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Qualification of taxable entities and treaty protection

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General Report

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1. Introduction to the General Report

1.1. Relevance of the topic

The qualification of entities as taxpayers is of significant importance in tax law. First, the status as an entity is relevant when determining whether an entity is actually subject to corporate income taxation in a certain country. Second, from the perspective of the owners/shareholders of the entity, recognition of the entity as a taxable one will often have the effect that the income derived at the level of the entity is only taxed in the hands of the entity rather than being attributed to the owners/shareholders that are "behind" the entity. The latter situation (taxation of income generated by the entity in the hands of owners/shareholders, typically with no change in the nature of the income and its source) is usually described as a transparent treatment of the entity. Therefore, when the present subject 2 deals with the qualification of taxable entities, it may well be alternatively described as drawing the line between transparent and non-transparent entities for corporate income tax purposes.

The treatment of a domestic entity as transparent or non-transparent is a policy decision to be made by probably all tax jurisdictions. It is up to the domestic legal order whether a domestic entity should be defined as being taxable or not (similarly, domestic law will also govern whether a certain legal arrangement is considered an "entity").

However, the policy issue of entity qualification is not limited to domestic entities only. Any tax system also has to provide for a solution to how foreign entities (i.e. entities that are legally established under the laws of a foreign country) are classified for tax purposes. Therefore, most tax systems will have a rule or doctrine in place about how this classification should be done in order to provide certainty in this respect. Such certainty in foreign entity classification has become even more important in the globalized economy of recent years. Nowadays foreign entities are seen in business transactions almost as frequently as domestic entities. Foreign entity qualification is obviously relevant for capital importing economies, i.e. from the perspective of the source state of income. But foreign entity classification issues often also arise for capital exporting economies (i.e. from the perspective of the entity's residence state) as the classification of the entity in the source state (where it is foreign) may govern the tax treatment of the repatriated income in that source state. One may therefore well say that there is a global relevance for entity qualification issues in tax law.

Entity qualification issues are, however, not only limited to domestic tax law. By contrast, they play an important role in tax treaty law as well. When applying a tax treaty, the first question will be whether an entity is actually entitled to benefits under that tax treaty. Already this first step requires an understanding of the tax status of the entity in question. The real tax treaty issue, however, is how effective treaty protection can be granted if the two contracting states disagree on the entity classification, as their respective domestic tax laws may well produce different classification results for a certain entity. The risk of having such conflict of qualfication of an entity in the two contracting states may have significant consequences if the result of the conflict is that no or at least no full relief from double

taxation is achieved. Therefore, it is of key relevance for the avoidance of double taxation that such conflicts in entity qualification either do not happen or are at least resolved to the extent possible.

1.2. Previous work done by IFA

Given the significant practical relevance of the above described issues, it is not surprising that the subject of the qualification of entities as taxpayers and how they are protected by tax treaties (or at least elements of this subject) has already been discussed at several previous IFA congresses. Examples of such previous attention paid to entity qualification issues are the former IFA congress main subjects *Partnership and joint enterprises in international tax law* (1973), *The fiscal residence of companies* (1987), *Recognition of foreign enterprises as taxable entities* (1988), *The disregard of a legal entity for tax purposes* (1989), *Interpretation of double taxation conventions* (1993), *International tax problems of partnerships* (1995) and *Double non-taxation* (2004). To this extent, it is not a greenfield topic for IFA.

1.3. Why the subject has been chosen for the Mumbai IFA congress

Nonetheless, it appears to be well justified to put this subject on the agenda again at the 2014 Mumbai congress. Some of the work at previous IFA congresses has now been done quite some time ago, so the results found at such previous congresses may be outdated or will at least require some checking. Further, some of the previous IFA congress subjects in the area were dealing with the practical effects of entity classification problems, but did not analyse in full the real source of the issue, i.e. what essentially creates the differences in entity classification in various states. This will now be done at the 2014 Mumbai congress.

In addition, the 2014 Mumbai congress gives an excellent opportunity to collect empirical data on how the various jurisdictions represented in IFA actually deal with the tax treaty conflicts that result from a disparity in entity classification. The *theory* of qualification conflicts in tax treaties and how such conflicts can be resolved by the contracting states was one of the most prominent work products that has been presented by the OECD in its recent history, when first published in the 1999 OECD Partnership Report and later included in the commentary to the OECD model. Now, almost 15 years later, it is time to analyse whether and to what extent the concepts proposed by the OECD to resolve entity classification conflicts are actually applied in bilateral tax treaty *practice*. This analysis of actual tax treaty practice at the 2014 Mumbai congress could provide evidence either for or against the assumption that the qualification conflict concepts proposed by the OECD have been adopted by the states' (OECD members and non-members) international tax treaty practice.

Dealing with entity classification issues in tax law can be a far-reaching exercise. Therefore, it is necessary to define the focus of the present subject 2 for the 2014 Mumbai IFA congress more precisely. This present subject will cover two main aspects (each of them being a main part of the branch reports and the General Report).

1.4. First part of the General Report

A first part will deal with the issue of how entities are classified under the domestic tax laws of the branch reporters' jurisdictions. For this purpose, classification of both domestic and foreign entities will have to be empirically analysed. Typically, it will be the classification of foreign entities that will create the more significant issues in practice (as there is usually a settled understanding of how to treat domestic entities for tax purposes). Nonetheless, an analysis of classification of domestic entities will also be necessary in order to make the conflicting approaches of different countries to the classification of the very same entity more visible. Also the comparison of classification approaches to domestic and foreign entities of the same country may produce insights about how those classification systems operate.

Without prejudice to the results of this General Report, the hypothesis is that, to put it mildly, the various states' domestic tax laws will not be in full harmony when classifying particular entities. Rather, it is actually expected that there will be fundamental disagreement in many cases on the tax classification of an entity. There is vast experience in international tax practice (in particular, but not only, relating to the tax treatment of partnerships) that justifies such an expectation. The purpose of this first part of the branch reports (and the General Report) is, however, not to ultimately resolve the detected conflicts (which could not be achieved anyway as entity classification is a matter of the fiscal sovereignty of states), but rather to identify the source of the problem and to find out how grave it actually is.

The General Report intends to be strictly limited to the above described scope. In particular, in order to maintain focus it does not go into detail on several other issues, although they might be closely related: residence issues (i.e. issues relating to the status of an entity as a "resident" for tax treaty purposes) are not dealt with in detail. This would certainly be a subject in itself. For the purposes of the present subject 2, the General Report rather makes the assumption that an entity, if classified as a taxable entity by a state, is granted the status as a treaty resident under article 4(1) of the OECD model convention (MC) by that state. In turn, if an entity is classified by a country as non-taxable (i.e. transparent), the assumption should be that this non-taxable entity is not regarded as a resident for tax treaty purposes.

Further, issues relating to the proper allocation of income to a certain taxpayer should be left out of scope. Again, this subject would deserve detailed attention in its own right, as it is equally important in practice. In the present context, however, allocation of income and classification of an entity should not be confused. The General Report rather treats the two topics as separate, limiting itself to the question of the classification of the entity as such. It is then a separate question (on which the General Report does not elaborate) whether the domestic laws of a jurisdiction would allocate a certain item of income to such an entity or not. But typically this attribution of income issue will not affect the status of the entity itself (i.e. the entity would still exist as in principle taxable, but with no actual income). Therefore, attribution of income issues are not dealt with.

Similarly, considerations on abuse of law rules or doctrines (either in the form of a general anti-avoidance rule – GAAR – or a specific anti-avoidance rule – SAAR – including controlled foreign company (CFC) rules or the like) are also not included in the General Report. Although it might well be that an entity is disre-

garded in a structure or transaction by applying a GAAR or SAAR, this is not a matter of entity classification in the sense of this General Report. Rather, the allegation of the abusive use of an entity in a structure or transaction even presupposes that the entity will be, if not disregarded for abuse of law reasons, classified as a taxable entity. So the disregarding of such an entity would take away the desired tax effects of the use of the entity, but would not deprive it of its entity status as such.

1.5. Second part of the General Report

The second part of this General Report will have a different focus, although it naturally evolves from the first part.

The second part will focus on how countries actually deal with qualification conflicts (which are the unavoidable product of the disparity of the different states' domestic laws) when applying their bilateral tax treaties. On the tax treaty level, the issue of qualification of an entity is closely linked to the issue of who the relevant taxpayer for tax treaty purposes is, since entities which are treated as taxpayers are usually entitled to treaty benefits. In contrast, entities to which a look-through approach is applied typically do not qualify for treaty benefits and income is not allocated to the entity but to the taxpayers "behind" it (shareholders, partners, beneficiaries, investors, etc.). In the case of different qualifications of the entity in different contracting states one has to decide which country's qualification is relevant, and whether one country's qualification has any impact on the treatment in another contracting state.

In 1999, the OECD dealt with such issues in its Partnership Report and most of the findings of this report became part of the OECD commentary. Today, however, it is interesting to find out to what extent administrative practice and courts follow the ideas of the OECD Partnership Report and are willing to extend them to other cases of conflict. Whereas the OECD Partnership Report deals mainly with allocation conflicts from the source state's perspective, these issues are also relevant from the residence country's view: in the case of different qualification of entities the tax administration of the residence state has to decide to whom it grants treaty benefits, such as credit for foreign taxes. Further, the qualification of entities is also relevant for the application of several distributive rules of the tax treaty: article 10(3) OECD MC seems to refer for the qualification of a company to the law of the source state and one has to find out to what extent this has a binding effect on the residence state as well. There are other tax treaty rules where the qualification of an entity is crucial. Just a few examples: article 13(4) OECD MC deals with the alienation of certain shares which makes it necessary to decide under which law the entity qualifies as a company in order to decide whether shares exist. Article 13(5) OECD MC deals with the alienation of other property, and therefore other shares as well, which raises similar issues. Similar questions are relevant for the purpose of article 16 OECD MC. In respect of article 15(2) OECD MC countries have to decide how an "employer" has to be defined and how far the qualification of this entity comes into play.

2. Entity qualification in domestic tax laws

2.1. Preliminary remark

The General Report on a main subject for IFA's annual congress is, by its nature, an empirical exercise. General reporters are given the truly exceptional luxury of a whole universe of branch reports from which they can summarize.

However, a mere country by country survey would not make appropriate use of the wealth of branch reports. The reader will certainly get more detailed information on a specific country or jurisdiction branch report by reading each branch report directly. Rather, the aim of the General Report should be to identify what the essence of the branch reports is in the light of the present subject. This subject is, in the first place, to find out how different jurisdictions classify vehicles as taxable (or non-taxable) entities. But the topic of entity classification goes further than that, because it is also about identifying likely sources for qualification conflicts in different jurisdictions, i.e. when a certain vehicle is classified as a taxable entity in one jurisdiction while it is seen as a non-taxable entity in another. The deeper purpose of this part of the General Report is, therefore, to give a better understanding of why such issues of entity qualification exist and where possible qualification conflicts may arise in tax practice. The following second part of the General Report will then analyse how tax treaties try to resolve such qualification issues. Therefore, the first part of the General Report is intended to serve as an empirical basis for the second one.

For this purpose, branch reporters were asked to structure their branch reports in a mandatory order (using given section headings) in order to enable the General Report to be structured identically to the branch reports for ease of reference for the reader. The following first part of the General Report applies this structure.

2.2. Domestic entities

2.2.1. Entities as taxpayers of income taxes

As a starting point, a first question could be whether a certain tax jurisdiction treats entities as separate taxpayers of a tax on income (e.g. a corporate income tax). This may appear somewhat simplistic, but it is actually a key assumption of the usefulness of an analysis of entity classification in the area of income tax. The distinction between taxable and non-taxable entities only makes sense if such a tax actually exists.

All submitted branch reports have confirmed that there is such a tax on the income of an entity, if it is qualified as a taxable one, in their tax jurisdiction. From that consensus, it can obviously be concluded that there is real practical life behind the subject matter, at least in the (significant) number of jurisdictions for which local IFA branches have contributed a branch report.

A more subtle point would have been to ask whether such a tax levied on an entity is actually a tax "on income" or whether the entity is taxed on an alternative (or surrogate) tax base that is used in substitution of income. Taking this even further,

one could also have asked how "income", if used as the basis for taxation, is actually defined. Finally, a question could also have been whether a tax levied on an entity is actually designed as a "corporate income tax", i.e. a tax that is distinct from an income tax levied on individuals, either by being imposed by different pieces of legislation or by being structurally different. It is obvious that all such questions would have gone far beyond the present topic, therefore they have not been further investigated.

2.2.2. "Domestic" nature of an entity

Before going deeper into the analysis, it has proved to be useful to differentiate for the purposes of entity qualification between domestic and foreign entities. Branch reports have shown that it may well be that a certain tax jurisdiction has different sets of rules for the purposes of entity classification for domestic entities on the one hand and foreign entities on the other.

A frequent example of such different approaches for domestic and foreign entities is if a tax system classifies domestic entities by having them included in a list or catalogue of taxable entities (i.e. specifying the specific legal form at issue as a taxable entity), while not having such a list or catalogue for foreign entities (but classifying such foreign entities e.g. by way of a structural comparison with the equivalent domestic entity). It is obvious that this approach to foreign entities is primarily for practical reasons, as it would be rather difficult (if not unrealistic) to include all relevant foreign entities in a catalogue (at least if the catalogue were not demonstrative only). However, already this rather frequent example shows that one should not generally assume that classification criteria for domestic and foreign entities are necessarily identical.

Such an approach differentiating between domestic and foreign entities in their classification may trigger a conceptual issue. If a certain domestic entity is given the status of a taxable entity, e.g. by inclusion in a list of specific legal forms without looking at the actual structure of the entity in the individual case (i.e. classifying the entity in any event as taxable regardless of its actual structure), while the equivalent foreign entity is not given taxable entity status as it does not need certain structural requirements that the jurisdiction would ask for in a taxable entity, this may well lead to discrimination issues. If the taxable entity status is seen as a benefit (as it protects shareholders in the entity from being taxed on the entity's income directly), the foreign entity (and its shareholders) suffers from discrimination relative to the equivalent domestic entity (and its shareholders) as the income of the foreign entity would be immediately taxed in the hands of its shareholders. An example of such a situation is the way many countries deal with complex entities (or, to put it neutrally, legal arrangements) such as trusts or foundations (*Stiftung*). It is not unusual for a jurisdiction to give taxable entity status to such legal arrangements only if they are domestic but at the same time to apply a look-through approach (i.e. deny taxable entity status) if a very similar (if not identical) legal arrangement is not domestic but foreign. Whether such discrimination has legal relevance will depend on the actual legal framework that is available for protection from discrimination in a specific case. Potential sources of such non-discrimination protection could be the European Union fundamental freedoms or non-discrimination provisions in tax treaties. However, an in-depth analysis of such non-discrimination situations would go beyond the scope of the present topic and this General Report.

For the above reasons, it can be relevant to determine what makes an entity a "domestic" one. As the branch reports have shown, there is no uniform approach to this. A number of countries primarily look for the "domestic" nature of an entity in their corporate law by asking whether a certain entity is incorporated under a legal form offered by the domestic corporate law of a jurisdiction. Typically, this is in line with the place of registration of the entity (e.g. with a court or other institution). Other countries do not look at their corporate law for the definition of "domestic", but rather apply criteria that are typically used for establishing whether an entity is tax resident in the country or not. Typical criteria that are used under this approach are the place of effective management of an entity or its seat (although there are various meanings of the term "seat"). A third group of countries seem to look at the two approaches together by assuming that an entity having a certain domestic legal form cannot, by definition under international private law, have its place of effective management or seat in another country without losing its legal status.

It is not the aim of this General Report to go into the details of the various concepts applied by the different domestic tax systems. Even a quick look into this question illustrates how complex this area can be. This complexity is well known from the problems that dual-resident companies create for many countries, as it is not entirely clear how they actually fit into the system of an entity being either domestic or foreign. From a practical perspective, however, the problem is to a large extent mitigated by the fact that the vast majority of entities will be easily classifiable as either domestic or foreign. It is therefore an issue only for a very small minority of entities. Nonetheless, those few minority cases show that the tax system of many countries does not precisely address whether (or under which condition) an entity is considered domestic or foreign and, specifically, whether this is governed by the same or other criteria that determine whether the entity is a tax resident or not.

2.2.3. Key factors for classifying an entity as a taxable one

If there is an income tax levied at entity level, what are the key factors for classifying an entity as a taxable one? Every domestic tax legal order (statutory legislation, case law, etc.) has to decide how it defines a "taxable entity" for corporate income tax purposes. At this stage, the focus of the analysis is not on the actual elements or requirements of classifying an entity, but more on the concept (resulting in a certain technique of the legislation) of how taxable entity status is defined.

One option would be for the domestic tax system to use generic criteria that define in a general way the taxable nature of an entity for tax purposes. At first sight, the advantage of this concept could be that it relies on a genuine "tax logic" (and not corporate law logic) for the dividing line between taxable and non-taxable entities. The issue, however, is that such a concept would require a decision on what the appropriate criteria should be that make an entity into a taxable one. Under such an approach, the tax system would have to define in a sufficiently precise way what these relevant criteria should be. This is not an easy exercise: should it be the "nature" of the entity and, if so, how is this "nature" defined?

Mostly for practical reasons most countries therefore apply a different concept to define what a taxable entity is. Under this concept, classification of an entity as taxable is done by reference to the corporate or private law of a jurisdiction, so that it is the legal nature of the entity (i.e. a certain type of legal form) that governs the status of a taxable entity. The advantages of such a reference to corporate or private law are obvious: this is a rather simple and easy to administer system as it links taxable entity status to the more easily defined legal status of the entity, without the need to look in detail at its structural substance, how it does its business, etc. As the branch reports have shown, there is a clear preference in the majority of countries for applying such a reference to corporate law for granting the status of a taxable entity.

A notable exception to this policy trend is the system applied in the USA. Under US federal tax law, there is no immediate recognition of certain legal forms as taxable entities. Rather the classification of entities for corporate law and tax law purposes is, to a large extent, in principle separate. The background to this concept is based on the different legislative competences under the US federal constitutional system. While federal tax law is in the legislative competence of the USA (i.e. the federation), corporate law legislation falls within the competence of the states. Therefore, it is not surprising that federal tax legislation is reluctant to accept the corporate law decision of a state that a certain vehicle should be granted entity status as automatically relevant (or even binding) for federal tax purposes. The US branch report elaborates in detail what the relevant criteria under federal tax law are for an entity to be recognized as taxable. In brief, an entity is considered to be taxable if it is organized under a statute that describes or refers to the entity as incorporated or as a corporation, a body corporate or a body politic or as a joint stock company or joint stock association. So, by result, it seems that this definition is in the end rather broad and will probably include a significant number of entities organized under the corporate laws of the states.

2.2.4. Relevance of corporate law status

Assuming that the domestic tax law of a given jurisdiction refers for entity classification to corporate or private law, a subsequent issue is whether the corporate law status of an entity (i.e. its having a certain legal form) is necessarily decisive for it being a taxable entity or whether it is possible that a corporate vehicle is de-classified for tax purposes to a non-taxable entity. Conversely, a non-taxable vehicle might not necessarily be treated in any event as a non-entity for tax purposes but may well be re-classified into a taxable entity. In other words, the question is whether there is always a truly binding effect of the corporate law status on the tax classification of an entity.

Looking more closely into domestic systems (as outlined in the branch reports), it becomes apparent that such de-classification or re-classification is actually very frequent. It seems that many tax systems, although in principle linking taxable entity status to corporate law features, still do exercise discretion in not necessarily following the corporate law treatment. A few examples.

A typical case for de-classification of an entity with legal personality into a non-taxable entity is found for partnerships. In many corporate or private law systems, partnerships (or at least some types of partnership available under the respective

domestic law) are given the status of having legal personality, i.e. being able to be the holders of rights and obligations, to appear in court, etc. In some countries, there is even a noticeable trend in recent private law history to grant partnerships status as legal persons while this traditionally has not been the case. However, in most of these countries it is still today's tax policy not to treat partnerships as taxable entities but to treat them as tax transparent. Interestingly, this traditional transparent tax treatment is still the rule even for most of those countries that nowadays grant partnerships legal personality under private law. The example shows quite obviously that legal personality is not necessarily seen, by many countries, as the decisive element for taxable entity status.

On the other hand, there is also a track record among countries for a re-classification of entities that one might expect to be treated as non-taxable into taxable entities, either in spite of their lack of legal personality or in overruling the conventional non-entity tax status. Some countries treat, for instance, investment fund vehicles as taxable entities due to their nature as collective investment vehicles, while such vehicles would under general criteria be seen a transparent. In such a case it is apparently the specific type of activity (the collective investment) that gives the policy reason for granting taxable entity status.

A broad range of examples of re-classification into taxable entities can also be found in the area of partnerships. There is evidence that some countries are contemplating integrating partnerships into the scope of taxable entities in the future (as reported for Poland from 2014 on), while they were traditionally seen as transparent. Other countries already have a tradition of differentiating between different types of partnerships that are available under their legal systems, giving some of them taxable entity status while others are seen as transparent. An example of such a differentiating view is reported for Australia. An interesting example is also found in the Netherlands, where partnerships are, in principle, seen as tax transparent, but are nonetheless given taxable entity status if they have certain characteristics that are largely similar to those of a corporate entity (in particular open limited partnerships, having a larger number of partners). Finally, sometimes even mere contracts (from a strict legal standpoint) can be re-classified into a taxable entity (like the *asociación en participación* in Mexico).

Given the by nature different policy backgrounds of the various domestic tax systems (which may provide for a lot of different reasons why a certain entity is either re-classified or de-classified), it will be difficult to assess whether there is a general trend in this area. However, what can be said is that there is broad evidence that domestic tax systems, even if using the corporate law status of an entity as a starting point for their tax classification, have few problems in discretionarily granting or taking away the status of a taxable entity if there is a certain policy reason for them to do so.

2.2.5. General reference to corporate law or list/catalogue approach

If the corporate law status of an entity is relevant to it being a taxable entity in a jurisdiction, there is the further question of how such a link to corporate law is actually designed by a tax system.

One option would be to include a list or a catalogue of such corporate law legal forms in tax legislation to clarify that such legal forms are treated as taxable entities.

The obvious advantage of such a list or catalogue approach is that it is a clear and simple way to define which types of entity should be taxable and which should not. Probably for this policy reason (i.e. simplicity and clarity) many tax systems do provide for such a list or catalogue. If such a list or catalogue approach is used, there are two options for how to structure the list or catalogue, i.e. either as a comprehensive or demonstrative list or catalogue. From the branch reports, it seems that most jurisdictions apply a demonstrative approach, which makes the list or catalogue more flexible in practice. In particular, this flexibility would be important if the corporate law of a country came up with a new legal form which would then not be automatically included in a comprehensive list of taxable entities. On the other hand, exclusion from a list (i.e. not being mentioned there) would give clarity to the non-taxable status of an entity only if the list were comprehensive.

Another option for the link to corporate law would be to use a general reference to corporate law in the tax system, so that corporate law vehicles (if they meet the requirements of the general reference) are automatically treated as taxable entities. This would avoid the need to precisely specify every individual type of legal form, which would make such a general reference approach by nature more comprehensive. Examples of such a general reference approach can be found in those jurisdictions which give taxable entity status to any "body corporate" that is included in their corporate law (such as in the UK, Australia and New Zealand). Of course this will require a precise understanding of what the body corporate actually is, otherwise such a general reference would create doubts.

A number of tax systems try to address the above definition issues by introducing catch-all clauses in their definitions of taxable entities with the intention of including all entities that meet a certain criterion (e.g. legal personality) as taxable entities. Examples of such a catch-all approach are systems that treat as taxable entities "any legal person under private law" (Germany, Austria) or that have "separate legal personality" (Belgium). Even broader than that are countries that declare as taxable entities all "persons who are not individuals" (Czech Republic), which covers essentially any vehicle that is a "person" (i.e. has legal personality) but is not an individual. A similar *e contrario* approach is to define as a taxable entity any vehicle under private law that is not included in a certain list of partnerships, which takes the listed partnerships as the starting point and defines a taxable person as any entity available under the private law or as long as it is not such a listed partnership (France).

2.2.6. Typical taxable entities

The branch reporters were requested to outline what typical taxable entities (and also typical non-taxable entities) in their jurisdictions are. There is no need to repeat the information given in the branch reports in this General Report. For the lists of taxable and non-taxable entities, reference is therefore made to the branch reports.

2.2.7. Mandatory or optional classification

It is a policy question whether the classification as a taxable entity in a jurisdiction should be necessarily mandatory or whether there should be an optional system that allows for an election for or against status as a taxable entity. Further, if a jurisdiction should decide in favour of an option system, subsequent questions on the actual design of the option system would arise, e.g. how the option is exercised and whether and for how long there should be a binding effect of the option (so that election for or against taxable entity status cannot be reversed in the short term).

The branch reports have shown that option systems are in use only in a limited number of jurisdictions. For the clear majority of jurisdictions, however, a mandatory taxable entity status (with no element of optionality) is applied. Nonetheless, the relatively few countries that do apply option systems are interesting to look at in further detail. These countries give examples of the type of entity or situation where a valid policy reason is seen for such optionality, at least in a certain jurisdiction. Therefore, these examples of optionality could serve as a policy inspiration for other countries when thinking about the future design of their own system.

One example of an option system can be found in various countries (e.g. France and Italy) for small and medium-sized companies (in some cases for a limited start-up period after the initial establishment of the company). Obviously, in this category it is the limited size of operations that is seen as a justification for the optionality of taxable entity status. Possibly, the underlying reason for that case of optionality is that low-income taxable entities suffer higher tax burdens if they are under a flat-rate tax (applied irrespective of the level of income), while the tax burden would be lower under the progressive rates that are typically applied to individuals.

Other examples of optionality can be found for family owned businesses, where it is apparently the family link between the shareholders (who need to belong to the same family) that justifies the option against taxable entity status (an example would be France). Similarly, optionality is also found for "personal companies" set up by individuals for a purpose close to their personal activity (South Korea). Another justification for an option against taxable entity status is seen in joint venture situations (e.g. where there is more than one shareholder, none of them with a majority interest, but all of them corporate entities; see Italy). In such a situation the option against taxable entity status of the joint venture vehicle is reasoned by expanding the effects of group taxation that would otherwise not be available due to the absence of a controlling shareholder.

All the above examples provide for an option against the taxable status of an entity. The opposite case, i.e. the option for taxable status of an otherwise non-taxable entity, is less frequent. This may be based on the fact that non-taxable entities (e.g. partnerships) are in some countries already mandatorily treated as taxable entities (where such a policy decision has been made), so there is no further need for optionality. An option for taxable status of partnerships can be found in France.

The best-known system of optionality is certainly the check-the-box system applied for federal tax purposes in the USA. This check-the-box system is the prototype of a rather flexible system of optionality, where an option against taxable status can be exercised. Under certain conditions (outlined in detail in the US branch report), eligible entities can opt against their taxable status with a binding effect for 60 months (or an earlier ownership change). It is interesting to see the policy background behind the check-the-box system: as the US branch report illus-

trates, this system is primarily seen as a tool to achieve simplification and fairness, because otherwise (i.e. without such an easily exercisable option) taxable entity status for federal US tax purposes would depend on a number of factors that could be structured to go in either direction by careful tax planning, which would exclude the non-advised taxpayer from the *de facto* optionality through the control of the required elements.

2.2.8. Varying tax status of an entity

So far, the analysis of taxable entity status has been on the assumption that a certain entity has such a taxable status due to its general nature, typically in a certain legal form. But it is actually possible that taxable entity status in a jurisdiction may vary from entity to entity depending on certain factors (e.g. ownership, type of activity, size, etc.), although the legal form of the entity is identical. This issue has a certain similarity to the optionality discussed above, but what is meant by a varying tax status is based not on subjective (like the exercise of an option) but on objective criteria.

It is obvious that this varying status approach has a number of practical issues. One issue is that it will be necessary to precisely define what the objective criteria should be that are relevant for the varying status of the entity, because it would not be sufficient to define a certain legal form as a taxable entity, but one would have to look more closely at the actual activity, the shareholders, the size, etc. Further, it would be very difficult for outsiders (e.g. business partners of the entity) to reliably assess whether the entity was actually a taxable one or not. This may be relevant, for instance, when a business partner of such a varying status entity had to determine whether the entity was actually protected under a tax treaty, which would typically require taxable entity status.

A typical example of such a varying status entity, which is found in a number of jurisdictions, is the treatment of trusts, foundations or similar entities or arrangements. Although it is not the purpose of this General Report (and also not of the branch reports) to investigate in detail the issues relating to trusts (and similar vehicles or arrangements), it can be noted that in a number of jurisdictions taxable entity status in this area will depend on various objective factors that can be fulfilled in a given case or not (such as the degree of influence or control of settlors, beneficiaries, the independence of a separate management, etc.).

Further examples of such varying status entities can be found in the area of partnerships with a varying tax status depending on who the partners are. In the Czech Republic, for instance, a limited partnership is treated as a taxable entity to the extent that the partners themselves have taxable entity status (i.e. are corporate vehicles), while a limited partnership is treated as transparent to the extent that the partners are individuals.

A specific case is reported from Portugal: an asset management company which is family owned (in a qualified way, i.e. with a voting majority for the family for more than half a year) or that has a limited number (fewer than five) of shareholders for the full year is seen as transparent (while the same type of entity would be non-transparent if such criteria were not met).

Again, probably the best-known example of a varying status entity is found in the USA. Corporations that would normally be taxable entities can elect non-

taxable status if they meet certain stock and ownership requirements and elect S corporation status. The US branch report also mentions a case of varying status going the other way: if an active business partnership (which would typically be transparent) is traded on an established securities market (or is readily tradable on a secondary market), it is seen as a taxable entity.

2.2.9. Fictional taxable entities

Many jurisdictions recognize the concept of a fictional taxable entity, i.e. taxpayers that derive their status as a taxable entity only from a fiction in the tax system while corporate or private law does not recognize such a fictitious body. A frequent example of such a fiction would be tax legislation that treats a mere business activity (without having any separate legal status) of a state (or its political subdivisions, agencies, etc.) as a taxable entity. The typical purpose of the creation of such a fictional taxable entity is to secure competitive neutrality with the private sector.

In addition to these common examples, there are a number of further cases of fictional entities reported in the branch reports, with a broad range of different backgrounds. Examples are the treatment of branches of foreign entities as separate entities, so-called *de facto* companies, investment funds, trusts (without legal personality), the Hindu joint family, joint activity agreements, property management agreements and others.

2.2.10. Registration with tax administration or other approvals

Typically, taxable entities have to register with the tax administration. However, it is a separate question whether the status as a taxable entity requires such registration (or other approval), giving the tax administration discretion (likely to be exercised on certain criteria) to except or deny taxable entity status. Similarly, taxable entity status could, at least in theory, depend on other regulatory approvals in a jurisdiction, such as permits, business licences, etc.

The branch reports have shown that such registration or approval requirements for taxable entity status are exceptional only. There is a clear pattern in international practice that registration with the authorities as such has no constituting effect on taxable entity status. Only in very few cases is the discretion of the tax administration to deny taxable entity status reported (e.g. in Hungary or in Peru). The picture is slightly more complex in jurisdictions (like the USA) where status as a taxable entity requires a filing with the tax administration, as otherwise the entity would be treated by default as a partnership. In the USA, an entity wishing to be classified as a corporation (i.e. as a taxable entity) that would be treated by default as a non-taxable entity must file an election with the IRS. However, this gives no discretion to the tax authorities but is rather a compliance matter that is under the control of the taxpayer.

2.2.11. Timing dimension

Another issue is the timing dimension of taxable entity status. The question here is what requirement or step actually creates taxable entity status so that the entity

exists from then on as a taxpayer (e.g. the deed of establishment, registration with a court or register, etc.). Equally, one has to identify what typically brings taxable entity status typically to an end (e.g. dissolution, liquidation, de-registration, etc.).

The branch reports have shown that most tax systems typically grant taxable entity status from the point in time when the entity is created for legal purposes. This may depend from jurisdiction to jurisdiction on whether the creation is actually achieved by the registration of the entity or by an earlier event (i.e. the establishment of articles or a similar document). Some jurisdictions, however, also recognize the existence of a taxable entity before it is legally created, i.e. in a period when the legal entity is in the process of being established or coming into existence. Such a view is typically found in systems that differentiate for legal purposes between the establishment of the articles (or similar deed) of an entity and its later registration. Such jurisdictions may grant tax status as a taxable entity already for the interim period (sometimes on condition of a later successful registration).

At the end of the lifetime of an entity, there is a common pattern to have the taxable status of an entity ended with its dissolution. Typically, dissolution is seen as the final stage or event after the company has been in liquidation for a certain period of time. From the branch reports, it seems that there is the typical understanding that an entity keeps its taxable entity status while in liquidation (although in such a liquidation status different tax rules may apply to the entity's income).

2.2.12. All or nothing approach vs. partial entity status

Typically, one can expect that taxable entity status is granted under an "all or nothing" principle (so that an entity can either be a taxable or a non-taxable one, but necessarily for all of its activities). This all or nothing approach is widely applied. This approach should not be confused with a situation where a certain entity is partially exempt for some of its activities, while other activities produce taxable income. This is often the case for non-profit entities, which benefit from a tax exemption for the non-profit area of their activities while the for-profit area remains fully taxable. However, even the exemption of the non-profit area does not change the status of the entity as taxable as such.

In some jurisdictions evidence can be found of exceptions from the all or nothing principle, so that a concept of a partial taxable entity is applied that grants taxable entity status only for certain parts of the entity (such parts being defined e.g. by the type of activities performed or by other factors). Examples of this partial taxable entity approach can be found where limited partnerships are treated as taxable or non-taxable entities depending on the nature of their partners (whether they are taxable entities themselves or not). Such a system is reported for the Czech Republic and France. Similarly, the Netherlands looks on an open limited partnership as a taxable entity to the extent that the limited partners' interests are concerned (but not the general partners' interests). Aside from such partnership cases, many countries apply a partial taxable entity approach to the state (or its political subdivision) where only its economic activities are given taxable entity status (by way of a fiction), while the state or other subdivision or institution as such is not a taxable entity.

2.2.13. Effect of tax exemptions

The effect of the tax exemptions available for the income of an entity is typically limited to the taxation of the income, i.e. such income will be tax exempt. A conceptually different effect would be for the entity to lose its entire status as a taxable one due to the fact that it receives only tax-exempt income.

The branch reports do not report evidence of such an effect on taxable status. It seems to be commonly accepted that even a company that derives only tax-exempt income will still be considered as a taxable entity. This is actually very important for many holding companies that derive only dividend income, which is in many cases tax exempt. For such companies, the continued taxable entity status in spite of the receipt of tax-exempt income is the basis for the application of tax treaties, which is often needed to reduce or avoid withholding taxes on dividends in the source country.

2.2.14. Group taxation

Group taxation is certainly a large topic in itself. What is interesting, however, in the given context is whether the membership of an entity in a taxation regime does or does not affect its taxable entity status. This question needs to be answered individually for any domestic group taxation regime, as there is a broad range of different concepts for such group taxation regimes (e.g. fiscal unity, group relief, group contribution system, etc.).

Not all jurisdictions for which branch reports have been submitted do have a group taxation system. Among the countries applying group taxation, the typical position is that membership of a tax group should not affect taxable entity status, so that an entity (being a group member) will still be seen as a separate taxpayer (although the actual levying of a tax may happen elsewhere in the group, e.g. at the group parent's level). Even systems that are typically known as fiscal unity regimes (such as in the Netherlands) keep the taxable entity status of members of that fiscal unity alive. Only in exceptional cases (as reported for Poland) will membership of a tax group (at least arguably) bring the taxable entity status of a group member to an end. In such a case, it will then be the group as a whole which is seen as the taxable entity.

The conclusion from the picture described above will be that although group taxation regimes, in their essence, conceptually try to mitigate the negative tax effects of a legal approach when looking at individual companies as taxpayers rather than looking at the group as a whole from an economic perspective, the designers of group taxation systems are apparently reluctant to also treat the group technically as if it were a single taxpayer. Therefore, such group taxation systems may be seen as interim solutions to the group problem only, as they typically do not tackle the problem at its source but only mitigate its effects. The reasons for that approach are probably practical. A true single taxable entity concept for the whole group would be very complex. There is evidence of such complexity from accounting (where consolidation applies a single entity approach) and also from the discussions within the European Union on a common consolidated corporate tax base (where consolidation, even done cross border, is one of the key features of CCCTB).

2.3. Foreign entities

2.3.1. "Foreign" nature of an entity

Before embarking on the analysis of foreign entities, one has first to determine what really makes an entity a "foreign" one. This is the mirror question to the one dealt with above for "domestic" entities. For the general relevance of the distinction between "foreign" and "domestic" entities, reference is made to section 2.2 above on "domestic" entities.

For foreign entities, the starting point of the analysis is, however, in most countries significantly more difficult. This is based on the fact that the tax legislation in many jurisdictions does not pay much attention to a precise definition of the "foreign" nature of an entity. Rather, foreign entities are, in simplified terms, in many countries seen simply as the opposite of domestic entities, with emphasis on the definition of what a domestic entity is. As a result of this legislative technique applied in many countries, the foreign nature of an entity in most countries is achieved by interpretation of the available legislation, rather than by relying on a clear definition.

A good example of the lack of emphasis of many tax systems on the definition of a foreign entity are countries that simply look at any entity as a "foreign" one if it is not a "domestic" one. This makes foreign entities no more than a residual (or default) group that does not meet the tests applied for "domestic" entities. At least such a residual approach will make sure that any entity can be classified easily as either domestic or foreign.

Similarly clear results can also be achieved under tax systems that use a single criterion to determine the domestic or foreign nature of an entity. This could be either at the place of incorporation or the place of effective management or another criterion. If a tax system therefore treats any company that is not incorporated under its laws as a foreign one (as, for instance, the US federal tax system does), there will be little room for doubt about which of the two categories an entity will fall into.

The dividing line between domestic and foreign is, however, much more difficult under tax systems that use multiple criteria for determining the domestic or foreign nature of the entity. If, for instance, a tax system grants domestic status to an entity alternatively based on its domestic place of effective management or place of incorporation, either of the two criteria will be enough to make an entity a domestic one in that country. If the other country (where the other criterion is applied) applies the same system, the result will be that both countries would look at the entity as if it were a domestic one. If one went deeper into the different possible scenarios (which is not the purpose of this General Report), it would soon become apparent that there are a number of situations where the domestic or foreign nature of an entity could well be in dispute. This phenomenon is well known from dual resident companies that have proved to be very difficult to categorize when it comes to the tax classification of an entity.

2.3.2. Key criteria for classifying foreign entities as taxable

If an entity is a foreign one, the next issue will be what the relevant key criteria are for classifying such a foreign entity as a taxable entity in a given jurisdiction. Not

surprisingly, the branch reports evidence that there is a very broad range of fundamentally different concepts applied by the various countries. Just a few examples.

There are, although this can be seen as exceptional, countries that do have a list of foreign entities as part of their legislation which are, by inclusion in such a list, declared as foreign taxable entities. The USA is the most prominent example of this approach.

However, more frequent is a different approach where there is no listing of specific foreign legal forms, but a general reference saying that foreign entities are taxable if they are, in one way or another (for the details of such an approach see below), equivalent or at least comparable to domestic taxable entities. This large group of countries apply a comparison (or equivalence) test, depending on which criteria they focus on when determining the comparability or equivalence. There are countries that apply a rather strict equivalence criterion, asking whether a foreign entity is (at least to a large extent) equivalent to one of the domestic legal forms that are classified as taxable entities (examples are Australia and Spain). Another group of countries (e.g. Germany, Austria, the Netherlands, Luxembourg) do not ask for the true equivalence of the foreign entity but require comparability with the key structural elements of domestic entities. In this group, it is sometimes not entirely clear whether more emphasis should be given in the comparability test on the legal status of the foreign entity or how it is actually structured (i.e. internally organized). It seems that at least some countries put more emphasis on the actual internal organization of a foreign entity (e.g. Denmark and India).

Still another group looks primarily at the legal personality of the foreign entity and essentially grants taxable entity status to any foreign entity that is a legal person (e.g. Belgium, Finland, Mexico, Poland, Russia). Similarly, other countries also look at the civil law features of the foreign entity but put more emphasis on whether the investors in the foreign entity are personally liable for the entity's debt (e.g. Norway, Switzerland).

There is another category of countries that apparently do not want to rely on isolated criteria but rather prefer a more comprehensive "overall" approach. Examples of this approach are the UK, where it is the "nature of the entity" that is seen as relevant. Similarly, Canada looks at the "nature of the relationship of the parties and their rights and obligations under the applicable laws and agreements". Obviously, this approach can produce very reasonable results in the individual case, although it will suffer from a low degree of predictability.

Some countries follow a rather different policy and do not have any specific rules at all when it comes to the classification of a foreign entity. Examples of that approach are reported for the Czech Republic and France. Where such an approach is applied, it seems that in practice it is relied upon to classify the foreign entity based on the way it is taxed in the foreign country (i.e. if it is treated there as a taxable entity, its taxable entity status will be respected).

On the other end of the scale there are countries (e.g. Greece, Italy and Portugal) that grant taxable entity status to all foreign entities, irrespective of their legal form or other characteristics. At least in Italy this radical approach is explained by the explicit desire for simplicity, trying to avoid the issue of foreign entity classification from the outset.

It is very obvious that, in the light of this diversity of approaches on how to deal with the foreign entity classification problem, it is difficult to identify a clear

policy trend. Rather, there is the strong impression that this diversity in tax policy approaches is one of the key sources of qualification conflicts between two countries classifying the same entity differently. Moreover, the various approaches described above may also well lead to a result where the very same type of entity, if classified by other countries, may well be seen differently from country to country.

2.3.3. List of foreign legal forms

From the above it becomes clear that there is a high likelihood of uncertainty in classifying a specific foreign entity as either taxable or not. One way to address this uncertainty would be to provide a list of foreign legal forms that clarify their taxable entity status for the purposes of the country issuing the list. Conceptually, if such a listing approach is chosen, further questions could arise, i.e. whether the granting of taxable entity status through this list is mandatory or only a presumption that can be rebutted in the individual case so that re-classification is possible. Further, it might be necessary to have such a list regularly updated. Finally, it would have to be clarified whether the list was considered to be complete (i.e. exhaustive) or demonstrative only.

The practical benefits of such lists are quite obvious. Nonetheless, there are only a limited number of countries for which the existence of such a list is actually reported. One example, the USA, has already been mentioned above. Based on the reports submitted for other countries, it seems, however, that no other country has actually included such lists in its legislation or equivalent parts of the legal order, but rather leaves the keeping of such lists to the tax authorities. Examples of such tax authority lists are found in Germany, Denmark, the Czech Republic and the Netherlands.

An interesting option, at least for European Union Member States, was chosen by Luxembourg by explicitly referring to the lists of entities available under the EU Parent–Subsidiary Directive and the EU Merger Directive, with the result that any entity of another EU Member State that is listed in the annexes to these EU directives will automatically be considered as a taxable entity for Luxembourg tax purposes.

2.3.4. Comparability test

For most countries, however, there is no such list available as a quick answer to the foreign entity classification question. For these countries typically a comparability test is envisaged, under which the foreign entity will be tested to ascertain whether, or at least to what extent, it is comparable to a domestic taxable entity. There are a number of options for designing such a comparability test: it could be that the legal or the tax status of the foreign entity (or a combination of both) is relevant for comparison. If multiple criteria are relevant, they could all have equivalent weight or, alternatively, an order of salience could be laid down. Also, some criteria could be considered as "must have" elements or the system could be designed to be more flexible so that, rather, the overall impression was relevant.

As the branch reports explain in detail, the criteria applied in the various jurisdictions for the purposes of the comparability test are, not surprisingly, rather diverse.

There is a full range of different approaches on what actually should be critical for the purposes of the comparison. There are even jurisdictions where there is no comparability test laid down at all, but where one is nonetheless applied in practice. Examples are reported for Australia and the UK. Generally, it appears that the precise content of the comparability test is in many countries more a matter of case law and practice rather than statutory law. Given the wide universe of possible elements that could, at least potentially, play a role in the comparison tests applied in the various jurisdictions, it will not be possible in this General Report to give a comprehensive overview of all the criteria that are in use. Looking at the various criteria from a more conceptual perspective, however, there is the impression that more emphasis is given to the legal aspects of a foreign entity than to its tax status in the other country (which will be dealt with in a separate section below). In any event, when it comes to the classification of a certain foreign entity in a specific country, it is clearly necessary to go into the respective countries' comparability tests in detail. In the following, therefore, only an overview of the various elements that were found in branch reports is given:

- no personal liability of shareholders/partners/investors for the entity's debt;
- profit distribution in accordance with invested capital;
- the entity has separate articles of association;
- separate annual accounts;
- separate decision-making bodies;
- the possibility of expanding the number of investors/shareholders/partners;
- the existence of share capital;
- centralized management and representation;
- limited liability of the entity;
- free transferability of shares;
- perpetual duration of the entity;
- legal personality in its home jurisdiction;
- the ability of the entity to have rights and obligations in its own name;
- competition of shareholders/partners with the entity is possible;
- an implied right to manage/represent the entity for every shareholder/partner;
- entitlement of shareholders/partners to salary, interest, etc.

Typically such criteria (i.e. the criteria that are actually relevant in a certain jurisdiction) are looked at from an overall perspective, so that it will be the general impression that is relevant for entity classification (of course, this will not exclude that in the practice of a given jurisdiction the implicit emphasis on some specific elements may be higher than on others).

An interesting and slightly different approach is reported for the Netherlands (at least in the view of the Netherlands tax administration). There are four questions that need to be answered to assess the transparent or non-transparent status of a foreign entity. These four questions address (a) the ability of the entity to legally own its assets; (b) the limited liability of the participants in the entity; (c) the existence of capital divided into shares; and (d) the entry of new (or replacement of existing) participants is possible without the consent of all participants (except in cases of inheritance or legacy). While these four questions as such are not unusual, it is interesting to see that taxable entity status is granted if three out of four of the questions are answered in the affirmative, which is a test that is applied with high certainty.

2.3.5. *Relevance of foreign tax treatment*

At least for some countries, the tax treatment of the entity in the foreign country is relevant for the treatment of the entity as a taxable one. Again, there is a certain range in the degree of such relevance. While for some countries foreign tax treatment is considered relevant "to a certain extent" (or a similar degree; see France, India, Spain, Sweden, Liechtenstein), other countries rely more heavily on the foreign tax status of the entity (such as the Czech Republic and Hungary, where the foreign tax treatment is seen as decisive).

An interesting approach is reported for Sweden and Finland, where the access of the foreign entity to a tax treaty concluded with the respective state grants the foreign entity taxable entity status. Also for Sweden, it is reported that a foreign entity will not be seen as taxable if, although being subject to tax there, it is taxed in the other state at an effective tax rate which is not more than 10 per cent. In other words, a low-taxed entity will not be considered as a taxable entity.

2.3.6. *Optionality*

As for domestic entities (see section 2.2 above), also for foreign entities one could consider an option system under which an election is possible as to whether a foreign entity should be treated as a taxable one. From a general point of view, very similar policy questions would arise from such optionality as were discussed above for domestic entities.

In the branch reports, there is only limited evidence of the existence of such option systems for foreign entities. The clear majority of jurisdictions do not consider such an option as feasible for classifying a foreign entity.

One example of an option system for foreign entities is reported for South Korea, where a foreign qualified entity is allowed to opt to be treated as transparent in the same manner as domestic entities are. For this option, there are several requirements: the foreign entity needs to have certain similarities to domestic entities which are allowed to make the election, it needs to have a permanent establishment in South Korea, and it must be treated as transparent in the foreign state where it is established. From the above criteria, it appears that the main purpose of this option system is to avoid qualification conflicts in cases where such a conflict would particularly matter (i.e. where there is a permanent establishment with potentially significant income).

Another example of an option system available for foreign entities can be found in the USA, where foreign entities that are not required to be classified as corporations for federal US tax purposes are eligible entities under the check-the-box system and may therefore elect their US federal tax classification.

2.3.7. *Advance clarification*

All the above has demonstrated that the classification of a foreign entity is, to say the least, not free from doubt. Given this, it could be helpful if there were a dedicated procedure available under which the status of the foreign entity could be clarified in advance with the tax administration (e.g. a ruling procedure, etc.).

The turnout of the branch reports shows that there is a ruling procedure available in most of the reporting jurisdictions. However, it seems that no country is contemplating the establishment of a truly dedicated procedure that specifically deals with the issue of classification of foreign entities. This seems rather to be done as part of the general ruling process. This may in practice have significant disadvantages. Ruling procedures are often reported to be lengthy and cumbersome, if not bureaucratic. This would not be a good fit for entity classification issues, which typically need to be resolved quickly. Further, such questions typically have a "yes or no" character, so it should be feasible to answer them in a fast-track procedure. However, as reported, there is no empirical evidence of such a system.

3. Qualifying foreign entities for tax treaty purposes

3.1. Preliminary remark

Tax treaties provide, by their nature, for a bridge between the tax systems of the two contracting states. Their rules have to be applied by the tax administrations of both countries. Entities play an important role in tax treaties, both as a subject of treaty law, if they are considered to be taxpayers in one or both countries, and as an object of treaty law, if an entity or activity connected with an entity is the source of income. The OECD MC defines the term "person",[1] which includes an individual, a company and any other body of persons, and the term "company",[2] which means any body corporate or any entity that is treated as a body corporate for tax purposes. Since the definition of person refers to the term "company" and the content of that term depends on the treatment for tax purposes, domestic law of the contracting states comes into play. Very often the term "person" is used in combination with the term "resident", which refers also to domestic law. However, it is often unclear which country's qualification prevails, which is in particular of interest if an entity is treated as a taxable entity in one country and as transparent in the other. These issues have to be analysed in the light of treaty entitlement, where the question is on which country's qualification does an entity's access to treaty benefits depend, and in the context of the distributive rules of the treaties, where entities serve as source rules.

The OECD Partnership Report[3] was pioneering in this respect. It was published in 1999 and most of its findings found their way into the OECD commentaries in 2000. The OECD deserves the credit for having for the first time raised many of the issues connected with different qualifications of entities and at least for trying to suggest solutions for some of them. The report is very illustrative, since it contains 18 small case studies and their solutions. However, this is at the same time its weakness: it is short on developing the underlying theory which is necessary to

1 OECD, *Model Tax Convention on Income and on Capital*, 2010, art. 3(1)(a).
2 *Ibid.*, art. 3(1)(b).
3 OECD, *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation No. 6, Paris, 1999.

provide the reasoning for these solutions. Moreover, the ideas developed in the report seem to be very much policy driven: it puts a lot of emphasis on the goal of avoiding double taxation and non-taxation,[4] but is short on providing explanations why the existing rules should always lead to these interpretation results. Fifteen years after the publication of the report it seems to be appropriate to examine the extent to which the findings of this report have been accepted by courts, tax administrations and scholarly opinions in various countries, and to analyse other issues of entity qualification that were not dealt with by the OECD report.

The branch reports are extremely valuable: branch reporters have looked into the administrative practice and the case law of their courts. However, many of the questions which we raised in the preparation of the reports have not been intensively discussed in all countries. Many of these issues have therefore been elaborated on by the reporters without them being able to refer to domestic practice in their countries. Hence, many of the written contributions go far beyond mere "reports" and present a lot of original ideas which can serve as the starting point of future discussions. As far as space limitations allow us to do so, we have tried to pick up some of these ideas and respond to them. Due to limited space we were not able to discuss bilateral deviations from the MC in our General Report; however, we acknowledge that some countries have already reacted to the shortcomings in the solutions for qualification conflicts offered by the OECD by including specific provisions in their treaties.

3.2. Treaty entitlement

The OECD report deals with treaty entitlement primarily from the perspective of the source state.[5] The OECD describes its concept by explaining the situation of an entity which is treated as a taxable entity in some states and as transparent in other states. Different states may come into play because the entity may be established in one state (P), its shareholders reside in another state (R) and its income comes from sources in a third state (S). The OECD takes the view that the treatment in the source state is not relevant for treaty entitlement.[6] If the entity is treated as a taxpayer in state P and as transparent in state R, both countries' tax treaties with state S should be applied by state S:[7] the tax treaty between P and S grants benefits to the entity which is a resident of state P, whereas the tax treaty between R and S gives treaty entitlement to the shareholders, due to their residence in R. Since both countries' treaties are applicable, no more withholding tax than the lowest percentage allowed according to each of the treaties can be levied in state S.[8]

[4] *Ibid.*, marginal number 15.
[5] *Ibid.*, marginal number 10.
[6] The OECD report states: "One broadly based approach would be to recognise as implicit in the structure of the Convention the principle that the source State, in applying the Convention where partnerships are involved, 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 taxpayer claiming the benefits of the treaty as a resident": *ibid.*, marginal number 53.
[7] *Ibid.*, marginal number 74.
[8] *Ibid.*

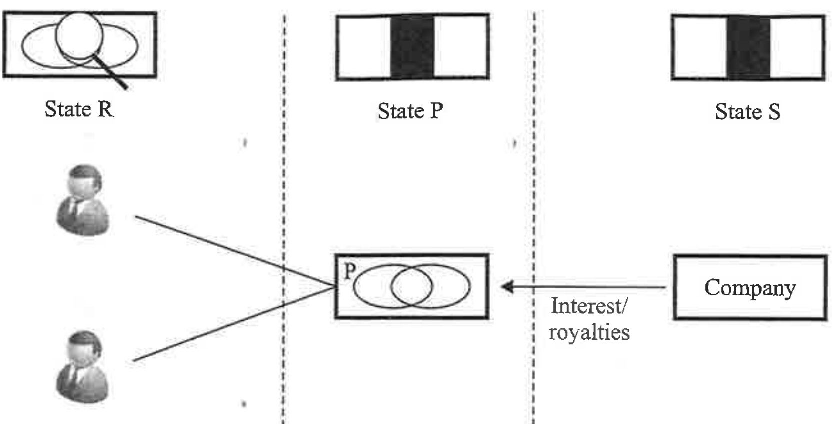

Figure 1. Treaty entitlement (1)

It is obvious that there is general agreement that the tax treaty between P and S is applicable if both countries treat the entity as a taxpayer (Figure 1). Therefore, it is more interesting to ask whether the tax treaty between R and S can be applied as well. Views are divided: branch reporters point out that in some countries the OECD approach is followed and since the shareholders are residents of state R they are entitled to the benefits of the treaty between R and S as well. However, in other countries the view prevails that the qualification of the entity in state S is decisive as to whether a tax treaty concluded by state S can limit withholding tax there. If state S allocates the income to the entity and not to the shareholders, only the residence of the entity can be relevant. However, state R does not treat the entity as a taxpayer and nor does the entity have its residence in its territory. This solution ensures that the taxpayer which is liable to tax in state S is also the one benefiting from the treaty. If more than one treaty were applicable in state S, practical problems might arise if both the entity and the shareholders requested a refund for the excess amount of withholding tax.[9] Neither first come, first served nor double entitlement for both the entity and the shareholders can be seen as satisfactory solutions.

There does not seem to be a consensus about whether the shareholders who are resident in state R get a credit for the withholding tax levied in state S. Some countries follow the approach of the OECD, which finds it consistent to grant a credit for the tax levied on behalf of the entity in state S at the level of the shareholders in R.[10] If a country looks through an entity and allocates income to its shareholders, they should also be granted the tax credit. In those countries it is not seen as an obstacle that the same withholding tax is credited twice, namely in state P at the level of the entity, and in state R at the level of the shareholder. In other countries

[9] *Ibid.*, marginal number 78; Michael Lang, "Taxation of Income in the Hands of Different Taxpayers from the Viewpoint of Tax Treaty Law", *Bulletin Tax Treaty Monitor*, December 2001, p. 599.
[10] OECD, *Model Tax Convention on Income and on Capital*, 2010, commentary on art. 23A and 23B, para. 69.2.

the view prevails according to which tax may only be credited which is levied at the level of the same taxpayer in the source and in the residence state. Since tax treaties do not grant indirect tax credits, a tax for which the entity is considered to be the taxpayer in state S cannot be credited at the level of the shareholders in state R. This view is convincing to us, too.[11] Of course, states may grant credits for taxes which are levied on other taxpayers. However, it is difficult to derive this from the tax treaties, since the MC at least, aside from a few explicit exceptions, deals with those types of double taxation which arise at the level of the same taxpayer.

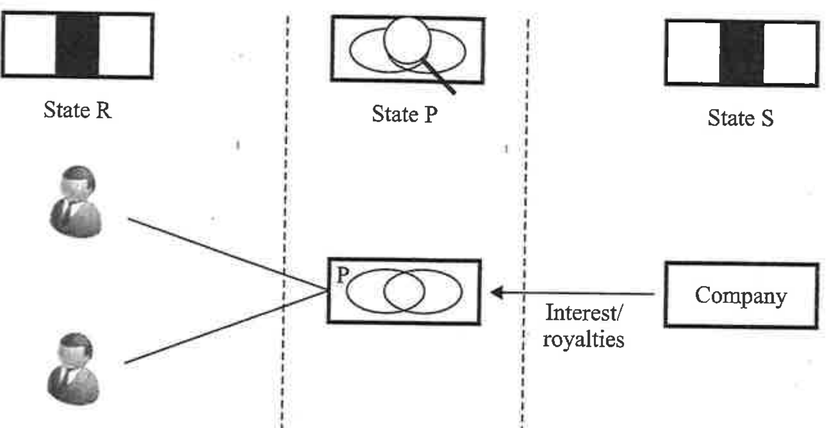

Figure 2. Treaty entitlement (2)

If the situation is reversed and the entity is treated as transparent in P and as a taxpayer in state R (Figure 2), according to the OECD view no tax treaty should give protection in state S:[12] the entity is not a taxpayer in state P and cannot be treated as a resident there; in state R the shareholders are residents, although not in respect of the income from state S, since state R's tax law allocates the income to the partnership. Interestingly enough, according to the branch reports, in most countries this approach seems to be accepted. Policy deliberations seem at first sight to support this view as well: most probably the state S-sourced income is taxed neither in P nor in R, so there does not seem to be a need to grant treaty protection in state S, since there is no double taxation. However, the effects of the allocation of the income under state R's tax law for the partnership established in state P are no different from exempting this income in state R. Usually treaty protection in the source state is granted even when the residence state exempts that income from taxation. The MC does not contain any subject to tax clause. Therefore, one would have an argument to apply the treaty between R and S despite the fact that

11 Michael Lang, *The Application of the OECD Model Tax Convention to Partnerships: A Critical Analysis of the Report Presented by the OECD Committee on Fiscal Affairs*, Vienna, Linde, 2000, p. 69.

12 OECD, *The Application of the OECD Model Tax Convention to Partnerships*, *op. cit.*, marginal number 69.

the income is not taxed in the hands of the shareholders there. This is even supported by the fact that most probably taxes will also be levied in state R as soon as the entity distributes the income to the shareholders.

In most countries the treaty between P and S is not regarded as being applicable either. Under a merely literal interpretation of the MC it is indeed difficult to assume that the transparent entity can be seen as a resident of state P.[13] However, if one goes beyond the letter of the treaty and just requires that such an entity meet those requirements in state P which typically lead to worldwide taxation (such as seat, place of residence or place of incorporation), one can grant treaty benefits to such an entity.[14] Klaus Vogel has already favoured this approach by pointing out that:

> "[a]pplication of the distributive rules is not conditional on the person concerned actually being taxed (as a resident). All it requires is that the person concerned has that personal attachment to at least one of the contracting States – the 'State of residence' – which might result in him becoming subject to full tax liability … The question whether a person … may be a taxable entity under the law of the State concerned, is not a condition for treaty entitlement. The consequence thereof for a partnership, if it is not taxable as such under the law of the State in question, is that its treaty entitlement depends on the local attachment which would apply if the partnership were a taxable entity in that State."[15]

The fact that treaty entitlement is usually granted to tax-exempt entities[16] leads in the same direction: it would be difficult to argue that tax-exempt entities are treated differently for treaty purposes from entities which are not covered at all under the tax code.[17] For domestic tax law purposes it does not make any difference and it is just a matter of drafting technique whether an entity is not covered under the tax rules at all or is listed as a taxpayer but at the same time is exempt from taxation. Domestic drafting technique should not be relevant for treaty application. Only substantive differences should count. Granting treaty entitlement to non-taxable entities is also justified from a tax policy perspective, as the case above illustrates: if the activities of the entity in state P constitute a permanent establishment there, it is very likely that state P will levy tax, although at the level of the shareholders. So there is a risk of double taxation. Article 4(1) MC therefore should be read, as

13 *Ibid.*, marginal number 34.

14 Lang, "Taxation of Income in the Hands of Different Taxpayers from the Viewpoint of Tax Treaty Law", *op. cit.*, p. 598.

15 Klaus Vogel, *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation on Income and Capital with Particular Reference to German Treaty Practice*, 3rd edn, Vogel, Kluwer, 1997, art. 4, marginal numbers 24(a) and 24(b).

16 *Ibid.*, marginal number 24 *et seq.*; Michael Lang, *Introduction to the Law of Double Taxation Conventions*, Vienna, Linde, 2013, marginal number 196; SE, *Regeringsrätten* 2 October 1996, RÅ 1996 ref. 84 (6301-1994).

17 Lang, *Introduction to the Law of Double Taxation Conventions*, *op. cit.*, marginal number 196; SE, *Regeringsrätten* 2 October 1996, RÅ 1996 ref. 84 (6301-1994); see also Joanna Wheeler, "The Missing Keystone of Income Tax Treaties", *World Tax Journal*, vol. 3, issue 2, 2011, p. 252, who criticizes such an approach but finally nevertheless seems to accept it.

suggested by several academics, as allowing "assimilated residence" in state P and thus the application of the treaty between P and S in state S.[18]

If the entity has a permanent establishment in state P, double taxation is very likely. State P might tax the state S-sourced income in the hands of the shareholders each of whom has a permanent establishment in state P for treaty purposes. In most states a permanent establishment does not get treaty benefits. However, in a considerable number of countries the permanent establishment non-discrimination clause of the treaty between R and P is regarded as applicable. An obligation can be derived from this clause that state P must extend the treaty benefits to shareholders who are residents in R.[19] However, even then a tax credit (if the treaty provides for the credit method for this type of income) can only be granted in state P if the fact that the relevant taxpayer for the withholding tax in state S is the entity and that in state P the tax is levied at the level of the shareholders is not seen as an obstacle and such an indirect tax credit is accepted under the treaty.

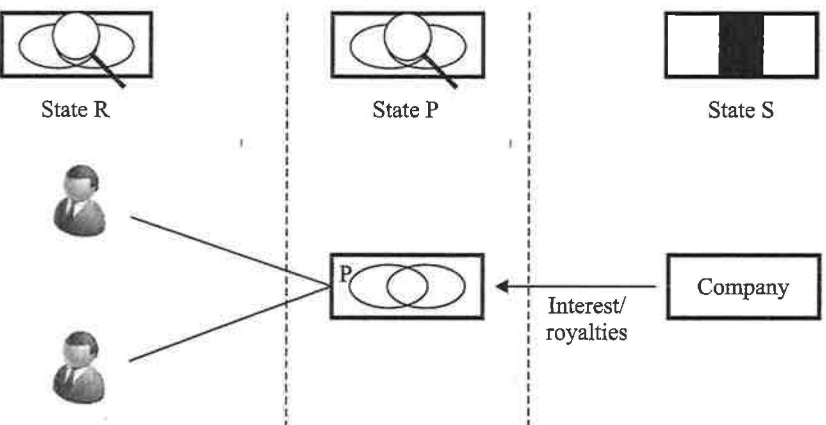

Figure 3. Treaty entitlement (3)

If the fact pattern is changed again and if we assume that both states R and P treat the entity as transparent (Figure 3), and state S as a taxpayer, the assessment for the treaty between P and S remains the same. However, most branch reporters state that in their countries the treaty between R and S would be seen as applicable

[18] According to the concept of abstract liability to tax, it is not essential for invoking art. 4(1) that a contracting state actually attributes income to an entity. Hence, also fiscally transparent entities such as partnerships could be residents of a contracting state. See in more detail Lang, *The Application of the OECD Model Tax Convention to Partnerships, op. cit.*, pp. 31 *et seq.*; Lang, "Taxation of Income in the Hands of Different Taxpayers from the Viewpoint of Tax Treaty Law", *op. cit.*, pp. 597–598.

[19] Alfredo García Prats, "Triangular Cases and Residence as a Basis for Alleviating International Double Taxation: Rethinking the Subjective Scope of Double Tax Treaties", *Intertax*, no. 11, 1994, pp. 473–474; Kees Van Raad, "The 1992 OECD Model Treaty: Triangular Cases", *European Taxation*, vol. 9, 1993, p. 299; Vogel, *op. cit.*, art. 24, marginal number 132(b).

in this situation. If the treaty provides for the application of the credit method, a credit of the tax levied in state S would only be granted in R if this kind of "indirect" tax credit were accepted.

If under the permanent establishment non-discrimination clause of the tax treaty between R and P, state P feels obliged to grant a credit for the withholding tax levied in state S as well, the same withholding tax is credited both in state P and state R. Only in a few countries do tax authorities have a problem with such a double credit and require that only the amount of tax which has not been "used" in state P can be credited against taxation in state R. In our view, such a double credit should not constitute a problem, since the income is taxed in both countries and therefore taxed twice as well. However, if state R applies the credit method for business profits under the tax treaty between R and P, the tax credit in state P will reduce the tax burden in that state and therefore the amount of state P's tax which has to be credited in state R as well is also reduced. If the tax treaty between R and S provides for the exemption method for business income, the credit of tax levied in state S could be denied under the maximum tax credit rules, since the permanent establishment profits include the income from state S and are therefore exempted in state R.

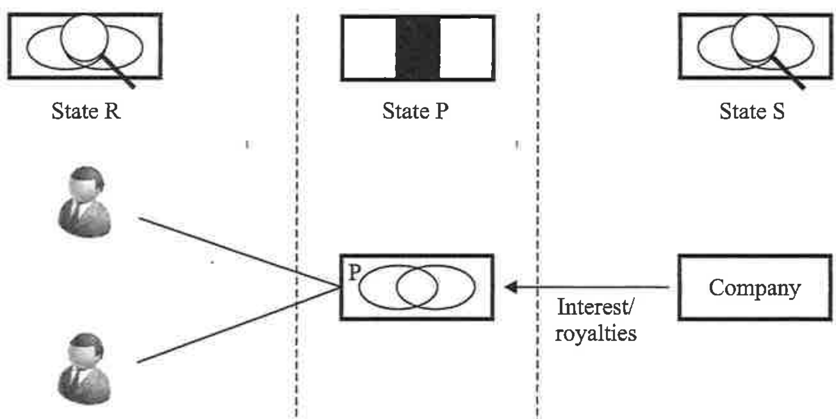

Figure 4. Treaty entitlement (4)

If the state where the entity is established (P) treats the entity as a taxpayer and both the source state (S) and the state where the shareholders reside (R) look through the entity and allocate the income to the shareholders (Figure 4), the OECD takes the view that both the treaty R–S and the treaty P–S are applicable in state S. State S has to comply with the obligations under both treaties; this means in practice that state S may not levy a higher withholding tax than the lowest provided under each of the treaties. The qualification of the entity in the source state (S) is not relevant according to this view.[20] The OECD looks at the countries of the

[20] OECD, *The Application of the OECD Model Tax Convention to Partnerships, op. cit.*, marginal number 73.

recipients and both states R and P allocate the income to the taxpayers who reside there, namely to the shareholder in R and to the entity in state P. Interestingly enough, in a considerable number of countries this view is not shared. Some countries apply only the treaty S has concluded with R, others only the treaty between P and S. In those countries where the view is prevailing that the allocation of the income according to the law of state S determines which treaty is applicable, it is logical that only the treaty between S and R is applicable. Since state S allocates the income to the shareholders, it is their residence which matters. However, the argument for only applying the treaty between P and S is that the income has been paid to this entity and therefore only the entity as such can claim treaty benefits. We have doubts whether this view is convincing. If state P also treated the entity as transparent, it would not be under dispute that the treaty between R and S would be applicable. Thus, the only difference is the tax treatment in state P, and there is no reason why this should have any influence on whether the treaty between R and S is applicable.

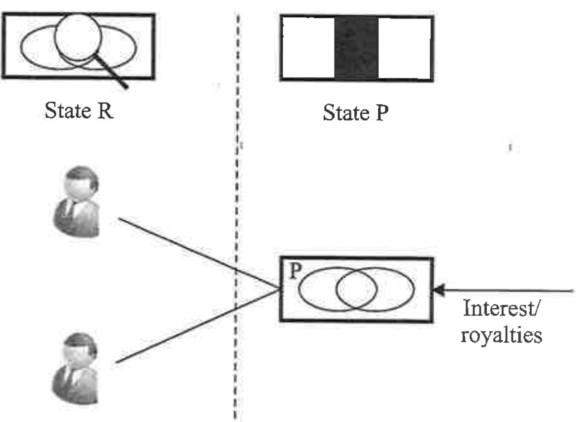

Figure 5. Treaty entitlement (5)

If we simplify that fact pattern and assume that state S coincides with state P, and both states R and P continue their treatment of the entity as in the fact pattern described above (transparent according to the tax laws of state R, opaque according to state P's tax system) (Figure 5), the issue is already a matter of controversy in the OECD Partnership Report.[21] The OECD is aware that the "general principles" it has itself developed lead to the result that the partners may invoke the treaty in state P and require there that the withholding tax on interest and royalties is reduced or not levied at all. However, only "some delegates" would continue to follow this approach in this case as well. The majority "was of the view that, despite the general principles … which would require the source State to take into consideration

21 *Ibid.*, marginal number 60.

the treatment of the income in the State of the residence of the partners, in this situation State P would not be limited in its taxation rights by the P–R Convention".[22] Today in almost all countries represented by the branch reporters this view seems to be shared. Policy-wise, this is perfectly understandable. From state P's perspective this is a purely domestic situation. If state R's tax rules look through the entity, as is e.g. often the case in a CFC situation, there does not seem to be any reason why state P should give up its taxation rights. However, as even the majority view of the OECD report admits, the application of the "general principles" developed by the report for other situations would lead to the result which was shared only by the minority of OECD delegates and which nowadays is rejected in almost all countries. In our view, these inconsistencies should give rise to challenging the whole approach. It is obvious that a much more convincing solution can be achieved by regarding the qualification of the entity in the state where the income is sourced to be decisive. The relevant taxpayer in this view is the entity which resides in state P and therefore state P has the exclusive taxation right under article 7 or under article 21 MC for domestic income. In our view, it would be appropriate to look at the treatment of the entity in the state of source in other allocation conflicts as well, as a general approach. Inconsistencies could be avoided, reasonable results achieved.

The OECD Partnership Report dealt in another case study with how the residence state of the shareholders should treat the income. The OECD assumes that state R is entitled to tax the income at the level of the shareholders. However, under the method article one either has to exempt the income which is allocated to the entity under state P's law or one has to grant a credit of the tax levied at the level of the entity. However, the branch reports show that this approach is not fully shared in all countries. According to some branch reporters, there is no room for taxation in state R at all because state R has to accept that state P has the exclusive taxation rights. Others take the view that state R may tax the income in the hands of the shareholders. However, not all of them follow the approach taken by the OECD according to which state R has to provide relief from double taxation. Some reject this view by not automatically accepting the entity which is a taxpayer in state P as a permanent establishment of the shareholder. In the case of some credit countries the credit of a tax levied at the level of the entity would be considered to be an indirect tax credit, for which the treaty does not provide.

The OECD Partnership Report deals also with another variation of this fact pattern. Contrary to the previous case study, the royalties are not derived from sources in state P but from sources in state R, which is also the residence state of the shareholders (Figure 6).[23] According to the general principles of the OECD Partnership Report, the view of the state where the beneficiary resides should prevail. A minority of the OECD delegates shared this view and drew the conclusion that under article 12 of the treaty between R and P, state R as the source state has lost its taxation rights.[24] Therefore, the royalties cannot be taxed by state R in the hands of the two individuals either. The majority view within the OECD rejected this approach and regarded the situation as merely domestic. Thus,state R cannot be prevented from

22 *Ibid.*, marginal number 131.
23 *Ibid.*, marginal numbers 51–52. Similar to example 17, but with both partners in state R.
24 *Ibid.*, marginal number 126.

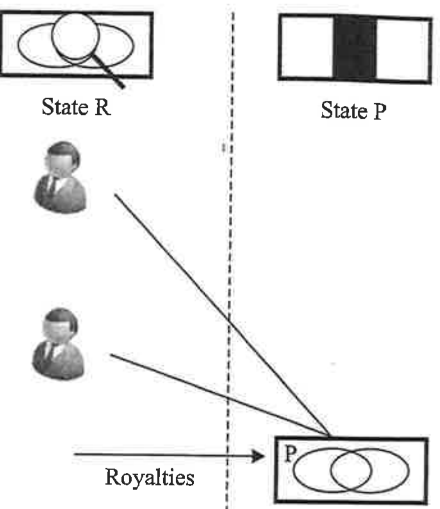

Figure 6. Treaty entitlement (6)

levying taxes. However, even from state R's perspective this is not fully convincing if the partnership constitutes a permanent establishment in state P. According to article 7 MC, taxation rights would be allocated to the permanent establishment state and state R has to exempt or grant a credit. In that situation, again, the question comes up whether an indirect credit has to be granted under the MC. Allocating unlimited taxation rights to state R is more convincing if the entity does not constitute a permanent establishment for the partners in state P. The application of either article 7 or article 21 MC leads to this result. However, this view is not in line with the "general principles" of the report. Again, taxation without any limits imposed by the treaty in state R can only be supported if one assumes that the source state (which is state R here) does not have to follow the qualification of the entity in the state where the entity, as a beneficial owner of the income, resides, but the qualification under its own tax law. It is unclear what the legal basis for a credit of the tax levied in state P should be, as is suggested by the OECD report. If one assumes that it is sufficient that the income "may be taxed" in state P according to article 23 MC, then it is difficult to refuse a credit for any other tax levied somewhere at the level of any taxpayer whatsoever, as long as the treaty does not prevent it.

The branch reports illustrate that the inconsistencies of the report have created confusion. In many countries the view prevails according to which state R has unlimited taxation rights; however, for different reasons, either because the majority view of the report is followed just because it is the majority view, or experts find it more convincing to regard the treatment of an entity in the source state for source taxation purposes as relevant, contrary to the "general principles" of the report. In some countries the "general principles" of the report are followed, with the effect

of limiting taxation rights in state R. In some countries a credit for the tax levied in state P may be granted; in other countries no legal basis is seen for that. The inconsistencies in the report seem to have contributed to a loss of authority of the report and of the OECD commentaries in which the findings of the report were included.

Fifteen years after the publication of the OECD report it is time to reconsider the "general principles" which were suggested in it. The branch experiences indicate that it might have been more convincing to require each country just to look at its own entity qualification for applying the treaties. If countries follow this approach, it would be much easier to treat allocation conflicts due to anti-abuse provisions,[25] CFC rules or any other different qualification of entities according to the same principles and arrive at policy-wise reasonable results. The prize for the attempt to avoid both double taxation and double non-taxation at all costs was a loss of authority of the OECD report and those OECD commentaries which adopted the approaches developed by the report. The lesson to be learned from this experience is that it is not enough to change the OECD commentaries if new principles are developed and then to expect country practice to follow. Even if tax authorities are willing to follow such OECD approaches, it is the courts that have the upper hand in the long run, and under the rule of law it has never been realistic to expect that judges will follow a position just because it is stated in the OECD commentaries, as they do not have any legal authority.

3.3. Dividends

The OECD Partnership Report deals with both allocation conflicts and qualification conflicts. Allocation conflicts are due to the fact that the two countries allocate income to different taxpayers, which may among other things have its reason in a different qualification of the entity which receives the income. Qualification conflicts are due to the fact that the two countries apply different distributive rules, which may also have its reason in a different qualification of an entity. In the case of a qualification conflict the treatment in the state of source should, according to the OECD view, prevail and the state of residence is expected to follow the other state's approach. However, the following example, which is not discussed in the OECD report, illustrates how difficult it is to apply these principles in concrete situations, and the solutions offered by the branch reporters show how disputed these principles are in practice and, even if applied, how different the conclusions one might draw from these principles can be.

An entity in state S is receiving rental income from immovable property located in the same state (Figure 7). That state treats the entity as transparent and taxes the income in the hands of the shareholders who are residents of state R. If state S looks at the treaty merely from its domestic point of view, it seems to be likely that state S will apply article 6 MC and, as the state where the immovable property is located, feels entitled to levy tax. This view seems to be at least implicitly sup-

[25] Michael Lang, "Die Besteuerung von Einkünften bei unterschiedlichen Personen aus dem Blickwinkel des DBA-Rechts", SWI, 2000, p. 527; Marlies Steindl and Marion Stiastny, "The Impact of the OECD Partnership Report (1999) on Tax Avoidance in Outbound Cases", *Bulletin for International Taxation*, February 2014, p. 114.

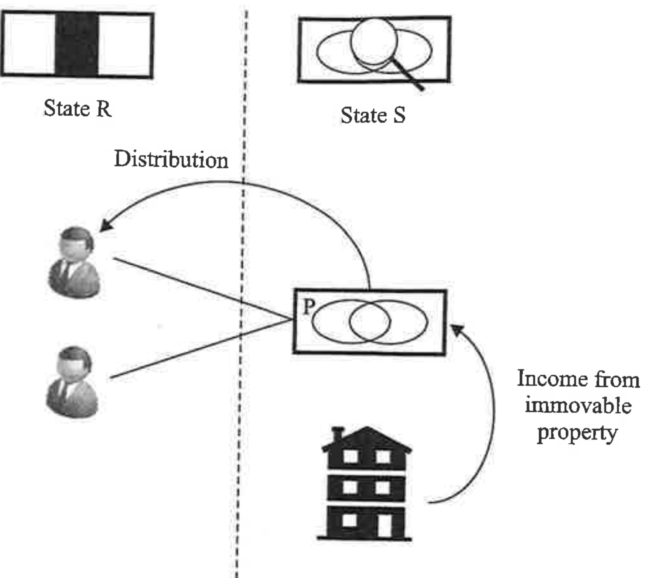

Figure 7. Dividends

ported throughout all branch reports. However, under the principles developed by the OECD report it could also be considered to not apply the treaty at all since state R only taxes the distributed profits of the entity, but the rental income as such is not taxed in the hands of the individuals.[26] In the situation described above this does not make any practical difference for state S, since state S could maintain its taxation rights anyway. However, if the entity were to receive e.g. interest, dividends or royalties instead it could matter, since the application of the treaty could limit or even abolish state S's taxation rights. If one takes the view, as the OECD report does, that state S is not obliged to apply the treaty in such a situation, one wonders whether it would make a difference if state R, e.g. were to apply CFC rules and look through the entity under its domestic law and tax the income received by the entity immediately in the hands of the individuals. The argument why the treaty was not applicable would fall apart and there would not seem to be any reason to refuse treaty application. If, however, the treaty is applicable where the taxation of the distribution of the profits is advanced, it seems odd that the treaty is not considered to be applicable where taxation is deferred until distribution.[27]

State R, as already mentioned, most probably taxes the dividends when they are distributed according to its domestic law. The rental income is not immediately

[26] L.H. Da Conceição Costa, "The Proposed OECD Treatment of Real Estate Investment Trust Distributions: Is the OECD Approach being Implemented in Tax Treaties?", *Bulletin for International Taxation*, 2012.

[27] For an analysis of trusts, refer to Robert Danon, "Conflict of Attribution of Income Involving Trusts under the OECD Model Convention: The Possible Impact of the OECD Partnership Report", *Intertax*, vol. 32, issue 5, 2004, pp. 210–222.

taxed in state R since it is allocated to the entity which is treated as a non-resident taxpayer who receives, from the point of view of state R, non-domestic income, which is not taxable there. Most branch reporters took the view that in state R article 10 MC is applicable to the profit distribution. The fact that the entity is considered to be opaque under state R's law was obviously sufficient for them to apply article 10 MC. For most branch reporters it was not relevant that state S applies a look-through approach, although the definition of dividends seems to refer to the treatment of the state where the entity resides. However, if one takes the view that the dividend definition is closely linked to the term "company" which is defined in article 3(1)(b) MC and every entity that is a taxable entity under at least one of the two contracting states may qualify as a "company",[28] the distribution can be covered under article 10 MC as well. The requirement of residence does not necessarily mean that the entity has to be taxable in state S. It is sufficient that it has the local attachment to state S that would apply if the entity were a taxable entity in that state. Therefore, this view can be supported. It is thus understandable that only a few branch reporters did not see any basis to apply article 10 MC in such a situation and applied article 21 MC instead. However, state R is entitled to tax under both article 10 and article 21. Interestingly enough, at least from a merely domestic point of view, article 6 MC was not taken into consideration, although if article 10 MC is not regarded as applicable, article 6 MC should have priority over article 21 MC. However, if the distribution of the profits of the entity is considered to be a different taxable event from receiving the rental income, as suggested by the OECD Partnership Report in the context of example 18,[29] it seems to be consistent from the perspective of state R not to apply article 6 MC to the profit distribution.

If different distributive rules are regarded as being applicable in the two contracting states and all of them seem to allow both states to levy tax, the question arises whether state R has to follow the qualification in state S to avoid double taxation. In this respect, branch reporters were divided. Some of them seemed to share the OECD approach according to which the residence state should follow the qualification of the source state. They suggested that the residence state should accept state S's taxation rights under article 6 MC and either exempt the income or grant a credit for the tax levied in state S. However, as we understand the OECD report, in such a situation the report would not support this solution, since receipt of the rental income and the distribution of the profits are regarded as different events under the OECD's approach. Even if one favours the approach according to which state R should provide relief from double taxation, it is in our view doubtful whether article 23 MC can serve as a legal basis: according to the OECD report's view, article 23 MC can only provide a solution if the conflict is due to differences in domestic law which become relevant under article 3(2) MC. In that situation no such difference can be seen since both states agree that the income stems from immovable property and that in principle the requirements for the application of article 6(2) MC are met. State R, however, does not apply article 6 MC for other reasons. Due to the argument that the distribution of the profits is different from the

[28] See already Michael Lang, *Hybride Finanzierungen im Internationalen Steuerrecht - Rechtsgrundlagen der Doppelbesteuerungsabkommen zur Beurteilung von Mischformen zwischen Eigen- und Fremdkapital*, Vienna, Orac, 1991.

[29] OECD, 1999, *op. cit.*, marginal number 53.

rental income, other branch reporters do not support an obligation of state R to grant relief from double taxation, although the tax is levied both in states S and R at the level of the same taxpayer (the individual). However, since state R looks through the entity under its domestic law and taxes the rental income immediately in the hands of the individuals, one may question this result. All this illustrates that the principles on which the OECD report is based are either not clear enough to be used in situations not exactly described in the OECD report, or the principles still lack general acceptance. In any case, the branch reports illustrate that there is a variety of solutions to be discussed here.

3.4. Interest

Article 11 MC at first sight does not have anything to do with entities. Article 11 MC divides taxation rights between the source state whose taxation right is limited up to 10 per cent of the gross amount of the income and the residence state which may tax as well and has to grant a credit for the withholding tax levied in the other state. For that purpose article 11(5) MC provides for a specific source rule:

> "Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."

Its application in triangular cases – where interest is paid by a taxpayer residing in one country and the interest is borne by a permanent establishment in the other country and the person receiving the interest resides in a third country – is already challenging. The application of the treaties the state of the recipient of the income has concluded with the other state may lead to a double tax credit. However, in situations where the entity paying the interest is characterized differently in the states involved, solutions are even more complex. This is also illustrated by the fact that branch reporters take completely different positions.

Let us assume that an entity which is located in state B and whose shareholders reside in state A is paying the interest to a taxpayer residing in state C (Figure 8). States A and C treat the entity as transparent whereas state B treats it as opaque. The treaties which are applicable are the treaties concluded by state C, hence the treaties between A and C on the one hand and B and C on the other hand. It is therefore not under dispute that the treaties concluded by state C are applicable; however, the interesting issue is whether these situations fall under the scope of the interest articles of these treaties. The application of article 11 MC, contrary e.g. to articles 7 and 21 MC, requires a cross-border relation between the two contracting states. The interest article of these treaties is only applicable if the interest has its source in states A or B or in both states under the equivalent of article 11(5) MC of these treaties. If the interest article in one of these treaties is not applicable, the income may only be taxed in the state of residence (C) under article 7 or article 21 of these treaties.

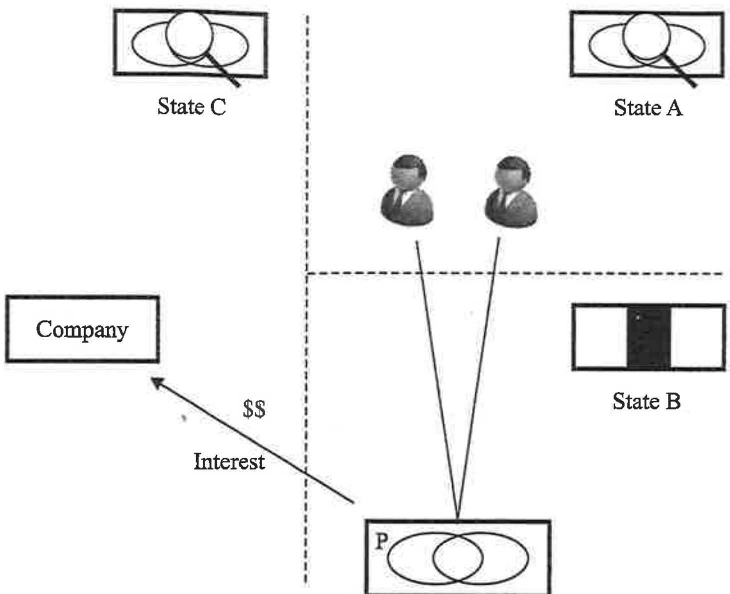

Figure 8. Interest (1)

If the countries involved in this case look at the treaty provisions from their respective domestic perspectives, we would end up with the following result. Under the treaty between A and C, it seems to be obvious that the persons paying the interest are the two individuals who are residing in state A. However, under the treaty between B and C it is the entity which is treated as a resident taxpayer in state B. Therefore, both states A and B seem to be entitled to levy source taxation. From the perspective of state C the interest is sourced in state A, since state C looks through the entity and therefore treats the individuals as the payers of the interest. Unless the entity constitutes a permanent establishment in state B, the treaty between B and C does not put state B in the position of a source state if seen from the perspective of state C. Therefore, one could argue that state C is only obliged to grant a credit for the taxes levied in state A, and in respect of state B's taxes double taxation would remain.

Since one state applies article 11 MC whereas the other state does not, this conflict can be regarded as a qualification conflict. According to the principles advocated in the OECD Partnership Report, the treatment in the source state should be relevant for the residence state.[30] Therefore, one could argue that state C should grant a credit for state B's taxes as well. However, all the arguments against these principles speak also against this solution. This is also one of the reasons why the solutions presented by the branch reporters are so diverse. Moreover, article 11(5)

[30] On an Austrian perspective: Michael Lang, "Conflicts of Allocation in Tax Treaty Law: The Differing Opinions of the Austrian Federal Ministry of Finance and the OECD", *Bulletin for International Taxation*, 2013, pp. 106–109.

MC requires that the payer be a "resident of that state". Therefore, this is not a case where a treaty term is undefined and where for that reason domestic law might come into play to fill the gap. The treaty rather uses a term which it defines itself in article 4 MC. According to this definition, the term "resident of a Contracting State" means any person who, under the laws 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, and also includes that state and any political subdivision or local authority thereof. Therefore, there are good reasons to conclude that state C has to grant a credit for the tax levied in state B, even if one disagrees with the principles developed by the OECD Partnership Report. There is no conflict and therefore there is no need to consider whether the relevance of the qualification in the source state follows from article 23 MC.

According to the view just developed, the qualification of the entity in state B by state C should not matter. Therefore, state C should also grant a credit both for the taxes levied in states B and C if state C treats the entity as opaque (Figure 9).

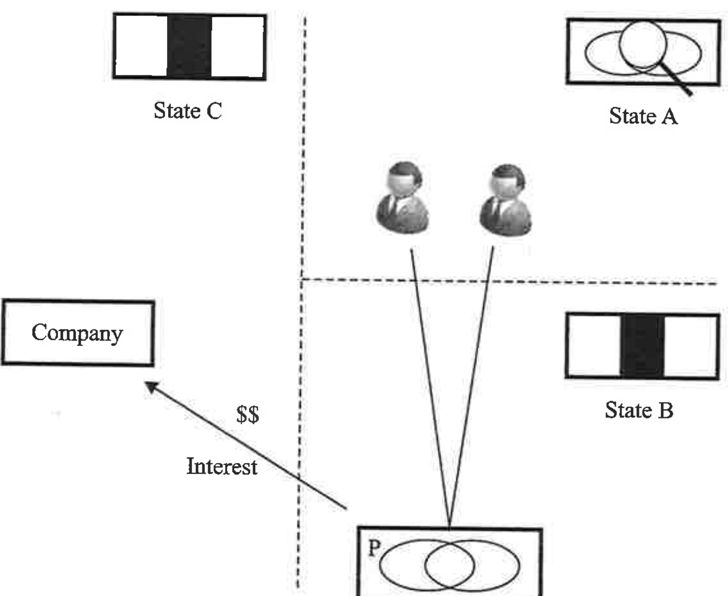

Figure 9. Interest (2)

It is more interesting to discuss the case if we reverse the approaches taken by states A and B (Figure 10): if state A assumes that the entity is opaque, then from its perspective it is a resident of another country who pays the interest. Although the individuals are residents of state A, they are not the ones paying the interest. Article 11(5) MC therefore does not apply and state A has to refrain from levying withholding taxes. From state B's perspective the individuals residing in state A are

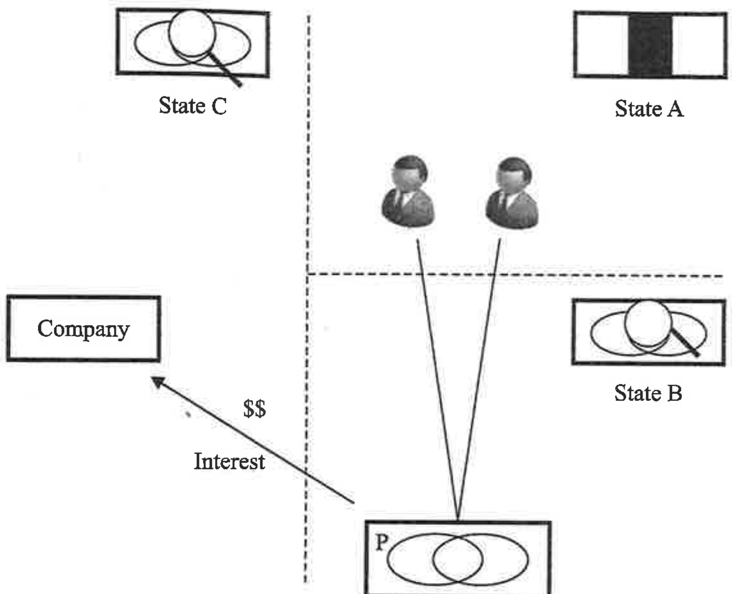

Figure 10. Interest (3)

paying the interest, unless the entity also constitutes a permanent establishment in state B. State B therefore may not claim taxation rights either since either article 7 or article 21(1) MC[31] are applicable. Since neither state may levy a withholding tax, state C does not have to grant a credit for any tax levied abroad. Even if states A or B, despite the reasoning just developed, levy such a tax, state C can refuse to grant a credit since such a tax is not levied in accordance with the treaties. However, one might end up at a different solution if one assumes that the entity established in state B, although treated as transparent there, may be treated as a resident taxpayer for treaty purposes since it has a local attachment which would apply if the partnership were a taxable entity in that state. Under this view, state B is the source state under article 11(5) MC of the treaty between B and C and has taxation rights, and state C has to grant a credit.

3.5. Capital gains

The alienation of entities can lead to treaty problems as well. The OECD Partnership Report already deals with cases where an interest in a partnership was sold and one state treats the entity as transparent, whereas the other treats it as opaque.[32] If one state applies article 13(2) and the other article 13(5) MC, double taxation or

[31] OECD, *Model Tax Convention on Income and on Capital*, 2010, articles applicable to, respectively, "Business profit" and "Other income".
[32] E.g. case 14, in OECD, 1999, *op. cit.*, p. 42.

non-taxation could be the consequence. The OECD Partnership Report uses these cases to explain the theory of how double taxation and non-taxation can be avoided by giving priority to the source state's qualification and requests the residence state of the alienator to follow this qualification. Article 23 MC was presented by the OECD as a legal base for this approach.[33] However, it has also been suggested that an analogy be drawn to the definition of dividends in article 10(3) MC and consider the source state's tax law qualification to be relevant due to the close link between dividends and the alienation of entities.[34] The result remains the same.

It is even more interesting to take a closer look at article 13(4) MC, a provision which is relatively young and not yet part of many tax treaties. The provision reads as follows: "Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State." The provision requires a cross-border situation between the two contracting states, but only in respect of the residence of the alienator, on the one hand, and the location of the immovable property, on the other hand, but not in respect of the entity which owns the immovable property and whose shares are sold. Therefore, this entity can also be established in any third state. Moreover, the provision does not define what kind of entity it has in mind. It refers only to the "alienation of shares" and thereby uses a term which can be found in article 10(3) MC as well, but which is not defined therein either. Most branch reporters explicitly or implicitly take the view that the use of the term "shares" indicates that the existence of a taxable entity is required in order to apply article 13(4) MC. This view gets support from the fact that the definition of article 10(3) MC uses not only the term "shares" but "company" as well and therefore links those two treaty terms. A "company", according to the definition in article 3(1)(b) MC, "means any body corporate or any entity that is treated as a body corporate for tax purposes". An entity that is treated as a body corporate for tax purposes can be understood as being a taxable entity.

In the context of article 10(3) MC the treatment in the state where the entity has been established is relevant. This has to be one of the contracting states. However, under article 13(4) MC shares in entities which are established in third countries are covered as well. For some branch reporters this is the reason to assume that the qualification of the entity in the state in which it was established is decisive for the application of article 13(4) MC and both the state where the immovable property is located and the state where the alienator resides should respect this qualification and follow it. However, at least from a policy point of view it does not seem convincing to us, assuming that both contracting states are bound by the qualification of a third state which is not a partner to that treaty and which might not even have concluded a treaty with either of the two contracting states.

The vast majority of the branch reporters take the view that the qualification of the entity in the state where the immovable property is located is relevant for that state. Thus, if the entity is treated as a taxable entity under the laws of state S in the

33 When addressing double non-taxation related to different interpretations of the convention, *ibid.*, marginal numbers 107–117.

34 Lang, *The Application of the OECD Model Tax Convention to Partnerships, op. cit.*, pp. 86–87. See also Dietmar Aigner and Hans-Jörgen Aigner, "Taxation of Gains from the Alienation of a Partnership Interest under the OECD Model", *Bulletin – Tax Treaty Monitor*, 2001, pp. 608–613.

case study below, state S may apply article 13(4) MC and, as a consequence, have taxation rights for the capital gains. This view can be supported by the close relation between article 6 and article 13(1) MC, on the one hand, and article 13(4) MC, on the other hand. The object and purpose of article 13(4) MC is to defeat attempts of taxpayers to escape taxation in the state where the immovable property is located by, instead of alienating the immovable property as such, transferring the property to an entity and selling the shares of the entity.[35] Since the term "immovable property", for the purpose of article 6 and article 13(1) MC, is, according to article 6(2) MC, at least to a large extent defined under the laws of the state where it is located, it makes sense that that state's qualification of the entity is also relevant for the purpose of article 13(4) MC, regardless of whether the entity has been established in a third state or even in the residence state of the alienator.

The branch reporters are quite divided as to which state's qualification of the entity is relevant for the treaty application in the state of residence. A considerable number of branch reporters take the view that the residence state's qualification should prevail. However, if one draws the parallel to article 6 and article 13(1) MC as suggested above, one can conclude that the qualification of the entity in the state of the location of the immovable property should be relevant and that the treaty requires the state of residence of the alienator to follow that qualification: if somebody receives income from immovable property or alienates this immovable property directly, it is also the definition of immovable property in the location state which prevails and has to be followed by the residence state. This solution derives directly from article 13(4) MC. There should not be any qualification conflict and therefore the question of whether article 23 MC could resolve such conflicts should not come up either.

The case study above explains what this means in practice (Figure 11). If shares of an entity which has been established in state P are sold by a resident of state R, and the entity possesses mainly immovable property located in state S, and if states R and P treat the entity as transparent whereas state S treats it as opaque, state S's qualification should prevail in both states R and S: state S may tax the capital gains of the shares under article 13(4) MC and state R has to apply article 13(4) MC as well and either grant exemption or, which in the context of article 13(4) MC is more common, a credit for the tax levied in state S. Under the tax treaty between states R and P, article 13(5) MC is applicable and state P loses its taxation rights under this treaty completely to state R. However, from the branch reports it can be

35 Luc De Broe, *International Tax Planning and Prevention of Abuse: A Study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, Online Books IBFD, accessed 17 October 2012, Part Three, Conduit and Base Companies – Prevention of Abuse under Belgian Tax Treaties, marginal number 5, also in Chapter 7 – Treaty Provisions preventing abuse of treaties, marginal number 436, among other references in his book. Although effective, such measures containing thresholds may be circumvented and abused, in Philip Baker, *Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion*, Papers on Selected Topics in Administration of Tax Treaties for Developing Countries, Paper 9-A, 2013, footnote 31. The OECD then suggests changes according to the understanding of the states concluding the treaty, e.g. in OECD, *Commentaries to the OECD Model Convention 2010*, para. 25.8: "In their bilateral conventions, many States either broaden or narrow the scope of the paragraph. For instance, some States consider that the provision should not only cover gains from shares but also gains from the alienation of interests in other entities."

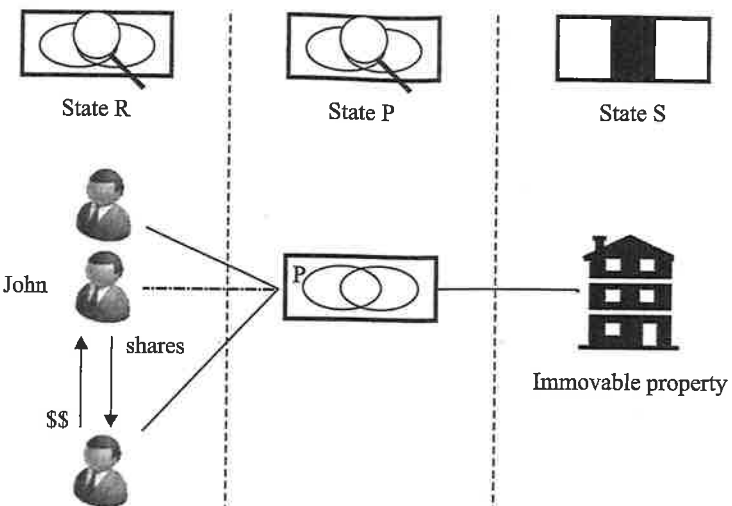

Figure 11. Capital gains

derived that many tax administrations, when their states are in the position of the residence state, are not easily convinced that it is their obligation under article 13(4) MC to provide relief from double taxation. If they apply article 13(1) MC instead, however, in most cases the result will not be that different.

3.6. Employment income

The qualification of entities is also relevant for the application of article 15 MC. The main rule of article 15(1) MC allocates the exclusive taxation rights to the state of residence, unless the employment is exercised in the other contracting state. In that situation the other contracting state may levy taxes. Article 15(2) MC, as an exception to this rule, gives exclusive taxation rights to the residence state, even if the employment is exercised in the other contracting state, under certain conditions. One of them is that the remuneration is paid by, or on behalf of, an employer "who is not a resident of the other State".

If state R treats the entity which is the employer as transparent, and state P treats it as opaque, such a qualification conflict will arise (Figure 12). From the perspective of state P it is clear that the employer is a resident of that state. Therefore, the requirement of article 15(2)(b) MC, according to which the employer is not a resident of the other contracting state, is not met.[36] Article 15(2) MC is there-

[36] See also Luc De Broe *et al.*, "Interpretation of Article 15(2)(b) of the OECD Model Convention: 'Remuneration Paid by, or on Behalf of, an Employer Who is not a Resident of the Other State'", *Bulletin for International Fiscal Documentation*, 2000, p. 515; Frank Pötgens, "Article 15(2)(b) of the OECD Model: Problems Arising from the Residence Requirement for Certain Types of Employers", *European Taxation*, 2002, pp. 216 *et seq.*; Bernhard Peeters, "Article 15 of the OECD Model Convention on 'Income from Employment' and its Undefined Terms", *European Taxation*, 2004, p. 81; Frank Pötgens, *Income from International Private Employment*, 2007, pp. 216 *et seq.*

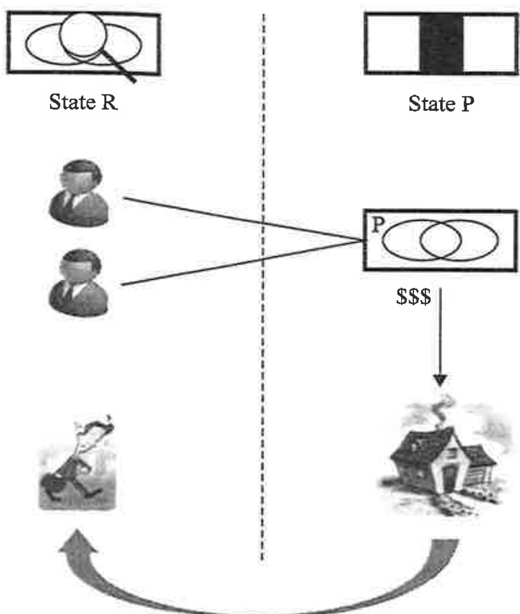

Figure 12. Income from employment (1)

fore as a whole not applicable and, according to the general rule of article 15(1) MC, state P may levy taxes if the employment is exercised in that state. Most branch reporters share this approach. This view is clearly supported by the wording of article 15(2)(b) MC where the phrase "resident of that State" is used.

The view among branch reporters is divided as to whether the qualification of the entity in the residence state of the employees should be decisive for the application of article 15(2)(b) MC in the residence state, or whether the residence state should just follow the source state's qualification. The case study illustrates that double taxation might be the consequence if the residence state's qualification prevails: in the view of state R's tax law the entity is not a resident of state P and therefore state R would have, if the other requirements are met as well, exclusive taxation rights. However, article 15(2)(b) MC clearly points to the state of source and the qualification of the entity under its tax law. The wording indicates that state P's qualification is also relevant for state R. Therefore, there is no need to accept a result which could lead to double taxation. Article 23 MC does not come into play to resolve a qualification conflict, since such a conflict can be avoided by assuming that the qualification in the state where the entity has been established is already relevant under article 15(2)(b) MC for both states.

If we reverse the situation (Figure 13), the solutions are more controversial. If the entity is established in state P, but treated there as transparent, one could conclude that the entity is not a "resident of that State". However, since the entity is established in state P and may have its seat or place of management there, it meets

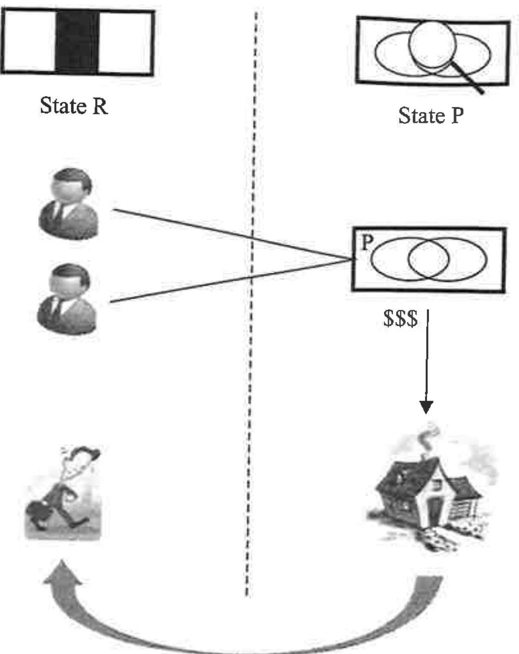

Figure 13. Income from employment (2)

the requirements which could lead to worldwide taxation. It has already been mentioned that it was Klaus Vogel who pointed out that:

> "[A]ll it requires is that the person concerned has that personal attachment to at least one of the contracting States – the 'State of residence' – which might result in him becoming subject to full tax liability" and that the "question whether a person .... may be a taxable entity under the law of the State concerned, is not a condition for treaty entitlement."[37]

Kasper Dziurdź recently explained that these ideas are also convincing in the context of article 15(2)(b) MC.[38] Since tax-exempt entities may qualify as "residents", it seems consistent that non-taxable entities are treated alike: it is just a question of drafting technique whether an entity is tax exempt or not treated as a taxable entity at all. The substantive result is the same, and therefore differences in drafting techniques should not have any impact on article 15(2)(b) MC either. Therefore, the entity should be treated as a "resident of that State" and state P has taxation

[37] Vogel, *op. cit.*, art. 4, marginal numbers 24(a) and 24(b).
[38] Kasper Dziurdź, "Article 15 of the OECD Model: The 183-Day Rule and the Meaning of 'Not a Resident' in Cases of Hybrid Partnerships", *Intertax*, 2013, pp. 492–498.

rights. This approach should be followed by the state of residence which has to provide relief from double taxation by either granting a credit or exempting the foreign income.

An entity which is established in a third state is, unless it has its seat or place of effective management there, definitely not a resident of one of the two contracting states. Therefore, the criteria of article 15(2)(b) MC are met and state P is able to levy a tax. State R has to provide relief from double taxation.

3.7. Directors' fees

Entity qualification is also important in the context of article 16 MC: "Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State." If the entity of which the recipient of the fee is a member of the board of directors is a taxable entity treated as transparent in one contracting state and as opaque in the other, the consequences for the application of article 16 MC might be questionable. It is decisive under which circumstances an entity may be regarded as a "company which is a resident of the other Contracting State".

If the state where the entity has been established treats it as opaque (Figure 14), the vast majority of branch reporters agree that state S should apply article 16 MC.

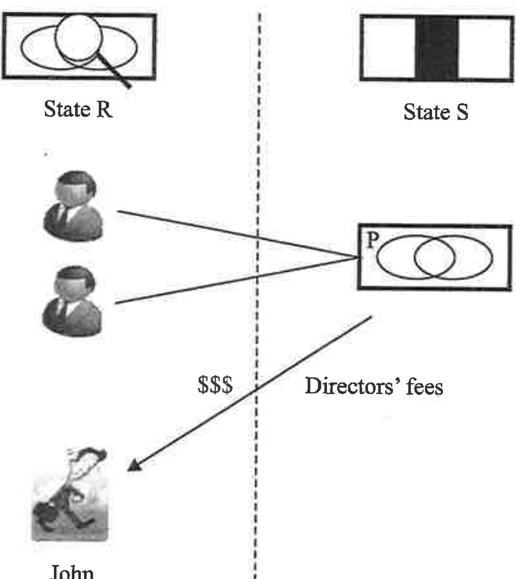

Figure 14. Directors' fees (1)

In this case there should not be any doubt that the entity is taxable in state S and therefore a "company"; it also meets the requirements there which usually lead to

worldwide taxation. It is more controversial whether the state of residence of the board member may apply its own qualification or whether it has to follow the qualification of state P: since article 16 MC requires that the company "is a resident of the other Contracting State", it seems to be convincing to assume that the qualification in state S is also relevant in state R and that state R has to apply article 16 MC as well.

Again, the reverse situation (Figure 15) is more interesting. Most branch reporters take the view that state S should not apply article 16 MC since state S

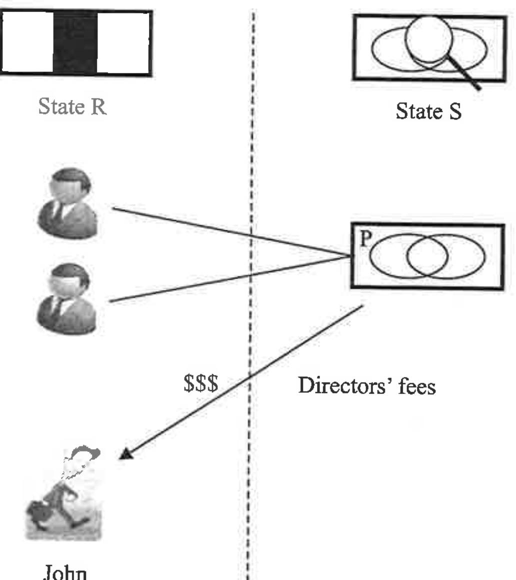

Figure 15. Directors' fees (2)

treats the entity as transparent. However, this deserves a more detailed analysis: article 16 MC requires a "company" which is "a resident of the other Contracting State". Therefore, both the terms "company" and "resident" are relevant. The term "company" is defined in article 3(1)(b) MC.[39] Although this definition is ambiguous, one can assume that taxable entities fall under the definition of "company".[40]

39 Para. 3 of the OECD commentary to art. 3 provides that the definition of company under art. 3(1)(b) has a bearing on art. 16.

40 Kees Van Raad, General Report in IFA (eds.), *Recognition of foreign enterprises as taxable entities*, CDFI 1988, pp. 34 *et seq.*; Thomas Day, "Article 3(1) Definitions", in Ecker and Ressler (eds.), *History of Tax Treaties*, 2011, p. 157; John F. Avery Jones, "Understanding the OECD Model Tax Convention: The Lessons of History", *Florida Tax Law Review*, 2009, p. 8; Michael Lang, "Die Ansässigkeit als das Kriterium für die Besteuerung im Quellenstaat nach den Verteilungsnormen des OECD-Musterabkommens", in Lang, Schuch and Staringer (eds.), *Die Ansässigkeit im Rechtder Doppelbesteuerungsabkommen*, 2008, p. 233; Eva Burgstaller, *Mitarbeiter-Stock-Options im Recht der Doppelbesteuerungsabkommen*, 2006, p. 223; Michael Lang, "Die abkommensrechtliche

If at least one of the two states treats the entity as taxable, this requirement is met.[41] Since the entity is taxable in state R, this is sufficient to treat it as a "company" in both states and therefore also in state S. Whether the company is also a resident of state S depends on whether it has the links to state S which can lead to worldwide taxation. If the entity is established in state S, this seems to be the case. Factual taxation is not required.[42] Therefore, there are also good reasons to assume that article 16 MC is applicable, although this view is not shared by approximately half of the branch reporters.

Since article 16 MC refers to the "other contracting state" for the purpose of residence of the company, the residence state of the board member should follow this approach of the source state and article 16 MC is applicable. However, in this case this does not seem to be difficult, since state R itself treats the entity as opaque. Exactly for this reason a considerable number of branch reporters favour the application of article 16 MC in state R as well.

4. Conclusions

The analysis of the branch reports has shown that most case studies were resolved very differently by the branch reporters. The approaches suggested by the OECD report are not generally followed.[43] This is partly due to the inconsistencies

cont.

Behandlung vor ausländischen Personengesellschaften mit Steuersubjektivität im Ausland", in Kleineidam (ed.), *Unternehmenspolitik und internationale Besteuerung - Festschrift für Lutz Fischer*, 1999, p. 720; Gerald Toifl, *Personengesellschaften im Recht der Doppelbesteuerungsabkommen*, 2003, pp. 50 *et seq.*; Lang, *Hybride Finanzierungen im Internationalen Steuerrecht*, *op. cit.*, pp. 112 *et seq.*; Eva Burgstaller, "Die Kriterien für die Festlegung des Quellenstaates nach den Doppelbesteuerungsabkommen bei Dividenden", in Gassner *et al.* (eds.), *Die Verteilung der Besteuerungsrechte in den Doppelbesteuerungsabkommen*, 2005, p. 227; Christoph Marchgraber, "Der Begriff 'Gesellschaft' im Recht der Doppelbesteuerungsabkommen", SWI, 2011, pp. 338 *et seq.*; Klaus Vogel in Vogel and Lehner (eds.) DBA, 2008, art. 3, marginal number 17; Gerald Toifl, "Internationales Steuerrecht", in Bergmann and Ratka (eds.), *Handbuch Personengesellschaften*, 2011, marginal numbers 16–42.

41 Helmut Debatin, "Das neue Doppelbesteuerungsabkommen mit den USA", DB, 1990, p. 600; Bernhard Gröhs, *Die Gewinnbesteuerung der Personengesellschaften im Internationalen Steuerrecht Österreichs*, 1986, pp. 95 *et seq.*; Lang, *Hybride Finanzierungen im Internationalen Steuerrecht, op. cit.*, pp. 117 *et seq.*; Burgstaller, "Die Kriterien für die Festlegung des Quellenstaats nach den Doppelbesteuerungsabkommen bei Dividenden", *op. cit.*, p. 228; Burgstaller, *Mitarbeiter-Stock-Options im Recht der Doppelbesteuerungsabkommen, op. cit.*, p. 224; Franz Philipp Sutter, "Die abkommensrechtliche Stellung der atypisch stillen Beteiligung", in Gassner, Lang and Lechner (eds.), *Personengesellschaften im Recht der Doppelbesteuerungsabkommen*, 2000, pp. 214 *et seq.*; Toifl, "Internationales Steuerrecht", *op. cit.*, marginal numbers 52 *et seq.*

42 Aigner and Züger,"Die Lösung des OECD Steuerausschusses für Qualifikationskonflikte bei Personengesellschaften", in Gassner, Lang and Lechner (eds.), *Personengesellschaften im Recht der Doppelbesteuerungsabkommen* (2000) 47 (49 *et seq.*); Michael Lang, "Steuerlich transparente Rechtsträger und Abkommensberechtigung", IStR, 2011, 1 *et seq.*; Kasper Dziurdź, *Kurzfristige Arbeitnehmerüberlassung im Internationalen Steuerrecht*, in Linde-Verlag, 2013, pp. 233 *et seq.*

43 On an Austrian perspective: Lang, "Conflicts of Allocation in Tax Treaty Law: The Differing Opinions of the Austrian Federal Ministry of Finance and the OECD", op. cit., pp. 105–109.

contained in the OECD report[44] and partly due to the lack of legal status of the report and the OECD commentaries. The lessons which can be learned from the experience in 1999 when the OECD report was published and when most of its findings were included in the OECD commentaries is that it is not sufficient to change the OECD commentaries if one wants to achieve a harmonious application of tax treaties. Most courts will not feel bound by mere changes of the OECD commentaries and even the tax administrations of OECD Member States sometimes struggle.

The OECD report takes as a starting point for the discussion of qualification conflicts that each contracting state in the first place has to follow its domestic law and the qualification conflicts arising from these premises have then to be resolved creatively. However, the discussion of many of the case studies in this part of the report has shown that even this starting point may be disputed. A more careful analysis of many of the allocation rules illustrates that the allocation rules already provide for solutions which should be acceptable to both countries. It is clear, however, that some of the interpretations suggested here may be disputed as well. However, it seems to be much more useful for the discussion to be focused on the question of how the allocation rules can be more convincingly interpreted and to come up with solutions acceptable for both sides instead of running into qualification conflicts by applying the domestic law of each contracting state automatically. We will have achieved a lot if we have contributed to a discussion on the content of the interpretation rules which will make the search for creative but rather artificial ways to resolve the self-created qualification conflicts unnecessary.

5. Case studies on tax treaty entity qualification issues

5.1. Treaty entitlement

An entity is established in state P and is receiving interest or royalties from sources in state S and the shareholders (partners) of this entity are residents of state R.

5.1.1. Case A

Assume that states P and S treat this entity as a taxable entity and state R as a transparent entity (Figure 16).

(a) If your country is state S: which tax treaties would be applicable in state S in order to reduce withholding taxes on interest and royalties? The treaty between states S and P, the treaty between states S and R or both?

(b) If your country is state R: would it be possible to grant a credit in your country for the (reduced) withholding tax levied in state S under the tax treaty between states S and R? (The withholding tax in state S is levied on behalf of the entity established in state P and the withholding tax will already be credited in state P at the level of the entity.)

44 Of similar opinion: Jean Schaffner, "The OECD Report on the Application of Tax Treaties to Partnerships", *Bulletin for International Taxation*, 2000, p. 226.

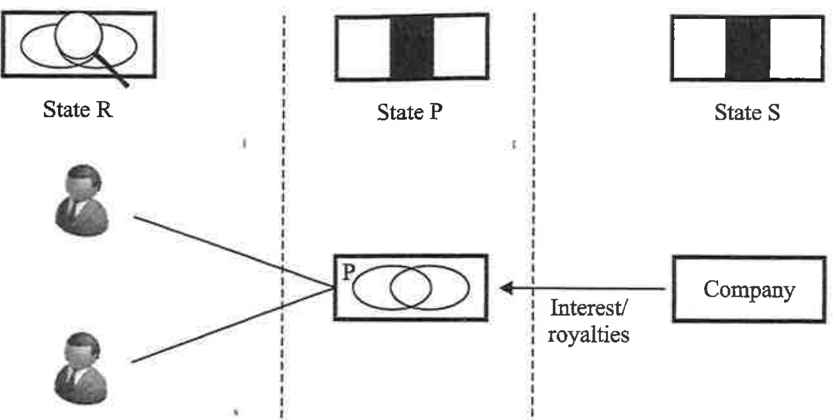

Figure 16

5.1.2. Case B

Assume that states R and S treat this entity as a taxable entity and state P as a transparent entity (Figure 17).

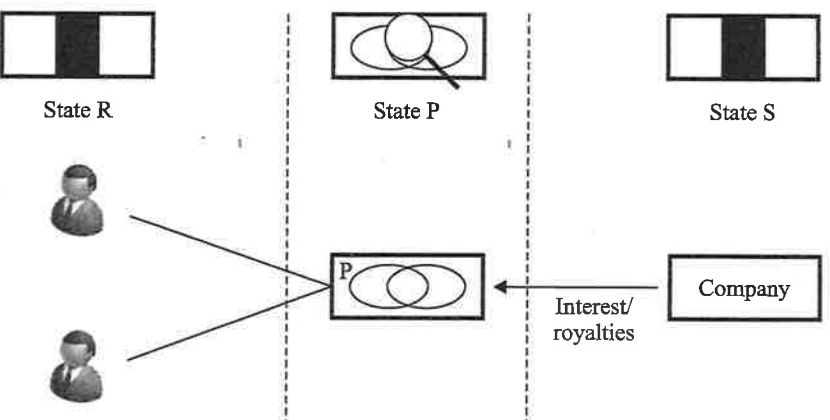

Figure 17

(a) If your country is state S: which tax treaties would be applicable in state S in order to reduce withholding taxes on interest and royalties? The treaty between S and P or the treaty between S and R or both?

(b) If your country is state P and the interest and royalties are attributed to a permanent establishment in state P: would it be possible to grant a credit in your country for the (reduced) withholding tax levied in state S under the non-discrimination clause of the tax treaty between states R and P?

5.1.3. Case C

Assume that state S treats this entity as a taxable entity and states R and P as a transparent entity (Figure 18).

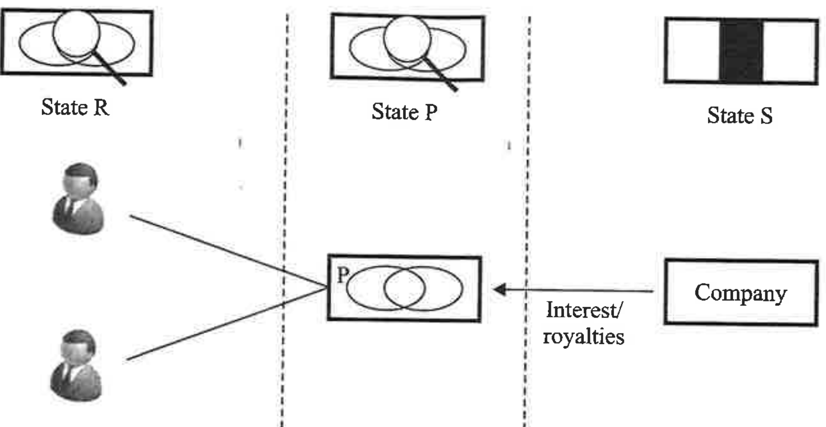

Figure 18

(a) If your country is state S: which tax treaties would be applicable in state S in order to reduce withholding taxes on interest and royalties? The treaty between S and P or the treaty between S and R or both?
(b) If your country is state P and the interest and royalties are attributed to a permanent establishment in state P: would it be possible to grant a credit in your country for the (reduced) withholding tax levied in state S under the non-discrimination clause of the tax treaty between states R and P? (The withholding tax in state S is levied on behalf of the entity established in state P and the withholding tax might be credited already in state R at the level of the individual shareholder.)
(c) If your country is state R: would it be possible to grant a credit in your country for the (reduced) withholding tax levied in state S under the tax treaty between states S and R? (The withholding tax in state S is levied on behalf of the entity established in state P and the withholding tax might be credited already in state P at the level of the entity.)

5.1.4. Case D

Assume that states R and S treat this entity as transparent and state P as a taxable entity (Figure 19).
(a) If your country is state S: which tax treaties would be applicable in state S in order to reduce withholding taxes on interest and royalties? The treaty between S and P or the treaty between S and R or both?
(b) If your country is state P: would it be possible to grant a credit in your country for the (reduced) withholding tax levied in state S under the tax treaty between states S and P? (The withholding tax in state S is levied on behalf of

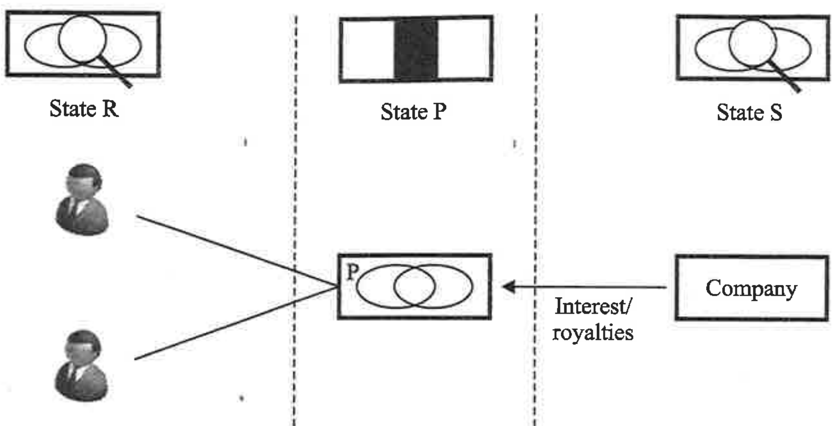

Figure 19

the individual shareholder who is resident in state R and the withholding tax will be credited already in state R at the level of the individual shareholder.)

5.1.5. Case E

Assume that state R treats this entity as a taxable entity and states P and S as a transparent entity (Figure 20).

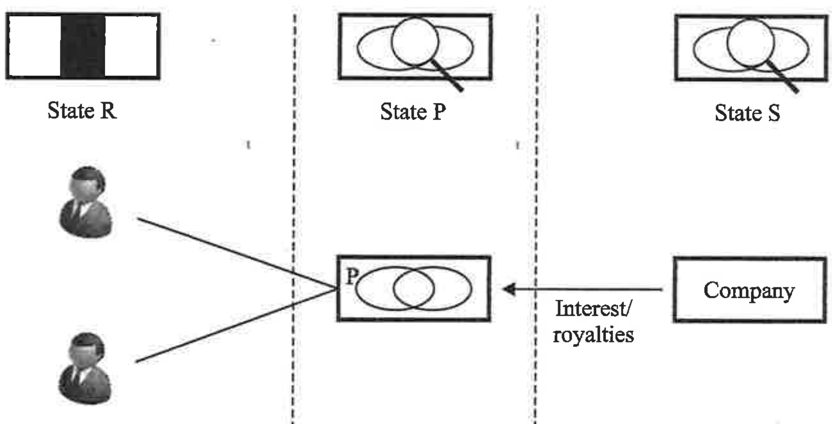

Figure 20

(a) If your country is state S: which tax treaties would be applicable in state S in order to reduce withholding taxes on interest and royalties? The treaty between S and P or the treaty between S and R or both?
(b) If your country is state R: would it be possible to grant a credit in your country for the (reduced) withholding tax levied in state S under the tax treaty

between states S and R? At the level of the entity (in whose hands the interest and royalties are taxed) or of the individual shareholder? (The withholding tax in state S is levied on behalf of the individual shareholder who is a resident of state R and the withholding tax might be credited already in state P at the level of the entity if state P applies the non-discrimination rule of the treaty between R and P.)

5.1.6. Case F

Assume that states R and P treat this entity as a taxable entity and state S as a transparent entity (Figure 21).

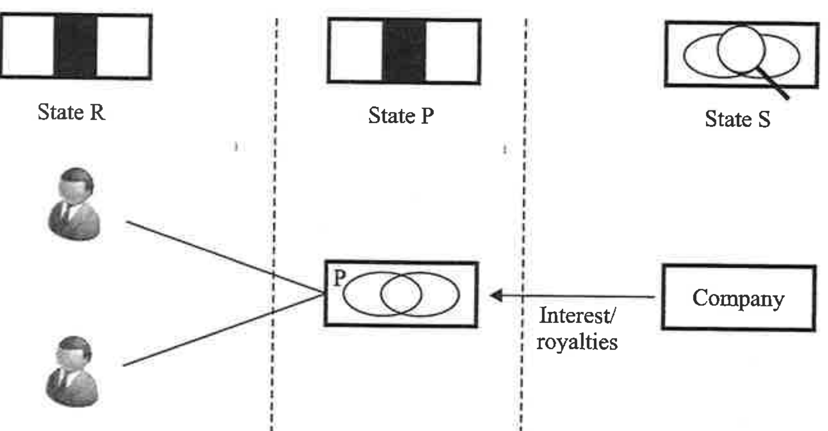

Figure 21

(a) If your country is state S: which tax treaties would be applicable in state S in order to reduce withholding taxes on interest and royalties? The treaty between S and P or the treaty between S and R or both?

(b) If your country is state P: would it be possible to grant a credit in your country for the (reduced) withholding tax levied in state S under the tax treaty between states P and S? (The withholding tax in state S is levied on behalf of the individual shareholder.)

5.1.7. Case G

Assume that state P treats this entity as a taxable entity and state R as a transparent entity and that interest and royalties are derived from sources in state P (Figure 22).

(a) If your country is state P: is the allocation of income in state R relevant for state P and has state P therefore to reduce the (withholding) tax on interest and royalties, according to the tax treaty (0 per cent withholding tax on royalties or 10 per cent withholding tax on interest under the OECD MC) or has this scenario been treated as a merely domestic situation with the result of exclu-

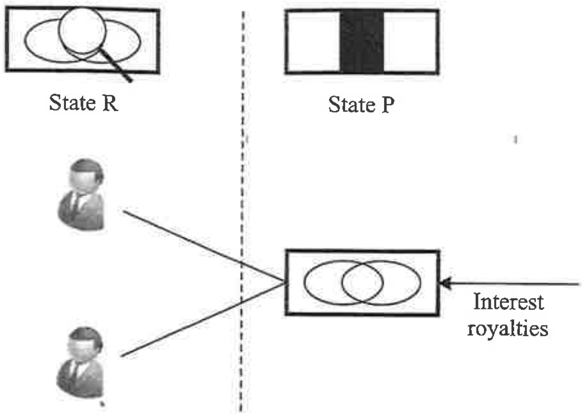

Figure 22

sive taxation in your country (according to article 7 or article 21 OECD MC, since the residence state of the entity is state P)?

(b) If your country is state R: is state R obliged to follow the allocation of income of state P and is state R therefore prevented from taxing the income in the hands of the shareholders? Which treaty rules would state R require to do this? Or is state R allowed to levy tax on the interest and royalty income? If so, why? And would state R have to grant a credit on the tax levied in state P at the level of the entity?

5.1.8. Case H

Assume that state P treats this entity as a taxable entity and state R as a transparent entity and that interest and royalties are derived from sources in state R (Figure 23). (Graph taken from Partnership Report example 16, but skipping partner A with his residence in state P – therefore the only partner should be resident in state R – named partner A then.)

(a) If your country is state P: is the allocation of income in state P relevant for state P and has state R therefore to reduce the (withholding) tax on interest and royalties, according to the tax treaty (0 per cent withholding tax on royalties or 10 per cent withholding tax on interest under the OECD MC) or has this scenario been treated as a merely domestic situation in state R with the result of exclusive taxation in state R (according to article 7 or article 21 OECD MC, since the residence state of the partner is state R)? And would state P be obliged to grant a credit at the level of the entity for a withholding tax levied in state R (where the partners are the relevant taxpayers)?

(b) If your country is state R: is state R obliged to follow the allocation of income of state P and is state R therefore forced to reduce its (withholding) tax on royalties or interest? Which treaty rules would state R require to do this? Or is state R allowed to levy tax on the interest and royalty income without any limitation? If so, why? And would state R have to grant a credit on the tax levied

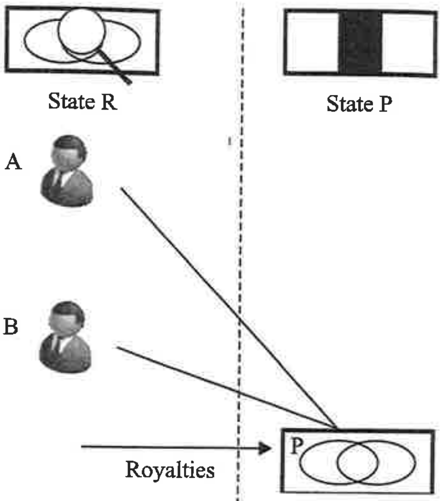

Figure 23

in state P at the level of the entity (if state P levies a tax on the interest or royalty at the level of the entity)?

5.2. Distributive rules

5.2.1. Article 10 – dividends

An entity is established in state S and its shareholders (partners) are residents of state R. The entity "distributes" income to its shareholders (partners).

5.2.1.1. Case A

Assume state R treats the entity as transparent and state S as a taxable entity (Figure 24).

(a) If your country is state R: would it be possible to grant a credit for the withholding tax levied in state S on the "dividends" distributed (although state R does not treat the entity of state S as a taxable entity)?

(b) If your country is state R and under your domestic law you allocate the profits of the entity in state S to the shareholders who are residents of your country: would your country feel prevented from taxing the entity's income in the hands of the shareholders under the tax treaty? If so, why?

(c) If your country is state R and under your domestic law you allocate the profits of the entity in state S to the shareholders who are residents of your country: if your country would not feel prevented from taxing the entity's income in the hands of the shareholders under the tax treaty: would a credit for the entity's tax levied in state S be available at the level of the shareholders in state R? If so, why?

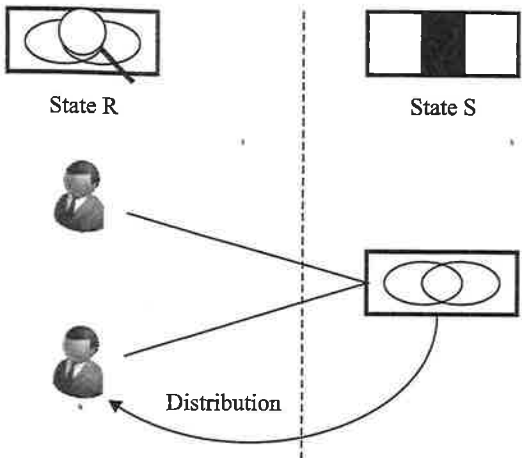

Figure 24

5.2.1.2. Case B

Assume state R treats the entity as a taxable entity and state S as a transparent entity (Figure 25).

(a) If your country is state R and under your domestic law you treat the income as a distribution of dividends, but under state S's domestic law the income is treated as income from immovable property in the hands of the individuals

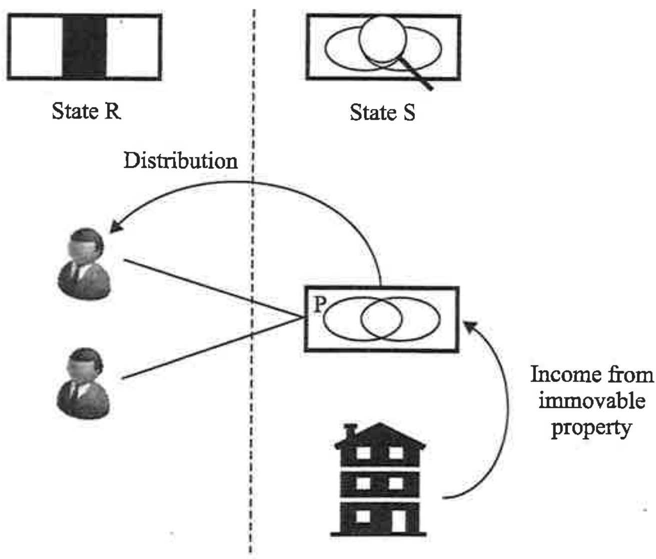

Figure 25

(residents in state R): would article 6 or article 10 OECD MC be considered to be applicable in your country?

(b) If your country is state R and your country would either apply article 10 or article 6 OECD MC and for article 6 OECD MC the credit method would be applicable: should a tax credit be granted at the level of the shareholders in state R for the tax levied on the income from immovable property in state S? If so, why?

5.2.2. Article 11 – interest

Entity P is established in state B and its shareholders (partners) are residents of state A. The entity pays interest to company X, resident in state C.

5.2.2.1. Case A

Assume that states A and C treat the entity as transparent, while state B treats it as opaque (Figure 26).

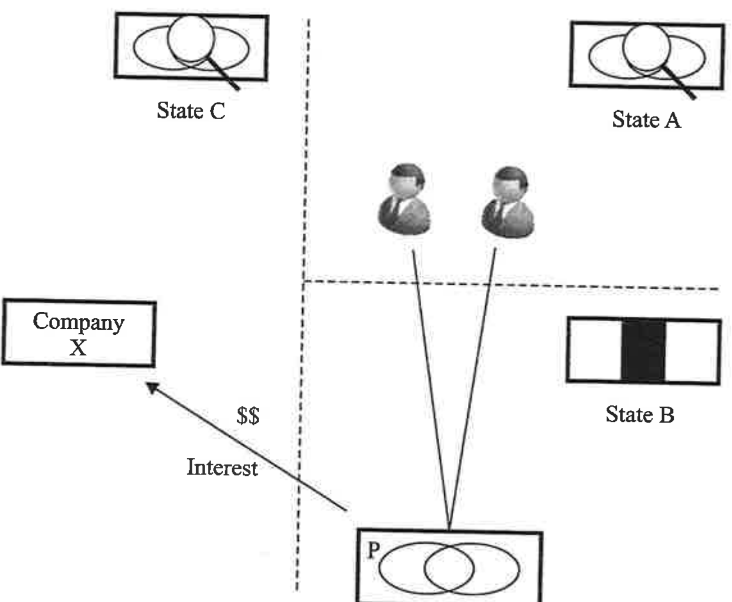

Figure 26

(a) If your country is state A: is the interest sourced in state A and has state A to apply article 11 of the treaty between C and A and reduce its withholding taxes accordingly?

(b) If your country is state B: is the interest sourced in state B and has state B to apply article 11 of the treaty between C and B and reduce its withholding taxes accordingly?

(c) If your country is state C: assume there is a reduced withholding tax levied in both A and B: is state C obliged to grant a credit for the withholding tax levied in A or in B or for both of them? Why?

5.2.2.2. Case B

Assume that state A treats the entity as transparent, while states B and C treat it as opaque (Figure 27).

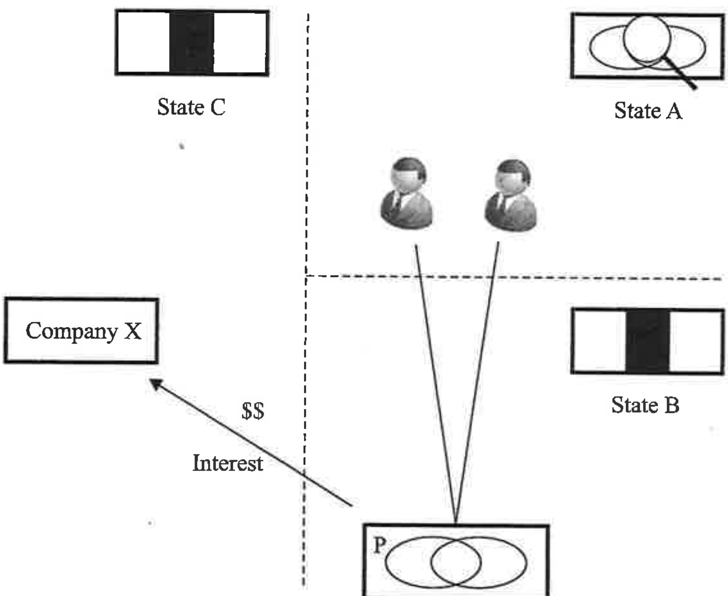

Figure 27

(a) If your country is state A: is the interest sourced in state A and has state A to apply article 11 of the treaty between C and A and reduce its withholding taxes accordingly?

(b) If your country is state B: is the interest sourced in state B and has state B to apply article 11 of the treaty between C and B and reduce its withholding taxes accordingly?

(c) If your country is state C: assume there is a reduced withholding tax levied in both A and B: is state C obliged to grant a credit for the withholding tax levied in A or in B or for both of them? Why?

5.2.2.3. Case C

Assume that states B and C treat the entity as transparent, while state A treats it as opaque (Figure 28).

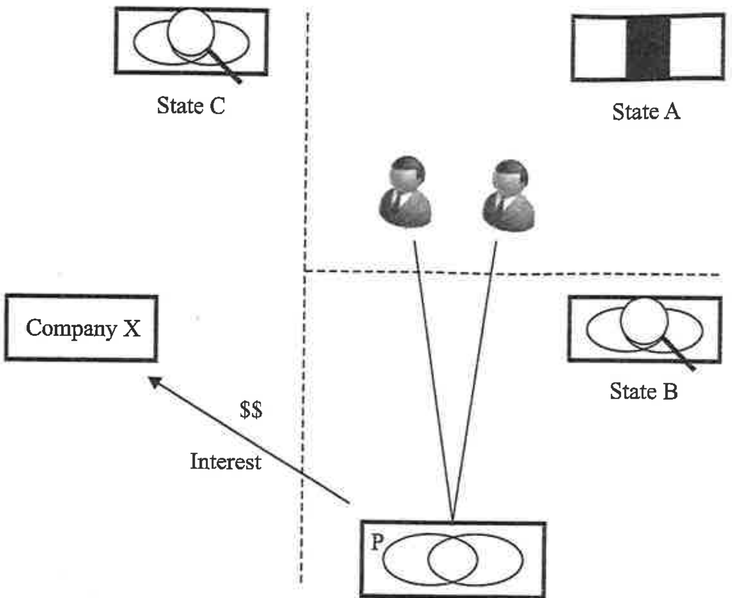

Figure 28

(a) If your country is state A: is the interest sourced in state A and has state A to apply article 11 of the treaty between C and A and reduce its withholding taxes accordingly?
(b) If your country is state B: is the interest sourced in state B and has state B to apply article 11 of the treaty between C and B and reduce its withholding taxes accordingly?
(c) If your country is state C: assume there is a reduced withholding tax levied in both A and B: is state C obliged to grant a credit for the withholding tax levied in A or in B or for both of them? Why?

5.2.2.4. Case D

Assume that state B treats the entity as transparent, while states A and C treat it as opaque (Figure 29).
(a) If your country is state A: is the interest sourced in state A and has state A to apply article 11 of the treaty between C and A and reduce its withholding taxes accordingly?
(b) If your country is state B: is the interest sourced in state B and has state B to apply article 11 of the treaty between C and B and reduce its withholding taxes accordingly?
(c) If your country is state C: assume there is a reduced withholding tax levied in both A and B: is state C obliged to grant a credit for the withholding tax levied in A or in B or for both of them? Why?

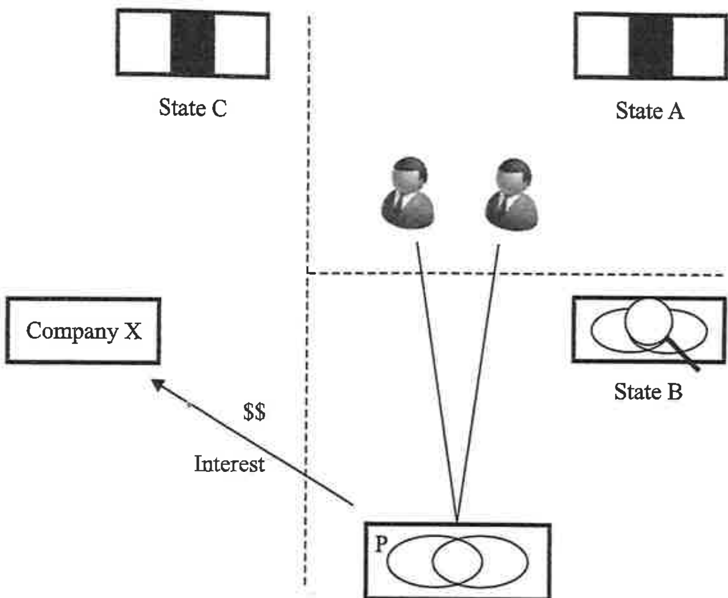

Figure 29

5.2.2.5. Case E

Assume that states B and C treat the entity as transparent, while state A treats it as opaque (Figure 30).
(a) If your country is state C and under state C's domestic law the income is treated as a payment of interest from sources in state C to company X, but under state A's domestic law the income is treated as derived from the entity (partnership) resident in state B: would you accept the application of article 11 of the OECD MC according to state A, and refrain from taxing that income (assume that there is no permanent establishment)?

5.2.3. Article 13(4) – capital gains

Entity P is established in state P and its shareholders (partners) are resident in state R. John, one of the partners, derives income from selling shares of the partnership to another person in state R. More than 50 per cent of those shares' value derives from ownership of immovable property located in S.

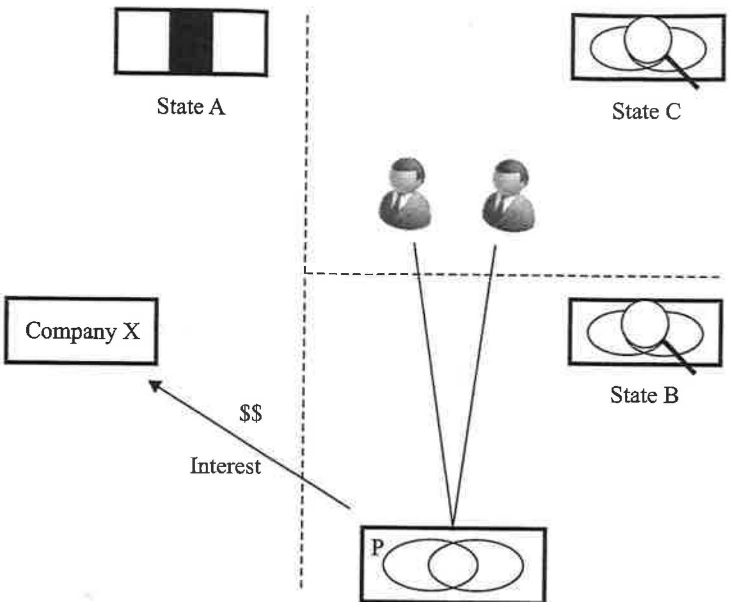

Figure 30

5.2.3.1. Case A

Assume that state R treats the entity as transparent, while states P and S treat it as taxable (Figure 31).

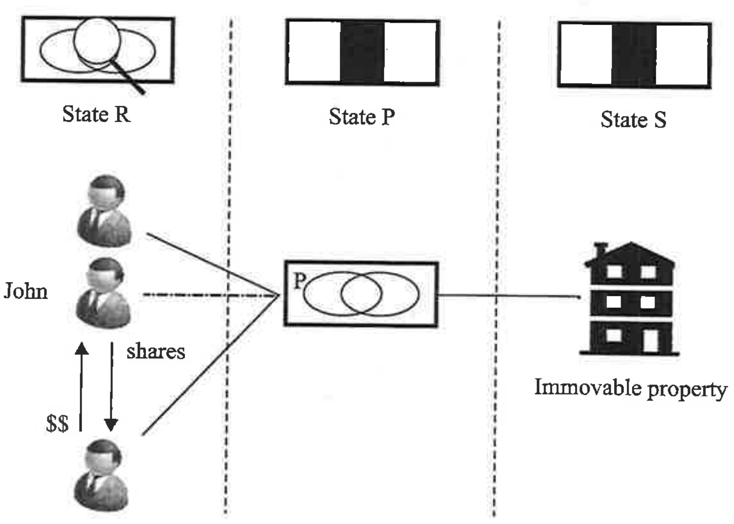

Figure 31

(a) If your country is state R: is article 13(4) OECD MC applicable under the treaty R–S? (Would state R consider the sale as an alienation of "shares" according to article 13(4) OECD MC?)
(b) If your country is state S: is article 13(4) OECD MC applicable under the treaty R–S? (Would state S consider the sale as an alienation of "shares" according to article 13(4) OECD MC?)

5.2.3.2. Case B

Assume that states R and P treat the entity as transparent, while state S treats it as a taxable entity (Figure 32).

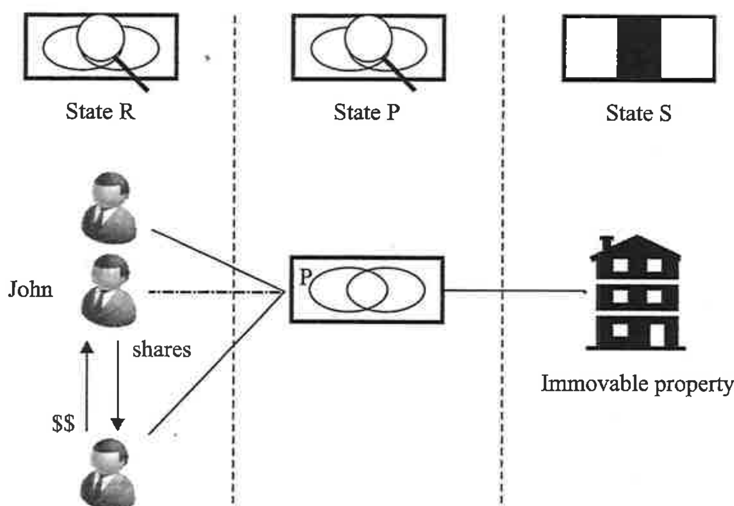

Figure 32

(a) If your country is state R: is article 13(4) OECD MC applicable under the treaty R–S? (Would state R consider the sale as an alienation of "shares" according to article 13(4) OECD MC?)
(b) If your country is state S: is article 13(4) OECD MC applicable under the treaty R–S? (Would state S consider the sale as an alienation of "shares" according to article 13(4) OECD MC?)

5.2.3.3. Case C

Assume that states R and P treat the entity as a taxable entity, while state S treats it as transparent (Figure 33).
(a) If your country is state R: is article 13(4) OECD MC applicable under the treaty R–S? (Would state R consider the sale as an alienation of "shares" according to article 13(4) OECD MC?)

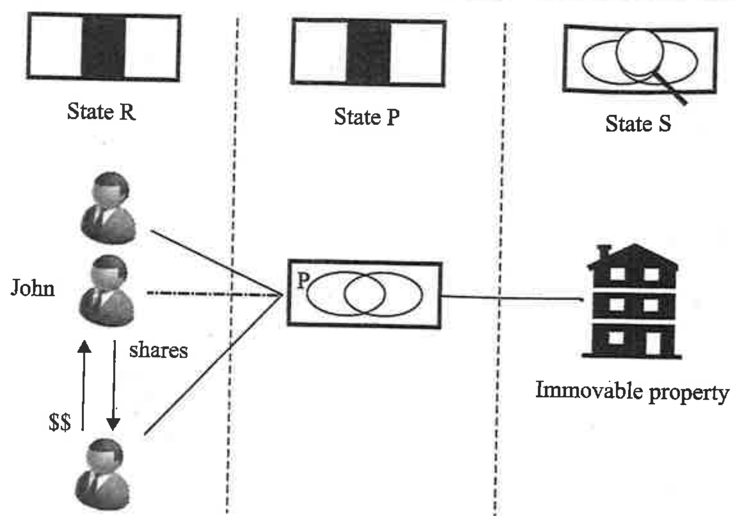

Figure 33

(b) If your country is state S: is article 13(4) OECD MC applicable under the treaty R–S? (Would state S consider the sale as an alienation of "shares" according to article 13(4) OECD MC?)

5.2.3.4. Case D

Assume that state R treats the entity as a taxable entity, while states P and S treat it as transparent (Figure 34).

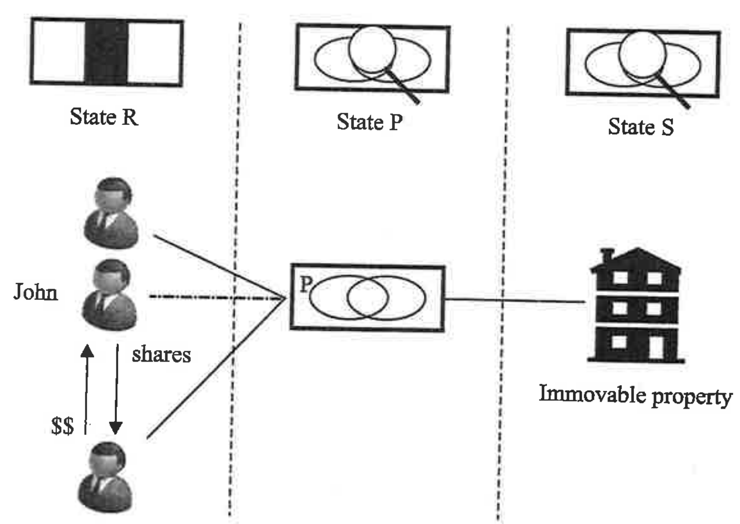

Figure 34

(a) If your country is state R: is article 13(4) OECD MC applicable under the treaty R–S? (Would state R consider the sale as an alienation of "shares" according to article 13(4) OECD MC?)

(b) If your country is state S: is article 13(4) OECD MC applicable under the treaty R–S? (Would state S consider the sale as an alienation of "shares" according to article 13(4) OECD MC?)

5.2.4. Article 15(2) – income from employment

The entity is established in state P and its shareholders (partners) are resident in state R. John is a resident of state P and works for the entity, but performs part of his work in R.

5.2.4.1. Case A

Assume that state P treats the entity as transparent, while R treats it as taxable (Figure 35).

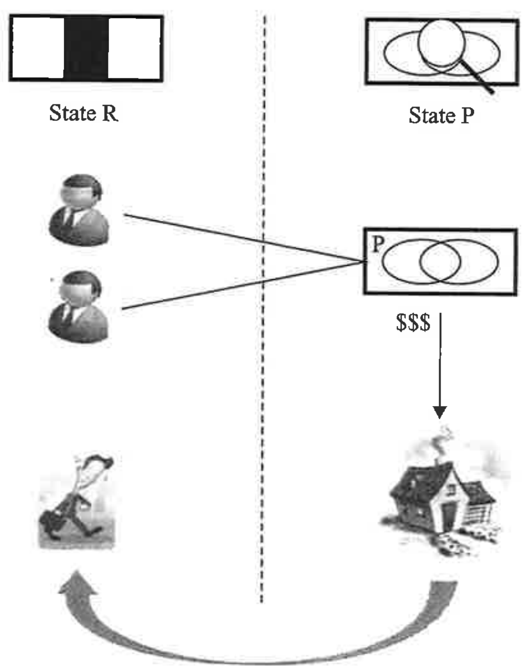

Figure 35

(a) If your country is state R, who would be considered as the employer according to article 15(2)(b) OECD MC: entity, shareholders or none? Would article 15(2) be applicable because the employer is not a resident of state P, since the

entity is not taxable in state P according to state P's domestic law? Or would article 15(2) not be applicable, since the entity is a resident of state P, according to state R's domestic law? Would therefore state R's or state P's perspective matter?

(b) If your country is state P, who would be considered as the employer according to article 15(2)(b) OECD MC: entity, shareholders or none? Would article 15(2) be applicable because the employer is not a resident of state P, since the entity is not taxable in state P according to state P's domestic law? Or would article 15(2) not be applicable, since the entity is a resident of state P, according to state R's domestic law? Would therefore state R's or state P's perspective matter?

5.2.4.2. Case B

Assume state R treats the entity as transparent, while P treats it as taxable (Figure 36).

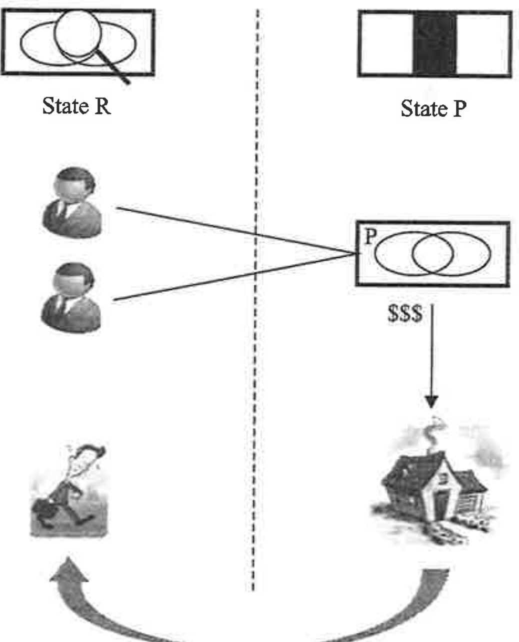

Figure 36

(a) If your country is state R, would the entity be considered as the employer according to article 15(2)(b) OECD MC? Would article 15(2) be applicable because the employer is not a resident of state P according to state R's domestic law? Or would article 15(2) not be applicable, since the entity is a resident of state P, according to state P's domestic law? Would therefore state R's or state P's perspective matter?

(b) If your country is state P, would the entity be considered as the employer according to article 15(2)(b) OECD MC? Would article 15(2) be applicable because the employer is not a resident of state P, since the entity is not taxable according to state R's domestic law? Or would article 15(2) not be applicable, since the entity is a resident of state P, according to state P's domestic law? Would therefore state R's or state P's perspective matter?

5.2.5. Article 16 – directors' fees

An entity is established in state S and its shareholders (partners) are residents of state R. John is a member of the entity's board of directors and is resident in state R. John receives a remuneration from the entity established in state S in his capacity as a member of the board of directors.

5.2.5.1. Case A

Assume state R treats the entity as transparent and state S as a taxable entity (Figure 37).

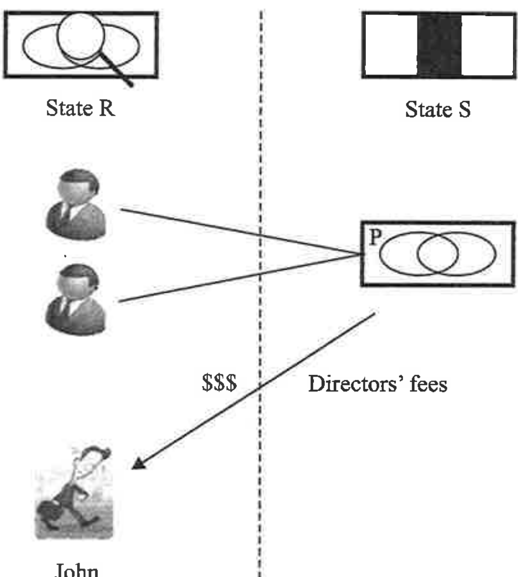

Figure 37

(a) If your country is state R: would article 16 OECD MC be applicable, although state R does not treat the entity as a resident of state S, since it is not seen as a taxable entity? Would it matter that state S treats the entity as a taxable and resident person?

(b) If your country is state S: would article 16 OECD MC be applicable, although state R does not treat the entity as a resident of state S, since it is not seen as a taxable entity?

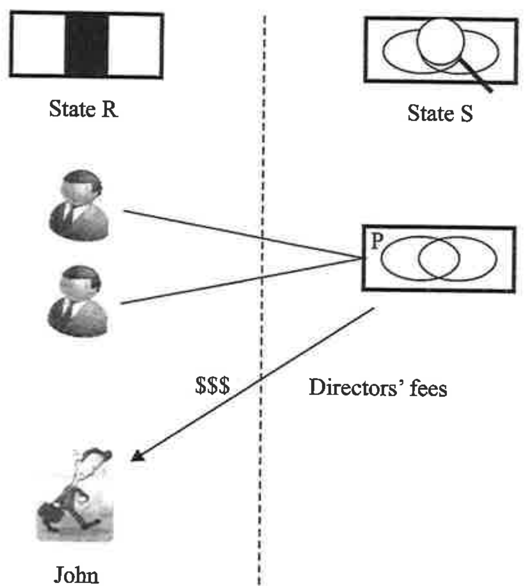

Figure 38

5.2.5.2. Case B

Assume state R treats the entity as a taxable entity and state S as a transparent entity (Figure 38).

(a) If your country is state R: would article 16 OECD MC be applicable, although state S does not treat the entity as a resident of state S, since it is not seen as a taxable entity there?

(b) If your country is state S: would article 16 OECD MC be applicable, although state S does not treat the entity as a resident of state S, since it is not seen as a taxable entity? Does it matter that the entity is considered under the domestic law of state R as a resident of state S?

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