Editor:
Joanna Wheeler

The Aftermath of BEPS

IBFD

The Aftermath of BEPS

Why this book?
This book is the product of one of the annual symposia held by IBFD to celebrate the advanced LLM programme, “International Tax Law: Principles, Policy and Practice”, offered jointly by the University of Amsterdam and IBFD. Each symposium aims to provide inspiration for debate and food-for-thought to all those who are interested in topics of fundamental importance to international tax law, both students and those with more experience. The symposium held in October 2018 was no exception and the chapters in this book reflect the critical questions posed during the symposium about the changes in the international tax order wrought by the OECD BEPS Project.

The book is divided into four parts. It begins by looking at the tax treaty entitlement of fiscally transparent entities, as well as the interactions of transparency, attribution and CFC regimes with tax treaties. The book goes on to consider the new law on permanent establishments, particularly in today’s digital economy, both the treaty changes introduced in the context of the BEPS Project generally and the effect of the modifications to article 5 on taxing the dependent agent permanent establishment in the state of source. A discussion follows on the extent to which the OECD Multilateral Instrument has achieved multilateralism in the international tax order. The book closes by considering whether the outcomes of the BEPS Project have pushed the balance of the international tax order too far in the direction of distrust and control, both for taxpayers structuring their affairs and for states structuring their tax systems.

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Visitors' address:
Rietlandpark 301
1019 DW Amsterdam
The Netherlands

Postal address:
P.O. Box 20237
1000 HE Amsterdam
The Netherlands

Telephone: 31-20-554 0100
Fax: 31-20-622 8658
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Foreword

IBFD is proud to present this book as part of its series celebrating the advanced LLM programme International Tax Law: Principles, Policy and Practice, offered jointly by the University of Amsterdam and IBFD. Each book in this series is written in conjunction with a symposium held at IBFD's headquarters. This book is a product of the symposium held in October 2018, at the start of the programme's fourth year.

The aim of the symposia and book series is to provide inspiration and food for thought for all those interested in the fundamental issues of international tax law and the development of the law. The symposia are held in an informal setting, before a small audience, in order to encourage debate. Similarly, the books often provide more than one view on each segment of the topic, in order to present a diversity of opinions. This volume also includes an extra chapter in Part 2, written by one of the 2018 graduates of the LLM programme.

IBFD is grateful to all the speakers/authors for their contributions to the symposium and their written contributions to this book. We look forward to lively discussions at future symposia, and we hope to continue being able to provide inspiration to many generations of students to come.

Joanna Wheeler
Programme Director, Advanced LLM, International Tax Law: Principles, Policy and Practice (2015-2019)

Chapter 1

Tax Treaty Entitlement and Fiscally Transparent Entities: Improvements or Unnecessary Complications?

Leopoldo Parada

1.1. Introduction

Bilateral tax treaties[1] are instruments designed to allocate taxing rights between two contracting states in order to prevent double taxation[2] and fiscal evasion.[3] That is, they are agreements between two sovereign states under which they agree to limit their fiscal sovereignty when identical or similar taxes are imposed in two states on the same taxpayer with respect to the same income, capital or event.[4]

1. The reference to bilateral tax treaties should not be interpreted as if tax treaties only apply to bilateral situations. Indeed, and although tax treaties are bilateral in nature, they are designed to function also in situations involving third states. *See*, for example, D. Sanghavi, *Structural Issues in the Income Tax Treaty Network. Towards a Coherent Framework*, PhD thesis defended in Maastricht University on 19 April 2018, p. 3.
2. For a more sceptical position as regards the traditional reasons for countries to sign tax treaties, *see* T. Dagan, *The Tax Treaty Myth* 32 N.Y.U. J. Int'l L. Pol. 939 (2000). *See also* R. Vann, *Chapter 18: International Aspects of Income Tax*, in *Tax Law Design and Drafting* Vol. II p. 37 (V. Thuronyi ed., International Monetary Fund 1998); J. Braun & M. Zagler, *An Economic Perspective on Double Tax Treaties with(in) Developing Countries*, 6 World Tax J. 3 (2014), Journals IBFD.
3. The 2017 *OECD Model* includes a modification in its title, which now includes a literal reference to tax evasion and tax avoidance. Likewise, a new preamble recognizing that tax treaties cannot create opportunities for non-taxation or reduced taxation through tax evasion or tax avoidance. This latter reference may also create the perception that tax treaties aim at avoiding double non-taxation. Such an interpretation may nonetheless be considered as premature. For a critical view on this interpretation, *see* L. Parada, *Double Non-Taxation and the Use of Hybrid Entities: An Alternative Approach in the New Era of BEPS* pp. 53-105 (Kluwer Law International 2018).
4. However, double tax treaties only contemplate the relief of juridical double taxation, namely when the same element of income is taxed twice in the hands of the same taxpayer. Thus, economic double taxation, namely when the same element of income or the same economic transaction is subject to the same type of tax in the hands of two or more different taxpayers, is not within the scope of double tax treaties. Accordingly, one should consider that the capacity of tax treaties to mitigate or eliminate double taxation is also limited as regards their scope of application. That is, even when tax treaties aim at relieving juridical double taxation, they can accomplish that aim only to the extent of taxes covered by the treaty, namely taxes on income and capital, and, more rarely, inheritance and gift taxes. M. Lang, *General Report*, in *Double Non-Taxation* pp. 78-81 (IFA Cahiers Vol. 89a, 2004), Books IBFD.

Generally speaking, tax treaties comprise two types of rules. The first type refers to the rules that determine whether a person is entitled to the benefits of a tax treaty or not – that is, whether a treaty is applicable to that person or not. These rules are part of articles 1 and 4 of the OECD Model. The second type of rules refers to those rules that distribute the taxing rights between the two contracting states in order to avoid double taxation. The latter kind, known as distributive rules, is a second step in the application of a tax treaty and necessarily depend on the results achieved after the application of the first type of rules. This chapter focuses on the first type of rules, especially in light of the recent modifications to the 2017 OECD Model as regards fiscally transparent entities. The ultimate aim of this chapter is to determine how these modifications have altered the dynamic of granting or denying tax treaty benefits and whether these changes represent an improvement or just an unnecessary complication. The time to revisit these issues could not be more appropriate.

Section 1.2. provides a brief review of the rules on tax treaty entitlement as regards tax transparent entities. Section 1.3. turns the analysis to the specific modifications introduced into the OECD Model as regards tax transparent entities. In particular, this section analyses the new article 1(2) of the OECD Model and the role of the "saving clause" in article 1(3) of the OECD Model. This section stresses that although the recently introduced provisions in the OECD Model represent a pragmatic and perhaps elegant solution to issues surrounding tax transparent entities and tax treaties, they still raise questions both regarding their coordination with other distributive rules within the treaties (especially in reference to the beneficial ownership requirement in articles 10, 11 and 12 of the OECD Model) and regarding the balance between residence and source states. Section 1.4. briefly explores some alternatives, both from tax treaty practice and from international tax law literature, that have attempted to provide an answer to the issues raised as regards the new provisions on tax treaty entitlement and tax transparent entities. Section 1.5. provides some final remarks.

1.2. Tax transparent entities and tax treaty entitlement in a nutshell

It is widely known that double tax treaties apply to persons who are resident in one or both of the contracting states. This is governed by articles 3(1) and 4(1) of the OECD Model, which refer to the concepts of persons and residents for tax treaty purposes. Therefore, as well as in the

case of individuals, the application of a treaty as regards to corporate and non-corporate entities (i.e. tax transparent entities) stresses two main basic questions: (i) is the entity a "person" for tax treaty purposes?; and (ii) can this person be regarded as a resident for the purpose of the application of a specific tax treaty?[5]

In regard to the first question, article 3(1) of the OECD Model provides an answer by defining a "person" for tax treaty purposes as any "individual, company and any other body of persons".[6] In its origin, this reference to "any body of persons" generated questions as to whether partnerships and other non-corporate or tax transparent entities were to be considered persons for tax treaty purposes. However, the conflict was resolved in the 1999 OECD Partnership Report.[7] At present, there is no doubt that partnerships are to be regarded as persons for tax treaty purposes. Therefore, what is of interest as regards the application of tax treaties to tax transparent entities lies exclusively in the determination of "residency" for treaty purposes.

For this purpose, and in answering the second question, article 4(1) of the OECD Model states that a "resident" for the purpose of the treaty is

> any person who, under the law of that state, is *liable to tax* therein by reason of his domicile, residence, place of management or any other criterion of a similar nature [emphasis added].[8]

The term "liable to tax" is applicable to a person who, based on various criteria, for example, residence, domicile, etc., is subject to "comprehensive taxation".[9] The OECD Commentaries do not offer a definition of "comprehensive taxation". However, it is widely accepted in the international tax literature and treaty practice that a person is considered liable to comprehensive taxation if it is subject to worldwide taxation, regardless

5. P. Baker, *The Application of the Convention to Partnerships, Trusts and Other, Non-Corporate Entities*, pp. 1-2, 2 GITC Rev. 1 (2002).
6. *OECD Model Tax Convention on Income and Capital* art. 3(1) (21 Nov. 2017), Treaties & Models IBFD [hereinafter *OECD Model*].
7. OECD, *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation No. 6, para. 30 (OECD 1999) [hereinafter *OECD Partnership Report*]. *See also OECD Model Tax Convention on Income and on Capital: Commentary on Article 3* para. 2 (21 Nov. 2017), Treaties & Models IBFD, concerning general definitions.
8. Art. 4(1) *OECD Model*.
9. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 4* paras. 8 and 8.6 (21 Nov. 2017), Treaties & Models IBFD, concerning the definition of resident.

of whether a state ultimately imposes effective taxation or not.[10] At first sight therefore both corporate and non-corporate entities would seem to be regarded as residents for the purposes of the treaty to the extent that they are fully liable to tax. This is precisely the issue, because the majority of non-corporate entities, for example, partnerships and other disregarded entities with a sole owner are granted full tax transparency, which is indeed inconsistent with the assertion of full tax liability based on worldwide taxation.[11] In other words, the benefits of a tax treaty should not be granted to a tax transparent entity to the extent that such an entity is not regarded as being liable to tax.

Yet, the fact that the benefits of a tax treaty cannot be granted to a tax transparent entity because this entity is not regarded as "liable to tax" still raises the question of whether or not a different resident partner of that entity can claim those benefits, especially if they are liable to tax on their share of the partnership income in their country of residence.[12] This is precisely the main issue assumed further on in this chapter.

1.3. New laws on tax treaty entitlement and tax transparent entities

This section turns the analysis to the latest modifications to the OECD Model as regards the entitlement to tax treaty benefits in the case of tax transparent entities.

In particular, it stresses that although the recently introduced article 1(2) and (3) of the OECD Model represents a pragmatic solution to issues derived

10. Para. 8.6 *OECD Model: Commentary on Article 4* concerning the definition of resident. The distinction between the terms "liable to tax" and "subject to tax" has also been assumed in the international tax literature in order to avoid confusing between the two concepts. *See*, for example, L. De Broe, *International Tax Planning and Prevention of Abuse* p. 240 (IBFD 2008), Books IBFD. *See also* R. Ismer & K. Riemer, *Article 4*, in *Klaus Vogel on Double Taxation Conventions*, 4th edn., at m.no. 26 (E. Reimer & A. Rust eds., Kluwer Law International 2015). This distinction has also received attention in the tax treaty case law. *See*, e.g. UK: TC, 10 Aug. 2012, *Paul Weiser v. HMRC* [2012] UKFTT 501 (TC); [2012] SFTD 1381, Case Law IBFD. For an analysis of this case, *see* B. Cleave, *The Weiser Case: UK Pension Income Not Subject to Tax in Israel under the Israel-United Kingdom Income Tax Treaty (1962)*, 67 Bull. Intl. Taxn. 6 (2013), Journal Articles & Papers IBFD.

11. Baker, *supra* n. 5, at p 3. *See also OECD Partnership Report*, *supra* n. 7, at para. 34.

12. *OECD Partnership Report*, *supra* n. 7, at para. 47. *See also OECD Model Tax Convention on Income and on Capital: Commentary on Article 8* para. 8.8 (21 Nov. 2017), Treaties & Models IBFD, concerning the definition of resident.

from items of income received by or through tax transparent entities, they still raise issues that appear not to have been conceived in its original design. Those issues are: (i) the apparently inappropriate interaction between article 1(2) of the OECD Model and the beneficial ownership requirement of articles 10, 11 and 12 of the OECD Model; and (ii) the imbalance between the interests of the residence state and source state within tax treaties resulting from the application of these rules. Both issues are subsequently analysed.

1.3.1. New article 1(2) of the OECD Model

Influenced by the recommendations of the OECD BEPS Action 2 concerning hybrid mismatch arrangements, the OECD introduced a specific provision dealing with tax transparent entities.[13] This provision mirrors the principles already settled during the 1999 OECD Partnership Report and the long-standing tax treaty practice in the United States under article 1(6) of the US Model.[14]

1.3.1.1. Scope

Article 1(2) of the OECD Model reads as follows:

> For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the taxation law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of the taxation by that State, as income of a resident of that State.[15]

13. OECD/G20, *Neutralizing the Effects of Hybrid Mismatch Arrangements – Action 2: 2015 Final Report* (OECD 2015), Primary Sources IBFD.

14. For an analysis of the *US Model* and the new *OECD Model* provision on tax transparent entities, *see* Parada, *supra* n. 3, at pp. 203-219. *See also* J. Kollmann, A. Roncarati & C. Staringer, *Treaty Entitlement for Fiscally Transparent Entities: Article 1(2) of the OECD Model Convention*, in *Base Erosion and Profit Shifting (BEPS). The Proposal to Revise the OECD Model Convention* (M. Lang, P. Pistone, C. Staringer et al. eds., Linde 2016).

15. This wording resembles the 2006 and 2016 *US Model*, which is indeed the first positive recognition of the principles settled by the 1999 *OECD Partnership Report* and the immediate precedent of art. 1(2) *OECD Model*.

Therefore, when one of the contracting states considers an entity or arrangement[16] to be tax transparent,[17] the income[18] received by or

16. The reference to "arrangements" could be interpreted as covering all those cases of transparent vehicles other than partnerships (for example, LLCs or trusts). Nonetheless, such non-corporate entities seem to be included already within the wording "entities", which reveals perhaps a further intention, namely to set up a more flexible concept that anticipates the appearance of future vehicles treated as fiscally transparent, but which might not be regarded as entities. However, this interpretation is still in the field of speculation. In this opinion, *also see* A. Nikolakakis et al., *Some Reflections on the Proposed Revisions to the OECD Model and Commentaries, and on the Multilateral Instrument*, *with respect to Fiscally Transparent Entities*" BTR 3, p. 335 (2017).

17. The *Commentary on Article 1 of the OECD Model* defines "fiscal transparency" as "…situations where, under the domestic law of a Contracting State, the income (or part thereof) of the entity or arrangement is not taxed at the level of the entity or arrangement but at the level of the persons who have an interest in that entity or arrangement". *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 9 (21 Nov. 2017), Treaties & Models IBFD. Additionally, it states that countries are nevertheless free to clarify this definition within their bilateral conventions. However, this option can be risky, because having many different definitions of "fiscal transparency" may result in ambiguous interpretations of the term resulting in a deterioration of the required legal certainty as it relates to allocation conflicts. *See*, for example, M. Lang, *Dreifache Nichtbesteuerung als Ergebnis der Anwendung von Doppelbesteuerungsabkommen*, 25 SWI 5, p. 198 (2015). Other questions may be raised as regards the definition of tax transparency, especially as regards CFC regimes with a complete flow-through approach (e.g. Brazilian CFC rules) and trusts. Although this author disagrees with such an extensive interpretation of the scope of art. 1(2) of the OECD Model so as to apply also to CFC cases, he recognizes that these issues may be a bit more complicated in the case of trusts. For an illustration of the problematic of the concept of tax transparency and trusts, *see* M. Brabazon, *Application of Tax Treaties to Fiscally Transparent Entities* sec. 2.1.3., Global Topics IBFD (accessed on 10 Oct. 2018). A further analysis can be found in M. Brabazon, *International Taxation of Trust Income: Tax Planning, Principles and Design*, Cambridge Tax Law Series, (Cambridge University Press 2019). Sharing a similar opinion as this author, *see* Nikolakakis et al., *supra* n. 16, at p. 316. However, some authors in the same collective contribution agree with an extensive interpretation of the scope of art. 1(2) of the OECD Model. Nikolakakis et al., supra n. 16, at p. 323. For an analysis of the concept of tax transparency in this collective contribution, *see* J. Wheeler, *Chapter 2: Some Thoughts about Transparency, Attribution and CFC Regimes and their Interaction with Tax Treaties*. Finally, the precondition that the entity or arrangement is considered as fiscally transparent applies also to cases of "partial transparency". Para. 10 *OECD Model: Commentary on Article 1* concerning the persons covered by the Convention. These concerns were originally raised in the 1999 *OECD Partnership Report*, *supra* n. 7, at para. 37.

18. Para. 8 *OECD Model: Commentary on Article 1* states: "The word 'income' must be given the wide meaning that it has for the purposes of the Convention and therefore applies to various items of income that are covered by Chapter III of the Convention (Taxation of Income), including, for example, profits of an enterprise and capital gains". Therefore, the range of income between arts. 6 and 21 *OECD Model* is included within the meaning of "income" and, consequently, that "capital" (i.e. art. 22 *OECD Model*) is not included within it. *See also* Kollmann, Roncarati & Staringer, *supra* n. 14, at p. 19. *See also* E. Schaffer, *Chapter 5: Implications of BEPS Action 2 and its Relevance for the*

through[19] that entity will be considered income of a resident of the state that considers the entity to be tax transparent, but only to the extent that the recipient is indeed liable to tax as a resident in that country.[20]

A proper reading of article 1(2) of the OECD Model is nonetheless crucial not to extend or to limit its scope of application. In this regard, one should be careful not to confuse article 1(2) of the OECD Model either with an attribution rule within the treaties (or one that modifies the domestic attribution of income) or with a coordination rule that modifies the domestic rules on the tax characterization of entities.

Application of Article 17 of the OECD Model, in *Domestic Attribution of Income and Taxation of International Entertainers and Sportspersons: Theory and Practice of Art. 17 OECD Model Convention* (M. Lang ed., IBFD 2017), Books IBFD.

19. In this regard, the *OECD Model: Commentary on Article 1* simply states: "The reference to 'income derived by or through an entity or arrangement' has a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State as to who derives that income for domestic tax purposes and regardless of whether or not that entity or arrangement has legal personality or constitutes a person as defined in subparagraph 1 a) of Article 3". Para. 7 *OECD Model: Commentary on Article 1*. Some authors have suggested, however, that the reference to "by or through" has the purpose of ensuring the application of the provision (i) in cases where the source state treats the entity X as tax transparent and, therefore, considers that the income is "derived through" that entity; and (ii) in cases where the source state treats the entity X as non-transparent (being regarded as transparent by the residence state), and thus, that the income is "derived by" such entity. Nikolakakis, et al., *supra* n. 16, at p. 303. *See also* Schaffer, *supra* n. 18. Although this justification is convincing, one should not forget that the problem with the use of the expression "derived by" within the *OECD Model* is that normally other attributive rules using similar expressions require a connection between the income and the taxpayer receiving the income, which might be misinterpreted as regards "income derived by a fiscally transparent entity". Regardless of the above, the author agrees that the clarification regarding the two functions of the provision is indeed appropriate. *See also*, sharing this opinion, Kollmann, Roncarati & Staringer, *supra* n. 14, at pp. 23-24; and A. Schnitger & M. Oskamp, *Empfehlungen der OECD zur Neutralisierung von 'Hybrid Mismatches' auf Abkommensebene*, 23 IStR 11, p. 390 (2014).

20. In the author's view, the phrase "but only to the extent that the income is treated, for purposes of the taxation by that State, as income of a resident…" cannot be interpreted as a requirement of effective taxation, because the requirement only implies that the income received by a tax transparent entity will flow through the entity until reaching a resident owner in the contracting state that treats the entity as tax transparent. Therefore, the use of the word "resident" simply refers to a person that must be "liable to tax" according to art. 4 *OECD Model*. The above is in line with the wording of para. 12 *OECD Model: Commentary on Article 1*, which provides: "By providing that the income to which it applies will be considered to be income of a resident of a Contracting State for the purposes of the Convention, the paragraph ensures that the relevant income is attributed to that resident for the purposes of the application of the various allocative rules of the Convention": para. 12 *OECD Model: Commentary on Article 1.*

As well-stated in the OECD Commentaries, article 1(2) has neither the purpose of an attribution rule within the treaties nor of modifying the domestic attribution of income.[21] Indeed, what article 1(2) does is simply to accomplish a two-fold purpose. On one hand, it clarifies to whom tax treaty benefits should be granted when an item of income is received by a fiscally transparent entity whose partners are also residents of the state that considers the entity to be fiscally transparent. On the other hand, it clarifies to whom the benefits of a tax treaty should be denied if the partners of the entity are not regarded as residents by the state that considers such an entity to be fiscally transparent.[22] Nonetheless, once article 1(2) of the OECD Model has been applied, one should always look at the specific provision governing the allocation of taxing rights within the treaty to ascertain whether or not the tax treaty benefits are finally granted. That is, this provision implies a role that must be complemented by the specific requirements of the tax treaty allocation provision applicable.

Similarly, it is highly arguable whether article 1(2) of the OECD Model can be interpreted as a coordination provision that requires the source state to follow the domestic tax characterization rules in the residence state.[23] It is true that article 1(2) of the OECD Model has the effect of giving priority to the domestic tax characterization rules in the residence state over the ones in the source states. Nonetheless, article 1(2) of the OECD Model does not require any of the contracting states to change their domestic rules with regard to the tax characterization of entities.[24] Accordingly, the fact that the source state considers that a taxable entity receives domestic income while the residence state considers the same entity as tax transparent should not prevent the source state from imposing taxation on the entity as another resident company. This is indeed ratified in article 1(3) of the OECD Model.[25]

Finally, it is important to highlight that article 1(2) of the OECD Model could apply either to situations in which the two contracting states disagree on the existence of an entity for tax purposes (i.e. hybrid and reverse hybrid entities) or in cases in which both states agree that there is a tax transparent entity. The practical relevance in the latter case is nevertheless reduced.

21. Para. 14 *OECD Commentary on Article 1*.
22. The two functions of the provision are clearly separated in art. IV(6) and (7) Canada-United States tax treaty. *See Can.-US Income and Capital Tax Treaty* (as amended through 2007), Treaties & Models IBFD. This distinction is nevertheless unusual. *See* Nikolakakis et al., *supra* n. 16, at p. 304.
23. Para. 14 *OECD Model: Commentary on Article 1*.
24. Id.
25. *See* the analysis in sec. 1.3.2.

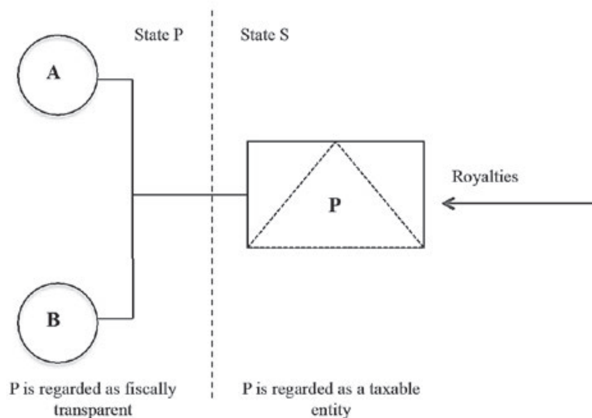
Therefore, the remaining examples in this chapter refer specifically to cases involving either hybrids or reverse hybrid entities.[26]

1.3.1.2. Illustration of the application of article 1(2) of the OECD Model

The application of article 1(2) of the OECD Model can be illustrated using a few simple examples.

Let us assume first a simple bilateral situation, shown in Figure 1.1., where P is a partnership established in State S and owned in equal percentages by A and B, who nonetheless have their tax residence in State P. State P considers entity P as a tax transparent entity, while State S considers entity P as a taxable or opaque entity. P derives royalty income from State S that is not attributable to a permanent establishment (PE) of A and B in State S.

Figure 1.1. Article 1(2) of the OECD Model: Bilateral case

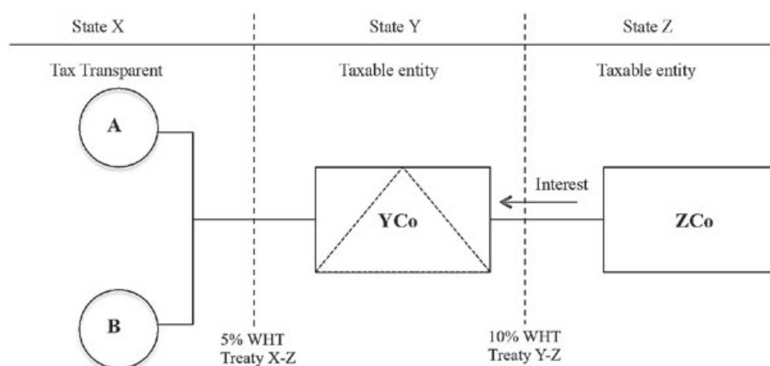


26. For this purpose, a hybrid entity should be understood as "an entity that is considered to be a taxable or opaque entity in the country of its establishment, that is, it is an entity which is different from its owners and which is subject to corporate income taxation in its country of organisation. In the other country, however, the same entity is regarded as tax or fiscally transparent, that is, there will be no taxation at the level of the entity but rather at the level of the partners. The same phenomenon of hybridity operates in the opposite direction also. That is to say, an entity can be treated as being tax transparent in the country of its establishment, but considered a taxable entity in the other country. These entities are known as 'reserve hybrids entities'". L. Parada, *Hybrid Entities and Conflicts of Allocation of Income Within Tax Treaties: Is New Article 1(2) of the OECD Model (Article 3(1) of the MLI) the Best Solution Available?*, BTR 3, pp. 338-339 (2018). *See also* Parada, *supra* n. 3, at pp. 116-118.

As noted, the conditions for the application of article 1(2) of the OECD Model are satisfied. That is, there is income (i.e. royalties) being received by or through an entity that is considered by one of the contracting states as tax transparent (i.e. State P treats entity P as tax transparent), and this income is considered for the purposes of State P as income received by a resident in that state (i.e. partners A and B). Therefore, the answer to the question regarding the application of the treaty between State P and State S should be answered in the affirmative. The remaining question, that is, about the final granting of a reduced withholding tax under that tax treaty, lies however in the application of the specific allocative rule, i.e. in article 12 of the treaty between State P and State S.

Let us assume now a triangular scenario, as depicted in Figure 1.2. In this hypothetical scenario, YCo is an entity, incorporated in State Y, that is owned by partners A and B, who nonetheless are residents of State X. Accordingly, we will assume that YCo has a subsidiary in State Z (ZCo), which receives a loan granted from YCo and, because of this, ZCo must make interest payments. We will also assume that the loan transaction is perfectly at arm's length. While YCo is considered to be a taxable entity in State Y and in State Z, it is however regarded as a tax transparent entity in State X. Likewise, although State Z applies a general withholding tax on interest paid abroad of 30 per cent of the gross amount paid, the treaty entered into by State X and State Z provides for a reduced withholding tax of 5 per cent, while the treaty entered into by State Y and State Z provides for a reduced withholding tax of 10 per cent.

Figure 1.2. Article 1(2) of the OECD Model: Triangular case



The application of article 1(2) in this triangular case should be analysed by first identifying the potential tax treaties applicable.

The treaty between State Y and State Z should be looked at first. Since both State Y and State Z treat YCo (the entity receiving the interest) as a taxable entity, there is no doubt that this treaty is applicable. Indeed, there is a person who is a resident in State Y and who receives interest income from the other contracting state. Article 1(2) of the treaty between State Y and State Z therefore plays no role here. Yet, the final withholding tax reduction (i.e. the benefit of the treaty) will depend on the specific requirements of article 11 of the treaty between State Y and State Z, including the fact that YCo must also be the beneficial owner of those interest payments.[27]

The situation is slightly different as regards the treaty between State X and State Z. While State Z still sees a taxable entity in State Y, and therefore considers the interest payments as being allocated to YCo (which would discard the application of the treaty with State X from its perspective), State X considers the interest payments indeed as received by partners A and B, who also appear to be residents of State X. In other words, the sole domestic tax characterization of YCo as a tax transparent entity in State X raises the question of whether or not the treaty between State X and State Z is also applicable.

Article 1(2) of the OECD Model resolves this issue, ensuring that the treaty between State X and State Z applies. Indeed, all the requirements of article 1(2) of the OECD Model are met. First, there is a contracting state (State X) treating the recipient entity established in a third state in this case (State Y),[28] as a tax transparent entity. Second, the state treating the entity as tax transparent (State X) considers the income (interest) to be income of one of its residents (partners A and B). Article 1(2) of the OECD Model therefore provides a pragmatic solution to the originally uncertain application of the treaty between State X and State Z.

In spite of the above, a couple of open questions remain. The first concerns the application of the withholding tax at source. As is widely known, the withholding tax will be applied only once in State Z. However, in our hypothetical scenario we have two potential treaties applicable, also providing for different withholding tax reductions at source. Therefore, the question is what rate should be applicable. The 1999 OECD Partnership Report and

27. A further analysis in sec. 1.3.1.3.1.
28. Where the entity is established is indeed irrelevant for purposes of the application of art. 1(2) *OECD Model*.

the subsequent modifications of the OECD Commentaries provided that the interest payments should be taxed in this case at the lowest withholding tax rate of the two potentially applicable treaties. That is, a 5 per cent withholding tax must be applied as regards the treaty between State X and State Z as well as the treaty between State Y and State Z.[29] At first glance, this solution appears to be unfair towards the source state, which is perhaps the reason why this paragraph in the Commentaries was deleted from the new OECD Model 2017.[30]

There is also the issue of a potential unsolved case of double taxation that may arise. If we look at the tax treaty relationship between State X and State Y, this is far from a residence-source relationship. Therefore, the treaty between State X and State Y is in principle irrelevant for purposes of the analysis. However, it becomes relevant if YCo is considered to be a PE of partners A and B in State Y. This immediately raises the question of potential double taxation relief, because only to the extent that YCo is indeed regarded as a PE will tax treaty relief be granted in State X. Nevertheless, if YCo is not a PE, nothing prevents State Y from still taxing the interest payments, which will also be taxed by State X in the hands of partners A and B. Double taxation in this case will not be relieved by the application of the treaty between State X and Y. The foregoing is also confirmed in the wording of the new saving clause in article 1(3) of the OECD Model.[31]

1.3.1.3. Main concerns as regards article 1(2) of the OECD Model

It is undeniable that article 1(2) of the OECD Model provides a very pragmatic (and perhaps also elegant) solution to most of the issues regarding tax transparent entities. However, this provision is far from perfect.[32] As argued in this section, article 1(2) of the OECD Model still raises important concerns both as regards the adequate alignment of this provision with other attributive rules within tax treaties (such as the beneficial ownership requirement in articles 10, 11 and 12 of the OECD Model) and as regards the balance between residence and source state in the tax treaty relationship. These two issues are analysed in the subsequent subsections.

29. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* (26 July 2014), Treaties & Models IBFD.
30. This paragraph has been deleted from the 2017 OECD Model. However, considering the non-binding nature of the OECD Commentaries, nothing prevents countries from still interpreting these situations according to the old OECD Commentaries.
31. For an analysis of the saving clause, *see* sec. 1.3.2.
32. For a previous and recent criticism raised by the author as regards art. 1(2) *OECD Model*, *see* Parada, *supra* n. 26.

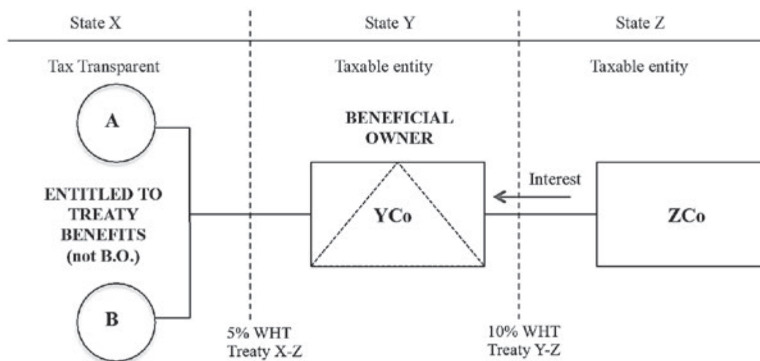
1.3.1.3.1. *The misalignment with the beneficial ownership requirement*

The first concern raised by the application of article 1(2) of the OECD Model refers to its misalignment with the beneficial ownership requirement in articles 10, 11 and 12 of the OECD Model.[33]

As noted already in this chapter, article 1(2) of the OECD Model is not a provision that automatically grants any tax treaty benefit. By contrast, once applied, it requires subsequent interaction with the respective allocative tax treaty rule in order to finally confirm that a person is granted the benefit of a tax treaty. As such, therefore, it is not possible to argue that article 1(2) of the OECD Model directly clashes with the beneficial ownership requirement established in articles 10, 11 and 12 of the OECD Model, because article 1(2) of the OECD Model simply answers a different and previous tax treaty question, which is whether or not a tax treaty is applicable as regards to a specific person when income is received by or through a tax transparent entity.[34] Nevertheless, the absence of a clash does not mean that the two provisions are necessarily aligned, let alone that they do not end up cancelling each other out in a circular nullifying effect.[35]

Allow me to illustrate the foregoing using the example in Figure 1.3.

Figure 1.3. Article 1(2) of the OECD Model and beneficial ownership



33. For the original criticism expressed by the author in this regard, *see* Parada, *supra* n. 26.

34. Although the author originally referred to this misalignment between art. 1(2) *OECD Model* and the beneficial ownership requirement as a "clash", this term was used in the sense of inadequate interaction of these rules, considering the treaty as a whole. *See* Parada, *supra* n. 26, at p. 357 (referring to the "clash"). *See also* Parada, *supra* n. 3, at pp. 250-264.

35. Also taking this position, Nikolakakis et al., *supra* n. 16.

While article 1(2) of the treaty between State X and State Z would provide that partners A and B are entitled to receive a reduced withholding tax at source, article 11 of the same treaty would prevent such a result, because it is indeed unlikely that partners A and B are regarded as the beneficial owners of the interest payments in State Z. That is, unless State Z considers YCo to be an agent, nominee or conduit company, entity P will still be regarded as a taxable entity by the source state and, therefore, it will most probably be considered the beneficial owner of those interest payments.[36] This means that the impact of article 1(2) of the OECD Model is practically zero in all those cases of hybrid entity transactions involving the payment of dividends, interest or royalties, because in all those cases the last word would rely exclusively on the determination of the beneficial owner.

Undeniably, the concept of beneficial ownership is not indisputable.[37] However, if one were to take into account the original intention of the beneficial ownership requirement in the 1977 OECD Model, one should reach at least two important conclusions. First, the beneficial ownership requirement was introduced as a way to clarify and to ensure that the benefits of a tax treaty are not granted to intermediaries.[38] This is why the OECD Commentaries confirm, although without defining the concept, that a nominee, agent or conduit company cannot be regarded as the beneficial owner of the income.[39] Secondly, since we refer to the benefits of the treaty granted

36. Accordingly, the solution of art. 1(2) of the tax treaty between State X and State Z might also contradict the purpose of the treaty itself, leaving open a potential double taxation issue. For example, if State X does not have a tax treaty with State Y, or if having a tax treaty, YCo is not regarded as a PE, there will be no double taxation relief for the taxes imposed at the level of YCo in State Y. Moreover, if the same situation is analysed in regard to a trust, the trust and the settlor being residents in State Y (using Danon's example) and the beneficiary being resident in State X, and having both State X and State Y treat the trust as tax transparent, the relief of double taxation becomes impossible. R. Danon, *Qualification of Taxable Entities and Treaty Protection*, 68 Bull. Intl. Taxn. 4/5, pp. 198-199, diagram 7 (2014), Journal Articles & Papers IBFD.

37. For the concept of beneficial owner, *see* C. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* (IBFD 1999); R. Fraser & J. Oliver, *Beneficial Ownership: HMRC's draft guidance on interpretation of the Indofood decision*, BTR 1 (2007); J. Bernstein, *Beneficial Ownership: An International Perspective*, 45 Tax Notes International 12 (2007); P. Baker, *The United Nations Model Double Taxation Convention between Developed and Developing Countries: Possible Extension of the Beneficial Owner Concept*, in: Committee of Experts on International Cooperation in Tax Matters, Fourth Session, Geneva, 20-24 October 2008; A. Martín Jiménez, *Beneficial Ownership: Current Trends*, 2 World Tax J. 1 (2010), Journal Articles & Papers IBFD; M. Lang et al. eds., *Beneficial Ownership: Recent Trends* (IBFD 2013), Books IBFD, and A. Meindl-Ringler, *Beneficial Owner in International Tax Law* (Kluwer Law International 2016).

38. De Broe, *supra* n. 10, at p. 656.

39. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 10* para. 12 (21 Nov. 2017), Treaties & Models IBFD, states: "The requirement of beneficial

in the source state, that is, a reduced withholding tax in cases of payments of dividends, interest and royalties, it appears almost self-evident that the determination of the beneficial owner should be an exclusive task of the source state.[40]

The misalignment between article 1(2) of the OECD Model and the beneficial ownership requirement in articles 10, 11 and 12 of the OECD Model is assumed in the new paragraph 13 of the new OECD Commentary on Article 1, which provides:

> Whilst the paragraph ensures that the various allocative rules of the Convention are applied to the extent that income of fiscally transparent entities is treated, under domestic law, as income of a resident of a Contracting State, the paragraph does not prejudge the issue of whether the recipient is the beneficial owner of the relevant income. Where, for example, a fiscally transparent partnership receives dividends as an agent or nominee for a person who is not a partner, the fact that the dividend may be considered as income of a resident of a Contracting State under the domestic law of that State will not preclude the State of source from considering that neither the partnership nor the partners are the beneficial owners of the dividend.

Therefore, article 1(2) of the OECD Model should not affect the determination of the beneficial owner in the source state, which, in the author's view, has no other meaning than that the source state should determine the beneficial owner based on its own qualification and attribution rules, regardless of the fact that the recipient entity of the income is considered as fiscally transparent in the other contracting state.[41] However, this conclusion is still

ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words 'paid…to a resident' as they are used in paragraph 1 of the Article". Likewise, the *OECD Model Tax Convention on Income and on Capital: Commentary on Article 12* para. 4 (21 Nov. 2017), Treaties & Models IBFD, provides: "The requirement of beneficial owner was introduced in paragraph 1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries". However, none of these references are a definition of the concept of beneficial owner. W. Eynatten, K. De Haen & N. Hostyn, *The Concept of 'Beneficial Owner' under Belgian Tax Law: Legal Interpretation is Maintained*, 31 Intertax 12, p. 523 (2003). Indeed, why the OECD introduced the beneficial owner requirement is still confidential information. *See* du Toit, *supra* n. 37, at p. 179.

40. This idea is recognized, for example in the *Technical Explanation to the 2006 US Model*, art. 11(1), which says: "[t]he term 'beneficial owner' is not defined in the Convention, and is, therefore, defined under the internal law of the Source state. The beneficial owner of the interest for purposes of Article 11 is the person to which the income is attributable under the laws of the source State". Similar interpretations can be found in decisions of the German Federal Fiscal Court (*Bundesfinanzhof*). *See*, for example, DE: BFH, 26 June 2013, I R 48/12 Re US S Corporation's German Withholding Tax Status, 12 ITLR 428, Case Law IBFD.

41. Some authors also take this position in Nikolakakis et al., *supra* n. 16, at p. 334. In contrast, Brabazon says: "…beneficial ownership may be taken to reflect residence

not sufficient to provide a solution for the misalignment between article 1(2) of the OECD Model and the beneficial ownership requirement.[42]

1.3.1.3.2. *Does article 1(2) of the OECD Model affect the tax treaty balance between residence and source state?*

Another concern regarding article 1(2) of the OECD Model is its tendency towards favouring the position of the residence state over the source state. This is especially evident if one considers that article 1(2) of the OECD Model prioritizes the tax characterization of the residence state over that of the source state without any convincing justification for this pragmatism.

Both figures illustrating the application of article 1(2) of the OECD Model in section 1.3.1.2. serve the purpose of demonstrating the unjustified preference towards the residence state.

In Figure 1.1. illustrating the bilateral case, for example, the royalties paid to entity P, legally organized in State S and treated as a taxable entity there, should be simply considered as a domestic situation. However, article 1(2) of the OECD Model allows the application of the treaty to the partners of entity P (partners A and B), just because of the different tax characterization of entity P in state R, i.e. as fiscally transparent.

Similarly, Figure 1.2. depicting the triangular case, at least before the deletion of paragraph 6.5 of the Commentary on Article 1, was a very good example to demonstrate the unbalanced residence-source conflict created by article 1(2) of the OECD Model. As noted already, former paragraph 6.5 of the Commentary on Article 1 of the OECD Model summarized the conclusions of the 1999 OECD Partnership Report regarding a similar triangular

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state attribution…as a positive condition, qualified by the exclusion of an undefined but internationally determined class of agency, nomineeship and forwarding cases as a negative condition". Brabazon, *supra* n. 17, at sec. 4.4.2. He also suggests an approach to beneficial ownership based on residence state attribution based on the New Zealand treaty practice. Id., at sec. 4.4.5. Also sceptical towards an interpretation that suggests a determination of the beneficial ownership exclusively by the source state, Sanghavi states: "It is also strange that the commentary suggests that the beneficial owner should be determined exclusively in accordance with the tax principles of the source state. A situation in which the source state considers a partnership to be the beneficial owner of dividends, but the other state treats that partnership as transparent would, absent unilateral relief, likely result in unrelieved double taxation because the partnership will not qualify as a treaty resident". D. Sanghavi, *BEPS Hybrid Entities Proposal: A Slippery Slope, Especially for Developing Countries*, 85 Tax Notes International 4, p. 361 (2017).

42. For some solutions, both from treaty practice and tax law literature, *see* sec. 4.

List of Contributors

Mattia Calabrese is a graduate of the advanced LLM programme International Tax Law: Principles, Policy and Practice, organized by the University of Amsterdam and IBFD. Previously, Mr Calabrese cooperated with Prof. Pasquale Pistone's academic team at the University of Salerno while also working as a tax adviser for an Italian consulting firm. In addition to his LLM, Mr Calabrese has a bachelor's degree in economics and a master's degree in business administration from the Federico II University of Naples.

Giammarco Cottani is a partner at Ludovici Piccone & Partners, where he coordinates the transfer pricing practice with regard to both the prevention and resolution of domestic and international disputes and providing assistance in complex audits of large multinational enterprise groups. Dr Cottani holds a PhD in corporate taxation in law from the Libera Università Internazionale degli Studi Sociali "Guido Carli" in Rome and an LLM in European and international taxation from the European Tax College. He is admitted to the Italian Bar Association.

Svetislav V. Kostić is a docent at the University of Belgrade Faculty of Law, where he teaches general tax law, international tax law and EU tax law to both undergraduate and graduate students, in addition to being an IBFD postdoctoral fellow. He is a graduate of the University of Belgrade Faculty of Law and holds a PhD from the same university (2014) and an LLM from the New York University School of Law (2008). He can be contacted at skostic@ius.bg.ac.rs or s.kostic@ibfd.org.

Tarcísio Diniz Magalhães is a postdoctoral researcher at Université McGill's Tax Law Faculty, where he is involved in teaching international taxation and tax policy and working on the project "Designing a Sustainable Global Tax System". He is a former postdoctoral research fellow at IBFD and a member of the Permanent Commission on Review and Simplification of Tax Legislation, Brazil. He holds doctoral, master's and bachelor's degrees in law, all obtained with honours from the Universidade Federal de Minas Gerais, and he has been a visiting scholar at the Wirtschaftsuniversität Wien (Institute for Austrian and International Tax Law), the Max-Planck-Gesellschaft (Institute for Tax Law and Public Finance) and the University of Wisconsin-Madison. He can be contacted at tarcisio.magalhaes@mcgill.ca.

Amar Mehta holds a PhD in international taxation from the University of Amsterdam and is a Chartered Accountant (India), a former tax partner of a Big Four accounting firm and a former international tax researcher at IBFD. His work is regularly published globally, including by IBFD. Recently, his extensive commentaries on articles 5 and 7 of tax treaties were published on www.dramarmehta.com, where he also writes on issues concerning tax treaties, BEPS and GAARs.

Leopoldo Parada is a visiting professor of international and EU tax law at the University of Turin and the Free University of Bolzano (Italy). He holds a PhD awarded by the University of Valencia (Spain) and an LLM in international taxation awarded by the University of Florida (United States). He is the author of a book and several articles on issues related to hybrid entities and hybrid financial instruments. Formerly, he was a postdoctoral research fellow at IBFD and a research associate at the Max Planck Institute for Tax Law and Public Finance (Germany).

Eric Robert is a tax policy adviser at the OECD, a role he has held since 2014. His work focuses primarily on the direct tax challenges posed by digitalization. Previously, he worked as a tax adviser at Deloitte in France and as a senior research associate for IBFD in the Netherlands. He obtained a university degree in law in 2005 and a PhD in public law from Université Paris II Panthéon-Assas in 2011.

Joanna Wheeler is a senior member of the IBFD academic group. She has served as the editor of many different IBFD publications and was the founding editor of IBFD's database on the taxation of trusts and the pioneer of IBFD's programme of online courses. She was seconded to the University of Amsterdam (UvA) as the director of the advanced LLM programme International Tax Law: Principles, Policy and Practice from 2015 to 2019 and continues to be involved in this programme as the thesis director. Dr Wheeler was awarded her PhD by the University of Amsterdam in 2012.

Notes

Contact

IBFD Head Office
Rietlandpark 301
1019 DW Amsterdam
P.O. Box 20237
1000 HE Amsterdam
The Netherlands

Tel.: +31-20-554 0100 (GMT+1)
Email: info@ibfd.org
Web: www.ibfd.org

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