity R as the beneficial owner. Again, the solution is pragmatic and solves the conflict, although it limits the exclusivity of the State of source to determine under its domestic law who is the beneficial owner.

On the contrary, if entity R *is* a nominee, agent of other intermediary under State P's perspective, this State should look at the members of the entity, i.e.

[1115] *Supra* Section 5.2.1.2.

A and B. As both are individuals (not fiscally transparent), Article 1(2) OECD Model is not in play. The author understands in this case that Article 11 should apply as to reduce the WHT at source with respect to A an B, who are the beneficial owners, regardless the tax characterization of entity R in State R. In other words, Article 1(2) might not apply as to deny the benefits of the treaty to A and B.

Example 3:[1116]

In this example, Article 1(2) of the treaty R-P acts as to deny the benefits of the treaty to A and B and to confirm that this is indeed a domestic situation. Nevertheless, the treaty might be still applicable from the perspective of State P, which consider entity P as fiscally transparent, and A and B as the beneficial owner of the interest. Let us thus apply now the proposed solution.

If entity P *is not* a nominee, agent or other intermediary under State P's perspective, but it is regarded as fiscally transparent by the State of source (State P) and as a taxable entity by the State of residence (State R), then State P should deem entity P as the beneficial owner, solving the conflict with Article 1(2).

On the contrary, if entity P *is* considered as a nominee, agent or other intermediary under State P's perspective, then State P must look at the members, A and B. Both are individuals (non-transparent); therefore, Article

[1116] *Supra* Section 5.2.1.3.

1(2) is not in play. Thus, State P will consider to reduce its WHT under Article 11 with respect to A and B, and they should, in principle, get a relief under Article 23, regardless the tax characterization in its State of residence (State R). In other words, Article 1(2) might not apply as to deny the benefits of the treaty to A and B.

Example 4:[1117]

In this example, Article 1(2) grants the benefits of the treaty R-P to A and B. However, State P considers that the beneficial owner is entity R and not A and B. Let us thus apply now the proposed solution.

If entity R *is not* a nominee, agent or other intermediary under State P's perspective, but it is considered as fiscally transparent by the State of residence (State R), then State P should deem A and B as the beneficial owners. The proposed solution works as to solve the conflictive position between Article 1(2) and the beneficial ownership requirement of Article 11 of the treaty R-P.

On the contrary, if entity R *is* a nominee, agent or other intermediary under State P's perspective, then State P must look at the members A and B. Both are individual persons (non-transparent); therefore, Article 1(2) is not in play. Namely, A and B would be granted the benefits of the treaty and

[1117] *Supra* Section 5.2.1.4.

would be also considered as the beneficial owners for purposes of Article 11 of the treaty R-P.[1118]

Example 5:[1119]

Let us analyze now the application of the rule in a triangular case. In example 5, the relevant treaty is X-Z, because in the treaty Y-Z both States considers YCo as a taxable entity, and thus, Article 1(2) does not apply.

If YCo *is not* a nominee, agent or other intermediary under State Z's perspective, but State X (State of residence) considers YCo as fiscally transparent, being opaque in State X (State of source), then State Z must deem A and B as the beneficial owners of the interest. This pragmatic solution solves the dichotomy between Article 1(2) and the concept of beneficial owner, and grants A and B the reduced WHT of 5% (from the treaty Y-Z). Accordingly, it creates two beneficial owners for the same income: one is YCo (the real one), as regards to the treaty Y-Z, and the other ones are A and B (a "deemed" one), as regards to the treaty X-Z. This author does not really see a reason how this solution might be accepted without hesitation from a strict State of source's perspective.

On the contrary, if YCo *is* considered as a nominee, agent or other intermediary under State Z's perspective, this State should look at the

[1118] Indeed, the fact that entity is considered as a nominee, agent or other intermediary under State P's perspective, means that it cannot be the beneficial owner for purposes of Article 11 of the treaty R-P.

[1119] *Supra* Section 5.2.2.1.

members A and B. As both are individuals (non-transparent), Article 1(2) is not in play. Therefore, A and B are the beneficial owners of the interest under State Z's perspective and they are also the residents who receives the income and are granted the benefits of the treaty in State X. However, one could still question whether the fact that YCo is considered a nominee, agent or other intermediary under State Z's perspective changes or not the consideration of who is the beneficial owner under the treaty Y-Z. In other words, if YCo is considered as a nominee, agent of other intermediary by State Z, the expectable result is that now Article 11 of the treaty Y-Z does not apply as regards to that treaty.

Example 6:[1120]

In example 6, both applicable treaties are relevant. In both treaties Article 1(2) applies as to deny the benefits of the treaty to A and B. However, in both cases A and B are indeed seen as the beneficial owners of the interest. Let us thus apply now the proposed solution.

As regards to the treaty Y-Z, if YCo *is not* a nominee, agent or other intermediary under State Z's perspective, but it is considered as fiscally transparent by this country (State of source), although as tax opaque by State Y (State of residence), the source State (Z) should deem YCo as the beneficial owner. Therefore, the treaty Y-Z is now fully applicable, and State Z should limit its taxing rights based on a "deemed" *beneficial*

[1120] *Supra* Section 5.2.2.2.

owner.[1121] Considering the same situation as regards to the treaty X-Z, i.e. YCo *is not* a nominee, agent or other intermediary under State Z's perspective; the solution is the same as above: YCo is deemed to be the beneficial owner. Thus, the treaty X-Z would not longer be applicable.[1122]

As regards to the treaty Y-Z, if YCo *is* considered a nominee, agent or other intermediary under State Z's perspective, this State should look at the members of the entity. As A and B are both individual (not fiscally transparent), Article 1(2) is not in play. Accordingly, since YCo is just a nominee, agent or intermediary, State Z might clearly deny a reduced WHT under Article 11 of the treaty Y-Z. On the other hand, State Z will consider to reduce its WHT under Article 11 with respect to A and B (treaty X-Z), and they should, in principle, get a relief under Article 23, regardless the tax characterization in its State of residence (State R). In other words, Article 1(2) does not apply anymore as to deny the benefits of the treaty to A and B.

Example 7:[1123]

In this example, the relevant treaty is between States Y-Z, because the treaty X-Z is not only not applicable, but also consider that both the State of residence (State X) and State of source (State Z) treat the entity as a taxable entity. Therefore, Article 1(2) does not apply. Let us thus focus on the treaty Y-Z. From the strict perspective of State Y, the treaty Y-Z is not applicable,

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1121 However, State Z keeps considering YCo as a transparent entity.

1122 This is consistent with the solution of Article 1(2) OECD Model, which in this case denies the benefits of the treaty X-Z to A and B.

1123 *Supra* Section 5.2.2.3.

because YCo is not a resident for purposes of the treaty. Nonetheless, State Z might still consider applying a reduced WHT under Article 11 OECD Model, because State Z considers YCo as a taxable entity, and thus, most probably the *beneficial owner* of the interest. Let us thus apply now the proposed solution.

If YCo *is not* considered as a nominee, agent or other intermediary under State Z's perspective, but the State of residence (State Y) considers YCo as fiscally transparent while the State of source (State Z) considers it as a taxable entity, State P (the State of residence) must apply the treaty as if the beneficial owners were the partners of YCo, i.e. A and B. In other words, the "deemed" *beneficial owner* in this case allows State Z to confirm that the reduced WHT at source under Article 11 Y-Z treaty does not apply. In other words, both State Y and State Z will not apply the treaty Y-Z.

On the contrary, if YCo *is* considered as a nominee, agent or other intermediary under State Z's perspective, State Z must skip the entity and look at the members A and B. As both are individual persons (not fiscally transparent in their State of residence), Article 1(2) is not in play. In simple words, neither the treaty X-Z (originally not applicable) not the treaty Y-Z will be applicable now.

5.3.1.3. The pragmatism of "deemed" rules: Critisism

The pragmatic solution proposed by these known commentators seems to rely in some basic ideas. On one hand, while the tax characterization of the

entity in the State of residence seems to be absolutely relevant to solve the dichotomy between Article 1(2) OECD Model and the *beneficial ownership* requirement of Articles 10, 11 and 12 OECD Model, the tax characterization of the entity at source lacks of complete relevance. In other words, it is assumed by these authors that the tax characterization of the entity at source seems to play no role in the determination of the beneficial owner. For example, if the entity is not a nominee, agent or other intermediary under the State of source's perspective and also is considered as a taxable entity by this country, although as fiscally transparent by the State of residence, the solution simply proposes to treat the members of that entity as "deemed" beneficial owners to the extent that they are also not considered as nominee, agents or other intermediary. But even if these latters are regarded as nominees, agents or other intermediaries, it is the tax residence of the principal, which decides the conflict. Indeed, if the principal is a residence and also tax opaque in the State of residence, it is deemed as the beneficial owner. In simple terms, the concepts of *beneficial owner* and *resident* for purposes of the treaty are merged in order to solve the dichotomy. Likewise, if the entity is originally not considered as a nominee, agent or other intermediary under the State of source's perspective, and it is treated as fiscally transparent by the State of source, but as tax opaque by the State of residence, the State of source should deem the entity as the beneficial owner.

The above, on the other hand, brings us to the second characteristic of this proposal: even though it relies initially in the State of source's approach to

determine the beneficial owner, which is in line with the proposed OECD Commentaries on Article 1(2),[1124] this idea is rapidly disregarded limiting the exclusivity of the State of source to carry out this determination, without contingencies in the State of residence. In the case of this proposal, it results evident that even though the State of source considers an entity as tax opaque and not a nominee, agent or other intermediary, and thus, most probably the beneficial owner of the income, it must make this decision contingent to the fact the State of residence also considers that entity as tax opaque.[1125] Otherwise, the proposed solution provides that the members of the entity are the "deemed" beneficial owners.[1126] In the same order of ideas, even though the State of source considers an entity as tax transparent and not a nominee, agent or other intermediary, the determination of the beneficial owner is still contingent to the fact that the State of residence also considers that entity as tax transparent to finally say that the members of the entity are most probably the beneficial owners, regardless the fact that this solution would have been indeed achieved before looking at the tax characterization of the entity in the State of residence. Indeed, if this latter State would consider the entity as opaque, then the State of source must again "deem" the entity as the beneficial owner. It is therefore not a secret that the whole proposal relies on the tax characterization of the entity in the

[1124] Proposed Commentary on Article 1(2), para. 26.14, OECD (2015), *supra* n. 6, p, 142.
[1125] Although in such a case, Article 1(2) OECD Model is not applicable at all.
[1126] Unless, these latters are also considered as nominee, agents or other intermediary, where the solution is even more straightforward and calls for looking at the residence of the principal. *See* Nikolakakis et al., *supra* n. 955, p. 337.

State of residence, even though no justifications for this approach are provided.

As regards to the outcomes derived from the test of the proposed solution in the Section above, this author recognizes that, as per his personal interpretation of the rule, the proposed solution results, in most of the cases, pragmatically effective to solve the dichotomy between Article 1(2) OECD Model and the application of the beneficial ownership requirement of Articles 10, 11 and 12 OECD Model, even sometimes bringing desirable results from the point of view of the State of source,[1127] there are still some very arguable outcomes. For instance, in example 5 (triangular case), the application of the proposed solution does not only create two beneficial owners, one real and one "deemed", but it puts the State of source in the position of applying again the two treaties involves, i.e. the treaty Y-Z and the treaty X-Z.[1128] In this particular case, however, the two treaties provides for different reductions in their WHT, being the State of source obliged to apply the lower reduction as regards to both treaties, and now also under the confirmation that both the entity and the owners of its must be considered as the beneficial owners of the interest.[1129] The above does not mean that the authors necessarily agree with this outcome, but as this rule is inspired in the treaty practice between Canada and the United States, some exceptions might also be applied considering the U.S. tax treaty practice, in this case

[1127] For example, the results in examples 2 and 3, where the State of source consider initially that the entity is a nominee, agent or other intermediary. *Supra* Section 5.3.1.2.

[1128] *Supra* Section 5.3.1.2.

[1129] Id.

attending to the already stressed treaty between Poland and the United States.[1130] As provided already, in a very similar situation (as example 5) and if some preconditions are met, Article 1(6) US Model (i.e. Article 1(2) OECD Model) is directly not applicable.[1131] These preconditions are: (i) that the entity is considered as tax opaque under the law of the State of source; (ii) that the entity receiving the interest payments is organized in a third State (not the treaty partners' States), and (iii) that the entity in this third State is eligible for the benefits of a treaty with the State of source (i.e. it is a taxable entity there), and which are more favorable than the benefits provided between the treaty partners (i.e. the State of residence of the members of the entity and the State of source).[1132]

In spite of the fact that a dichotomy between Article 1(2) and 10, 11 and 12 OECD Model (as regards to the *beneficial ownership* requirement), seems to be addressed only through the use of "deeming rules", or exceptions to the general principles, this author still believe that this conflict might be solved perhaps in a more simple manner, without attending perhaps to the implementation of deeming rules to the deeming rules of the already existing deeming rules within tax treaties. In other words, a step towards simplicity is crucial at this point. This step should start from the basis that perhaps Article 1(2) OECD Model is not the ideal solution to the problem of hybrids and reverse hybrid entities, i.e. a domestic problem with tax treaty

[1130] US/PL: Article 1(6)((b) of the Convention between the United States of America and the Republic of Poland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of 13 Feb. 2013. *Supra* Section 4.3.1.1.1.

[1131] Id.

[1132] Id.

implications. This author thus still argues in favor of a simpler domestic rule, which might also positively impact the application of tax treaties.[1133]

5.3.2. *"Saving clause"* and Relief from Double Taxation

According to the released draft contents of the 2017 update to the OECD Model, paragraph 3 of Article 1 OECD Model will read 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] [B], 24, 25 and 28".[1134]. This provision, which resemblances Article 1(4) US Model (saving clause),[1135] is aimed at ensuring the Contracting State's right to tax its own residents, regardless the application of the treaty, being relevant thus for the State of source when a limitation under the treaty prevents it to tax its own residents. Le me illustrate the above with example 1 of Section 3.3.2.1.1 of this Chapter, although with some minimal variations.

1133 *Supra* Chapter VI, referred to the proposal for a *"reactive coordination rule"*.

1134 OECD (2017), *supra* n. 462, Article 1(3) OECD Model. The OECD BEPS proposal on Action 2, as regards to tax treaties, came originally with a phrase in brackets saying: "[In no case shall the provisions of this paragraph to be construed so as to restrict in any way a Contracting State's right to tax the residents of that State]". OECD (2014), *Neutralizing the Effects of Hybrid Mismatch Arrangements*, OECD Publishing, Paris, p. 86. Similarly, paragraph 26.16 of the proposed Commentary on Article 1 provided: "The last sentence of the paragraph clarifies that the paragraph is not intended to restrict in any way a State's right to tax its own residents". Id., p. 91. Although the final draft of the OECD BEPS Action 2 deleted this phrase, it kept paragraph 26.16 of the Commentaries on Article 1, which now provides: "As confirmed by paragraph 3, paragraph 2 does not restrict in any way a State's right to tax its own residents". OECD (2015), *supra* n. 6, p. 143.

1135 *Supra* Section 3.2.3.2.

Let us assume that an entity P is organized and resident in State P and has two owners: A and B, who are residents of State R. Accordingly, Entity P receives royalties from the same State P. While State P considers the entity as a taxable entity, State R considers the same entity as fiscally transparent. State P applies a general WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

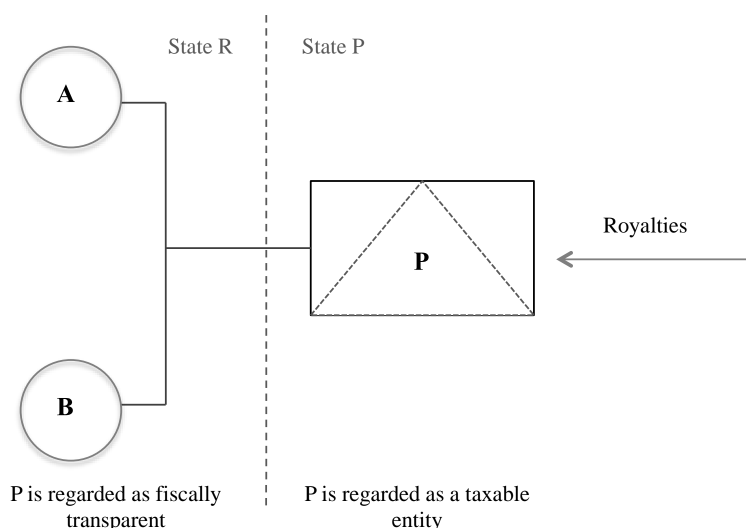


Figure 64: Article 1(2) OECD Model, Ex. 1

As per to Article 1(2) OECD Model, partners A and B are entitled to the benefits of the treaty R-P, because indeed State R is treating the royalties as being received by two of its residents. However, according to the saving clause, State P can still tax entity P (a taxable entity), regardless the application of the treaty. In practice, however, A and B might still claim a double taxation relief under Article 23 in State R.

Paragraph 26.16 of the Commentaries states as regards to the *saving clause*: "This [*referred State's right to tax its own residents*], however, does not restrict the obligation to provide relief of double taxation that is imposed on a Contracting State by Articles 23A and 23B where income of a resident of that State may be taxed by the other State in accordance with the Convention, taking into account the application of the paragraph" (emphasis added).[1136] Although the wording of the Commentary suggests that A and B in the case under analysis should be entitled to double taxation relief, it is difficult to figure out in practice how that relief will be provided. For example, if State R provides a tax credit to relief double taxation, it is clear in this case that no taxes where paid directly by A and B as regards to the taxation of entity P in State P. Thus, unless an extensive interpretation of Article 23 OECD Model is accepted, i.e. as including a potential indirect tax credit, the relief of double taxation in State R would not be possible.[1137]

Nevertheless, this issue seems to be definitely clarified in the proposal of paragraph 64 of the OECD BEPS Action 6, which provides the following modification on Article 23 OECD Model (referred in this case to Article 23B–tax credit): "Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in

[1136] OECD (2015), *supra* n. 6, p. 143.

[1137] As regard to this situation, Lang raises doubts: "I am not convinced about the legal basis for such an indirect tax credit, even though it eliminates double taxation. It might be difficult to interpret article 23 so extensively that an indirect credit has to be granted". Opinion of M. Lang in the conference *"Practical Problems of Tax Treaty Interpretation and Application",* held in Vienna on 21 Oct. 2013, and summarized in: K. Dziurdz, D. Fuentes and E. Pinetz, *Case Studies on Partnerships and Other Hybrid Entities,* 68 Bull. Intl. Taxn. 3 (2014), Journals IBFD, p. 153.

accordance with the provisions of this Convention (*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*), may be taxed in the other Contracting State, the first mentioned State shall allow […] (emphasis added)".[1138] This may be exactly the case where income (e.g. royalties) are taxed by each Contracting State, because one of the Contracting States taxes the worldwide income of an entity, which is considered a resident (i.e. entity P in our example above), and the other State considers the same entity as fiscally transparent and taxes its members (i.e. A and B in our example), who are also residents of that other State.[1139]

As regards to 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,* the proposed text of paragraph 11.1 to the Commentary on Article 23A and 23B OECD Model clarifies that: "[…] in such cases, both States 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

[1138] OECD (2015), *supra* n. 200, para. 64 (replacement of Article 23B OECD Model), p. 88.
[1139] Text of paragraph 11.1 to the Commentary on Article 23A and 23B. Id., p. 89.

solely be in accordance with paragraph 3 of Article1".[1140] Therefore, there are no doubts that, in our example above, if State P taxes entity P just because it is a resident in its State (i.e. because of the saving clause), there is no obligation to State R to provide a double taxation relief under Article 23 OECD Model in such a case. Although this author agrees that this conclusion might also be achieved by the sole interpretation of Article 23 OECD Model, it recognizes that the inclusion of paragraph 11.1 in the Commentary on Articles 23A and 23B, helps in avoiding misinterpretations.

Yet, the proposal of paragraph 64 of the OECD BEPS Action 6, if finally implemented, raises some questions as regards to the inclusion of a *saving clause*.[1141] On one hand, because paragraph 64 already clarifies that taxation of income derived by a resident, and exercised exclusively because of the resident status, might exist. On the other hand, because it clearly states that no relief of double taxation must be provided by the other Contracting State when the taxation was carried out solely because the income is also income derived by a resident of that State and not because taxation by the other State is in accordance with provisions of the Convention. The above avoids the uncertainty regarding the interpretation of Article 23 OECD Model. Such a solution, however, might still create problems in some countries

[1140] Id.

[1141] This was also recognized in the OECD Action 2 (deliverable 2014), which provides: "A proposal included in the Treaty Abuse Discussion Draft would make that paragraph unnecessary". OECD (2014), *supra* n. 1134, p. 91. Interestingly, however, the provision (*saving clause*) is recommended again in Article 3(3) MLI. *Infra* Section 6.2. It is also part of paragraph, Article 1 of the proposed UN Model. UN (2016), *supra* n. 1098, Annex I.

where, based on specific provisions or the tax treaty practice, use to grant double taxation relief in those cases. For example, the treaty Germany-Australia (2015) provides in its Protocol with respect to Article 1(2): "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 partially 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 Article 25 to find the appropriate solution" (emphasis added).[1142] Thus, the tax authorities in this case might perfectly find that double taxation relief should be granted in one of the Contracting States, even if the taxation by the other Contracting State was due solely because the income was considered as derived by a resident of that State. In simple words, the solution might be exactly the opposite as the one provided in paragraph 64. Similarly, the United Kingdom has the practice of providing for a tax credit where the same income is taxed by the other State, even when it is taxed in the hands of two different persons, and regardless the existence of a fiscally transparent entity.[1143]

[1142] 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, of 12 Nov. 2015, Article 2 of the Protocol with reference to paragraph 2, Article 1 of the Convention.

[1143] Nikolakakis et al., *supra* n. 955, p. 347. However, *see* in contrast the decision in UK: CA, 23 Mar. 2011, *Bayfine UK v. Commissioner for H M Revenue and Customs*, [2011] EWCA Civ 304, where the Court of Appeal held that both Contracting States are not reciprocally obliged to provide double taxation relief. *See also,* Arnold, *supra* n. 1013 and Cleave, *supra* n. 321. See also the decision in UK: *Anson (Appellant) v.*

5.3.2.1. A *"reverse saving clause"* as an alternative solution

It is perhaps interesting to note that some countries have also the treaty practice of including a provision known in doctrine as *"reverse saving clause"*, which basically precludes residence-based taxation of an entity by the State in which this is a resident, and preclude the taxation by the State of distributions by that entity.[1144] A good example of the above is the treaty between the Netherlands and Belgium (2001), where in the Protocol states: "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

Commissioners for Her Majesty's Revenue and Customs (Respondent) [2015] UKSC 44 on appeal from [2013] EWCA Civ 63, 1 July 2015. *See also*, Lemos, *supra* n 591; Popa, *supra* n. 592; Rogers, Cassidy and Mace, *supra* n. 611. In this case, however, the relief was granted on the view that the income of the entity should be attributed to the members as such (as the "same income"), even though the member did not have a direct or indirect proprietary interest in the any of the entity's property income. Nikolakakis et al., *supra* n. 955, p. 358.

[1144] Nikolakakis et al., *supra* n. 955, p. 353.

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".[1145]

Accordingly, as provided in the Protocol: "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 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 from the preceding sentence". [1146]

Although the solution presented above is practical and certainly solve the double taxation risk, is contrary to the idea of paragraph 64 of the OECD BEPS Action 6.[1147] The above, however, does not mean that it should be discarded. Instead, it should be considered as a consistent alternative to address the same issue, but from a different perspective.

[1145] Convention between the Kingdom of Belgium and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital and its Protocol I of 5 June 2001, Article 2 of the Protocol with respect to Article 3(1)(c) of the Convention.
[1146] Id., Article 4(b) of the Protocol with respect to Article 4 of the Convention.
[1147] Nikolakakis et al., *supra* n. 955, p. 347 (fn. 183) and 354.

5.3.3. Article 1(2) OECD Model and the Base Erosion of Developing Countries: A UN Model's proposal

All the illustrations as regards to the application of Article 1(2) OECD Model allow us to see its preferential results for the State of residence. It is interesting thus that developing countries, normally acting as States of source in bilateral relations, might be willing to include such a provision within their tax treaty network. Contrary to this logic though, however, the U.N. Committee of Experts on International Cooperation in Tax Matter has agreed in including within the U.N. Model a provision similar to Article 1(2) OECD Model.[1148] This idea is not only contradicting the historic position of the U.N. Committee of Experts as to recognize the principles of the OECD Partnership report,[1149] but it might negatively impact the tax base of developing countries.

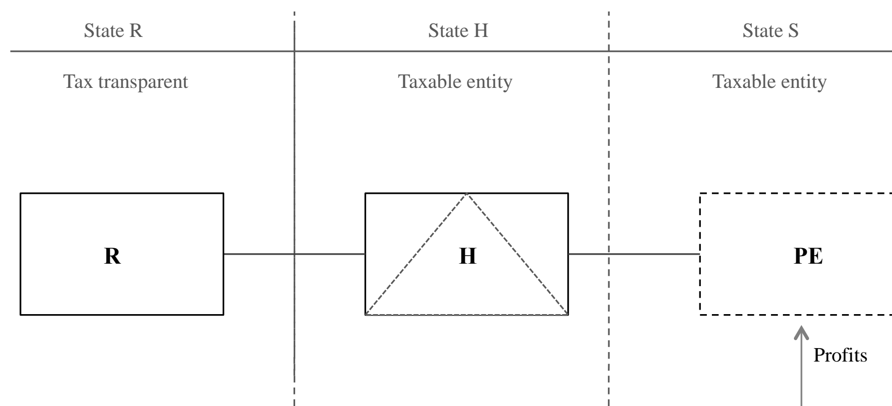
Let me illustrate the economic impact of a provision similar to Article 1(2) OECD Model introduced within the UN Model, as follows:[1150] let us imagine a company R residents in State R, which is the sole proprietorship

[1148] UN (2016), *supra* n. 1098.

[1149] The principles of the OECD Partnership Report were never acknowledged. This idea is not derived from the official minutes of meetings sustained by the Committee of Experts discussing the principles of the OECD Partnership Report, but by the sole lecture of paragraph 5 and 6 of the Commentary on Article 1 UN Model. *See* UN: United Nations Model Tax Convention between Developed and Developing Countries, UN, New York, 2011, p. 42.

[1150] Regardless that the analysis is focused on the impact in the tax base of developing countries, the legal concern raised by the author as regard to the interplay between Article 1(2) OECD Model and the concept of beneficial owner can be indeed reproduced in the case of a provision within the UN Model.

of an entity H, resident in State H, and which provides services to its client in a third country S, a developing country, constituting a PE in this country. Likewise, while State H and State S consider entity H as a taxable entity, State R considers it as a fiscally transparent entity. It is also assumed that the treaty between State R and State S follows the OECD Model and does not include a service PE provision.[1151]



Under the treaty H-S, there is a service PE in State S. Thus, State S has the exclusive right to tax the profits attributable to that PE. However, by application of Article 1(2) R-S treaty, those profits are indeed income of R. The treaty R-S also does not consider that a PE is constituted in State S.

Figure 65: Article 1(2) OECD Model and developing countries

According to the treaty between State H and State S, the business profits generated by entity H are attributable to its PE in State S. Thus, State S has exclusive taxing rights to tax those profits attributable to the PE according to Article 7 of the treaty H-S. However, as per Article 1(2) R-S treaty, the

[1151] This example is extracted from Sanghavi to explain what he calls the "economic anomalies" of Article 1(2) OECD Model. *See* Sanghavi, *supra* n. 1091, pp. 361-362, Fig. 2.

income is attributed to company R, which is also entitled to the benefits of the treaty. This result is given by the sole fact that State R treats entity H as fiscally transparent, and the income is allocated to a resident of State R. Likewise, and considering that the treaty R-S does not contain a service PE provision, i.e. there is no a PE as per the understanding of the treaty R-S, Article 7 of the R-S treaty prevents State S from taxing any of the profits associated to the services rendered in State S. Moreover, double taxation might occur since State H will anyway tax the profits of entity H in State H, and these profits will be taxed again in State R, at the level of company R. Thus, unless under the treaty R-H, entity H is regarded as a PE, there will be no relief from double taxation in State R. The same results if States R and State H do not have a treaty.

It is surprising that the outcome above-explained in which the State of source (State S, a developing country) must give up its taxing rights just because the State of residence of the partner (company R) considers entity H as fiscally transparent, is indeed accepted by State S when the erosion of its tax base and the negative economic impact is evident. This situation resemblances also the example analyzed in *supra* Section 5.3.1, where the State of source should give the benefits of its reduced WHT not only to the country where the intermediary entity was established, which was correct since both countries treated the entity as a taxable entity, but also to the State where the partners of this entity were residents, since this country

treated that entity as fiscally transparent.[1152] The above certainly benefited the State of residence of the partners, since the reduction of the WHT was lower within the treaty between the State where the entity is established and the State of source, in comparison with the treaty between the State of residence of the partners and the State of source. Once again, however, the sole fact that the State of residence of the partners considers the intermediary entity as fiscally transparent granted the partners a more beneficial tax treaty and jeopardized the position of the State of source.

6. Transparent entities and the MLI: Some brief remarks

This last Section has the purpose of briefly stressing some issues as regards to Article 3(1) MLI and some other related provisions within the MLI dealing with transparent entities.[1153] As most of the provisions resemblance or directly refer to the interpretation of the OECD Model proposal on Article 1(2), this Section will stress only the most important commonalities and differences, avoiding thus repetition.

[1152] The "deemed" *beneficial owner* proposal reaffirms this conclusion as well. *Supra* Section 5.3.1.1. However, the alternative stated within the United States/Poland tax treaty seems to be a suitable and fairer alternative from a State of source's perspective. *Supra* Section 4.3.1.1.1.

[1153] OECD (2016), Text of the Multilateral Convention to Implement Tax treaty Related Measures to prevent Base Erosion and Profit Shifting, adopted on 24 Nov 2016, Part II-Hybrid Mismatches (hereinafter also, "MLI text"); OECD (2016), *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, OECD Publishing, Paris (hereinafter also, "MLI Explanatory Statements"). For a critical analysis of the MLI, *see* J. Zornoza, *Acción 15. El instrumento multilateral y el plan de acción BEPS*, in: J. Ramos (coord.), *Erosión de la Base Imponible y Traslado de Beneficios: Estudios sobre el plan BEPS de la OCDE,* Aranzadi, Navarra (2016), pp. 425-452.

6.1. Article 3(1) MLI: A mirror of Article 1(2) OECD Model

Article 3(1) MLI states as follows: "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".[1154]

As it can be easily noted, both the text of Article 1(2) OECD Model, already analyzed, and the text of Article 3(1) MLI are exactly the same. Indeed, the MLI Explanatory Statements notes that Article 3(1) replicates the text of Article 1(2) OECD Model "with changes made solely to conform the terminology used in the model provision to the terminology used in this Convention".[1155] Therefore, since the MLI Explanatory Statements do not elaborate further on the interpretation of Article 3(1) MLI, one might presume that the intention is to give relevance to the OECD Commentaries on Article 1(2) in this regard.[1156] In this order of ideas, therefore, the analysis and conclusions achieved as regards to the interpretation and

[1154] OECD (2016), MLI Text, *supra* n. 1153, Article 3(1).
[1155] OECD (2016), MLI Explanatory Statements, *supra* n. 1153, para. 40.
[1156] For example, the MLI Explanatory Statements establish: "The commentary that was developed during the course of the BEPS Project and reflected in the Final BEPS Package has particular relevance in this regard". Id., para. 12. In the same opinion: Nikolakakis et al., *supra* n. 955, pp. 298-299.

application of Article 1(2) OECD Model can also be extended to Article 3(1) MLI without need of a further analysis. [1157]

Finally, it is perhaps important to note that Article 3(1) MLI is not required as a minimum standard. Thus, a Party might opt completely out of this Article.[1158]

6.2. *"Saving clause"* and Relief from Double Taxation

As well as the OECD Model, the MLI includes expressly two provisions dealing with the rights of the Contracting States to tax their own residents. These provisions are optional and they can be selected in a detailed version, i.e. Article 11 MLI, or in a simplified one, i.e. Article 3(3) MLI as regards to Article 3(1) MLI.[1159] In both cases, it is clear that the final purpose of the provision is to ensure that Contracting States within a tax treaty are not precluded from taxing their own residents. [1160] However, while the version of Article 11 MLI seems to retain the obligations to provide double taxation relief under provisions such as Article 7(3), Article 9, Article 19, Article 20, Article 23A and 23B, Article 24, Article 25 and Article 28 OECD Model, Article 3(3) MLI does not expressly preserve treaty obligations as regards to

[1157] *Supra* Section 5.

[1158] OECD (2016), MLI Explanatory Statements, *supra* n. 1153, para. 46.

[1159] Article 3(3) MLI states that, with respect to Covered Agreements for which one or more parties have made the reservation of Article 11(3) MLI, the following sentence must be added to Article 3(1): "In no case shall the provisions of this paragraph be construed to affect a Contracting State Jurisdiction's right to tax the residents of that Contracting Jurisdiction". OECD (2016), MLI Text, *supra* n. 1153, Article 3(3).

[1160] Nikolakakis et al., *supra* n. 955, p. 345.

those Articles.[1161] Therefore, the inclusion of one provision or the other might not have the same effect.[1162]

There are also other two provisions within the MLI dealing with tax credits and exemption obligations that should be considered. The first one is Article 3(2), which provides: "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".[1163] As noted, the wording mirrors the already analyzed paragraph 64 of the OECD BEPS Action 6, which introduces a new paragraph 11.1 to the Commentaries on Articles 23A and 23B.[1164] In that modification, it is clearly stated that both States *are not* reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer. In contrast, they are 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

[1161] OECD (2016), MLI Text, *supra* n. 1153, Article 11 and Article 3(3).
[1162] Nikolakakis et al., *supra* n. 955, p. 345.
[1163] OECD (2016), MLI Text, *supra* n. 1153, Article 3(2).
[1164] *Supra* Section 5.3.2.

is attributable.[1165] Similarly, Article 5 MLI–Option C, which applies only to credit-based relief along the lines of Article 23B OECD Model, would limit the obligation of the State of residence to the extent that the treaty allows taxation by the other Contracting State solely because the income is also income of a resident of that other Contracting State.[1166] Indeed, as provided by the Article: "Where a resident of a Contracting Jurisdiction derives income or owns capital which may be taxed in the other Contracting Jurisdiction in accordance with the provisions of a Covered Tax Agreement (except to the extent that these provisions allow taxation by that other Contracting Jurisdiction solely because the income is also income derived by a resident of that other Contracting Jurisdiction), the first-mentioned Contracting Jurisdiction shall allow […]".[1167]

As well as stressed with respect to paragraph 64 of the OECD BEPS Action Plan 6, introduces a new paragraph 11.1 to the Commentaries on Articles 23A and 23B, the approach adopted within the MLI might create problems in some countries where double taxation relief as a matter of treaty practice.

[1165] OECD (2015), *supra* n. 200, p. 89, text of paragraph 11.1 to the Commentary on Article 23A and 23B.

[1166] Nikolakakis et al., *supra* n. 955, p. 347. These authors stress that, curiously, there is no such an option as regards to the exemption-based relief along the lines of Article 23A OECD Model, regardless that paragraph 64 of the OECD BEPS Action Plan 6 provides such a proposal.

[1167] OECD (2016), MLI Text, *supra* n. 1153, Article 5, Option C.

7. Final Remarks

The allocation of taxing rights between countries due to the application of a tax treaty is not an easy task, because in fact it assumes to renounce part of the sovereignty of a State to tax. This task becomes even more complex when countries do not agree on the tax treatment that a foreign entity should have for domestic tax purposes. Such a decision is also crucial for tax treaty purposes since tax treaties do not deal with the characterization of entities, being the above a strict domestic tax issue.

Since the OECD Partnership Report in 1999, the solutions provided have been, intentionally or not, designed in a manner in which winners and losers seem to appear clearly established: the States of residence certainly enjoys a more favorable outcome when compared with States of source. The above can be clearly noticed in the materialization of those principles both in Article 1(6) US Model and Article 1(2) OECD Model. The above, nevertheless, does not rest merit to these provisions that mirror one each other, although it must be recognized that perhaps this is precisely the problem.

Article 1(6) US Model is a provision created to protect the position of the United States both as a resident and source State, which, as noted, can be found even before 1999. When the provision is analyzed being the United States the State of residence, it fits perfectly to the intention that the benefits of a treaty signed by the United States are not allocated to persons other than

U.S. persons. Therefore, when an item of income is received through an entity that the United States considers as fiscally transparent, the income and the benefits of the treaty are allocated to the U.S. partners only. In contrast, being the United States the State of source, the application of the *"saving clause"* protects again the position of the United States, disregarding the tax treaty obligation in order to tax its own residents. Article 1(2) OECD Model, on the other hand, follows the same patterns,[1168] regardless that the OECD Model is used by developed and developing countries, being these latter countries remarkably relying on source taxation. In this regard, it results at least curious that Article 1(2) OECD Model does not propose a more equilibrated balance between the interests of residence and source States, appearing, in principle, as an inadequate strategy to address all the concerns that arise in this context.[1169] The above idea is reinforced when the text of Article 1(2) OECD Model is simply replicated within Article 3(1) MLI.

An special legal concern as regards to Article 1(2) OECD Model, it is its almost inexistent interplay with the *beneficial ownership* requirement in case of payments of dividends, interest and royalties under Articles 10, 11 and 12 OECD Model. Indeed, the reduced WHT at source in those cases depends not only on the fact that a resident in the other State receives the income, but also that this resident is considered as the *beneficial owner* of those items of income. In all the illustrations used in this Chapter, it was

[1168] Except that a saving clause is not necessary since the proposed modification of paragraph 64 of the OECD BEPS Action Plan 2 that includes a modification on Article 23 OECD Model. *Supra* Section 5.3.2.

[1169] *See also* in this opinion: Nikolakakis et al., *supra* n. 955, pp. 358-359.

demonstrated that the two provisions are indeed permanently in conflict or not properly aligned. A recent attempt to solve this dichotomy has been, however, elaborated by a bunch of recognized tax academics. The proposal is simple in terms of principles: it uses a "deeming rule" to provide who is the *beneficial owner* when Article 1(2) OECD Model does not coincide giving the same person the benefits of a treaty. Nevertheless, and although the rule initially attends to the fact that no relevant party is acting as an agent or nominee or other intermediary for a third party from the source State's perspective, it is strictly designed to give prevalence to the tax characterization of the entity in the State of residence.[1170] As such, this author does not see how States of source might fully agree with this pragmatic solution without hesitation.

Another concern as regards to Article 1(2) OECD Model and also Article 3(1) MLI is the interplay between a *"saving clause"*, which ensures Contracting States the taxation of their own residents regardless the application of a treaty, and the relief of double taxation's obligations under a treaty. The solution adopted by paragraph 64 of the OECD BEPS Action 6, which introduces a new paragraph 11.1 to the Commentaries on Articles 23A and 23B is clear in this regard: the Contracting States *are not* reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer. Therefore, relief of double taxation remains only to the extent that taxation by the other State is in

[1170] *Supra* Section 5.3.1.3.

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. This solution is replicated in Article 3(2) and Article 5–Option C MLI. Both Articles refer expressly refer to paragraph 64 of the OECD BEPS Action 6. However, when dealing with the optional *saving clauses* within the MLI, it seems to be that opting for one or another might not bring the same results. For example, while the detailed *saving clause* of Article 11 MLI seems to retain the obligations to provide double taxation relief under provisions such as Article 7(3), Article 9, Article 19, Article 20, Article 23A and 23B, Article 24, Article 25 and Article 28 OECD Model, the simplified version of Article 3(3) MLI does not expressly preserve treaty obligations as regards to those Articles. Likewise, a solution such as the one proposed in paragraph 64 of the OECD BEPS Action 6 might still create issues in some countries where, based on specific tax treaty provisions, e.g. the tax treaty Germany/Australia, or by treaty practice, e.g. the United Kingdom, use to grant double taxation relief in those cases, and other analogous ones, by an extensive interpretation of Article 23 OECD Model. In other words, the inclusion of a *saving clause* is perhaps not strictly necessary for all States.

All in all, it seems to be that after a deeper look at Article 1(2) OECD Model and Article 3(1) MLI, and the proposed *saving clauses* in Article 1(3) OECD Model and Articles 3, 5 and 11 MLI, they are not necessarily the most adequate manners to address the issue of hybrids and reverse hybrid

entities within the treaty context.[1171] It is perhaps time to think on a different solution, which truly targets the disparities in the characterization of entities, and which should not necessarily be implemented within tax treaties.[1172] As this author proposes in Chapter VI, a domestic coordination in the tax characterization of entities might achieve better results, on one hand, reducing the scope of application of Article 1(2) OECD Model only to those cases in which both the State of residence and source treat the entity as fiscally transparent, and, on the other hand, might provide more consistent tax treaty outcomes, indirectly balancing the position between residence and source States, at least when compared with a pure application of Article 1(2) OECD Model, i.e. without coordination in the tax characterization.[1173]

[1171] Also in this opinion: Nikolakakis et al., *supra* n. 955, p. 358 and 360.
[1172] *See* the proposal for a *"reactive coordination rule"* in *infra* Chapter VI.
[1173] The tax treaty implication of the domestic proposal of coordination (*reactive coordination rule*) is analyzed at *infra* Chapter VI, Section 3.

–PART THREE–

Double Non-Taxation and Hybrid Entities: The new trend of (*mis*) matching outcomes

V. CHAPTER

Hybrid Mismatch Arrangements and *Linking Rules*: Creating Artificial (Mis)Matches

1. Introduction

The international tax world and the manners to deal with hybrids and reverse hybrid entities have certainly changed after the issuance of the OECD BEPS Project.[1174] Since then, the trend has been especially inclined to match transactions involving hybrid and reverse hybrid entities with the outcomes derived from those transactions, i.e. specially "deduction/non-inclusion" (D/NI) outcomes or DNT. This approach has been proposed and designed within the OECD BEPS Action Plan 2 and attempts to recognize a new single category of (international) problems denominated *"hybrid mismatch arrangements"* (HMA).[1175] Likewise, and as a remedy to those problems, the OECD proposes the implementation of domestic rules that primarily deny a deduction if the respective income is not included in the hands of the recipient in the other country, i.e. a *primary response*, or to tax the income that originally was not taxed in the hand of the recipient, i.e. a

[1174] OECD (2013), *supra* n. 2.

[1175] OECD (2015), *supra* n. 6, p. 16. However, the OECD already used the concept of HMA in 2012 when it elaborated a report on "hybrid mismatch arrangements". This report is with no doubts the anteroom of the proposals included within the BEPS Action Plan 2. *See* OECD (2012), *supra* n. 6.

secondary rule.[1176] Both rules are recognized under the single denomination of *"linking rules"*, as their design also suggests.

This Chapter attempts to demonstrate that both the notion of HMA and the solutions created to counteract them (*"linking rules")* are indeed ad-hoc constructions that artificially attempt to match transactions involving hybrid entities and reverse hybrids with the DNT outcome (i.e. D/NI), disregarding the core of the issue with respect to hybrids, which is the uncoordinated characterization of entities by two different countries.[1177] Moreover, this matching practice has the risk of creating a presumption of abusive practices in all those cases in which a transaction involving hybrid entities derives in a D/NI outcome, which certainly deviates from a proper understanding of the notion of DNT and restrict the ability of the taxpayers to efficiently manage their businesses.[1178] Likewise, this Chapter suggests that the implementation of domestic *linking rules*, i.e. the domestic remedy suggested by the OECD, might generate important concerns both from a tax policy and from a legal perspective. This latter issue will be particularly tested in light of the application of double tax treaties and the application of Article 24 OECD Model (Non-discrimination) and with EU primary and secondary law.[1179] A

[1176] Chapter 3, 4 and 5 of the OECD Action Plan 2 refer specifically to the recommendations with respect to payments made by a hybrid entity and payments received by a reverse hybrid entity and which result in D/NI. *See* OECD (2015), *supra* n. 6, pp. 49-66.

[1177] *Supra* Chapter III.

[1178] *Supra* Chapter I.

[1179] Testing the implementation of *linking rules* as regards to the non-discrimination clause of Article 24 OECD Model has special relevance, because it is indeed the only provision within the OECD Model, which could raise concerns with respect to the proposed rules.

similar analysis will be made with respect to the interaction between *linking rules* and interest limitation and CFC rules, respectively.

Section 2 analyzes the concept of HMA and the elements required for its formation, specifically referred to hybrid entities and reverse hybrid entities: (i) the *'hybrid element'*; (ii) the existence of a *payment* and (iii) D/NI outcome (DNT). It also illustrates with examples the cases in which the use of hybrid entities and reverse hybrid entities might derive in a D/NI outcome in order to demonstrate that in both situations this outcome is more temporal than permanent. The illustration includes the cases of a D/NI outcome using a hybrid entity, a reverse hybrid and the case of *"imported mismatches"*. Section 3 turns the analysis into the specific domestic measures recommended by the OECD to counteract HMA, i.e. *linking rules*. This Section also stresses the tax policy and legal concerns associated with the implementation of linking rules, particularly with respect to the application of tax treaties and EU law. Section 4 analyzes the interaction between *linking rules* and the application of other domestic anti-abuse and anti-base erosion rules, especially with respect to interest limitation rules and CFC

Likewise, the use of EU law as a subject of analysis is also justified. On one hand, because of the less restrictive notion of "discrimination" elaborated within the CJEU when compared to the one of Article 24 OECD Model, and, on the other hand, because the EU has been particularly involved in the implementation of the OECD BEPS measures, including the ones counteracting hybrid mismatches. This task has been materialized with the approval of the EU ATAD I, which opted for including *linking rules* to deal with hybrids (both as regards to entities and financial instruments), and the recent development included within the EU ATAD II, which covers HMA with third countries. All these developments were previously analyzed in this work. See *supra* Chapter III, Section 5.3.

rules that might affect transactions involving hybrid and reverse hybrid entities, respectively. Section 5 provides some final remarks.

2. The Concept of Hybrid Mismatch Arrangements (HMA)

The final OECD report on Action 2 refers to HMA as arrangements that "exploit differences in the tax treatment of an entity or instrument under the laws of two or more jurisdictions to achieve double non-taxation, including long term deferral".[1180] A similar definition was proposed in the first draft on Action 2 in 2014, which provided that a HMA is "an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement".[1181] Likewise, this work follows the direction already settled in the previous OECD report on hybrid mismatch arrangements (2012), which referred to them as "arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries […] They often lead to 'double non-taxation' that

[1180] OECD (2015), *supra* n. 6, p. 11

[1181] OECD (2014), *supra* n. 1134, p. 29. Before the issuance of the 2014 Report, the OECD opened the discussion to the public issuing two documents of 19 March 2014: (i) OECD (2014a), Public Discussion Draft, *BEPS Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements (Recommendations for domestic Laws)* and (ii) OECD (2014b), Public Discussion Draft, *BEPS Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements (Treaty Issues)*. The comments received are summarized in a document of 7 May 2014: OECD (2014c), Comments Received on Public Discussion Drafts, *BEPS Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements,* available online at www.oecd.org.

may not be intended by either country, or may alternatively lead to a tax deferral which if maintained over several years is economically similar to double non-taxation”. [1182]

Therefore, exclusively referring to hybrid and reverse hybrid entities, it is possible to argue that, in the OECD view, there will be a *“hybrid entity mismatch arrangement”* when an entity organized in a determined country is regarded either as transparent or taxable entity in that country, while in the other country is characterized exactly in the opposite manner, and whose result is therefore a mismatch in the payments made under that arrangement, which is normally traduced in a D/NI outcome, i.e. DNT or a DD.[1183] In other words, at least three elements will be required in order to determine that a hybrid entity mismatch exists: (i) an ‘*hybrid element’*, i.e. a disparity in the characterization of the same entity by two or more countries involved in the transactions; (ii) the existence of a *‘payment’* between the two parties involving in the hybrid structure, and iii) a *mismatch* in that payment, namely, a D/NI outcome or DNT. These elements are subsequently analyzed as regards to hybrid and reverse hybrid entities.

[1182] OECD (2012), *supra* n. 6, p. 1

[1183] O. Popa, *Hybrid Entity Payments–Extinct Species after the BEPS Action Plan?*, 59 Eur. Taxn. 9 (2014), Journals IBFD, p. 408.

2.1. The *'hybrid element'*

As already stressed in Chapter III, hybrid entities and reverse hybrids are the result of the different characterization of entities in two jurisdictions.[1184] In this regard, a *hybrid entity* is an entity regarded as a taxable entity in the country of its organization while in the other country the same entity is regarded as fiscally transparent. In other words, the entity under analysis is subject to taxation at the level of the entity in its country of organization whilst in the country of the shareholders is considered 'tax transparent', i.e. non-taxable at the level of the entity but rather at the level of the shareholders. A *reverse hybrid*, on the other hand, supposes the opposite situation. This is to say, an entity considered as a tax transparent entity in its country of organization while as a taxable entity in the other country, i.e. where the shareholders are residents.[1185]

The 'hybrid element', as described within the OECD BEPS Action 2, seems to be thus a simple recognition of an obvious reality in taxation: domestic rules among different jurisdictions are not necessarily coordinated, less harmonized.[1186] Indeed, one should start from the basis that disparities, including disparities in the characterization of entities, are the general rule and not the exception within cross-border transactions. The above was demonstrated in Chapter III, where dealing with the domestic rules on

[1184] *Supra* Chapter III, Section 3.1.
[1185] Id.
[1186] *Supra* Chapter III, Section 6.

characterization of entities concluded, on one hand, that there is no a perfect system to characterize entities for tax purposes, which can be used homogeneously by States, and, on the other hand, that the distinction of systems to characterize entities, i.e. resemblance test; elective system, etc., do not go beyond of being an interesting academic exercise, although in practice the different systems are normally interconnected, namely, they present elements of each other.[1187] For example, as already stressed in Chapter III, the resemblance test applied in the United States before the CTB regulations were not less elective than the current elective system, because in fact taxpayers could achieve certainty in the characterization of a foreign entity in advance involving themselves in costly tax advisory. This is what this author has called a '*de facto* elective system'.[1188]

Regardless the above, the "hybrid element" is indeed a fundamental factor (if not the real reason of the disagreement between States) whose presence determines the first step to confirm the existence of a HMA with respect to entities. On the contrary, the absence of this element implies also the absence of a HMA (or the impossibility of its formation), and thus, makes the OECD recommendations inapplicable. The above is especially relevant considering the cases of countries that might remotely or never face issues with respect to hybrid entities or reverse hybrids either because of a coordination in their characterization of a foreign entity, by statute or administrative practice, as per the rule in the foreign country where the

[1187] Id.
[1188] *Supra* Chapter III, Section 4.

entity is established,[1189] or simply because they do not provide the alternative for tax transparency within their domestic law or specific rules to characterize a foreign entity as transparent.[1190] Whilst the former, i.e. the coordination in the characterization of entities as per the foreign rules, reduces the probabilities of originating hybrid entities, the latter reduces the probabilities of reverse hybrid entity mismatches to zero.

Another issue of particular relevance with respect to the 'hybrid element' is the fact that countries might treat some entities as only "partially" tax transparent, as it is the case of some trusts and LLPs.[1191] Although this

[1189] *See*, e.g. the case of Spain with respect to the characterization of foreign entities for tax purposes. As stressed in Chapter III, the administrative practice of the DGT (Spanish tax administration) is to follow the characterization in the foreign country, regardless that by statute the Spanish domestic law provides for a resemblance test. *Supra* Chapter III, Section 5.1.

[1190] Although many developed countries provide the alternatives of tax transparent entities, e.g. partnerships or trusts, this is indeed not the case in developing countries. For example, Brazil and Colombia do not provide for domestic tax transparent partnerships. In Uruguay, a partnership whose partner is a company also resident in Uruguay is not regarded as tax transparent either. Likewise, e.g. Brazil, Colombia and South Africa do not have rules that allow treating a foreign subsidiary as a tax transparent entity. For a full analysis with respect to problematic of HMA and developing countries (particularly with respect to Brazil, Colombia, Uruguay and South Africa), *see* B. Kuzniacki et al., *Preventing Tax Arbitrage via Hybrid Mismatches: BEPS Action 2 and Developing Countries*, WU International Taxation Research Paper Series No. 2017-03, of 31 March 2017, available online at www.ssrn.org.

[1191] In the Netherlands, e.g. an "*open commanditaire venootschap"* is always transparent for the general partners, while it is taxed at the level of the entity with respect to the limited partners. Similarly, the *"société en commandite simple"* in France, provides for tax transparency with respect to the general partners, while the limited partners are not taxed within the regime of transparency. Baker distinguishes at least four levels of transparency: 1) complete transparency, where the entity has no existence, e.g. a contractual joint venture, or where the entity is completely disregarded for tax purposes; 2) transparency with reporting obligations, where the entity has still the obligation to report income or gains, but the tax liability remains on the participants; 3) optional

issues is not directly treated within the OECD report on Action 2 referred to domestic recommendations, it is indeed analyzed within the tax treaty recommendations and the access to tax treaty benefits.[1192] As provided within the proposed paragraph 26.11 of the commentaries on Article 1(2) OECD Model: "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 […] whilst the rest would remain taxable at the level of the entity or arrangement".[1193] In the same order of ideas, therefore, it is possible to conclude that a "partial hybridity" could exist. In such cases, only the part of the entity treated as tax transparent by one country and taxable by the other country could give rise to the "hybrid element" that is necessary to originate a HMA. In other words, if the country of establishment of an LLP, e.g. treats the entity as fiscally transparent only with respect to the general partners, while the other country considers the LLP as taxable in full, only the part of the income or payments associated to the general partners could originate the hybrid element that subsequently might give rise to a HMA.

transparency, where the entity or participants may elect for transparency; 4) Partial transparency, where part of the income of the entity is taxed in the hands of the entity and part in the hand of the participants. *See* Baker, *supra* n. 884, pp. 22-23.

[1192] OECD (2015), *supra* n. 6, pp. 133 et seq. *See also* the discussion regarding *"wholly and partially"* fiscally transparent, referred to the wording of Article 1(2) OECD Model at *supra* Chapter IV, Section 5.1.4.

[1193] OECD (2015), *supra* n. 6, p. 141. (Proposed paragraph 26.11 of the Commentaries on Article 1(2) OECD Model).

2.2. The existence of a *'payment'*

The second element that constitutes the notion of HMA refers to the existence of a *payment* between the parties involved in the hybrid entity structure.[1194] In this regard, Action 2 of the OECD BEPS Action Plan states that a *payment* means: "any payment of money (which includes money's worth) made under the financing instrument and includes a distribution, credit or accrual. It includes an amount that is *capable of being paid* and includes any future or contingent obligation to make a payment. The definition of payment includes notional amounts that accrue in respect of a future payment obligation even when the amount accrued does not correspond to any increase in the payment obligation during that period".[1195] Accordingly, a payment is considered as such when the relevant payment obligation is incurred under the laws of the payer jurisdiction or the payment is derived under the laws of the recipient jurisdiction.[1196] The report, however, expressly excludes a unilateral deduction for invested equity that does not require a payment from the taxpayer, such as the case of "deemed interest deductions for equity"[1197] and differences in the value with respect

[1194] As provided within the OECD report: "The extent of a mismatch is determined by comparing the tax treatment of the payment under the laws of each jurisdiction where the mismatch arises". Id., p. 17.

[1195] A payment should also include a part of a payment where the context requires. Id., p. 130.

[1196] Id.

[1197] These payments would be "economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated by Action 2". Id., p.18

to a payment, such as the case of gain or losses from foreign currency fluctuation.[1198]

The concept of *payments* used within the report, however, has not been exempt of criticism.[1199] In fact, if one considers e.g. an allowance for corporate equity such as a "deemed interest deduction for equity" (i.e. a fictional deduction), it is clear that this would be immune to the OECD recommendations, although it treats equity like debt in one country[1200] and could perfectly derive in DNT (i.e. the main target of the HMA concept and the proposed *linking rules*), considering that the majority of these notional

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[1198] "The hybrid mismatch rules are not generally intended to pick-up mismatches that are attributable to differences in the value ascribed to a payment. For example, gain and losses from foreign currency fluctuations on a loan can be said to give rise to mismatches in tax outcomes but these mismatches are attributable to differences in the measurement of the value of payments (rather than its character) and can generally be ignored for the purposes of the hybrid mismatch rules". Id.

[1199] Cooper e.g. states that it is interesting that the concept and the rules in question [*linking rules*] refer only to "payments". Indeed, he gives the example of a "double dip" lease where two taxpayers claim the entitlement to depreciation deductions or investment tax credits, and he argues: "There are certainly 'payments' being made, i.e. the price paid by the financier for the equipment and the rent and residual paid by the user, but these are not the same payment, and the tax-relevant item for the user or financier is not itself a "payment", but, rather, the depreciation deduction created by law. While depreciation is derived from the amount of a payment, it is not itself a payment. What does appear to be clearer is that both parties could claim any additional investment allowance or tax credit that might to be given to the "owners" without being affected by these rules". In the same order of ideas, Cooper sustains that, e.g. a duplication of FTC, i.e. where two parties enjoy the same credit, can occur without the need of a "payment" between the two claimants. *See*, G. Cooper, *Some Thoughts on the OECD's Recommendations on Hybrid Mismatches*, 69 Bull. Intl. Taxn. 6/7 (2015), Journals IBFD, p. 342. The conclusion of Cooper is correct if we consider that the OECD states that "payments that do not involve the creation of economic rights between the parties" are not regarded as "payments. *See* OECD (2015), *supra* n. 6, p. 123, in reference to the definition of "payment".

[1200] Cooper, *supra* n. 1199.

interest deductions will be regarded as equity in the country of the payee and subject to a participation exemption.[1201] Moreover, if one also considers the differences among the regimes on NID, the determination of what is a "deemed interest deduction" or whether there was a "payment" becomes even more complicated. Let us take as example the *"Juros sobre o capital propio"* (or *Juros*) in Brazil to illustrate the issue.[1202]

[1201] In Germany, e.g. it is clear that *"interest on equity"* are to be treated as dividends under German Tax Law (DE: Sec. 20(1) No. 1 of the Income Tax Act [*Einkommensteuergesetz*–EStG]), and thus exempted from taxation in a 95% according to Sec. 8b(5) of the Corporate Income Tax Act [*Körperschaftsteuergesetz*–KStG]. *See* C. Kahlenberg, *Prevention of Double Non-Taxation: An Analysis of Cross-Border Financing from German Perspective*, 43 Intertax 3 (2015), p. 222. *See also*, e.g. DE: BFH, 6 Jun. 2012, I R 6, 8/11; Federal Tax Gazette II 2012, 111, which refers specifically to the treatment of the "Brazilian *juros"* and confirming the application of the participation exemption.

[1202] Similar examples of "fictitious interest deductions for equity" can be found, e.g. in the "NID regime" under Belgian law. In brief, Belgian law provides the possibility for any company subject to CIT in Belgium, to deduct from its taxable base a so-called "notional interest deduction" (*deduction pour capital à risqué*). The amount of NID is calculated by multiplying a fictitious interest rate with the relevant equity, which is determined by adjusting certain deductions and based on the non-consolidated annual accounts of the previous accounting year. Likewise, the interest rate is determined considering the interest rate of medium long-term linear government bonds ("OLO bonds"). For further analysis on the Belgian NID *see*, e.g. W. Heyvaert and D. Deschrijver, *Belgium Stimulates Equity Financing*, 33 Intertax 10 (2005); M. Gérard, *Belgium moves to dual allowance for corporate equity*, 46 Eur. Taxn. 4 (2006), Journals IBFD. It is arguable, however, that the Belgian NID is indeed a "deemed interest deduction" when, on one hand, it is calculated on a function of net equity invested and, on the other hand, it does not refer at all to effective loan transactions entered into with related or unrelated parties. *See* A. Bax and S. Claes, T*he new Belgium-US tax treaty-an analysis*, 47 Eur. Taxn. 7 (2006), Journals IBFD, p. 353. Other European countries have also introduced similar regimes. *See*, e.g. the cases of Latvia (2008), Portugal (2008), Lichtenstein (2011) and Italy (2011). For further references in the case of Latvia, s*ee* Z. Kronbergs, *Latvia-2014 Corporate Tax Changes*, 54 Eur. Taxn. 11 (2014), Journals IBFD; in the case of Portugal, *see* G.J. Oliveira Everaert, *Portugal - Corporate Taxation sec. 1.,* Country Surveys IBFD (accessed 31 May 2017), para. 1.7.1.7.*;* in the

In 1995 Brazil introduced an option for Brazilian companies to deduct from their taxable base the remuneration of net equity as "notional interest".[1203] The deduction is calculated on a daily basis, multiplying relevant net equity by a legal rate of interest: *"taxa de juros de longo plazo",* which is quarterly published by the Brazilian Central Bank and whose basis is the inflation rate, increase by a risk premium.[1204] Likewise, the existence of current profits or accumulated earnings in certain amount is pre-condition to allow the company to make the distribution and to consider the deductibility of those payments.[1205] One of the unique features of the Brazilian notional interest deduction is, however, that they have to be paid or credited to

case of Lichtenstein, *see* B. Büchel, *Liechtenstein - Corporate Taxation sec. 1.,* Country Surveys IBFD (accessed 31 May 2017), para. 1.3.3. and, finally, in the case of Italy, *see* F. Leone and E. Zanotti, *Notional Interest Deduction Regime Introduced*, 52 Eur. Taxn. 8 (2012), Journals IBFD. A comparative analysis of these regimes can also be found in: F. Massimi and C. Petroni, *Real-World ACE Reforms and the Italian Experience. Towards a General Trend?*, 40 Intertax 11 (2012).

1203 BR: Article 9 of Law No. 9.249/95 of 26 Dec. 1995. *See also*, R. Tavares, J. Womack and D. Wilson, *New Brazilian Equity Interest Rules: Efficient Financing for U.S.-Owned Subsidiaries*, Tax Notes Int'l, January 6,1997, p. 45 et seq. ; J. Malherbe and G. Vettori, *Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared*, 1 Eur. Tax Stud. 28 (2010). For an updated analysis in reference to the conflicts of qualification derived from the Brazilian *juros,* particularly within the context of the tax treaty Brazil–Spain, *see* F. Martinez Laguna, *Institutional Hybrid Financial Instruments and Double Non-Taxation under Domestic Rules and Tax Treaty Law: The Example of Spain*, 44 Intertax 6/7 (2016).

1204 BR: Law No. 9.365; Law No. 10.183 and Central Bank Resolution No. 2.654/99, cited in: Massimi and Petroni, *supra* n. 1202, pp. 636-637, footnote 45; Martinez Laguna, *supra* n. 1203, p. 450.

1205 Martinez Laguna, *supra* n. 1203, p. 451. Originally, the payments were dependent on current benefits or retained earnings in the amount of two times the *juros* paid. However, as noted by Akie Utumi, the limit of 50% of the accumulated profits from previous years does not longer exist due to the adoption of IFRS. Thus, profits from previous years must have a specific destination and such accounts do not exist anymore. *See* A. Akie Utumi, *Brazil,* in: Cahiers de droit fiscal international Vol. 97b, *The Debt Equity Conundrum* (IFA 2012), p. 140.

residents and non-residents shareholders.[1206] Thus, if credited, interests do not need to be paid to shareholders in order to be deducted.[1207] Finally, once paid or credited, the notional interest is subject to a 15% WHT,[1208] which is indeed final in case of individuals.[1209]

Considering thus the features of the Brazilian *Juros* and the definition of *payments* provided by the OECD report, one could in principle conclude that these amounts are indeed *payments* as they are an amount *capable of being paid*, which also "includes notional amounts that accrue in respect of a future payment obligation even when the amount accrued does not correspond to any increase in the payment obligation during that period".[1210] Nevertheless, the special features of the Brazilian *Juros* can also drive us to a different conclusion. Indeed, the pre-condition of the existence of current profits or accumulated earnings to make the distribution and to consider the deductible amounts, on one hand, and the fact that a shareholder is not entitled to claim a payment in the same way that in a contractual obligation, i.e. the company is not liable for any payments derived from the equity

[1206] Massini and Petroni, *supra* n. 1202, p. 636.
[1207] Id.
[1208] The distribution of dividends out of profits to residents and non-residents is not subject to WHT in Brazil. Accordingly, since 2015, dividends are determined based on IFRS rules. *See* E. Salomao and J. Prada, *Corporations and partnerships in Brazil*, Kluwer Law International, Alphen aan den Rijn, 2011, p. 118-120, Sec. III.
[1209] The WHT tax is final in the case of individuals, because the interest received or credited is not included in the payee's taxable income. In contrast, shareholding corporations include the payments in their taxable income, and thus, the WHT is credited against the corporate tax owed by the payee. Id., p. 637. The WHT increases to 25% if the payee is resident in a tax heaven. Id.
[1210] OECD (2015), *supra* n. 6, p.130.

participation with the shareholders,[1211] on the other hand, reinforces the idea that if a payment is made (or accrued), it does not correspond to a future payment obligation, because there is indeed no obligation to pay off interest, but an option to distribute benefits to the shareholders.[1212] This latter feature would situate the Brazilian *Juros* closer to "a unilateral deduction for invested equity that does not require a payment from the taxpayer",[1213] even though it will most probably generate a conflict of qualification in the country of the shareholder. This issue was indeed recently subject to judicial scrutiny in Spain.[1214] In brief, the issue referred to the tax treatment of the Brazilian *Juros* and whether or not they could be subject to the Spanish participation exemption under Article 21 of the Spanish CIT.[1215] In this regard, the Spanish National High Court, on one hand, stated that the Brazilian *Juros* share the same legal nature than dividends, and thus, they could perfectly be subject to the exemption under Spanish domestic law.[1216]

[1211] "The company is not liable for any payment derived from equity participation vis-à-vis any shareholder right". *See* Martinez Laguna, *supra* n. 1203, p. 451.

[1212] "The shareholder is not entitled to claim a payment in the same way as it is in a contractual obligation". Id.

[1213] Indeed, the Brazilian regime gets closer to Belgian NID where the interest is calculated on a function of net equity invested and it does not refer at all to effective loan transactions. *See* Bax and Claes, *supra* n. 1202. *See also*, OECD (2015), *supra* n. 6, p.18

[1214] ES: Judgment of the Spanish High National, SAN 27.2.2014, r. 4. For a more extensive analysis on this matter, *see* a*lso* Martínez Laguna, *supra* n. 1203. A Reference can also be found in: M. Cencerrado and M. Soler, *Limit Base Erosion via Interest Deduction and Others*, 43 Intertax 1 (2015), pp. 64-65.

[1215] Martinez Laguna, s*upra* n. 1203, p. 456;

[1216] "The Court focused on the relevant provisions of the relevant Tax Treaty between Brazil and Spain, specially the concept of dividend (Article 10) and interest (Article 11) which, according to the Court shall be interpreted following the rule in Article 3.2, which meant in this case, according to the Brazilian legislation. Following this reasoning, the Court considered that the payments corresponding to the juros qualify as dividends and

Likewise, the Court dismissed the argument that such an interpretation would result in DNT and considers that the application of a tax benefit in the source country shall not denature the Spanish tax benefits once the payment has been considered as dividend both from a Spanish and Brazilian perspective.[1217]

In spite of the above, the recognition of the existence of a payment in order to determine the existence of a HMA might, implicitly, be referring to the fact that in absence of a payment, the disparity in the characterization of entities, i.e. the hybrid element, is irrelevant for tax purposes, which indeed makes sense. In fact, in the alternative proposal provided by this author, he emphasizes also that the concept of "tax relevance" is important for the application of the *reactive coordination rule*. [1218] In most of the cases, a payment makes the characterization of the entity relevant.[1219]

therefore, the exemption granted by Article 21 CTA applied in this case". *See* Cencerrado and Soler, s*upra* n. 1214, p. 64.

[1217] ES: Judgment of the Spanish High National, SAN 27.2.2014, r. 6. *See also*, Martinez Laguna, *supra* n. 1203, p. 457. Perhaps it is also interesting to note that the Spanish High National Court referred expressly to the judgment of the German Federal Fiscal Court [*Bundesfinanzhof*] of 6 June 2012, where the German Court achieved also the conclusion that the Brazilian *juros* should be considered in Germany as "dividends" for purpose of applying the participation exemption. *See* DE: BFH, 6 Jun. 2012, I R 6, 8/11, and Kahlenberg, *supra* n. 1201.

[1218] *Infra* Chapter VI, Section 2.2.

[1219] For example, a characterization of a foreign entity under U.S. tax law is relevant when U.S. income was paid to the entity. *See* US: Treas. Reg. Sec. 301.7701-3(d)(1)(i).

2.3. A D/NI outcome (Double Non-Taxation)

More importantly, however, the existence of a payment is not enough to raise concern or to constitute a HMA that triggers the application of the rules recommended by the OECD.[1220] Indeed, it is necessary that the *payment* is deductible in one country while not recognized as income or disregarded in the other country.[1221] In other words, there must be a "mismatch in the payments", namely, a D/NI, or, which is the same, double non-taxation, in order to trigger the application of the suggested *linking rules.*[1222]

2.3.1. Deduction and Inclusion as Ordinary Income

The OECD report states that a: "Deduction (including deductible), in respect to a payment, means that, after a proper determination of the character and treatment under the laws of the payer jurisdiction, the payment is taken into account as a deduction or equivalent tax relief under the laws of that jurisdiction in calculating the taxpayer's net income".[1223] Therefore, a payment will be taken as a deduction when under the laws of the payer jurisdiction; this is part in the calculation of the taxpayer's net income. An immediate question arises in this regard: should that "deduction" (or

[1220] *Infra* Section 3.
[1221] "The hybrid mismatch rule focuses on payments and whether the nature of that payment gives rise to a deduction for the payer and ordinary income for the payee". OECD (2015), *supra* n. 6, p. 17
[1222] *Infra* Section 3.
[1223] OECD (2015), *supra* n. 6, p. 121

deductible payment) be considered before or after the application of general rules limiting the deductibility of certain payments? In particular, a conflict should arise with respect to domestic rules limiting the deductibility of interest (e.g. interest limitation rules or thin cap rules). The OECD position seems to be clear in this respect when it says: "[…]the jurisdiction specific details of the taxpayer's net income calculation should not generally affect the question of whether a payment is deductible for tax purposes".[1224] Similarly, the OECD report provides that in case of application of hybrid mismatch rules (*linking rules*) and interest limitation rules, the former have priority over the latter. Nevertheless, as this author argues further on in this this work, there are strong practical reasons to follow the opposite approach, mostly considering the possibility of indirectly solving hybrid mismatches without need of *linking rules*.[1225]

As regards to the inclusion of the payment as *ordinary income* in the country of the payee, the OECD considers that a payment will be treated as "included in ordinary income" in the country of the recipient "to the extent that, after a proper determination of the character and treatment of the payment under the laws of the relevant jurisdiction, the payment has been incorporated as ordinary income into a calculation of the payee's income under the law of that jurisdiction".[1226] Accordingly, *ordinary income*, for these purposes, "means income that is subject to tax at the taxpayer's full

[1224] Id., p. 125
[1225] *Infra* Section 4.1.
[1226] OECD (2015), *supra* n. 6, p. 122

marginal rate and does not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments (such as indirect credits for underlying tax on income of the taxpayer)".[1227] Moreover, the OECD provides that "income is considered subject to tax at the taxpayer's full marginal rate notwithstanding that the tax on the inclusion is reduced by a creditor other tax relief granted by the payee jurisdiction for WHT or other taxes imposed by the payer jurisdiction on the payment itself".[1228]

At least two questions arise with respect to inclusion of income as "ordinary income" as per the concept used within the OECD report. The first question has to be with the use of losses in the payee jurisdiction, which have been carried-forward from previous taxable years. In other words, may the taxpayer entity consider the income as "included as ordinary income", regardless the fact that this income has been offset against carried-forward losses? The logic answer should be yes, considering that the use of losses to offset income does not change the fact that a determined taxpayer is subject to tax at the taxpayer's full marginal rate. Indeed, the use of losses to offset the inclusion of income should not vary the conclusion that the income has been indeed included as ordinary income. This position seems to be shared by the OECD when it provides: "A payment that is offset against deductible expenditure or losses that have been carried-forward, on this definition, be

[1227] Id., p. 123
[1228] Id.

treated as having been included in income".[1229] The second question refers to the role of WHTs at source. Could WHTs vary the conclusion that income is not included in the payee jurisdiction when WHTs precisely affect the creditor of the loan (payee of the interest) and not the payer? May WHTs indeed accomplish a similar role to that of including income in the corporate tax base of the payee jurisdiction? Shall, e.g. a denial in the deduction be still necessary (primary response) necessary? The OECD adopts a quite arguable position in this regard, when it provides: "The function of WHTs under the laws of the payer jurisdiction is generally not to address mismatches in the tax outcomes and a payment should not be treated as included in ordinary income simply because it has been subject to withholding at source".[1230] Nevertheless, the reality on taxation seems to show the opposite result. As provided by Cooper, e.g. in Australia, a dividend on a non-equity share paid by an Australian company is likely to be subject to WHT at source, which means that the fact the same payment was deductible from the taxable base of the Australian company is to certain extent offset with the application of the WHT.[1231] In other words, if the final OECD "evil" is the DNT outcome, the issue seems to be solved with the application of WHTes at source.[1232] This interpretation seems to be also coherent in case of inbound payments. Indeed, if e.g. due to the different characterization of the payer entity, the country of the payee disregard a

[1229] Id., p. 127
[1230] Id.
[1231] Cooper, *supra* n. 1199, p. 348.
[1232] Id.

payment (i.e. consider the income as not included as ordinary income) and the payer jurisdiction denies the deduction, but applies a WHT, that WHT will most probably not be credited in the payee jurisdiction, because of the non-inclusion of income, and it will become a real cost for the whole transaction.[1233] The D/NI outcome could be avoided if WHTes are regarded as "inclusion of income", even though this is not formally made within the tax base of the payee jurisdiction.

Another argument to support this interpretation is the fact that, economically speaking, a WHT refers exclusively to the position of the payee jurisdiction, namely, where e.g. the creditor of a loan (or the recipient of the interest) is located. In other words, regardless the fact that a WHT is applied at source (payer's jurisdiction), it is the taxpayer in the country of the payee who economically suffers the WHT. Therefore, if a deductible payment is not included in the taxable base of the payee entity, but rather is assumed through a WHT on the payment at source, economically speaking should not be any difference, because in both cases will be the payee entity the only one economically affected. In other words, the WHT will have the effect of offsetting the non-inclusion of the income at the hands of the payee.

[1233] In Australia, e.g. the fact that a company receives interest on a loan that is equity for Australian tax purposes (not assessable in Australia) changes to the extent a WHT applied at the border, because in such a case the WHT will not be creditable in Australia. Id. That is also the reason why denying a deduction and maintaining a WHT at source may transform this WHT in a permanent cost, i..e. as there will be no inclusion of income in the country of the payee, there will be no credit. *See also*, Lüdicke, *supra* n. 840, p. 315, who referring to the explanation of Fig. 4 at p. 314, arrives to the same conclusion.

2.3.2. Is a D/NI outcome a presumption of base erosion; a presumption of abusive practices or both?

As noted already, an important characteristic of the HMA concept is its restricted application, which involves hybrid entity mismatches whose result is a D/NI.[1234] Nevertheless, it is evident that other outcomes can come into play when cross-border transactions are involved, not even including hybrids. For example, a non-inclusion/non-inclusion outcome could be achieved in case of a sale of shares held in a non-land-rich company made by a resident in a State that applies a participation exemption.[1235] This outcome is, however, out of the scope of the concept of HMA. Similarly, and as noted already, a deduction might rarely be a presumption of base erosion in the payer jurisdiction when that country also applies a WHT at source.

More arguable is, however, the use of the concept of HMA (limited to D/NI outcomes) and the proposed remedies to counteract them strictly within a context of anti-abuse or anti-avoidance measures. The above can be seen in the recently approved EU ATAD and the inclusion of an Article 9 dealing with hybrid mismatches.[1236] As noted somewhere else by this author, however, the absence of a satisfactory explanation to focus an anti-hybrid

[1234] As already stressed somewhere else in this work, the outcome of DD is also included. However, its analysis is out of the scope of this work. *Supra* Introduction, Section 2.

[1235] Cooper, *supra* n. 1199, p. 339.

[1236] Article 9 includes a *primary response* and a *defensive rule* as proposed by the OECD within the Action Plan 2. *See* Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I).

rule on the result of a transaction (i.e. D/NI) and not on the purpose of it, distinguishing e.g. between abusive or artificial transactions, not only distorts the aim of an "anti-abuse" measure and reinforces the idea that the anti-hybrid mismatches rule at stake creeps closer to a mechanism designed exclusively to generate more revenues rather than to combat abuse,[1237] but it certainly contradicts the jurisprudence of the CJEU with respect to domestic measures implemented in order to target abusive transactions.[1238] In simple words, the fact of assuming that a transaction involving hybrid entities or reverse hybrid entities should be counteracted just because its outcome is a D/NI (i.e. DNT), regardless the existence or not of abusive elements in that transaction, creates indeed a true presumption of abuse that might finally negatively impact upon many companies that use legitimate tax planning structures to minimize costs. [1239]

Furthermore, the reference of D/NI outcomes as an exclusive factor to originate a HMA, included as a kind of "holy grail" in the design of domestic anti-hybrids measures, increases even more the presumptions above mentioned when other important factors, which are part of the

[1237] Navarro, Parada and Schwarz, *supra* n. 455, p. 130.

[1238] EU: *Cadbury Schweppes* case, *supra* n. 112.

[1239] Tax planning is certainly a legitimate practice whose ultimate goal is to achieve double non-taxation. *See* Eicke, *supra* n. 166. *See also* OECD (1987), *supra* n. 162. In the United States, e.g. this idea is widely accepted. *See,* e.g. *Helvering v. Gregory, supra* n. 159. In the same direction *see*, e.g. *Cadbury Schweppes* case, *supra* n. 112. By other side, there is no doubt that the persons called to manage a company are legally bound to involve in tax planning in order to minimize costs. As provided by Schön: "[T]he minimization of the corporate tax burden [is] an integral part of the managers' duty of care …Therefore, they – i.e. the directors themselves – are legally bound to engage in tax strategies". *See* Schön, *supra* n. 164.

transaction involving hybrids, are not taken into consideration. In particular, the mechanic of group taxation and the fact of considering more than one-year approach should be at least included.[1240] The analysis of these two factors is, nevertheless, analyzed in the illustrations below.

2.4. Illustrations of HMAs with respect to hybrid entities and reverse hybrid entities

2.4.1. Example 1: D/NI using a hybrid entity

Let us assume the hypothetical where XCo, a taxable entity incorporated in country X, grants a loan to Y Sub, an entity organized in country Y. YSub pays back interest in the amount of 100i connected to that loan. Let us preliminary assume that country Y does not apply a WHT at source. Whilst country X considers YSub as tax transparent, country Y considers the same entity as a taxable entity.

[1240] Lüdicke, *supra* n. 840, pp. 313-317.

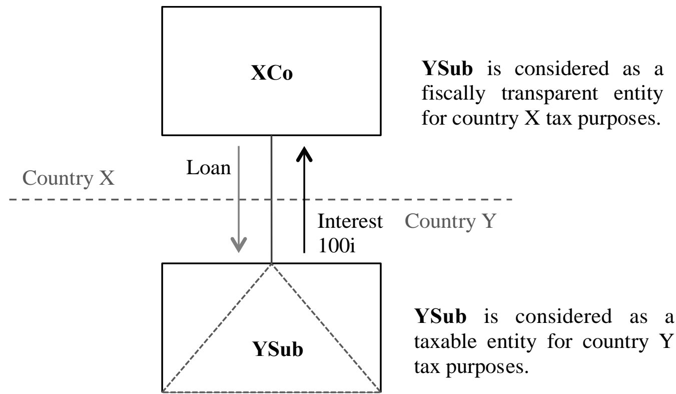

Figure 66: Example 1– D/NI using a hybrid entity

Under this scenario, the interest paid (100i) by Y Sub can be deducted from the gross income of YSub, because Y Sub is considered as a taxable entity in country Y. Accordingly, the interest paid will not be included as an item of income by XCo, because under the tax law of country X, Y Sub is considered as a tax transparent entity. In other words, the loan and the interest are completely disregarded for tax purposes. The result is a D/NI derived from the different characterization of the same entity.

However, let us now include the factors of group taxation and multi-year taxation.[1241] For this purposes, we will assume that YSub has also a subsidiary in country Y (YSub1), which together with YSub form a tax group. We will also assume two different scenarios. The first scenario is that YSub1, in year 1, has income of 100i and YSub pays interest of 100i, but has no income. In year two, however, YSub has income of 100i, but pays no

[1241] Id.

interest. YSub1 has no income. Thus, in year one and year two together, the combined income of the group is 200i.

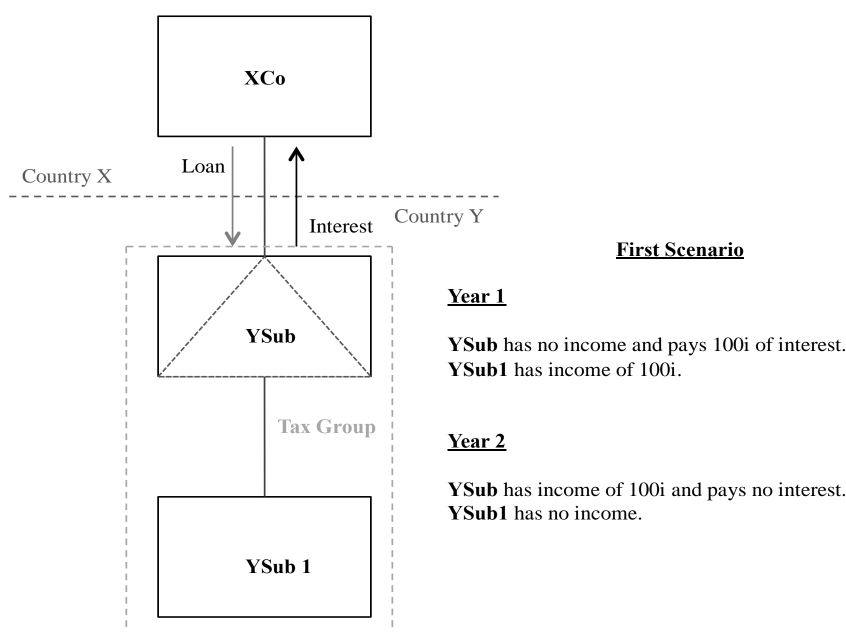

Figure 67: D/NI analysis and group taxation (first scenario)

The result in the first scenario, without considering the second year, is exactly as appeared in the Figure above. This is to say, the income of the group is offset against the interest deduction and the interest are not included as income in country X, because the loan is disregarded. In other words, we will face a D/NI outcome. This result is obtained isolating year 1.

Nevertheless, if we consider now year one and two together, and we assume that no FTC is granted by country X in year two, then the result in year two is that 100i will be included in the tax base of both country Y and X, which indeed reflects the combined income of the group.

Two important conclusions can be extracted from the above. On one hand, it demonstrates that if the problem is that income is not taxed at all in year one, this can easily be solved considering the double inclusion of income in year two, without a FTC in country X. In other words, the fact that the income remains untaxed in year 2 will depend of the design of the FTC in country X. On the other hand, it shows that more than DNT, the real outcome here, when considering the two years together, is a "one-year deferral", but not properly a permanent DNT outcome.[1242] This coincides with what this author already stated in Chapter I of this work: DNT and tax deferral are not equivalent concepts.[1243] Therefore, as well stated by Lüdicke, a deduction of a payment raises policy concerns only when the income is not included in the tax base of the other country, which only happens in the example above, when a single-year of taxation is considered. Therefore, a multi-year rather than one-year period has to be taken into account.[1244]

[1242] Id.
[1243] *Supra* Chapter I, Section 2.2.
[1244] Lüdicke, *supra* n. 840, p. 314.

The second scenario is that YSub has no income or expenses in year two. YSub1 pays dividends of 100i to YSub. Thus, the economic burden of the group in both years taken together is 100i.[1245]

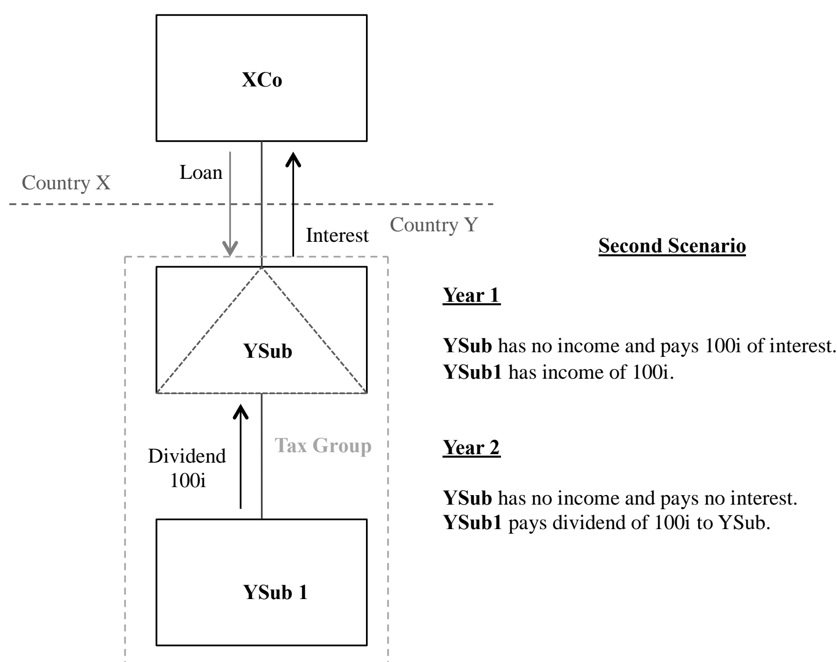

Figure 68: D/NI analysis and group taxation (second scenario)

Similarly, in this second scenario, the dividend distributed from YSub1 to YSub will be taxable in country X, but not in country Y, because the

[1245] These assumptions are taken from the analysis that Lüdicke makes with respect to hybrid entities and D/NI outcomes in order to demonstrate that the assumption that a D/NI occurs is indeed relative. Id., Fig. 4.

underlying income was already attributed to and taxed in country Y in year one (i.e. the 100i of income that YSub1 had in year one). There will be no FTC in country X in year one, because income and expenses were offset due to the group taxation in country Y. Therefore, the overall result considering year one and year two is the taxation of the combined income of the group (100i), although having one year of deferral.[1246]

Some important conclusions derive from the example above. Firstly, and as already stressed, the consideration of the mechanics of group taxation should be taken into account in order to reflect a consistent result. Secondly, the D/NI outcome is only temporal, i.e. it is a short-term outcome. Thus, if a rule denying a deduction in country Y applies in year one (primary response), this rule will be targeting most properly a one-year deferral, but not a true D/NI. Indeed, if under the circumstances described in the example above, such a rule applies; the final outcome will be economic double taxation. Thirdly, if we add to the examples above that a WHT might also be applied in country Y, regardless the denial of the deduction, such a WHT will not be credited in country X and it will be a permanent cost for the taxpayer.[1247]

[1246] Lüdicke explains that the same is true if, e.g. in the absence of a dividend, a capital gain upon the disposal of the shares in YSub1 in our example in a later year is taxable in country X, at the level of XCo. Id.

[1247] Lüdicke proposes that in case a deduction is denied in the country of the payer, the potential WHT that country Y can also apply should be prevented. Id., p. 315

2.4.2. Example 2: D/NI using a reserve hybrid

Let us assume the same facts as the first example above, with the difference that YSub is regarded as a reverse hybrid entity. This is to say, under the tax law of country Y, YSub is considered as a transparent entity while country X and country Z considers YSub as a taxable entity. Accordingly, we will assume that YSub receives interest from YSbub1, which is established in a third country Z.

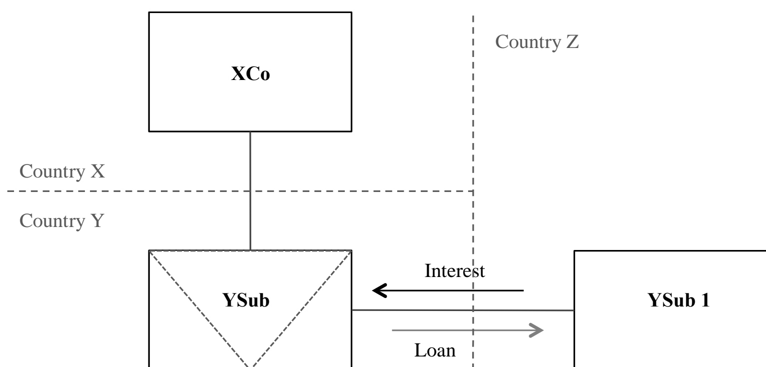

Figure 69: D/NI using a reverse hybrid entity

Under these circumstances, the interest received by YSub are deducted in country Z and not included as ordinary income in country Y, because YSub is regarded as a tax transparent entity there. They are also not included as ordinary income in country X, unless dividends are distributed to XCo, because country X considers YSub as a taxable entity. In simple words, the interest payments remain untaxed and the general outcome is a D/NI.

The example above, however, assumes that country X does not have proper CFC rules to tax the interest income received by YSub in country B. Accordingly, it assumes that YSub is indeed a holding company, which will never distribute dividends to XCo. If both assumptions are, nevertheless, disregarded, i.e. country X has indeed strong CFC rules and YSub sooner than later will distribute dividends, the evil D/NI outcome disappears.[1248] A counterargument thus could be that in case YSub is not a controlled company of XCo, e.g. due to a minority of shares owned or because XCo

[1248] As provided by Cooper: "Similarly, for the payments to reverse hybrids, the obvious remedy is to amend the CFC rules in the jurisdiction in which the parent is resident. If that jurisdiction treats the foreign hybrid as an entity and it is deriving passive income or base company income, the CFC rules are well understood and perfectly acceptable mechanism that should define the scope of tax on the foreign hybrid". Cooper, *supra* n. 1199, p. 348 In the same order of ideas, the OECD BEPS Action 2 acknowledges that the hybrid mismatch disappears if proper CFC rules or similar anti-deferral regimes are applies when it states: "Payments made through a reverse structure will not result in D/NI outcomes if the outcome is fully taxed under a CFC, foreign investment fund (FIF) or a similar anti-deferral rule in the investor jurisdiction that requires the investor to include its allocated share of any payment of ordinary income made to the intermediary on a current basis […[Treating income allocated by a reverse hybrid as taxable under the laws of the investor jurisdiction would have the effect of neutralizing any hybrid mismatch under a payment to a transparent entity". OECD (2015), *supra* n. 6, p. 64.

and YSub are indeed unrelated, CFC rules will be ineffective.[1249] That is indeed correct. However, as it will be explained later, the type of hybrid mismatches that derive from transactions between unrelated parties (not being part of an structured arrangement either) are indeed out of the international concern.[1250] In addition, it should be remark that the OECD proposes in this case, i.e. payments to reverse hybrid entities, an alternative remedy, which is to "switch-off" the tax transparency treatment in the country of establishment of the reverse hybrid entity, ensuring the taxation in country Y in the example above.[1251]

Finally, and as well as with respect to hybrid entities, two important conclusions can be extracted from this example on reverse hybrids. On one hand, the D/NI outcome is not necessarily a permanent outcome. The above will rather depend of the design of the CFC rules in country X as well as the fact that YSub distributes dividends to country X. On the other hand, it confirms the fact that in a group transaction (i.e. between related parties) in

[1249] Lüdicke, *supra* n. 840, p. 316.

[1250] *Infra* Section 3.3.

[1251] As stated by the OECD: "Tax transparency proceeds on the assumption, however, that the income allocated to the investor will be taxable in the hands of the investor. In the cross-border context, this is not always the case". Thus, the recommendation 5.2 (*Limiting the tax transparency for non-resident investors*) "encourages jurisdictions to turn off their transparency rules when those rules are primarily used to achieve hybrid mismatches". OECD (2015), *supra* n. 6, p. 64, Recommendation 5.2. The OECD also states that the recommendation only applies under the following circumstances: a) a person [entity] is treated as tax transparent under the laws of the country where it is established; b) that person receives income not subject to tax in that country, and c) all of part of that income is allocated to non-resident investors that are part of the same control group. Id.

which a reverse hybrid receives a payment that results in a D/NI outcome, it is presumed that either an abusive practice or base erosion arises. [1252]

2.4.3. Example 3: Indirect D/NI: '*Imported Mismatches*'

One of the peculiarities of the OECD BEPS proposal on Action 2 refers to the possibility of "indirectly" achieving a D/NI outcome, namely, when a deduction in certain country is on balance not accompanied by an inclusion of income in another country, using a hybrid arrangement between two other countries.[1253] This is so-called *imported mismatch* and the rule proposed calls for denying a deduction in the payer jurisdiction to the extent that the payee treats the payment as set-off against a hybrid deduction in the payee jurisdiction.[1254] As provided by the OECD: "The policy behind the imported mismatch rule is to prevent taxpayers from entering into structured arrangements or arrangements with group members that shift the effect of an offshore hybrid mismatch into the domestic jurisdiction through the use of a non-hybrid instrument such as an ordinary loan".[1255] Accordingly, they rely on the absence of rules (i.e. *linking rules*) counteracting the mismatch in the offshore jurisdiction in order to generate the mismatch in tax outcomes, which is later imported into the payer country.[1256] In this sense, some

[1252] *Infra* Section 2.3.2.
[1253] R. de Boer and O. Marres, *BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements*, 43 Intertax 1 (2015), p. 29.
[1254] OECD (2015), *supra* n. 6, p. 83.
[1255] Id.
[1256] Id., p. 85.

authors consider justifiable that arrangements producing an "indirect D/NI outcome" are addressed separately within the OECD BEPS report.[1257]

Although almost all the examples within the report refer to HFI, an illustration of an *imported mismatch* considering exclusively hybrid and reverse hybrid entities could be as follows:

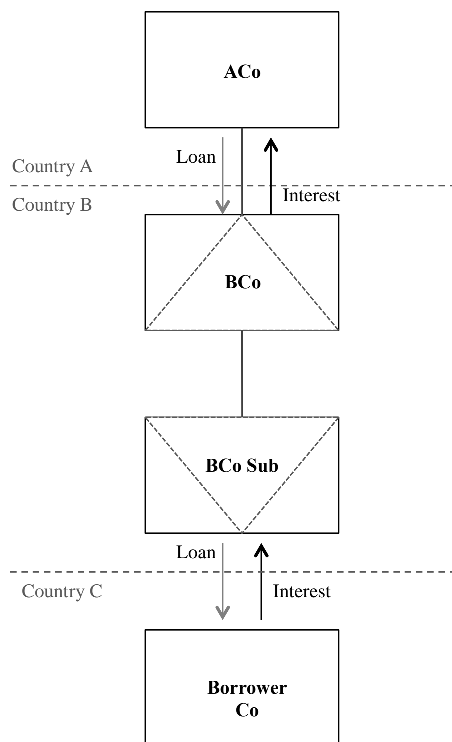

Figure 70: Imported Mismatch

[1257] De Boer and Marres consider that otherwise "[…] they lead to a proliferation of mismatch arrangements". *See* De Boer and Marres, *supra* n. 1253.

Let us assume three given countries (Fig. above): A, B and C. Accordingly, ACo has a subsidiary in country B, BCo, which is for purposes of country A, tax transparent, whilst it is a taxable entity in country B (i.e. BCo is a hybrid entity). Consequently BCo has a subsidiary in the same country, BCo Sub. This latter entity is regarded as a tax transparent entity in country B, but for country A's tax purposes is a taxable entity (i.e. a reverse hybrid). Finally, there is another entity in country C, Borrower Co, which is not related to BCo Sub or BCo. Likewise, there are two different debtor-creditor relationships. On one hand, Borrower Co borrows money to BCoSub and pays interest back to country B. On the other hand, BCo borrows money to ACo and pays interest payments back.[1258]

As regards to the interest payments from Borrower C to BCo Sub, these are not taxed at the level of BCo Sub, because this is a tax transparent entity in country B. The interest payments, however, flow through BCo Sub and are taxed at the level of BCo. As a result, this loan does not generate a HMA, because interest are deducted in country C and included as income in country B. On the contrary, the loan and the interest payments between ACo and BCo are disregarded, because of the different tax treatment of BCo. In this case, therefore, there is a D/NI outcome.

The example above, however, does not consider two important issues. On one hand, country A might apply its CFC rules and then claim the right to tax the income that, under its view, is attributed to BCo Sub as CFC income.

[1258] Originally, De Boer and Marres provide this example. Id., p. 30, Fig. 8

If we consider that many countries provides for indirect ownership, BCo Sub might perfectly be considered owned indirectly by ACo. In addition, interest paid from Borrower Co to BCo Sub will be generally regarded as CFC income. As a result, double taxation might certainly arise, because interest might be tax as CFC income in country A and they will definitely be taxed at the level of BCo.[1259] Thus, unless a tax credit is granted in country A, double taxation will be a reality. This situation can be perfectly assumed in the real world. For example, let us assume that ACo is a USCo that owns 100% of BCo, and this latter subsequently owns 100% of BCoSub. ACo would be deemed to own BCoSub because of the indirect ownership rules in the United States.[1260] Accordingly, no tax credit would be granted considering that BCo and not BCoSub paid the respective taxes in country B. The double taxation in this case remains as a permanent effect.[1261] On the other hand, the example does not consider, e.g. the possibility that BCo and BCo Sub are part of a "tax group". In such a case, the interest received and interest paid at the level of the group will be set-off. It would be thus arguable that a mismatch is imported to country C.

The justification for *imported mismatches* is rather clear: it pretends to avoid that *linking rules* become useless by using countries that do not introduce

[1259] Although it can be just an interest spread on balance. Id.

[1260] The indirect ownership consists of stock beneficially owned by a U.S. person through a foreign corporation, partnership, trust or state. Thus, ACo would be deemed to indirectly own BCo Sub. Bitter and Lokken, *supra* n. 530, p. 69-10.

[1261] An indirect tax credit would not apply either, because the indirect tax credit gives double tax relief for the cases of a U.S. Corp. that owns at least 10% of the foreign subsidiary and receives dividends from this latter. US: IRC Sec. 902.

the OECD recommendations.[1262] Nevertheless, it is undeniable also that they increase the level of complexity to determine cases of HMA. Indeed, they require looking at beyond the transaction between two members of a control group (or a structured arrangement) to identify possible mismatches. The above sets up an important burden both to taxpayers and tax administrations, an issue that it is in part recognized by the OECD as well.[1263]

3. *Linking rules* and the new era of BEPS

The mechanical process of matching transactions related to the different characterization of the same entity by two different jurisdictions and the outcome of DNT (i.e. D/NI) –*hybrid mismatch arrangements*– has certainly given rise to also ad-hoc or mechanical solutions. Indeed, Action 2 of the BEPS Action Plan recommends a two level solution to deal with the issue. On one hand, a *primary response*, which is applied at the level of the payer. On the other hand, a *defensive rule*, which is applied at the level of the recipient of the payment part of the transaction. Both rules are subsequently analyzed.

[1262] "Imported Mismatches rely on the absence of effective hybrid mismatch rules in offshore jurisdictions in order to generate the mismatch in tax outcomes which can then be imported into the payer jurisdiction". *See* OECD (2015), *supra* n. 6, p. 85.

[1263] As provided by the OECD: "While these rules involve an unavoidable degree of coordination and complexity […]". Id., p. 84. *See also*, De Boer and Marres, *supra* n. 1253, p. 30.

3.1. Primary Response

The *primary response* consists in a recommendation to introduce a rule at a domestic level, which denies the deduction of interest payments if these payments are not included as ordinary income in the recipient country.[1264] In other words, and particularly with respect to hybrids and reverse hybrid entities, means to deny the deductibility of certain payments in all those transactions in which those payments made by a hybrid entity or received by a reverse hybrid, resulted in a D/NI outcome, because of the different characterization of the same entity.[1265] Therefore, as it can be noted, the domestic deductibility in this case is contingent to the inclusion or recognition of income in a foreign country, which in both cases, i.e. hybrid entities and reverse hybrids, will not occur because the two countries involved in the transaction considers the payer (in the case of payments from a hybrid entities) or the payee (in the case of payments made to a reverse hybrid entities) differently for tax purposes, being thus the payment and the whole transaction either disregarded, as it is the case of payments made by hybrid entities, or simply not recognized in the country of the investors until they are distributed as dividends, as it is the case of reverse

[1264] As stated by the OECD: "Both payments made under hybrid financial instruments and payments made by and to hybrid entities can give rise to D/NI outcomes. In respect of such hybrid mismatch arrangements this report recommends that the response should be to deny the deduction in the payer jurisdiction". *See* OECD (2015), *supra* n. 6, p. 17.

[1265] In reference to the concept of "deduction" and recognition of income as "ordinary income", *supra* Section 2.3.1.

hybrids.[1266] Likewise, it results obvious that a payment must be originally allowed to be deductible in order to apply the *primary response*.[1267]

Unlike the primary response remains as a recommendation to be introduced at a domestic level by the countries around the globe, there are countries that have already started introducing it within their domestic legislations, particularly with respect to counteract HMA related to hybrid financial instruments. For example, Section 12(1) No. 10 of the Austrian Corporate Income Tax Law (Austrian CITL) provides for a denial of the interest paid to a foreign corporation if the receiving corporation belongs to the same group and the payment is exempted at the level of the foreign receiving corporation or the income is subject to an effective tax rate of less than 10%.[1268] Similarly, Article 15(j) of the Spanish Corporate Income Tax Law (Spanish CITL) introduced a rule applicable to hybrid instruments, which provides that expenses of a transaction between related parties will not be

[1266] The application of the *primary response* with respect to cases of hybrid financial instruments is slightly different, because implies, in most of the cases, the application or not of the exemption system to relieve double taxation in the country of the payee. In most of the countries, the participation exemption will apply regardless the taxation of the income in the other countries. At least this is a pure interpretation of the exemption system. However, there are countries that have included switch-over clauses that allow not applying the exemption to the extent the payment was deducted in the country of the payer.

[1267] As provided by the OECD: […] the disregarded hybrid payments rule should only operate to the extent that the payer is entitled to a deduction for a payment under local law". OECD (2015), *supra* n. 6, p. 51. The interaction of the primary response and other domestic rules denying the deductibility of interest, in particular "interest limitation rules", is analyzed in *infra* Section 4.

[1268] M. Jann, J. Schuch and G. Toifl, *Austria - Corporate Taxation* sec. 1., Country Analyses IBFD, sec. 1.4.10 (accessed 6 June 2017).

considered as deductible if, due to a conflict of qualification, they do not generate income or generate exempted income or income subject to a nominal tax rate below 10% at the level of the recipient.[1269] For this provision to apply therefore the following three circumstances must be met: (i) the transaction must take place between related parties, as defined by Article 18 Spanish CITL; (ii) the Spanish taxpayer must incur in expenses that are, in principle, tax deductible under the Spanish law, and (iii) the expenses do not give rise to corresponding taxable income in the associated non-resident taxpayer due to a conflict in the characterization of the payment.[1270] Likewise, it was discussed in Germany the introduction of a similar provision disallowing an interest to the extent the recipient does not characterize the income received as interest.[1271] However, this provision has not yet entered into force.[1272]

[1269] ES: Article 15(j) of the Corporate Income Tax Law [*Ley del Impuesto sobre Sociedades*], as introduced by the Royal Law Decree [*Real Decreto Legislativo]* No. 4/2004 of 5 March 2014. *See also*, Á. de la Cueva González-Cotera and C. Morlán Burgasé, *Spain - Corporate Taxation* sec. 1., Country Analyses IBFD (accessed 6 June 2017).

[1270] S. López Ribas, *Financing Activities: Hybrid Mismatches and the Tax Deductibility of Interest in Spain*, 70 Bull. Intl. Taxn. 8 (2016), Journals IBFD, p. 455. The provision is written in a neutral way avoiding to refer to income received "by a non-resident". However, it appears to be clear that this is the only situation in which a different characterization might arise.

[1271] The draft stated that payments should not be deductible if such payments are not included in the tax base of the direct or indirect recipient or subject to an exemption at the level of it due to a qualification mismatch between the two legal systems: the payer and payee. Accordingly, the payments shall only be deductible as business expenses in Germany provided they are not deductible from the tax base of the payer in another jurisdiction. *See* D. Gutmann et al., *The Impact of the ATAD on Domestic Systems: A Comparative Survey*, 57 Eur. Taxn. 1 (2017), Journals IBFD, p. 17.

[1272] Id.

At the EU law level, a *primary response* was also introduced within the final text of the EU ATAD, which could certainly fill out the gap of all those EU countries that do not have reacted so far to the OECD recommendations.[1273] Indeed, one particular characteristic with respect to the rule introduced within the EU ATAD is that it applies to both hybrid instruments and hybrid entities, which extents the scope of the existing domestic rules that were launched mostly targeting hybrid financial instruments. As read within the text of Article 9 of the EU ATAD: "To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment".[1274] Similarly, the text of the recently approved EU ATAD II, dealing with hybrid mismatch arrangement with third countries, provides that:" To the extent that a hybrid mismatch results in a deduction without inclusion: a) the deduction shall be denied in the Member State that is the payer jurisdiction […]".[1275] The above, however, does not mean to recognize that the solution adopted is necessarily the correct one. As this author argues further on in this work, a more direct manner to counteract HMA with respect to hybrid entities and reverse hybrid shall be constructed targeting the real reason of the mismatch, i.e. the disparity in the characterization of entities, and not indirectly affecting the deductibility of payments.[1276] Interestingly, this approach was originally

[1273] *Supra* Chapter III, Section 5.3.
[1274] EU: Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I).
[1275] EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II).
[1276] *Infra* Chapter VI.

supported by the European Commission, but later on abandoned perhaps due to the political pressure that the whole OECD BEPS proposal involves.[1277]

3.2. Defensive Rule

The *defensive rule* consists in recognizing the payment as ordinary income in the country of the recipient, being a mirror image of the primary recommendation above-mentioned.[1278] The *defensive rule*, therefore, as its name suggests, applies only to the extent the payer country did not disallow the deduction of the payment and thus there is still a risk that this remains untaxed.[1279] From a tax policy perspective, it makes sense to leave the source country, i.e. country of the payer, to give the first bite to the apple, after all it is where the payment is issued and the mismatch is originated by the characterization of an entity in its home country (payer country) by the payee country. The above, however, also embodies a practical reason: to avoid the simultaneous application of the proposed countermeasures. Nevertheless, as it will be argued later on in this work, this aim if far of being accomplished and the circular effect of *linking rules*, i.e. the contingent application of *primary response* and *defensive rule*, is one of the main negative characteristics of the OECD proposals that may carry States

[1277] *Supra* Chapter III, Section 5.3.2.

[1278] OECD (2015), *supra* n. 6, p. 52

[1279] The contingent application of the *defensive rule* is clearly stated by the OECD when it provides: "*If the payer jurisdiction does not neutralize the mismatch* then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI outcome" (emphasis added). *See* OECD (2015), *supra* n. 6, p. 49.

to confuse themselves in terms of who is entitled to react, affecting thus the final effectiveness of the rules.[1280] Last but not least, the *defensive rule* applies only with respect to cases involving hybrid entities and not with respect to reverse hybrids, where the *primary response*, the improvement of offshore investment regimes (e.g. CFCs) and the restrictions to tax transparency in the country where the reverse hybrid is located, are the proposed countermeasures instead.[1281]

As well as the primary response, some countries have already introduced a *defensive rule*, also in most of the cases dealing with HMA derived from hybrid financial instruments. This is, e.g. the case of Austria, which introduced Section 10(1) and 7 within the CIT, and which provide that the general exemption of dividends does not apply if those dividends were treated as tax-deductible expenses at the level of the payer (source State).[1282] Accordingly, Spain introduced Article 21(1)(b) within the Spanish CIT, which provides that dividends received, which derives from profit participation that have generated a deduction at the level of payer, will not

[1280] *Infra* Section 3.4.1.

[1281] The exclusion of a *defensive rule* with respect to cases of reverse hybrid receiving payments is, however, very clear. Indeed, in most of those cases the D/NI outcome targeted by the rules can easily be solved with the application of CFC rules in the country of the investors. See also with respect to turning off the tax transparency treatment in the country where the reverse hybrid entity is established, *supra* Section 2.4.2, *supra* n. 1251. As regards to the interaction between the primary response and the CFC rules, *infra* Section 4.2.

[1282] Jann, Schuch and Toifl, *supra* n. 1268, Sec. 7.2.6.2.

be exempted in Spain.[1283] As noted, therefore, the rule has no other link that the deductibility at the level of the payer, without reference e.g. to the characterization of the payments.[1284] Likewise, Germany also enacted a provision that intended to deal with the application of the domestic exemption method with respect to payments considered equity in Germany.[1285] The rule states that the domestic exemption of remuneration payments from dividend-generating equity is not granted insofar as the payment are deducted in the country of the payer, demonstrating again that exemption on dividend is contingent to the tax treatment of those dividends in the foreign country.[1286]

[1283] The Law No. 27/2014 of 27 Nov. 2014 introduced different rules tackling D/NI schemes, including a *defensive rule* with respect to hybrid financial instruments. However, prior to this reform in 2014, the exemption method applied to the extent the following requirements were met: i) the resident company has, directly or indirectly, maintained for one year a participation of, at least, 5% ownership in the subsidiary; ii) the subsidiary must have been subject to a tax equivalent to the Spanish CIT, and iii) the distributed profits derive necessarily from business activities running abroad. The requirement of bullet "ii)", however, is considered fulfilled if the subsidiary is a resident of a country with which Spain had signed a tax treaty containing an exchange of information provision. *See* Martinez Laguna, *supra* n. 1203, p. 453 and 458. *See also*, D. Jiménez-Valladolid de L'Hotellerie-Fallois, *Double (no) imposición e híbridos financieros: tendencias internacionales y reforma del Impuesto sobre Sociedades*, in: *La Reforma del Sistema Tributario Español (2a parte), Encuentro de Derecho Financiero y Tributario (3a Ed.), Doc. No. 10/2015*, Institutos de Estudios Fiscales, Madrid, 2015.

[1284] Martinez Laguna, *supra* n. 1203,p. 458.

[1285] DE: Section 8b(1) of the German CIT. The provision, however, does not deal with the application of the exemption method by reason of a tax treaty. *See* S. Bärsch and C. Spengel, *Hybrid Mismatch Arrangements: OECD Recommendations and German Practice,* 67 Bull Intl. Taxn. 10 (2013), Journals IBFD, p. 526.

[1286] Id.

The *defensive rule* has also been introduced within EU law through a series of modifications of it. In particular, I refer to the modification of the PSD in 2014 that basically provided that MS should refrain from taxing profits to the extent that such profits are not deductible at the level of the subsidiary, or to tax them if a deduction was indeed granted.[1287] This provision that originally applied only with respect to hybrid financial instruments, is now also extended to cover HMA related to hybrid entities and reverse hybrid entities with the introduction of Article 9 of the EU ATAD[1288] and the recent issuance of the ATAD II, applied with respect to the mismatches with third countries outside the EU.[1289]

The mechanic of the *defensive rule* as regards to hybrid entities is quite interesting and deserves special attention. Indeed, if one looks closer into the application of the rule, one could conclude *a priori* that the effect is no other than providing, at the level of the payee State, an implicit recognition of the characterization of the entity at the level of the payer State, which is the same than providing that the *defensive rule* establishes a *de facto* rule of

[1287] EU: Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU.

[1288] EU: Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I). Also *infra* Chapter III, Section 5.3.2. The compatibility of the defensive rule considered before and after the introduction of this Directive is discussed in *infra* Section 3.5.2.1.2 of this Chapter.

[1289] Following the OECD proposal in terms of having a defensive rule that applies contingently to the prior application of a primary response in the payer country, the final text of the EU ATAD II states: “To the extent that a hybrid mismatch results in a deduction without inclusion: b) where the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome shall be included in income in the Member State that is the payee jurisdiction”. EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II), Article 9.

coordination at source.[1290] Nevertheless, this statement is not entirely correct. On one hand, the *defensive rule* provides that income should be recognized as "ordinary income" in the State of the payee entity (i.e. taxed there), which is not the same than providing that the characterization of the entity at source should prevail. In fact, if the rule were to target the HMA considering the different characterization in both countries, i.e. the core of the issue, neither *primary response* nor *defensive rule* would be needed. On the other hand, the taxation of income at the level of the payee would never be mandatory if a rule coordinating the characterization of entities is applied. The above would finally depend on the specific rules in the country of the payee. In other words, the outcome of the transaction (i.e. D/NI) would not be the basis for the application of the rule, as it is in the case of the *defensive rule*, which only applies if a HMA occurs and to the extent the *primary response* did not apply first. On the contrary, the outcome would be relegated to the background, renouncing to the consequentialist approach adopted by the OECD.[1291]

3.3. "Limitations" within the scope of the *linking rules*

The *primary response* and the *defensive rule* apply with certain limitations. This is to say, not every single hybrid entity mismatch giving rise to a D/NI

[1290] Accordingly, and with respect to hybrid financial instruments, one could argue that the *defensive rule* acts also in a similar way than a "switch-over clause" that permits to switch off the application of the exemption method.

[1291] A deeper analysis is developed further on in this work, which finally opts for proposing a domestic rule coordinating the characterization of entities. *Infra* Chapter VI.

outcome may trigger the application of the rules, but rather only hybrid entity mismatches that are within the context of either a "control group" or a so-called "structured arrangement".[1292] Nevertheless, as demonstrated below, both concepts are not necessarily limitations to the application of *linking rules*, but rather an excessive extension of these rules, which leaves almost no space for cases in which they would not be applied.

3.3.1. Control Groups and 'Acting Together' test

The concept of "control group", as defined within the OECD BEPS Action plan 2 is rather wide.[1293] Indeed, it includes at least four different scenarios: a) when there is a consolidation for accounting purposes under IFRS or local GAAP; b) when a person can "effectively control" the second person

[1292] As provided by the OECD with respect to the rules applicable in case of payments made by a hybrid entity: "This rule only applies if the parties to the mismatch are in the same control group or where the payment is made under a structured arrangement and the taxpayer is a party to that structured arrangement". OECD, *supra* n. 6, p. 49. In the same order of ideas, and with respect to the recommended rules applied with respect to payments received reverse hybrid entities, the OECD states: "The recommendation only applies where the investor, the reverse hybrid and the payer are members of the same control group or if the payment is made under a structured arrangement and the payer is party to that structured arrangement". Id., p. 55. Similarly, hybrid mismatches derived from a HFI and whose outcome is a D/NI, are also limited to "related parties" and "structured arrangements". The concept of "related parties" and "controlled groups", however, are slightly different, starting from the consideration of different percentages of ownership required.

[1293] The final report of the OECD BEPS Action plan 2 states: "Two persons are in the same control group if: i) they are consolidated for accounting purposes; ii) the first person has an investment that provides that person with effective control of the second person or there is a third person that holds the investments which provides that person with effective control over both persons; iii) the first person has a 50% or greater investment in the second person or there is a third person that holds a 50% or greater investment in both; or iv) they can be regarded as associated enterprises under Article 9 [OECD Model]". OECD (2015), *supra* n. 6, p. 113.

through an investment in that person or there is a third person that has sufficiently significant investment in both persons giving rise to an effective control;[1294] c) when a person holds, directly or indirectly,[1295] 50% or more of the voting rights or value of equity interests[1296] of a second person or a third person holds 50% or more of the voting rights or value of equity interests in both, and d) when two persons are regarded, for purposes of Article 9 OECD Model, as "associated enterprises".[1297]

While some authors have argued that the reasons to restrict the scope of HMA would have been to avoid an undue complexity in the application of

[1294] The OECD gives the example of a substantial shareholder in a widely held company and that participation gives him the effective control over the appointment of directors. Id., p. 116.

[1295] The understanding of indirect participation is rather clear. The OECD illustrates this giving the example of a person (A), who holds the 50% of the shares in BCo, and this latter holds also 50% of CCo. Thus, A would be indirect owner of CCo in a 25% of indirect ownership. Id. The concept of indirect ownership coincides with the one used within U.S. law with respect to CFC rules, where the stock held by foreign entities is considered as indirectly owned proportionally by its shareholders or partners. *See* Bitter and Lokken, *supra* n. 530, p. 69-10. See also the explanation of "indirect ownership" under the U.S. tax law at *supra* n. 686.

[1296] The reference to voting rights "or" equity interest has the clear purpose of avoiding the circumvention of the rule, e.g. issuing shares without voting rights. Similar rules are applied, e.g. in the United States with respect to CFC rules. In fact, before 1987 the control was measure only by voting power and the alternative of total value was added to avoid manipulation. *See* US: Staff of Joint Committee on Taxation, 99th Cong., 2nd Sess., General Explanation of the Tax Reform Act of 1989, p. 988, cited in: Bittker and Lokken, *supra* n. 530, p. 69-8.

[1297] It is not entirely clear the reason of this inclusion, because the meaning of "control" for purposes of the application of Article 9 OECD Model is left to the domestic laws of the countries. The OECD Model does not give any hints with respect to thresholds or criteria to consider two enterprises as *"associated enterprises"*. Nevertheless, the OECD justifies this reference as to clarify that *linking rules* should apply even in the case a transaction is subject to transfer pricing's adjustments. OECD (2015), *supra* n. 6, p. 117. Perhaps it would have been enough to state this reference without complicating the own definition of *control group*.

the linking rules,[1298] or implicitly constrains the application of the rules to transactions that might be abusive,[1299] this aim seems to contradictory with the extremely wide concept of control group provided by the OECD.[1300] Indeed, what seems to be clear instead is that there is a strong attempt to include as many situations as possible within the concept of control group in order to avoid the manipulation of the rules. For example, if control groups would include only the participation of a person over another in certain percentage or voting rights or equity interest, as it happens with other rules tax rules that require control, e.g. CFC rules, it would be very easy to circumvent the application of linking rules by the taxpayers.[1301] Nevertheless, the fear with respect to the circumvention of the rules should not be a basis for an unnecessary extension of concepts that finally increase the level of complexity in the application of the rules, rather than reducing it.

The above can specially be seen with respect to the concept of "Acting Together", which extends even more the interpretation of the own concept of control group. As provided by the OECD: "For purposes of the related

[1298] De Boer and Marres, *supra* n. 1253, p. 19

[1299] *See*, e.g. Cooper, *supra* n. 1199, p. 342.

[1300] The intention of the OECD to limit the scope of the rule to *control groups* might be regarded as a small attempt to affect only those hybrid transactions that might be considered *'abusive'*, presuming that this will happen more likely with transactions within control groups. Nonetheless, the wide construction of the concept of *control groups* is contradictory and it does not give the impression of any limitation within the scope. In contrast thus the proposal of this author does not contemplate the limitation of the "*reactive coordination rule"* to transactions within control groups. The above has to be with the main tax policy reason behing the design of the proposed rule, which is the simplicity in its application. *Infra* Chapter VI, Section 2.2.

[1301] De Boer and Marres, *supra* n. 1253, p. 19

party rules a person who acts together with another person in respect of ownership or control of any voting rights or equity interests will be treated as owning or controlling all the voting rights and equity interests of that person".[1302] The purpose of the "acting together" rule is thus, on one and, to prevent taxpayers from avoiding the control group requirement by transferring their voting interest or equity interests to another person, who continues to act under their direction.[1303] On the other hand, it aims to prevent that, e.g. a group of minority shareholders enter into an arrangement that allow them to act together and benefit from the outcome of a HMA, avoiding again the application of *linking rules.*[1304] Accordingly, and as well as with the concept of "control group", the "acting together" test considers at least the following scenarios with respect to two persons that act together in respect of the ownership or control of any voting right or equity interest: a) they are member of the same family; b) one person acts as per the wishes of the other person; c) they have entered into an arrangement that has materially impacted the value or control of the voting rights or equity interests, or d) the ownership or control of any such rights or interests are managed by the same person or group of persons.[1305]

As regards to the first scenario, the OECD provides that a "a person will be deemed to hold any equity or voting interests that are held by the members

[1302] OECD (2015), *supra* n. 6, p. 113.
[1303] Id., p. 117.
[1304] Id.
[1305] Id., p. 113, Recommendation 11.

of that person's family".[1306] This requirement resembles the concept of "constructive ownership" in the United States, which means that a person is regarded to be the owner of stock owned by certain relatives, e.g. a spouse.[1307] The second scenario includes the situations where a person is required or expected by another person to act in accordance to the wishes of another person in respect of the voting rights or equity interest of the latter.[1308] The OECD clarifies, however, that a person is acting in accordance to the wishes of another only when the person is "legally bound to act".[1309] The distinction seems to be very straight forward, although it can represent problems in countries (mostly civil law countries), where an indirect representation is possible.[1310] Indeed, in many civil law countries the concept of *'commissionaire'* implies that a person acts in its own name, but for the account of the principal.[1311] Therefore, before third parties, the only relationship is with the commissionaire, but never with the principal.[1312] Therefore, since the commissionaire acts in its own name, it is difficult to sustain that he acts on behalf of another or that he is "legally bound to act" by another person, when in fact the representation is only indirectly with

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[1306] Id.

[1307] *See* US: IRC Sec. 318 and explanation of the concept of *"constructive ownership"* at *supra* n. 687.

[1308] OECD (2015), *supra* n. 6, p. 117, para. 370, letter a).

[1309] Id. This author assumes that this would cover basically all the situations in which two parties have, e.g. an agency agreement.

[1310] Avery Jones and Ward, *supra* n. 346, p. 345. *See also*, Parada, *supra* n. 346.

[1311] This is not the same as the *"undisclosed agency"* in common law countries, where even thought the name of the principal is not disclosed, the only relationship is always with the principal, because no distinction is made in common law with respect to direct and indirect representation. *See* Parada, *supra* n. 346, p. 63.

[1312] The principal is not legally bound with third parties, who may e.g. not initiate a legal action against the principal. Id.

respect to the principal, being perhaps these type of arrangement outside the scope of the concept of "acting together". This interpretation, however, could be refuted because of the reference that a person "[…] can be expected to act", and also because the contract between the principal and the commissionaire exists regardless the lack of relationship between a third party and the principal.[1313] The third scenario assumes that the arrangement must have a material impact on the value of those interests or rights. In other words, they must have a material impact on the ability of a holder to exercise control or ownership over its equity or voting rights.[1314] For example, if a shareholder is part of a shareholder's agreement by which he is obliged to offer his shares to the existing shareholders at a FMV, before selling them to third parties, would not generally create a material impact in the value of the shares.[1315]. This seems to be a restriction on the test itself, which is also restricted in term that this is intended to capture only arrangement with other investors and it does not cover arrangements that are part of the term of the equity or voting interests or those which operate exclusively between the holder and the issuer, e.g. an arrangement between a partnership and one of the partners would not be included.[1316] Finally, the fourth scenario treats investors as "acting together" when they are managed by the same person or group of persons, e.g. the case of a group of partners

[1313] The commissionaire arrangement is still legally bound for the principal. Id., p. 62.
[1314] Id.
[1315] OECD (2015), *supra* n. 6, p. 451, Ex. 11.4.
[1316] Id., p. 118.

(investors) within a partnership, who are managed by the general partner.[1317] This element is, however, constrained by the fact that it does not apply to investors that are CIV.[1318]

In spite of the above, the “acting together” test also attempts to catch situations between unrelated parties, even when the common control has not played any role in the transaction giving rise to the mismatch.[1319] The above is illustrated in example 11.4 of the OECD Action Plan 2, which in brief refers to a company (BCo), which is owned by a majority shareholder (ACo), which holds 40% of the shares. The remaining ownership is represented by a 55% owned by different shareholders and 5% owned by C, a minority shareholder. C acquires a financial instrument, and even though is not a “related party” with BCo (he does not meet the requirement of being in the same control group and does not hold at least 25% of the shares by value or voting rights), the sole fact of being part of an agreement with the other shareholders that provides the majority shareholder with the first right or refusal on any disposal of shares, brings him within the scope of application of the linking rules.[1320] Although the example is not illustrated using the concept of control group, but rather the concept of “related parties” (applicable to hybrid financial instruments), it is interesting to remark that the sole fact that the investor has entered into an agreement with

[1317] Id.
[1318] It is important to remark in this case that the “investors” are who must rely on the exception for CIV and not, e.g. the partnership where they are investing and who is related to the entity with whom the mismatch was generated. Id., p. 453, Ex. 11.5.
[1319] Id., p. 118.
[1320] Id.

a majority shareholder puts him under the umbrella of the "acting together" test, and therefore, under the application of *linking rules*.[1321] Indeed, in the author's view, the above simply reaffirms what has already been stressed before with respect to the (unnecessary) extension of the concept of "control group", mostly when other concepts are also coming into play, such as the concept of *structured arrangements* analyzed below.

3.3.2. Structured Arrangements

The OECD defines a *structured arrangement* as "any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch".[1322] As such, therefore, an structured arrangement is intended to capture transactions that are structured or based on hybrid outcomes, e.g. D/NI, or that depend on these outcomes in order to produce a commercial profit.[1323]

As per the definition above, there are at least three main elements that are required to conclude that a *structured arrangement* exists, and thus, to confirm the application of *linking rules*: (i) the existence of an arrangement; (ii) a hybrid mismatch priced into the terms of that arrangement, or facts and circumstances of the arrangement that indicate that the arrangement was

[1321] Id.
[1322] Id., p. 105.
[1323] Cooper, *supra* n. 1199, p. 342.

designed to produce a hybrid mismatch, and (iii) a person being party to this arrangement.[1324] As regards to the existence of an arrangement, the OECD states that an arrangement "will include a number of separate arrangements that all form part of the same plan or understanding and will include all the steps and transactions by which that plan or understanding is carried into effect".[1325] The above also confirms the idea that tax administrations should not only look at the specific transaction (or contract) generating the hybrid mismatch, e.g. the loan agreement, but to the whole structure or tax planning in order to determine the existence of a *structured arrangement*. This makes the concept of arrangement certainly very wide.

Accordingly, it is required that the hybrid mismatch is "priced into the arrangement" or that the "facts and circumstances" surrounding the arrangement suggest that this was designed to produce a hybrid mismatch. These two requirements represent two different realities. On one hand, the former, i.e. the "priced into the agreement" test, is the intention to objectivize the test. Indeed, as per the OECD a hybrid mismatch will be "priced into the terms of the arrangement if the mismatch has been factored into the calculation of the return under the arrangement".[1326] The test therefore focuses only on the terms of the arrangement itself, without paying

[1324] Although the report does not mention it, this author believes that these three elements are interconnected, and therefore, the absence of any of them supposes the failure in passing the test to confirm the existence of a structured arrangement, and subsequently, the application of *linking rules*.

[1325] OECD (2015), *supra* n. 6, p. 106.

[1326] Id.

attention to other factors, such as the relationship between the parties.[1327] In other words, it represents an honest intention to establish an objective criterion. On the other hand, however, the "fact and circumstances" test is not only a wider test, as recognized by the OECD,[1328] but certainly a more subjective one.[1329] The OECD provides a non-exhaustive list of facts and circumstances that would suggest that an arrangement should be treated as structured, including e.g. arrangements designed, or part of a plan, to create hybrid mismatches; arrangements that incorporate a term, step or transaction used to create hybrid mismatches; marketed arrangements where all the advantages, or some of them, are based on the hybrid mismatch, among others.[1330] All these factors, that includes to look at e.g. the relationship between parties; the circumstances under which the arrangement was made; the steps and transactions involved, or the economic and commercial benefits derived from it, must be considered under the view of an "objective and well informed observer", who will conclude that the arrangement was

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[1327] Id., p. 107

[1328] Id.

[1329] The OECD, however, argues that both tests are created to determine whether a st*ructured arrangement* exists are indeed "objective". Id., p. 106, para. 319.

[1330] The full non-exhaustive list includes: "a) an arrangement that is designed, or is part of a plan, to create a hybrid mismatch; b) an arrangement that incorporates a term, step or transaction used in order to create a hybrid mismatch; c) an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all the tax advantage derives from the hybrid mismatch; d) an arrangement that is primarily marketed to taxpayers in a jurisdiction where the hybrid mismatch arises; e) an arrangement that contains features that alter the terms under the arrangement, including the return, in the event that the hybrid mismatch is not longer available; or f) an arrangement that would produce a negative return absent the hybrid mismatch". Id., p. 105, Recommendation 10.2.

designed to produce a hybrid mismatch.[1331] Similarly, e.g. an arrangement is considered marketed not only by written or electronic manners, but also "orally".[1332] However, who else, beyond the persons who were part of a meeting, could certainly prove that the arrangement was indeed marketed in absence of written and electronic support? And if witnesses do it, what is the legal value of their statement? After all, what is clear so far is that the *structured arrangement* test, as designed, will generate an important extra burden not only for the tax administrations, but also for the taxpayers who decide to counter argue the reasoning of the tax administrations in determining the existence of a structured arrangement, not avoiding, and perhaps increasing, the complexity for cases involving hybrid mismatches.[1333]

In the same order of ideas, and at least referring exclusively to structures involving hybrid entities and reverse hybrids, it is almost impossible not to consider any arrangement involving these types of structures as *structured arrangements*. Let us assume, e.g. a simple tax planning structure involving the financing of some subsidiaries through simple loans and the use of CTB to avoid CFC rules in the parent companies in the United States due to

[1331] Id., p. 107.
[1332] Id., p. 109.
[1333] In this opinion, de Boer and Marres argue: "This complexity may be mitigated by the limitation in scope, but complexity is not avoided, not in the least because the scope is extended to structured arrangements, which is a rather vague concept". De Boer and Marres, *supra* n. 1253, p. 40.

passive income received at the level of the subsidiaries.[1334] This planning is developed by a law firm, which, nevertheless write a report to the taxpayers in a general manner, i.e. as a type of "doing business" report, which includes a general explanation of the U.S. tax rules, including CFC rules and CTB regulations and the tax treatment of the loan for U.S. tax purposes. Would that be considered as "marketed" by an "objective observer"? If not marketed, can be affirmed by this "objective observer" that the arrangement was made to create a hybrid mismatch? It is evident that the "hybrid mismatch" will come up after all, because if a parent company in the United States is borrowing money to a subsidiary in Europe, which for U.S. tax purposes is regarded as tax transparent while in Europe is considered as a taxable entity, will end up in a deduction at the level of the payer and a non-recognized loan in the United States. In certain manner, that is publicly known information.[1335] Moreover, if it is clear that the use of the CTB rules were to avoid CFC legislation and not to disregard the loan,[1336] it is difficult to affirm that the arrangement was directly designed for the purpose of generating a hybrid mismatch. Yet, as the "facts and circumstances test" also incorporates a term, step or transaction used for the purpose of creating a hybrid mismatch and an arrangement that is "part of a plan" to create a

[1334] For references to the CTB system and its use to avoid Subpart F income in the United States (CFC rule), *supra* Chapter III, Section 4.4.1. and 4.4.2.

[1335] It is within the law and can be consulted by anybody.

[1336] Let us imagine, e.g. that the report was made based on the necessities of the client to simply avoid the anticipation of distributions, and thus recognition of income in the United States due to the application of CFC rules, without any other references to tax benefits.

hybrid mismatch, it could still be possible for an "objective observer" to consider this planning as a *structured arrangement*.[1337] Therefore, it seems to be, at least *a priori*, impossible that a structure involving hybrid entities or reverse hybrids not being regarded as a *structured arrangement*. The above only reaffirms an idea already stressed in this work, which is that the concept of *structured arrangement*, more than a limitation to the application of linking rules, is indeed an excessive extension of their scope, where almost everything fits.[1338]

In spite of the above, the presence of a *structured arrangement* lacks of importance if taxpayers are not being part of that arrangement.[1339] For this purpose, a person is considered to be party to a structured arrangement "when that person has sufficient involvement in the design of the arrangement to understand how it has been structured and what its tax effects might be".[1340] In contrast, the OECD clarifies that a person will not be party to a structured arrangement if that person does not benefit from the mismatch. Likewise, the concept excludes a person who could not "reasonably have been expected to be aware of it".[1341] According to the OECD, the knowledge test is "objective", i.e. a taxpayer should not have an obligation to undertake additional due diligence on a commercial transaction

[1337] OECD (2015), *supra* n. 6, p. 108.
[1338] This is perhaps given by the vague construction of it. De Boer and Marres, *supra* n. 1253, p. 40.
[1339] Id., p. 110.
[1340] Id., p. 106.
[1341] Id.

beyond what “would be expected of a reasonable and prudent person”.[1342] It is, however, difficult to agree that a test requiring such a criterion, i.e. the reference to a “reasonable and prudent person” criterion, can indeed be regarded as objective. On the contrary, it is most likely that the understanding of what is a prudent and reasonable person varies significantly from country to country, becoming a very subjective rather than objective test, if not completely vague. In addition, and regardless the absence of reference to this matter, it seems to be logic, at least from a juridical point of view, that the tax administrations have the burden of the proof in this case. In simple words, the tax administrations should prove that a taxpayer is sufficiently involved in the design of the arrangement and not otherwise.

Moreover, a person is not regarded as party to the arrangement if this person did not benefit from the mismatch or reasonably have been expected to be aware of it.[1343] The reasonable question is again who should prove the above. An intuitive answer, at least from a legal point of view, is that the tax administration should prove that the taxpayer benefited from the hybrid mismatch or that this taxpayer was at least aware of it, considering that in many jurisdictions it is not accepted the proof of negative facts, i.e. that the taxpayer was not benefited. Nevertheless, the OECD seems to only partially recognize the above when it states: “[…] a tax administration should not be required to establish that the taxpayer has benefited from the mismatch

[1342] Id., p. 111.
[1343] Id.

before requiring that the adjustment be made".[1344] In other words, a presumption is created since the taxpayer should first neutralize the mismatch, regardless that finally it was not aware or did not benefited from it, and then the tax administration might prove its involvement.

As a result, it is possible to conclude that the whole design of the concept of *structured arrangements* lacks not only of proper objectives criteria, but it is also very risky to apply from a legal point of view, particularly when referring to ensure legal certainly. It is expected that taxpayers involved in transactions with a hybrid entities and reverse hybrids are constantly challenged, and in most of the cases, be finally regarded as part of *structured arrangements*, considering the ambiguous nature of this concept. Indeed, if the final intention of the OECD was reducing the scope of application of *linking rules* getting perhaps closer to target only abusive transactions, it would have been better, at least from a practical point of view, to rely more in accepted concepts, rather than introducing new and more complex ones.[1345] Last but not least, it should not be less expected that the number of complexities in the application of this concept increase in

[1344] Id.
[1345] Although this issue exceeds the purpose of this Chapter and the whole work, it would have been perhaps more interesting to follow common criteria, generally accepted, such as the concept of "wholly artificial arrangements" widely recognized by the CJEU in Europe. *Supra* Chapter I, Section 4.2. *See also*, de Boer and Marres, *supra* n. 1253.

practice, generating also a negative effect in terms of administrative efficiency.[1346]

3.4. Tax policy concerns

Beyond the limitations in the scope of application of *linking rules,* the design and introduction of them within domestic laws raises also other important tax policy concerns. The author summarizes these general concerns as follows: i) the "circular effect"; ii) dependency on foreign laws; iii) and economic double taxation issues. All these tax policy concerns are analyzed as follows.

3.4.1. Circular Effect

Perhaps the most evident deficiency in the proposed *linking rules* is its "circular effect".[1347] Indeed, a payment will not be considered deductible in the country of the payer to the extent such payment is not included as income in the country of the recipient, and vice versa, a payment will be taxed to the extent a deduction on such payment was granted.[1348] Therefore,

[1346] Cooper indirectly refers to this when he says: "Clearly, there are practical difficulties in applying these rules [*control groups and structured arrangements*] to widely held instruments where the treatment of the payer might be contingent on the treatment of holders in many different states" (emphasis added). Cooper, *supra* n. 1199, p. 342.

[1347] *See* K. Dziurdz, *"Circular Linked" Rules Countering Deduction and Non-Inclusion Schemes: Some Thoughts on Tie-Breaker Test*, 67 Bull. Intl. Taxn. 6 (2013), Journals IBFD. *See also*, Marchgraber, *supra* n. 851, pp. 141-142; Lüdicke, *supra* n. 840, p. 313.

[1348] *Supra* Section 3.1. and Section 3.2.

if two countries decide to include *linking rules* to target hybrid entity mismatches, they will necessarily become circularly linked since the application of the rules will necessarily depend on the tax treatment of the entity in the other country, which originated the mismatch in the payments.[1349] The above could drive us to the absurd result that while the country of the payer denies the deduction so long as that payment is not exempted in the payee country (or the payment is disregarded in case of a payment derived from a hybrid entity), the payee country considers that it will not apply the exemption only to the extent that the deduction was granted in the country of the payer, keeping both countries in an undecided position.[1350]

As proposed already in the past, these problems of circularity could be solved using "tie-breakers rules".[1351] However, the design of such rules is

1349 This issue, however, would not exist if only one of the two approaches is used to counteract D/NI outcomes, i.e. either denying a deduction in the country of the payer or taxing a disregarded payment (or not granting the exemption in case of HFI) in the country of the payee. *See* Dziurdz, *supra* n. 1347, p. 307.

1350 Id. *See also*, N. Schmidt and K. Binder, *Chaos durch doppelten Kampf gegen doppelte Steuervorteile,* Die Presse (14 Jan. 2013), available at www.dipresse.com

1351 "It would be hard to say which of the two rules [pr*imary response* or *defensive rule*] should have priority, whether both rules apply or both do not apply, or whether the only effective solution is to toss a coin. Consequently, a tie-breaker test is needed". Dziurdz, *supra* n. 1347, p. 310. In 2012 (before the OECD BEPS Project), the OECD also recognized this issue when it says: "[c]ountry rules linking the domestic tax treatment to the foreign tax treatment do not generally contain a tie-breaker test for cases where the other country involved has similar rules". OECD (2012), *supra* n. 6, p. 24. *See also*, Marchgraber, *supra* n. 851, p. 142. Nevertheless, the OECD seems to address a different position with respect to tie-breaker rules within the OECD BEPS report: "[…] these recommendations contain an ordering rule so that one rule is turned-off when the counterparty jurisdiction with the same set of rules can neutralize the effect of the hybrid mismatch arrangements in a more effective and practical way. This ordering rule *avoids*

again not an easy task. For example, the OECD BEPS Action plan 2 provides for a priority in the application of the rules.[1352] In this sense, a *primary response* will apply to deny a deduction to the extent that the corresponding payment is not included as income in the other country, and a defensive rule will apply only to the extent that a primary response was not applied.[1353] This is indeed a tie-breaker rule that provides for the application of the respective rule to counter the hybrid entity mismatch only if the other country did not apply the rule. However, as it can be seen, the tie-breaker rule does not solve the circular problem itself, because the application of the rule depends again on whether the other country's corresponding rule is applied.[1354] In other words, the circularity issue is simply moved from the rule counteracting the hybrid mismatch to the tie-breaker rule.[1355]

the need for an express tie-breaker rule and achieves the necessary degree of co-ordination without resorting to the competent authority procedure" (emphasis added). Id., p. 96. The above, however, would not solve the problem of opportunistic behaviors or who is "getting in first" in terms of revenue collection.

1352 As regards to the *linking rules*, the OECD states: "The rules apply automatically and there is a rule order in the form of primary rule and a secondary rule or defensive rule. This prevents more than one country applying the rule to the same arrangement and also avoids double taxation". OECD (2015), *supra* n. 6, pp. 11-12.

1353 Id.

1354 As stated by Dziurdz: "One country's rule countering deduction and non-inclusion schemes would apply only if the other country's corresponding rule did not apply, and the other country's corresponding rule would not apply only if the first-mentioned rule applied. This yet again depends on whether or not the other country's corresponding rule applied, and so on". Dziurdz, *supra* n. 1347, p. 308

1355 "[i]f the tie-breaker test considered the fact of whether or not the other country's corresponding rule applies […] there would again be a "circular link", but this time at the level of the tie-breaker test". Id.

Authors have also analyzed other approaches that include, on one hand, the possibility of disregarding the rule in the other country when it includes a "back link" and, on the other hand, to assume an international meaning of the concept of debt and equity (as regards to HFI).[1356] With respect to the first approach, it could indeed stop the problem of circularity, although only temporarily and perhaps at a much higher cost. Indeed, if both countries include the tie-breaker rule, they will nullify each other's corresponding anti-hybrid rule resulting in non-deduction/ non-exemption, or which is the same, economic double taxation.[1357] This result is evident in the case of primary response and defensive rule, because both rules involve a "back link" to the each other countries' rules.[1358] As regards to the second approach, it seems more logical, because it targets the real cause of hybrid mismatch arrangements: the divergent characterization of financial instruments or entities.[1359] Nevertheless, it is the author's opinion that such an approach in the case of hybrid entities and reverse hybrids should not be reduced to a simple tie-breaker rule solving the problems of application of

[1356] Id., pp. 308-309, who proposes a "solution (2)" and "solution (3)".

[1357] Although, it appears that countries are more willing to accepts this result rather than economic double non-taxation. For example, in 2007 Denmark introduced a provision by which an interest deduction is granted only to the extent that the correspondent interest amount is not exempted in the other country. This rule, or the underlying policy behind it, was widely criticized, because the same precautions (i.e. avoiding the mismatch) are not considered when double taxation, rather double non-taxation, arises. *See*, e.g. Bundgaard, *supra* n. 793, pp. 202-204. *See also* (from an Austrian perspective): S. Kirchmayr and G. Kofler, *Beteiligungsertragsbefreiung und Internationale Steuerarbitrage, 10* Zeitschrift für Gesellschaftrecht und angrenzendes Steuerrecht 9 (2011); M. Stefaner, *Konsequenzen der Anwendung von § 10 Abs. 7 KStG*, 22 Steuer und Wirtschaft International 8 (2012).

[1358] Dziurdz, *supra* n. 1347, p. 308

[1359] Id., p. 309.

the complex *linking rules*, but rather be applied as a separate standard that simply replaces the proposed OECD rules.[1360]

3.4.2. Dependency upon Foreign Laws

Another important feature of the proposed *linking rules* is the high reliance on foreign laws that involves their application.[1361] One could argue that there are plenty of other rules within tax law referring to foreign laws and which impose a certain degree of dependency, e.g. rules on tax credit or CFC rules, and thus there should not be a problem at all to include rules "linking" the outcomes of transactions involving hybrids. Nonetheless, there is a huge difference between a certain degree of reliance on foreign law and a full dependency, as it seems to be proposed under the linking rules.[1362] Indeed, it is difficult to argue that a country could become contingent or structurally dependent on the policies and practices of another country just because the former applies CFC rules or calculate a foreign tax credit relying of the concept of income in the other country. However, the design of the *linking rules* implies a direct connection to the law of the other country, including

1360 I will go back to this proposal at *infra* Chapter VI.

1361 As stressed by Cooper: "It has been clear for a long time that, if these recommendations [*linking rules*] are pursued and properly implemented, a state's tax law would become much more contingent and structurally dependent on the policies and practices of other governments". Cooper, *supra* n. 1199, p. 346.

1362 To explain this difference, Lüdicke states: "The former [CFC rule] seems easier for taxpayers and tax administrations as it requires less technical understanding about foreign tax rules and less factual knowledge about the fact and circumstances". Lüdicke, *supra* n. 840, p. 313.

its further modifications, which demonstrates indeed a much higher degree of dependency.[1363]

A dependency on foreign law in case of tax matters should be carefully analyzed from a tax policy perspective, because one should not forget that countries attempt to accomplish a basic aim when imposing taxes: to generate revenues.[1364] Thus, even though countries might sometimes act in the interest of other countries, they will most probably do that with those countries with which they have a deeper affinity given by cultural, economic or geographical reasons.[1365] In all other cases, it is expected that these

[1363] An experience from excessive reliance on foreign laws can be taken from the modification to the German DCL regime (Dual Consolidated Losses). The German tax group of companies (*Organgesellschaften*), unlike other countries, is also applicable to dual residence entities, as it is not required that the legal seat of the members of the group is located in Germany, rather it is only required that the place of management of the tax group and the controlling company [*Organträger*]'s participation in the tax group is allocated to a German PE. The above implies that, in cases where no double tax treaty is applicable, losses from dual residents of the tax group could be set off against income in Germany and in the country where the relevant legal seat is located. In order to avoid this effect, the German law was modified establishing now that the negative income of a controlling company [*Organträger*] or a controlled company [*Organgesellschaft*] is disregarded for German tax purposes to the extent that it is taken also into account by a foreign country in the taxation of the controlling company, the controlled company or any other person. However, as argued by Bärsch and Spengel, the simultaneous application of DCL rules in Germany and other country and the fact that the rule will apply in cases beyond DCL cases, e.g. negative income generated by a foreign PE where the foreign income is not tax exempt in Germany due to the application of the credit method, might result in no loss set off at all. *See* Bärsch and Spengel, *supra* n. 1285, p. 527. In the same order of ideas, i.e. in reference to the German experience on DCL, Lüducke argues that collateral damage is unavoidable, and that there is no doubt in German tax literature that the provision is excessive, inappropriately drafted and not administrable. *See* Lüdicke, *supra* n. 840, p. 313*, also* footnote 16.

[1364] To give up revenues is not always an easy task. Cooper, *supra* n. 1199, p. 346.

[1365] Id.

countries want to act in their own interest, which could generate new issues that could make these rules be destined to fail. For example, if two countries introduce both a *primary response* and a *defensive rule*, will the country of the payee accept that the deduction was denied in the country of the payer or it will consider a different approach and will decide to apply a *defensive rule*? As noted by Cooper, there is indeed a high risk of "getting in first", which is in fact an expected reaction of countries whose interests are based in the generation of revenues.[1366] Similarly, the risk of extreme dependency cannot only derive from the law in the other country, but also from the facts and circumstances, which puts countries in a more complicated situation.[1367] Following the example of Cooper with respect to HFI, it is clear that if a deduction associated to a payment using a HFI is denied in the country of the payer, because this is made to a related party or *structured arrangement*,[1368] but then the instrument is sold to an unrelated party, the deduction should be reinstated.[1369] The above demonstrates that the taxpayer's position in the country of the payer is directly linked in this case to the behavior of the foreign taxpayer. In other words, the deduction of the payment will finally depend on the behavior of the taxpayer in the foreign country.

[1366] Id.

[1367] As stressed by Cooper: "It is one thing to accept a constrain on sovereignty, as another sovereign state has acted, but it is quite a different matter to accept a constrain on sovereignty based on facts and circumstances happening abroad". Id.

[1368] *Supra* Section 3.3.2.

[1369] Cooper, *supra* n. 1199, p. 347.

A different dimension of the same problem is given by the costs associated to the reliance on foreign law both from taxpayers and tax administrations' perspective. In fact, it is undeniable that taxpayers will still attempt to escape the *linking rules* in one way or another. The above could indeed imply an increase in tax planning costs, given by the most complex set of international *linking rules* and foreign laws that should be taken into consideration when preparing a tax planning.[1370] Accordingly, tax administrations will need a further and deeper knowledge of foreign laws in order to determine whether a deduction was indeed granted or whether the other country "included" the payment as income, even though the concepts of deduction, inclusion and income might certainly vary from each other. In a nutshell, and once again, *linking rules* increase uncertainty and transaction costs, both negative effects from a tax policy perspective. As argued by Lüdicke: "Legislators should not underestimate the theoretical and the practical difficulties which arise if the application of the domestic taxation is made dependent on the details of foreign tax laws".[1371]

[1370] The probabilities for complexities increase considering, e.g. *imported mismatches*. *Supra* Section 2.4.3.

[1371] Lüdicke, *supra* n. 840, p. 317.

3.4.3. Economic Double Taxation and lack of coherence

Connected to the circularity issues already discussed, it is undeniable that *linking rules* might generate new situations of economic double taxation.[1372] This issue, in principle, should not raise major concerns since there are plenty of examples in which economic double taxation is indeed an accepted or tolerated outcome.[1373] Nevertheless, this potential outcome should be analyzed in line with the supposed coherence that Action 2 attempts to implement.[1374] Indeed, as noted already in this work, *linking rules* attempts to counteract transactions involving hybrid entities (and hybrid financial instruments) in which the outcome of DNT arises in the form of a D/NI, although without creating new situations of double taxation.[1375] However, the proposed rules demonstrate a sound preference for the avoidance of economic DNT (i.e. D/NI outcome) over the avoidance of economic double taxation (i.e. non-deduction/inclusion).[1376] This idea is reinforced when one sees that there is no rule to solve potential issues of economic double

[1372] This could perfectly happens when a *primary response*, denying a deduction in the payer country applies simultaneously with a *defensive rule*, which provides for taxation of a, in principle, disregarded payment made by a hybrid entity.

[1373] *Supra* Section 3.4.1.

[1374] As stated by the OECD: “The recommendations set out in this report are intended to operate as a *comprehensive* and *coherent* package of measures to neutralize mismatches that arise from the use of hybrid instruments and entities without imposing undue burdens on taxpayers and tax administrations”. OECD (2015), *supra* n. 6, p. 94.

[1375] *Supra* Section 2.

[1376] *Supra* Section 3.4.1.

taxation if, e.g. the denial of a deduction (i.e. *primary response*) finally results in the inclusion of income in the other country.[1377]

This situation becomes even clearer when we analyze the interaction of the *linking rules* with other rules denying deductions at a domestic level. Let us assume, for example, the application of *linking rules* and interest limitation rules in a given country.[1378] As a general rule, interest limitation rules, i.e. earning stripping rules, are designed in a way that if a taxpayer (Corporation) is in a situation of excess of indebtedness, i.e. its amount of interest expenses is over the amount of interest income, the amount of deductible interest income is limited according to certain criteria, normally a percentage of the amount of EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization).[1379] The above implies that for that given

[1377] On the contrary, the pragmatic approach taken by the OECD, in terms of taxing the income "no matter where" and "no matter base erosion", can be seen in the wording used to described the policy behind the anti-hybrid rules [*design principles*], where it clearly says: "[…] hybrid mismatch rules apply automatically and without regard for whether the arrangement has eroded the tax base of the country applying the rule. This approach assures consistency in the application of the rules (and their outcomes) between jurisdictions and also avoids the practical and conceptual difficulties in distinguishing between acceptable and unacceptable mismatches or trying to allocate taxing rights based on the extent to which a country's tax base has been eroded thorough the hybrid mismatch arrangement". OECD (2015), *supra* n. 6, p. 95.

[1378] Interest limitation rules are also part of the proposal in the BEPS Action 4. *See* OECD (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report*, OECD Publishing, Paris. *See also*, OECD (2016), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD Publishing, Paris.

[1379] For example, in Germany, as a general rule, a "business" [*Betrieb*] is limited to deduct net interest expenses, i.e. the amount after offsetting the interest expenses against the interest earnings of the business, as business expenses up to 30% of the amount of the taxable EBITDA. If there is thus an excess of net interest expenses, this is not deductible

taxable year, the Corporation will see how its taxable base is increased in the same amount of non-deductible interest expenses, which, nonetheless, will be included in the country of the recipient, generating thus a situation of economic double taxation.[1380] This effect, however, is normally offset with the possibility for the taxpayer to carry forward the non-deductible amount and use those non-deductible expenses as per the same limitations already

in the fiscal year, although it can be carried forward indefinitely and deducted in the subsequent fiscal years subject to the same threshold limitation. This general rule, however, has some exceptions. Firstly, it only applies to the extent that the amount of net interest expenses exceeds 3 million EUR ("*de minimis* rule"). This amount was increased in 2009. The original amount was 1 million EUR. *See* DE: Citizen Relief Act [*Bürgerentlastungsgesetz*] of 16 July 2009, BGBl 1, 1959 (2009) and Growth Acceleration Act [*Wachstumsbeschleunigungsgesetz*] of 22 Dec. 2009, BGBl 1, 3950 (2009). Secondly, it does apply only to the extent a business belongs, even partially, to a tax group ("stand-alone clause"). Thirdly, and finally, even in the case a business belongs to a tax group, the interest limitation rule does not apply if the business's equity ratio does not fall short of the group's equity ratio by more than 1% ("escape clause"). Generally speaking, the German interest barrier is codified in Sec. 4h of the Income Tax Act [*Einkommensteuergesetz*– EStG], which contains the general rule and the exceptions applicable to this rule. Likewise, §8a(2) and §8a(3) of the Corporate Income Tax Act [*Körperschaftsteuergesetz*– KStG] provides some special rules regarding the exceptions when applied specifically to corporate entities. The German interest limitation rule replaced the former thin capitalization rule previously applied and it is applicable for accounting periods starting after 25 May 2007 and not ending before 1 January 2008. *See* K. von Brocke and E. Garcia Perez, *Group Financing: From Thin Capitalization to Interest Deduction Limitation Rules*, 16 Intl. Transfer Pricing J. 1 (2009), Journals IBFD, p. 31. *See also* in reference to the German rules, e.g. M. Scheunemann and T. Müller-Duttiné, *New German Tax Rules on Financing Expenses*, 35 Intertax 8/9 (2007); A. Fross, *Earnings Stripping and Thin Cap Rules: Maintaining an Arm's Length Distance*, 53 Eur. Taxn. 10 (2013), Journals IBFD.

[1380] A very simple example could be the following: let us imagine a company, in Year X, with a given taxable EBITDA of 2,000, net interest expenses of 1,000, and taxable profits of 1,000. The amount of interest expenses is, however, limited to a 30% of the amount of EBITDA in that year X. Therefore, the company may only deduct 600, being the remaining 400 added back to the taxable income, increasing the tax base of the company. Accordingly, however, the full amount of interest paid (1,000) will be taxable in the payee country. As a result, therefore, the non-deduction of 400, and its inclusion as income in the other country, represents a clear case of economic double taxation.

mentioned.[1381] Now, let us imagine that the payment of interest is connected with HFI, and thus, we should also apply the *primary response*. As per the OECD report on Action 2, the *primary response* has priority over the interest limitation rule and should apply first, while the remaining part of the interest expenses not affected by the linking rule will be subject to the interest limitation. [1382] Therefore, the country of the payer will deny the deduction, because it considers that the income is not taxed in the other country. The denial of the deduction, in this case, will not generate economic double taxation if the income is not included in the other country. However, if for any reason the income is included in the other country (e.g. because the other country applies a different criteria for inclusion or a timing issue), the effect of economic double taxation will not be solved since the *primary response* does not provide for a non-deductible expense to be carried forward. In other words, if this hypothetical happens, the part of the interest expenses paid and affected by the *primary response*, i.e. where the interest limitation rule does not apply, will suffer economic double taxation if the income is included in the other country, without any chance of turning that back. The above thus simply reinforces the idea that when putting together economic double taxation and economic double non-

[1381] In some cases, however, regardless the fact that an unlimited carry-forward is offered, in practice such an option is limited. In Germany, e.g. in case of the discontinuance of the business or change of control, the non-deductible expenses cannot be used, which in other words implies that the economic double tax effect is permanent. DE: Sec. 4(h)(5)(1) of the Income Tax Act [*Einkommensteuergesetz*– EStG]. *See also*, C. Knöller, *The Efficacy of thin Capitalization Rules and their Barriers: An Analysis from UK and German Perspective,* 39 Intertax 6/7 (2011), pp. 324-325.

[1382] For a more complete analysis on the interaction of linking rules and interest limitation rules, *infra* Section 4.1.

taxation in a balance, there is certain inclination to opt for counteracting the latter rather than the former, even under the risk of producing new cases of economic double taxation.[1383] This is not only contrary to what the OECD attempts to demonstrate, i.e. the coherence within the application of the rules, but also an evident proof of lack of consistency when applying the rules, at least when the two aims (i.e. double taxation and DNT) are confronted.

3.5. Legal Concerns

Another issue associated to the implementation of the OECD *linking rules* as a manner to deal with the issues of hybrid and reverse hybrid entities refers to the legal compatibility of these rules, specially when they are tested against tax treaties (in particular Art. 24 OECD Model/ non-discrimination provision) and EU primary and secondary law. This Section provides some insights with respect to this analysis.

3.5.1. Compatibility with Tax Treaties

Both the *primary response* and the *defensive rule* might *a priori* raise issues with respect to the compatibility between these domestic rules and tax treaties. In particular, it refers specifically to the possibility that the denial of a deduction in the country of the payer, unless a respective inclusion of

[1383] *Supra* Section 3.4.1.

income occurs in the other country, or the taxation of income (and the recognition of a transaction in principle disregarded) at the level of the payee, if a deduction of such payment was granted in the other country, might be regarded as discriminatory as per the non-discrimination rules established in Article 24 OECD Model.

3.5.1.1. General Structure of Article 24 OECD Model: Non-Discrimination

Unlike other non-discrimination provisions, Article 24 OECD Model is very straightforward in terms of its application.[1384] Indeed, e.g. it covers only cases of direct or *de jure* discrimination, excluding indirect, hidden or *de facto* discrimination.[1385] Indeed, in order to establish that discrimination

[1384] The above also means that the analysis of discrimination if rather restricted.

[1385] *See*, e.g. A. Rust, in: Reimer & Rust (eds.), *Klaus Vogel on Double Taxation Conventions*, 4th ed. (2015), Article 24 at m.no. 5. In a different perspective, e.g. the approach to discrimination under WTO covers both *de jure* and *de facto* discrimination, and it also includes possibilities for justification. *See* K. Dziurdz, *Non-Discrimination and Harmful Tax Competition under WTO Law and Article 24 of the OECD Model*, in: D. Weber and P. Pistone (eds.), *Non-Discrimination in Tax Treaties: Selected Issues from a Global Perspective*, EC and International Tax Law Series Vol. 14, IBFD, Amsterdam, 2016, p. 210. Similarly, the EU law approach to non-discrimination both types of discrimination (direct and indirect) and provides for justification grounds. *See* F. Vanistendael, *Non-Discrimination: Can the EU Learn from the OECD Model Convention and Vice Versa?*, in: D. Weber and P. Pistone (eds.), *Non-Discrimination in Tax Treaties: Selected Issues from a Global Perspective*, EC and International Tax Law Series Vol. 14, IBFD, Amsterdam, 2016, p. 227. As Vanistendael well explains, however, the difference is basically because the aim of the EU was to achieve a rather stronger level of integration, which included “the establishment of a common market, which later would develop into the internal market”. Id., p. 226. This is certainly not the aim of the OECD Model or the international tax treaty network. *See also* in this opinion, e.g. K. Dziurdz and C. Marchgraber, *Non-Discrimination in European and Tax Treaty Law: An Overview*, in: K. Dziurdz and C. Marchgraber (eds.), *Non-Discrimination in European and Tax Treaty Law*, Linde, Vienna, 2015, p. 10. Accordingly, The OECD

occurs, a strict *comparability test* is applied: only those domestic provisions differentiating by reason of nationality or residence might give rise to discrimination.[1386] Therefore, every other relevant difference in circumstances is considered for purposes of preventing comparability.[1387] Likewise, Article 24 OECD Model gives no space for 'justifications'.[1388] This latter characteristic is, nevertheless, not absolute, because where a grounds for different treatment acts as a substitute or a proxy for nationality of residence, direct discrimination can still be established.[1389]

The non-discrimination situations within Article 24 OECD Model include, on one hand, paragraphs 1 and 2 referred to discrimination based on

Commentaries on Article 24 clearly state: "The nondiscrimination provisions of the Article seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions. For that reason, the Article should not be unduly extended to cover so-called "indirect" discrimination". *See* OECD Commentary on Article 24 concerning non-discrimination, para. 1.

1386 Rust, *supr*a n. 1385, Article 24 at m.no. 35.

1387 For example, residence is a relevant comparability for purposes of Article 24(1) OECD Model, because everything in the circumstances, except for nationality, must be the same. *See* OECD Commentary on Article 24 concerning non-discrimination, para. 7 et seq. *See also* Dziurdz and Marchgraber, *supra* n. 1385.

1388 Rust, *supra* n. 1385, Article 24 at m.no. 4 and 132. Indeed, as explained by Vanistendael in reference to the fact that the OECD Model does not contain express grounds for justification: "Unlike in the EU treaties, there are no reasons of public policy to make exceptions to the non-discrimination rule. Since the rules of the Model Convention are to be interpreted by many different national courts, chances that these courts would develop any doctrine resembling the rule of reason doctrine of the ECJ, permitting them to make exceptions to the non-discrimination principle on the basis of a uniform juridical doctrine, are non-existent". *See* Vanistendael, *supra* n. 1385, p. 246.

1389 For example, as per the OECD Commentaries on Article 24, the requirement of holding or being entitled to a passport is regarded as substitute for nationality. *See* OECD Commentary on Article 24 concerning non-discrimination, para. 1. *See also*, Dziurdz, *supra* n. 1385, and Dziurdz and Marchgraber, Id.

nationality.[1390] On the other hand, paragraphs 3, 4 and 5, which include discrimination based on residence.[1391] Therefore, and as per the design of the proposed *linking rules*, the analysis will concentrate on paragraphs 4 and 5

[1390] Article 24(1) OECD Model, on one hand, prohibits a contracting State from subjecting the nationals of another Contracting State, who find themselves in the same circumstances, in particular with respect to residence, as the nationals of the first State, to a more burdensome tax treatment in comparison with the one imposed on nationals of the first State. *See* Rust, *supra* n. 1385, Article 24 at m.no. 5. The rule applies both to individuals and legal entities. Nevertheless, the importance for individuals is rather reduced, considering that nationality is not longer a proxy used to determine tax liability. *See* Y. van Brussel, *The Relevance of Residence as a Safeguard in Article 24(1) of the OECD Model*, in: K. Dziurdz and C. Marchgraber (eds.), *Non-Discrimination in European and Tax Treaty Law*, Linde, Vienna, 2015, p. 354. As an exception, the United States still uses nationality to determine the worldwide taxation of individuals. This is also stated within the observation made by the United States to the Commentaries on Article 24, when they emphasize that "its non-resident citizens are not in the same circumstances as other non-residents", precisely because the United States taxes its non-resident citizens on worldwide income. *See* OECD Observations to the Commentary on Article 24 concerning non-discrimination, para. 83. For an critical analysis regarding the use of citizenship in the United States, *see* e.g. R. Avi-Yonah, *The Case of Taxing Citizens*, Public Law and Legal Theory Working Paper No. 10-009 (2010), available at Michigan Law ELSC Website. *See also*, R. Mason, *Citizenship Taxation*, Southern California Law Rev. 89, Virginia Law and Economics Research Paper No. 2015-07, available at SSRN. Accordingly, Article 4 OECD Model, in order to allocate taxing rights, uses nationality as a "tie-breaker" when competing claims over individual taxpayers result in a jurisdictional collision. *See* Article 4, para. 2 d) of the OECD Model Tax Convention (2014). A similar norm is contained in Article 4, para. 3 d) of the US Model Tax Convention (2016). The practical importance of Article 24(1) OECD Model varies with respect to companies, because full tax liability by reason of incorporation under domestic law is often the criterion to determine nationality under Artcile 3(1)(g) OECD Model. *See* K. van Raad, *Nondiscrimination in International Tax Law*, Series of International Taxation No. 6, Kluwer Law and Taxation Publishers, Deventer, 1986, p. 75. Article 24(2), on the other hand, applies the same rule with respect to discrimination to persons who are regarded as "stateless" who have no nationality. There is no equivalent provision under EU law. *See* Vanistendael, *supra* n. 1385, p. 243.

[1391] The scope of Article 24(3), however, is limited to PEs. According to this article, a PE cannot be taxed worse than a domestic enterprise. For a further analysis, *see* e.g. H. Bhuta, *Progressive Tax Rates in a Profit or Loss Situation under Article 24(3) of the OECD Model*, in: K. Dziurdz and C. Marchgraber (eds.), *Non-Discrimination in European and Tax Treaty Law*, Linde, Vienna, 2015, p. 377 et seq.

of Article 24 OECD Model. Whilst the former refers to a specific non-discrimination rule with respect to the deductibility of expenses paid by an enterprise to a resident of the other Contracting State, the latter prohibits a more burdensome taxation of an enterprise established in a Contracting State by the sole reason of being wholly or partially owned by taxpayers in the other Contracting State.

3.5.1.2. *Linking rules* and Article 24(4) OECD Model

Article 24(4) OECD Model provides that "interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if the had been paid to a resident of the first-mentioned State".[1392] Therefore, in principle, a rule denying a deduction of certain deductible payments (e.g. interest), which only applies in cross-border situations, might be considered against the non-discrimination provision of Article 24(4) OECD Model. In contrast, however, it could also be argued that if the rule (hypothetically) applies indistinctively to domestic and cross-border situations, and since Article 24(4) OECD Model does not cover cases of indirect or hidden discrimination, *linking rules* would be perfectly compatible with the non-discrimination provision.

[1392] Article 24(4) OECD Model Tax Convention (2014).

The analysis becomes even more complex if we consider the lack of comparability between domestic and cross-border situations. Indeed, as HMA involving hybrid entities and reverse hybrids may only occur in cross-border situations, i.e. a country will never disagree with itself with respect to the characterization of entities, there is no a pure domestic situation to compare with and, in absence of comparability, there is no discrimination.[1393] Additionally, and as stressed somewhere else already, *linking rules* are not designed based on residence, but rather based on the existence of a hybrid mismatch, i.e. for purposes of this work, a disparity between two countries with respect to the characterization of the same entity.[1394] All of the above would drive us to conclude *a priori* that a non-deductibility based on the recognition of income in the other Contracting State (i.e. *primary response*) would be a simple additional condition for the deductibility, which may not be regarded as directly discriminatory.

In spite of the above, it is still relevant to question whether the existence of a hybrid entity mismatch that results in a D/NI outcome might be regarded as a substitute proxy for discrimination based on residence or nationality.[1395] Dzuirdz assumes this question in the hypothetical situation of a country, without access to the sea, which provides for a less favorable tax treatment

[1393] Dziurdz, *supra* n. 1385, p. 213.

[1394] As stated by Rust with respect to the design of *linking rules*: "[…] residence in the other Contracting State is neither necessary nor sufficient condition". *See* A. Rust, *BEPS Action 2: 2014 Deliverable–Neutralizing the Effects of Hybrid Mismatch Arrangements and its Compatibility with the Non-Discrimination Provisions in Tax Treaties and the Treaty on the Functioning of the European Union*, BTR 3 (2015), p. 312.

[1395] Dziurdz, *supra* n. 1385, p. 215.

to the profits of PEs belonging to non-residents enterprises if the respective enterprise, in its residence country, is located 50 kilometers to the sea.[1396] According to Dzuirdz, this situation mirrors in part what happens with HMA, where mismatches will not arise in all circumstances, but rather only with respect to certain non-residents where the hybrid mismatch results indeed in a D/NI.[1397] In both situations, however, the less favorable treatment might be a relevant criterion for the domestic "anti-sea access" or the "anti-HMA" provision, justifying the different treatment.[1398] Therefore, the relevant question is still whether or not the sea access or the HMA prevent direct discrimination or they are indeed a mere pretext for disadvantaging non-residents.[1399] If the genuine tax policy were to prevent sea access or the occurrence of a HMA, there would not be conflict with Article 24(4) OECD Model, because as stressed already, this article only prevents discrimination based on nationality or residence, i.e. direct discrimination.[1400]

If the question above were analyzed within a bilateral context, there would certainly be more possibilities to conclude that a discriminatory treatment

[1396] The author assumes the case of Austria, which does not have sea borders. Id., p. 214.
[1397] Nevertheless, Dziurdz explains that the fact that only few non-residents are disadvantaged does not prevent discrimination under Article 24(3) OECD Model. Id.
[1398] Id., p. 215.
[1399] "Determining the actual reason for different treatment and the background of a rule is not merely an issue of subjective intent. It is rather necessary to objectively determine the aim of the rule under scrutiny by analyzing its wording, context and systematics as well as the historical background". Id.
[1400] *Supra* Section 3.5.1.1.

occurs.[1401] For example, if Spain provides for a domestic rule denying the deduction of interest paid to a German parent company if due to the different characterization of the Spanish entity by Germany, the payment is not recognized as income in Germany, it is evident that the rule will affect all German residents (as non-residents). However, if Germany were to include the same rule, no Spanish parent company with a German subsidiary would be affected, considering the Spanish practice to follow the characterization of foreign entities according to the rules of the foreign country.[1402] This analysis can be compared with the analogy that Dzuirdz makes with respect to the sea-access.[1403] If the treaty applied were Austria-Malta, then only Maltese companies with PEs in Austria would be affected, but no in the other way around.[1404] Nevertheless, avoiding the specific bilateral context, it is clear hat a rule such as the one introduced by Spain in the example above, applicable to all countries, would affect some countries and others not. The above, however, would simply mean that an indirect discrimination, not covered by Article 24(4) OECD Model, would arise.

As a result, therefore, it is possible to conclude that a different treatment to non-residents may exist when this different treatment is not necessarily a substitute for residence or nationality. In the same order of ideas, it is arguable that *linking rules* raise *a priori* discriminatory issues considering mostly the strict comparability sets up in Article 24(4) OECD Model.

[1401] Id.
[1402] *Supra* Chapter III, Section 5.1.
[1403] Dziurdz, *supra* n. 1385, p. 216.
[1404] Id.

3.5.1.3. *Linking rules* and Article 24(5) OECD Model

The majority of tax treaties around the globe include a provision similar to Article 24(5) OECD Model. According to this provision: "Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected".[1405]

As per the wording of paragraph 5, therefore, it is possible to identify some minimum requirements for its application.[1406] Firstly, the provision applies only in case of resident subsidiaries, which are treated in a less favorable manner because of being controlled by a non-resident rather than a resident company.[1407] In other words, the rule aims to ensure an equal treatment for taxpayer residing in the same State or, which is the same, it prohibits a Contracting State from giving a less favorable treatment to a resident enterprise, whose capital is owned or controlled by a resident(s) of the other

[1405] Article 24(5) OECD Model Tax Convention (2014).

[1406] B. Da Silva, *Revisiting the Application of the Capital Ownership Non-Discrimination Provision in Tax Treaties*, in: D. Weber and P. Pistone (eds.), *Non-Discrimination in Tax Treaties: Selected Issues from a Global Perspective*, EC and International Tax Law Series Vol. 14, IBFD, Amsterdam, 2016, p. 74

[1407] OECD Commentary on Article 24 concerning non-discrimination, para. 5, m.no. 76.

Contracting State.[1408] Secondly, the reason for discrimination must rely exclusively on the fact that resident enterprises are owned or controlled, directly or indirectly, by a resident enterprise in the other Contracting State. In other words, and as stressed already with respect to Article 24 OECD Model in general, this provision covers exclusively cases of direct discrimination.[1409] Thirdly, the discriminatory treatment refers to "other or more burdensome taxation" or "connected requirements". Whilst the reference to a "more burdensome taxation" clearly requires a comparison of tax burdens, i.e. quantum of tax,[1410] the reference to "other taxation" is rather unclear.[1411] Nevertheless, the inclination of some scholars to associate the first expression to a comparison of tax rates, while the later as a reference to tax base, which would include, e.g. limitation in the deductibility of expenses, seems to be a clearer path for interpretation.[1412] Finally, and as regards to the object of comparison, the provision refers to "similar enterprises". Despite the unclear wording of Article 24(5) OECD

[1408] *See* A. Rust, *International Tax Neutrality and Non-discrimination–Legal Perspective*, in: M. Lang, P. Pistone, J. Schuch, C. Staringer, A. Storck and M. Zagler (eds.), *Tax Treaties: Building Bridges between Law and Economics,* IBFD, Amsterdam, p. 641. Article 24(5) OECD Model does not protect the shareholders, resident in the other Contracting State. *See also,* Rust, *supra* n. 1385, Article 24 at m.no. 108.

[1409] *Supra* Section 3.5.1.1.

[1410] J. Avery Jones et al., *The Non-discrimination Article in Tax Treaties*, 31 Eur. Taxn. 10 (1991), Journals IBFD, p. 336.

[1411] J. Kostohryz, *Ownership Non-Discrimination under Article 24(5) of the OECD Model in the Case of Low-Taxed Payments, Linde*, Vienna, 2015, p. 542.

[1412] *See*, e.g. van Raad, *supra* n. 1390, p. 93. Indeed, disallowing a deduction in one country has the direct effect of increasing the tax base in the country where the restriction is carried out. Therefore, the quantum of the tax is also higher. *See* Da Silva, *supra* n. 1406, p. 76.

Model to ascertain similarity,[1413] it is entirely clear now that "similar enterprises" refers to a comparison with domestic entities owned or controlled by residents of the same State of the subsidiary.[1414]
As regards to *linking rules*, however, i.e. rules motivated by the prevention of HMA that result in DNT, the relevant question remains the same: do these rules genuinely aim to prevent DNT resulting from hybrid entity mismatches or do they indeed, by reason of a foreign ownership, puts the residence enterprise in a more burdensome position? Only in this latter case, i.e. a case of direct discrimination, the application of Article 24(5) OECD Model could be relevant.

As this author has stressed already, the design of *linking rules* is rather broad.[1415] In principle, they attempt to cover all situations, domestic and cross-border, that might give rise to D/NI, regardless the fact that in practice hybrid mismatches involving hybrid entities and reverse hybrids are limited or might only arise in cross-border transactions.[1416] One could argue in

[1413] The dispute of interpretation referred basically to consider that the comparison should be made either with an enterprise owned by residents of the same State or by residents of a third State. *See* D. Oliver, *Differential Treatment of Discrimination?* , BTR 6 (1993), pp. 435-441.

[1414] OECD (2007), *Application and Interpretation of Article 24 (Non-Discrimination)-Public Discussion Draft*, OECD Publishing, Paris, p. 27. *See also*, inter alia, Rust, *supra* n. 1390, Article 24 at m.no. 114; van Raad, *supra* n. 1390, pp. 188-189; B. Arnold, Tax Treaty Monitor: Tax Teaty News, 63 Bull. Intl. Taxn. 7 (2009), Journals IBFD, p. 270; J. Oliver, *Other Similar Enterprises –NEC Semi-Conductors Ltd and others v Inland Revenue Commissioners*, BTR 2 (2004), pp. 80-83.

[1415] *Supra* Section 3.3.

[1416] *See* the examples of Spain, Austria and to certain extent Germany at *supra* Section 3.1. and 3.2.

contrast that, nevertheless, *linking rules*, as regards to hybrid entity mismatches, only apply in case of control groups.[1417] The above could give some hints that the rules provide indeed a limitation based on foreign ownership, which could conflict with Article 24(5) OECD Model. Indeed, a *primary response* denying the deduction of a payment in the source country will apply only if that payment is not recognized as income (which occurs in case of hybrid entities because of the tax treatment of the payer under the domestic rules of the payee country) and only to the extent that transaction is made within a control group.[1418] However, the inclusion of the broader concept of *structured arrangements*, which also trigger the automatic application of the rules together with cases of control groups, might certainly refute this argument.[1419] The broader interpretation of the concept of *structured arrangement* makes in theory, possible to include all of other cases that are not strictly within a control group, refuting the idea that the rule is designed as to provide a limitation based exclusively in the foreign ownership of entity. Indeed, one should not forget that it is not *prima facie* relevant, for purposes of Article 24(5) OECD Model, whether or not interests are paid to a resident or non-resident creditor.[1420] The discrimination must be based exclusively on the foreign ownership or control. In other words, paragraph 5 is not concerned about debtor-creditor relationship, unless a different treatment is based on the ownership or

[1417] *Supra* Section 3.3.1.
[1418] Id.
[1419] *Supra* Section 3.3.2 referred to the concept of "*structured arrangements"*.
[1420] OECD Commentary on Article 24 concerning non-discrimination, para. 79.

control.[1421] In this regard, e.g. a *primary response* denying an interest deduction in case the payment is not regarded as income because of the different characterization of the payer entity, might arguably be considered discriminatory if the rule would apply, indistinctly, in cases of a resident entity controlled by a foreign parent company (i.e. control groups) and, at the same time, in cases where is considered that an arrangement was marketed in order to produce the hybrid entity mismatch, and the DNT result (i.e. structured arrangement), independently on the ownership or control relationship between debtor and creditor.

Finally, considering that Article 24(5) OECD Model does not prevent discrimination at the level of the resident-shareholders, the taxation at the level of the payee entity by reason of a deducted payment at the level of the payer, i.e. the potential discrimination derived from the application of a *defensive rule,* would not be included within the scope of this article.

3.5.2. Compatibility with EU law

As regards to the analysis of the compatibility of *linking rules* and EU law, the author will attend to the classic distinction between EU secondary law and EU primary law (fundamental freedoms), as detailed below.

[1421] The debtor-creditor relationship might be targeted within the scope of Article 24(4) OECD Model. Rust, *supra* n. 1385, Article 24 at m.no. 107.

3.5.2.1. EU Secondary Law

Scholars discussed in the early stage of the BEPS Project the potential introduction of *linking rules* denying a deduction in the payer MS if the income were not recognized as such and taxed in the other country, or taxing the income at the level of the payee MS, i.e. not applying an unconditional exemption, if the deduction in the other MS was indeed granted.[1422] The discussion related basically to the compatibility of the proposed *linking rules* with respect to two EU Directives: (i) the I&R Directive 2003/49/EU,[1423] and (ii) the PSD 2011/96/EU,[1424] as regard to the primary response and secondary rule, respectively. Both rules are, nonetheless, included today within the 2016 EU ATAD[1425] and the EU ATAD II of 2017.[1426] Therefore, as such *linking rules* are indeed in compliance with EU secondary law.

3.5.2.1.1. Primary Response

As regards to the primary response, Article 1(1) of the I & R Directive states that: "Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by

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1422 Rust, *supra* n. 1394.

1423 EU: Council Directive 2003/49/EC of 3 June 2003.

1424 EU: Council Directive 2011/96/EU of 30 Nov. 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L345/ 8 (2011), hereinafter "Council Directive 2011/96/EU of 30 Nov. 2011".

1425 EU: Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I). See also, *supra* Chapter III, Section 5.3.2.

1426 EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II).

deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State".[1427] As such, it is clear that the rule attempts to prevent the source MS to impose taxation on those payments when these are received by a recipient in another MS. Therefore, in principle, denying a deduction at the level of the payer MS (i.e. primary response) would not infringe the Directive, because the Directive does not refer to the taxation of the payer (who owes the interest) but rather to the taxation of the creditor (payee).[1428] This interpretation is based on the decision of the CJEU in *Scheuten Solar Technology GmBH v. Finanzamt Gelsenkirchen-Süd*, which concerned a Dutch parent company (Scheuten Solar System BV), which wholly owned a German LLC (SST).[1429] In a period of time, which included August 2003 and December 2004, Scheuten Solar System BV granted a series of loans and received thus payment of interest back from SST.[1430] For purposes of the tax assessment in Germany, however, SST was allowed to deduct only 50% of the interest paid, which generated that the other 50% had to be added back to the tax base of the company.[1431] SST initiated thus a proceeding against the decision of the *Finanzamt* in Germany, arguing that the fact of adding back the amount of non-deductible interest expenses was

[1427] Article 1(1) of the Council Directive 2003/49/EC of 3 June 2003.
[1428] Rust, *supra* n. 1422, p. 312.
[1429] EU: Judgment in *Scheuten Solar Technology GmBH v. Finanzamt Gelsenkirchen-Süd,* C-397/09, ECLI:EU:C:2011:499.
[1430] Id., para. 14.
[1431] Id., para. 15.

indeed contrary to Article 1(1) of the I&R Directive, because it constitutes taxation on the amount of non- deductible interest.[1432] The Court, in this regard, was clear and provided that: "The scope of Directive 2003/49, as defined in Article 1(1) of the directive, thus concerns the exemption of interest and royalty payments arising in their source Member State, provided that the beneficial owner is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State".[1433] Accordingly, it stated: "It follows that Article 1(1) of Directive 2003/49, read in the light of recitals 2 to 4 in the preamble to the directive, aims to avoid legal double taxation of cross-border payments of interest by prohibiting the taxation of interest in the source Member State to the detriment of the actual beneficial owner. That provision thus concerns solely the tax position of the interest creditor".[1434] This last statement of the CJEU clarifies therefore that denial of a deduction in the source MS do not violate the Directive, because indeed the scope of the Directive only includes the potential legal double taxation that the creditor could suffer, but it cannot be interpreted beyond this scope.[1435] In other words, the domestic rules used to calculate the tax assessment of the taxpayer who paid the interest, e.g. rules denying a deduction under certain circumstances, is out of the scope of Article 1(1) I&R Directive.[1436] Therefore, when applying the reasoning of the Court to the application of a *primary response* denying a

[1432] Id., para. 18-19.
[1433] Id., para. 25
[1434] Id., para. 28.
[1435] Id., para. 34. *See also*, Rust, *supra* n. 1422, p. 312.
[1436] Id.

deduction at the level of the payer, our conclusion should be similar: it is not an infringement of the Directive.

Most of this discussion is, however, completely overcome today due to approval of the final of the EU ATAD in 2016.[1437] Indeed, Article 9(2) of the ATAD states: "To the extent that a hybrid mismatch results in deduction without inclusion, the Member State of the payer shall deny the deduction of such payment".[1438] In other words, the denial of a deduction in the source MS is allowed under EU secondary law to the extent that this denial attempts to counteract the non-inclusion of income in the other MS, which resulted from the use of a hybrid structure, either through the use of a financial instrument or an entity.[1439] Likewise, considering the latest development with respect to hybrid mismatches in Europe, a similar rule has been extended to situations involving third countries.[1440]

3.5.2.1.2. Defensive Rule

With respect to the *defensive rule*, i.e. the rule imposing the State receiving a payment involving a hybrid structure in case that payment was deductible in the State of source, one should be aware that this rule was already introduced within Article 4(1)(a) of the PSD in 2014.[1441] Indeed, as provided

[1437] EU: Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I).
[1438] Article 9(2) of the Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I).
[1439] *Supra* Chapter III, Section 5.3.2.
[1440] EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II).
[1441] EU: Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU.

within the updated text of Article 4(1)(a) of the PSD, a parent company will refrain to tax the profits received by a subsidiary: "[…] to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary".[1442] Currently thus MS are obliged to tax, and not to grant unconditionally the exemption method to relieve double taxation, if a distribution of profits were deductible in the source MS.[1443] In the other way around, MS would be refrained from taxing those payments, to the extent that they were not deductible, which includes the possibility that they were not deducted by application of, e.g. a thin cap rule, earning stripping rule (i.e. interest limitation) or any other anti-base erosion provision.[1444]

The introduction of the *secondary rule* within EU law, even before the issuance of the EU ATAD in 2016, explains why it was not originally necessary to include such a rule within the final text of the EU ATAD.[1445] However, the inclusion of a *secondary rule* within the PSD limits by itself

[1442] Art. 4(1)(a) of the Council Directive 2011/96/EU as amended by Council Directive 2014/86/EU of 8 July 2014.

[1443] Originally, however, the exemption had to be granted without conditions as it can be interpreted from the original text of the PSD, which provided that the parent company should "refrain from taxing such profits". Art. 4(1)(a) of the Council Directive 2011/96/EU (original text).

[1444] In this opinion, *see also* de Boer and Marres, *supra* n. 1253, p. 34. This issue has special importance after the approval of the final text of the ATAD (2016), because indeed this document contains both an interest limitation and a rule dealing with hybrid mismatches, which resemblances the proposal of the OECD BEPS Action Plan. The ATAD does not contain any rule of hierarchy to solve this issue. *See* Art. 4 and 9 of the Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I).

[1445] EU: Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU, Art. 4(1)(a).

the application of the rule. On one hand, the PSD only applies to transactions between MS, excluding therefore third countries.[1446] On the other hand, it only applies in case of a relationship "parent-subsidiary", with a minimum participation and other requirements,[1447] which could e.g. exclude cases of hybrid mismatches involving *structured arrangements* that are not necessarily related to such relationship.[1448]

Perhaps recognizing the limitations stated above, the European Commission launched in the beginning of 2017 a proposal for amending the EU ATAD (2016), which introduces a *secondary rule* but within Article 9 of the ATAD, whose final text was approved on May 2017.[1449] As regards to D/NI outcomes, the new Article 9(2)(b) reads as follows: "To the extent that a hybrid mismatch results in a deduction without inclusion: […] (b) where the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome shall be included in

[1446] Article 1(1), letters (a) to (d) of the Council Directive 2011/96/EU as amended by Council Directive 2014/86/EU of 8 July 2014.

[1447] For example, a minimum holding period of two years can be required in order to apply the PSD. *See* Article 3(2)(b) of the Council Directive 2011/96/EU as amended by Council Directive 2014/86/EU of 8 July 2014.

[1448] The proposal for a Directive modifying the Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I), provides that a *structured arrangement* "means an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch". EU: Proposal ATAD II (17 Feb. 2017), p. 17. This text was included also in the finally approved Council Directive EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II).

[1449] Id. See also, *Supra* Chapter III, Section 5.3.3.

income in the Member State that is the payee jurisdiction".[1450] As noted, therefore, the wording and scope of the proposed *secondary rule* included as part of Article 9 of the ATAD is indeed wider than the existing rule within the PSD. Firstly, it refers to "payments" rather than just "distribution of profits", as it is the current scope of application of the PSD.[1451] Secondly, it applies to cases that might include third countries outside the EU, which is indeed prevented under the pure application of the PSD. Therefore, the implementation of a *defensive rule* would not be in infringement of EU secondary law neither before the implementation of the ATAD not after it, because it was already part of the PSD since 2014. Nevertheless, it is the author opinion that the implementation of Council Directives targeting specifically hybrid mismatches both inside and outside the EU (ATAD I and II) will create an overlapping rule with respect to the *defensive rule* included within the PSD, which unless modified, will become useless.

3.5.2.2. EU Primary Law: Fundamental Freedoms

The EU was created with the purpose of economically binding European countries in order to avoid future wars.[1452] This economic integration supposes also the accomplishment with some minimum standards of protection, i.e. fundamental freedoms that includes the free movements of

[1450] EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II).

[1451] Article 4(1) of the PSD provides that: "Where a parent company or its permanent establishment, by virtue of the association of the parent company with its subsidiary, receives distributed profits […]". Article 4(1) of the Council Directive 2011/96/EU as amended by Council Directive 2014/86/EU of 8 July 2014.

[1452] R. Mason, *A Theory of Tax Discrimination*, NYU Jean Monnet Working Paper No. 09/06 (2006), p. 2.

goods, person, services and capital, which are rigorously enforced before the CJEU.[1453] In other words, and unlike direct taxation remains as a matter of MS's sovereignty within the EU, this competence must be exercised in accordance with the fundamental freedoms.[1454] Therefore, every national tax measure must be reviewed by the CJEU under an infringement procedure or a preliminary ruling. [1455]

In order to determine whether a national rule creates or not tax discrimination,[1456] the CJEU carries out an analysis involving different phases. In first place, the CJEU determines which of the fundamental freedoms is indeed potentially infringed. Once this has been done, it proceeds to make comparability analysis, by which it compares the situation

1453 Id.

1454 The lack of harmonization in direct taxes is due to the unanimity requirement, which requires all MS to agree. The above is, nonetheless, a very difficult aim to achieve. Terra and Wattel, *supra* n. 355, pp. 16-17. There are, however, two possible exceptions to the unanimity requirement in tax matters. The first one is Articles 107 and 108(3) last sentence [State Aid rules] of the TFEU, which forfid granting any aid to undertakings without prior Commission approval. The second one is Article 116 TFEU, concerning market distortions caused by disparities between national laws or practices, allowing a qualified majority for the adoption of directives counteracting those matters. Id. *See also*, e.g A. J. Easson, *Taxation in the European Community*, European Community Law Series: 5, The Athlone Press, London, 1993, pp. 15-16.

1455 EU: Consolidated Version of the Treaty on the Functioning of the European Union (TFEU) of 26 Oct. 2012, OJ C 326/47 (2012). See Art. 258 and 267 TFEU. *See also*, e.g. EU: Judgment in *Wielockx v Inspecteur der Directe Belastingen*, C-80/94, EU:C:1995:271 and Judgment in *Royal Bank of Scotland plc v Elliniko Dimosio (Greek State),* C-311/97, EU:C:1999:216.

1456 Mason and Knoll argue that: " […] in common markets, like the EU and the United States, the best interpretation of the nondiscrimination principle is that it requires what we call "competitive neutrality", which prevents states from putting residents at a tax-induced competitive advantage or disadvantage relative to nonresidents in securing jobs". R. Mason and M. Knoll, *What is Discrimination?,* 121 Yale L.J. 1014 (2012), p. 1014.

of the complaining taxpayer (normally a non-resident with economic connection with the host country) with a comparable domestic situation in order to determine whether or not these two comparable situations are treated equally.[1457] If the result of this second phase is that the national rule is discriminatory, there must be still justifications for the discrimination.[1458] The analysis between *linking rules* and EU primary law[1459], therefore, will be made considering this line of analysis. It will also distinguish between *primary response* and *defensive rule*, and it will finally include a separate Section with the analysis regarding proportionality.[1460]

[1457] Mason, *supra* n. 1452, p. 3.

[1458] *See* J. Di Maria, *Comparability in the case of Hybrid Mismatch: In Search of an Approach Suitable for the Current European Landscape*, in: K. Dziurdz and C. Marchgraber (Eds.), *Non-Discrimination in European and Tax Treaty Law*, Linde, Vienna, 2015, p. 70. For purposes of this work, it is interesting to question specifically whether or not the "fight against tax abuse" or the DNT outcome itself (i.e. the D/NI outcome) might be used as a justification grounds to allow a different treatment between domestic and cross-border situations.

[1459] Some scholars have already expressed their concerns with respect to the compatibility of *linking rules* and EU primary law. *See*, e.g. Rust, *supra* n. 1422; Marchgraber, *supra* n. 851. *See also*, J. Bundgaard, *Hybrid Financial Instruments and Primary EU law–Part 1,* 53 Eur. Taxn. 11 (2013), Journals IBFD; J. Bundgaard, *Hybrid Financial Instruments and Primary EU law–Part 2,* 53 Eur. Taxn. 12 (2013), Journals IBFD; C. Kahlenberg, *Extension of the Domestic Correspondence Principle*, 54 Eur. Taxn. 1 (2014), Journals IBFD; O. Thömmes and A. Linn, *The New German DCL and Dividends Matching Rules and EU Law*, 42 Intertax 1 (2014); J. Becker and T. Loose, *Zur geplanten Ausdehnung des materiellen Korrespondenzprinzips auf hybride Finanzierungen*, 21 Internationales Steuerrecht 19 (2012); O. Dörfler, R. Heurung and G. Adrian, *Korrespondenzprinzip bei verdeckter Gewinnausschüttung und verdeckter Einlage*, 45 Deutsches Steuerrecht 12 (2007).

[1460] The analysis of proportionality is important, because even though a national provision is considered discriminatory, but justified, it should be tested whether it is proportionate.

3.5.2.2.1. Primary Response

3.5.2.2.1.1. Analysis of Comparability

As regards to the *primary response* and whether or not this rule would infringe the non-discrimination principle under the TFEU, it should be noted that the jurisprudence of the CJEU is unfortunately neither consistent not uniform to provide an unequivocal answer.[1461]

If we consider as a starting point the decision in *Schempp* (Case C-403/03), we could rapidly conclude that rules addressing disparities or inconsistencies between MS would not infringe the non-discrimination principle under the TFEU, because of the lack of comparability between domestic and cross-border situations in those cases.[1462] In *Schempp* the

[1461] *See*, e.g. N. Bammens, *The Principle of Non-Discrimination in International and European Tax Law*, IBFD Doctoral Series, Vol. 24, IBFD, Amsterdam, 2012, p. 521.

[1462] The case basically referred to a German taxpayer who intended to deduct some maintenance payments paid to his former spouse, an Austrian resident, within the period 1994 and 1997. The German tax authority [Finan*zamt München*] required a certification from the Austrian tax authority demonstrating that the maintenance payments were actually taxable in the hand of his former spouse in Austria. However, considering that these payments are generally excluded from taxation under Austrian law and that this law does not allow the payments to be deducted, such certification was not provided. The German taxpayer was therefore prevented from deducting the maintenance payments in Germany. *See* EU: Judgment in *Egon Schempp v. Finanzamt München V* (C-403/03) [2005] ECLI:EU:C:2005:446, hereinafter "*Schempp* case", para. 7-9. Determining comparable situations is indeed the cornerstone in the CJEU's discrimination analysis. This task, however, is very challenging and there is little guidance on how to choose a comparable. *See* Mason, *supra* n. 1452, p. 22. Likewise, a worse treatment for cross-border situations will be discriminatory only when the cross-border situation is similar to a pure domestic situation, such that there is no justification for treating those situations in a different manner. Id. *See also*, EU: Judgment in *Finanzamt Köln-Altsadt v Schumacker*, C-279/93, ECLI:EU:C:1995:31. For an analysis

CJEU linked the deductibility of maintenance payments at the level of the obligor with the payment of taxes at the level of the beneficiary. Therefore, the fact that a deduction was denied because there was not a respective inclusion of income in the other country was indeed regarded as acceptable.[1463] As provided by the CJEU: "It follows that, contrary to Mr. Schempp's claims, the payment of maintenance to a recipient resident in Germany cannot be compared to the payment of maintenance to a recipient resident in Austria. The recipient is subject in each of those two cases, as regards taxation of the maintenance payments, to a different tax system. Consequently, the fact that a taxpayer resident in Germany is not able […] to deduct maintenance paid to his former spouse resident in Austria does not constitute discrimination within the meaning of Article 12 EC".[1464] Nevertheless, a complete different approach was assumed in *Eurowings* (Case C-294/97).[1465] In this decision, the CJEU concluded hat the deductibility of leasing payments for purposes of the German trade tax should not be denied based on the contingency that these payments are subject to trade tax at the level of the recipient, considering that the tax advantage, i.e. the deductibility, and the disadvantage, i.e. the taxation of

on *Schumacker*, see F. A. Garcia Prats, *Revisiting "Schumacker":Source, Residence and Citizenship in the ECJ Case Law on Direct Taxation*, in: I. Richelle, W. Schön and E. Traversa (Eds.), *Allocating Taxing Powers within the European Union*, Springer, Heidelberg, 2013, pp. 1-42.

1463 Marchgraber, *supra* n. 851, p. 139. *See also*, Rust, *supra* n. 1422, p. 317.

1464 EU: *Schempp* case*, supra* n. 1462, para. 35. Article 12 EC corresponds to Article 18 TFEU today.

1465 EU: Judgment in *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna*, C-294/97, EU:C:1999:524, hereinafter "*Eurowings* case".

these payments, concern two different taxpayers.[1466] As stated by the Court: "[…] a merely indirect link between a fiscal advantage accorded to a taxable person, such as the absence in the case of German undertakings leasing from lessors established in Germany of the obligation to make the add-backs in question, an unfavorable tax treatment of another taxable person, such as the liability of such lessors to pay trade tax, cannot be used to justify the fact that German undertakings are treated differently […]".[1467]

As regards to the comparability analysis and the case law of the CJEU, two different approaches can be distinguished.[1468] On one hand, the CJEU applies an "overall approach", i.e. an analysis considering the overall position of the taxpayer or a group of taxpayers, taking into account the deviating tax advantages in another MS.[1469] The above can be seen, e.g. in

1466 Rust, *supra* n. 1422, p. 317.

1467 EU: *Eurowings* case, *supra* n. 1465, para 42.

1468 Therefore, depending on which CJEU's approach is finally adopted; a *primary response* could be (or not) regarded as discriminatory. In addition, however, Mason proposes a third alternative approach, which has never been applied by the CJEU so far: *"the internal consistency test".* As stated by Mason: "Under this approach, developed by the U.S. Supreme Court to analyze state tax discrimination claims under the Dormant Commerce Clause, the ECJ would ask: If all twenty-seven member states enacted the challenged rule, would intra-Community commerce bear a burden that purely domestic commerce would not also bear?". R. Mason, *Made in America for European Tax: The Internal Consistency Test*, 49 Boston College Law Rev. 4 (2008), p. 1277. According to the author: " […] the internal consistency test would help prevent two kinds of judicial errors in tax discrimination cases. One type of error occurs when the ECJ fails to recognize that cross-border disadvantages arise from disparities, not discrimination; another type occurs when the ECJ fails to discover discrimination because compensatory taxes in one state obscure the cross-border tax disadvantage caused by another state's discrimination". Id., p. 1325.

1469 In a critical view on the overall approach, Weber states: "The assumption, which the ECJ accepts, that it is only the Member States have the power to define the criteria for

Shempp,[1470] where the Court considered that there could not be a comparable situation and that the discrimination was the result of a disparity between MS, considering also the deviating tax consequences in the other MS to conclude that a deduction could be denied because there was not a respective inclusion of income in the other MS.[1471] Nevertheless, it is very arguable that the Court had achieved such a conclusion (i.e. lack of comparability) on the basis of differences between tax systems, because disparities are indeed a consequence of the coexistence of discrete national

direct taxation means, in my opinion, under Community law, prohibited restrictions of the freedom of movement arise only as the result of the legislation of a single Member State and not the legislation of another Member State. Thus, restrictions do not depend on disparities between Member States […]". D. Weber, *In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC*, 34 Intertax 12 (2006), p. 599. *See also*, Di Maria, *supra* n. 1458, p. 76.

1470 This approach has also been applied in other several decisions of the CJEU, starting from the landmark case of *Schumacker* case, *supra* n. 1462. *See also,* e.g. *Wielockx* case, *supra* n. 1455; EU: Judgment in *P.H. Asscher v Staatsecretaris van Financiën*, C-107/94,EU:C:1996:251; EU: Judgment in *F.W.L. de Groot v Staatsecretaris van Financiën*, C-385/00, EU:C:2002:750; EU: Judgment in *Arnoud Gerritse v Finanzamt Neukölln-Nord*, C-234/01, EU:C:2003:340; EU: Judgment in *Friederike Wallentin-Hermann v Alitalia*, C-169/03, EU:C:2004:771; EU: Judgment in *Pirkko Marjatta Turpeinen*, C-520/04, EU:C:2006:703; EU: Judgment in *Bosal Holding BV v Staatsecretaris van Financiën*, C-168/01, EU:C:2003:479; EU: Judgment in *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)*, C-446/03, ECLI:EU:C:2005:763; EU: Judgment in *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*, C-524/04, EU:C:2007:161 and EU: Judgment in *Columbus Container Services BVBA & Co. v Finanzamt Bielefeld-Innenstadt*, C-298/05, EU:C:2007:754. *See also*, e.g. opinions of the Advocate General Geelhoed in EU: *Judgment in Test in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*, C-374/04, EU:C:2006:139, point 39; in EU: Judgment in *Denkavit International and Denkavit France*, C-170/05, EU:C:2006:266, points 33-40; in *Thin Cap Group* case, Id.; in EU: Judgment in *Maragarete Block v Finanzamt Kaufbeuren*, C-67/08, EU:C:2008:92, para. 31. As noted by Weber: "It has become clear that Advocate General Geelhoed does not agree with the per-country approach […] and (thus) is a proponent of the overall approach". Weber, *supra* n. 1469, p. 600.

1471 EU: *Schempp* case, *supra* n. 1462.

tax systems[1472] and they are not equivalent to prohibited discrimination under EU law.[1473] In this regard, it is always worth to remember that, within the current EU framework, MSs remain free to design their own tax policies and the failure to recognize tax discrimination undermines the economic integration of Europe.[1474] On the other hand, the CJEU has opted for a "per-country approach", i.e. determining the existence of a discriminatory provision as per the specific jurisdiction under analysis, without considering the offsetting tax advantages that might be independently available for the taxpayer in another MS.[1475] In *Eurowings,* e.g. the CJEU analyzed the disadvantage created in isolation, i.e. disregarding the tax burden of the lessor in another MS, and concluding that the leasing payments for purposes of the German trade tax should not be denied based on the contingency that these payments are subject to trade tax at the level of the recipient.[1476] This

1472 S. Douma, *The Three Ds of Direct Tax Jurisdiction: Disparity, Discrimination and Double Taxation,* 46 Eur. Taxn. 11 (2006), Journals IBFD, pp. 522-533.

1473 As well provided by Mason: "Only discriminatory tax law, not disparate ones, violate the EC Treaty". *See* Mason, *supra* n. 1452, p. 4. In the same order of ideas, Weber argues: " […] disparities do not result in restriction of the freedom of movement because that would mean that the sovereignty to levy tax would be endangered […] *inherent* to tax sovereignty to levy taxes is that exercise of this sovereignty does not depend on how another Member State taxes". *See also*, Weber, *supra* n. 1469, p. 602.

1474 Mason, *supra* n. 1452, p. 1.

1475 Di Maria, *supra* n. 1458, p. 72.

1476 *Eurowings* case, *supra* n. 1465. Other decisions in which the CJEU has applied the "per-country approach" are, e.g. *Cadbury Schweppes* case, *supra* n. 112; EU: Judgment in *Société de Gestion Industrielle (SGI) v Belgian State*, C-311/08, ECLI:EU:C:2010:26, hereinafter "SGI case"; EU: Judgment in *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt,* C-324/00, ECLI:EU:C:2002:749; EU: Judgment in *X and Y v Riksskatteverket*, C-436/00, EU:C:2002:704; EU: Judgment in *Deutsche Shell GmbH v Finanzamt für Dortmund-Unna*, C-294/97, EU:C:1999:524; EU: Judgment in *Finanzamt Offenbach am Main-Land v Keller Holding GmbH*, C-471/04, EU:C:2006:143; EU: Judgment in *Rewe Zentralfinanz eG v Finanzamt Köln-Mitte*, C-347/04, EU:C:2007:194, among others.

approach seems, in principle, to be more consistent with the current EU framework where MSs have exclusive competence on matters related to direct taxation and where harmonization is still not achieved.[1477] In other words, considering the sovereignty of MSs on direct tax matters, MSs' tax systems should not be affected by other MSs' tax systems.[1478] In the same order of ideas, a MS should not be obliged to adapt their own tax system to the different systems of tax of the other MS.[1479]

Finally, it is important to remark that HMA create prohibited discrimination because of their very nature, and as such the CJEU should not refrain from characterizing *linking rules* as discriminatory, regardless the good intentions behind their proposal. [1480] Nevertheless, and considering the EU framework

[1477] Weber, *supra* n. 1469, pp. 601-607. Here the author explains his arguments to support the "per-country approach" over the "overall approach". In the same order of ideas, Lang states: "The ECJ should be consistent in taking into account the legal situation in *one Member State only* when deciding whether a Member State has not complied with the freedoms ('per-country approach'). An 'overall approach' makes it difficult to determine responsibility for infringements of the freedoms". M. Lang, *Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions*, EC Tax Rev. 3 (2009), p. 113. *See also*, Di Maria, *supra* n. 1458, pp. 81-86.

[1478] Mason, *supra* n. 1452, p. 59. Likewise, Weber states: " […] it is inherent to the sovereignty to tax that MS may limit their tax jurisdiction (in other words, not levy tax) and that taxation in one MS is not linked to taxation in another MS". Weber, *supra* n. 1469, p. 593.

[1479] Id.

[1480] Beyond technicalities, HMA derived from the use of hybrid and reverse hybrid entities may only appear in cross-border situations. Therefore, a rule denying a deduction because income is not recognized in the other country due to the differences in characterizing the same entity will always involve an "indirect" or "hidden" discrimination, regardless the neutral manner in which these rules are drafted. In this opinion: Rust, *supra* n. 1422, p. 313 and 320. In an analysis exclusively within the EU context, and before the issuance of the BEPS Action Plan in 2013, Fibbe also recognizes that conflicts derived from the different classification of an entity are exclusively referred to entities involved in cross- border activities. As provided by Fibbe:

and the uncoordinated existence of direct taxation, it is important that the determination on whether particular rules violate the TFEU is made without regard to any offsetting tax advantage in another MS, but rather independently.[1481] The above might not only grant more consistency to the comparability test, but also more clarity to the jurisprudence of the CJEU on these matters.[1482]

3.5.2.2.1.2. Justification Grounds for Discrimination

Assuming that a domestic *primary response* is regarded as discriminatory, there are still grounds for justification to such discrimination.[1483] In this regard, the question is which type of justification must be used in order to allow a discriminatory rule. As this task has been already assumed somewhere else,[1484] this author will focus only on whether the "cohesion of tax systems", "the fight against tax abuse" or the "DNT outcome itself"

"Classification conflicts due to autonomous classification methods only arise in situations where an entity incorporated under the laws of one state is involved (actively or passively) in cross-border activities and as a consequence is classified for the tax purpose of two or ore MS". *See* Fibbe, *supra* n. 833, p. 176.

[1481] Mason, *supra* n. 1452, p. 59.

[1482] Id.

[1483] Di Maria, *supra* n. 1458.

[1484] Bundgaard provides a deeper analysis in this regard, which covers different justifications grounds, including: (i) loss of revenues, (ii) the level of taxation and prevention of harmful tax competition, (iii) ensuring the effectiveness of fiscal supervision, (iv) coherence of the tax system, (v) balanced allocation of the power to impose taxes, (vi) prevention of double use of losses and (vii) prevention of tax abuse. This author concludes that, at least in respect of these justification grounds, it is highly expected that none of them be successfully used considering the case law of the CJEU. *See* Bundgaard, *Hybrid Financial Instruments and Primary EU law–Part 2, supra* n. 1459, pp. 587-594.

might be regarded as justification grounds for the imposition of discriminatory provisions.

3.5.2.2.1.2.1. The Cohesion of Tax Systems

The decision in *Schempp* is not only important to confirm the lack of comparability, as noted above, but also to reinforce the idea of "cohesion of tax systems" as a justification ground to allow discrimination. The "cohesion of tax systems" is based on the idea that a direct link exists between granting a tax advantage and offsetting that tax advantage by a fiscal levy.[1485] This idea was already argued in *Bachmann* (Case C-204/09)[1486] and *Commission v. Belgium* (Case C-300/09).[1487] In *Bachmann*, which in brief referred to the deductibility of contributions in Germany related to the insurance of individuals and the condition of being subject to tax in Belgium, the CJEU sustained: "The cohesion of such a tax system, the formulation of which is a matter for each Member State, therefore presupposes that, in the event of a State being obliged to allow the deduction of life assurance contributions paid in another Member State, it should be able to tax sums payable by insurers".[1488] Accordingly, in *Commission v. Belgium*, which also referred to the deductibility of contributions being offset by the taxation of payments made by insurers pursuant to their

[1485] Marchgraber, *supra* n. 851, p. 140.
[1486] EU: Judgment in *Hans Martin Bachmann v Belgian State* (C-204/90) [1992], ECLI:EU:C:1992:35, hereinafter "*Bachmann* case"
[1487] EU: Judgment in *Commission of the European Communities* v Kingdom of Belgium (C-300/90) [1992], ECLI:EU:C:1992:37, hereinafter "*Commission v Belgium* case".
[1488] EU: *Bachmann* case, *supra* n. 1486, para. 23

contracts, the Court stated: "The cohesion of such a tax system, the formulation of which is a matter for the Belgian State, presupposes, therefore, that in the event of that State being obliged to allow the deduction of life assurance contributions paid in another Member State, it should be able to tax sums payable by insurers".[1489] In both cases thus the CJEU concluded that a link between the deductibility of those payments and the taxation in the other MS would exist, which would also be needed to keep the cohesion of tax systems.[1490] As provided by the Court: "As regards the need to preserve the cohesion of the tax system at issue, it should be noted that there exists a connection under the Belgian rules between the deductibility of contributions and the liability to tax of sums payable by insurers pursuant to pension or life assurance contracts".[1491]

The "cohesion of tax systems", however, has not always been successfully applied, and when it has been, it did it only when provisions at issue concerned the same taxpayer and the same tax.[1492] Moreover, the "coherence of tax systems" as a justification for discriminatory domestic provisions was expressly restricted in *Eurowings*.[1493] In this case law, the Court argued that: "[…] a difference of treatment cannot be justified on grounds linked to the need for coherency of taxation".[1494] Interestingly also,

1489 Id., para. 16.
1490 Id.
1491 Para. 14
1492 Bundgaard, *Hybrid Financial Instruments and Primary EU law–Part 2, supra* n. 1459, p. 589. *See also*, Marchgraber, *supra* n. 851, p. 140.
1493 EU: *Eurowings* case, *supra* n. 1465.
1494 Id., para. 41.

the Court rejected the idea that "difference of treatment can also not be justified by the fact that the lessor established in another Member State is there subject to lower taxation".[1495] Similarly, the CJEU argued in *Cadbury Schweppes* (Case C-196/04) that any tax advantage given from low taxation to a subsidiary in a MS, different from the MS where the parent company is incorporated, cannot by itself authorize a MS to offset that tax advantage by a less favorable treatment to the parent company, which could happen e.g. when a deduction is denied to the extent the income is not recognized in the other MS.[1496] In simple words, a *primary response* at hand could not be justified on the basis of the coherence of the tax systems within the EU.

3.5.2.2.1.2.2. The Fight Against Tax Abuse

As regards to the "fight against tax abuse" as a justification ground for discrimination, it is highly arguable that a rule denying a deduction in all cases involving hybrid entities or reverse hybrids, where the outcome is a D/NI, is indeed justified. This rule as such would certainly go beyond preventing tax abuse.[1497] Indeed, the boundaries of tax abuse (avoidance) are well settled both in case law and in the EU law doctrine.[1498] With respect to

[1495] Id., para 43. *See also*, de Boer and Marres, *supra* n. 1253, p. 33.

[1496] As provided by the Court in *Cadbury Schweppes*: "In that respect, it is settled case-law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorize that Member State to offset that advantage by less favorable tax treatment of the parent company". *Cadbury Schweppes*, *supra* n. 112, para. 49. *See also*, de Boer and Marres, *supra* n. 1253, p. 34.

[1497] Rust, *supra* n. 1422, p. 313.

[1498] *Supra* Chapter I, Section 4.2.3.

the former, the CJEU has stated in *Cadbury Schweppes*: "[…] in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality […]".[1499] The CJEU has already stated that a subjective and objective test that would determine the existence of a wholly artificial arrangement. While the subjective test would require the intention of the taxpayer to obtain a tax advantage, the objective one is determined by the physical existence of an entity in term of premises, staff and equipment.[1500] As provided by the Court: "If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular the case of a 'letterbox' or 'front' subsidiary […]".[1501] Therefore, provisions as the *primary response*, which contain requirements as regards to the level of taxation in the other country, would be beyond the understanding of tax abuse within the EU, unless they refer exclusively to wholly artificial arrangements. In other words, and as well settled by the case law of the CJEU, restrictive national provisions that are applicable to every situation

[1499] *Cadbury Schweppes* case, *supra* n. 112, para. 55.
[1500] Id., para. 67.
[1501] EU: *Cadbury Schweppes* case, *supra* n. 112, para. 68.

and for whatever reason are too general to combat abuse.[1502] Likewise, the CJEU, although with respect to a VAT case, has settled that "tax arbitrage", i.e. using different VAT rules in two MS, is not equivalent to tax abuse.[1503]

3.5.2.2.1.2.3. The DNT Outcome

Finally, with respect to the use of DNT (i.e. a D/NI outcome) as a justification ground for discrimination, the jurisprudence of the CJEU is also very ambiguous.[1504] For example, since the landmark decision in *Mark & Spencer* (Case C-446/03), it seems to be accepted that the risk of double

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[1502] D. Weber, *Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ–Part 2*, 53 Eur. Taxn. 7 (2013), Journals IBFD, p. 313. *See also*, e.g. EU: Judgment in *Hughes de Lasteyrie du Saillant v Ministère de l'Economie des Fianances et de l'Industrie,* C-9/02, ECLI:EU:C:2004:138; Judgment in *Commission of the European Communities v* Hellenic Republic, C-178/05, ECLI:EU:C:2007:317; EU: *Lankhorst-Hohorst* case, *supra* n. 1476; Judgment in *Jobra Vermögensverwaltungs-Gesellschaft mbH v Finanzamt Amstetten Melk Scheibbs*, C-330/07, ECLI:EU:C:2008:685.

[1503] EU: Judgment in *HMRC v. RBS Deutschland Holding GmbH*, C-277/09, ECLI:EU:2010:810. As provided by Bundgaard as well: "In light of the Commission's conclusion that new coordinated solutions need to be developed, tax arbitrage does not seem (in view of the EU Commission) to be considered abuse de lege lata". Bundgaard, *Hybrid Financial Instruments and Primary EU law–Part 2, supra* n. 1459, p. 593. *See also*, Rust, *supra* n. 1422, p. 313.

[1504] In this opinion: Marchgraber, *supra* n. 851, p. 141. De Broe also recognizes that whether or not an arrangement leading to DNT abuses EU law remains unanswered. *See* L. De Broe, *Some observations on the 2007 communication from the Commission: 'The application of anti-abuse measures in the area of direct taxation within the EU and in relation to third countries'*, 17 EC Tax Rev. 3 (2008), pp. 142 et seq. Nonetheless, De Broe also analyzes the issue of compensatory taxation and prevention of DNT, concluding that tax jurisdiction shopping is only illegitimate, and thus a compensatory taxation permitted, if a taxpayer has set up a wholly artificial arrangement with the purpose of avoiding taxation. For this purpose, De Broe gives as example *Lasteyrie* (Case C-9/02), emphasizing that the CJEU did not suggest in this case that there were abuse when the French resident moved to Belgium and sold his shares to get a tax-free capital gain and then returning to France, but there would be only if that is done in short time frame. *See* De Broe, *supra* n. 229, p. 921; EU: *Lasteyrie* case, *supra* n. 1502.

utilization of losses can be a justification for a different treatment between the domestic and cross-border situations.[1505]As stated by the Court: "As regards the second justification, relating to the danger that losses would be used twice, it must be accepted that Member States must be able to prevent that from occurring".[1506] Nevertheless, in *Philips Electronics* (Case C-18/11) the CJEU expressed doubts with respect to the double utilization of losses as an independent justification ground.[1507] This is confirmed in words of the Court, when it says: "As regards, secondly, the objective of preventing the double use of losses, it must be observed that even if such a ground, considered independently, could be relied on, it cannot in any event be relied on in circumstances such as those in the main proceedings to justify the national legislation of the host Member State".[1508] In the same order of ideas, *Philips Electronics* could serve the purpose of confirming, in case of hybrid entity or reverse hybrids transactions, that rules denying a deduction in one country unless there is a respective inclusion of income in the other country would not be justified.[1509]

[1505] EU: *Mark & Spencer* case, *supra* n. 1470. The comparability between double utilization of losses and other situations of double non-taxation is, nevertheless, arguable. *See,* e.g. M. Lang, *Direct Taxation: Is the ECJ Heading in New Direction?*, 46 Eur. Taxn. 9 (2006), Journals IBFD, p. 426.

[1506] EU: *Mark & Spencer* case, *supra* n. 1470, para. 47.

[1507] EU: Judgment in *The Commissioners for Her Majesty's Revenue & Customs v. Philips Electronics UK Ltd*, Case C-18/11, ECLI:EU:C:2012:532.

[1508] Id., para. 28.

[1509] "It follows that the host Member State, on whose territory the economic activity giving rise to the losses of the permanent establishment is carried out, cannot, in a situation such as that at issue in the main proceedings, use the objective of preserving the allocation of the power to impose taxes between the Member States as justification for

Likewise, as regards to the use of DNT as a justification ground for discrimination, one should ask whether or not the avoidance of DNT is indeed an obligation under EU law. A good starting point for answering this question could be the opinion of the CJEU with respect to the obligation to prevent double taxation. In this sense, it is worthy to recall what the Court just said in *Kerckhaert and Morres* (Case C-513/04): “Community law […] does not lay down any general criteria for the attribution of areas of competence between Member States in relation to the elimination of double taxation within the Community”.[1510] Accordingly, the Court in *CIBA* (Case C-96/08) stated that: “double taxation […] does not alone constitute a restriction prohibited by the Treaty”.[1511] Therefore, if EU law does not set up any obligation to prevent double taxation, it seems, at first glance at least, inconsistence that to accept the avoidance of DNT as a justification ground for restriction, mostly when both double taxation and double non-taxation are identified as incompatible with the internal market.[1512] Also considering

the fact that, under its national legislation, the possibility of transferring, by means of group relief and to a resident company, losses sustained by the permanent establishment in that Member State of a non-resident company is subject to a condition that those losses cannot be used for the purposes of foreign taxation, while the transfer of losses sustained in that Member State by a resident company is not subject to any equivalent condition”. Id., para. 27. *See also*, Bundgaard, *Hybrid Financial Instruments and Primary EU law–Part 2, supra* n. 1459, p. 590, who provides a similar conclusion with respect to HFI.

1510 EU: Judgment in *Mark Kerckhaert and Bernadette Morres v Belgische Staat,* C-513/04, ECLI:EU:C:2006:713, para. 22.

1511 EU: Judgment in *CIBA Speciality Chemicals Central and Eastern Europe Szolgáltató, Tanácsadó és Keresdedelmi kft v Adó- és Pénzügyi Ellenőrzési Hivatal (APEH) Hatósági Főosztály,* C-96/08, ECLI:EU:C:2010:185, para. 28.

1512 Marchgraber, *supra* n. 851, p. 141. As provided also by the European Commission: “Tax systems must allow cross-border economic activity to develop within the Union. However, at the same time, there is a need to ensure that the increased opportunities for

the above, this author rejects the idea that ensuring single taxation might serve as a justification ground.[1513]

Therefore, neither the cohesion of tax systems within the EU nor the fight against tax abuse, or DNT itself, can be successfully serving the purpose of justifying a discriminatory measure. The spectrum of justification is thus severely reduced and it opens the door for future issues with respect to the application of the *primary response* and *linking rules* in general.

3.5.2.2.2. Defensive Rule

Unlike the case of HFI, the *defensive rule* in case of hybrid entities works in a slightly different manner.[1514] In fact, in case of hybrid entities, i.e. when the MS of the parent company considers the entity as tax transparent for domestic tax purposes while the MS of the place where the subsidiary is established considers the same entity as a taxable entity, there is no

cross-border trade an investment do not lead to an unacceptable loss of tax revenues through tax arbitrage, avoidance or fraud. Just as it is necessary to prevent the double taxation of cross-border income flows, transactions within the Union should not be able to escape tax altogether". EU: European Commission, *Taxation in European Union, Report on the Development of Tax Systems*, COM (96) 546 final, OJ C 296/43, 22 Oct. 1996.

1513 Bundgaard also recognizes this idea when he states: "Member States may initially argue that any anti-arbitrage measure is being put in place simply to ensure single taxation of income and to prevent white income (i.e. non-taxed income). Ensuring single taxation can thus be said to align the cross-border situation to the domestic situation or to a cross-border situation where no tax benefit can be obtained. However, to date, such a justification has not been seen in the case law […]". J. Bundgaard, *supra* n. 1459, p. 587. For the analysis of the *"single tax principle"* and the origin of the idea of ensuring single taxation within cross-border transactions, see *supra* Chapter I, Section 3.

1514 The *defensive rule* is not part of the OECD BEPS proposal in the case of payment received by reverse hybrid entities.

discussion with respect to the application or not of the exemption method in the MS of the parent entity with respect to the payment received from the MS of the payee,[1515] but rather the issue is with respect to the taxation of such payment in the MS of the parent company when, in principle, the whole transaction between the parent company and the other entity should have been disregarded in the MS of the parent company, because of the characterization that this country gives to the entity established in the other MS.[1516]

If one considers that MS have exclusive sovereignty to classify foreign entities for domestic tax purposes, there should not be, in principle, a problem when a MS, as part of its classification rules, provides for some exceptions under which its own classification of the entity will not be taken into account or it will be switch in order to follow the one provided in the MS where the entity is established.[1517] In other words, as the *defensive rule*

[1515] On this matter, Rust states that denying the exemption method in case of the application of the defensive rule is equivalent to the application of the indirect credit method. He considers that the non-application of the exemption ensures that domestic and cross-border investments are treated equally. *See* Rust, *supra* n. 1422, p. 321. Nevertheless, he also recognizes that a defensive rule in case of HFI might be regarded as a hidden discrimination. Id. 320.

[1516] *Supra* Section 2.4.1 provides an example of a payment made by a hybrid entity, which results in D/NI. The non-inclusion, in this case, derives exclusively to the non-recognition of the transaction between the payer and the payee due to the different characterization of the payee entity in both countries.

[1517] The CJEU clearly held in *Columbus Container Services* that MS are autonomous in classifying foreign entities for domestic tax purposes. As stated by the Court: " it must be recalled that the fiscal autonomy referred to in paragraphs 44 and 51 of this judgment also means that the Member States are at liberty to determine the conditions and the level of taxation for different types of establishments chosen by national companies or partnerships operating abroad, on condition that those companies or partnerships are not

has an effect similar to a "switch-over clause" in the sense that, to certain extent, obliges the MS of the parent company to recognize the characterization of the entity in the other MS, taxing a payment, which, in principle, should be disregarded because of its own classification of the entity in the other MS. Indeed, one could conclude that such an exception, i.e. the taxation of the payment, and thus, the recognition of a tax transparent entity as taxable under certain circumstances, is part of the sovereignty of the MS of the parent company to determine who is a taxpayer.[1518]

Nevertheless, the design of the *defensive rule*, as proposed, is rather different. On one hand, it does not refer to the characterization of the entity at all.[1519] On the contrary, the contingency relates exclusively to the fact that the payment was or not deducted in the payee MS. Therefore, this author maintains his conclusions with respect to the *primary response*, namely, the tax disadvantage in this case (i.e. the taxation of a payment in the MS of the parent company) should be analyzed in isolation and not considering the overall effects in the other MS.[1520] If analyzed in isolation, there are indeed

treated in a manner that is discriminatory in comparison with comparable national establishments". EU: Judgment in *Columbus Container Services BVBA & Co. v Finanzamt Bielefeld-Innenstadt,* C-298/05, ECLI:EU:C:2007:754, para. 53. For an analysis on *Columbus Container Services, see* Fibbe, *supra* n. 833, pp. 167-177. Likewise, as provided by Weber: "In my view, each Member State has the freedom to classify whichever taxpayer in whatever way, on the basis of its own tax rules. If this were not the case, the Member State's sovereignty would be at risk". Weber, *supra* n. 1469, p. 593.

[1518] *Supra* Section 3.2.

[1519] Id.

[1520] *Eurowings* case, *supra* n. 1465.

more probabilities of finding discriminatory features than applying an overall approach.

As regards to the justification grounds for discrimination, I refer to the analysis already made with respect to the *primary response*.

3.5.2.2.3. *Primary Response/ Defensive rule* and the Proportionality Test

The final step that the CJEU conducts in order to determine the compatibility of a domestic provision with EU law is a test of proportionality. Under the proportionality test, the CJEU carries out an analysis on whether the domestic legislation that applies is broader than its aim and whether its means and ends correspond.[1521] As per the design of the *linking rules*, it is highly expected that they raise EU law issues, especially considering their automatic application[1522] and the fact that they disregard which jurisdiction has the right to tax. [1523]

[1521] Bundgaard, *Hybrid Financial Instruments and Primary EU law–Part 2, supra* n. 1459, p. 593. Bundgaard, however, does not carry out the analysis on proportionality, because he considers that none of the justifications grounds potentially used to justify a discriminatory measure would be indeed successful. Therefore, the analysis on proportionality would lack of real interest.

[1522] The OECD states that "[t]he rules apply automatically […]". OECD (2015), *supra* n. 6, p. 11

[1523] The whole premise behind the HMA and the *linking rules* is indeed to tax "somewhere" the income derived from a hybrid mismatch, which does not only deviates from the rest of the BEPS project that attempts to tax income in the jurisdiction where the income is sourced or the activities are conducted, but also to rely on a sort of unproved certainty that income "should be taxed somewhere". The OECD Action Plan clearly states: "Specifically, this Action Plan should provide countries with domestic and international

As already stressed, the proportionality test will depend on the justifications under which the *linking rules* are implemented domestically. In this regard, and if the justification of the rules is, e.g. the balanced allocation of taxing rights, it is clear from the CJEU case law that the rules, as proposed, would not pass the proportionality test. For example, in *National Grid Indus* (Case C-371/10) the Court stated: "The Member State concerned is exercising its power of taxation solely in relation to the capital gains generated in *its territory* […]".[1524] Accordingly, it said: "Such a measure [tax on capital gains] is intended to prevent situations capable of jeopardizing the right of the Member State of origin to exercise its powers of taxation in relation to activities carried on in its territory, and may therefore be justified on grounds connected with the preservation of the allocation of powers of taxation between the Member States".[1525] Furthermore, the Court argued: "[…] a Member State is entitled to tax the economic value generated by an unrealized capital gain *in its territory* […] (emphasis added)".[1526] "It is proportionate for that Member State, for the purpose of safeguarding the

instruments that will better align rights to tax with economic activity". See OECD (2013), *supra* n. 2, p. 11. For a critical analysis of the idea that income should be taxed somewhere, see *supra* Chapter I, Section 3, referred to the discussion on the "single tax principle". In a similar opinion with respect to the issues of proportionality with respect to *linking rules*, *see* P. Benéitez Régil, *BEPS Actions 2, 3 and 4 and the Fundamental Freedoms: Is There a Way Out?*, 56 Eur. Taxn. 6 (2016), Journals IBFD, pp. 242-243. She advocates for the inclusion of a "valid economic reasons" test within the BEPS measures under analysis, regardless of EU considerations and considering that taxation should aim for neutrality. Id., p. 245.

[1524] EU: Judgment in *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, C-371/10, ECLI:EU:C:2011:785, para. 43.

[1525] Id., para. 46.

[1526] Id., para. 49.

exercise of its powers of taxation, to determine the tax due on the unrealized capital gains that have arisen *in its territory* […] (emphasis added)".[1527] Similarly, in *SGI* (Case C-311/08), the Court stated: "First, as regards the balanced allocation between Member States of the power to tax, it should be recalled that such a justification may be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardizing the right of a Member State to exercise its tax jurisdiction in relation to activities carried out in *its territory* (emphasis added)".[1528] Accordingly, it provided: "[…] national legislation which is not specifically designed to exclude from the tax advantage it confers such purely artificial arrangements – devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out *on national territory* […] (emphasis added)".[1529] In the same order of ideas, the CJEU in *N* (Case C-470/04) recognized that the exist taxation regime in the Netherlands can be justified by reason of a balanced allocation of the power to tax between MS, but in order to be proportionate, such system should consider the decrease in value of the assets after the transfer of the residence.[1530] It is arguable thus that *linking rules*, i.e. rules attempting to

[1527] Id., para. 52.
[1528] EU: *SGI* case, *supra* n. 1476, para. 60.
[1529] Id., para. 66.
[1530] The case referred to the transfer of residence from the Netherlands to another MS and the respective application of exit taxation. In this case, the amount of exit tax was calculated without considering the decreased in value occurring after the transfer of the residence. Marchgraber, *supra* n. 851, p. 141. The Court held that such a regime could be justified by reason of a balanced allocation of taxing powers between MS. However, in order for it to be considered as proportional, such system should take into considerations this reduction in value of the assets after the transfer, unless such

ensure taxation "somewhere" might be suitable to accomplish the role of balancing the allocation of taxing rights. In fact, those rules do not distinguish between income generated from activities performed in a specific jurisdiction or somewhere. As such, they could rarely be considered proportional.

Similar concerns are raised if other justification grounds are accepted. For instance, if the fight against tax abuse were the justification ground, it is clear that the application of *linking rules* beyond what is properly considered tax abuse and would be disproportionate.[1531] Indeed, the rules do not include any element of "abuse" that should be tested.[1532] On the contrary, and as already stressed in this work, they apply to counteract any D/NI outcome derived from the use of hybrid and reverse hybrid entities no matter what.[1533] The above conclusion does not change with the restriction on '*control groups'* and '*structured arrangements'*, which, as analyzed already, are either an extension of classic concepts of control or are indeed extremely vague that it is almost impossible to determine its proper extension, as it

reduction has already been taken into account in the host country. EU: Judgement in *N v. Inspecteur van de Belastingdienst Oost/kantoor Almelo*, C-470/04, ECLI:EU:C:2006:525, para. 54. *See also*, H. van den Broek and G.T.K. Meussen, *Netherlands- National Grid Indus Case: Re-Thinking Exit Taxation,* 52 Eur. Taxn. 4 (2012), Journals IBFD, sec. 5.5., referred to proportionality and the *N* case.

1531 *Cadbury Schweppes* case, *supra* n. 112. *See also*, Rust, *supra* n. 1422, p. 313.

1532 Following Dourado, HMA in absence of artificiality will amount to aggressive tax planning, but not to avoidance of abuse. Dourado, *supra* n. 179, p. 48.

1533 The author has already expressed his concern that the limitation of the HMA concept to cases of D/NI exclusively, and the respective automatic application of the countermeasures, creates a presumption of abuse. *Supra* Section 2.3.2.

happens with the case of structured arrangements.[1534] Moreover, if tax avoidance or abuse is accepted and applied as a justification ground, the design of *linking rules* suggests that there is no opportunity for the taxpayer to prove otherwise.[1535] The above would contradict the case law of the CJEU, where it has consistently held that for anti-avoidance legislation to be considered proportional, it is necessary that the taxpayer can prove, without administrative concerns, that the arrangement is commercially or economically justified.[1536] The rules apply automatically. Using DNT itself as a justification ground could, on the other hand, might change the analysis. After all, HMA do not cover all cases of DNT, but rather specific cases of DNT derived from the used of hybrid entities or HFI, which suppose the deductibility of a payment in one country and the non-inclusion of the respective income in the other country.[1537] However, it is hard to believe that without any obligation to prevent DNT at the EU law level, DNT be even accepted as a justification ground.[1538]

[1534] *Supra* Section 3.3.1 and Section 3.3.2.

[1535] Benéteiz Régil, *supra* n. 1523, p. 243.

[1536] "National legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons, is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance where, first, on each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions, *the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction* (emphasis added)". *See SGI* case, *supra* n. 1476, para. 71.

[1537] *Supra* Section 2.

[1538] *See* references at *supra* n. 1504

All in all, it seems that *linking rules* will suffer serious difficulties when passing the proportionality test, at least in the form they have so far, because as such, they certainly conflict with most of the case law of the CJEU.

4. Interaction between *Linking Rules* and other domestic anti-avoidance and anti-base erosion provisions

This last Section analyzes the interaction between the recommendation of the OECD Action Plan 2 (*linking rules*) and the application of domestic interest limitation rules and CFC rules that might affect transaction involving hybrid and reverse hybrid entities. The analysis demonstrates, on one hand, that in both cases the application of interest limitation rules, in the case of payments made by a hybrid entity, and CFC rules, in the case of payments received by a reverse hybrid, might be highly efficient to mitigate cases of hybrid mismatches without the need of applying *linking rules*. On the other hand, it stresses that, for sake of simplification, domestic interest limitation rules and CFC rules should be applied with priority over *linking rules*.

4.1. *Linking rules* and Domestic Interest Limitation Rules

Many countries around the globe include within their domestic legislations rules limiting the deductibility of interest expenses involving cross-border

financial structures.[1539] The design of these rules is, generally speaking, made either by way of establishing a fixed debt-equity ratio, i.e. thin capitalization rules, or by way of limiting the excess of interest expenses to a certain percentage of EBITDA, i.e. "earning stripping rules", being these latter rules the most widely applied during these days. Indeed, many countries opt today for a limitation in the deduction of net interest expenses up to 30% of the amount of EBITDA to the extent that the net interest expenses do not exceed a certain threshold, in some cases, and only if the entity in excess of indebtedness is part of a tax group, in other cases.[1540] The application of the interest limitation rule implies thus that certain amount of interest expenses, normally deductible within a taxable year, will not be deductible in this case, although under certain circumstances might be carried forward.[1541] As such, therefore, it is possible to imagine many situations in which a hybrid entity taxpayer paying interest abroad will be subject to both a domestic interest limitation rule and a domestic linking rule, i.e. *primary response*, limiting the deductibility of the same amount interest. The question is therefore which rule should be applied first.

[1539] These rules are also part of the BEPS proposal, included specifically in Action 4, *supra* n. 1378.

[1540] *See,* e.g. the case of Germany and references at *supra* n. 1379. A mirror rule has been also recently introduced as secondary EU law. EU: Council Directive Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD), Article 4.

[1541] As noted already, however, even though an unlimited carry-forward is offered under the laws of certain countries, its practical application is limited in certain cases. In Germany, e.g. the above happens in case of the discontinuance of the business or change of control. DE: Sec. 4(h)(5)(1) of the Income Tax Act [*Einkommensteuergesetz*– EStG]. *See also*, Knöller, *supra* n. 1381.

The OECD Action Plan 2 provides that in case of application of an interest limitation rule and hybrid mismatch rule, the former has priority, because "the hybrid mismatch rule make adjustments in respect of particular items that are taken into account for the purposes of calculating taxpayer's overall income or expenses and therefore, as a matter of logic, would generally apply before any such general or overall limitation".[1542] In the same order of ideas, the OECD states: "Rules to address hybrid mismatch arrangements should be applied by an entity before the fixed ratio rule and group ratio rule to determine an entity's total net interest expense. Once this total net interest expense figure has been determined, the fixed ratio rule and group ratio rule should be applied to establish whether the full amount may be deducted, or to what extent net interest expenses should be disallowed".[1543]

The position of the OECD is, nevertheless, arguable. On one hand, both rules, i.e. interest limitation rules and hybrid mismatch rules, are used to calculate the taxpayer's overall income and expenses. Indeed both rules will have the same effect of increasing the taxable base of the payer entity in the amount of non-deductible interest in the country of the payer.[1544] As such, therefore, it is not evident that an interest limitation rule accomplishes a role

[1542] OECD (2015), *supra* n. 6, p. 97.
[1543] Id., p. 103.
[1544] *See*, e.g. the EBITDA example at *supra* n. 1380. Now, instead of considering the non-deductibility by an interest limitation rule (400), please consider that the full amount of 1,000 (deductible interest expenses) is disallowed. The effect is exactly as regards the interest limitation rule. In this case, the amount of disallowed interest expenses must be added back to the taxable profits of the payer entity, and therefore, they increase the tax base for that taxable year.

different than helping in determining the taxpayer's overall income and expenses, as suggested by the OECD.[1545] On the other hand, a *primary response* should be applied only to the extent the taxpayer is effectively entitled to deduct interest in the country of the payer. The above, however, could not be affirmed in the case of an entity that is being generally prevented to deduct interest through an interest limitation rule. This latter issue seems to be recognized within the OECD Action Plan 2, which provides: "The hybrid entity rule (Recommendations 3 to 7), however, only operate to the extent a taxpayer is actually entitled to a deduction for a

[1545] For example, it could also be argued that both interest limitation rules and anti-hybrid rules attempting to deny deductible payments, equally contravene the "ability-to-pay" principle. This idea is also argued by Lüdicke, who states with respect to *linking rules* that: "They contravene the ability-to-pay principle and may hit minority shareholders". Lüdicke, *supra* n. 840, p. 317. Although a deeper analysis as regards to *linking rules* and the ability-pay-principle certainly exceeds the purpose of this work (mostly considering the lack of an homogeneous concept), it is perhaps interesting to note that issues concerning the limitation in the deductibility of payments and ability-to-pay principle have even achieved the level of judiciary in some countries, e.g. Germany. In this country, the ability-to-pay principle is expressly recognized within Article 3 of the German Constitution granting the equal treatment to taxpayers in similar circumstances, including corporations through the objectives net principle or *objektives Netto Prinzip,* which means that corporation should consider for their calculation of annual taxes all the income and expenses related to the business. Therefore, a limitation in the deductibility of ordinary expenses, regardless the policy reasons given for their establishment, would be in principle violating the "ability-to-pay" principle. This important debate has been considered in a recent landmark decision of the German Federal Fiscal Court [*Bundesfinanzhof*], which confirmed most of the constitutional concerns stressed already in the past with respect to the German interest limitation rule [*Zinsschranke*]. DE: BFH, 14 Oct. 2015, I R 20/15. The final decision depends of the German Federal Constitutional Court [*Bundesverfassungsgericht*, BVerfG), which is still pending. For an analysis on the arguments of the BFH, *see* e.g. S. Lampert, T. Meickmann and M. Reinert, *Article 4 of the EU Anti Tax Avoidance Directive in Light of the Questionable Constitutionality of the German "Interest Barrier" Rule*, 56 Eur. Taxn. 8 (2016), Journals IBFD, pp. 324-327.

payment under local law. Accordingly these rules will not apply to the extent the taxpayer is subject to transaction or entity specific rules under the parent or payer jurisdiction that prevent the payment from being deducted".[1546] In the author's view, interest limitation rules accomplish this role of preventing that a payment (i.e. interest) is deducted in the country of the payer and should therefore be considered before applying a different rule, whose aim is also different, but whose result is similar, i.e. limitation in the deductibility of certain payments.

By other side, there are also strong practical reasons to support the application of an interest limitation rule before the hybrid mismatch rule, which can be summarized as follows: i) the possibility of "carrying forward" the non-deductible expenses if the interest limitation rules is applied first; ii) the control on the application of the *defensive rule,* which will be applied only on the amount of interest effectively deducted in the payer's country, and, in some cases, iii) the possibility of indirectly solving the issue of a hybrid mismatch without applying complex *linking rules*.[1547] All these reasons can be illustrated in the following hypothetical: let us assume a company, ACo, incorporated in country A, with a subsidiary, BCo, incorporated in country B. ACo grants a loan to BCo and this latter pays interest of 200i back to ACo in year X. Country A considers that BCo is tax

[1546] OECD (2015), *supra* n. 6, p. 97.
[1547] In the same opinion: De Boer and Marres, *supra* n. 1253, pp. 40-41. These authors state that "the introduction of a more generic interest deduction limitation, such as the limitation of excessive interest deduction through thin cap or earning striping rules, or via global allocation of interest expenses by formulary apportionment" could work.

transparent, while country B regards the same entity as a taxable entity. Accordingly, let us also assume that country B has within its domestic laws both an interest limitation rule and a *primary* response. The domestic interest limitation rule in country B, on one hand, provides for a limitation in the deductibility of interest up to 30% of the amount of EBITDA, without threshold amount and applicable both to single entities and entities being part of the same tax group. The *primary response*, on the other hand, provides for a denial in the deductibility of interest in those cases in which deductible interest are paid by an entity considered as taxable in its country of incorporation, while tax transparent in the country of the recipient of the income, and that transaction gives rise to a D/NI outcome. Finally, let us assume the following given amounts for BCo:

Interest Expenses	200i
Interest Income	0i
Net Interest Expenses	200i
EBITDA	400i

Figure 71:Linking rules and Interest Limitation Rules

In the first scenario, i.e. applying the *primary response* first, BCo will be denied to deduct interest expenses in the amount of 200i, because the loan and the respective amount of interest are disregarded in the country of the payee, and thus, not included as income by ACo. Likewise, this amount of

non-deductible interest will not be carried forward to future years. In addition the interest limitation rule will not be applicable after all, because there are no remaining interest on which to apply the interest limitation rule. Indeed, if applied, it would imply a "double non-deduction" affecting the same item of expenses, which is an issue that should be certainly avoided.[1548]

On the contrary, in the second scenario, i.e. assuming that the interest limitation rule applies first, the outcome is certainly different. In such a case, the deductibility of interest is limited first to an amount of 30% of EBITDA. This is on our case the amount of 120i. Likewise, the amount of non-deductible interest is reduced to 80i, which may also be carried forward to further years according to the domestic rules of country B. Therefore the *primary response* will be applied only of the amount of "effectively deductible interest", namely, the amount of 120i. This also means that the *defensive rule* in the country of the payee (country A) will be limited to that amount. In other words, the payee could be obliged to include only 120i of interest as income. Secondly, the amount of 80i of non-deductible expenses can be carried forward and used in future years, subject to the same limitation of 30% of EBITDA.

[1548] The OECD is indeed concerned about denying a deduction twice when provides: "The mechanism for coordinating the interaction between the two rules [interest limitation and hybrid mismatch rule] will depend on how the interest limitation rule operates; however, the interaction between these rules should not have the net effect of denying a deduction twice for the same item of expenditure". OECD (2015), *supra* n. 6, p. 98.

In principle, and pragmatically speaking, the outcome of the first scenario seems to be more effective, because it simply denies the full amount of interest expenses just because a hybrid structure is involved. Nonetheless, the above result is indeed disproportionate, mostly considering that the denial of the deduction applies as a presumption that the fact of having a payment involving a hybrid payer is indeed abusive because of the DNT outcome.[1549] Accordingly, the denial of the interest deduction derived from the application of the *primary response* cannot be used in further years, which might conflict with domestic tax principles recognized in some countries, e.g. the ability-to-pay principle.[1550] On the contrary, as noted in the second scenario, if the interest limitation rule is applied first, it guarantees that at least an amount of interest will be effectively deductible in the taxable year in which they arise, giving the possibility to the other country to react and to tax the same amount of income using a *defensive rule*. Accordingly, the amount of non-deductible expenses derived from the application of the interest limitation rule can, in most of the cases, be carried forward, which would not conflict with, e.g. the ability-to-pay principle.[1551]

There is, however, one critic that can be made with respect to the application of the interest limitation rule before a hybrid mismatch rule (i.e. *primary*

[1549] *Supra* Section 2.3.2.
[1550] *Supra* n. 1545.
[1551] This is, however, relative. *See*, e.g. the case of the German interest limitation rule, which although providing a carry-forward of non-deductible interest, they are indeed lost in case of a change of control or discontinuance of the business. *Supra* n. 1379.

response) and this is the possibility of the taxpayer to manipulate the amount of EBITDA in order to obtain a higher amount of deductible expenses. The above can certainly be possible if the EBITDA is calculated on a whole group of companies. This chance, nevertheless, is diminished if the country of the payee has included a *defensive rule* and tax the amount of interest whose deduction was granted. Therefore, if the final aim of the BEPS Action Plan 2 is to ensure single taxation, this aim could be anyway accomplished giving priority to the interest limitation rule over the primary response.[1552]

4.2. *Linking rules* and CFC rules

As well as the case of interest limitation rules, countries around the world normally include rules to anticipate the taxation in the shareholders' country of undistributed profits generated at the level of the subsidiary, avoiding thus a long-term deferral.[1553] These rules, known as "CFC rules", generally operate in the same manner all around the world:[1554] they require control

[1552] The above, however, does not mean to recognize that the aim pursued by the OECD is correct. It simply means that, having "coherence" in mind, it would not really matter to apply the interest limitation rule with priority over the anti-hybrid rule proposed (i.e. *primary response*), giving the taxpayer also a fairer result.

[1553] *See*, e.g. the reference to CFC rules in the United States, *supra* Chapter III, Section 4.4.1, which was also the pioneer country to introduce these types of rules in 1962. *See* Parada, *supra* n. 250, p. 958.

[1554] Perhaps one interesting exception is Brazil, where e.g. the CFC rules apply both to passive and active income, not following the international standard of taxing only passive income. BR: Article 74 of the Provisional Measure No. 2158-35/2011. *See also* Parada, *supra* n. 250, p. 964; Freita de Moraes e Castro (2010), *supra* n. 250, p. 13.

from the shareholders and they are applied on undistributed passive income generated at the level of the foreign controlled subsidiary.[1555] This is to say, a "deemed dividend" is calculated on the profits of a foreign subsidiary and it is taxed then in the country of residence of the shareholders controlling the company.

When analysing the application of linking rules, specially in transactions involving deductible payments to reverse hybrids, it is easy to figure out that CFC rules can be very effective to accomplish a role similar to that provided under a *defensive rule*.[1556] Let us assume the following hypothetical: ACo is a Corporation incorporated in country A, which wholly owns BCo, an entity established in country B. This latter entity receives deductible interest from a subsidiary established in country C, CCo. Likewise, BCo is regarded as tax transparent in its country of establishment, while as an opaque entity in country A and C. We will also assume that interest payments are fully deductible in country C and that country A possesses CFC rules, which applies on passive income holds by foreign subsidiaries. The transaction, therefore, gives rise to a deduction in country C, without inclusion of income in country B and A.

[1555] Bittker & Lokken, *supra* n. 530, p. 69-3.

[1556] This is reinforced and recognized by the OECD BEPS Report on Action 2, when it says: "A payment to a reverse hybrid will not be treated as giving rise to a D/NI outcome if the mismatch is neutralized by the investor or the establishment jurisdiction adopting a specific rule designed to bring into account items of ordinary income paid to a reverse hybrid. This includes any rules […] (including under a CFC regime) […]". OECD (2015), *supra* n. 6, p. 57.

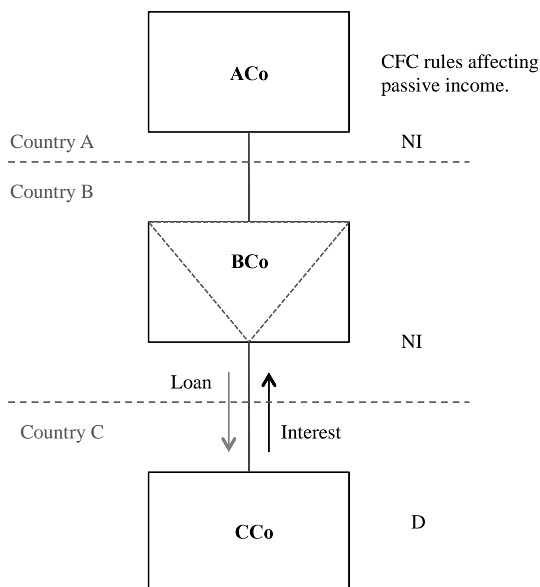

Figure 72: Linking rules and CFC legislation, Ex. 1

If also assumed that all the countries introduced *linking rules,* the question is: should country C apply first a *primary response* denying the deduction of interest or should be equally effective to just let country A to apply its CFC rules instead?

It is the author's view that a coherent and coordinated application of the rules is a key issue to avoid compliance costs and extra administrative burden.[1557] Having this in mind, it seems to be rather clear that in a

[1557] As stated by the OECD as well: "The recommendations set out in this report are intended to operate as a comprehensive and coherent package of measures to neutralize mismatches that arise from the use of hybrid instruments and entities without imposing undue burdens on taxpayers and tax administrations". Id., p. 94.

triangular situation as the one described above, it would be a more simpler solution to let country A to tax the income according to its own CFC rules, rather than obliging country C to deny a legitimate deduction. In other words, a *primary response* in country C should be relegated to the background if country A possesses strong CFC rules that may guarantee that the income remain untaxed, which is again the goal of Action 2. These ideas are indeed recognized by the OECD BEPS Action Plan, when provides: "Payments made through a reverse hybrid structure will not result in D/NI outcomes if the income is fully taxed under a CFC, foreign investment fund (FIF) or a similar anti-deferral rule in the investor jurisdiction that requires the investor to include its allocated share of any payment of ordinary income made to the intermediary on a current basis".[1558] Moreover, the final report on Action 2 states: "Treating income allocated by a reverse hybrid as taxable under the laws of the investor jurisdiction would have the effect of neutralizing any hybrid mismatch under a payment to a transparent entity".[1559] Finally, and recognizing that a proper application of CFC rules in the investor country (country A in our case) could solve the hybrid mismatch, the OECD proposes that " the payer jurisdiction could suspend the application of the hybrid mismatch rule insofar as payments were allocated to investor in the investor jurisdiction".[1560] Accordingly, the report clearly states that a *defensive rule* in country B, in our example, is

[1558] Id., p. 64.
[1559] Id.
[1560] Id.

unnecessary given the fact that a CFC rule will apply in country A. As provided by the OECD: “A defensive rule is unnecessary given the specific recommendations in Chapter 5 for changes CFC rules and other offshore investment regimes that would require payments to a reverse hybrid to be included in income in the investor jurisdiction”.[1561]

Yet, special attention should be taken on the design of the domestic CFC legislation that might allow an easy circumvention of the rules. The above can be illustrated with the application of the “same-country exception” in the United States.[1562] This exception states that Subpart F income (CFC income) will not include dividends, interest, rents and royalties received by a related corporation organized under the same laws of the CFC and which has a substantial part of its assets used in its trade or business located in that country.[1563] Therefore, in our example above, if we assume that country A is the United States and CCo were established in country B, instead of country C, the same country exception would most probably apply in order to exclude the interest received by BCo as CFC income.

[1561] Id., p. 56.
[1562] US: IRC Sec. 954(c)(3). Also, *supra* Chapter III, Section 4.4.1.
[1563] Id.

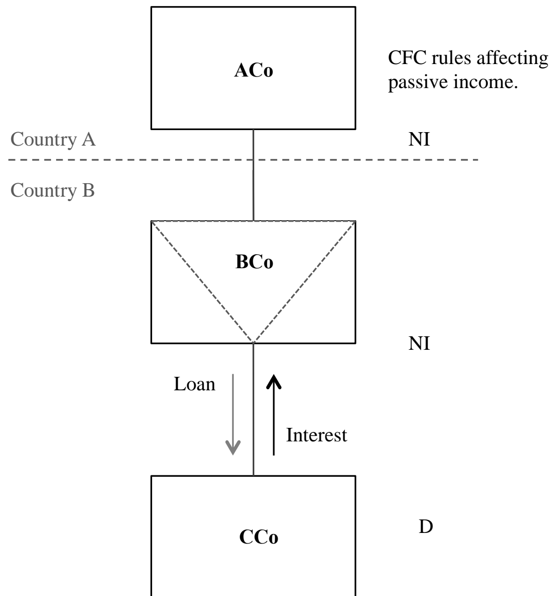

Figure 73: Linking rules and CFC legislation, Ex. 2

In addition, and contrary to some that could argue that this result could have also been achieved because of the elective characterization of entities in the United States (i.e. CTB regulations), treating BCo as tax transparent, what this example shows is, however, that regardless this characteristic of the U.S. tax laws, the avoidance of the rule had nothing to do with the possibility of ACo to elect how to treat the BCo for tax purposes, but mostly with the existence of the *same-country exception*. The above reaffirms what

this author already stated in Chapter III when referring to the CTB rules and CFC legislations.[1564]

Finally, one should also consider that if countries will start implementing CFC rules around the world, some conflicts might arise with respect to "who is entitled" to apply their CFC rules. The OECD opts for giving priority to the country where the shareholder chain has a closest relationship with the CFC in questions.[1565] Nevertheless, it is possible that issues will still exist.[1566] For this purpose, it would be perhaps a most interesting and direct solution to truly solve the hybrid entity mismatch (indirectly helping also to achieve the aim of taxing the income "somewhere") to provide a rule in the country of the investor, which allows in these reverse hybrid mismatch situations, to follow the characterization of the country where the entity is established (i.e. to treat the entity as tax transparent). In such a case, income would flow-through the final investor, where will be recognized as income, without the need of relying on CFC rules, avoiding also potential conflicts of application of these rules. [1567]

[1564] *Supra* Chapter III, Section 4.4.1.

[1565] OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report,* OECD Publishing, Paris, P. 67, rec. 130, Fig. 7.1.

[1566] C. Kahlenberg, *The Interplay between OECD Recommendations of Action 2 and 3 Regarding Hybrid Structures*, 44 Intertax 4 (2016), pp. 320-322.

[1567] I will get back to this proposal at *infra* Chapter VI.

5. Final remarks

There is no doubt that HMA is an *ad-hoc* tax notion, as many other *ad-hoc* tax notions internationally used within the international tax context, including e.g. the concepts of residence and source. Nevertheless, its problem relies particularly on the exacerbated attempt to match transactions involving hybrids and reverse hybrid entities with the outcomes derived from those transactions, under the assumption that income should be taxed 'somewhere', and interestingly, no matter where. The above does not only deviate from the problem of hybrid entity mismatches itself, i.e. the different characterization of the same entity by two jurisdictions, but also it creates new presumptions of base erosion and potentially abusive transactions just because they involve the DNT outcome. This idea is certainly reinforced when the concept of *imported mismatches*, as regards to hybrid entities, comes into play.

Linking rules follow a similar pattern. This is to say, once the problem is created (i.e. a HMA is recognized), the rules to solve it make indeed sense in such a context, i.e. where everything must be matched and income should be taxed somewhere, no matter where. Nonetheless, none of these rules truly solve the true hybrid entity mismatch. On the contrary, they assume a *consequentialist role* based exclusively on the outcome that the hybrid entity transactions generate, i.e. a D/NI outcome (or DNT), targeting just indirectly

the hybrid entity mismatch.[1568] It is precisely this consequentialist design of *linking rules*, which generates important issues both from a tax policy and a legal perspective. From a tax policy perspective, *linking rules* tend to be circular, namely, if implemented by all countries, will have no other effect than nullifying each other, even if a tie-breaker rule gets into force. More importantly perhaps, an uncoordinated application of a *primary response* and a *defensive rule*, i.e. a circular application, might give rise to new issue of economic double taxation, which did not exist before the application of these rules. Accordingly, it should not be underestimated that *linking rules* are extremely dependent on the functioning and application of foreign laws, which, unless a broader and efficient access to information between tax administrations, especially between developing countries, might raise serious concerns with respect to their effectiveness.

As regards to the legal concerns, it is true, on one hand, that *linking rules* do not raise many concerns with respect to Article 24 OECD Model (non-discrimination), mostly derived from the restrictive approach that the non-discrimination provision within the OECD Model has in comparison, e.g. with EU law. On the other hand, issues with respect to EU law are restricted to primary law, especially after the inclusion of *linking rules* targeting hybrid entity mismatches within the 2016 EU ATAD and the recent EU ATAD II, which make these rules applicable to both EU and non-EU

[1568] Nevertheless, neither the *primary response* nor the *defensive rule* solve the hybrid mismatch, they simply make income to be taxed, which is arguable, the true reason for the existence of HMA.

mismatches. Unfortunately, however, the jurisprudence of the CJEU is neither unequivocal nor consistent to provide a concrete answer with respect to the compatibility between *linking rules* and EU primary law. The above, however, as presented during the Chapter, should not prevent us to argue that some issues could still raise concern. For this reason, *linking rules* and fundamental freedoms should be thoroughly analyzed with respect to the non-discrimination principle within the TFEU, at least, as stated by other authors, "before all Member States fall completely in love with such provisions in the global battle against tax arbitrage".[1569]

All in all, it seems to be clearer now that the idea that "coordination" with respect to the characterization of entities for tax purposes seems to be not only a more direct manner to face issues with hybrid and reverse hybrid entities, but also it might provide a more efficient (and manageable) manner to face perhaps the only real problem with respect to hybrid entity mismatches: the disparate tax characterization of entities.

[1569] Bundgaard, *Hybrid Financial Instruments and Primary EU law–Part 2, supra* n. 1459, p. 594.

VI. CHAPTER

Hybrid Entities *without* Double Non-Taxation: An Alternative Approach

1. Introduction

The assumed interconnection between the use of hybrid and reverse hybrid entities and the DNT outcome has derived in a complex set of rules to implement both at a domestic and tax treaty level, whose true efficacy is still an incognito.[1570] This set of rules, however, carries not only the problems of a potential extra burden for tax administrations and taxpayers, but also, and more importantly, it does not truly solve the hybrid entity mismatch, i.e. the different tax characterization of the same entity.

This Chapter follows a different path and proposes a domestic *reactive coordination rule,* which aims to be a domestic alternative to coordinate the characterization of entities as per the tax characterization of the entity given in the *home country*, i.e. the country where the entity is formally and legally organized. Likewise, the proposal is based on three main tax policy ideas, which support its whole design: simplicity, coherence and administrability, and it is completely agnostic as regards to the DNT outcome derived from the hybrid entity structure.

[1570] *Supra* Chapter IV and Chapter V.

Section 2, describes the mechanics of the proposal, including its scope of application and the tax policy ideas behind it, i.e. simplicity, coherence and administrability. Likewise, it explains with concrete examples, both as regards to hybrids and reverse hybrid entities, the functioning of the proposal, detailing also its advantages and disadvantages, mostly when compared with other current proposals on hybrid entity mismatches. It finally provides a comparison between the proposed rule and other existing rules addressing the same path of coordination in order to clearly set up the common points and deviations that makes the proposed rule in this Chapter anyway preferable. Section 3 analyses the implications of the domestic *reactive coordination rule* at a tax treaty level, in particular, as regards to the application of Article 1(2) OECD Model. As recognized in Chapter IV, the inclusion of a new Article 1(2) OECD Model solves many issues regarding the proper allocation of tax treaty benefits when tax transparent entities are involved. However, this article if far from being a fair solution for developing (source) countries. This issue could, nevertheless, be mitigated in the hypothetical that the domestic *reactive coordination rule* is applied worldwide. Indeed, if that occurs, the scope of application of Article 1(2) OECD Model will be automatically reduced, providing more consistent tax treaty outcomes, and indirectly enhancing the position of source countries in those cases where the pure application of Article 1(2) OECD Model originated unfair results.

2. ***Reactive Coordination Rule*: A Domestic Alternative**

This Section describes the domestic proposal to coordinate the characterization of entities according to the legal characterization of the entity in the home country, i.e. the country where the entity, whose characterization is under debate, is legally and formally established, organized or incorporated. It also provides an analysis of the general tax policy justification, advantages and disadvantages of its application, mostly when compared with the existing OECD *linking rules*.[1571]

2.1. General Description of the Proposal

Despite the suggestive wording of this proposal, it is important to remark that it has nothing to do with the unrealistic attempt to harmonize the characterization of entities all around the world. This idea, which would also theoretically eliminate the mismatches derived from the different characterization of entities, would not be feasible to implement worldwide and it would not go beyond being a very optimistic academic approach without practical consequences.[1572]

On the contrary, the current proposal attempts a more realistic approach, which consists in establishing a *reactive coordination* rule that aligns the

[1571] *See* analysis at *supra* Chapter V.

[1572] Although the harmonization in a regional level, e.g. within the European Union is indeed an attractive and more direct solution. For a proposal to harmonize the characterization of entities in the EU through a mutual recognition of entities in the internal market, *see* Fibbe, *supra* n. 833.

characterization of foreign entities for domestic tax purposes according to the characterization given in the country where the entity is established or incorporated, i.e. the “home country”.

A general wording for this rule could be as follows:

> *Where according to the rules of a State, a different tax characterization is given to the same entity, the tax characterization given to the entity by the State where the entity is organized, shall be followed by the other State.*

2.1.1. *“Entity”* understood in a broad sense

As stressed already in Chapter III,[1573] this work uses the term *entity* as including also any other arrangement, regardless the legal position taken by a country on who derives the income from that entity or arrangement and on whether this has or not legal personality according to the rules of a specific jurisdiction. Similarly, the proposed wording of the *reactive coordination rule* does not refer to “entity” as limited to a *legal entity*, i.e. a body having legal existence separate from its owners or participants, and having its own rights and liabilities, but rather to *entities* in broad sense including legal entities and other arrangements. Therefore, no interpretation issues should

[1573] *Supra* Chapter III, Section 2.1.

arise just because of the fact that one of the States considers an entity as tax transparent, and thus, not a legal entity in strict sense.[1574]

2.1.2. Home country: where the entity is formally/legally organized

As the wording of the proposed rule suggests, the coordination in the characterization of the entity should be done according to the tax characterization given in the country where the entity is organized. For this purpose, the reference to *"where the entity is organized"* should be understood as the country where all the necessary formalities required for its establishment are fulfilled. For example, if a taxpayer decides to carry out a business through an LLC in the United States, he will have to accomplish with all the formalities required by the specific state governing the constitution of the LLC, e.g. Delaware, Florida, etc. Accordingly, if a taxpayer wanted to establish a silent partnership in Germany [*stille Gesellschaft*], he would have to accomplish with the formal requirements provided under German law. As it can be noted, therefore, in all those cases

[1574] Alternatively, the wording may include a specific reference to *"entity or arrangement"*. However, the author considers that the above inclusion might create more interpretation problems than limiting the wording to entities and explaining that the concept is used in a boarder way, the above does not prevent countries to include such a reference to "arrangements" if that, in the country's view, avoids further interpretation conflicts of the rule. The wording "entity or arrangement" is also used within the proposed Article 1(2) OECD Model. For a critical view on the reference to "arrangements" in thir context, e.g. within Article 1(2) OECD Model, see *supra* Chapter IV, Section 5.1.3.

there will be always only one jurisdiction governing the formalities of constitution of an entity.[1575]

The reference to the *"country where the entity is formally and legally organized"* should not represent a problem even in the cases of legal entities organized at a supranational level, because even in those cases there is still a reference to one jurisdiction in the end. For example, the European Company (SE),[1576] the European Cooperative Society (SCE)[1577]or the European Economic Interest Grouping (EEIG)[1578] are legal forms that, to a large extent, are governed by uniform EU law, but which are still partly regulated by the national provisions of the MS of incorporation.[1579]

2.1.3. Home country v. Source country

The reference to "home country", instead of "source country", has the purpose of covering both the cases of hybrid and reverse hybrid entities without providing different rules that might complicate the wording and the application of the proposal.[1580]

[1575] This differs from the criteria to determine the tax residence of entities, in whose cases there might be more than one jurisdiction claiming that an entity is resident in its jurisdiction.

[1576] EU: EC Regulation 2157/2001, Official Journal L 204/01.

[1577] EU: EC Regulation 1435/2003, Official Journal L 207/03.

[1578] EU: EEC Regulation 2137/1985.

[1579] *See* Cerioni, *supr*a n. 523. *See also,* Korving and Wijtvliet, Id.

[1580] However, a different wording could read as follows: "Where according to the rules of a State, a different legal characterization is given to the same entity taxpayer, the legal characterization given to the entity by the State *where the payment is sourced*, *in the*

As stressed already in this work, most of the cases of hybrid entities that are relevant for tax purposes, i.e. where a cross-border payment comes into play, imply that a hybrid entity is making such payment. In other words, in all those cases, the source country will coincide with the home country of the hybrid entity.[1581] The above does not mean to disregard the fact that, in some cases, a hybrid entity could receive a payment, being the source country different from the home country. However, such cases are generally not relevant from the OECD perspective and the application of *linking rules*, because such payments will be taxed at the level of the of the hybrid entity or at the level investors anyway, which would ensure the single taxation policy behind its proposed *linking rules*.[1582] In my perspective and the application of the *reactive coordination rule* in those cases, however, it would be relevant only in case the rule refers to the source country instead

case of hybrid entities, or where the entity is organized or incorporated, in the case of reverse hybrids, shall be followed by the other State" (emphasis added).

1581 This idea is implicitly recognized within the OECD BEPS Action Plan 2, which only considers the cases of payments made by a hybrid payer and which result in a D/NI outcome (or DD). OECD, *supra* n. 6, p. 49, Recommendation 3(3). Similarly, the EU proposals to deal with hybrid mismatches, both inside and outside the internal market (i.e. EU ATAD I and EU ATAD II), also consider only the cases of payments made by a hybrid entity. *See* EU: Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I) and Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II). The above has to be with the design of the countermeasures. In simple words, as *linking rules* start from the assumption that a mismatch in the tax outcomes is what finally determines the application of the rules, the payments received by an entity considered as taxable entity in its country of organization and tax transparent in the country of the investors, would, most probably, not generate a D/NI outcome, because the income would be taxed either in the country of the hybrid entity or in the country of the investors, or both. Therefore, such payment is irrelevant for purposes of the rules, even though a potential double taxation might occur and regardless that the true mismatch, i.e. the different characterization of the same entity, remains. For the analysis of HMA and linking rules, see *supra* Chapter V, Sections 2 and 3.

1582 Id.

of the home country if the source country is a third country that also considers the entity as tax transparent. In such a case, the hybrid mismatch rule proposed would not be effective to solve the mismatch at all.[1583] This concern disappears, however, if the third country (i.e. source country) also treats the entity as opaque.[1584]

Similarly, in most of the cases involving reverse hybrid entities, it is assumed a reverse hybrid entity receiving a payment, normally from a third country.[1585] In this case, the source country of the payment and the home country of the reverse hybrid do not coincide at all. Moreover, in most of those cases, the country of the investors and the source country normally characterize the entity in the same manner, i.e. as taxable entity. Therefore, in such a case the disparity is given by a characterization of the entity different from that in the home country.[1586] The above, however does not mean to recognize that payments from a reverse hybrid might also occur. They might, but once again, they would not be relevant from an OECD perspective and the application of *linking rules*, because in such a case, the payment will be recognized as income in the country of the investor (i.e. if the payee is there), ensuring single taxation.[1587] For purpose of the

[1583] Because the home country would keep considering the entity as opaque and the country of the investors would "follow" the characterization of the source country (a third country), which also treats the entity as tax transparent.

[1584] In such a case the only concern would be to ensure a double taxation relief for the potential double taxation of the income both in the home country of the hybrid entity and in the country of the final investors.

[1585] OECD (2015), *supra* n. 6, pp. 55 et seq.

[1586] *Supra* Chapter V, Section 2.4.2.

[1587] The same would occur if the payments were made to a third country with which the reverse hybrid has, e.g. a loan transaction, that gives rise to the payment. In such a case,

application of the *reactive coordination rule* to cases involving payments from a reverse hybrid, the distinction between source and home country would be irrelevant, because the home and source country in those cases will be the same.

All in all, for purposes of simplicity and as per the arguments already stressed, the proposed *reactive coordination rule* will refer to the characterization of the entity in the *home country*.

2.2. Scope of the rule

As stressed within the OECD BEPS Action Plan 2, most of the concerns derived from the potential abuse of hybrid entities and reverse hybrid entities are given within the context of "control groups", being thus the scope of the OECD proposed rule reduced to those cases.[1588] The above, however, does not coincide with the rather wide concept of 'control groups'[1589] and "acting together" and the vague concept of "structured arrangements"[1590]. All these concepts demonstrate rather the opposite idea, i.e. the OECD proposed rules attempt to apply to a wider range of possible situations. Needles to say is that the use of these concepts certainly make the application of the OECD rules certainly very complex.

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however, as the entity is transparent in its home country, the payments made are never deductible. In other words, even today would be considered a HMA.

[1588] *Supra* Chapter V, Section 3.3.1.

[1589] Id.

[1590] For a deeper analysis on the concept of *"structured arrangements",* see *supra* Chapter V, Section 3.3.2.

The *reactive coordination rule* assumes a simplified and more honest approach instead. It proposes an application of the rule to all those cases where there are disparities between two countries with respect to the tax characterization of the same entity. This is, on one hand, in line with the three main policy reasons that sustain this proposal: simplicity, coherence and administrablity of the rule,[1591] and, on the other hand, with the idea of designing rules targeting the core of the issue regarding hybrids and reverse hybrid entities, i.e. the different characterization of entities for tax purposes. The above, however, does not mean that the rule attempts to harmonize the domestic characterization of foreign entities for domestic tax purposes at all. On the contrary, it attempts to be an alternative, which applies in a simple manner and raises more coherent results, avoiding thus unnecessary complexities in its design.

Another issue with respect to the scope of the proposed rule is the fact that the rule aims to apply only to the extent the disparity in the characterization of entities is "tax relevant", i.e. if there is a transaction that originate a payment that makes the disparity relevant for tax purposes. This idea mirrors a U.S. tax rule that applies in the case an eligible entity elects to treat a foreign entity in a manner different than the one provided by the U.S. default classification rules.[1592] For this purposes, the U.S. tax law provides that " a foreign entity's classification would be relevant if U.S. income was

[1591] *Infra* Section 2.3.
[1592] *Supra* Chapter III, Section 4.3.

paid to the entity […]".[1593] The reference to "tax relevance" thus ensures that the rule does not apply automatically, but only when a relevant tax payments has been made. A similar idea is behind the construction of the concept of HMA, which includes the existence of a payment as a necessary element to determine the existence of a HMA.[1594]

2.3. Tax Policy Justifications

The proposed *reactive coordination rule* is based on three main tax policy justification grounds: (i) simplicity, (ii) coherence and (iii) administrability, which are explained below.

2.3.1. Simplicity

Simplicity should be the basis of any tax rule, mostly when it implies the regulation of transactions that involve the interaction of tax laws from many different jurisdictions. For that reason, the proposed *reactive coordination rule* attempts to be designed and to apply in a very simple manner. This is to say, the rule will provide a simple exception to be implemented within domestic laws with respect to the rules used to characterize foreign entities for tax purposes. When a country does not contemplate these rules, it will directly apply as a specific anti-hybrid measure added to the domestic legislation. And when the country provides for a similar measure, it will

[1593] US: Treas. Reg. Sec. 301.7701-3(d)(1)(i).
[1594] *Supra* Chapter V, Section 2.2.

apply to the extent not covered by that rule. For example, the Danish anti-hybrid rules (or anti-CTB regulations) attempt to re-characterize a Danish domestic entity when the majority of the shareholders consider the entity in a different manner than for Danish tax law.[1595] These rules could co-exist with a rule that provides that when Denmark characterizes a foreign entity differently than the foreign country, Denmark should follow the characterization of the foreign entity given in its foreign country of organization. Similarly, e.g. a *reactive coordination rule* could be perfectly compatible with the administrative practice in Spain, which interprets the domestic law as to follow the characterization of the entity in the other country.[1596] Nevertheless, in this case an express inclusion of the rule within Spanish domestic law would be more recommendable to avoid contradictory interpretations.

Contrary to the proposed OECD *linking rules*, therefore, the *reactive coordination rule* does not look at the tax outcomes in one or the other country, but rather it focuses directly in the origin and very cause of the mismatch, i.e. the different characterization of foreign entities for domestic

[1595] For the Danish anti-hybrid rules, see *supra* Chapter III, Section 5.2.
[1596] For the Spanish administrative practice, see *supra* Chapter III, Section 5.1.

tax purposes.[1597] The above does not only avoid complexity, but also it prevents presumptions of abusive practices.[1598]

2.3.2. Coherence

From a strict tax policy perspective results at least curious that all the proposals to counteract the use (or misuse) of hybrid entities and reverse hybrid entities so far either target only the outcome of the transactions, i.e. D/NI outcome, e.g. OECD linking rules,[1599] or they provide for the country where the entity is established to accommodate its legal characterization of the entity to the one provided in the country of the investors relegating thus the characterization of the entity to the backyard, e.g. Article 9a EU ATAD II.[1600]

In a consistent and coherent approach, however, at least from a tax policy perspective, it should be the country that creates the hybrid entity mismatch, i.e. the country that characterizes the entity in a manner different than the home country, which should originally react in this situation. As well stressed by Lüdicke: "It is primarily for the state which qualifies foreign entities differently from their home state to introduce anti-hybrid mismatch

1597 Interestingly, however, as demonstrated later on in the application of the rule to cases involving hybrids and reverse hybrid entities, it also solves issues of DNT and do not generate cases of double taxation. As such, the rule should also be well received by those supporting the idea that single taxation in cross-border transactions. *Infra* Section 2.4.1 and 2.4.2.

1598 *Supra* Chapter V, Section 2.3.2.

1599 *Supra* Chapter V, Section 3.

1600 *Supra* Chapter III, Section 5.3.3.2.

rules […]".[1601] Following this idea, the *reactive coordination rule* calls for the country generating the hybrid mismatch to react accommodating its tax characterization of the entity to the one provided in the country where the entity whose characterization is relevant, is organized. In other words, it avoids that the home country of the hybrid entity or reverse hybrid change its own characterization of a domestic entity just because of a legal fiction in another country, avoiding an excessive reliance on foreign laws and contingencies based on the fact that income was or not deductible in one country, or included or not as "income" in the other country.

2.3.3. Administrability

Finally, a rule coordinating the characterization of entities is indeed easier to administer than one providing for more complex contingencies, such as deductibility in one country or inclusion as income in the other country. It is evident that under the proposed *reactive coordination rule* a contingency still exists: a country should follow the characterization of the entity in the other country. However, this contingency is more or less inherent to the hybrid mismatch itself, [1602] resulting thus in a more beneficial scenario both for tax administrations and taxpayers.

[1601] Lüdicke, *supra* n. 840, p. 317.

[1602] For example, a tax authority in the country of the shareholder will only have to determine what is the characterization of the entity in its home country, which is a rather clear issue, since domestic laws generally provide certainty on whether an entity is tax transparent or tax opaque.

For tax administrations, on one hand, it will reduce the complexities of determining whether, under foreign laws, an income was deducted or included as income, reducing to certain extent the uncertainty on whether taxing rights should be given up or not.[1603] Likewise, a rule providing for coordination as per the home country of the entity seems to be more in line with other tax rules relying on what happens offshore,[1604] although without a sequence framework as the one proposed within the OECD *linking rules*. In other words, the proposed *reactive coordination rule* applies more as a unilateral measure taken into account the treatment of the entity offshore, but without excessively relying on all the movements on foreign laws.

For taxpayers, on the other hand, a rule providing for coordination in the characterization of entities will allow them to be less aware on the domestic foreign laws, which should definitely reduce the costs related to tax planning and tax compliance.

2.4. Application of the *reactive coordination* rule

Some illustrations might be helpful to understand the application of the proposed rule. As follows, some examples are given as regards to hybrid and reverse hybrid entities.

1603 "Surrendering sovereignty over tax matters to other states is not something governments are used to or are likely to enjoy". Cooper, *supra* n. 1199, p. 346.

1604 E.g., rules on foreign tax credit.

2.4.1. Application to cases concerning payments made by *hybrid entities*

As regards to hybrid entities, the application of the rule can be illustrated in the following hypothetical: XCo is a taxable entity incorporated in country X, which grants a loan to YSub, an entity organized in country Y. YSub pays back interest in the amount of 100i. Whilst country X considers YSub as tax transparent, country Y considers the same entity as a taxable entity.

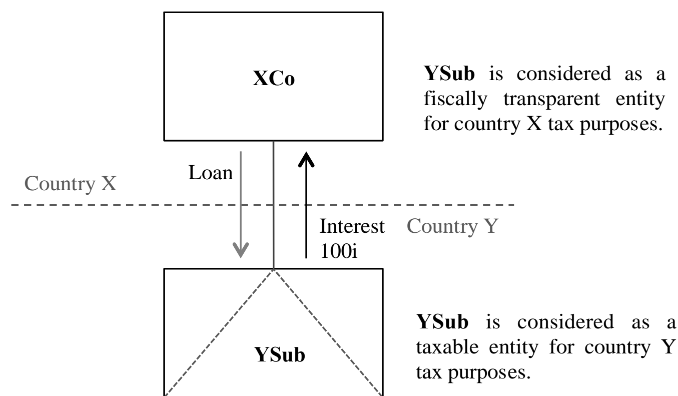


Figure 74: Reactive coordination rule and payments made by hybrid entities

In this scenario, the amount of interest paid (100i) by YSub can be deducted from the gross income of YSub, because Y Sub is considered as a taxable entity in country Y. Accordingly, the interest paid will not be included as ordinary income in country X, because under the tax law of country X, YSub is considered as a tax transparent entity. In other words, the loan and the interest are completely disregarded for tax purposes.

If we now consider that all countries have introduced the proposed *reactive coordination* rule, it would imply, in the example above, that once a disparity exists with respect to the characterization of YSub, which is tax relevant, i.e. there is a payment of interest and a loan between YSub (country Y) and XCo (country X), the taxpayer in country X (XCo) should follow the characterization of the entity in the source country: country Y. Therefore, once the rule is applied, the loan and the interest payments between XCo and YCo must be recognized in both countries, which means, on one hand, that there will be no need to limit the deductibility in country Y, being also, most probably, taxed in country X.[1605] More importantly, there will be no hybrid mismatch as regards to the entities anymore. The potential disparity has therefore been solved.

2.4.2. Application to cases concerning payments made to *reverse hybrid entities*

Let us assume the same facts as the example using hybrid entities, with the only difference that YSub is regarded as a reverse hybrid entity, i.e. under the tax law of country Y, YSub is considered as a transparent entity while country X and country Z consider YSub as a taxable entity. Likewise, we will assume that YSub receives interest payments from YSbub1, which is

[1605] The risk of economic double taxation is also reduced, because of the non-deductibility in country Y, when income was included anyway in country X, which is likely to occur with the application of the OECD *linking rules*, despite the existence of a hierarchy in the application of those rules. This is discussed at *supra* Chapter V, Sections 3.4.1 and 3.4.3 referred to the circular effect of *linking rules* and economic double taxation.

established in a third country Z, which makes the disparity in the characterization of YSub as tax relevant.

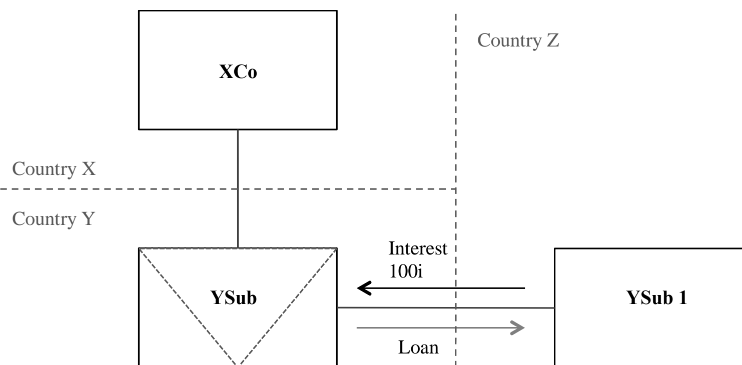


Figure 75: Reactive coordination rule and payments made to reverse hybrid entities

The interests payments received by YSub are deductible in country Z, but not included as ordinary income neither in country Y, where YSub is considered as a tax transparent entity. They are also not included as ordinary income in country X, because country X considers YSub as a taxable entity.[1606]

If we now consider the application of the proposed *reactive coordination* rule, country X shall follow the characterization of YSub, i.e. it will treat YSub as tax transparent as well. The above implies that the income might be taxed in the hands of the investors. More importantly, it would not be necessary to establish a limitation in the deductibility of the interest

[1606] Unless, of course, dividends are distributed from YSub to XCo or country X effectively applies CFC rules.

payments in country Z to the extent that income is not included in country Y, or relying in the effective application of the CFC legislation of country X. On the contrary, under the proposed ruled, the right to tax is finally granted at the level of the investors and the hybrid mismatch is solved through the coordination in the characterization of YSub.

2.4.3. Advantages

The *reactive coordination rule* has some evident advantages, which have mostly to do with the simple and direct functioning of the proposed rule when compared to the proposed OECD *linking rules.*

2.4.3.1. Non-contingent application

The proposed *reactive coordination rule* supposes the reaction of only one country without the contingency on what is going to happen in the other country.[1607] This is to say, if all countries introduced the rule, it is only the country originating the mismatch, i.e. the country that characterize the entity differently than the home country, which should react aligning its characterization of the foreign entity according to the rules in the home country of the entity. The above would eliminate, on one hand, the sequence mechanic between *primary response* and *defensive rule*, avoiding

[1607] As stressed already in this work, one of the main critics to the OECD *linking rules* is their sequencing application. A *primary response* applies denying a deduction in the country of the payer to the extent income has not been included in the country of the payee. Accordingly, a *defensive rule* depends exclusively from the application of the primary response, i.e. it applies only to the extent a deduction was granted anyway in the country of the payer. *Supra* Chapter V, Sections 3.1 and 3.2.

circularity, and the potential economic double taxation issues that might arise, and, on the other hand, it would certainly delete the unnecessary dependency on foreign laws that the application of *linking rules* imply.[1608]

2.4.3.2. Disparities over outcomes

As stressed already, there is a sound critic with respect to the proposed OECD *linking rules,* which is their excessive focus in the outcomes of the hybrid transactions, rather than in the core of the disparities, i.e. the different characterization of entities by two or more countries.[1609]

The proposed *reactive coordination rule* provides a more direct approach, which privileges the origin of the disparities, i.e. the different characterization of the same entity, over the tax outcome of the transaction in order to design the rule. The above also brings back to the first line the core of the problem, which was relegated to the background under the proposed OECD *linking rules.* This is also coherent with was has been concluded in this work, which is that DNT should not be used as proxy to

[1608] *Supra* Chapter V, Section 3.4.

[1609] As Cooper well explains: " […] there is a sense in which constructing the rules around outcomes clouds as much as it reveals. The rules for situations (1) to (3) involving hybrid entities are all separately constructed, i.e. they have distinct preconditions, only one involves changes to domestic law, the exceptions are different and for one there is no secondary defensive rule. And yet all the situations identified have the same problem at their core, i.e. *the states do not agree whether there is an entity*" (emphasis added). Cooper, *supra* n. 1199, p. 339.

determine the existence of abusive practices through the use of hybrids and reverse hybrid entities.[1610]

2.4.3.3. Complexity is reduced

This is perhaps the most important advantage of the proposed *reactive coordination rule,* being also in line with one of the main tax policy aim behind it: simplicity.[1611]

The application of the rule is rather simple, because it attempts to coordinate the tax characterization of the entity according to the one given in the country where the entity is formally and legally organized, avoiding unnecessary complexities, such as establishing whether or not a payment was deducted in one country or included in the other country, relying excessively on foreign laws.[1612] Likewise, the rule is easy to administer both for taxpayers and tax administrations.[1613]

2.4.4. Disadvantages

The proposed rule is, however, far from being perfect and might result in a series of disadvantages explained below.

[1610] *Supra* Chapter I, Section 6 and *infra* chapter VII, Section 2.
[1611] *Supra* Section 2.3.1.
[1612] *Supra* Section 2.3.3.
[1613] Id.

2.4.4.1. Legal certainty

Legal certainty might be affected because of the application of the *reactive coordination rule*. Indeed, taxpayers in the investor country might feel affected by a rule providing for a characterization of entities according to the rules in the other country, affecting therefore the characterization of the foreign entity given by their own countries.

Nevertheless, the legal certainty issue might be more illusory than real, because since the rule is implemented, taxpayers will certainly know that in all those case involving hybrid and reverse hybrid entities, being this tax characterization tax relevant, the rules will apply as to follow the tax characterization of the entity in the home country. Therefore, it could arguably be sustained that the principle of legal certainty is affected. A different situation could be the case in which the rule provides for a re-characterization of domestic entities as per the characterization of the entity in a foreign country, e.g. the Danish anti-hybrid rule. In such a case, there could be more arguments to sustain that the legal certainty in terms of the domestic characterization of entities might affect taxpayer that decided to make business in a country opting for a determined legal entity, e.g. a partnership, instead of another, e.g. a corporation.

2.4.4.2. Some undesirable effects

Another disadvantage of the rule has to be with some undesired effects derived exclusively from the application of the rules. As follows, three

situations are analyzed: (i) potential double taxation; (ii) tax benefits not granted in absence of the rule, and (iii) disregarded transactions for the sole application of the rule.

2.4.4.2.1. Potential double taxation

Although not so likely to happen, and excluded from the OECD BEPS Action Plan 2, a hybrid entity might also receive some payments.[1614] In such a case, the pure application of the *reactive coordination rule* might derive in double taxation.

Let us assume, e.g. the same example in Section 2.4.1 with the difference that YSub has a subsidiary in country Z, from where it receives interest payments associated to a loan granted by YSub to YSub 1.

[1614] This case is, however, not included within the OECD BEPS Action Plan 2, because in fact it does not generate a D/NI outcome. As the entity receiving the income is considered as tax transparent in the country of the investors, it is assumed that the income will be taxed in that country. OECD (2015), *supra* n. 6, p. 49 et seq. Likewise, this case is excluded from the EU ATAD I and EU ATAD II. *See* EU: Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I) and Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II). However, this case might generate double taxation if the country of investors does not grant double taxation relief for the taxes paid in the country where the entity is organized, i.e. where the entity is indeed a taxable entity. The proposed *reactive coordination rule*, on the contrary, does not start from the assumption of matching tax outcomes to avoid DNT, but rather of matching the characterization of entities, which is the true core of the issue regarding hybrid and reverse hybrid entities.

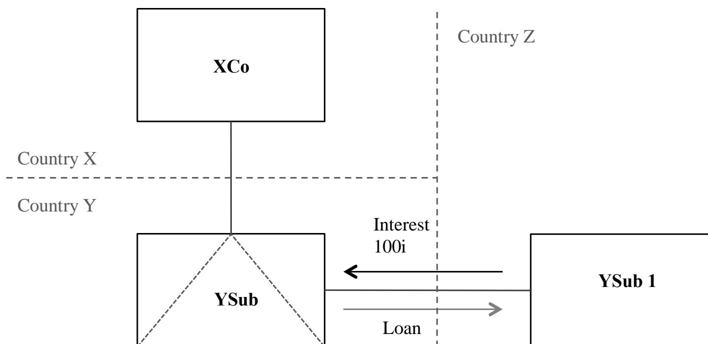


Figure 76: Potential double taxation

In absence of the rule, this situation would not raise much concern following the OECD tax policy behind the *linking rules*, i.e. single taxation, because the interest payments would flow-through the investor (XCo) and most probably would be taxed there. Nevertheless, the hybrid mismatch remains.

Applying the *reactive coordination rule*, however, country X would also consider YSub as an opaque entity. The above means that country X would no longer be able to tax the interest payments (100i), unless CFC rules apply. If that happens, however, income might be taxed twice: once at the level of country Y, because the entity is taxable, and once at the level of country X, because of the application of CFC rules. Therefore, in order to avoid such a result, it is recommendable that together with the implementation of the *reactive coordination rule*, CFC rules guarantee a tax credit for the taxes already paid in country Y.

2.4.4.2.2. Tax benefits not granted in absence of the rule

Another good example of cases in which the pure application of the *reactive coordination rule* might bring undesirable results is the case of payments made from a reverse hybrid entity.

If an interest payment is made from a reverse hybrid entity to a third country that also consider the entity as tax transparent,[1615] the outcome of that transaction would be a non-deductible interest payment in the payer country, whose income will also not be recognized in the country of the payee, which considers the payer as tax transparent. Accordingly, the country of the investors considers the payer as a separate entity; therefore, it has no impact in the transaction between payer and payee. As per the state of the art, this transaction does not generate concerns because there is no D/NI outcome that might trigger the classification of the transaction as a HMA, and thus, the application of *linking rules*. In other words a non-deduction/non-inclusion, i.e. DNT outcome, is a perfectly acceptable outcome even under the current view of the OECD. [1616]

Let assume the same example in Section 2.4.2 above with the only difference that YSub pays interest to YSub 1 in country Z, and that this latter also considers YSub as tax transparent.

[1615] The country of the investors considers the entity as opaque, which becomes the entity in a reverse hybrid entity. *Supra* Chapter III, Section 3.1.

[1616] Because the disparity do not originate a D/NI outcome. *See* OECD (2015), *supra* n. 6, pp. 55 et seq. It is also not included within the EU ATAD I and II. *See* EU: Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD I) and Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II).

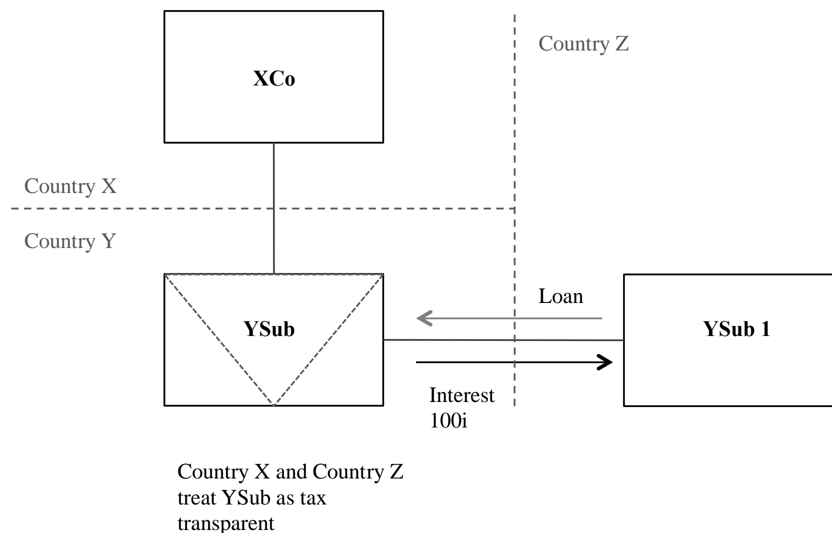


Figure 77: Benefits not granted in absence of the rule

In this scenario, the outcome is a non-deduction/non-inclusion, which is certainly out of the scope of BEPS and the concept of HMA.

However, if we consider now the application of the *reactive coordination rule* to this transaction, it would imply that that the country of the investors (country X) should follow the characterization of the entity in the country where this is organized (country Y). Thus, a deduction might be created in the country of the investors only because of the application of the rule, which could give rise to future abusive situations. Such a result seems to be inappropriate, considering that it grants a tax benefit that did not exist before the application of the *reactive coordination rule* and might be an open door

for abusive practices. Therefore, in order to avoid this potential negative effect, the author proposes that in those triangular cases in which both the payer country (country Y) and the payee country (country Z) treat the reverse hybrid as tax transparent, the *reactive coordination rule* be "switched-off".[1617] As the outcome without the application of the proposed rule did not generated any international tax policy concerns before the application of the rule, it might be a perfectly acceptable result if the *reactive coordination rule* is not applied in this case.

2.4.4.2.3. Disregarded transactions for the sole application of the rule

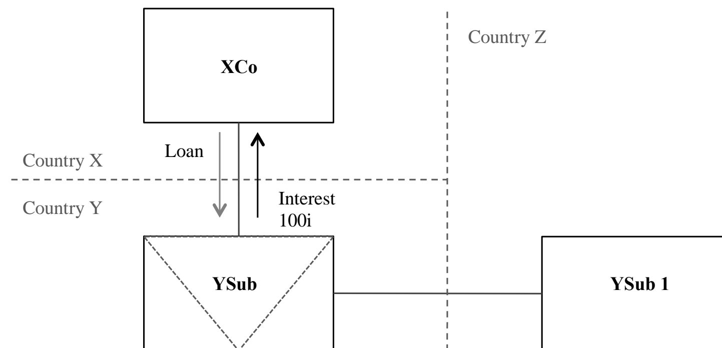
Another example might be given when the reverse hybrid entity is making a payment to the investors, [1618] which by the sole application of the *reactive coordination rule,* might be disregarded for tax purposes.

Let assume the example in Section 2.4.2 with the sole difference that XCo grants a loan to YSub and this latter pays interest back. In such a case, and only due to the application of the *reactive coordination rule* that provides for the coordination in the characterization of YSub as per its characterization in country Y (i.e. as tax transparent entity), results in

[1617] The "switch-off" of the rule does not require a deeper explanation, because it only implies that countries might opt to include in their domestic laws, together with the wording of the *reactive coordination rule*, an exception for the application of the rule in cases as the one described above, i.e. where a reverse hybrid entity makes a payment to a payee in a third country different from the country of the investors.

[1618] This scheme is also out of the scope of the OECD *linking rules*, because they do not generate a D/NI outcome, and thus, there is no HMA

disregarding the whole transaction between XCo and YSub, whose outcome would not arise in absence of the rule.



In order to avoid the non-recognition of the loan and the interest payments as a result of the application of the *reactive coordination rule*, the rule will be switched-off in this case.

Figure 78: Disregarded transaction for the sole application of the rule

The possibility of disregarding the whole transaction just because of the application of the *reactive coordination rule* might, however, gives rise to abusive practices. Therefore, the author considers, once again, that a “switch-off” rule with respect to the *reactive coordination rule* might be applied.

Generally speaking, the possibility of “switching-off” the application of the *reactive coordination rule* should not be interpreted neither as a contradiction nor a defect of the proposed rule. On the contrary, as stressed already, the tax policy behind the proposed rule is not achieving a full

harmonization in the rules used to characterize foreign entities for tax purposes, but rather to create a more direct and simple manner to tackle the potential misuse of hybrid and reverse hybrid entities, when compared with the existing *linking rules*. Likewise, and as its name suggests, a "reactive" rule necessarily implies that some cases will remain out of the scope of it, as it can be, e.g. with all the cases in which the disparate characterization of the same entityby two States has not become tax relevant.

2.5. Similarities and differences with other examples of coordination

At first glance, the proposal of this Chapter mirrors perhaps other existing proposals of coordination already studied in Chapter III.[1619] This statement is indeed correct since those proposals and the one developed in this Chapter attempt to coordinate the tax characterization of entities, rather the tax outcome of the transactions involving hybrid or reverse hybrid entities, solving thus the core of the hybrid entity mismatch. Nevertheless, there are still substantial differences. Both similitudes and differences are analyzed in the following sub-sections.

2.5.1. The Spanish example of coordination and the *reactive coordination rule*

The Spanish example of coordination is perhaps not the strictest point of comparison since the Spanish coordination outcome is exclusively the result

[1619] *Supra* Chapter III, Section 5.

of the interpretation of the Spanish law repeatedly sustained by the Spanish tax administration, rather than the result of the specific wording of a tax provision.[1620] Nonetheless, more similitudes than differences can be found when the outcomes of both, i.e. the Spanish administrative practice and the proposed rule, are putted together.

As stressed already in Chapter III,[1621] Article 37 of the Spanish NRITL provides for a resemblance test as regards to the tax characterization of foreign entities.[1622] In particular, Spanish law attempts to treat foreign entities whose juridical nature is identical or analogous to those of the entities subject to the income attribution regime in Spain, i.e. a tax treatment in which the income of the entity is taxed only in the hands of the owners, as if they were subject to that income attribution regime in Spain.[1623] Although the wording of the Spanish law is not entirely clear, many Spanish scholars coincide that, as per the Spanish tax administration's practice, the tax treatment given in the foreign country is the central element to determine the legal characterization of the foreign entity.[1624] Like the *reactive coordination rule*, therefore, the Spanish tax administration practice tends to respect the tax characterization of the entity in the country in which this is indeed organized, i.e. the home country.

[1620] *Supra* Chapter III, Section 5.1.
[1621] *Supra* Chapter III, Section 5.1.
[1622] *Supra* Chapter III, Section 5.1.2. *See also*, ES: Article 37 of the Spanish Non-Resident Income Tax Law–NRITL, Royal Legislative Decree No. 5/2004 of 5 March 2004.
[1623] For the different binding rulings issues by the DGT (Spanish tax administration), see *supra* Chapter III, Section 5.1.3.
[1624] *See*, e.g. Jiménez-Valladolid de L'Hotellerie-Fallois and Vega Borrego, *supra* n. 773. *See also*, Mosquera Mouriño, Id.

Nevertheless, the Spanish rule cannot be interpreted neither from the strict wording of the rule nor one might ensure that the same interpretation might be sustained during the time. Thus, a proper rule within the Spanish statute, which recognizes the long-standing tax administration practice in Spain, would be definitely more recommendable. In this regard, the *reactive coordination rule* may replace such a gap, ensuring also through its implementation by other countries, the Spanish characterization of its own entities be respected, solving thus also those cases of hybrid entity mismatches that the current administrative practice cannot solve up to now.[1625]

2.5.2. The Danish rule and the ***reactive coordination rule***

In 2004 and 2008, the Danish tax law was modified in order to include some rules attempting to counteract the influence and the use of the U.S. CTB regulations with respect to Danish entities.[1626] In brief, the Danish rules provide that if certain requirements are met, a domestic Danish taxable entity, considered tax transparent by a foreign country, can be re-characterized also as a transparent entity in Denmark.[1627] Likewise, a Danish transparent entity can be re-characterized as taxable entity if the foreign

[1625] As stated in Chapter III, there is no rule in Spain that guarantees that a Spanish entity is considered either transparent or opaque under the laws of a foreign country, which might certainly generate a hybrid entity mismatch. *Supra* Chapter III, Section 5.1.

[1626] *Supra* Chapter III, Section 5.2.

[1627] A detailed analysis in *supra* Chapter III, Section 5.2.1.

country considers it also as taxable entity.[1628] To certain extent, one might argue that the Danish rules represent thus an attempt to solve the hybrid entity mismatches coordinating the characterization of their own entities as per the one provided in the country of the investors, or the majority of them at least.

As per the design of the Danish rules they represent exactly the opposite of what it is proposed in this Chapter. The above, however, does not diminish the importance of the Danish rules. On the contrary, they make complete sense in the context where the rules were launched: to limit the scope of application of the CTB regulations in the United States through a unilateral response coming from Denmark. Indeed, a "coordination rule" in the country of the investors (i.e. the U.S.) would have been simply impracticable.[1629]

Another characteristic of the Danish rules is that they attempt to apply within a limited scope. For example, one of the requirements under the Danish rules referred to hybrid entities is that more than 50% of the ownership, by value or votes, is in the hands of a foreign entity.[1630] Similarly, for the rules preventing reverse hybrid entity mismatches provide that the direct owners/partners holding more than 50% of the capital or voting rights must be tax residents in one or more foreign jurisdictions,

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1628 A detailed analysis in *supra* Chapter III, Section 5.2.2.

1629 In this opinion, e.g. Dell'Anese, *supra* n. 4, p. 254. *See also*, Møllin Ottosen and Nørremark, *supra* n. 793, p. 513; Bundgaard, Id., pp. 200-201. All these authors coincide that the target of the 2004 and 2008 rules were exclusively the negative impact of the U.S. CTB regulations.

1630 This is referred as the "controlled foreign legal entity". *Supra* Chapter III, Section 5.2.1.

including the Faroe Islands or Greenland.[1631] The above does not coincide with the attempt of the *reactive coordination rule*, which is to apply the rule to all hybrid entity mismatches, regardless whether they were originated within 'control groups' or not.

There are, however, other substantial differences. For example, the anti-hybrid entity rule in Denmark applies to the extent the foreign country is a member of the EEA or a tax treaty partner with Denmark.[1632] This regional limitation is not contemplated in the proposal for a *reactive coordination rule*. Accordingly, e.g. the Danish anti-reverse hybrid rule applies not only in case the jurisdiction where the owners are tax resident considers the Danish entity to be a separate taxable entity, but also in case this country does not exchange information with the Danish tax authorities.[1633] The above certainly extends the scope of the rule beyond cases of disparities in the characterization of entities, or at least presumes that the foreign characterization of Danish transparent entities is opaque by the sole reason that information is not available. Although this rule might be practical in terms of avoiding uncertainty when information is not available, the author estimates that it would not be necessary for purposes of the *reactive coordination rule*, mostly considering the ongoing international scenario in which automatic exchange of information seems to prevail.[1634]

[1631] *Supra* Chapter III, Section 5.2.2.
[1632] *Supra* Chapter III, Section 5.2.1.
[1633] *Supra* Chapter III, Section 5.2.2.
[1634] For a reference on the global tendency towards transparency and automatic exchange of information, see *supra* Chapter I, Section 4.1.2.

2.5.3. The EU ATAD I and II and the reactive coordination rule

As noted already in Chapter III, the reactive coordination rule might also be compared with the original proposal for a EU ATAD and the current Article 9a of the EU ATAD II.

2.5.3.1. The Proposal on EU ATAD I and the *reactive coordination rule*

As regards to the original proposal for EU ATAD, it indeed attempted to solve the hybrid entity mismatch making the residence country to follow the characterization of the "source country".[1635] Nonetheless, the rule maintained the reference to D/NI outcomes in order to determine the existence of a mismatch. [1636] In other words, the matching of tax outcomes seems to be the final aim, rather than the hybrid mismatch itself. The above, e.g. excludes cases in which a hybrid entity is receiving, rather than paying interest, or cases where a reverse hybrid is making a payment, rather than receiving it, because in both cases there is no D/NI concern.

Contrary to the above, however, the *reactive coordination rule* attempts exclusively and directly to solve the hybrid entity mismatch, taking into consideration even those situations excluded from the proposal for EU ATAD.[1637] For example, since the rule attempts to simply respect the characterization of the entity in its home country, it could also avoid

[1635] *Supra* Chapter III, Section 5.3.1.
[1636] EU: Article 10 of the Proposal for EU ATAD.
[1637] *Supra* Section 2.4.

mismatches in which a hybrid entity is receiving a payment from a third country, i.e. different form the investors country where the entity is treated as tax transparent and the home country where this is tax opaque.

In spite of the above, the proposed *reactive coordination rule* must be carefully and restrictively applied in cases where a payment is made to a hybrid entity from a third country, or the cases where a reverse hybrid entity makes a payment to a third country also treating the entity as tax transparent or to the country of the investors, mostly to avoid a potential double taxation or the creation or tax benefits by the sole application of the rule.[1638] For the first case, i.e. a hybrid entity receiving a payment from a third country, the author has proposed to contemplate within the CFC rules in the country of the investors, specific rules that grant double taxation relief for the taxes paid in the country of the hybrid entity. As regards to the cases of reverse hybrid entities, a "switch-off" rule has already been proposed and explained.[1639]

2.5.3.2. Article 9a EU ATAD II and the *reactive coordination rule*

As stressed already in this work, Article 9a of the EU ATAD II resemblances the Danish anti-reverse hybrid rule, providing for a re-characterization of a reverse hybrid entity in cases where 50% or more of the voting rights, capital interests or rights to a share of profit in that entity is maintained by shareholders located in a jurisdiction or jurisdictions that

[1638] *Supra* Sections 2.4.4.2.1, 2.4.4.2.2 and 2.4.4.2.3.
[1639] Id.

regard the entity as a taxable person.[1640] In such a case, the reverse hybrid entity will be also treated as a taxable entity.[1641] Accordingly, the rule contained within the EU ATAD II applies with priority over *linking rules*.[1642]

Although there are elements of connection with respect to the proposed *reactive coordination rule*, e.g. the fact that it does not make any reference to tax outcomes, but rather to the disparities in the characterization of the same entity, the EU ATAD II rules works exactly in the opposite direction. In other words, it attempts to coordinate via re-characterization in the home country, i.e. making the reverse hybrid to change its own domestic characterization. The above, as argued already, might be justified in order to keep the revenues within the EU.[1643] However, re-characterizing an entity in the MS where the entity is organized might also increase uncertainty for those taxpayers who originally decided to opt carrying on businesses using a certain legal form rather than others.[1644] Moreover, the rule within the EU ATAD II is still ineffective to target payments made to a reverse hybrid entity in all those cases when the reverse hybrid is incorporated in a third country, outside the EU.[1645]

[1640] EU: Article 9a(1) of the Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II). For further details, *supra* Chapter III, Section 5.3.3.2.

[1641] Id.

[1642] EU: Council Directive (EU) 2017/952 of 29 May 2017 (ATAD II), rec. 29.

[1643] *Supra* Chapter III, Section 5.3.3.2.

[1644] *See,* e.g. McDaniel, McMahon and Simmons at *supra* n. 628 to see, e.g. why in the United States taxpayer prefers transparency rather than opacity.

[1645] This is further explained with examples in *supra* Chapter III, Section 5.3.3.2.

The *reactive coordination rule* works in a different manner, because it assumes as a primary tax policy aim that the country that generates the mismatch should react coordinating its characterization as per the one provided in the country where the entity is formally and legally organized.[1646] The above grants, on one hand, legal certainty for those who originally decided to carry out businesses using tax transparent forms and, on the other hand, it might also be more effective to target cases in which in a reverse hybrid is not organized within the EU, because it simply provides for coordination in the home country, regardless where this is located. Yet, the disadvantages derived from the application of the proposed *reactive coordination rule*, might be mitigated with the proposed solution already explained by the author.[1647]

3. Implications of the *Reactive Coordination Rule* within Tax Treaties

As recognized in Chapter IV, the inclusion of a new Article 1(2) OECD Model solves many issues regarding the proper allocation of tax treaty benefits when tax transparent entities are involved, avoiding conflicts of allocation of income. However, this provision if far from being a complete fair solution, mostly for developing (source) countries.[1648]

Nevertheless, the negative impact of Article 1(2) OECD Model as regards to source countries might be indirectly mitigated by the application of the

[1646] *Supra* Section 2.3.2.
[1647] *Supra* Section 2.4.4.
[1648] *Supra* Chapter IV.

domestic *reactive coordination rule.* This is to say, once domestic coordination in the characterization of entities has been achieved, the application of Article 1(2) OECD Model might be restricted exclusively to those cases in which the source or residence country, in a bilateral context, treats their own domestic entities as tax transparent.

The analysis of the implications of the application of the *reactive coordination rule* as regards to tax treaties will be performed using study cases of hybrids and reverse hybrid entities and involving both pure bilateral situations and triangular situations. These study cases are inspired in the illustrations already analyzed in Chapter IV with respect to the application of Articles 1(6) US Model[1649] and Article 1(2) OECD Model[1650], and all of them assume that there is no PE in the State of source. Accordingly, all the examples also assume that all the anti-abuse restrictions within domestic law and tax treaties were overcome.

3.1. Bilateral cases using *hybrid entities* and *reverse hybrid entities*

This Section contains four study cases analyzing the implication of the *reactive coordination rule* within the tax treaty context. Whilst Case A and B refer to income received by or through a hybrid entity, Case C and D refer to income received through a reverse hybrid entity. All cases assume strict

[1649] *Supra* Chapter IV, Section 4.2.
[1650] *Supra* Chapter IV, Section 5.2.

bilateral situations where interest payments are paid from one Contracting State to the other Contracting State.

3.1.1. Case A

Entity P is organized and resident in State P and has two owners: A and B, who are residents of State R. Accordingly, Entity P receives interest payments from a debtor in State P. While State P considers the entity as a taxable entity, State R considers the same entity as fiscally transparent, and thus, that the income is allocated to the partners A and B. State P has a general WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

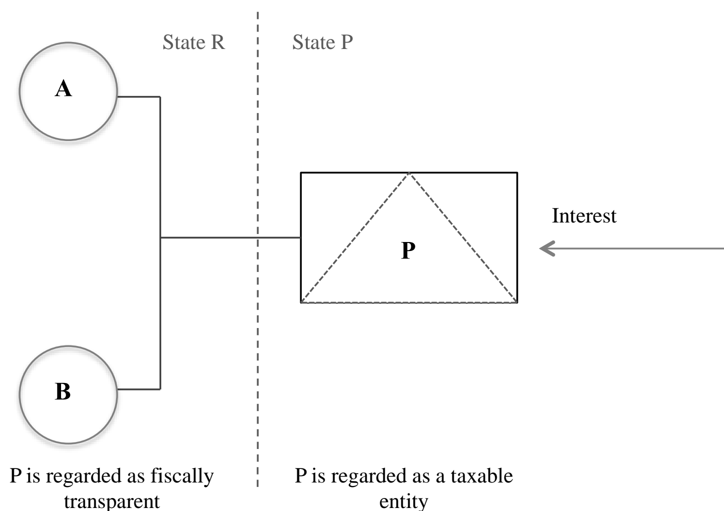


Figure 79: Case A

Let us first analyze the solution given by Article 1(2) OECD Model without considering the application of the domestic *reactive coordination rule*.

As stressed in Chapter IV, the preconditions of Article 1(2) OECD Model are met, since there is an entity considered as fiscally transparent by one of the Contracting State, which is receiving income from the other Contracting State and that income is allocated to the partners, who are residents of the State considering the entity as tax transparent. Therefore, according to Article 1(2) of the treaty R-P, partners A and B should be granted the benefits of the tax treaty R-P. On the other hand, according to Article 11 of the treaty R-P, State P should apply a reduced WHT of 10% on the gross amount of interest, but only to the extent partners A and B are regarded as the beneficial owners of the interest. The conflict between the two provisions is thus evident.[1651] In simple words, if State P limits its taxing rights in application of Article 1(2) of the treaty R-P, it would be only because State R characterizes the entity (organized in State P) in a different manner.[1652]

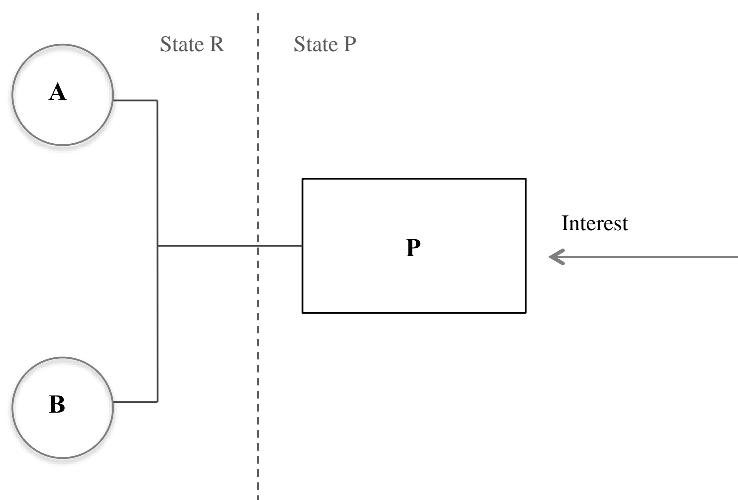
The result is certainly unfair from the State of source's perspective. If one assumes that neither Article 1(2) OECD Model nor the principles of the

[1651] *Supra* Chapter IV, Section 5.3.1.

[1652] *See* as an alternative to the dichotomy between the solution of Article 1(2) OECD Model and the beneficial ownership requirement of Article 11, the "deemed" *beneficial owner* proposed by some scholars. *Supra* Chapter IV, Section 5.3.1.1. When applying the solution to this hypothetical, the conflict is pragmatically solved deeming A and B as the *beneficial owners*, although it does not justify why the characterization in the State of source, i.e. where the entity is organized, should be completely disregarded. *Supra* Section 5.3.1.2. For additional comments from the author to this proposal, see *supra* Section 5.3.1.3.

OECD Partnership Report apply, the transaction above should remain as a domestic transaction, because for State P purposes, the payment is being made to a domestic entity, which is considered as taxable in its country of organization. Nevertheless, the characterization of the entity by State R is the sole factor that determines the application of the treaty R-P, and thus, the limitation of taxing rights in the State of source. In simple words, it is the characterization in State R that makes the transaction relevant for bilateral tax purposes.

Let us now assume the application of the *reactive coordination rule* implemented domestically both in State R and State P.



State R and State P consider Entity P as tax opaque, because of the application of the *reactive coordination rule.*

Figure 80: Case A after the application of the reactive coordination rule

In such a case, the hybrid entity mismatch would have been solved even before the application of the R-P treaty. Indeed, according to the *reactive coordination rule,* State R should follow the characterization of the entity in its country of organization, i.e. State P in our case. As State P and State R treat the entity as tax opaque, Article 1(2) and the whole treaty R-P are not longer applicable. In other words, the interest payments to entity P turns back to be a pure domestic concern, which seems to be at least a fairer position from the State of source's perspective, since this treaty applied before by the sole different tax characterization of entity P in the State of the residence of its partners.

Nevertheless, the application of the *reactive coordination rule* in this case might potentially generate double taxation if the income is also taxed as undistributed profits at the level of the partners of entity P, now regarded by States R and P as a taxable entity. For this purpose, it will be necessary that the domestic design of the CFC rules in State R ensure a tax credit for the taxes already paid in State P,[1653] or that CFC rules are simply not applied in this case.

3.1.2. Case B

Let us assume now that Entity R is organized in State R and has two owners, A and B, who are also residents of State R. Accordingly, some

[1653] For example, I.R.C. Sec. 960 provides for a FTC with respect to the taxes paid at the level of the foreign subsidiaries. If the credit is claim by Corporations, the applicable provision is I.R.C. Sec. 902. Likewise, the deemed FTC under Sec. 960 is available for taxes paid by subsidiaries until the sixth tier. US: I.R.C. Sec. 960 and I.R.C. Sec. 902.

interest payments are paid from State P. While State R considers entity R as tax opaque, State P considers it as tax transparent. State P has also a general WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

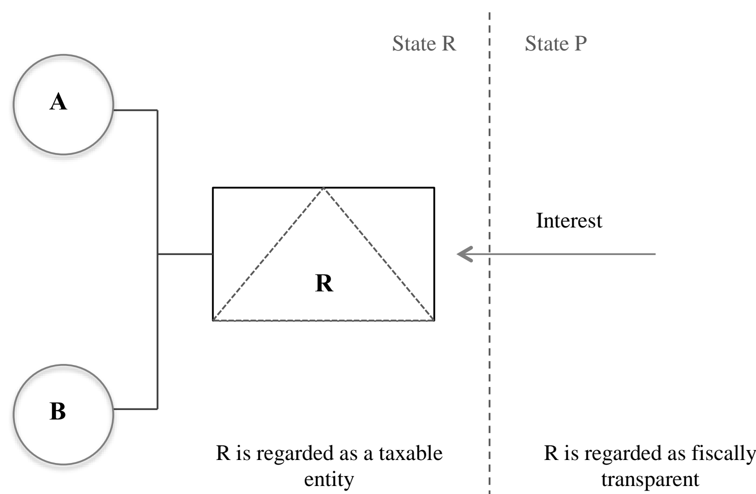


Figure 81: Case B

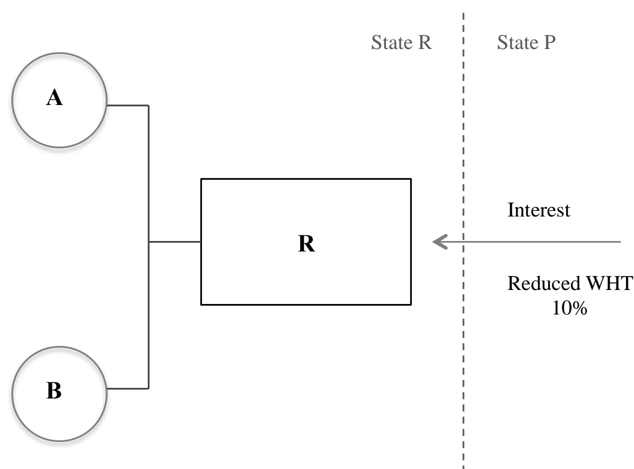
Article 1(2) of the treaty R-P acts in this case as denying partners A and B the benefits of the treaty and ensuring that the benefits of this are allocated to entity R.[1654] Accordingly, Article 1(2) of the treaty R-P clarifies who is entitled to claim the double tax relief in the State of residence under Article 23 of the same treaty.[1655] However, however, State P will, most probably,

1654 *Supra* Chapter IV, Section 5.2.1.2.
1655 Id.

not consider entity R as the beneficial owner for purposes of Article 11 of the treaty R-P, denying thus the reduced WHT at source.[1656]

Let us now assume the application of the proposed *reactive coordination rule* at a domestic level first. According to the rule, State P should follow the characterization of the entity R in its country of organization, i.e. State R. As State R considers the entity as opaque, State P by its own domestic law will consider it also as opaque. Therefore, as a result of the pre-coordination in the characterization of entity R at a domestic level, Article 1(2) becomes irrelevant, because none of the Contracting States treat the entity as tax transparent.

[1656] The alternative "deemed" *beneficial owner* rule analyzed in *supra* Chapter IV, Section 5.3.1.1, applies in this case distinguishing two situations: a) if entity R is not considered as a nominee, agent or other intermediary as per the analysis of State P, entity R is "deemed" as the beneficial owner. However, if entity R is a nominee, agent or other intermediary as per the analysis of State P, the rule states that State P should look at the members A and B. As both are individuals (not fiscally transparent), Article 1(2) *"is not in play"*. This author understands thus that Article 11 should apply as to reduce the WHT at source with respect to A an B, who are the beneficial owners, regardless the tax characterization of entity R in State R. In other words, Article 1(2) might not apply as to deny the benefits of the treaty to partners A and B. The solution is pragmatic and deals in such a manner with the conflict between the two provisions, i.e. Article 1(2) and 11 OECD Model.



There is no need to apply Article 1(2) OECD MC, because after the application of the *reactive coordination rule*, both countries treat Entity R as tax opaque.

Figure 82: Case B after the application of the reactive coordination rule

The application of the *reactive coordination rule* at a domestic level brings thus similar results at a tax treaty level as if Article 1(2) would have been applied, although without conflicting with the *beneficial ownership* requirement of Article 11 of the treaty R-P. State P thus, on one hand, will grant a reduced WHT of 10% in this case, because it considers entity R as tax opaque and the beneficial owner.[1657] State R, on the other hand, would

[1657] If for any reason, State P considers that entity R is a nominee, agent or other intermediary, a rule "deeming" A and B as the *beneficial owner* would be necessary. In such a case, Article 11 should apply as to reduce the WHT at source with respect to A an B, regardless the tax characterization of entity R in State R. This might be another case of "switch-off" of the *reactive coordination rule*. For a rule deeming the beneficial owners, see *supra* Chapter IV, Section 5.3.1.1.

tax the interest at the level of entity R, but granting a relief of double taxation according to Article 23 of the treaty R-P.[1658]

Although the outcomes of the hypothetical are practically the same either by application of Article 1(2) OECD Model (without considering the *reactive coordination rule*) or after the domestic application of the *reactive coordination rule* domestically, because in both cases the characterization of the entity in its country of organization is followed,[1659] there are still reasons to prefer the *reactive coordination rule*. On one hand, the pre-coordination of the characterization of the entity provides to certain extent more certainty as regards to the application of the treaty R-P and the allocation of taxing rights. The above is because the analysis of the treaty provisions will start from the basis that both Contracting States already agreed, domestically, in the characterization of the entity, i.e. as tax opaque in this case. Thus, the discussion will remain only on the application of Article 11 OECD Model, being perhaps the determination of the beneficial owner for purposes of paragraph 2, Article 11 OECD Model the only real issue. Yet, the fact of having the source State treating the payee entity as a taxable entity under its domestic law might certainly simplify the answer of who is the beneficial owner in that case. If not, a deeming rule might apply, which should have the effect of switching-off the *reactive coordination rule*.[1660]

[1658] This result is even achieved without the proposed *reactive coordination rule* and by the sole application of Article 1(2) of the treaty R-P.
[1659] The home country and the country of residence coincide in this case.
[1660] *Supra* n. 1657.

The are however other reasons to prefer a coordinated solution given at a domestic level first, rather than relying exclusively on the application of Article 1(2) OECD Model in these cases. Let us assume, e.g. that A and B in the original example of Case B were residents of State P (source State), which considers the entity R as tax transparent. According to the application of Article 1(2) of the treaty R-P, the owners of entity R, A and B, might now be potentially entitled to obtain a reduced WHT. Nevertheless, this result seems to be absurd, because according to Article 11(1) OECD Model, the requirement that an interest arising in a Contracting State is paid to a resident of the other Contracting State would not be met, making the treaty anyway inapplicable.[1661] The interest payments in this case would arise in the same State where the recipients of the payments are residents; therefore, it would not go beyond of being a domestic situation. However, nothing would prevent State R to tax the interest, because entity R is indeed a taxable entity there. The double taxation outcome in this case seems to be unavoidable.

[1661] Article 11(1) OECD Model states: "Interest *arising in* a Contracting State and *paid to* a resident of the other Contracting State may be taxed in that other State"(emphasis added).

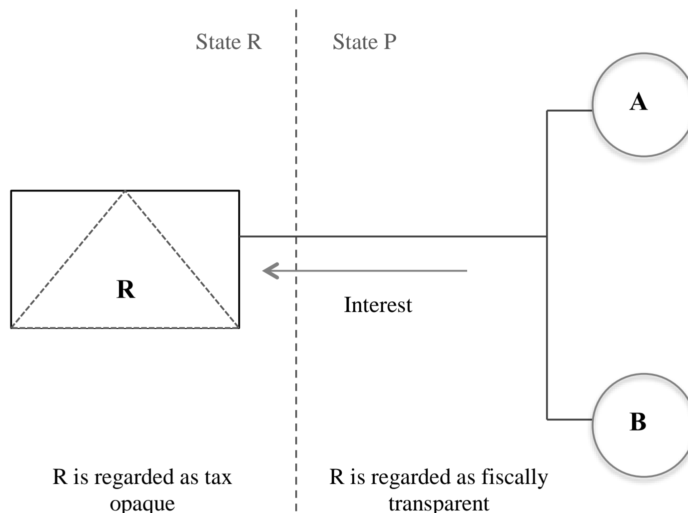


Figure 83: Case B (variation)

The risk disappears, however, considering the application of the *reactive coordination rule*. Since the rule applies domestically and prior to the application of the treaty, there will be no country treating the entity as tax transparent, and thus, there would not be the need to apply Article 1(2) OECD Model. The above thus ensures, on one hand, a consistent result as if the Article 1(2) OECD Model was applied and, on the other hand, avoids potential conflicts.

3.1.3. Case C

Entity P is organized and resident in State P and has two owners: A and B, who are residents of State R. Accordingly, Entity P receives interest payments from a debtor in State P. While State R considers the entity as tax

opaque, State P considers the same entity as fiscally transparent, and thus, that the income is allocated to the partners A and B. Entity P is thus a reverse hybrid entity. State P has a general WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

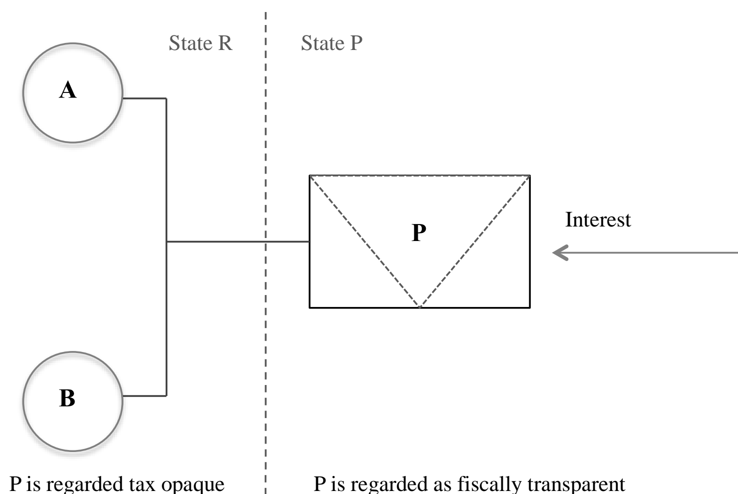
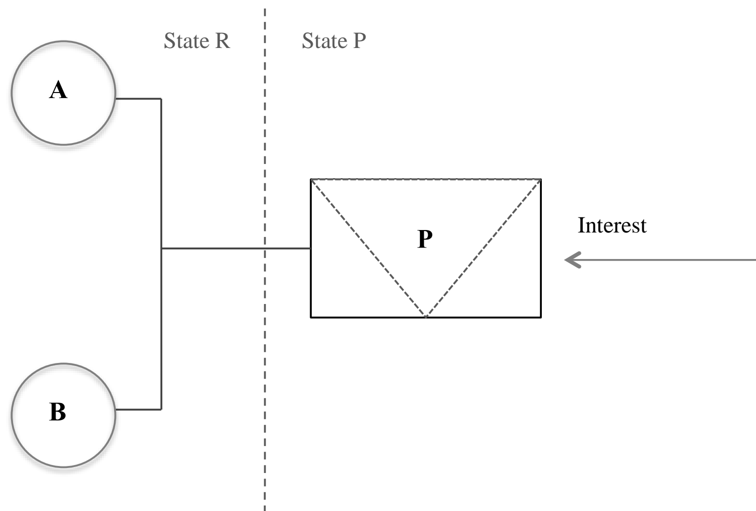


Figure 84: Case C

Article 1(2) OECD Model applies in this case as to deny the benefits of the treaty to A and B and to confirm that the payments of interest in this case is a mere domestic situation. Therefore, the solution of Article 1(2) OECD Model maintains the transaction as a domestic one, which, however, does not prevent that A and B might recognize undistributed profits generated at the level of entity P, taxed in country R as CFC income. Likewise, the

solution of Article 1(2) does not prevent that State P still considers A and B as the beneficial owners of the income.[1662]

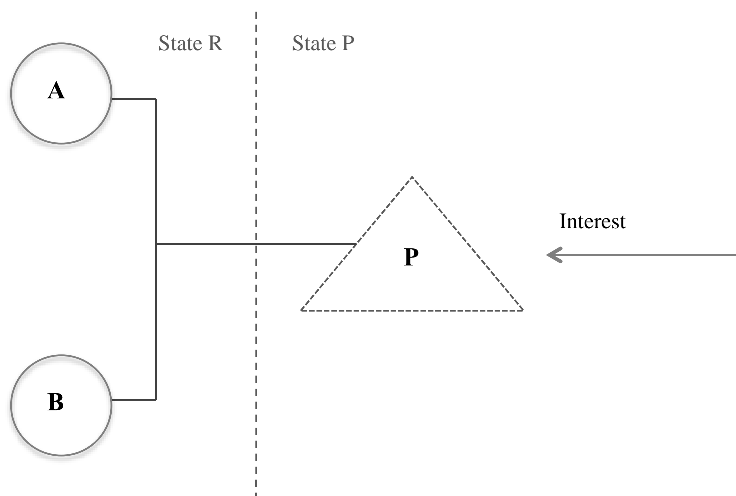


According to Article 1(2) OECD Model, the interest payments are not allocated to A and B. The transaction remains as a domestic one. The characterization in State R prevails.

Figure 85: Case C before the application of the reactive coordination rule

If we now consider that State R and P introduced the *reactive coordination rule* at a domestic level, and thus, that the characterization of the entity is coordinated before the application of the tax treaty between R-P, the solution to the case might be slightly different.

[1662] *Supra* Chapter IV, Section 5.2.1.3.



State R and State P consider Entity P as fiscally transparent because of the application of the *reactive coordination rule*. Article 1(2) OECD Model is anyway applied and allocates the interest payments to A and B. Both receive the benefits of the treaty between R-P.

Figure 86: Case C after the application of the reactive coordination rule

Firstly, the *reactive coordination rule* attempts to coordinate according to the characterization rules in the entity in its home country, i.e. where the entity is legally organized. Therefore, in this case, entity P is organized in State P, where the entity is originally characterized as tax transparent; therefore, State R should also treat entity P as tax transparent. The above implies that both countries will consider that income flows through entity P and it is finally allocated to partners A and B. Secondly, the tax treaty between R-P will come into play. For this purpose, and considering that now both countries will consider the entity P as tax transparent, Article 1(2) of the treaty R-P should apply. The solution of Article 1(2) in this case will be

to grant A and B the benefits of the treaty R-P, which in this case consists in a reduced WHT of 10% applied on the gross amount of interest paid.

As noted, therefore, the solutions of Article 1(2) OECD Model, *ex-ante* and *ex-post* the application of the *reactive coordination rule* at a domestic level, are different. While the solution of Article 1(2) OECD Model *ex-ante* is to deny the benefits of the treaty to A and B, making the characterization of the entity in the State of residence to prevail and keeping the transaction as a domestic one, the solution *ex-post* goes in the opposite direction: it allocates the income to A and B, and thus, it grants them the benefits of the treaty between R-P. In other words, it reduces the WHT that A and B might suffer in the State of source, and it grants double taxation relief in the country of their residence.[1663]

The solution of Article 1(2) OECD Model *ex-post* the application of the proposed *reactive coordination rule* seems thus to be preferable. On one hand, it solves the disparity in the characterization of the entity, which is the core of the issue with regards to hybrid and reverse hybrid entities. The above is made at a domestic level, which, to certain extent, allows the application of the treaty in a more consistent manner. Indeed, Article 1(2) OECD Model is not a provision created to deal with hybrid entities and reverse hybrid entities purely. On the contrary, it deals with items of income

[1663] As both countries are considering Entity P as tax transparent, even though the entity withheld the tax and paid it, that WHT would be understood as flowing to the partners A and B as if they directly paid that tax. This is indeed the basic principle of tax transparency. Therefore, the tax credit or exemption in the country of residence should be granted on the WHT paid.

received by or through an entity that is considered as fiscally transparent by, at least, one of the Contracting States in order to avoid conflicts of allocation of income. That is its original intend. Indirectly, however, and when hybrid or reverse hybrid entities are involved, it makes the characterization of the State of residence to prevail. Nevertheless, when the solution to the disparities in the characterization of entities was already provided within the domestic laws, i.e. when both countries previously agree on the characterization of the entity either as tax transparent, the application of Article 1(2) OECD Model results more directly connected with the aim of preventing conflicts of allocation of income.

On the other hand, allocating the income to partners A and B seems to be more logic since the perspective of State P, the source State, because most probably A and B are regarded as the *beneficial owners* of the interest under the source State's perspective and not entity P, which is seen originally as fiscally transparent in State P. In other words, coordinating the characterization of the entity as per the one given in its home country, which coincides with the source State in this case, and then applying the treaty R-P, i.e. Article 1(2), brings a solution more coherent from the perspective of the State of source, rather than just applying Article 1(2) OECD Model with the existing disparity in the characterization of the entity at a domestic level. This is because for State P's perspective, the transaction was never purely domestic, as pretended in the solution of Article 1(2) OECD Model without considering the application of the *reactive coordination rule,* but rather a bilateral one. The reason is simple: entity P was since its organization in

State P regarded as fiscally transparent and considered that income should be allocated to A and B.[1664]

Finally, and although not relevant under the author's perspective, it might be interesting to see also that the solution of Article 1(2) OECD Model *ex-post* the application of the *reactive coordination rule* might be relevant to ensure taxation in at least one country as well. Indeed, if we consider the application of Article 1(2) OECD Model without the proposed *reactive coordination rule*, it would imply that the interest payments are not taxed neither in State P (entity P is tax transparent) nor in State R (Article 1(2) OECD Model considers that income is not allocated to A and B). The only option to ensure taxation in this case would be to rely on the application of CFC rules in State R. Nevertheless, once Article 1(2) OECD Model is applied after the coordination of the characterization of entity P at a domestic level in this case, i.e. *ex-post* the application of the domestic *reactive coordination rule*, income is immediately allocated to A and B, which, to certain extent, allows to ensure taxation in State R, without relying exclusively in the application of CFC rules. Therefore, the outcome of the *reactive coordination rule* as regards to tax treaties should equally satisfy skeptics and less skeptics on single taxation.

[1664] This solution is also clearly more consistent than deeming entity P as the *beneficial owner*. See the solution to example 3, *supra* Chapter IV, Section 5.3.1.2.

3.1.4. Case D

Let us assume now that Entity R is organized in State R and has two owners, A and B, who are also residents of State R. Accordingly, some interest payments are paid from State P. While State R considers entity R as tax transparent, State P considers it as a taxable entity. State P has also a general WHT on interest paid abroad of 30%, calculated on the gross amount of payments.

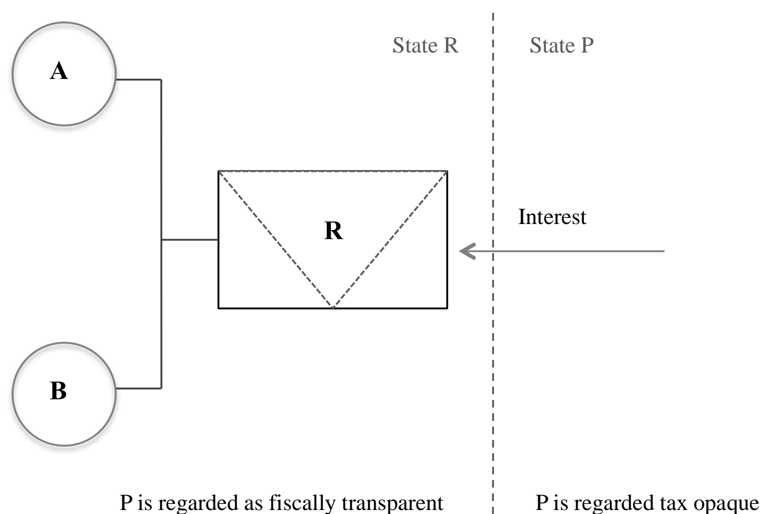
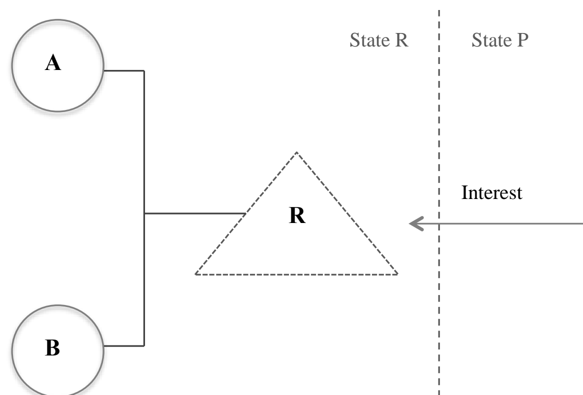


Figure 87: Case D

Article 1(2) of the treaty R-P clarifies that the partners A and B are the ones who should claim the benefits of the treaty R-P. However, the application of Article 1(2) of the treaty R-P might still leave open some uncertainty as

regards to the application of the treaty between State R and State P, because A and B are not regarded as the beneficial owner of the payments.[1665]

Nevertheless, if the domestic *reactive coordination rule* is applied first, both State R and State P will agree in the tax treatment given to entity R as per the characterization in its home country, i.e. State R. The above will not prevent Article 1(2) to apply, but it will ensure that the benefits of the treaty are allocated to A and B, who should be now also regarded as the beneficial owners under State P's perspective.[1666]



P is regarded as fiscally transparent in State R and State P after the application of the *reactive coordination rule*. The solution of Article 1(2) OECD Model should not thus conflict with any of the countries involved since they both have agreed in coordination the characterization of entity R according to the rules of its home country.

Figure 88: Case D after the application of the reactive coordination rule

[1665] *Supra* Chapter IV, Section 5.2.1.4.
[1666] Since State P will domestically consider entity R as fiscally transparent, it will most probably look at the owners A and B as to determine who are the beneficial owners of the interest payments. This solution coincides with the outcome in case a "deemed" *beneficial ownership* rule is applied. *Supra* Chapter IV, Section 5.3.1.2, ex. 4.

In addition, if A or B or both were residents of State P, however, the treaty R-P would not be applicable, because in such a case the requirement of Article 11(1), which provides that interest arising in a Contracting State and paid to a resident of the other Contracting State, would not be met. This result should, nevertheless, be considered irrelevant since for both State R and P, the entity R is considered as tax transparent.[1667]

3.2. Triangular cases using *hybrid entities* and *reverse hybrid entities*

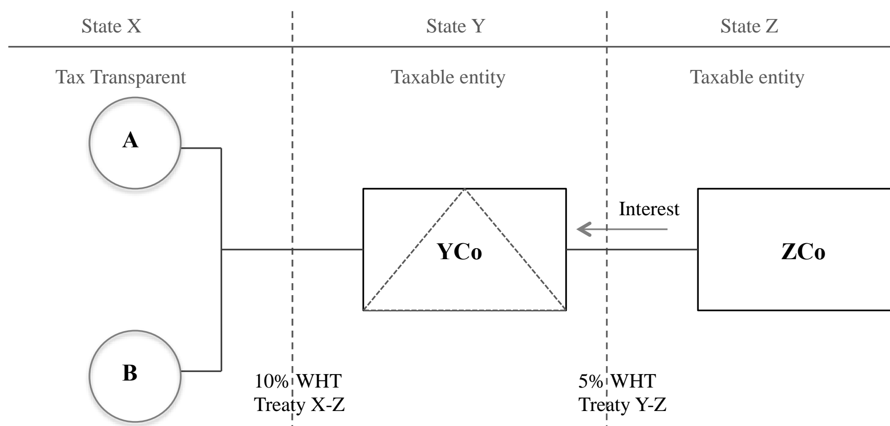
This Section contains three study cases analyzing the implication of the *reactive coordination rule* within tax treaties, but assuming now exclusively triangular situations involving three given countries X, Y and Z. As well as in the bilateral cases, Cases E, F and G of this Section demonstrate that the effects of the application of the *reactive coordination rule* might bring more positive outcomes increasing simplicity and consistency in the application of tax treaties. Likewise, it has an indirect positive impact with respect to the position of source States when compared with pure solutions granted by Article 1(2) OECD Model, in absence of a previous domestic coordination.

3.2.1. Case E

Let us assume that YCo is an entity incorporated in State Y, which has two partners, A and B, who are residents of State X. Accordingly, YCo has a

[1667] Entity R is just a pass-thru entity. Interest payments will not be subject to tax in State R and State P will apply a WHT with respect to the partners A and B. There is thus not even a risk of double taxation.

subsidiary in State Z, i.e. ZCo, which is financed by a loan granted by YCo and because of which it receives interest payments back from State Z.[1668] YCo is considered as a taxable entity in State Y and in State Z. However, it is regarded as a fiscally transparent entity in State X. Likewise, although Country Z applies a general WHT on interest paid abroad of 30% of the gross amount paid, the treaty State X/State Z provides for a reduced WHT of 10% while the treaty State Y/State Z provides for a reduced WHT of 5%.



While Yco is regarded as tax transparent in State X, State Y and Z consider it as tax opaque. Likewise, State Z applies a general WHT of 30% on the payments of interest abroad, although the treaty State X/State Z provides for a reduced WHT of 10% while the treaty State Y/State Z provide for a reduced WHT of 5%.

Figure 89: Case E

As stressed in Chapter IV,[1669] according to the treaty Y-Z, State Z should reduce its WHT to 5% according to Article 11 and State Y should grant a

[1668] The example assumes that the loan and interest are arm's length.
[1669] *Supra* Chapter IV, Section 5.2.2.1.

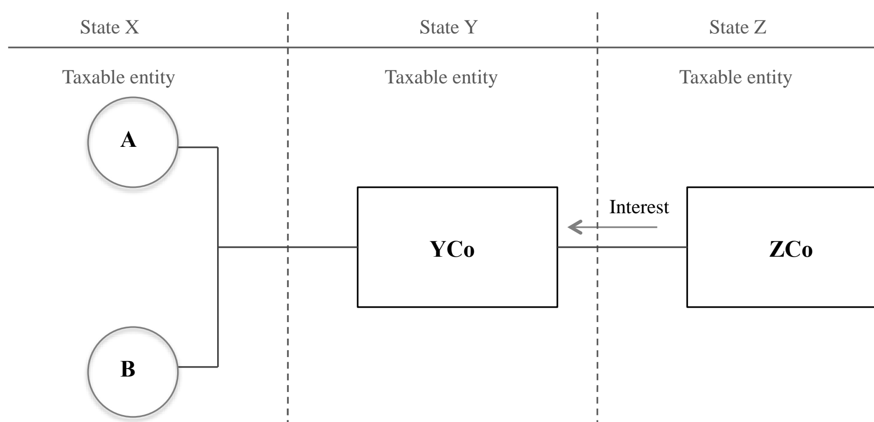
relief of double taxation as per Article 23. It is clear that the income and the benefits of the treaty are allocated to YCo.[1670] The treaty X-Z, on the other hand, is also applicable. According to Article 1(2) treaty X-Z, there is income received by or through an entity or arrangement considered as fiscally transparent by one of the Contracting States, and which is allocated to the partners A and B, who are also residents of the State treating the entity as tax transparent, i.e. State X. Therefore, in principle, State Z should accomplish with both treaties, which, under the principles of the OECD Partnership Report would mean that State Z must apply the lower WHT rate (5%) as regards to both treaties.[1671] This solution is not only in conflict with the beneficial owner requirement of Article 11, but it seems to be completely arbitrary and unfair for the State of source.[1672]

Let us now assume the application of the *reactive coordination rule*. According to the proposed rule, State X will apply the same characterization that YCo has in its country of organization, i.e. State Y. Therefore, the analysis regarding which tax treaty is applicable in this case will start from the basis that all three States involved agree in the fact that YCo is indeed a taxable entity.

[1670] Article 1(2) treaty Y-Z does not apply, because YCo is considered as a taxable entity in both Contracting States. Id.

[1671] OECD Commentary on Article 1 concerning the persons covered by the Convention, para. 6.5.

[1672] *Supra* Chapter IV, Section 5.2.2.1 and Section 5.3.1 and 5.3.3.



The effect of the *reactive coordination rule* is that all three States in this hypothetical consider now YCo as a taxable entity, which is the original characterization given in its country of organization. As a consequence of the above, Article 1(2) OECD Model is not longer applicable.

Figure 90: Case E after the application of the reactive coordination rule

Therefore, the application of the *reactive coordination rule* solves the disparity in the characterization of entities before the tax treaty is applied, bringing simplicity in the application of tax treaties themselves. For example, after the application of the *reactive coordination rule*, Article 1(2) OECD Model is no longer applicable (or necessary) because all three countries involved have previously agreed that YCo is indeed a taxable entity. Consequently, Article 11 of the treaty Y-Z, the only treaty applicable in this case, will determine the allocation of taxing rights. In this case, there is almost complete certainty that the *beneficial owner* is YCo.[1673] The non-

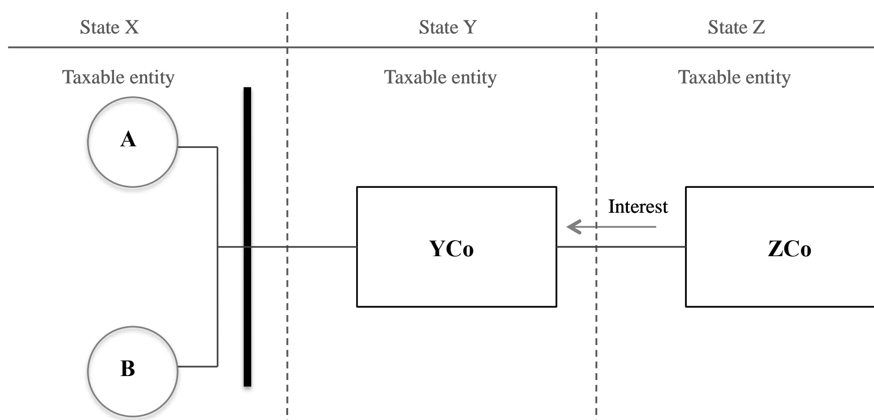
[1673] In this regard, this solution seems to be preferable than applying a "deemed" *beneficial ownership*. *Supra* Chapter IV, Section 5.3.1.2, ex. 5. This author does not even see the need of a "deeming rule" in case State Z considers the entity as a nominee, agent or other intermediary, because if State Z would consider YCo as a nominee, agent or other intermediary (i.e. not as the beneficial owner), the treaty Y-Z would be simply not

application of the X-Z treaty, on the other hand, is coherent with the object and purpose of tax treaties, because since State X does not longer consider BCo as tax transparent, it will not consider that any income is allocated to A and B, residents of State X, and thus, there will be no longer the risk of double taxation. The *reactive coordination rule* thus helps clarifying the application of tax treaties in this triangular case.[1674]

The solution given by the *reactive coordination rule* is also fairer with the position of State Z, i.e. the source State, when tax treaties come into play. Indeed, State Z will no longer be obliged to limit its taxing rights at source just because a third country's characterization of an entity differs from the characterization given to that entity where this is organized and with whom the source State does not disagree in the characterization of that entity. In other words, the domestic coordination in the characterization of the entity (YCo) helps avoiding the results of Article 1(2) OECD Model, which, solely due to the tax transparent treatment in State X, makes the treaty X-Z applicable.

applicable. The determination of the *beneficial owner* is a rather exclusive task of the State of source.

[1674] The solution in light of the *reactive coordination rule* also resemblances the U.S. tax treaty practice within the treaty United States/Poland, analyzed in *supra* Chapter IV, Section 4.3.1.1.1.



The only relevant applicable tax treaty in this case, after the *reactive coordination rule,* is the tax treaty Y-Z, which originally should have been the only treaty applicable, because Y-Z never disagreed in the characterization of YCo. The solution given by Article 1(2) OECD Model, in absence of the domestic coordination, obliges State Z to limit also its taxing rights with respect to State Y by the sole reason that this country treats YCo differently. After the application of the *reactive coordination rule,* this outcome is avoided and the treaty X-Z is not longer applicable.

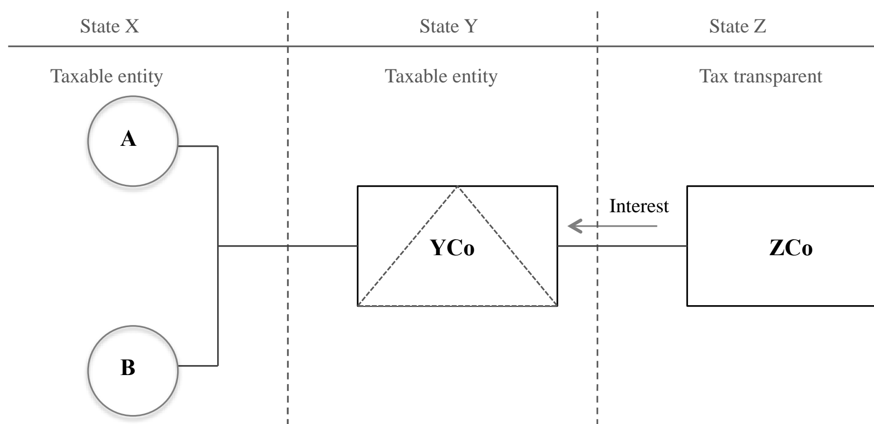
Figure 91: Case E and another effect of the reactive coordination rule

Regardless the above, the result after the application of the *reactive coordination rule* in this case might, however, potentially generate double taxation if the income is also taxed as undistributed profits at the level of the partners of YCo, which is now regarded by States X, Y and Z as a taxable entity. For this purpose, it will be necessary that the domestic design of the CFC rules in State X ensure a tax credit for the taxes already paid in State P.[1675]

[1675] *Supra* n. 1653, as regards to Case A at *supra* Section 3.1.1.

3.2.2. Case F

Case F considers the same facts as Case E, with the sole difference that YCo is treated as fiscally transparent in State Z while it is regarded as a taxable entity in State X and Y. Likewise, this hypothetical also assumes that all applicable treaties provide similar reductions of WHT of 10% at source.



While State X and Y considers YCo as a taxable entity, State Z considers it as fiscally transparent.

Figure 92: Case F

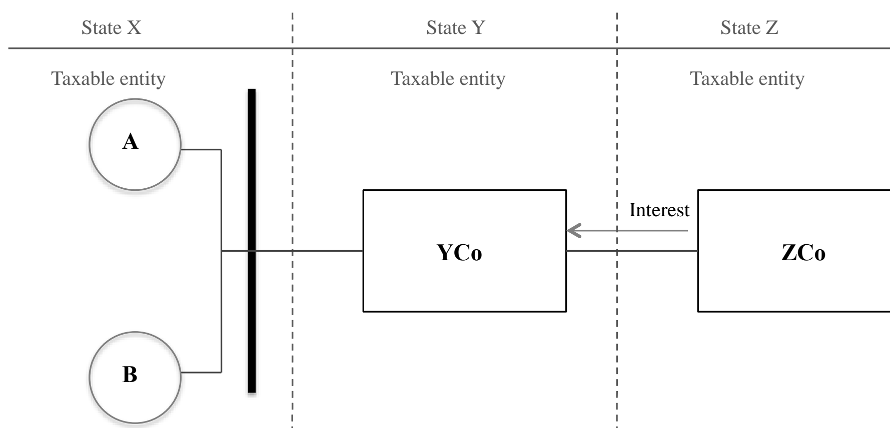
As regards to the treaties Y-Z and X-Z, Article 1(2) acts as to deny A and B the benefits of the treaties and to ensure that these benefits are allocated to YCo. Nevertheless, in both cases Article 1(2) does not solve the dichotomy with the *beneficial ownership* requirement of Article 11. In other words,

while Article 1(2) grants in both cases the benefits of the treaty to YCo, Article 11, in both treaties, considers A and B as the beneficial owners.[1676]

If we now assume the application of the domestic *reactive coordination rule*, the results seem to be more consistent from a tax treaty perspective. Indeed, as noted below, the immediate effect of the application of the rule is that State Z would respect the characterization of YCo according to the domestic law of State Y, i.e. the home country of the entity. This is to say YCo would be regarded as a taxable entity for the three States involved in this hypothetical. Therefore, on one hand, there are no doubts that the treaty Y-Z will be fully applied in this case. The above means that State Z will apply a reduced WHT to YCo, and State Y, subsequently, will tax the interest payments, but it will apply also a relief of double taxation for the full amount of WHT.[1677] On the other hand, it confirms that the treaty X-Z will not be longer applicable.

1676 *Supra* Chapter IV, Section 5.2.2.2.

1677 YCo will most probably be the beneficial owner from State Z's perspective. In addition, no "deemed" *beneficial owner* rules would be needed, because even if State Z would consider YCo as a nominee, agent or other intermediary (i.e. not as the beneficial owner), then the treaty Y-Z would be simply not applicable. The determination of the beneficial owner is a rather exclusive task of the State of source. Compare the solution of the "deemed" *beneficial owner* rule in supra Chapter IV, Section 5.3.1.2, ex. 6.



The application of the *reactive coordination rule* does not only eliminate the hybrid entity mismatch, but it clarifies the doubts with respect to which tax treaty is applicable in this case. Since State Z recognizes the characterization of YCo given in its country or organization, the interest payments are allocated to YCo and the treaty Y-Z is the only one applicable.

Figure 93: Case F after the application of the reactive coordination rule

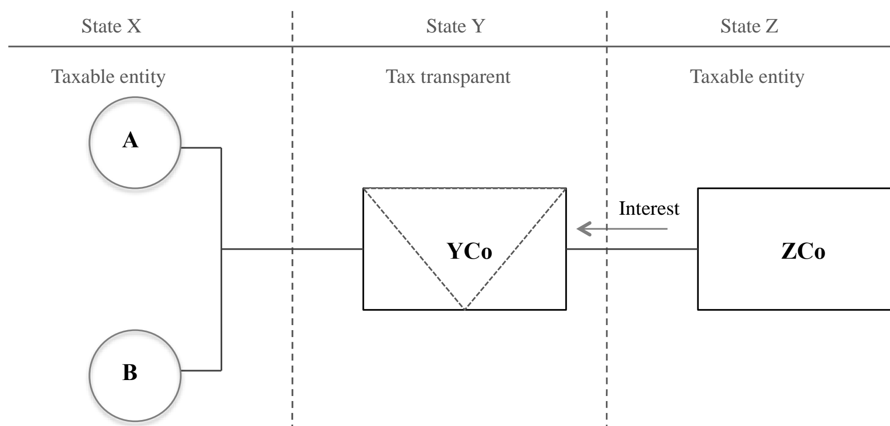
As it can be noted, therefore, after the application of the *reactive coordination rule* domestically, Article 1(2) OECD Model is not longer needed. Thus, the scope of the provision is again restricted, although justified in the simplicity and consistency of the application of tax treaties. As we have seen before, Article 1(2) OECD Model was not able to solve in this hypothetical the disparity in the characterization of YCo, which derived in an improper or incomplete application of Y-Z tax treaty. This issued is, however, immediately disregarded with the application of the *reactive coordination rule*, which does not only solve the disparity *ex-ante,* but it clarifies the bilateral situation and the tax treaty applicable in this case.

Finally, and as well as in Case E, the result after the application of the *reactive coordination rule* might generate double taxation of income: once by State Y on the interest received, and once again on the attributed amount of undistributed profits at the level of A and B (i.e. CFC rules). For this purpose, it will be necessary that the domestic design of the CFC rules in State X ensure a tax credit for the taxes already paid in State P.[1678]

3.2.3. Case G

Case G considers the same facts as Case E, with the sole difference that YCo is regarded as a tax transparent entity in State Y, its country of organization, while as a taxable or tax opaque entity for State X and Z purposes.

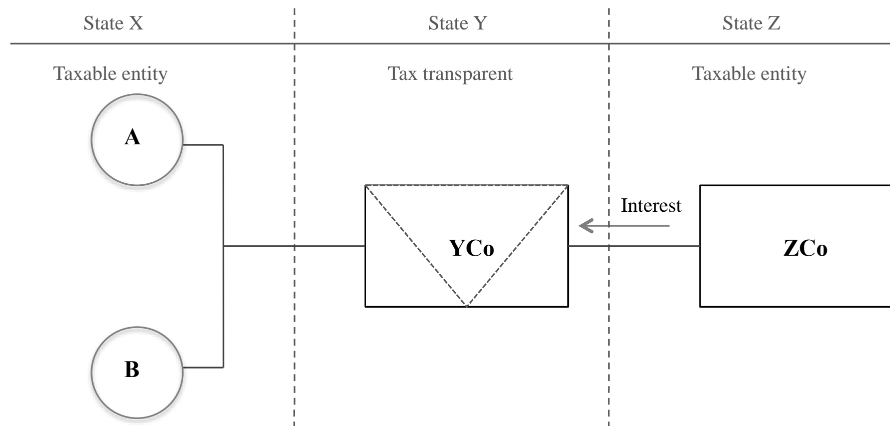
[1678] *Supra* n. 1653, as regards to Case A at *supra* Section 3.1.1.



While State Y considers YCo as a fiscally transparent entity, States X and Z consider it as a taxable or tax opaque one. YCo is thus a *reverse hybrid entity.*

Figure 94: Case G

Once again, the solution to this case, without considering the impact of the proposed *reactive coordination rule*, must be analyzed considering first the application of the treaty Y-Z. In this regard, as per Article 11 of the Y-Z tax treaty, State Z will consider that interest are being paid to a resident of State Y. Therefore, in principle, State Z should restrict it WHT from 30% to 10% as per the treaty between Y-Z. However, State Y will consider that such interest is not received by YCO, which is considered in that country as tax transparent. Therefore, it will rarely grant the benefit of the treaty Y-Z to YCo. Article 1(2) of the treaty Y-Z works thus denying the benefits of the treaty to A and B, which are not considered residents of State Y.

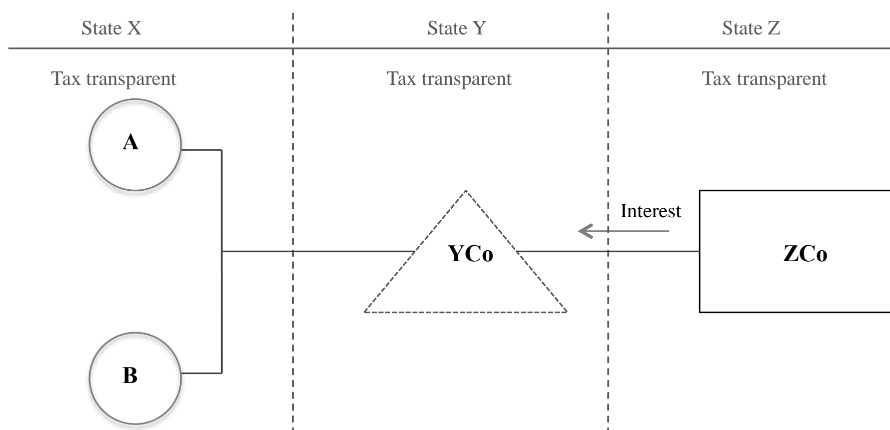


The treaty between Y-Z applies in the perspective of State Z. This country would thus, in principle, limit its taxation rights. However, from the perspective of State Y, there is no interest payment received by a resident of State Y, which means that the benefits of the treaty should not be granted to YCo. Likewise, Article 1(2) OECD Model would grant the benefits the treaty Y-Z if A and/or B were residents of State Y. Nevertheless, that does not occur in this hypothetical.

Figure 95: Case G and its solution before the application reactive coordination rule

Accordingly, as regards to the treaty X-Z, it is very clear that this treaty does not apply at all, because both State Z and State X consider that the interest payments are paid to YCo, which is a resident of State Y.

Let us now assume that the domestic *reactive coordination rule* applies first coordinating the characterization of YCo in the three countries according to its original characterization in its country of organization, i.e. State Y.



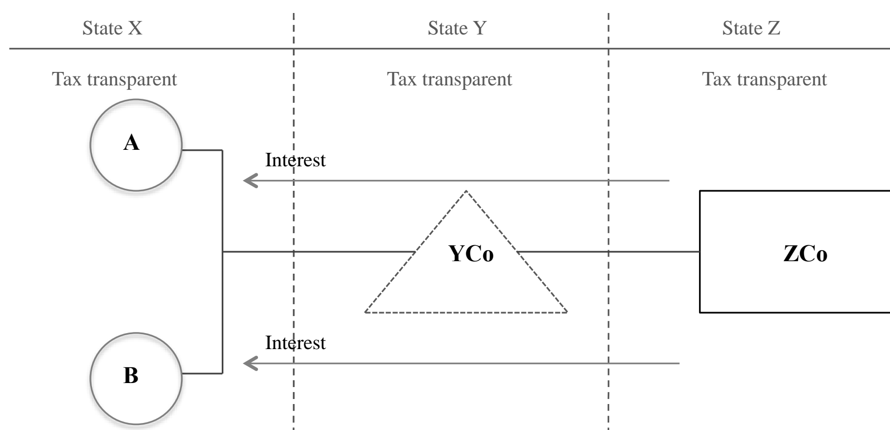
Scenario after the application of the *reactive coordination rule.*

Figure 96: Case G after the application of the reactive coordination rule

As a consequence of the coordination in the characterization of YCo according to State Y's rules, the treaty Y-Z is no longer applicable. The reason of the above is that now, both for States Y and Z, consider YCo as fiscally transparent, and thus, not a resident for purposes of the treaty. Both countries consider now that the income flows through YCo until the final partners A and B, residents of State X. The only relevant treaty thus is the one between X-Z.

Accordingly, the requirements of Article 11 of the treaty X-Z, in terms of the existence of income arising in one Contracting State and paid to a resident of the other Contracting State, are met in this case. Likewise, State Z considers that the reduction of WHT at source proceeds, because interest

payments are paid to the *beneficial owners* of them.[1679] The application of Article 1(2) of the X-Z treaty is also consistent with the above, allocating the benefits of the treaty between X-Z to A and B, residents of State X and the beneficial owners under State's Z perspective.



The only relevant treaty applicable is between X-Z. The solution of Article 1(2) OECD Model in this case, is consistent with the treatment that all countries give to the entity, allocating the benefits of the treaty between X-Z to A and B, residents of State X.

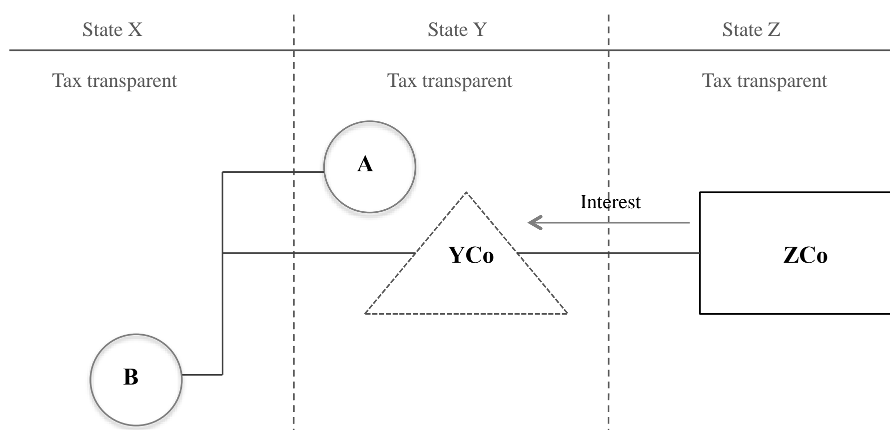
Figure 97: A more consistent tax treaty outcome

Although the solution after the application of the *reactive coordination rule* seems to be, in principle, a simple switch in the treaty applicable when compared with the solution without the proposed rule, it certainly brings a more coherent result from a tax treaty perspective. The above can be see, e.g. in the fact that State Z, the State of source, limits its taxation rights only

[1679] YCo is considered as a fiscally transparent entity in the State of source, and thus, most probably as a simple intermediary (not as the beneficial owner). However, A and B, who are individuals resident in State X, will be for sure considered as the beneficial owners.

with respect to the State of the final beneficiary of the income: A and B, the partners of YCo. This idea might coincide with the fact that, under State Z's perspective, partners A and B are the beneficial owners of the interest payments since State Z considers now YCo as fiscally transparent.[1680]

If we assume for a moment that A is resident of State X while B is resident of State Y, then both treaties Y-Z and X-Z would be applicable.



Due to the application of Article 1(2) OECD Model, part of the income would be allocated to A, who could claim the benefits of the treaty Y-Z. Likewise, the other part of the income would allocated to B, who could claim the benefits of the treaty X-Z. The source State X shall thus limit its taxing rights as regards to State Y and X.

Figure 98: Case G (variation)

Although this solution is legally consistent with the fiscally transparent treatment of YCo in all States involved, it might be arguable from a pure economic perspective in the State of source. However, the *reactive*

[1680] YCo acts in the hypothetical as a simple conduit company, i.e. the money is just flowing through the entity to the final beneficiaries.

coordination rule does not attempt the switch the preferences between residence and source States, but rather to achieve more balanced outcomes. In this case, therefore, this result should be assumed as a simple sunk cost since in a global perspective, there are other cases in which the State of source's position is certainly improved.

3.3. The "switch-off" and Article 1(2) OECD Model

As already stressed by the author, there might be cases in which tax benefits or disregarded transactions might result exclusively from the application of the *reactive coordination rule*.[1681]

A tax benefit might arise, on one hand, when an entity, considered as fiscally transparent in its country of organization, pays interest to a payee located in another country, and this country and the country of the investors (which are different ones), both consider the payer entity as non-transparent or tax opaque.[1682] Since the proposed rule attempts to coordinate the characterization of the according to the rule in its home country, i.e. all countries involved will treat the entity as fiscally transparent, a deduction might be created in the country of the investors only because of the application of the proposed rule.[1683] Similarly, on the other hand, a transaction might be disregarded by the sole application of the proposed rule in case, e.g. a *reverse hybrid entity* pays interest to its sole investors, which

[1681] A "switch-off" the rule was also discussed as regards to Case B, *supra* n. 1657.
[1682] *See* the example in supra Section 2.4.4.2.2.
[1683] Id.

after the application of the rule, should also consider the entity as tax transparent, and thus, disregard the payment and the loan associated to it.[1684] As the situations described above arise by the sole application of the proposed rule and might be misused for tax purposes, the author proposed a "switch-off" in the application of the *reactive coordination rule*.

A "switch-off" of the proposed rule might, however, negatively impact in the positive results that the rule brings within tax treaties, especially as regards to restrict the application of Article 1(2) OECD Model. Indeed, as noted already, once domestic coordination in the characterization of entities has been achieved, the application of Article 1(2) OECD Model is restricted exclusively to those cases in which the source or residence State, in a bilateral context, treat their own domestic entities as tax transparent, which could also, indirectly, brings better solutions for source States. Nevertheless, this concern lacks of practical considerations due to the reduced scope of Article 1(2) OECD Model.

As the author has already argued in this work, the scope of Article 1(2) Model is limited to cases in which an entity or arrangement is treated by one or both Contracting States as fiscally transparent, and which has "income derived by or through" that entity or arrangement. In other words, Article 1(2) OECD Model seems not to cover cases in which a tax transparent entity, either *hybrid* or *reverse hybrid*, does not receive income. These are exactly the cases in which the author has proposed a "switch-off" in the

[1684] *See* the example at *supra* Section 2.4.4.2.3.

reactive coordination rule, i.e. cases in which a *reverse hybrid entity* pays, but does not receive income. Therefore, even though the switch-off of the *reactive coordination rule* results in keeping the disparity in the characterization of the entity, its application does not impact within tax treaties, because Article 1(2) OECD Model does not apply to those cases in which the switch-off can be turned on either.

As a result, in all those cases in which the switch-off might be used, Article 1(2) OECD Model is also inapplicable. Therefore, the hybrid mismatch will remain. This outcome is, however, perfectly acceptable, since the proposed rule does not attempt to be a rule that harmonizes the characterization of entities for tax purposes in every sense. The above implies thus that there will be cases, which are not covered by the rule. Likewise, one could argue that the outcome of the transactions in which the switch-off applies did not generate any international tax policy concern before the application of the *reactive coordination rule*. Thus, they could rarely be a cause of concern now.

4. Final Remarks

The *reactive coordination rule* appears as an interesting alternative to re-focus the discussion as regards to the design of rules counteracting the potential misuse of hybrid and reverse hybrid entities. Indeed, and unlike other proposals discussed in a global context so far, the *reactive coordination rule* is a unique example of a rule that, on one hand, targets the

core of the issue as regards to hybrid and reverse hybrid entities, i.e. the disparate characterization of an entity by two or more jurisdictions, and, on the other hand, it attempts for a simple application, avoiding, e.g. contingencies related to the outcomes of transactions, such as that an item of income is deducted in one State while not included in the other, or vice versa.

The above, however, does not make the proposed *reactive coordination rule* neither a perfect nor a non-improvable solution. On the contrary, as demonstrated in this Chapter, there are still open questions as regards to its application, which are mostly related to some undesirable effects that the application of the rule might originate. These cases refer to the potential double taxation issues in cases a hybrid entity receives a payment and the cases in which a tax benefit is granted or a disregarded transaction results solely because of the application of the proposed rule. Nevertheless, and in order to mitigate such results, the authors has proposed a coordinated application of the rule with other tax measures, such as CFC rules, as regards to the potential double taxation cases involving hybrid entities receiving payments, and even a "switch-off" of the proposed rule in case of tax benefits or disregarded transactions resulting exclusively from the application of the proposed rule. Yet, it is still evident that an impartial implementation of the rule around the world would rest potential to it.[1685]

[1685] There is, however, no need to be completely pessimistic in this regard. On the contrary, in many of the latest global tax proposal leaded by the OECD, it has been demonstrated the will of countries to work together, even though some of those proposals lack of a

The *reactive coordination rule* has also demonstrated to have a positive impact within tax treaties. On one hand, it solves the disparities with respect to the characterization of an entity before a tax treaty comes into play, which makes the application of the treaty more straightforward. In other words, hybrid entities and reverse hybrid entities will not be a tax treaty concern anymore, at least not to the extent known before the application of the proposed rule.[1686] On the other hand, it restricts the application of Article 1(2) OECD Model to those cases where the country in which the entity under analysis is organized, treats the entity as fiscally transparent. The above is clear, because only in those cases the other countries will follow the tax transparent treatment of the entity if the *reactive coordination rule* was also implemented. A similar conclusion might be achieved as regards to Article 3(1) MLI whose text mirrors Article 1(2) OECD Model.[1687]

Likewise, the restriction in the application of Article 1(2) OECD Model, indirectly achieved through the previous domestic coordination in the entity's characterization (i.e. through the *reactive coordination rule*), has a positive impact for source States normally affected by the straightforward

correct design and focus. Therefore, if a rule attempts to counteract the core and not the boundaries as regards to hybrids and reverse hybrid entities, it might be expected at least that the proposed rule be received with positive eyes.

1686 Some could argue that *hybrids* and *reverse hybrid entities* were never a tax treaty concern, at least not directly, since the moment that domestic laws and not tax treaties govern the characterization of entities for tax purposes. That statement is, in principle, correct, but it forgets the sole existence of the disparity in the characterization of an entity and the absence of a rule within tax treaties dealing with such disparity, might impact the proper allocation of taxing rights according to a specific tax treaty. Therefore, a coordinated solution at a domestic level is of great relevance for tax treaty purposes.

1687 *Supra* Chapter IV, Section 6.1.

application of Article 1(2) OECD Model. As analyzed already in Chapter IV and demonstrated in the study cases used in this Chapter VI, Article 1(2) OECD Model gives to certain extent prevalence to the characterization of the entity in the residence State, indirectly affecting the position of source States. This effect is, nevertheless, mitigated in part after the application of the *reactive coordination rule*, as it can be seen in Cases E, F and G. In Case G, however, it might be arguable that the economic position of the State of source is better in cases whether the partners of the entity are residents in two different countries with a treaty with the State of source. Yet, the above, should not be taken as a negative outcome, but as a simple demonstration that the *reactive coordination rule* was not created to switch the results of Article 1(2) OECD Model in favor of the position of source States, but rather to eliminate the disparities in the characterization of entities at a domestic level, which, however, might to certain extent indirectly generate a positive outcome as regards to tax treaties, including better outcomes for source States when compared with the application of Article 1(2) OECD Model in absence of the *reactive coordination rule*.

VII. CHAPTER

Summary and Conclusions

1. Introduction

As stressed in the beginning of this work, the present research has attempted to answer the following research questions:

1. Is there necessarily an interconnection between the use of hybrid and reverse hybrid entities and the DNT outcome? Should the rules targeting the use (or misuse) of hybrid and reverse hybrid entities be designed based exclusively on the DNT outcome?

2. Is there an alternative approach to deal more directly with the use (or misuse) of disparities in the characterization of entities for tax purposes, which does not consider the DNT outcome, or should the current *consequentialist approach* prevail?

In answering these questions, some preliminary assumptions have been taken into consideration:

a. The sole result of a D/NI outcome, i.e. DNT, should not be considered *per se* a matter of concern in any cross-border transaction. Likewise, the use of the DNT outcome as an immediate

proxy to determine the existence of practices that might be considered abusive when they derive exclusively from the use of hybrids or reverse hybrid entities should be prevented.

d. *Linking rules*, i.e. rules matching deductions with the respective inclusion of income in the other country, as the ones proposed within the OECD BEPS Action Plan 2, have the risk of setting up strong presumptions of abusive practices by the sole reason that the outcome of DNT has been achieved. Likewise, these rules are highly complex to administer and they do not target the core issue with respect to hybrids and reverse hybrid entities, i.e. the different tax characterization of entities. An alternative should thus be evaluated.

e. Rules regulating the use of *transparent entities* at the level of tax treaties in order to prevent the access to the benefits of a bilateral tax treaty by third countries out of that treaty are, in principle, recommendable. Nevertheless, the inclusion of an Article 1(2) within the OECD Model, resembling Article 1(6) US Model, might generate important issues with respect to developing countries, mostly considering that these countries generally rely on source taxation. Similar concerns are shared as regards to Article 3(1) MLI, which mirrors the OECD proposal of Article 1(2) OECD Model. Alternatives solutions, including domestic ones, should be analyzed.

As follows, therefore, the author presents the main findings as regards to the research questions and hypotheses surrounding this work.

2. The unnecessary international concern on DNT

The major part of the debate regarding DNT and the use of hybrid and reverse hybrid entities has been contaminated with some assumptions given by granted. In particular, this is due to the generalized idea that income should be taxed at least once in any cross-border transaction, which *a priori* rejects the DNT outcome in any form.

It is undeniable that the idea of tax systems around the world working in a manner to ensure single taxation is attractive. Nevertheless, it is also very risky. As stressed in Chapter I, the above can bee seen, e.g. in the common confusion between DNT and other traditional, and undesired legal consequences, such as tax evasion or tax avoidance. However and perhaps more importantly, it can be noted in the appearance of new pseudo-legal concepts, such as the notion of ATP, whose *consequentialist approach* has only contributed to increase the level of uncertainty among taxpayers. A similar path can be seen in the design of specific anti-hybrid rules (i.e. *linking rules*), which assume as starting point the matching of tax outcomes in order to ensure single taxation, disregarding the origin of the issue regarding hybrid and reverse hybrid entities, i.e. the disparate characterization of entities for tax purposes. Nevertheless, there is one thing

that one should not forget in this whole debate regarding DNT and this is that DNT is an outcome, which, absent of any subjective interpretations, should not be regarded *per se* as a cause of concern.

In the same order of ideas, after analyzing the OECD Model provisions and the international tax practice, it is possible to conclude that double taxation treaties do not aim to prevent DNT either. This conclusion, as demonstrated in Chapter II, is maintained even after the inclusion of a reference to tax avoidance or tax evasion within the title of some tax treaties. Indeed, what the tax treaty practice demonstrates is something completely different: both pursuing and avoiding (or preventing) DNT are indeed exceptional aims of tax treaties. Therefore, no general tax policy can be interpreted as to argue that tax treaties, generally speaking, aim to prevent or to eliminate DNT. On the contrary, both the prevention and the concius seek for the DNT outcome are given under very specific circumstances within tax treaties. For example, the DNT outcome occurs and it is tolerated (if not, conciusly intended) when tax treaties include *tax sparing* or *matching credits* clauses. In the other way around, tax treaties aim to specifically avoid the DNT outcome when a *subject-to-tax* or *switch-over* clause is introduced within a specific tax treaty. This conclusion remains valid even after the implementation of the new OECD interpretation of Articles 23A and 23 B OECD Model in the OECD Commentaries and the inclusion of a new Article 23A(4) OECD MODEL. None of the above mentioned provisions are effective enough to solve all the situations of DNT derived from either conflicts of qualification or interpretation.

A different approach could, however, be suggested with the proposal of the OECD BEPS Action Plan 6, which includes the modification of the title and preamble of the OECD Model and the inclusion of the STR rule, both referred specifically to the avoidance of DNT. Nevertheless, the unhappy wording of the modified OECD Model preamble could only suggest that the aim to prevent DNT is reserved exclusively to the cases where this is the result of tax evasion or tax avoidance. Likewise, the STR rule in case of Articles 11, 12 and 21 OECD Model does not suggest any obligation to the source State to tax the item of income. On the contrary, it is still facultative to this State to exercise its taxing right, as demonstrated in the use of the word "may be" instead of "is" or "must be", which could suggest otherwise. Therefore, an interpretation of such a rule as preventing that interest, royalties or other income, remain untaxed because of being subject to a STR, would be simply imprecise.

As a result, in the current international scenario in which no obligation exist to prevent or to eliminate DNT, or which is the same, to ensure single taxation, both at a domestic and at a tax treaty level, this author concludes that the outcome of DNT should remain as such, i.e. as an outcome, neither being used as proxy to determine the existence of abusive practices through the use of hybrids and reverse hybrid entities nor to assume a crucial role in the design anti-hybrid provisions.

3. Hybrid Entities: Disparities as the true core of the issue

As stressed in this work, hybrid entities and reverse hybrids are the result of domestic and sovereign tax policy decisions that determine the tax treatment of a foreign entity for domestic tax purposes. This outcome, which is not surprising at all considering that tax systems around the world are neither uniform nor consistent in their tax policies and they normally differ with each other in many aspects, simply confirms that the core issue regarding hybrid and reverse hybrid entities is no other than the disparities in the tax characterization made by two or more jurisdictions on the same entity. This issue is of fundamental importnate as regards the design of potential proposals delaing with hybrid and reverse hybrid entities.

With respect to the rules used to characterize foreign entities for domestic tax purposes, one can conclude that there are no rules that fit all the requirements to be completely inviolable. Therefore, the discussion should not be focused on whether a system is more or less elective than the other. Indeed, as demonstrated in Chapter III, resemblance or comparative tests normally fail in creating consistent characterizations of foreign entities due, most of the time, to the incompatible characteristics between foreign and domestic entities. Likewise, these tests tend to be generally not less elective than a formally elective system that relies completely in a taxpayer's election. A good example of the above is the *Kintner* test in the United States, which was in force before the issuance of the CTB regulations. This system allowed sophisticated taxpayers, after a proper legal advice, to set up

the structures that most accurately fit their pretentions, predicting thus in advance the desired tax treatment of those entities. The above, however, does not mean to recognize the influence of the elective U.S. CTB system to circumvent Subpart F Income and to inappropriately claim a FTC. In those cases, however, the circumvention does not necessarily attend to the electivity of the system used to characterize entities for tax purposes, but rather to the poor design of domestic anti-deferral and FTC rules. It is thus necessary that the debate regarding systems to characterize entities for tax purposes does not dismiss this issue.

Another important finding within the discussion regarding hybrid and reverse hybrid entities was the existence of examples where coordination in the characterization of entities, by statute or by administrative practice, is beyond being just an academic optimistic idea and could certainly serve to re-direct the debate as regards to the design of rules countering abusive practices with respect to the use of hybrid and reverse hybrid entities. Chapter III analyzed three specific cases: 1) the Spanish administrative practice; 2) Denmark rules to deal with hybrid and reverse hybrid entities, and 3) the proposal for EU ATAD and the specific anti-reverse hybrid rule within the EU ATAD II. All these measures and practices showed one thing in common: they are all designed starting from the core of the issue regarding hybrid and reverse hybrid entities, i.e. the disparate characterization of entities, being also very effective to solve the real mismatch.

In Spain, e.g. the administrative interpretation of the statute (i.e. Article 37 of the Spanish NRIT–*Income Attribution Regime*) is as to follow the characterization of the entity given in the foreign country. Therefore, and even though this interpretation might be subject to critics mostly considering the complete deviation from the strict text of the law, its practical implication demonstrates that the probabilities of disparities in all those cases in which Spain is the country characterizing a foreign entity established in a country from where Spanish residents receives income, are reduced to zero. In Denmark, on the other hand, there are rules that allow re-characterizing domestic entities in cases of disparities with the characterization given by the majority of the shareholders owning the entity. Unlike interesting in terms of coordination, this approach has also been criticized for relying excessively in foreign laws, increasing also the levels of uncertainty for taxpayers due to the re-characterization. Likewise, a special reference should be made with respect to the Proposal for EU ATAD (2016), which, although maintaining the reference to specific tax outcomes, provided for a coordination in the characterization of entities where the resident MS should follow the characterization given in the source MS. Unfortunately, this rule was not longer included in the final text of the EU ATAD I (2016), although the recent EU ATAD II (2017) included a rule dealing specifically with reverse hybrid entities and third countries (Article 9a), which provides for a re-characterization of a fiscally transparent entity when the entity is regarded by the majority of the shareholders, residents in a third country, as a taxable entity, which resemblances the Danish rule already stressed.

The above-mentioned experiences are indeed a very optimistic precedent, which allows this author to conclude that the coordination in the characterization of entities is indeed a more direct and effective manner to deal with hybrid and reverse hybrid entities, rather than indirectly attempting to match the tax outcomes derived from the transactions in which these hybrid structured are involved.

4. Hybrid Entities and the Entitlement to Tax Treaty Benefits

The sole different tax characterization of entities by two Contracting States might generate problems as to determine to whom income should be allocated, and thus, the benefits of a tax treaty be finally granted. In other words, hybrid entities and reverse hybrid entities are indeed a tax treaty concern since tax treaties are applicable to persons who are also considered as residents for tax treaty purposes, i.e. as *liable to tax* or subject to full tax liability based on worldwide taxation, regardless the effective payment of taxes. The issue is, however, that most of the non-corporate entities, e.g. partnerships and other disregarded entities are granted full or partial tax transparency, which is indeed inconsistent with the assertion of full tax liability based on worldwide taxation. In principle, therefore, rules dealing with the allocation of income received through a fiscally transparent entity, considered as such by at least by one of the Contracting States, are desirable.

A preliminary look at the principles of the OECD Partnership Report recognized within Article 1(6) US Model, which is also the precedent of the

proposed Article 1(2) OECD Model and Article 3(1) MLI, give us the impression of providing a practical solution to the issue: the State of source should follow the attribution principles of the State of residence and attribute the income accordingly. In other words, the tax characterization of the entity in the State of residence prevails, although the above-mentioned provisions do not refer at all, at least not directly, to the prevalence of the tax characterization in one Contracting State over the other, less to a potential coordination in the tax characterization of the entity.

The pragmatic solution offered by the provisions analyzed in Chapter IV, especially as regards to Article 1(2) OECD Model and Article 3(1) MLI, has, nevertheless, important inconsistencies. One of the most notorious inconsistencies is the complete absence of a proper interplay between the transparent entities' provision and the *beneficial ownership* requirement of Article 10, 11 and 12 OECD Model. Curiously, however, this issue was neither addressed within the 1999 OECD Partnership Report nor within the normative precedent of Article 1(2) OECD Model, i.e. Article 1(6) US Model. Regardless the above, one should not rest merits to some interesting isolated examples of rules dealing with this issue, which can be found both in the tax treaties between the United States/ Poland and the United States/Canada. This latter example is indeed a direct rule dealing with the conflict between the transparent entities' provision and *beneficial ownership* requirement, being also the inspiration for a recent academic proposal based on a "deeming rule" (i.e. deemed *beneficial owner*). Although this author recognizes that the proposal initially attends to the fact that no relevant party

is acting as an agent or nominee or other intermediary for a third party from the source State's perspective, which would demonstrated a more balanced provision, it rapidly turns to give prevalence to the tax characterization of the entity in the State of residence as a manner to solve the conflict. In other words, the conflict between the transparent entities' rule and the *beneficial ownership* requirement finally depends on deeming a resident in the State of residence as the *beneficial owner*. In other words, the State of source, once again, must limit its right to determine exclusively, and based on its domestic laws, to whom dividends, interest and royalties are paid. As such, therefore, this author does not see how States of source might fully agree with this pragmatic proposal without at least a minimum of hesitation.

Another issue as regards to Article 1(2) OECD Model and Article 3(1) MLI is the interplay between the *"saving clause"*, which ensures Contracting States the taxation of their own residents regardless the application of a treaty, and the relief of double taxation's obligations under a treaty. In this regard, the solution adopted by paragraph 64 of the OECD BEPS Action 6, introducing paragraph 11.1 to the Commentaries on Articles 23A and 23B is rather clear and straightforward, providing that the Contracting States *are not* reciprocally obliged to relief the double taxation caused for each other's tax levied exclusively on the basis of the residence of the taxpayer. In other words, relief of double taxation remains available *only* 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 PE to which that income is attributable. This

solution is replicated in Article 3(2) and Article 5–Option C MLI. Both Articles refer expressly to paragraph 64 of the OECD BEPS Action 6. However, when dealing with the optional *saving clauses* within the MLI, it seems to be that opting for one or another might not necessarily bring the same results. For example, while the detailed *saving clause* of Article 11 MLI seems to retain the obligations to provide double taxation relief under provisions such as Article 7(3), Article 9, Article 19, Article 20, Article 23A and 23B, Article 24, Article 25 and Article 28 OECD Model, the simplified version of Article 3(3) MLI does not expressly preserve treaty obligations as regards to those Articles. Likewise, a solution such as the one proposed in paragraph 64 of the OECD BEPS Action 6 might still create issues in some countries where, based on specific tax treaty provisions or the tax treaty practice, use to grant double taxation relief in those and other analogous cases by an extensive interpretation of Article 23 OECD Model. In other words, perhaps the inclusion of a *saving clause* is not strictly necessary for all States.

As concluded in Chapter IV, therefore, Article 1(2) OECD Model and 3(1) MLI, together with the proposed *saving clauses*, might not necessarily be the most adequate manner to address the issue of hybrids and reverse hybrid entities within the treaty context. In this regard, the idea of a domestic coordination rule, which should not necessarily imply a modification of the proposed Article 1(2) OECD Model, but rather a restriction of its scope, gains strength.

5. Avoiding the artificial link between DNT and the use of hybrid entities

The attempt to create a direct link between the DNT outcome and the use or hybrid and reverse hybrid entities have derived in the elusive notion of HMA. This notion, whose construction is also based on the assumption that income should be taxed 'somewhere', no matter where, does not only deviate from the problem of hybrid entity mismatches itself, i.e. the different characterization of the same entity by two jurisdictions, but also creates new presumptions of base erosion and abusive transactions just because the outcome of D/NI (i.e. DNT) arises. Similarly, *linking rules*, i.e. the rules created to counteract such arrangements, follow the same pattern, although none of these rules solve the true hybrid entity mismatch. On the contrary, they assume a *consequentialist role* based exclusively on the outcome that the hybrid entity transactions generate, i.e. a D/NI outcome (or DNT), targeting just indirectly the hybrid entity mismatch.

The approach adopted in the design of anti-hybrid rules, as demonstrated in Chapter V, raises important questions both from a tax policy and a legal perspective. From a tax policy perspective, *linking rules* tend to be circular, namely, if implemented by all countries, they will have no other effect than nullifying each other, even if a tie-breaker rule gets into force. More importantly perhaps, an uncoordinated application of a *primary response* and a *defensive rule*, might give rise to new issue of economic double taxation, which did not exist before the application of these rules.

Accordingly, it should not be diminished the fact that these rules are extremely dependent on the functioning and application of foreign laws, which, unless a broader and efficient access to information between tax administrations, especially between developing countries, might raise serious concerns with respect to their real effectiveness. Likewise, and although *linking rules* do not raise many concerns with respect to Article 24 OECD Model (non-discrimination), mostly derived from the restrictive approach adopted within that non-discrimination provision, there are still serious doubts as regards to their compatibility with EU law, especially EU primary law or fundamental freedoms. Unfortunately, however, the jurisprudence of the CJEU is neither unequivocal nor consistent to provide a concrete answer with respect to such issue.

For all of the above, this author concludes that a different approach should be taken, which, on one hand, targets in a more direct manner the issues with respect to hybrid and reverse hybrid entities, and, on the other hand, provides for a simpler and more efficient design of the rules targeting hybrid entity mismatches.

6. The Alternative: The *Reactive Coordination Rule*

Against those who argue for a necessary interconnection between DNT and the use of *hybrid* and reverse *hybrid entities*, this work proposes a different approach. This approach is based on two fundamental ideas. On one hand, it is to propose a simple rule that avoids the complex set of OECD *linking*

rules, and which might serve as a valid and more administrable alternative to them, both at a domestic and tax treaty level. On the other hand, it is the idea to propose a rule that truly focuses on the real issue involving hybrid and reverse hybrid entities, i.e. the disparate characterization of entities by two or more jurisdictions, rather than being designed based exclusively on the outcomes of the transactions involving the use of hybrid entity structures.

Chapter VI presented in detail a proposed *reactive coordination rule,* whose mechanic is simple and consists in aligning the characterization of foreign entities for domestic tax purposes according to the characterization given in the country where the entity is legally and formally organized, i.e. the "home country". The use of the "home country" as aligning factor is justified, because although it is true that the home and source country will coincide in all those cases in which a payment is made from a hybrid entity, they will certainly not coincide in all those cases in which a payment is received by a reverse hybrid entity. Therefore, having in mind the simplicity of the rule, the author has opted for using a more proper connection, i.e. the home country. This is also related to the coherence that this rule looks for. Indeed, hybrid entity mismatches are the result of a different characterization of an entity when compared to the characterization given in its country of legal or formal organization, i.e. the home State. Therefore, and at least from a tax policy perspective, the design of a rule aligning the characterization of the entity in its home country is at least more coherent in

terms of forcing the State producing the mismatch, i.e. the State that applies a characterization of an entity different from the one given domestically where the entity is organized, to react. Likewise, the *reactive coordination rule* assumes a more honest approach in its scope. Indeed, it applies to all those cases where there are disparities between two or more countries with respect to the characterization of the same entity. The above is, on one hand, aligned to the three main tax policy reasons sustaining the proposal: simplicity, coherence and administrablity of the rule,[1688] and, on the other hand, it accomplishes with the idea of targeting the core of the issue regarding hybrids and reverse hybrid entities: the different characterization of entities for tax purposes.

As stressed in Chapter VI, the proposed rule has the positive impact of solving the hybrid entity mismatch, avoiding unnecessary contingencies associated to the outcomes of the transactions involved, reducing thus its complexity, and more importantly, putting disparities again in the front of the discussion regarding hybrid and reverse hybrid entities. In spite of the above, the rule is not exempt of further improvement. Indeed, the proposed design of the rule leaves open questions as regards to its application, which is mostly related to some undesirable effects that the application of the rule might originate. These cases refer to the potential double taxation issues in cases a hybrid entity receives a payment and the cases in which a tax benefit is granted or a disregarded transaction results solely because of the

[1688] *Infra* Section 2.3.

application of the proposed rule. Nevertheless, and in order to mitigate such results, the authors has proposed a coordinated application of the rule with other tax measures, such as CFC rules, as regards to the potential double taxation cases involving hybrid entities receiving payments, and a "switch-off" of the proposed rule, in case of tax benefits or disregarded transactions resulting exclusively from the application of the proposed rule. Yet, a worldwide and uniform implementation of the rule keeps being a fundamental issue to ensure its real practical impact.

It is also interesting to note that the *reactive coordination rule* might be an efficient solution from a tax treaty perspective. In fact, the coordination in the characterization at a domestic level ensures a more proper application of the proposed Article 1(2) OECD Model, restricting its scope exclusively to cases in which the home country treats the entity under analysis as tax transparent, which indirectly brings also fairer results for States of source when compared with the pure application of Article 1(2) OECD Model, in absence of a previous coordination in the tax characterization of entities at a domestic level. As analyzed in the study cases in Chapter VI, however, the application of the *reactive coordination rule* does not always derives in positive results for the State of source. The above is, however, far from being a negative characteristic of the rule, but rather it is the best demonstration that the proposed rule aims to eliminate the disparities in the characterization of entities at a domestic level, indirectly generating more consistent outcomes as regards to the application of tax treaties, but it is not

a rule created to switch the balance from the States of residence to the States of source.

All in all, the use and misuse of *hybrid entities* and *reverse hybrid* entities is a challenge that should be adequately addressed, which should starts from assuming a less consequentialist approach. At present, we have just witnessed an attempt to present issues in a different costume, whose pragmatism is sometime difficult to argue against too. However, the above should not prevent us to re-orientate the discussion to what really matters in the debate regarding hybrid entity mismatches. This challenge should be assumed before all countries get truly convinced on who is the evil and that matching outcomes is indeed a preferable path. As proven in this work, alternatives might still be possible.

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ANNEX A: Summary in Spanish (Español)

La Doble No Imposición y el Uso de Entidades Híbridas

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1. Introducción

La doble no imposición y el uso de entidades híbridas han estado en la agenda de comunidad tributaria internacional durante largo tiempo. Sin embargo, su análisis adquiere particular importancia en nuestros días en donde las transformaciones a nivel tributario global han alcanzado una velocidad, y tal vez un compromiso internacional, no antes visto, el cual se materializa en el reciente proyecto de la OCDE sobre erosión de las bases imponibles (BEPS).

La comunidad tributaria internacional, o su gran mayoría, se ha mostrado generalmente escéptica tanto con respecto a la doble no imposición como al uso de entidades híbridas. La doble no imposición, por una parte, supone la completa ausencia de tributación y como tal parece ser tan injusta o indeseable como su contrapartida: la doble imposición. Esta idea ha sido largamente reforzada bajo el postulado académico de que las rentas

derivadas de transacciones transfronterizas debiesen tributar al menos una vez en algún Estado. Las entidades híbridas, por otra parte, han sido criticadas por abrir una puerta a la creación de ventajas derivadas de las diferencias en el tratamiento jurídico dado en dos o más ordenamientos jurídicos con respecto a la misma entidad jurídica, lo cual podría ser utilizado con el objeto de duplicar beneficios tributarios o de minimizar la carga tributaria general de los contribuyentes. Sin embargo, ni el hecho de que las rentas transfronterizas deban tributar al menos una vez en un Estado, ni el uso de un tratamiento jurídico distinto en dos o más Estados con respecto a la misma entidad jurídica han probado ser, al menos no *a priori*, un objeto de preocupación internacional. A pesar de lo anterior, la influencia de las recientes reformas tributarias a nivel internacional, y quizás la simplificación que ofrece el uso de conceptos dados por sentados, han creado el escenario prefecto para la aparición de puntos de vista más pragmáticos, los cuales optan por una simple combinación de ambos elementos, esto es, la doble no imposición y la calificación jurídico-tributaria dispar de la misma entidad jurídica, en un solo elemento que debería ser contrarrestado, denominado *"hyrbid mismatch arrangements"* (HMA). Esta idea parece convencer a muchos, siendo también muy difícil de argumentar *a contrario sensu* debido a su construcción compleja y a su marcado pragmatismo. A pesar de lo anterior, no debiera encasillarse como en ningún caso como incuestionable.

En este vertiginoso camino de cambios a nivel internacional, este trabajo adopta una posición distinta, tomándose el tiempo para descubrir hasta que

punto la doble no imposición y el uso de entidades híbridas se encuentran realmente interconectadas, si es que alguna vez lo han estado realmente, en cuanto a servir una a la otra en el diseño de normas anti-híbridos tanto a nivel doméstico como a nivel de tratados internacionales, o si bien dicho debate debiese ser reorientado. Esta tarea no tiene nada de superficial, puesto que sólo una vez que dichas dudas se despejen, será posible determinar de manera seria si es que la posición mayoritariamente adoptada por la comunidad tributaria internacional, incluyendo las soluciones propuestas por la OCDE, debiesen recibir soporte, se debiesen mejorar o simplemente descartar en búsqueda de nuevas alternativas.

2. Objeto y Propósito

El objeto y propósito del presente estudio es analizar la interacción entre la doble no imposición y el uso de entidades híbridas dentro del contexto internacional, lo que incluye la aplicación de tratados internacionales para evitar la doble imposción. Con este propósito, el trabajo considera las siguientes peguntas inciales de investigación:

1. Existe necesariamente una interconexión entre el uso de entidades híbridas y el resultado de la doble no imposición? Deberían las reglas que regulan el uso (o mal uso) de entidades híbridas estar diseñadas exclusivamente sobre la base del resultado exclusivo de doble no imposición?

2. Existe una propuesta alternativa para lidiar más directamente con el uso (o mal uso) de las disparidades en la calificación de entidades jurídicas para propósitos tributarios, la cual no considere el resultado de la doble no imposición, o la *posición consecuencialista* que la mayoría adopta debiese primar?

De la misma manera, este trabajo toma como punto de partida las siguientes hipótesis de trabajo, las cuales serás analizadas y contrastadas durante el desarrollo de la presente tesis:

a. El sólo resultado de una deducción/no-inclusión de renta, esto es, doble no imposición, no debería considerarse *per se* como un objeto de preocupación en lo relativo a transacciones transfronterizas. De la misma manera, se debiese evitar el uso de la doble no imposición como una conexión inmediata para determinar la existencia de practicas que podrían considerarse como abusivas cuando derivan exclusivamente del uso de entidades híbridas.

b. *Linking rules* o reglas que establezcan una conexión o contingencia entre una determinada deducción en un Estado con la correspondiente inclusión o reconocimiento de renta en el otro Estado, como las propuestas por la OCDE en su Plan de Acción BEPS No. 2, tienen el riesgo de establecer presunciones de practicas abusivas que se dan por el sólo hecho de que el resultado de doble no imposición aparece envuelto. De la misma manera, estas reglas son altamente complejas de administrar y en ningún caso atacan el

verdadero meollo del problema con respecto al uso de entidades híbridas, esto es, la calificación dispar de una misma entidad por dos o más Estados. Alternativas a estas reglas debiesen ser evaluadas.

c. Las reglas que regulan el uso de *entidades transparentes* en el contexto de tratados bilaterales para evitar la doble imposición, con el objeto de prever el acceso a los beneficios de dichos tratados por parte de terceros Estados ajenos a los mismo son, en principio, recomendables. Sin embargo, la inclusión de un Articulo 1(2) en el Modelo OCDE, el cual se inspira en el Articulo 1(6) del Modelo de los Estados Unidos, podría generar problemas importantes para países en desarrollo, principalmente si se considera que estos países descansan en una tributación basada en la fuente de la renta. La misma preocupación se extiende con respecto a la inclusión de un Articulo 3(1) del nuevo Convenio Multilateral, cuyo texto refleja lo ya establecido en el Articulo 1(2) del Modelo OCDE. Soluciones alternativas, incluyendo soluciones a nivel de legislación doméstica, debieran ser analizadas.

3. Alcance de la Investigación

Este trabajo se refiere exclusivamente al estudio de casos en los cuales el resultado de doble no imposición deriva exclusivamente de la calificación dispar de una misma entidad por parte de dos Estados distintos, esto es, cuando dicha calificación dispar resulta en una deducción/no inclusión de

renta. Por lo tanto, este trabajo no se referirá a casos de “doble deducción” (DD), los que si se incluyen en la Acción 2 del proyecto BEPS, ni tampoco analizará casos de “incompatibilidades por doble residencia” [*dual resident mismatches*], ya que tales casos no se relacionan con la calificación de entidades, como sucede con los casos de incompatibilidades por doble residencia, o simplemente no envuelven el resultado de doble no imposición, como sucede con los casos de entidades híbridas en donde el resultado es una DD.

En el mismo sentido, el presente estudio excluye también los casos de doble no imposición derivados del uso de instrumentos financieros híbridos, que constituyen casos en que un mismo instrumento financiero se le califica de manera distinta por dos Estados, esto es, como deuda en un Estado mientras que como capital en el otro Estado. Esta exclusión se justifica por dos motivos. En primer lugar, las entidades híbridas y los instrumentos financieros híbridos son dos problemas distintos. Mientras el primero supone la calificación dispar de una misma entidad, el segundo se refiere a la calificación del pago (renta) hecho por un contribuyente a otro. Lo anterior, sin embargo, no significa reconocer que muchas transacciones transfronterizas pueden en la práctica envolver ambas cuestiones al mismo tiempo. En segundo lugar, la exclusión tiene por objeto la simplificación del análisis respecto a la doble no imposición como un resultado derivado exclusivamente del uso de entidades híbridas, de manera de permitir un mejor entendimiento respecto a la naturaleza del problema. En la misma línea de pensamiento, el estudio no se refiere a casos relativos a

"transferencias híbridas", es decir, acuerdos para transferir un instrumento financiero híbrido en donde las leyes de dos Estados difieren en relación a si el enajenante o el beneficiario ha adquirido la propiedad de los pagos sobre los activos subyacentes, por ejemplo, la re-compra (REPO) o transacciones de préstamo de valores.

Finalmente, el presente trabajo no incluye los casos de "Establecimientos Permanentes (EP) híbridos", esto es, los casos en que dos Estados no acuerdan con respecto a si una actividad económica esta siendo llevada a cabo a través de un EP o no. Las razones con respecto a esta exclusión son ciertamente obvias. Por una parte, EP no son estrictamente entidades jurídicas, más allá del hecho de que pueden ser parte de una entidad. Por otra parte, la incompatibilidad o *"mismtach"* en este caso se origina con respecto a la existencia (o no) de una EP, es decir, una ficción legal en si misma creada para gravar las rentas de una negocio (*branch*) cuando existe una presencia económica suficiente en un Estado, y no con respecto a la existencia o no de una entidad debido a su calificación dispar en dos Estados. Esta es tal vez la razón por la cual la OCDE decidió elaborar un informe separado con este objeto. En base a los mismos argumentos esgrimidos con respecto a la exclusión de "Establecimientos Permanentes (EP) híbridos" en el presente estudio, cualquier referencia a la potencial aplicación de la propuesta que se presenta en el Capítulo VI (*reactive coordination rule*) a estos casos, será omitida.

4. Metodología

El presente trabajo ha optado por un análisis no estrictamente ligado a una jurisdicción particular, lo cual, en principio, no seguiría necesariamente los parámetros tradicionales de una tesis de doctorado en derecho, la que comúnmente utiliza como punto de partida el estudio de una jurisdicción en particular. Sin embargo, la metodología propuesta en este caso encuentra su justificación en dos motivos. En primer lugar, en lo relativo a la naturaleza de los conceptos bajo análisis, esto es, la doble no imposición y las entidades híbridas. Ambas cuestiones representan problemas que involucran la interacción de diferentes jurisdicciones, esto es, problemas internacionales que no se limitan a un Estado en particular y que muchas veces envuelven incluso la aplicación de leyes supranacionales, como el caso de la leyes tributarias a nivel de la Unión Europea (EU), y los casos de convenios internacionales para evitar la doble imposición. En este sentido, resulta más apropiado situar estos problemas dentro de un contexto internacional, antes que suscribirlos a un determinado Estado, lo cual simplemente limitaría el alcance de los resultados del presente trabajo. Por otra parte, un análisis más agnóstico, es decir, no limitado a una jurisdicción específica, permite al autor llevar a cabo un estudio más profundo dentro de los pilares fundacionales de dichos conceptos en abstracto, ausente de las limitaciones de una legislación doméstica específica, permitiendo pensar y ofrecer soluciones aplicables a una generalidad de casos. Como tal, por tanto, el presente trabajo de investigación podría ser considerado propiamente como una tesis de *derecho tributario internacional.*

Lo anterior, sin embargo, no significa reconocer que este autor renuncia completamente a referirse a la legislación particular de ciertos Estados, ya sea a modo de ejemplo o bien como soporte al análisis de los temas específicos que se desarrollan dentro del presente trabajo. En este sentido, es importante destacar que la elección de Estados cuya legislación se utiliza no ha sido hecha al azar. Muy por el contrario, ésta atiende estrictamente a las directrices dadas por la naturaleza de los temas principales bajo análisis, esto es, la doble non imposición y las entidades híbridas, y a la manera en que este trabajo ha sido estructurado. Así, el autor ha optado por desarrollar un análisis más extenso con respecto a la calificación de entidades extranjeras en los Estados Unidos de América (reglas de *Check-the-box* o CTB) en el Capitulo III. Este análisis encuentra su justificación en la importancia de estas reglas en cuanto a originar problemas relativos a entidades híbridas en el contexto internacional, siendo también un ejemplo único a nivel mundial en donde la calificación jurídica de entidades extranjeras es dejada a la elección del contribuyente. De la misma manera, el *Régimen de Atribución de Rentas Español* se analiza en el Capitulo III como un ejemplo de coordination respecto a la calificación de entidades jurídicas extranjeras, aún cuando dicho resultado de coordination es producto de una práctica administrativa de la autoridad tributaria española (DGT), la cual no guarda necesariamente relación con el texto estricto de la norma. De la misma manera, se analiza la legislación Danesa en el Capitulo III como otro importante ejemplo de coordinación para resolver cuestiones relativas a entidades híbridas. De hecho, la legislación de Dinamarca aparece como una

reacción al uso (o mal uso) de las reglas de CTB en los Estados Unidos y ha servido como orientación a las recientes reformas relativas a la Directiva ATAD II, que regula casos de HMA con terceros Estados fuera de UE. Todas las otras referencias a la legislación específica de ciertos Estados se realiza acorde a los temas específicos que se tratan durante el desarrollo de la presente investigación. En este sentido, por ejemplo, el Capitulo I se refiere a la normas de crédito fiscal y Limitación de Beneficios (LOB) en los Estados Unidos como parte de la discusión respecto a la existencia o no de un principio internacional que obligue a pagar impuestos en al menos un Estado en los casos de transacciones transfronterizas, también conocido como *"single tax principle"*. Ambas normas se utilizan como parte de los argumentos en pro y contra para probar o desaprobar la existencia de este principio, por lo que difícilmente podrían ser omitidos. Otro ejemplo se puede encontrar en uso de la legislación Alemana para ejemplificar los casos en los que se utiliza *"switch-over clauses"* dentro de los tratados para evitar la doble imposición, como también con respecto a la práctica del *"treaty override"* en el capítulo II. Asimismo, algunos ejemplos de soluciones relativas a la dicotomía entre el Articulo 1(2) del Modelo OCDE y el requisito de *beneficiario efectivo* de los Artículos 10, 11 y 12 del Modelo OCDE, son extraídos de los acuerdos bilaterales para evitar la doble imposiciónentre Polonia/Estados Unidos y Canadá/Estados Unidos. Todo lo anterior ratifica el carácter internacional del presente trabajo de investigación y justifica el uso de la legislación tributaria y la jurisprudencia de diferentes países de acuerdo se requiera por el desarrollo del mismo.

Por otro lado, el aparente análisis asistemático con respecto a la legislación tributaria de la UE podría también generar preocupación desde un punto de vista tradicional. Sin embargo, la utilización de la legislación tributaria de la UE sigue la metodología adoptada para esta tesis, esto es, se le analiza como parte del contexto internacional, apareciendo y desapareciendo durante el desarrollo de la tesis de acuerdo lo requiera la misma. Esta es la razón de porqué la legislación tributaria de la UE aparece originalmente en el Capitulo I asociada exclusivamente al estudio del concepto de *Planificación Fiscal Agresiva* o *Aggressive Tax Planning* (ATP), puesto que la noción Europea de ATP requiere de una referencia particular. De la misma manera, la legislación tributaria de la UE se utiliza como parte del análisis del concepto de Regímenes Tributarios Especiales o *Special Tax Regimes* (STR), incluidos en la Acción 6 del proyecto BEPS y analizados en el Capitulo II del presente trabajo, ya que dicho concepto podría generar preocupación a nivel de legislación Europea primaria y secundaria. En el Capitulo III aparece nuevamente una referencia a la legislación tributaria Europea como una manera de ejemplificar la evolución en el tratamiento de HMA en el seno de la UE. Esta evolución es ciertamente interesante debido al reciente desarrollo en la UE con respecto a HMA, en particular, lo referido a las Directivas EU ATAD I y II. Finalmente, una referencia a la legislación tributaria de la UE aparece como parte del análisis respecto a las *linking rules* de la OCDE en el Capitulo V y su compatibilidad con el derecho primario y secundario de la UE. La utilización de la legislación tributaria de la UE con el objeto de determinar la eficacia de las *linking*

rules se justifica por dos motivos principalmente. Por una parte, debido a la noción de “discriminación” elaborada por el Tribunal de Justicia de la UE, el cual, comparado con el Articulo 24 del Modelo de la OCDE (no-discriminación a nivel de tratados), analizado también en este Capitulo V, deriva en resultados dispares. Por otra parte, debido a que la UE ha mostrado un compromiso particular en la implementación del proyecto BEPS de la OCDE, incluyendo lo relativo a HMA. De hecho, lo anterior se ha materializado con la aprobación de la EU ATAD I, la cual ha optado por incluir las recomendadas *linking rules* de la OCDE para lidiar con híbridos, tanto en lo relativo a entidades como instrumentos financieros, y que en su reciente desarrollo en la EU ATAD II, también incluye HMA con terceros Estados. Todo lo anterior demuestra un análisis metodológico de la legislación tributaria de la UE de acuerdo lo requiera el desarrollo de la presente investigación, poniendo en evidencia un tratamiento sistemático.

Un análisis más agnóstico cobra también especial relevancia con respecto a los conceptos de doble no imposición y el uso de entidades híbridas en el contexto de los tratados bilaterales para evitar la doble imposición. De la misma manera, y aunque cada tratado constituye un mundo en particular, el uso de Modelos de tratados para la elaboración de los mismos, especialmente el uso del Modelo OCDE, podría ayudar para extraer conclusiones aplicables a la generalidad de tratados que utilizan clausulas similares. El Capítulo II, por ejemplo, analiza algunas cláusulas específicas del Modelo OCDE, las cuales a primera vista podrían interpretarse en post de prever la doble no imposición. De la misma manera, el Capítulo IV

analiza el Articulo 1(6) del Modelo de tratado de los Estados Unidos, el cual a pesar de no incluirse en todos los tratados finalmente firmados, se puede comparar con la actual propuesta de Articulo 1(2) del Modelo OCDE, permitiendo extraer nuevamente conclusiones generales con respecto al uso de entidades híbridas en el contexto de los convenios para evitar la doble imposición. En particular, el uso de casos de estudio en el Capítulo IV, tanto para explicar el Articulo 1(6) del Modelo de tratado de los Estados Unidos como para explicar el Articulo 1(2) del Modelo OCDE, encuentra su justificación en el hecho de que esos mismos casos de estudios son nuevamente utilizados para analizar la eficacia de la propuesta entregada en el Capítulo VI de la presente investigación, lo cual crea un punto de comparación armónico, a pesar de que dicha propuesta no pretende ser implementada directamente a través de los tratados bilaterales para evitar la doble imposición.

Finalmente, existe otra importante razón para preferir un análisis no estrictamente restringido a una jurisdicción en particular. El presente trabajo propone una propuesta alternativa (*reactive coordination rule*) para lidiar con casos de uso de entidades híbridas, el cual no sólo se aleja de lo propuesto por la OCDE a través de las *linking rules*, sino que también tiene la característica de que está diseñada sin considerar su aplicación en una jurisdicción determinada. Lo anterior tiene la ventaja de ser una regla que, en principio, se podría aplicar a cualquier jurisdicción, tomando en consideración también que las entidades híbridas son una preocupación internacional y no se restringen a un solo Estado.

En relación a la propuesta, ésta se basa en alguna ideas fundamentales. En primer lugar, pretende ser una regla simple que evite complejidades y que sirva también como una alternativa válida y administrable en comparación al set de reglas *"linking rules"* propuesto por la OCDE. En segundo lugar, la propuesta pretende enfocarse en el único problema real con respecto al uso de entidades híbridas, esto es, la calificación tributaria dispar de la misma entidad jurídica por dos o más Estados, obviando cualquier referencia los resultados de las transacciones transfronterizas en las cuales el uso de entidades híbridas se puede dar, en particular la doble no imposición. Finalmente, la propuesta pretende entregar resultados más consistentes en lo referido al uso de entidades híbridas y su impacto en los tratados bilaterales para evitar la doble imposición, en particular en comparación al Artículo 1(2) del Modelo OCDE y el Artículo 3(1) del Convenio Multilateral. Lo anterior podría instintivamente entenderse, puesto que una vez que la coordinación en la caracterización jurídico-tributaria de una entidad se ha alcanzado a nivel doméstico, los conflictos por el uso de entidades híbridas en el contexto de los tratados para evitar la doble imposición, simplemente desaparecen, dejando espacio para una aplicación restringida del Articulo 1(2) del Modelo OCDE, la cual se limitaría a los casos en que ambos Estados Contratantes en un tratado bilateral consideran a la misma entidad como una entidad transparente. Estos resultados se analizan en detalle en el Capítulo VI.

5. Estructura de la Investigación

El presente trabajo se divide en tres partes.

Primera Parte

La primera parte se refiere al estudio de la doble no imposición e incluye dos Capítulos.

El **Capitulo I**, por una parte, el cual pretende demostrar que la doble no imposición no debería ser considerada *per se* como una causa de preocupación en la transacciones transfronterizas. Este Capitulo también incluye los argumentos contra aquellos que soportan la idea respecto a la existencia de un principio internacional que obligaría a que las rentas derivadas de una transacción transfronteriza deban tributar al menos en uno de los Estados involucrados. En el mismo sentido, este Capítulo pretende demostrar que la noción de doble no imposición no se debería confundir con los conceptos tradicionales de evasión y elusión fiscal, lo cual ciertamente desvirtúa la naturaleza de la noción de doble no imposición. El análisis en abstracto de la noción de doble no imposición en este Capítulo permite, ciertamente, evitar *a priori* ideas negativas de un concepto que no deja de ser un simple resultado.

El **Capítulo II**, por otra parte, analiza la noción de doble no imposición a la luz de los tratados bilaterales para evitar la doble imposición. Tomando como punto de partida ciertas cláusulas del Modelo OCDE y algunos ejemplos particulares de tratados bilaterales, este Capitulo busca demostrar

que ninguna de estas cláusulas permite extraer una idea general de que los tratados para evitar la doble imposición persiguen de la misma manera evitar la doble no imposición. Lo anterior no significa reconocer que en algunas circunstancias los tratados bilaterales pueden perseguir dicho resultado, como pasa, por ejemplo, cuando se incluye expresamente en el tratado específico a través de lo que se conoce como *"subject-to-tax clauses"* o *"switch-over clauses"*. Sin embargo, estos casos son tan excepcionales como lo son aquellos en donde los tratados incluyen clausulas que directamente buscan o toleran el resultado de doble no imposición, como pasa, ejemplo, con las cláusulas *"tax sparing"* y *"matching credit"*.

Segunda Parte

La segunda parte se concentra en el segundo pilar del presente estudio, esto es, las entidades híbridas. Esta parte de la investigación también incluye dos Capítulos.

El **Capitulo III**, por una parte, el cual se refiere primeramente a algunos conceptos claves antes de entrar en el análisis del concepto de entidades híbridas. Este Capítulo incluye, asimismo, un análisis general de los distintos métodos utilizados a nivel internacional para calificar entidades extranjeras con propósitos fiscales, demostrando que no existe un sistema que cumpla todas y cada una de las condiciones que impidan su abuso. De la misma manera, el Capitulo provee un análisis detallado del sistema Norteamericano de *"Check-the-box"*, el cual es sin lugar a dudas el único ejemplo a nivel internacional en donde el contribuyente tiene la libertad de

elegir la calificación jurídico-tributaria de una entidad. El análisis incluye también la comparación con el antiguo sistema utilizado en los Estados Unidos, antes de la implementación de la normativas de *Check-the-box*, esto es, el test *Kintner.* Asimismo, el Capítulo analiza los casos de oportunidades de planeación fiscal derivadas de la normativa *Check-the-box*, especialmente en referencia a evitar la normativa anti-diferimiento (*CFC rules*) y al uso inapropiado de crédito por impuestos pagados en el extranjero, demostrando que el carácter electivo del sistema *Check-the-box* es más aparente que real cuando se le compara, por ejemplo, con sistemas que utilizan parámetros de comparación objetiva (*resemblance tests*) entre entidades extranjeras y domésticas, en lo cuales es igualmente probable predecir la calificación que se desea obtener. Finalmente, el Capitulo trata tres ejemplos concretos de coordinación en la calificación jurídico-tributaria de entidades: España, Dinamarca y el intento de coordinación en el texto original de la directiva ATAD en la UE, y el más reciente intento a través de la inclusión del Articulo 9a EU ATAD II, el cual extiende las propuesta a diferencias en la calificación de entidades con Estados fuera de la UE. Estos ejemplos demuestran que la coordinación en la calificación de entidades no es sólo una idea académica utópica, sino que una manera efectiva de lidiar con el uso (o mal uso) de entidades híbridas, sirviendo también como antesala a la propuesta del Capitulo VI.

El **Capitulo IV**, por otra parte, trata el uso de entidades híbridas y el acceso a los beneficios de un tratado para evitar la doble imposición. Para este propósito, el Capítulo se refiere primeramente a los requisitos generales para

acceder a los beneficios de un tratado con respecto a entidades jurídicas y analiza los principios establecidos en el reporte de la OCDE sobre entidades transparentes en 1999 (*OECD Partnership Report*). Luego, en relación al Articulo 1(6) del Modelo de los Estados Unidos, el Capitulo entrega ejemplos concretos de la relación entre esta norma y otras normas dentro del Modelo de los Estados Unidos, en particular en lo referido al requisito de *beneficiario efectivo* de los Artículos 10, 11 y 12 de dicho Modelo; la conocida *"saving clause"* (Articulo 1(4) del Modelo de los Estados Unidos); la normativa *Check-the-box* y la Sección 894(c) de la legislación doméstica. Asimismo, con respecto al Articulo 1(2) del Modelo OCDE, el Capítulo trata cuestiones referidas a su aplicación, que incluyen su relación con el concepto de beneficiario efectivo de los Artículos 10, 11 y 12 Modelo OCDE; la *"saving clause"* y las cuestiones relativas a la prevención de la doble imposición, en particular, lo referido al párrafo 64 de la Acción 6 del proyecto BEPS, y al impacto negativo con respecto a países en desarrollo que la inclusión del Articulo 1(2) Modelo OCDE puede generar. Finalmente, el análisis y las conclusiones referidas al estudio del Articulo 1(2) Modelo OCDE se extienden al Articulo 3(1) del Convenio Multilateral, el cual contiene prácticamente el mismo texto. A pesar de lo anterior, un análisis más en detalle se realiza con respecto a los Artículos 3(3) y 11 del Convenio Multilateral, referidos a la *"detailed saving clause".* De la misma manera, se analizan los Artículos 3(2) y 5–Option C del Convenio Multilateral, referido al impacto de la *saving clause* y las cuestiones relativas a la doble imposición.

Tercera Parte

Finalmente, la tercera parte del presente trabajo analiza la interacción entre la doble no imposición y las entidades híbridas dentro del concepto de "*hybrdid mismatch arrangements"* (HMA). Esta parte consta de tres Capítulos, incluyendo el capitulo final con las conclusiones de la presente investigación.

El **Capítulo V**, analiza primeramente la noción de HMA desde un punto de vista crítico, sobre todo en lo relativo a su confusa construcción como concepto jurídico. Asimismo, se sostiene en este Capítulo que la intención de generar una conexión entre las disparidades en la calificación de una misma entidad jurídica por al menos dos Estados y el resultado de la doble no imposición puede finalmente generar presunciones de practicas abusivas. Esto puesto que el "uso criticable" de entidades híbridas se reduciría exclusivamente a los casos en que el resultado de la transacción transfronteriza mediante el uso de entidades híbridas es precisamente la doble no imposición o una deducción/no inclusión de renta. En otras palabras, por el sólo hecho de concurrir la doble no imposición como resultado, se presumiría que un tratamiento dispar de una entidad es el resultado de una práctica abusiva. En el mismo sentido, el Capitulo refuerza la idea de que la deficiente construcción del concepto de HMA se extiende también al set de normas creadas para contrarrestar dichos resultados, esto es, *linking rules*. De hecho, el autor plantea que dichas normas podrían generar problemas de compatibilidad tanto a nivel de tratado bilaterales para

evitar la doble imposición como a nivel de legislación de la UE. Finalmente, el Capítulo analiza la interacción entre la aplicación de *linking rules* y otras normas domésticas que podrían limitar su eficacia, o su necesidad de aplicación, como son los casos de las normas que regulan la deducción de intereses pasivos (*interest limitation rules*) y las normas anti-diferimiento (*CFC rules*).

Contrariamente a la tendencia de generar una conexión casi natural entre la disparidad en la calificación de una misma entidad jurídica en dos Estados y el resultado de doble no imposición, el **Capitulo VI** de la presente investigación adopta una posición alternativa, proponiendo una regla de coordinación en la calificación de entidades para efectos tributarios, denominada *reactive coordination rule.* La propuesta tiene como propósito presentar una alternativa doméstica al uso de entidades híbridas, la cual consiste en respetar la calificación jurídica del Estado en donde dicha entidad se ha organizado o ha sido legalmente constituida, esto es, el *home country.* Asimismo, la propuesta tiene como base tres ideas pilares de política fiscal: simplicidad, coherencia y administrabilidad. La primera parte del capítulo describe la mecánica de la propuesta, incluyendo su alcance de aplicación y los objetivos de política fiscal en los que se ampara. De la misma manera, se explica el funcionamiento de la propuesta a través de ejemplos particulares, detallando tanto sus ventajas como desventajas. Finalmente, esta primera parte entrega una comparación entre la propuesta de *reactive coordination rule* y otra propuestas similares que siguen la senda de la coordinación en la calificación de entidades, dejando ver las razones

que hacen preferible a la presente propuesta. La segunda parte de este Capitulo analiza las implicancias que la regla propuesta tendría en el contexto de tratados bilaterales para evitar la doble imposición. Tal y como se reconoció en el Capitulo IV, la inclusión de un nuevo Articulo 1(2) en el Modelo OCDE [y Articulo 3(1) del Convenio Multilateral] resuelve bastantes cuestiones relativas al acceso a los beneficios de un tratado en caso de entidades transparentes. Sin embargo, este artículo esta lejos de constituir una solución aceptable para países en vías de desarrollo, los cuales descansan mayormente en una tributación basada en la fuente de la renta más que en la residencia. Esta cuestión podría, sin embargo, ser mitigada si la propuesta de *reactive coordination rule* se aprueba de manera global. De hecho, de ocurrir lo anterior, el alcance del Articulo 1(2) del Modelo OCDE se reduciría automáticamente a los casos en que ambos Estados Contratantes consideren a la misma entidad como una entidad transparente, luego de la aplicación de la *reactive coordination rule*, indirectamente mejorando también la posición de muchos Estados que descansan en una tributación sobre la base de la fuente de la renta. No obstante lo anterior, la presente propuesta no tiene por objeto ser presentada como una solución perfecta (o no mejorable) ni menos definitiva, no obstante pretende servir como un aliciente para demostrar de que el debate con respecto al uso de entidades híbridas puede ser reorientado.

El **Capitulo VII** finalmente resume los principales resultados de la presente investigación.

6. Conclusiones

Tal y como se ha presentado en el comienzo de la presente investigación, este trabajo ha pretendido responder a la siguientes preguntas de investigación:

1. Existe necesariamente una interconexión entre el uso de entidades híbridas y el resultado de la doble no imposición? Deberían las reglas que regulan el uso (o mal uso) de entidades híbridas estar diseñadas exclusivamente sobre la base del resultado exclusivo de doble no imposición?

2. Existe una propuesta alternativa para lidiar más directamente con el uso (o mal uso) de las disparidades en la calificación de entidades jurídicas para propósitos tributarios, la cual no considere el resultado de la doble no imposición, o la *posición consecuencialista* que la mayoría adopta debiese primar?

Asimismo, en la búsqueda de respuestas, el presente trabajo a utilizado como punto de partida las siguientes hipótesis de trabajo:

a. El sólo resultado de una deducción/no-inclusión de renta, esto doble no imposición, no debería considerarse *per se* como un objeto de preocupación en lo relativo a transacciones transfronterizas. De la misma manera, se debiese evitar el uso de la doble no imposición como una conexión inmediata para determinar la existencia de

practicas que podrían considerarse como abusivas cuando derivan exclusivamente del uso de entidades híbridas.

b. *Linking rules* o reglas que establezcan una conexión o contingencia entre una determinada deducción en un Estado con la correspondiente inclusión o reconocimiento de renta en el otro Estado, como las propuestas por la OCDE en su Plan de Acción BEPS, tienen el riesgo de establecer presunciones de practicas abusivas que se dan por el sólo hecho de que el resultado de doble no imposición aparece envuelto. De la misma manera, estas reglas son altamente complejas de administrar y en ningún caso atacan el verdadero meollo del problema del uso de entidades híbridas, esto es, la calificación dispar de una misma entidad por dos o más Estados. Alternativas a estas reglas debiesen ser evaluadas.

c. Las reglas que regulan el uso de *entidades transparentes* en el contexto de tratados bilaterales para evitar la doble imposición, con el objeto de prever el acceso a los beneficios de dichos tratados por parte de terceros Estados ajenos a los mismo son, en principio, recomendables. Sin embargo, la inclusión de un Articulo 1(2) en el Modelo OCDE, el cual se inspira en el Articulo 1(6) del Modelo de los Estados Unidos, podría generar problemas importantes para países en desarrollo, principalmente si se considera que estos países descansan en una tributación basada en la fuente de la renta. La misma preocupación se extiende con respecto a la inclusión de un

Articulo 3(1) del nuevo Convenio Multilateral, cuyo texto refleja lo ya establecido en el Articulo 1(2) del Modelo OCDE. Soluciones alternativas, incluyendo soluciones a nivel de legislación doméstica, debieran ser analizadas.

6.1. La innecesaria preocupación internacional por la doble no imposición

La mayor parte del debate relativo a la doble no imposición y el uso de entidades híbridas ha sido contaminado por ciertas suposiciones dadas por sentadas. Lo anterior se debe en particular a la idea generalizada de que las rentas en una transacción transfronteriza debiesen pagar impuestos en al menos uno de los Estados involucrados, lo que *a priori* rechaza el resultado de la doble no imposición en cualquiera de sus formas.

Es innegable de que la idea en donde los diferentes sistemas tributarios a nivel internacional trabajen en conjunto para asegurar que las transacciones transfronterizas paguen impuestos en al menos unos de esos Estados, independiente donde, es atractiva. Sin embargo, es también muy riesgosa. Tal como se señaló en el Capítulo I, lo anterior se puede ver en la confusión que existe hoy entre la doble no imposición como resultado y otros conceptos tradicionalmente considerados poco deseables como la evasión y elusión fiscal. Más importante y claro aún es la aparición y uso de conceptos pseudo-legales, tales como la noción de *Planificación Fiscal Agresiva* (ATP, en inglés), cuya *mirada consecuencialista* ha simplemente

contribuido a incrementar los niveles de incertidumbre entre los contribuyentes. Una senda similar se puede ver en el diseño de reglas anti-híbridos (*linking rules*), las cuales asumen como punto de partida el generar una conexión entre los resultados tributarios (*matching tax outcomes*) de manera de asegurar la imposición en al menos un Estado, aunque sin tomar en consideración el verdadero origen de la existencia de entidades híbridas, el cual no es más que la calificación jurídico-tributaria dispar de la misma entidad jurídica por dos Estados distintos. Sin embargo, hay un punto crucial que no debiera olvidarse en este debate, y es que la doble no imposición no es otra cosa que un simple resultado, el cual, ausente de interpretaciones subjetivas, no debería ser considerado en si mismo un problema.

En el mismo orden de ideas, y luego de analizar el Modelo de tratado bilateral para evitar la doble imposición de la OCDE y algunas cláusulas especificas incluidas en la práctica de los tratados bilaterales, es posible concluir que éstos instrumentos en ningún caso se podrían interpretar en el sentido de prever la doble no imposición. Esta conclusión, tal y como se demuestra en el Capitulo II, se mantiene incluso luego de la inclusión de la referencia a la evasión y elusión fiscal en el titulo de algunos tratados bilaterales. De hecho, lo que la práctica en cuanto a los tratados bilaterales para evitar la doble imposición demuestra es completamente lo contrario, esto es, la prevención así como la búsqueda deseada del resultado de doble no imposición a través de los tratado bilaterales es, sin lugar a dudas, excepcional. Esto es, mal se podría concluir que una regla de política fiscal se pueda interpretar de dichos instrumentos en cuanto a prevenir la doble no

imposición. Así, por ejemplo, los tratados bilaterales muchas veces toleran el resultado de doble no imposición cuando cláusulas de *tax sparing* o *matching credits* son incluidas en los mismos. En otros casos, dicho resultado de doble no imposición se evita a través de normas específicamente introducidas en los tratados bilaterales, tales como *subject-to-tax clauses* and *switch-over clauses*. Esta conclusión es válida aún con posterioridad a la nueva interpretación de los Artículos 23A and 23B del Modelo OCDE incluida en los comentarios al Modelo OCDE, y a la inclusión del Articulo 23 A(1) Modelo OCDE. Ninguna de las normas antes señaladas resuelve con eficacia todas las situaciones de doble no imposición derivadas de conflictos de calificación o interpretación.

Una tendencia distinta podría, sin embargo, sugerirse con la propuesta del Plan de Acción BEPS No. 6, el cual incluye modificaciones al titulo y preámbulo del Modelo OCDE, y la inclusión de la norma sobre *"Special Tax Regimes"* (STR). No obstante, la poco feliz redacción del preámbulo del Modelo OCDE, solo sugeriría que la prevención de la doble no imposición se limita a los casos en que dicho resultado es producto de la evasión o la elusión fiscal. Asimismo, la regla sobre STR en relación a los Artículos 11, 12 y 21 del Modelo OCDE no sugiere ninguna obligación para el Estado de la fuente en cuanto a ejercer una efectiva tributación. Por el contrario, sigue siendo facultativo para este Estado el ejercer su tributación, tal y como se demuestra en el uso de las palabras en inglés *"may be"* en vez de *"must be"* u otras similares, que podrían sugerir una obligación implícita. Por lo tanto, una interpretación de tal regla en cuanto a prevenir que

intereses, royalties u otra renta permanezca sin tributación debido a estar sujeta a un STR, sería simplemente imprecisa.

Por lo tanto, en el actual escenario internacional en el cual no existe ninguna obligación para prevenir o eliminar la doble no imposición, o lo que es lo mismo, una obligación para asegurar la tributación en al menos un Estado, tanto a nivel doméstico como a nivel de tratados, este autor concluye que el resultado de doble no imposición debería permanecer como tal, esto es, como un *resultado,* sin utilizarse como proxy para determinar practicas abusivas a través del uso de entidades híbridas, o bien como un elemento necesario en el diseño de normas anti-híbridos.

6.2. *Entidades Híbridas*: Las disparidades en la calificación jurídica como elemento central

Como se ha ya sostenido en este trabajo, las entidades híbridas son el resultado de las políticas fiscales domésticas y soberanas en cuanto a determinar el tratamiento fiscal que se le dará a una entidad extranjera para efectos fiscales domésticos. Este resultado, el cual no es para nada sorpresivo, sobre todo considerando que los sistema tributarios alrededor del mundo no son para nada uniformes en la aplicación de políticas fiscales y difieren en muchos aspectos, simplemente confirma que el meollo del asunto relativo a entidades híbridas no es otro que las disparidades en la calificación jurídico-tributaria de la misma entidad por dos Estados distintos. Este elemento es crucial para entender propiamente la discusión en

cuanto a las entidades híbridas así como respecto a las soluciones que se propongan.

Con relación a la normas utilizadas para calificar entidades extranjeras para efectos tributarios domésticos, uno podría concluir que no existen reglas que cumplan todos los requerimientos para ser absolutamente inviolables. Por lo tanto, la discusión no debería estar enfocada en si un sistema de calificación es más o menos electivo que el otro. De hecho, tal y como se ha demostrado en el Capitulo III, un *test de comparabilidad* normalmente falla en cuanto a crear una calificación consistente, debido mayormente a las notables diferencias entre entidades domesticas y extranjeras. De la misma manera, estos test de comparabilidad tienden a ser no menos electivos que un sistema electivo puro en cuanto a la calificación de una entidad extranjera para efectos fiscales internos. Un ejemplo de lo anterior es el test *Kintner*, utilizado en los Estados Unidos, y el cual estuvo vigente antes de la entrada en vigor de las reglas *Check-the-box.* Este sistema permitía a los contribuyentes más sofisticados, y con acceso a mejores asesores, establecer las estructuras societarias que más se adecuasen para efectos internos con el objeto de obtener la calificación deseada. Lo anterior no significa reconocer la influencia del sistema de *Check-the-box* en cuanto a generar oportunidad para evitar la legislación anti-diferimiento (CFC) o relativa créditos por impuestos extranjeros en los Estados Unidos. En dichos casos, sin embargo, la evasión de la normativa no atiende necesariamente al carácter electivo del sistema de calificación de entidades extranjeras, sino al pobre diseño de las

normas anti-diferimiento o relativas a créditos por impuestos pagados en el extranjero.

Otro aspecto importante con respecto a la discusión respecto a entidades híbridas son las experiencias prácticas de coordinación como herramienta de solución al problemas del uso (o mal uso) de entidades híbridas las que, ya sea a través de norma positiva o de práctica administrativa, permiten concluir que las posibilidades de coordinación en la calificación de entidades son más que una idea académica utópica y tienen asiento en la realidad. El Capitulo III analizó tres casos en particular: 1) la práctica administrativa en España; 2) la ley Danesa sobre entidades hibridas, y 3) la propuesta de directiva ATAD y la norma especifica introducida en la reciente ATAD II en la legislación de la UE. Todos estos casos demuestran un solo elemento en común, y es que todas ellas están diseñadas considerando el elemento central en cuanto a las entidades hibridas, que es la calificación dispar respecto a la misma entidad por parte de dos o meas Estados distintos. En España, por ejemplo, la practica administrativa interpreta la norma del *Régimen de Atribución de Rentas* en el sentido de respectar la calificación jurídica de la entidad en el país extranjero. Por lo tanto, más allá de las criticas que dicha interpretación por parte de la autoridad tributaria Española (DGT) pueda levantar, dicha interpretación elimina todas las probabilidades de generar entidades híbridas en los casos en que España califica una entidad extranjera desde la cual residentes Españoles reciben rentas. En Dinamarca, por otro lado, existen normas que permiten la re-calificación de entidades domésticas en casos en que la

calificación jurídica hecha por la mayoría de los accionistas de dichas entidades en el extranjero, genere una disparidad con la calificación en Dinamarca. A pesar de que el estudio de estas normas es interesante como ejemplo de coordinación, estas normas han sido criticadas por descansar excesivamente en el derecho extranjero, incrementando por tanto los niveles de incertidumbre entre los contribuyentes. Asimismo, una referencia especial se ha hizo con respecto a la propuesta de directiva ATAD (2016) a nivel de la UE, la cual, a pesar de mantener las referencias al resultado de doble no imposición, entregaba un ejemplo concreto de coordinación como alternativas de solución (alternativa las *linking rules* de la OCDE), estableciendo que en caso de disparidad en la calificación de una misma entidad jurídica por parte de dos Estado Miembros, la calificación del Estado Miembro en la fuente prevalecería. Desafortunadamente, esta regla no ha sido incluida en el texto final de la directiva ATAD I (2016), la cual ha optado por la recomendación de la OCDE. Sin embargo, recientemente se ha propuesto un Articulo 9a en la ATAD II (2017) , que regula los HMA con terceros Estados fuera de la UE, y que establece la posibilidad de re-calificar una entidad considerada como fiscalmente transparente dentro de la UE, cuando la mayoría de sus accionistas o socios la trate como una entidad opaca o tributable, lo que en cierta medida recuerda lo ya señalado con respecto a la norma en Dinamarca.

Las experiencias antes mencionadas son un precedente muy optimista y que permiten a este autor concluir que la coordinación en cuanto a la calificación de entidades es de hecho una manera más directa y efectiva de lidiar con las

entidades híbridas, en vez de tratar de indirectamente generar una conexión entre los resultados tributarios, esto es, generando un link artificial entre deducción por una parte e inclusión de renta por la otra.

6.3. *Entidades Híbridas* y el acceso a los beneficios de un tratado para evitar la doble imposición

A pesar de que los tratados para evitar la doble imposición no persiguen la prevención de la doble no imposición como política general, es indudable que la sola diferencia en la calificación de una misma entidad jurídica en dos Estados Contratantes podría generar problemas en cuanto a determinar a quien se asigna la renta y, por tanto, los beneficios de un tratado. En otras palabras, las entidades híbridas son de hecho una preocupación a nivel de tratados, ya que los tratados para evitar la doble imposición se aplican a personas quienes también son consideradas residentes, es decir, *liable to tax* o sujetas a una tributación comprehensiva o completa, más allá de la imposición efectiva de impuestos. El problema es, sin embargo, que la mayoría de las entidades no-corporativas gozan de transparencia fiscal total o parcial, lo cual contradice una tributación comprehensiva. En principio, por lo tanto, las normas que regulan la asignación de rentas recibidas a través de entidades transparentes, consideradas como tal por al menos uno de los Estados Contratantes, son deseables.

Una mirada preliminar a los principios establecidos en el Reporte de la OCDE sobre entidades transparentes en 1999, los cuales se reconocen en el

Articulo 1(6) del Modelo de los Estados Unidos, el cual sirve a su vez como precedente del Articulo 1(2) Modelo OCDE y Articulo 3(1) del Convenio Multilateral, nos entrega la impresión de una solución práctica, puesto que el Estado de la fuente debería seguir los principios de atribución de renta en el Estado de residencia y atribuir la renta de esa manera. En otras palabras, la calificación jurídico-tributaria de la entidad en el Estado de residencia prevalece a la del Estado de la fuente, aún cuando el texto de la norma no lo señale expresamente.

La solución pragmática ofrecida por las normas analizadas en el Capitulo IV, especialmente en relación al Articulo 1(2) del Modelo OCDE y del Articulo 3(1) del Convenio Multilateral tiene, sin embargo, importantes inconsistencias. Una de las más notorias es la completa ausencia a la conexión entre la solución adoptada para el caso de rentas recibidas a través de una entidad transparente y otras normas dentro del Modelo de tratado, en particular, respecto al requisito de *beneficiario efectivo* de los Artículos 10, 11 y 12 del Modelo OCDE. Curiosamente esta cuestión no fue analizada ni en el reporte de la OCDE en 1999, ni en lo relativo al Articulo 1(6) del Modelo de los Estados Unidos, el cual es el precedente directo de la propuesta actual de un Articulo 1(2) en el Modelo OCDE. A pesar de lo anterior, es posible encontrar algunos ejemplos aislados en la practica tributaria. El primer ejemplo se puede encontrar en el tratado entre los Estados Unidos y Polonia, en donde indirectamente se soluciona la dicotomía sobre la base de la no aplicación del Articulo 1(6) bajo ciertas circunstancias. El segundo ejemplo, constituye una verdadera regla que

atiende al problema en si mismo estableciendo una especie de "ficción de beneficiario efectivo" cuando las normas del Articulo 1(6) y 10, 11 y 12 del Modelo de los Estados Unidos lleva a diferentes resultados. Esta norma se encuentra específicamente en el tratado entre los Estados Unidos y Canadá y ha sido "relanzada" recientemente como una propuesta al amparo de una serie de académicos (*deemed beneficial owner*), la cual podría aplicarse de manera global. Si bien este autor reconoce que en principio la regla propuesta atiende al hecho de que la entidad bajo análisis no es un agente, asignatario o intermediario (*agent, nominee or intermediary*), lo cual se determina desde el punto de vista del Estado de la fuente, la regla rápidamente se torna a favor del Estado de residencia, dando prevalencia a la calificación de la entidad en dicho Estado como manera de solucionar la dicotomía. En otras palabras, el conflicto entre la norma sobre entidades transparentes y el concepto de *beneficiario efectivo* depende finalmente en asumir que un residente en el Estado de residencia sea el *beneficiario efectivo*. En términos simples, el Estado de la fuente, una vez más, debe limitar su derecho a determinar sobre la base de su ley doméstica quién es el beneficiario efectivo del pago de dividendos, intereses y cánones. Como tal, este autor ve serias dificultades para muchos Estados que descansan en una tributación basada mayormente en la fuente de la renta acepten tal solución.

Otro hecho en relación al Articulo 1(2) del Modelo OCDE y al Articulo 3(1) del Convenio Multilateral es la interacción entre dichas normas y la norma *"saving clause",* que asegura que los Estados Contratantes puedan gravar a sus residentes más allá de lo que señale el tratado. En este sentido, la

solución adoptada por el párrafo 64 del proyecto BEPS de la OCDE (Acción 6), el cual introduce el párrafo 11.1. a los Comentarios de los Artículos 23 A y 23 B Modelo OCDE, es bastante claro y directo en cuanto a señalar que los Estados Contratantes *no están* recíprocamente obligados a mitigar la doble imposición causada exclusivamente por la carga tributaria que el contribuyente sufre sobre la base de su residencia. En otras palabras, la mitigación de la doble imposición es una opción disponible solamente en la medida en que la tributación realizada por el otro Estado Contratante se permite por las normas del tratado como Estado de la fuente o como Estado donde exista un EP al cual se le atribuye renta. La solución se replica 3(2) y Articulo 5–Opción C del Convenio Multilateral. Ambas normas se refieren al párrafo 64 de la Acción 6 de BEPS. Sin embargo, cuando se trata de la *saving claus* opcionales dentro del Convenio Multilateral, pareciera ser que optar por una u otra no genera los mismo resultados. Por ejemplo, mientras la *saving clause* detallada del Articulo 11 del Convenio Multilateral pareciera retener la obligación de mitigar la doble imposición fundada en los artículos 7(3), 9, 19, 20, 23 A, 23 B, 24, 25 y 28 Modelo OCDE, la versión simplificada del Articulo 3(3) del Convenio Multilateral no preserva dicha obligación con respecto a esos artículos. De la misma manera, una solución tal como la propuesta en el párrafo 64 de la Acción 6 del proyecto BEPS, podría aún generar problemas en algunos Estados donde, basados en clausulas especificas en los tratados bilaterales, mitigan la doble imposición en esos casos y otro análogos, pero por extensión de la interpretación del Artículo 23 del Modelo OCDE. En otras palabras, quizás la inclusión de una *saving clause* no sea estrictamente necesaria para todos los Estados.

Como se concluye en el Capítulo IV, por lo tanto, el Articulo 1(2) Modelo OCDE y el Articulo 3(1) del Convenio Multilateral, en conjunto con la propuesta de una *saving clauses*, podría no ser necesariamente la manera más adecuada de direccionar la discusión relativa a las entidades híbridas en el contexto de los tratados bilaterales para evitar la doble imposición. En este sentido, la idea de una solución alternativa, tal como la *reactive coordination rule*, toma fuerza.

6.4. Evitando la conexión artificial entre la doble no imposición y el uso de entidades híbridas

El intento de crear una conexión directa entre la doble no imposición y el uso de entidades híbridas ha derivado en el resbaladizo concepto de HMA. Esta noción, cuya construcción se basa en el supuesto de que toda renta transfronteriza debe tributar alguna vez, sin importar dónde, no solamente se desvía del verdadero problema respecto a las entidades híbridas, esto es, la calificación dispar de una misma entidad jurídica por dos Estados distintos, sino que también crea nuevas presunciones de erosión de bases y practicas abusivas por el sólo hecho de la concurrencia del resultado de doble no imposición o deducción/no inclusión. De la misma manera, *linking rules,* esto es reglas creadas con el objeto de contrarrestar HMA, siguen la misma tendencia, aun cuando dichas normas son completamente ineficaces para solucionar el verdadero *mismatch* que es la calificación jurídico-tributaria dispar de una misma entidad.

La atendencia adoptada en el diseño de normas anti-híbridos, tal como se demuestra en el Capitulo V, genera importantes cuestionamientos tanto desde un punto de vista de política fiscal como desde un punto de vista legal. Desde una perspectiva de política fiscal, *linking rules* tienden a ser circulares, es decir, si son implementadas por todos los Estados, no tendrán otro efecto que anularse una a la otra, incluso si una regla de *tie-break* se establece. Aún más importante, una aplicación descordinada de una *primary response* y una *defensive rule* , esto es, una aplicación circular, podría generar nuevos problemas de doble imposición económica, los cuales no existían antes de la implementación de dichas normas. De la misma manera, no debería dejarse de lado el hecho de que estas normas son extremadamente dependientes de la aplicación de la legislación foránea, la cual, a menos que exista un acceso a información más eficaz, especialmente entre países en desarrollo, podría generar serias dudas con respecto a su verdadera efectividad. En el mismo orden de ideas, y aunque las *linking rules* no generan mayores preocupaciones con respecto al Articulo 24 del Modelo OECD mayormente debido a la aplicación restrictiva de dicha norma, existen aún dudas con respecto a su compatibilidad con la legislación tributaria de la UE, especialmente con la legislación primaria. Desafortunadamente, sin embargo, la jurisprudencia de la Corte de Justicia de la UE no es inequívoca ni menos consistente para entregar una respuesta concreta al respecto.

Por todo lo anterior, este autor concluye que una aproximación diferente es necesaria, la cual debiese considerar, por una parte, una tendencia más

directa para solucionar los problemas relativos a entidades híbridas, y por la otra, una regla mas simple y fácil de administrar en comparación con la actual propuesta de la OCDE.

6.5. La Alternativa: *Reactive Coordination Rule*

Contrariamente a aquellos que argumentan por una conexión entre el resultado de doble no imposición y el uso de entidades híbridas, este trabajo propone un camino distinto, el cual se basa en alguna ideas bases. En primer lugar, es proponer una regla simple que evite las complejidades de las *linking rules* propuestas por la OCDE y que sirva como una propuesta valida y administrable tanto a nivel doméstico como a nivel de tratados bilaterales para evitar la doble imposición. Por otra parte, es proponer una regla que verdaderamente se enfoque en resolver la única real cuestión con respecto a la entidades híbridas, esto es, la calificación dispar de una misma entidad por parte de dos o más Estados.

El Capitulo VI ha presentado en detalle la propuesta de implementación de una *reactive coordination rule*, cuyo mecanismo de aplicación es simple y consiste en alinear la calificación jurídica de una entidad extranjera para efectos domésticos de acuerdo a la calificación jurídica que ésta reciba en el país donde se encuentra organizada legal y formalmente, esto es, el *"home country"*. La utilización del *"home country"* como factor de alineación se justifica, ya que aunque muchas veces el "*home country"* y *"source country"* coinciden, por ejemplo, en todos los casos en que un pago se

realiza desde una entidad híbrida, no coincidirán en todos aquellos casos en donde un pago se recibe por parte de una entidad híbrida reversa, esto eso, una entidad considerada como fiscalmente transparente en el Estado donde se constituye, mientras que se le considera por el otro Estado como una entidad tributable. Por lo tanto, teniendo en cuenta la simplicidad que esta propuesta busca, este autor opta por utilizar una conexión más apropiada, esto es, el “home country”. Asimismo, este hecho se relaciona a la coherencia que la propuesta también persigue. De hecho, HMA son el resultado de la calificación dispar de una entidad cuando ésta se le compara con la calificación jurídica-tributaria entregada en el Estado en donde dicha entidad se ha organizado legalmente. Por lo tanto, y al menos desde un punto de vista estrictamente de política fiscal, el diseño de una regla que alinea la calificación jurídico-tributaria de una entidad de acuerdo a la entregada en el país de su organización legal es al menos más coherente en términos de forzar al país que genera el la desalienación (*mismatch*) a seguir la calificación del otro Estado. En el mismo sentido, la *reactive coordination rule* asume una aproximación más honesta en su alcance. De hecho, aplica a todos los casos en donde exista una disparidad entre dos Estados en cuanto a calificar jurídica-tributariamente una misma entidad. Lo anterior, por una parte, se encuentra coordinado con las razones de política fiscal que subyacen la propuesta, esto es, simplicidad, coherencia y adminitrabilidad, y, por la otra, cumple con el propósito de contrarrestar el verdadero motivo de la existencia de entidades híbridas, cual es la calificación jurídica dispar de dos o más Estados sobre la misma entidad.

Tal y como se señaló en el Capítulo VI, la propuesta tiene un impacto positivo resolviendo la desalineación en la calificación de la entidad (el verdadero *mismatch*), y evitando las contingencias innecesarias asociadas a los resultados de las transacciones que envuelven entidades híbridas, reduciendo así también su complejidad. Más importante aún, ubica a las disparidades en la calificación de entidades de vuelta en el frente de la discusión respecto a las entidades híbridas. A pesar de lo anterior, la regla no es perfecta ni está exenta de perfeccionamiento. De hecho, el diseño propuesto a la regla deja abierta cuestiones relativas a su aplicación, lo cual se relaciona mayormente con efectos indeseados a la misma. Estos casos se refieren específicamente a la potencial doble imposición en aquellos casos en que la entidad híbrida reciba un pago y los casos en los cuales se genera un beneficio fiscal por el sólo hecho de aplicar la regla propuesta, y el cual no existía con anterioridad. Sin embargo, y con el objeto de mitigar dichos resultados, el autor ha propuesto, por una parte, la coordinación de la norma propuesta con otra normas, tales como reglas anti-diferimiento (CFC), con respecto a los potenciales casos de doble imposición, y, por otra parte, un "switch-off" de la norma propuesta en aquellos casos en que se generen beneficios tributarios indebidos derivados exclusivamente de la aplicación de la norma. Con todo, una implementación a nivel global y uniforme de la presente propuesta sigue siendo una cuestión fundamental para asegurar su verdadero impacto práctico.

Es interesante destacar que la *reactive coordination rule* podría generar también un impacto positivo desde un punto de vista del uso de entidades

híbridas en el contexto de los tratados bilaterales para evitar la doble imposición. De hecho, la coordinación en la calificación de entidades a nivel doméstico asegura una aplicación más restringida del Articulo 1(2) del Modelo OCDE, el cual se limitaría a los casos en que el "home country" trata a la entidad como una entidad transparente. Dicha restricción indirectamente asegura resultados más justos para Estados cuya tributación descansa principalmente en la fuente de la renta. A pesar de lo anterior, y tal como se señaló en los casos de estudio del Capitulo IV, la aplicación de la *reactive coordination rule* no siempre deriva en resultados más positivos para los Estados de la fuente. Sin embargo, lo anterior está lejos de considerarse como una característica negativa de la regla, sino más bien es la mejor demostración de que la regla propuesta tiene por objeto eliminar las disparidades en la calificación de entidades a nivel doméstico, indirectamente generando resultados más coherentes desde un punto de vista de los tratados bilaterales para evitar la doble imposición, pero en ningún caso se trata de un regla creada para inclinar la balanza a favor del Estado de la fuente en relación al Estado de la residencia en un contexto bilateral.

En consideración a todo lo anterior, el uso y mal uso de las entidades híbridas es un desafío que debiera direccionarse adecuadamente, comenzando por el hecho de asumir una posición menos consecuencialista. Hoy por hoy, hemos sido testigos de la intención de presentar los problemas en un traje distinto, cuyo pragmatismo es en algunas veces difícil de contra-argumentar también. Sin embargo, lo anterior no debiera limitarnos en reorientar la discusión a lo realmente importante en el debate sobre las

entidades híbridas. Este desafío debería asumirse antes que todos los países se convenzan de quién es realmente el enemigo y de que el camino de generar conexiones artificiales entre resultados es preferible. Como este trabajo ha demostrado, las alternativas son aún posibles.