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Hybrid entities

APPLICATION OF TREATY RULES TO HYBRID ENTITIES

Summary

The present note introduces the work undertaken by the Committee of Experts on International Cooperation in Tax Matters regarding a 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.

While text for the 2017 Model update has already been agreed as a result of that work, the question has been raised of whether future updates of the Model might benefit from a close consideration of other possible ways to address the issue, consistently with the source state taxation preferences of many developing countries. The Attachment to this paper puts forward one view of those issues as a spur to Committee consideration of the issue.

At the 2013 session of the Committee, Henry John Louie (United States) presented his country's approach to the application of the provisions of bilateral tax treaties to payments made through so-called hybrid entities. A hybrid entity, for this purpose, is an entity that two contracting States that are parties to a bilateral tax treaty characterize differently (e.g. an entity, such as a limited liability company, that one contracting State may view as a company and the other contracting State as fiscally transparent (for this purpose, an entity is treated as fiscally transparent if the character, source and timing of taxation of an item of income are unchanged when the item of income flows through the entity)). Mr. Louie explained that the following unintended outcomes may arise when applying a tax treaty to such payments: (a) double taxation because of the inappropriate denial of treaty benefits; (b) non-taxation because of the granting of treaty benefits in unintended cases, such as to third-country residents; or (c) the granting of treaty benefits at the inappropriate level (e.g. the granting of the lower withholding rate on dividends paid to companies when such dividends were derived by an individual shareholder).

2. The principles set out in the Organization for Economic Cooperation and Development (OECD) report entitled The Application of the OECD Model Tax Convention to Partnerships are aimed at preventing such unintended results. It has not proven to be the case, however, that all countries, in applying their tax treaties, implicitly recognize those principles. To the contrary, the position of many countries is that the report's outcomes cannot be obtained absent provisions in a tax treaty that explicitly provide for such results.

3. Mr. Louie described a provision that is found in United States bilateral income tax treaties. The Committee discussed the provision and concluded that further work should be done to incorporate such a provision, and thus the report's principles, into the United Nations Model. Mr. Louie observed that the OECD Working Party 1 on Tax Conventions and Related Questions had undertaken the same task in recent years and had made significant progress in drafting a new treaty provision and accompanying commentaries for the OECD Model.

4. While the provision found in United States tax treaty practice and the provision developed by Working Party 1 are broadly similar, the two provisions have some differences. After a discussion of those differences, the Committee concluded that the work

on a possible new provision for the United Nations Model should be based on the OECD version. Mr. Louie offered to consult with the OECD secretariat and prepare a short paper for discussion at the 2014 session of the Committee that would incorporate into the United Nations Model the new provision for payments made through hybrid entities.

5. At the 2014 session, Mr. Louie presented a proposed new paragraph 2 of article 1 of the United Nations Model, as well as draft commentary in which the relevant portions of the new OECD Model commentary are quoted. During that meeting, some Committee members and representatives of Member States, including those of the Czech Republic, France and Slovakia, expressed the view that, with regard to payments made through entities located within a third State, the new provision should apply only if an exchange-of-information mechanism is in place between the State of source and the third country.

6. Mr. Louie acknowledged the concerns and explained that he was aware of existing variations of the proposed new paragraph 2 regarding payments made through entities located in third States that restrict the scope to entities located in States that have established an exchange-of-information mechanism with the source State. The Committee invited Mr. Louie to revise the proposed commentary to provide an alternative version of paragraph 2 that would employ such a narrower scope.

7. At the 2015 session, Mr. Louie presented a revised version of the proposed Commentary (E/C.18/2015/3) that included as an alternative a version of the treaty provision that would apply with respect to entities in third states only if there is an agreement in effect between the source State and the third state. During the discussion, a number of members of the Committee as well as some observer countries expressed the view that the view that the alternative provision did not address their concerns. In particular, the alternative provision did not adequately address situations in which both the entity and its interest holders could claim entitlement to benefits under different tax treaties with the source State. Additionally, it was suggested that countries concerned about the application of the treaty provision could consider concluding and making publicly available competent authority arrangements setting forth a common understanding of the rule.

8. At the 2016 session, Mr. Louie presented another revised version of the proposed Commentary. The revised version deleted some existing texts from the 2014 session and

added some clarifications in the proposed Commentary (E/C.18/2015/3CRP.7) on the application of treaty benefits. The Committee also addressed the issue regarding the application of the treaty when income is derived by or through an entity or arrangement resident in a third state and that has interest holders resident in a Contracting state under whose tax laws the entity is treated as fiscally transparent with respect to the income. In such the case, the tax treaties of both the country of residence of the entity or arrangement and the country of residence of the interest holders could be applicable, creating the risk of duplicative claims of benefits under both tax treaties.

9. The text of the new paragraph 2 of Article 1 as agreed by the Committee was as follows:

> 2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. In no case shall the provisions of this paragraph be construed so as to restrict in any way the right of a Contracting State to tax the residents of that State.

10. At the Committee's fourteenth session, in April 2017, an observer made the suggestion that the paragraph may reduce source taxation rights at the instance of actions by its treaty partner. While it was agreed that the agreed paragraph 2 would form part of the 2017 update of the UN Model, it was also agreed to allow for a discussion at the fifteenth session of the Committee on possible better ways of dealing with hybrid entities.

11. The Attachment to this paper is an article on this issue that addresses some of the issues and may form one basis for consideration by the Committee of whether and, if so, how to further address the hybrids issue.

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BEPS Hybrid Entities Proposal: A Slippery Slope, Especially for Developing Countries

by Dhruv Sanghavi

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FEATURED PERSPECTIVE

BEPS Hybrid Entities Proposal: A Slippery Slope, Especially for Developing Countries

by Dhruv Sanghavi

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The author is grateful to Henry Louie (member), Armando Lara Yaffar (chair), and Michael Lennard (secretary) for their time to discuss these issues during some of the coffee breaks of the 12th and 13th meetings of the Committee of Experts on International Cooperation in Tax Matters held in Geneva (in October 2016) and New York (in December 2016). He is also grateful to John Avery Jones and David Cameron for their comments on an earlier draft. However, the author is solely responsible for any mistakes.

In this article, the author discusses article 1(2) as proposed to be included in the OECD and U.N. model tax conventions and contends that it fails to adequately address aggressive tax planning that results in double nontaxation or obstructs the goal of allocating taxing rights to the state in which the economic activity that gives rise to income occurs.

The commentary on article 1 of the 2014 OECD model tax convention pertaining to partnerships[1] was adopted in 2000 in accordance with the recommendations of the OECD's 1999 report, ''The Application of the OECD Model Tax Convention to Partnerships'' (the partnership report). The U.N. model tax convention, which is aimed at protecting the interests of developing countries, has since been updated twice. However, while acknowledging the report,[2] the U.N. Committee of Experts on International Cooperation in Tax Matters has refrained (deliberately or not[3]) from adopting the OECD commentary. The interpretation proposed in that commentary would restrict source states' taxing rights by two tax treaties.[4] So it is surprising that the committee has now proposed including article 1(2),[5] which is but a codification of that commentary, in the U.N. model.[6]

The OECD/G-20 base erosion and profit-shifting project has two principal purposes:

- to combat aggressive tax planning that results in less than single taxation; and
- to allocate taxing rights to the state in which the economic activity gives rise to income.

[1] *See* OECD, commentary on article 1 of the model tax convention, paras. 6.1 to 6.7.

[2] *See* commentary on article 1 of the 2011 United Nations Model Double Taxation Convention between Developed and Developing Countries, para. 4.

[3] Since the meetings of the Committee of Tax Experts are not minuted, much is left to speculation. However, it does appear from paragraphs 5 and 6 of the commentary on article 1 of the U.N. model that the committee may have deliberately refrained from adopting the recommendations of the partnership report.

[4] *See* OECD commentary, *supra* note 1, at para. 6.5.

[5] Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Nov. 24, 2016) (BEPS multilateral instrument), article 3.

[6] 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, E/C.18/2016/CRP.7 (Oct. 4, 2016), Annex I, at 4 (reproducing the commentary on article 1(2) proposed in the final report on BEPS action 2).

As this short article demonstrates, article 1(2) achieves neither of these goals. Further, the provision may have unintended legal and economic consequences. These consequences make the provision generally undesirable, but particularly for developing countries since their revenues frequently rely heavily on source taxation.

Section I of this article provides the text and a brief overview of article 1(2), as proposed in the U.N. model, noting ways it is similar to the partnership report. Section II elucidates some of the legal and economic anomalies resulting from the provision. Section III draws and presents conclusions.

I. Proposed Article 1(2)

Article 1(2), as proposed at the October 2016 meeting of the U.N. Committee of Experts, provides:

> For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. In no case shall the provisions of this paragraph be construed so as to restrict in any way the right of a Contracting State to tax the residents of that State.

The second sentence is not included in article 1(2) as proposed in the BEPS final report on action 2 (''Neutralising the Effects of Hybrid Mismatch Arrangements'' (BEPS action 2)), but it is separately provided for in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS multilateral instrument).[7]

The effect of article 1(2) is that taxing rights over income earned by or through a transparent entity or arrangement (both undefined terms) will be allocated among the contracting states in accordance with the tax treaty, even if that income is taxed as the income of another person resident in a contracting state. This resolves the problem of double taxation that may be caused when the transparent entity is regarded as a ''person'' because it is a ''body of persons,''[8] but does not qualify as a resident because it is not ''liable to tax'' under article 4(1). Notably, while the partnership report deals with only partnership firms, article 1(2) deals with any hybrid entity. Examples of hybrid entities include a partnership firm, a company, a foundation, a trustee, a beneficiary of a trust, a family, or even an individual member of a family.[9]

Article 1(2) does not state that the entity ought to be treated as transparent by the state in which it is organized, nor does it state anything about the legal or factual circumstances in which the income is taxable in the hands of a resident of a contracting state. Thus, it does not matter if the entity is organized/incorporated in a third state, even if that state regards the entity as opaque.[10] Nor does it matter if the source state regards that entity as opaque. Tax treaties concluded by a state will apply as long as the state attributes the income to a resident of that state. Attribution may be a result of a specific legal fiction (for example, taxpayer election or controlled foreign corporation legislation) or a legal norm (for example, partnerships may be deemed transparent as a matter of law, thus attributing income to partners). The impact of article 1(2) is explained in the following hypothetical:

> State R regards a family as a taxable entity,[11] and income earned by the family is not treated as income of any individual member of the family; thus, family members are regarded as transparent for tax purposes in that state. Family X is a resident of State R under the tax laws of State R. A member of the family, Ms. X is a resident of State H and earns income from State S. Both State H and State S regard her as the taxable person, and the family is transparent to both for tax purposes. While the H-S tax treaty would apply for the purposes of Ms. X's income, article 1(2) of the R-S tax treaty would also apply to restrict the taxing rights of State S, only because the internal tax laws of State R attribute the income to a resident of that State (the family).

Also, article 1(2) does not avoid nontaxation or less than single taxation in the scenarios discussed in the partnership report. Consider, for example, placing the

[7]See BEPS multilateral instrument, *supra* note 5, at articles 11 and 3(3).

[8]*See* 2014 OECD model tax convention, article 3(1)(a); and 2011 United Nations Model Double Taxation Convention between Developed and Developing Countries, article 3(1)(a).

[9]There is nothing in the description of ''income derived by or through an entity or arrangement'' to exclude natural persons. On the contrary, commentary stating that ''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'' suggests that even natural entities qualify as ''entity or arrangement.'' *See* BEPS commentary, *supra* note 6, para. 26.8.

[10]*Id.*

[11]For example, Bangladesh, India, and Pakistan consider a ''Hindu undivided family'' to be a taxable person. See, for example, the Supreme Court of India's decision in *Gopal and Sons (HUF) v. CIT Kolkata-XI*, Civil Appeal No. 12254 of 2016 (Jan. 4, 2017). In this case, dividends on shares held by the head of a Hindu undivided family were attributed to the family on the ground that they were purchased from the funds belonging to the family, which was the beneficial shareholder.

hypothetical in Example 6 of the partnership report[12] into the context of the U.N. model:

> A and B, both residents of State R, are partners in a partnership firm organized in State P. The internal tax law of State R regards the firm as an opaque entity, while State P treats it as transparent. The firm receives royalties arising in State P. The partners are persons generally liable to tax in accordance with the criteria of Article 4(1) and likely would be considered residents of State R for treaty purposes despite not immediately being liable to tax on the royalties. Thus, State P would likely apply Article 12 of the P-R tax treaty, unless it adopts one of the three policy-oriented arguments (which have been criticized for being short on legal reasoning[13]) in the Partnership Report to deny treaty benefits.[14] While Article 12 would restrict State P's taxing rights, State R would not tax the income under its internal tax law because it does not regard the royalties to be the partners' income. This would result in less than single taxation under the UN Model. Likewise, at least until the partnership distributes profits to the partners, it also results in non-taxation of income under the OECD Model since Article 12 prevents the state in which the royalties arise from taxing the income. Article 1(2) does not address this issue.[15]

Further, specifically in the context of the U.N. model, a ''conflict of qualification'' could also result in nontaxation of income. Consider the converse scenario to the hypothetical described in Example 14 of the partnership report:

> A and B, both residents of State R, are partners in a partnership organized in State P. Under State R's internal laws a partnership is transparent, while State P regards it as a taxable entity. The business of the partnership is carried on through a fixed place of business in State P. A sells her share in the partnership to D, a resident of State P, earning a capital gain. Both State R and State P want to tax the capital gains under their internal laws. The R-P tax treaty adopts articles 13 and 23A of the UN Model.
>
> Since A, a resident of State R, earns the capital gains, there is no controversy regarding to the applicability of the tax treaty. The sale of her share of the partnership assets represents the sale of her permanent establishment in State P. Thus, State R applies Article 13(2) of the R-P tax treaty, under which the capital gains may be taxed in State P. State P, on the other hand, applies article 13(6) to exempt the capital gains.[16] In the absence of a provision similar to article 23A(4) of the OECD Model, nontaxation of the capital gains would not be abated, despite Article 1(2).[17]

II. The Unintended Consequences

While article 1(2) may be intended to remedy some of the problems plaguing hybrid entities, it results in some unintended consequences. These include at least one legal anomaly that produces results that run contrary to the goals of most tax treaties. It also creates other economic anomalies that erode the source state's tax base, despite income-generating activities taking place in that state. These are explained below.

A. Legal Anomaly: *The* Beneficial Owner

Consider a hypothetical in which a company, SCo (a resident of State S) pays dividends to HCo (a resident of State H). Both State H and State S regard HCo to be an opaque entity. However, State R gives its resident RCo, the majority shareholder of HCo, the option of treating HCo either as an opaque or transparent entity. RCo chooses the latter. State R thus regards HCo

[12]*See also* OECD, ''The Application of the OECD Model Tax Convention to Partnerships'' (1999), example 3.

[13]Michael Lang and Claus Staringer, ''General Report,'' 99B *Cahiers de Droit Fiscal International* 39-40 (2014).

[14]Partnership report, *supra* note 12, at para. 64-66.

[15]Compare this hypothetical with the one in paragraph 26.7 of the proposed commentary on article 1(2) found in the final report on BEPS action 2 (see *supra* note 6). The two hypotheticals are not mutually exclusive. This is because the words ''shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State'' do not translate to ''shall *not* be considered to be income of a resident of a contracting state *but only* to the extent that the income is *not* treated, for purposes of taxation by that State, as the income of a resident of that State.'' The following language would be more useful for avoiding the consequences of the instant hypothetical:

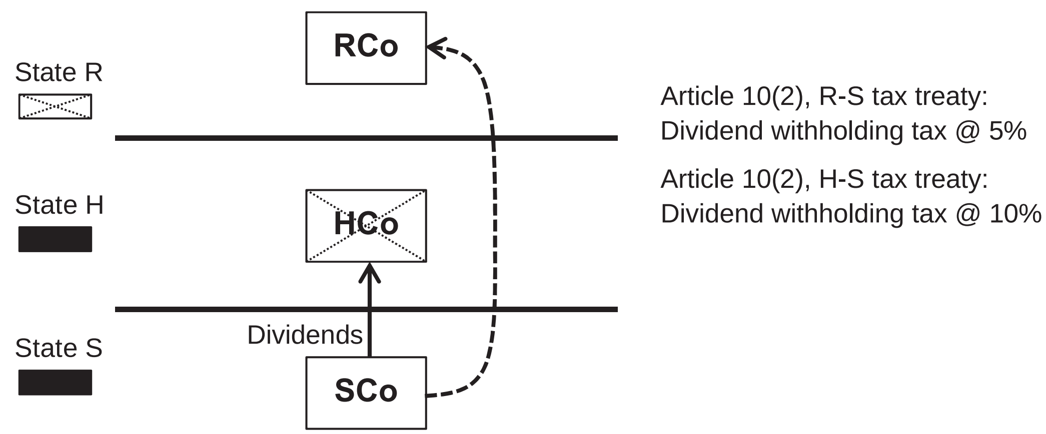
> For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only *if and only* to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

However, even this language would not address the other issues outlined in this note.

[16]Article 13(5) will not apply, since an interest in a partnership does not qualify as ''shares of a company,'' but ''other corporate rights.'' (For the use of these terms in contradistinction to each other, see article 10(3).) *See* Dhruv Sanghavi, '''Company' and 'Shares' Under the 2016 India-Mauritius Protocol and the U.N. Model Treaty,'' *Tax Notes Int'l*, Aug. 8, 2016, p. 509.

[17]The existence of article 23A(4) in a tax treaty may not necessarily avoid such nontaxation of income should the internal tax laws of the residence state adopt the exemption method to relieve double taxation, without a similar switchover provision.

Figure 1. Legal Anomaly



as transparent and attributes the dividends to RCo. Article 10(2) of the H-S tax treaty restricts the source state's tax claim over the dividends to 10 percent, whereas the R-S tax treaty restricts it to 5 percent. It is assumed for this hypothetical that HCo meets all substance and antiavoidance requirements of the H-S tax treaty and the internal laws of states H and S. Aside from the varied rates, the relevant portions of all applicable tax treaties conform with the U.N./OECD model.

If one adopts the solution suggested by the OECD commentary, article 10(2) of both the R-S and the H-S tax treaties would restrict State S's taxing rights, and State S would be able to tax the dividends at the lowest tax rate between the versions of article 10(2) in both tax treaties, that is, 5 percent.[18] According to this interpretation, which is codified in article 1(2), State S loses its legitimate taxing rights of taxing the dividends merely on account of a legal fiction of State R (in this case triggered by a taxpayer election). 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 state. While the exact meaning of the term may be elusive, it is clear that the ''beneficial owner'' generally refers to a singular entity.[19] It is an obvious flaw in the commentary that it ignores the beneficial ownership requirement in suggesting the application of the most restrictive tax rate of the two tax treaties.[20]

This issue has been partially addressed by the inclusion of the following italicized words in the proposed U.N. commentary on article 1:

> As the 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

[18]OECD commentary, *supra* note 1, at para. 6.5, fifth sentence.

[19]According to the commentary on article 10 of the OECD model, the term ''beneficial owner'' has been used to clarify the meaning of the words ''paid . . . to.'' In other words, the term has been used in the endeavor to identify the person to whom the divided should be considered to have been ''paid . . . to,'' and that person may not be the one to whom the direct payment of dividends has been made to. A person is considered to be a beneficial owner if she has ''the right to use and enjoy the dividends unconstrained by a contractual or legal obligation to pass on the

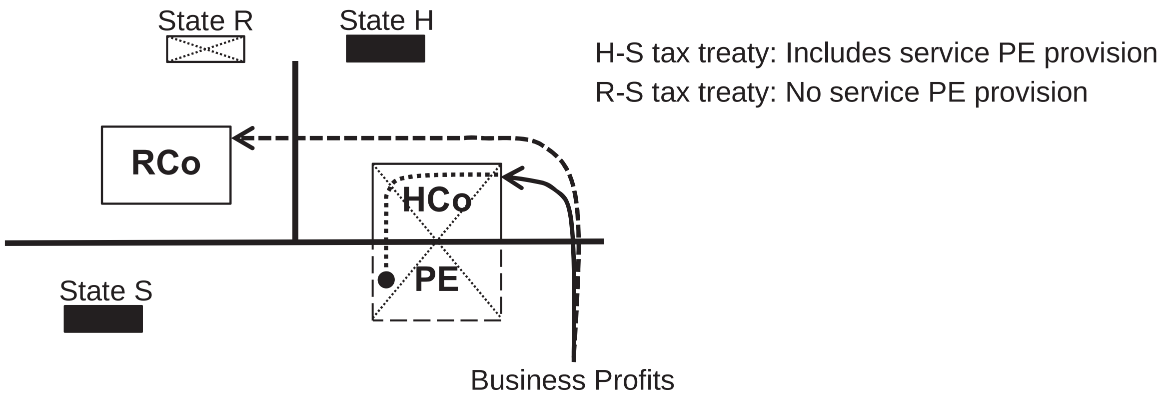
(Footnote continued in next column.)

payment receive to another person.'' *See* paras. 12-12.7, commentary on article 10 of the OECD model. While not impossible — there might be exceptional scenarios like one in which dividends are jointly owned (with right of survivorship) by more than one person, without them qualifying as a body of persons in which case there may be a plurality of beneficial owners — it would follow that there would usually be a singular beneficial owner of dividends. Especially in the case of hybrid entities such as HCo in the instant hypothetical, it would be difficult to regard any other as being the beneficial owner of the dividends.

It is interesting to observe that the partnership report, at para. 73, identifies only one beneficial owner — the partnership — in a triangular case similar to the instant hypothetical, but insinuates that there may be more than one beneficial owner when it suggests dual treaty benefits for the partners and the partnership. In adopting the commentary, however, the OECD makes no reference to the issue of identifying the beneficial owner in para. 6.5 of the commentary on article 1. In contrast, the OECD is more circumspect in its comments about whether a collective investment vehicle can be regarded as the beneficial owner of income. *See* OECD commentary, *supra* note 1, at para. 6.14, fourth sentence.

[20]*See* BEPS commentary, *supra* note 6, at para. 26.14, second sentence (stating that neither the partners nor the partnership may be treated as not being the beneficial owner, should dividends be received in their capacity as agents or nominees. However, the proposed commentary does not address the issue of which one of the two — partner or partnership — should be regarded as the beneficial owner).

Figure 2. Economic Anomaly



must also satisfy any additional requirements that are set forth in the applicable treaty, *such as beneficially owning the item of 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.[21] [Emphasis added.]

Contrary to the above commentary, no corresponding change has been made to Example 2, which continues to follow the philosophy of dual treaty benefits espoused by the OECD commentary.[22] 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 would not qualify as a treaty resident. Indeed, article 1(2) would attribute the income to the partners, but not the beneficial ownership.

B. Economic Anomalies

The anomalous effects of article 1(2) are not limited to the technicalities of the term ''beneficial owner,'' but also raise profound policy issues for developing countries insofar as the provision may result in a drastic erosion of tax base of the source state.

Consider a hypothetical in which HCo, a company that is a resident of State H, provides services to its clients in State S (a developing country), so that its profits are attributable to a service PE in State S under the H-S tax treaty. As in the previous hypothetical, RCo, a resident of State R, is the majority shareholder of HCo and elects to treat HCo as transparent for the purposes of State R tax laws. Both State H and State S regard HCo as an opaque entity, which fulfils all substance and antiavoidance requirements for tax treaty and internal law purposes. The R-S tax treaty follows the OECD model and does not contain a service PE provision.

For the purposes of the H-S tax treaty, HCo is the recipient of the profits, which may be taxed in State S to the extent attributable to HCo's PE in State S. However, according to article 1(2) of the R-S tax treaty, that part of the business profits (corresponding to RCo's shareholding in HCo) considered to belong to RCo according to tax laws of State R, would simultaneously be subject to the provisions of the R-S tax treaty. Since the R-S tax treaty does not contain a service PE provision, article 7 of that treaty prevents State S from taxing the business profits.

It is surprising that a developing country (in particular) would be willing adopt a provision that erodes its tax base merely because a third state, applying a unilateral legal fiction, attributes the profits to a resident. It is evident from the foregoing hypothetical that article 1(2) defeats the principal purpose of the BEPS project of allocating taxing rights to the state in which the economic activity takes place.

Perhaps the most significant problem afflicting article 1(2) is that it does not ensure the avoidance of either double taxation or nontaxation of business profits. As is explicitly provided in the U.N.[23] and OECD[24] versions of the provision, article 1(2) does not affect the residence state's taxing rights. Thus, the income would suffer double taxation (albeit economic double

[21] U.N. proposal, *supra* note 6, at para. 6.

[22] *See* OECD commentary, *supra* note 1, at para. 6.5, fifth sentence.

[23] U.N. proposal, *supra* note 6.

[24] OECD commentary, *supra* note 5.

taxation)[25] in State R and State H, assuming that the H-S tax treaty adopts article 23B for relieving double taxation, and that the profits are not attributable to a PE in State H.

The possibility of nontaxation of income is explained by adding the following assumptions to the above hypothetical:

- first, the business of HCo is effectively managed through a fixed place of business in State H; and
- secondly, the H-S and H-R tax treaties adopt article 23A for relieving double taxation.

In this scenario, State R would perceive a PE belonging to RCo in State H, and most, if not all, of the business profits would be attributable to that PE. State R would exempt the profits that "may be taxed" in State H in accordance with article 7 of the H-R tax treaty.[26] State H would, in turn, be required to exempt the same business profits because they "may be taxed" in State S in accordance with the H-S tax treaty. State S, as already observed, would be barred from taxing the profits because of article 1(2) of the R-S tax treaty, and the absence of the service PE provision in that tax treaty.

III. Conclusion

Some might be predisposed to perceive article 1(2) as desirable simply because it has been proposed as part of the G-20/OECD BEPS project; this is perhaps why it has also been proposed for inclusion in the U.N. model. However, a closer examination tells a different story. As the foregoing analysis illustrates, article 1(2) does not achieve either of the principal purposes of the BEPS project. It fails to remedy situations in which hybrid entities result in less than single taxation and fails to ensure the allocation of taxing rights to the state in which the economic activities are undertaken. To the contrary, article 1(2) will likely achieve the opposite result — base erosion from the state in which the economic activities are carried on, less than single taxation, or both.

This short article does not endeavor to propose a concrete solution to the problem, but rather demonstrates that the solution proposed in article 1(2) is problematic and suggests that its unintended consequences may warrant its rejection. Rejection is especially important for developing countries, since article 1(2) is likely to negate their efforts to use tax treaties to achieve greater source taxing rights, especially if another state, with which it has been unable to conclude a similar tax treaty, attributes the income to its own resident.

Resolving the problems created by hybrid entities is a worthy goal. But, what exactly are these hybrid entities? Article 1(2) uses the phrase "entity or arrangement that is treated as wholly or partly transparent" without defining the underlying terms. The commentary to article 1(2) as proposed in the final report on BEPS action 2 refers to the "concept of fiscally transparent" as a "situation,"[27] but the explanation does not identify the inherent characteristics of an entity or arrangement that could be regarded as fiscally transparent.[28] In this context, hybrid entities appear to arise out of conflicts in attribution of income to different persons whether because of the inherent characteristics of a person or because of legal fictions.[29] However, the existing OECD and U.N. models already contain income attribution rules applicable to most distributive rules, albeit not all.[30]

Much has been written on the topic of conflicts in the attribution of income to persons, the leading work being Joanna Wheeler's doctoral thesis.[31] Perhaps taking a more scientific approach could lead to a clearer treaty attribution rule (or more likely several — one for each distributive rule) that avoids the problems highlighted in this article. The United Nations may be a useful forum for undertaking this task. In the meantime, article 1(2) is a slippery slope best avoided, especially by developing countries. ◆

[25]Economic double taxation refers to the taxation of the same income in the hands of different persons.

[26]When included in the R-S tax treaty, article 10 of the BEPS multilateral instrument does not address this scenario and does not affect the obligation on State R to exempt under article 23A of the H-R tax treaty.

[27]BEPS commentary, *supra* note 6, at para. 26.10.

[28]*See supra* note 9 for further discussion regarding the definition of the relevant "entity or arrangement" in the U.N. commentary.

[29]This proposition can also be explained as: If a contracting state attributes the income of another person to its own resident, it is because the state does not see the person, that is, regards it as "transparent" generally or for the purposes of income ownership.

[30]*See* Kees van Raad, "Application of Tax Treaties to Items of Income That Are Covered by More Than One Distributive Provision," in *A Vision of Taxes Within and Outside European Borders: Festscrift in Honor of Prof. Dr. Frans Vanistendael* 729-736, at 730 (2008): "In view of this diversity in attributing income to the one state or to the other state or the other state or to both states, it is obvious that it is of great importance that the distributive rules that provides the attributions are perfectly clear as to which state(s) may tax a particular item of income. Surprisingly perhaps, but — for a variety of reasons — it is not always perfectly clear how in a given case the taxing rights are distributed."

[31]Joanna Wheeler, *The Missing Keystone of Income Tax Treaties* (2011).