Hybrid Entities in Tax Treaty Law: Issues, their Source and Possible Solutions

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1. Introduction

On 5 October 2015, the OECD published the Final Report on *Neutralising the Effects of Hybrid Mismatch Arrangements*[1], which is an output of the Action 2[2] of the BEPS Project[3]. The Final Report contains recommendations to counter issues regarding hybrid mismatch arrangements resulting from international tax planning to achieve double non-taxation, which led, amongst others, to the inclusion of Article 1(2) in the 2017 update of the OECD Model.

According to BEPS Action 2, hybrid mismatches may arise from payments made under a hybrid financial instrument, payments made to or by hybrid entities, as well as indirect mismatches arising when the effects of a hybrid mismatch arrangement are imported into a third country.[4] Nevertheless, the present study is limited to issues related to hybrid entities in a tax treaty scenario.

Although the topic has lately been in the spotlight due to the BEPS Project, the global concern with the use of such structures to avoid taxation is not new. The classification of entities and their treaty entitlement has been the subject of a number of studies at the level of the IFA since 1973.[5] Additionally, in 1997, the US enacted the Taxpayer Relief Act of 1997[6], which amended the US Internal Revenue Code (IRC) to include a provision dealing with hybrid entities in a tax treaty scenario.[7] Soon after, in 1999, the OECD published the Partnership Report[8], addressing problems related to transparent entities and allocation of income. Even though the conclusions reached in that report were incorporated in the 2000 update of the Commentary of the OECD Model,[9] the discussions were far from over. Since then, the OECD has dealt with issues related to hybrid mismatch arrangements in several reports.[10]

In 2012, the OECD acknowledged in its report on *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* that hybrid mismatches raise a number

1 OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements*, Action 2 – 2015 Final Report (Paris: OECD, 2015) (hereinafter BEPS Action 2 Final Report).

2 As highlighted in the OECD *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (hereinafter BEPS Action Plan), p. 15.

3 OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013). On BEPS, see M. Lang et al. (eds), *Base Erosion and Profit Shifting (BEPS): The Proposals to Revise the OECD Model Convention* (Vienna: Linde, 2016).

4 BEPS Action 2 Final Report, p. 11.

5 E.g. IFA congresses on *Partnership and joint enterprises in international tax law* (1973), *The fiscal residence of companies* (1987), *Recognition of foreign enterprises as taxable entities* (1988) and *The disregard of a legal entity for tax purposes* (1989).

6 H.R. 2014, PL. 105-34; August 5, 1997.

7 Namely, US IRC Sec. 894(c), "denial of treaty benefits for certain payments through hybrid entities".

8 OECD, *The Application of the OECD Model Tax Convention to Partnerships* (Paris: OECD, 1999).

9 See e.g. OECD Model (2000), Commentaries on Article 1, paras. 6.2–7; Article 3, paras. 2 and 10.1; Article 4, paras. 8.2–8.4; and Article 23, paras. 32.1–32.7 and 69.1–69.3.

10 E.g. OECD, *Addressing Tax Risks Involving Bank Losses* (Paris: OECD, 2010); *Corporate Loss Utilisation through Aggressive Tax Planning* (Paris: OECD, 2011); and *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (Paris: OECD, 2012) (hereinafter 2012 Report).

of policy issues, impacting not only the revenue, but also competition, efficiency, transparency and fairness.[11] Therefore, it remains to be seen whether the recommendations proposed by the OECD in the BEPS Project to neutralize the tax effects of such arrangements, i.e. Article 1(2) and (3) of the OECD Model, are the most appropriate ones.

In this regard, this chapter aims to identify the origin of the issues related to hybrid entities in a tax treaty scenario and possible solutions to counter their effects. Section 2 provides the definition of hybrid entities. Section 3 looks at the source of the issues and their effects on tax treaty law. Finally, section 4 analyses the OECD's recommendations to neutralize the effects arising from hybrid entities and alternative solutions presented in the literature so far.

2. What are Hybrid Entities?

2.1. Distinction Between Domestic and Foreign Entities

Even though this distinction seems to be straightforward, when dealing with international relations, the classification of an entity as "domestic" or "foreign" is not always crystal clear. Around the world, jurisdictions use different approaches to determine whether an entity is considered a "domestic entity". Each country sovereignly establishes its possible legal forms (e.g. corporations, partnerships), typically through corporate and/or private laws, as well as the criteria for determining what makes an entity a domestic one.[12] Usually, countries follow specific rules that may coincide with the criteria for determining whether a company is regarded as a tax resident therein, such as the concepts of place of incorporation and the place of effective management (PoEM).

However, such rules are not uniform across jurisdictions.[13] For instance, some countries opt for using the criteria alternatively (i.e. an entity is considered domestic if either the place of incorporation or the PoEM is in that jurisdiction)[14], whereas others choose for only one single criterion[15] or both at the same time.[16] The use of different methods by different jurisdictions when dealing with the same entity can create problems. On the one hand, an entity can be considered "domestic" in more than one jurisdiction, as it can be incorporated under a legal form of a country that uses the place of incorporation as a criterion for considering

11 2012 Report, para. 22.
12 L. Parada, *Double Non-taxation and the Use of Hybrids Entities – An Alternative Approach in the New Era of BEPS* (Alphen aan den Rijn: Kluwer Law, 2018), p. 187.
13 See M. Lang/C. Staringer, 'General Report' in *Qualification of Taxable Entities and Treaty Protection* (IFA Cahiers vol. 99B, 2014), p. 25 (hereinafter IFA 2014).
14 E.g. UK. See L. Parada, *supra* n. 12, p. 186.
15 See e.g. J. Gooijer/M. de Graaf, 'Netherlands' in IFA 2014 p. 559.
16 See e.g. see M. Teixeira De Abreu, 'Portugal' in IFA 2014, pp. 657–658.

it "domestic", while its management is exercised in another country that uses the PoEM instead.[17] On the other hand, an entity could be considered resident nowhere.[18]

Similarly to the classification of entities as "domestic", rules for regarding them as "foreign" may exist, which are also not homogenous throughout the world. While certain countries have different set of rules for classifying domestic and foreign entities,[19] others simply consider an entity as "foreign" if it is not a domestic one.[20]

All in all, one of the important reasons for classifying an entity as "domestic" or "foreign" is that, for tax purposes, a domestic entity is generally taxed on its worldwide income, while a foreign entity is taxable only on income sourced within the country.[21]

2.2. Classification for Tax Purposes: Opacity or Transparency

Another important explanation that is worth outlining is the classification of entities for tax purposes, i.e. whether an entity is considered taxable or non-taxable from the viewpoint of a certain jurisdiction.

Usually, entities are classified as either "transparent" or "opaque" for tax purposes.[22] In general, an entity is regarded as "transparent" if it is seen as a non-separate legal entity, i.e. it is not separate from the persons who have an interest in it and is considered a non-taxable entity. In this case, the taxation will be at the level of those who have an interest in it. Conversely, an entity is regarded as "opaque" if it is a separate legal entity, meaning that the entity is separate from the persons who have an interest in it and therefore taxable.[23] It should be noted that this transparency is not related to the granting of exemptions to an entity, which allows it not to be taxed on certain items of income or on some activities performed.[24]

Finally, some legal forms are usually regarded as transparent in most jurisdictions. For example, partnerships are entities that whereas many countries regard as having legal personality, most countries treat as fiscally transparent.[25] Other

17 See B. Peeters, 'Classification of Foreign Entities for Corporate Income Tax Purposes', in D. Gutmann (ed), *Corporate income tax subjects* (Amsterdam: IBFD, 2015), p. 61.
18 See e.g. L. Parada, *supra* n. 12, pp. 186-187.
19 See e.g. A. Archer/C. Elliffe, 'New Zealand' in IFA 2014, pp. 583 and 587.
20 M. Lang/C. Staringer, 'General Report' in IFA 2014, p. 34.
21 B. Peeters, *supra* n. 17, p. 60.
22 Although some semi-transparent entities may also exist. See e.g. L. Parada, *supra* n. 12, p. 189; and O. Popa, 'Past, Present and Future of Tax Structuring Using Hybrid Entity Mismatches', in: M. Cotrut (ed), *International tax structures in the BEPS era: an analysis of anti-abuse measures* (Amsterdam: IBFD, 2015), p. 155.
23 See O. Popa, *supra* n. 22, p. 155.
24 See L. Parada, *supra* n. 12, p. 189.
25 M. Lang/C. Staringer, 'General Report' in IFA 2014, pp. 26-27. See e.g. J. Gooijer/M. de Graaf, 'Netherlands' in IFA 2014, p. 560.

examples are trusts, foundations or similar entities or vehicles, whose tax status may depend on some objective factors imposed by a given country.[26]

2.3. The Origin of Hybridity: Conflicts in the Classification of Entities

As well as the classification of "domestic" or "foreign", countries sovereignly decide the tax status of entities at a domestic level. Thus, each country has its own rules for classifying its legal forms as transparent or opaque and, as a result, this definition is not uniform around the world. Although different countries have similar legal forms (e.g. partnerships), they may have a distinct tax status depending on the approach adopted by each jurisdiction (transparent or opaque).

When classifying domestic entities for tax purposes, countries often rely on their corporate and/or private laws, meaning that the legal form or nature of an entity governs its tax status.[27] In contrast, some countries separate the classification of entities for corporate law from the tax purposes.[28] Therefore, each jurisdiction has its own rules to determine the tax status of its domestic entities, which usually does not raise many problems. However, due to cross-border activities, states also have to classify foreign entities for tax purposes, as they may derive domestic sourced income and the state has to determine whether such income is attributed to the foreign entity (and taxed at its level) or to the persons who have an interest in the entity (and taxed in their hands). This makes the situation much more complex as countries use different methods of classification.

Commonly used approaches to classify foreign entities are: comparative approach, legal personality approach, fixed approach, overall approach, and the elective approach.[29] Under the comparative (or similarity[30] or analogy[31]) approach, states look at the characteristics of the foreign entity to assign the same tax status of the most similar or equivalent domestic one.[32] In contrast, states may prefer to look at the "legal personality" of the entity under the foreign law and then treat it as opaque insofar as it is a "separate legal person" in the other country.[33] Furthermore, some states either opt for making a list of the foreign entities and their

26 See e.g. M. Lang/C. Staringer, 'General Report' in IFA 2014, p. 30.
27 See e.g. Y. Schuchter-Mang, 'Austria' in: G. Fibbe/T. Steves (eds), *Hybrid entities and the EU direct tax directives* (The Hague: Kluwer Law, 2015) p. 52.
28 As is the case of the US. See L. Parada, *supra* n. 12, p. 188; and M. Lang/C. Staringer, 'General Report' in IFA 2014, p. 26.
29 The main sources used were L. Parada, *supra* n. 12 and M. Lang/C. Staringer, 'General Report' in IFA 2014. For the EU countries classification see the contribution of Rik Baete in this volume.
30 See e.g. O. Popa *supra* n. 22, p. 155.
31 See e.g. R. Russo, *Fundamentals of international tax planning* (Amsterdam: IBFD, 2007), p. 134.
32 E.g. Germany. See M. Lang/C. Staringer, 'General Report' in IFA 2014, p. 35.
33 E.g. Belgium. See L. Parada, *supra* n. 12, p. 201.

respective tax status[34] or to deem all the foreign entities in the same way (either transparent or opaque); both methods are referred to as "fixed approach".[35] Yet, some countries prefer not to look at a single criterion, but rather to an "overall approach", e.g. the tax status of an entity may vary depending on the situation.[36] Lastly, an entity may choose its tax status under the elective (or optional[37]) approach.[38]

Thus, states use different methods when classifying entities for tax purposes. The problem is, however, that a conflict of classification[39] can arise when dealing with the same entity, as one country may treat it as "transparent", while the other treats it as "opaque". Hence, such conflict can be seen as the origin of the hybridity since countries may regard different persons as taxpayers (either the entity or the persons who have an interest in it).[40]

2.4. Defining Hybrid (and Reverse Hybrid) Entities

It can be assumed from the foregoing that hybrid entities exist as a result of two or more countries classifying the same entity differently for tax purposes. However, a legal definition of "hybrid entity" has not yet been globally harmonized. Despite the fact that even using different definition approaches, people achieve (as far as possible) the same result with regard to the effects and concerns about hybrid entities, there is no generally accepted concept.

Nonetheless, the OECD defined "hybrid entities" in the 2012 Report as "[e]ntities that are treated as transparent for tax purposes in one country and as non-transparent in another country".[41]

In the literature, though, the concept generally adopted has a small deviation from that of the OECD. Although there is no consensus,[42] scholars normally describe "hybrid entity" as an entity that is classified as opaque in its country of residence, while in the other country it is classified as transparent.[43] Therefore, un-

34 See e.g. P. Berna/P. Mischo/F. Van Kuijk, 'Luxembourg' in IFA 2014, p. 522.
35 See e.g A. Crazzolara, 'Italy' in IFA 2014, p. 447.
36 E.g. UK. See L. Parada, *supra* n. 12, p. 204. Also, see D. Bunn/N. Johnston, 'Canada' in IFA 2014, p. 178.
37 See J-P. Van West, 'Tax Treaty Entitlement and Hybrid Entities: Article 1(2) and Article 1(3) of the OECD Model (2017)' in: M. Lang et al., *Tax treaty entitlement*, p. 197 and M. Lang/C. Staringer, 'General Report' in IFA 2014, p. 38.
38 As the US check-the-box regime. See the contribution of Alexandre Barbosa in this volume.
39 Some use the term "qualification conflict", e.g. R. Russo, *supra* n. 31, p. 134.
40 J.-P. Van West, *supra* n. 37, p. 197.
41 2012 Report, p. 7.
42 As pointed out by C. Kahlenberg, 'Hybrid Entities: Problems Arising from the Attribution of Income Through Withholding Tax Relief – Can Specific Domestic Provisions be a Suitable Solution Concept?', *Intertax* (2016), p. 148.
43 Adopting this definition, see e.g. L. Parada, *supra* n. 12, p. 191.

like the OECD, this description indicates which country (of residence or not) treats the entity as transparent or opaque. Due to this, the literature suggests that just as there is a "hybrid entity", there is also a "reverse hybrid entity". The latter is generally described as the opposite of the former, i.e. an entity treated as transparent in its country of residence but considered opaque in the other country.[44] However, as well as the use of this term different from the term "hybrid entities", this definition is also not uniform.[45] Interestingly, in the BEPS Action 2 Final Report, the OECD included the term "reverse hybrid" as being "any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction."[46]

Moreover, some countries refer to hybrid entities in their domestic legislation. This is the case of the US, which mentions "hybrid entities" in the IRC,[47] meaning an entity that is treated as transparent to the US, while the other country considers it opaque.[48] The term "reverse hybrid entity" is also present in the US law, which refers to "a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction".[49] Hence, the US takes a different approach from the literature in defining hybrid and reverse hybrid entities.[50]

The EU, in turn, defines "hybrid entity" in ATAD 2 as an entity or arrangement treated as taxable under the laws of one jurisdiction and whose income or expenses are considered belonging to one or more other persons (either entities or individuals) under the laws of another jurisdiction.[51] The European approach is thus more in line with the OECD, which is expressly mentioned in the text of the ATAD, since the latter was a response to the conclusions of the BEPS Project.

Due to these different definitions, it is therefore necessary to delimit the terms for the purposes of this chapter: "hybrid entity" as an entity classified in its state of residence as opaque, whereas classified as transparent for tax purposes in the other relevant state, and "reverse hybrid entity" as an entity classified as transparent for tax purposes in its residence state and classified as opaque in the other relevant state.

44 With a similar definition, J.-P. Van West, *supra* n. 37, p. 196.
45 E.g. the IBFD Glossary, available online at the IBFD Tax Research Platform.
46 BEPS Action 2 Final Report, p. 55.
47 US IRC, Sec. 267A(d)(1) and 894(c).
48 See M. S. Domingo, 'Hybrid Mismatch.com: Neutralizing the Tax Effects of Hybrid Mismatch Arrangements', *North East Journal of Legal Studies* (2019), p. 28.
49 US CFR, Title 26, Section 1.894-1(d)(2)(i).
50 For the US treatment of hybrid entities see the contribution of Lucas Ulloa in this volume.
51 Article 1(2)(b)(i) of the Council Directive 2017/952 of 29 May 2017 (ATAD 2).

3. The Source of Issues: Conflict of Allocation of Income

3.1. Divergent Entity Classification: Issues in the Allocation of Income

As mentioned above, in cross-border relations, states may classify the same entity differently for tax purposes, resulting in a hybrid (or reverse hybrid) entity. However, in a tax treaty perspective, the major issue is that this conflict of classification typically leads to a conflict of allocation of income.[52]

By having different views on the tax status of an entity, states may allocate the income it derives to different persons, either the entity or the persons who have an interest in it.[53] That is to say, the state that considers the entity "transparent" will allocate the income to the persons behind it, while the state that treats the entity as "opaque" will allocate the income to the entity itself. Thus, due to such conflict of allocation, each state will tax a different person on the same income.[54]

In this context, the attribution of income to different taxpayers may ultimately result in double taxation or double non-taxation, as will be demonstrated in section 3.2. Moreover, this may affect the principles governing treaty entitlement under the OECD Model and tax treaties. This is because, due to a conflict of allocation of income, the issue lies in the question of who is entitled to treaty benefits: the entities and/or the persons behind it?[55]

Pursuant to Article 1(1) of the OECD Model, tax treaty entitlement is granted to persons who are residents of at least one of the contracting states. Two main elements, therefore, need to be clarified to determine the application of tax treaties to a certain taxpayer: first, whether it is a person in the meaning of Article 3(1), and second, whether this person is a resident of at least one of the contracting states under the terms of Article 4(1).

52 See J. Kollmann/A. Roncarati/C. Staringer, 'Treaty Entitlement for Fiscally Transparent Entities: Article 1(2) of the OECD Model Convention', in: M. Lang et al., *Base Erosion and Profit Shifting (BEPS): The Proposals to Revise the OECD Model Convention* (Vienna: Linde, 2016), p. 3; L. Parada, 'Hybrid Entities and Conflicts of Allocation of Income Within Tax Treaties: Is New Article 1(2) of the OECD Model (Article 3(1) of the MLI) the Best Solution Available?', *British Tax Review* (2018), p. 340; and R. Danon, 'Qualification of Taxable Entities and Treaty Protection', *Bulletin for International Taxation* (2014), p. 193.

53 C. Bergedahl, 'Hybrid Entities and the OECD Model (2017): The End of the Road?', *Bulletin for International Taxation* (2018), p. 417.

54 The combination of conflicts of classification and allocation of income may also lead to a "qualification conflict", i.e. states apply different distributive rules to the same income. On this idea, see M. Lang, 'Qualification Conflicts' in *Global Tax Treaty Commentaries* (Global Topics IBFD, 2018 update), pp. 1–2.

55 See M. Verhoog/A. Breuer, 'Hybrid Entity Issues in a Tax Treaty Context: OECD Approach versus Actual Tax Treaties', *Intertax* (2016), p. 684.

Although transparent entities may be regarded as "persons" for tax treaty purposes,[56] determining whether they are residents is, by contrast, not entirely clear.[57] This is because Article 4(1) requires that, in order to be resident, a person has to be "liable to tax", and, when dealing with hybrid entities, the difficulty is to determine whether an entity treated as transparent in a particular state can be considered liable to tax therein,[58] thus blurring the answer to whether and which tax treaty benefits should be granted.[59] That is why new provisions proposed by the OECD and scholars are seeking to solve such conundrum, as will be discussed in section 4.

In addition, a conflict of allocation of income can also arise even when both states classify an entity in the same way.[60] For instance, in the case of CFC rules of a given state that attribute the income of a foreign entity to its resident shareholder, although both states consider the entity opaque for tax purposes.[61]

3.2. Tax Effects of Conflict of Allocation of Income

3.2.1. General Remarks

Hybrid entities result from the interaction of different laws and policy choices among states. They are not per se "bad",[62] as sometimes their existence is unintended. However, according to the OECD, in many cases they are used with the intention of obtaining tax benefits unduly.[63] Indeed, from a tax treaty law perspective, the divergent classification of entities leads to difficulties in their taxation, namely double taxation or double non-taxation.

56 The Partnership Report affirmed that partnerships are regarded as persons for treaty purposes, which was included in the Commentary on Article 3(1) of the OECD Model (2000), para. 2. See L. Parada, *supra* n. 52, p. 339, FN 10.

57 See M. Lang, 'Taxation of Income in the Hands of Different Taxpayers from the Viewpoint of Tax Treaty Law', *Bulletin for International Taxation* (2001), p. 598; and L. Parada, *supra* n. 52, pp. 339–340.

58 M. Verhoog/A. Breuer, *supra* n. 55, p. 687.

59 On the one hand, some argue that a transparent entity cannot be considered "liable to tax", as it is inconsistent with the definition of tax liability based on comprehensive taxation. See e.g. L. Parada, *supra* n. 52, p. 340 and the conclusion of the Partnership Report, para. 34. On the other hand, some believe that being a resident of a state should not be linked to the fact that the person is considered a taxpayer. They argue that Article 4(1) of the OECD Model only requires a connection between the person and the state capable of resulting in unlimited taxation. In this sense, if an exempt person can be treated as resident this must also be possible for persons who are not considered taxable entities, such as transparent entities. See e.g. M. Lang, *supra* n. 57, p. 598.

60 See H. Salomé, 'BEPS Action 2 Treaty Provisions on Hybrid Entities' in: R. Danon (ed), *Base erosion and profit shifting (BEPS): impact for international tax policy* (Geneva: Schulthess, 2016), p. 71.

61 H. Salomé *supra* n. 60, pp. 73–74. For the CFC rules in the context of hybrid entities see the contribution of Larissa Pimentel in this volume.

62 See J. Lüdicke, '"Tax Arbitrage" with Hybrid Entities: Challenges and Responses', *Bulletin for International Taxation* (2014), p. 309; and J. Kollmann/A. Roncarati/C. Staringer, *supra* n. 52, p. 2.

63 BEPS Action Plan, p. 15.

3.2.2. Double Taxation

Although the recent developments of the OECD that resulted in the BEPS Action 2 Final Report show that the international concern regarding hybrid entities is to counter double non-taxation,[64] double taxation can also arise from the existence of hybrid entities. Such double taxation may result not only from conflicts of allocation of the same income to different persons, but also from the denial of tax treaty relief.[65]

To begin with, double taxation arises in case of allocation conflicts, since each state may allocate the income derived by an entity to the person (entity or the person who have interest in it) that is resident therein.[66] As a result, the same income will be taxed twice, i.e. in the hands of the entity and in the hands of the person behind it, in their respective state of residence. If no relief is granted, double taxation will arise.

One could presume that it would be easy to avoid double taxation by applying a tax treaty.[67] However, in the case of hybrid entities, due to the conflict of allocation of income, the effect produced is the so-called economic double taxation, "i.e. where two different persons are taxable in respect of the same income or capital."[68] Indeed, the main purpose of the OECD Model has always been to provide means to eliminate juridical double taxation[69], i.e. "when the same person is taxed twice on the same income by more than one state."[70] As a result, Articles 23A and 23B of the OECD Model, which refer to the methods of eliminating double taxation, do not deal with cases of economic double taxation.[71] Thus, many have argued that the prevention of double taxation through tax treaties is limited, and cases of economic double taxation are not solved by them.[72]

In short, the problem regarding the hybrid nature of entities and double taxation is that (in principle) no tax treaty relief would be granted, either because allocation conflict leads to economic double taxation, or because the transparent entity is not entitled to treaty benefits.

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64 See 2012 Report, p. 7 and BEPS Action 2 Final Report, pp. 11–12.
65 M. Verhoog/A. Breuer, *supra* n. 55, p. 687.
66 R. Danon, *supra* n. 52, p. 193.
67 Assuming that tax treaties apply to transparent entities.
68 Commentary on Article 23 of the OECD Model (2017), para. 2.
69 OECD Model (2017), Introduction, para. 3.
70 OECD Glossary of Tax Terms (available at https://www.oecd.org/ctp/glossaryoftaxterms.htm, accessed 7 Fev. 2020)
71 Commentary on Article 23 of the OECD Model (2017), para. 1.
72 See M. Lang, *The Application of the OECD Model Tax Convention to Partnerships: A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs* (Vienna: Linde, 2000) p. 29; and L. Parada, *supra* n. 52, p. 336, FN 1. The problem, however, could be solved if the treaty includes a provision which grants such relief, or by the combination of the treaty and domestic law. See, G. Kofler, 'Article 23B – Methods for Elimination of Double Taxation', in *Global Tax Treaty Commentaries* (Global Topics IBFD, 2019 update), p. 4.

3.2.3. Double Non-taxation

Besides double taxation, the use of hybrid entities may also lead to double non-taxation, which is the focus of the BEPS Action 2 and has been the core of OECD efforts lately.

As described in the 2012 Report, the use of hybrid entities often leads to "unintended double non-taxation",[73] i.e. the absence of taxation was not planned and agreed upon by the relevant jurisdictions.[74] On the other hand, their use results in intended effects by the taxpayers,[75] which has led the OECD to recognize the use of hybrid entities arrangements as "aggressive tax planning".[76] Therefore, if the jurisdictions have not agreed on the double non-taxation outcome and the taxpayer intended such effect, aggressive tax planning may be at stake. Consequently, the problem is not double non-taxation as such; but rather the unintended double non-taxation, which is often linked to aggressive tax planning.

The common effects of hybrid entities arrangements resulting in double non-taxation are: double deduction of expenses, double non-inclusion of income or a combination of both, deduction/non-inclusion schemes.[77]

4. Possible Solutions

4.1. Treatment of Hybrid Entities under the OECD Approach

4.1.1. The Partnership Report

In 1999, the OECD published its first report dealing with concerns related to transparent entities as a result of a working group formed in 1993 to study the application of the OECD Model to partnerships.[78]

The Partnership Report attempted to solve the issues of both classification and qualification conflicts,[79] from the perspective of the source and the residence states. Regarding classification conflicts, the general principle followed by OECD was that, for the application of tax treaties, these conflicts might be solved through the source state following the treatment of the income in the residence state of the taxpayer claiming treaty benefits as a resident,[80] a solution that was

73 2012 Report, p. 5.

74 F. D. Laguna, 'Abuse and Aggressive Tax Planning: Between OECD and EU Initiatives – The Dividing Line between Intended and Unintended Double Non-Taxation', *World Tax Journal* (2017), p. 203, explains that "'unintended double non-taxation' relates to those treaty measures that avoid the outcome of double non-taxation in advance from an agreed perspective."

75 2012 Report, p. 7.

76 BEPS Action 2 Final Report, p. 15.

77 The OECD also mentions "tax deferral" in the 2012 Report, p. 5. For examples of double non-taxation outcomes, see BEPS Action 2 Final Report.

78 Partnership Report, p. 7, para. 1. See the contribution of Rahmat Muttaqin in this volume.

79 See *supra* n. 54.

80 Partnership Report, para. 53. See C. Bergedahl, *supra* n. 53, p. 418.