I. Introduction

This chapter will deal with hybrid entities in an international tax law context. The focus will be on cross-border situations where the attribution of income in situations involving transparent entities is the key question.

In the OECD Report on Hybrid Mismatch Arrangements, hybrid entities are described as "[e]ntities that are treated as transparent for tax purposes in one country and as non-transparent in another country".[1] With these entities the problem can arise that the two contracting states allocate the income to different persons. This can lead to double taxation, as well as to double non-taxation.

Hybrid entities are the result of differing laws among nations. They are not per se "bad", but simply a consequence of the interaction of two different sovereign jurisdictions. However, they are often used intentionally to obtain tax benefits unduly.[2] As practice and literature show, the situation is unlikely to become easier over the next years. Indeed, a more similar approach by jurisdictions to the treatment of partnerships and other hybrid entities is unlikely to occur in the near future.[3]

From the above, the OECD has concluded that counter-measures against arrangements involving hybrid entities must be implemented. Thus, the OECD issued Action 2 on "Neutralising the Effects of Hybrid Mismatch Arrangements" in its Action Plan on Base Erosion and Profit Shifting (BEPS).[4]

While the 1999 Partnership Report provided principles on how to interpret and apply tax treaties to partnerships, the BEPS Action Plan sets forth a new provision that covers all fiscally transparent entities. Thus, the BEPS project, which places more emphasis on this tricky field of allocating taxing rights and aims at a real, functioning solution, can be seen as a further chance to counter the problems deriving from hybrids.

First, the principles of the OECD Partnership Report will be explained in section II.A., followed by an examination of the origin of this clause from the US Model Convention (US Model) in section II.B. The main part of this chapter (section III.) is to analyse the wording and functioning of this new provision. Similarities and differences to the provision of the US Model will be noted.

1 OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD Publishing 5 Mar. 2012), para. 10, International Organizations' Documentation IBFD.

2 OECD, Hybrid Mismatch Arrangements, supra n. 1, para. 9.

3 J. Lüdicke, *"Tax Arbitrage" with Hybrid Entities: Challenges and Responses*, 68 Bull. Intl. Taxn. 6/7 (2014), at 309, Journals IBFD.

4 OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: 2014 Deliverable*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2014), International Organizations' Documentation IBFD.

II. Hybrid arrangements and tax treaty entitlement: Current principles

The allocation of income is of critical importance in tax law. Whether an entity is treated as taxable or as fiscally transparent mainly depends on domestic law, as does the allocation of income. Similarly, domestic law will also define whether an arrangement can be regarded as an entity or as a legal person. The consequences of this qualification are enormous: The recognition of the entity as opaque will have the effect that income is considered to be derived at the level of the entity, and the income will also be taxed there. On the other hand, the qualification of an arrangement or entity as transparent will lead to the attribution of income to the owners or shareholders of such arrangement. Therefore, the income will not be taxable at the level of the arrangement, but rather at the level of the owners or shareholders. This difference in the qualification of entities may also lead to a conflict of allocation of income. This means that in cases where the status as taxable person of an entity is not clear, the question regarding to whom the income is attributable also is not easy to answer. Problems will arise if two contracting states allocate income differently. Such mismatches can lead to double taxation, as well as double non-taxation.

However, the issue of such hybrid mismatches and when they should nonetheless be allowed to have access to treaty benefits is not new. Already in 1993 the OECD formed a working group to investigate the application of the OECD Model Convention (OECD Model) to partnerships, trusts and other non-corporate entities.[5] For partnerships, the determination of how the allocation conflicts that arise can be resolved was then presented in the 1999 OECD Partnership Report and later incorporated into the Commentary on the OECD Model.[6] The findings of this working group have been applied in practice, but have also given rise to criticism by tax administrations and scholars, as well as in jurisprudence.[7] With the new article 1(2) these principles will now be implemented into the OECD Model.

A. Principles of the OECD Partnership Report

For reason of this historic background, a brief analysis of the OECD Partnership report will now be given. The OECD Partnership Report follows a case study-

5 OECD, *The Application of the OECD Model Tax Convention to Partnerships* (OECD Publishing 1999) at 7, International Organizations' Documentation.

6 OECD Model Tax Convention on Income and on Capital: Commentary (22 July 2010), Models IBFD.

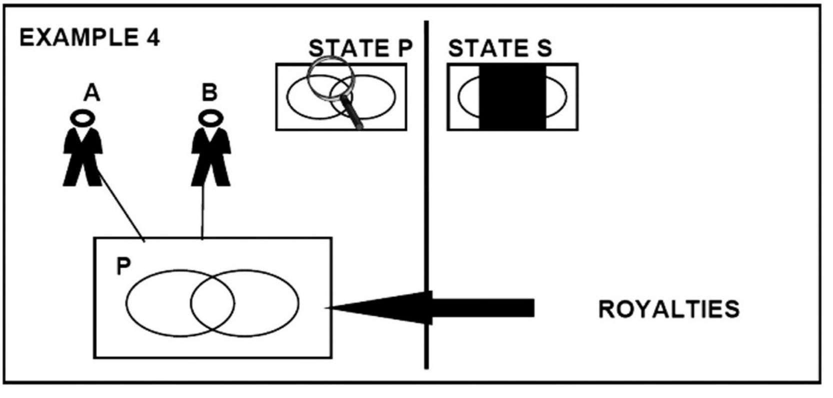
7 *See* e.g. M. Lang, *The Application of the OECD Model Tax Convention to Partnerships* (Linde 2000); M. Lang, *Qualifikationskonflikte bei Personengesellschaften*, Internationales Steuerrecht (IStR) (2000), at 132; M. Lang, *Personengesellschaften im DBA-Recht*, Steuer und Wirtschaft International (SWI) (2000), at 64; M. Lang, *Steuerlich transparente Rechtsträger und Abkommensberechtigung*, IStR (2011), at 1.

based approach. For each case, the relevant aspects of domestic law are described. Then, the applicability of the OECD Model is analysed and suggestions are put forward. However, before analysing the case studies, the Partnership Report deals with the problem of whether partnerships can be regarded as "persons" under article 3(1)(a) of the OECD Model. The Report concludes that partnerships can be seen as "persons" because they are either treated as companies or as bodies of persons under domestic law.[8]

Furthermore, the Report concludes that – from the perspective of the source state – partnerships qualify as residents of a contracting state if they are regarded as opaque by the state where they have been organized and, thus, taxation can take place at the level of the partnership.[9] On the other hand, if a partnership is treated as fiscally transparent, it does not qualify as a resident. In such cases, the partners of the partnership can be entitled to treaty benefits.[10] To sum up, the qualification as person and resident is of key importance for the entitlement to treaty benefits in the source state.

1. Case study-based approach

In order to better understand the problem caused by fiscally transparent entities, three examples from the Partnership Report will be described in more detail here. The proposed solution of the Partnership Report will be examined, followed by a thorough analysis of the newly proposed article 1(2), a discussion of these examples and application of the new provision to these examples.



"*P* is a 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 State *S* treats it as a taxable entity. *P* derives

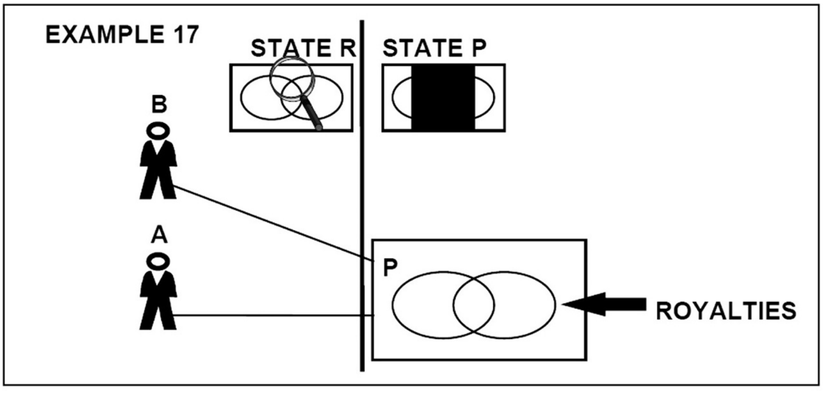
8 OECD, *Partnership Report*, *supra* n. 5, at 12, para. 29 et seq.
9 OECD, *Partnership Report*, *supra* n. 5, at 13 et seq., para. 33 et seq.
10 OECD, *Partnership Report*, *supra* n. 5 at 17, para. 47.

> royalty income from State *S* that is not attributable to a permanent establishment in State *S*".[11]

This example shows that partnerships can be treated differently in two contracting states. For State *S* the question will arise regarding how to treat the partnership: From the perspective of State *S*, the partnership is the taxpayer. However, the recommendation of the Partnership Report for this case is that the source state – State *S* – must follow the view of the residence state – State *P* – in order to determine to whom the income must be considered to be paid. As State *P* considers the partnership to be transparent, income is regarded as paid to *A* and *B*. Thus, State *S* needs to follow the view of State *P* and treat the partnership as transparent.[12]

Consider the second example:

> "*P* is a partnership established in State *P*. *A* and *B* are *P*'s partners who reside in State *R*. State *P* treats *P* as a taxable entity while State *R* treats it as a transparent entity. *P* derives royalty income from State *P* that is not attributable to a permanent establishment in that State".[13]



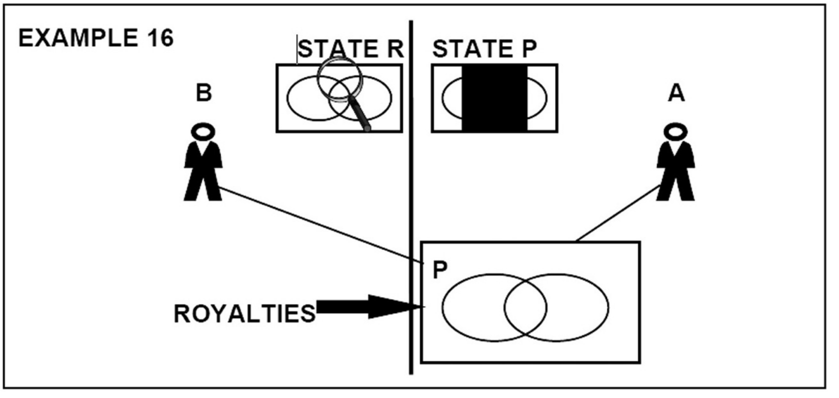
From the perspective of State *P*, this is a purely domestic situation where it does not seem necessary to apply a tax treaty. In this scenario, State *P* would regard the partnership as a resident and thus tax the partnership. On the other hand, State *R* treats the partnership as transparent and allocates the income to the partners *A* and *B*. The income would then again be taxed in the hands of the partners and double taxation would arise. The view of the OECD member countries is controversial. Under the general principle of the Partnership Report, the source state (State *P*) must take into consideration the treatment of the royalties in the resi-

11 OECD, *Partnership Report*, *supra* n. 5, at 23, Example 4.
12 OECD, *Partnership Report*, *supra* n. 5, at 23 et seq., para. 59 et seq.
13 OECD, *Partnership Report*, *supra* n. 5, at 47, Example 17.

dence state of the partners (State *R*). Therefore, State *P* must apply article 12 of the OECD Model and leave exclusive taxing rights to State *R*, which will then tax the income in the hands of the partners. In contrast, the majority of the OECD delegates were of the opinion, that this situation must be treated differently. As in the view of State *P* this is only a domestic matter, State *P* should not be limited in its taxing rights by the *P*-*R* tax treaty.[14]

Consider the third example:

> "*P* is a partnership established in State *P*. Partner *B* is a resident of State *R* while partner A is a resident of State *P*. State *P* treats the partnership as a taxable entity while State *R* treats it as a transparent entity. *P* derives royalty income from State *R* that is not attributable to a permanent establishment in State *R*. [...]".[15]



Under domestic law, State *P* would like to tax the partnership because it treats the partnership as a resident. State *R* treats the partnership as transparent and thus would like to tax Partner *B* on its income. Again, the OECD delegates had different opinions on this case. A minority favours the application of the general principles, following the approach of the residence state of the recipient of the income. As the partnership is treated as opaque by State *P*, the resident state is State *P*. This means that, under article 12(1), the royalties may be taxed only in State *P*. On the other hand, the majority of the OECD delegates were of the opinion that State *R* may not be limited in its taxing rights of Partner *B*. The reason for this view is that article 12 is applicable only for royalties arising in one state and being paid to a resident of the other contracting state. As State *R* treats the partnership as transparent, the residents that receive the royalties are the partners. Thus, State *R* taxes partner *B*.

14 OECD, *Partnership Report*, *supra* n. 5, at 47 et seq., para. 130 et seq.
15 OECD, *Partnership Report*, *supra* n. 5, at 45, Example 16.