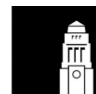

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## Hybrid Entity Mismatches and the MLI: A Tax Policy Assessment

Leopoldo Parada*

### Abstract

*This article argues that despite its apparent success as a political instrument to achieve global coordination, and particularly referred to hybrid entity mismatches, the MLI has failed. Most notably, the MLI has been incapable of keeping cohesion with the main object and purpose of tax treaties, also reinforcing an unequal distribution of taxing powers between residence and source states. In light of the above, this article explores some prospective alternatives that could not only help with restoring cohesion and equality within tax treaties, but also add certainty and simplicity to the interpretation of the MLI and the issues related to hybrid entity mismatches.*

### 1. Introduction

Eight years have passed since the OECD BEPS Project proposed a multilateral instrument (hereinafter, "MLI") to simplify the modification of bilateral tax treaties worldwide.[1] Since then, ninety-five countries have signed the multilateral instrument, and thirty of

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[1] OECD, *Action 15: A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS* (OECD Publishing, 2015). See also, OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing, 2013), and OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, 2013). For an early evaluation of BEPS and the different actions of the Action Plan, see Y. Brauner, *BEPS: An Interim Evaluation*, 6 World Tax J.1 (2014).

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them have ratified it already.[2] Nobody could argue that this is not a political success, especially in a world where multilateralism is still not the general rule.[3] However, and from a strict policy perspective, the MLI's success is more questionable, and this is particularly evident when we refer to the provisions on hybrid entity mismatches.[4]

This article argues that despite its apparent success as a political instrument to achieve global coordination, and particularly referred to hybrid entity mismatches, the MLI has failed. Most notably, the MLI has been incapable of keeping cohesion with the main object and purpose of tax treaties, reinforcing also an unequal distribution of taxing powers between residence and source states. This can be especially noticed when we consider the interaction of the new MLI provision on tax treaty entitlement with provisions aiming to protect residence taxation at source, as well as with some specific allocative rules within tax treaties. In light of the above, the article explores some prospective alternatives that could not only help with restoring cohesion and equality within tax treaties, but also add certainty and simplicity to the interpretation of the MLI and the issues related to hybrid entity mismatches.

Section 2 briefly describes the modifications introduced in the MLI regarding hybrid entity mismatches, including both provisions on tax treaty entitlement and those referred

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2 OECD, *Signatory and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, Status as of 30 March 2021, available at http://www.oecd.org/tax/beps/beps-mli-signatories-and-parties.pdf

3 For the text of the MLI, see OECD, *Text of the Multilateral Convention to Implement Tax treaty Related Measures to prevent Base Erosion and Profit Shifting*, adopted on 24 Nov. 2016, Part II-Hybrid Mismatches (hereinafter, "MLI"). See also, OECD, *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (OECD Publishing, Paris, 2016) (hereinafter, "MLI Explanatory Statement"). For an interim analysis of the MLI, see, for example, J. Zornoza, "Acción 15. El instrumento multilateral y el plan de acción BEPS" in J. Ramos (ed) *Erosión de la Base Imponible y Traslado de Beneficios: Estudios sobre el plan BEPS de la OCDE* (Aranzadi, 2016) at 425-452. More recently, see N. Bravo, *A Multilateral Instrument for Updating the Tax Treaty Network* (IBFD Doctoral Series, 2020). See also, R. García Antón, *Multilateral Dynamics in Bilateral Settings: Back to Realpolitik* British Tax Review 4 (2019) (stressing the constant tensions between global standards and bilateral approaches in the path towards multilateralism).

4 For some criticism regarding the hybrid entity mismatches rules in the context of bilateral tax treaties, see L. Parada, "Tax Treaty Entitlement and Fiscally Transparent Entities: Improvements or Unnecessary Complications?" in J. Wheeler (ed), *The Aftermath of BEPS* (IBFD, 2020).



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to the protection of residence taxation at source. Section 3 suggests an analysis of the MLI in light of two specific tax policy baselines: cohesion with tax treaty objectives and equal allocation of taxing powers. After explaining why these two policy baselines are chosen for the purpose of this work, this Section elaborates on the argument that the MLI has been incapable of aligning with any of them, contradicting the main purpose of tax treaties (avoidance of double taxation), as well as reinforcing an unequal distribution of taxing powers between residence and source states. Section 4 explores three alternatives that could overcome this criticism: i) a *reverse* saving clause to avoid double taxation; ii) an enhanced (deemed) beneficial ownership rule, and iii) a coordination of entities' rule within the MLI. As argued in this Section, these prospective alternatives could not only help restore cohesion and equality within tax treaties, but also add certainty and simplicity to the interpretation of the MLI and the issues related to hybrid entity mismatches. Section 5 concludes.

## 2. The MLI and Hybrid Entity Mismatches

The MLI introduces two types of provisions in relation to hybrid entity mismatches.[5] The first type is a particular provision which helps answering the question of who is entitled to the benefits of a tax treaty in those cases when income is received by or through a tax transparent entity. The second type is a particular provision that aims to protect contracting states of their right to tax their own residents, regardless of the limitations of the treaty, also known as *saving clause*. Both types of provisions are described as follows.

[5] This contribution uses the term "hybrid entity mismatches" in reference to the disparities caused by the different characterisation of the same entity for tax purposes, giving rise to either hybrid or reverse hybrid entities. A *hybrid entity* is generally understood as an entity that is considered to be a taxable entity in the country of its establishment, whilst in the other country the same entity is regarded as fiscally transparent, that is, there is no taxation triggered at the level of the entity but rather at the level of the partners. In contrast, a *reverse hybrid* entity assumes the inverse case, that is, an entity that is considered as tax transparent in the country of its establishment, but as a taxable entity in the other country. See L. Parada, *Double Non-Taxation and the Use of Hybrid Entities: An Alternative Approach in the New Era of BEPS,* 115-118 (Kluwer Law International, 2018).



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## 2.1. Tax Treaty Entitlement and Transparent Entities

The first provision introduced by the MLI is Article 3(1), which reads as follows:

"For the purposes of a Covered Tax Agreement, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting Jurisdiction shall be considered to be income of a resident of a Contracting Jurisdiction but only to the extent that the income is treated, for purposes of taxation by that Contracting Jurisdiction, as the income of a resident of that Contracting Jurisdiction." [6]

This provision helps answer the question of who is entitled to the benefits of a tax treaty in those cases when income is received by or through a tax transparent entity.[7] Indeed, and it is widely understood in the tax literature, tax treaties only apply to persons who are also residents in a contracting state.[8] Therefore, the challenge relies on the fact that the concept of "resident" attends to someone who is "liable to tax", or which is the same, someone subject to worldwide taxation in either or both contracting states.[9] In other words, entities considered as tax transparent will never be considered residents for tax treaty purposes, because the concept of transparency is indeed inconsistent with the assertion of full tax liability based on worldwide taxation.[10]

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[6] Article 3(1) of the MLI.

[7] The concept of "tax transparency" is not exempt of interpretation issues. For an analysis of tax transparency in the context of tax treaties, see, J. Wheeler, *Some Thoughts about Transparency, Attribution and CFC Regimes and Their Interaction with Tax Treaties*, in J. Wheeler (ed), *The Aftermath of BEPS* (IBFD, 2020). This work, although recognising the problems behind the concept of tax transparency, adopts a more restricted approach, which is limited to hybrid and reverse hybrid entities. See the concept of "hybrid entity mismatches" at supra note 5.

[8] Article 4(1) of the OECD Model Tax Convention 2017.

[9] OECD Commentary on Article 4 concerning the definition of resident, paras 8 and 8.6.

[10] P. Baker, *The Application of the Convention to Partnerships, Trusts and Other, Non-Corporate Entities*, 2 GITC Rev 3 (2002). See also, OECD, *The Application of the OECD Model Tax Convention to Partnerships*, *Issues in International Taxation No. 6* (OECD Publishing, 1999), para. 34. For a criticism of the OECD Partnership Report, see M. Lang, *The Application of the OECD Model Tax Convention to Partnerships, A Critical Analysis of the Report Prepared by the OECD* (Wolters Kluwer, 2000). See also, R. Danon, *Qualification of Taxable Entities and Treaty Protection*, Bull. Intl. Taxn. 68 4/5, 198-200 (2014). For a recent analysis on the positive influence of the OECD Partnership Report after BEPS, see H. Ault, *The Partnership Report Revisited: BEPS, the Multilateral Convention, and the 2017*



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Article 3(1) MLI attempts to overcome this challenge providing that — and for purposes of a Covered Tax Agreement— when one of the Contracting States considers an entity or arrangement to be tax transparent, the income received by or through that entity will be regarded as income of a resident of the state, which considers the entity as tax transparent, but only to the extent that the recipient is indeed liable to tax as a resident in that country.[11] In this regard, and not coincidentally, the MLI Article mirrors Article 1(2) OECD Model Convention (OECD MC). Indeed, the MLI Explanatory Statements expressly recognises that the interpretation of Article 3(1) MLI must be carried out considering, in particular, the OECD Commentaries on Article 1(2) OECD Model MC.[12] Therefore, one could see Article 3(1) MLI as a sort of multilateral version of its bilateral counterpart in the OECD MC.

Finally, it is also interesting to note that Article 3(1) MLI does not constitute a minimum standard within the MLI, and as such it can be opted out —totally or partially— by the Contracting Jurisdictions if they decide so.[13]

### 2.2. Saving clause and taxation of residents at source

The second type of provisions introduced by the MLI in the context of hybrid entity mismatches is one known in the literature as "saving clause".[14] The MLI introduces a

*OECD Model* Convention, in *Festschrift for Jacques Sasseville* (Canadian Tax Foundation, 2018).

[11] L. Parada, *Hybrid Entities and Conflicts of Allocation of Income Within Tax Treaties: Is New Article 1(2) OECD Model (Article 3(1) of the MLI) the Best Solution Available?,* British Tax Review 3, 340-344 (2018). See also, A. Nikolakakis et al., *Some Reflections on the Proposed Revision to the OECD Model and Commentaries, and on the Multilateral Instrument, with respect to Fiscally Transparent Entities* BTR 3 (2017), and J. Kollmann, A. Roncarati and C. Staringer, "Treaty Entitlement for Fiscally Transparent Entities: Article 1(2) of the OECD Model Conventio*n*" in M. Lang, P. Pistone, C. Staringer (eds), *Base Erosion and Profit Shifting (BEPS). The Proposal to revise the OECD Model Convention* (Linde, 2016).

[12] MLI Explanatory Statements, para. 12.

[13] MLI Explanatory Statements, para. 46.

[14] The saving clause was originally recommended in Action 6 of the BEPS Report relating to tax treaty abuse. See OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances,* Action 6—2015 Final Report (OECD Publishing, 2015). However, the principles embraced by the "saving clause" were already recognized in the OECD 1999



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saving clause with two optional versions: a *detailed version* (Article 11 MLI), and a *simplified version* (Article 3(3) MLI).[15] In both cases, and beyond the particular details of these provisions, the purpose is to protect the right of the source state to tax their own residents, regardless of the effect of the treaty. This can be noticed in the wording of both versions of the provision. For example, Article 11(2) MLI states: "…the Covered Tax Agreement would not affect the taxation by a Contracting Jurisdiction of its residents".[16] Similarly, Article 3(3) MLI provides that the following sentence should be added to the end of Article 3(1) MLI: "In no case shall the provisions of this paragraph be construed to affect a Contracting Jurisdiction's right to tax the residents of that Contracting Jurisdiction."[17]

Although it is apparently difficult to figure out situations in which contracting states are limited in their rights to tax their own residents —after all, tax treaties are mostly concerned about the right to tax non-residents—[18] the situation is rather different in the case of hybrid entity mismatches where countries simply disagree on the existence of a taxpayer.[19] Indeed, one could argue at first sight that the saving clause is rather limited in scope as it does not apply to several situations described in the detailed version of it. However, all these exceptions —see Article 11(1), letters (a) to (j) MLI— assume that

Partnership Report. OECD Partnership Report, supra note 10, paras. 126 and 127. See also, M. Brabazon, *Application of Tax Treaties to Fiscally Transparent Entities –Global Tax Treaty Commentaries*, Global Tax Treaty Commentaries IBFD, sec. 1.2.6; G. Kofler, *Some Reflections on the 'Saving Clause'*, 44 Intertax 8/9, 574 et seq. (2016). For an analysis of the saving clause introduced in the OECD Model Tax Convention, and in the context of hybrid entities, see L. Parada, *The 'OECD Saving Clause': An American Tailored Provision Made to Measure the World,* Rivista di Diritto Finanziario e Scienza delle Finanze LXXVIII, 1, I, 13-52 (2019). The "saving clause", although relatively new in the OECD tax treaty context, it has a long-standing tradition in the tax treaty policy of the United States. See U.S. Model Income Tax Convention of 17 February 2016, Article 1(5). See also, Technical Explanation of the United States Model Income Tax Convention of 15 November 2006 at 3 (example of application); P. McDaniel, H. Ault and J. Repetti, *Introduction to United States International Taxation*, 5th Ed., 181(Wolters & Kluwer, 2005).

15 For an early analysis of the MLI optional provisions, see V. Chand, *Should states opt for the saving clause in the multilateral instrument?,* 86 Tax Notes Int'l. 8 (2017).

16 Article 11(2) of the MLI.

17 Article 3(3) of the MLI.

18 J. Sasseville, *A Tax Treaty Perspective: Special Issues*, in: G. Maisto (ed.), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, 49 (IBFD, 2006).

19 Kofler, supra note 14, at 580.



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the same income is attributed by the Contracting States to the same taxpayer.[20] That is why tax treaties are normally silent with respect to the cases in which the same income is attributed to different taxpayers, which is precisely the case of hybrid entity mismatches.[21]

There are two more provisions within the MLI that are worth considering for the purpose of protecting the right to tax residents at source. First, Article 3(2) MLI, which states that no relief from double taxation shall apply in the residence state to the extent that taxation at source occurred exclusively because of the right of this latter state to tax its own residents.[22] Second, Article 5-Option C MLI, which repeats a similar idea, stating that a credit is generally applicable "except to the extent that these provisions allow taxation by that other Contracting Jurisdiction solely because the income is also income derived by a resident of that other Contracting Jurisdiction".[23] As it can be noticed, therefore, these two provisions simply confirm the approach that no relief from double taxation shall be granted when taxation at source is just the result of the right of this state to tax their own residents.[24]

Finally, it is important to note that both Article 11 and 3(3) MLI can be opted out in their entirety. That is, signatory parties can simply decide not to include them in their respective Covered Tax Agreements (tax treaties).[25]

### 2.3. Illustration

The interaction between the new rule on tax treaty entitlement (Article 3(1) MLI) and those provisions aiming for a protection of the source state to the right to tax its own

[20] Id. (referring to the exception to the saving clause as regards Articles 7(3), 9(2), 19, 20, 23A (and B), 24, 25 and 28 OECD MC). These exceptions coincide with those referred in Article 11(1) MLI.

[21] Supra note 5 (for the use of the concept of "hybrid entity mismatches" in this work).

[22] Article 3(2) MLI states: "Provisions of a Covered Tax Agreement that require a Contracting Jurisdiction to exempt from income tax or provide a deduction or credit […] shall not apply to the extent that such provisions allow taxation by that other Contracting Jurisdiction solely because the income is also income derived by a resident of that other Contracting Jurisdiction".

[23] Article 5–Option C MLI.

[24] Parada, supra note 5, at 273.

[25] Article 3(5) and (6) MLI. See also, Article 11(3) and (4) MLI.



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residents (*saving clause*) can be well understood using a simple example. Let me assume a simple bilateral situation where P is an entity established in State S, and which is owned equally by A and B, who are residents in State R. We will also assume that State R considers entity P as a tax transparent entity, whilst State S considers the same entity P as a taxable entity. Let us also assume that entity P receives royalties from the use of an intangible located in State S, and which is not attributable to a permanent establishment (PE) of A and B in State S. Similarly, we will assume that both countries have a tax treaty in force, and that both signed and ratified the MLI making no reservations on Article 3(1), adopting also the simplified version of the saving clause, i.e., Article 3(3) MLI.

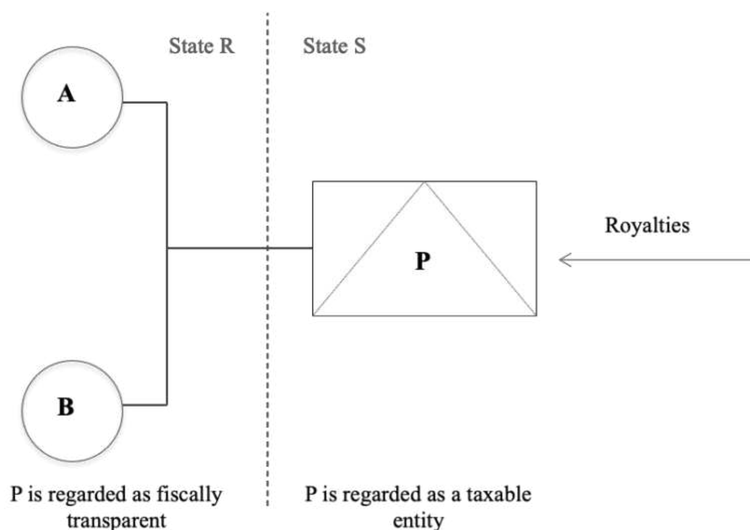


*Figure 1: Hybrid entity mismatch and the MLI*

As per Article 3(1) MLI, the benefit of the tax treaty between State R and S (which is the Covered Tax Agreement) shall be allocated to the owners A and B, who are residents in the country treating entity P as tax transparent. We will also assume for now that A and B are also the beneficial owners of the interest received. Therefore, exclusive taxing rights should be granted to State R in application of the tax treaty between both countries.[26] However, the signatory parties have also agreed to introduce Article 3(3) MLI, which, in simple terms, means that State S is allowed to tax the royalties at the level of entity P but

[26] Assuming that the tax treaty between countries R-S follows Article 12 OECD MC.



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not by application of the treaty, but rather based exclusively on its capacity as a resident of State S.[27]

As the reader can predict at this point, the interaction between the new MLI provision on tax treaty entitlement with the provisions aiming to protect the right to tax residents at source may create outcomes which are not necessarily aligned with the policy aims informing tax treaties.[28] However, this is not the only policy concern regarding the new MLI provision on tax treaty entitlement and its interaction with the rest of the tax treaty provisions, as we will learn in the remaining part of this work.

## 3. Assessing the MLI from a Tax Policy Perspective

This Section suggests an analysis of the MLI and hybrid mismatches in light of two specific tax policy baselines: cohesion with tax treaty objectives and equal allocation of taxing powers. After briefly explaining why these two policy baselines are chosen for the purpose of the analysis, the Section elaborates on the argument that the MLI has been incapable of aligning itself with any of them, contradicting the main purpose of tax treaties (the avoidance of double taxation), as well as reinforcing an unequal distribution of taxing powers between residence and source states.

### 3.1. Cohesion and Equality as tax policy baselines

Choosing cohesion with the objectives of tax treaties and the equal allocation of taxing powers as the two policy baselines of this analysis is not random. In fact, it attends to the essence of tax treaties as instruments aimed to allocate taxing powers internationally.[29]

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[27] This is also why, in essence, the saving clause in the United States served the purpose of protecting the U.S. right to tax its citizens at source. See Technical Explanation of the United States Model Income Tax Convention of 15 November 2006 at 3 (example of application);

[28] *Infra* Section 3.2.

[29] P. Baker, *An Analysis of Double Tax Treaties and their Effect on Foreign Direct Investment*, World Investment Report. Non-Equity Modes of International Production and Development, at 2 (United Nations, 2012) (arguing that tax treaties mitigate double taxation by "harmonizing tax definitions, defining taxable bases, assigning taxation jurisdictions, and indicating the mechanisms to be used to remove double taxation when it arises").



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First and foremost, the prevention or mitigation of double taxation is one of the foundational stones of the tax treaty interpretation, regardless that one could rightfully question whether countries ultimately sign tax treaties having as a unique purpose the avoidance of double taxation.[30] Yet, what nobody could argue against is that the objective of mitigating double taxation is not intrinsically embodied within the idea of dividing taxing powers among treaty partners. In fact, this is reflected in the core of the tax treaty relationship, where we will always see a contracting state giving up, wholly or partly, its sovereignty to tax an item of income when a person is subject to taxation on the same income in the other contracting state where he/she is a resident for tax treaty purposes.[31]

Some tax treaty textualists could argue that even though it is true that tax treaties mitigate double taxation, this is exclusively limited to juridical double taxation, i.e., situations in which the same taxpayer is taxed twice on the same item of income.[32] Although the argument is (textually) correct, nothing really prohibits that tax treaties are interpreted also as to cover cases of economic double taxation, that is, cases in which two different taxpayers are taxed on the same item of income. Indeed, there are plenty of examples from the tax treaty practice where this actually occurs, demonstrating that the distinction between economic and juridical double taxation is somehow redundant. For example, the 2015 tax treaty between Australia and Germany provides the possibility of a MAP in

[30] For example, see T. Dagan, *The Tax Treaty Myth*, 32 N.Y.U. J. Int'l L. Pol. 939 (2000) (arguing that the idea tax treaties exist primarily to alleviate double taxation would have its origin in a false premise that countries would not be able to do so in absence of them); R. Vann, "Chapter 18: International Aspects of Income Tax", in V. Thuronyi (ed), *Tax Law Design and Drafting* Vol. II, 37 (International Monetary Fund, 1998) (arguing that double taxation is less of a problem for developing countries or transition economies, which receives less foreign source income); J. Braun and M. Zagler, *An Economic Perspective on Double Tax Treaties with(in) Developing Countries*, World Tax J. 6 (2014) (providing an econometric analysis that demonstrates different motivations for developing countries to sign tax treaties).

[31] B. Arnold, *An Introduction to Tax Treaties*, UN Primer on Double Tax Treaties, at 10, available at https://www.un.org/esa/ffd/wp-content/uploads/2015/10/TT_Introduction_Eng.pdf (arguing that "originally, the focus of tax treaties was almost exclusively on solving the problem of double taxation. Multinational enterprises were facing risks of substantial double taxation, few countries provided unilateral relief for double taxation and treaty networks were just being developed").

[32] See, for example, M. Lang, "General Report", in *Double Non-Taxation*, 78-81 (Cahiers de droit fiscal international, Vol. 89a, International Fiscal Association, 2004) (arguing that tax treaties do not provide relief of economic double taxation).



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cases of economic double taxation generated by the taxation of residents at source.[33] Similarly, the UK tax treaty practice —although inconsistent— also recognises many cases in which a tax credit is granted when the same income is taxed in the hands of two different taxpayers.[34] The Australia-New Zealand tax treaty (2009) also includes a special provision that applies together with the tax transparency entity clause and which provides that where one state taxes a resident entity and the other a resident participant on the same income, the participant's state must give credit for residence taxation at the level of the entity, regardless of the source of the income.[35]

The analysis considers as a second policy baseline, which is the equal allocation of taxing powers between residence and source states. This second baseline comes more intuitively, and it is linked to the foundational rationale of tax treaties: the allocation of taxing rights. Actually, tax treaties embrace the idea of allocating taxing rights among contracting states in an equal manner in order to avoid double taxation. This is recognised in the general structure of tax treaties, which limit the taxing rights in the source state, but under the premise that a subsequent obligation to relief double taxation arises in the residence state, recognising a sort of *de jure* reciprocity.[36] Indeed, almost all provisions in a tax treaty

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[33] Parada, supra note 4, at 24. See also, Article 23(3) Australia/New Zealand Tax Treaty (2009) and paras. 2.318-2.322 of the Explanatory Memorandum, International Tax Agreements Amendment Bill No. 2, 2009.

[34] Nikolakakis et al., supra note 11, at 347. See also, UK: CA, 23 Mar. 2011, *Bayfine UK v. Commissioner for H M Revenue and Customs*, [2011] EWCA Civ 304 (where the UK claim exclusive taxing rights since no PE existed in the US); and UK: *Anson (Apellant) v. Commissioners for Her Majesty's Revenue and Customs (Respondent) [2015] UKSC 44 on appeal from [2013] EWCA Civ 63*, 1 July 2015 (where relief from double taxation was granted on the view that the income of the entity should be attributed to the members as such). In the opinion that the UK actually grants a tax credit every time that the saving clause is applied, see M. McGowan, *The Classification of Entities and the Meaning of "Tax Transparency" in United Kingdom Tax Law*, 179-185 (Doctoral Thesis defended on 29 Match 2021 at Vrije Universiteit, the Netherlands) (referring to the example of the 2001tax treaty US-UK, which provide the obligation to relief double taxation). See also, *Technical Explanation of the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains*, Article 1(8) in relation to Article 24 (the solution provided here is to give primary taxing rights to the State in which the entity is a resident, ensuring that double taxation is relieved by having the other State give a foreign tax credit for the taxes paid by that entity).

[35] Brabazon, supra note 11, at sec. 4.7.

[36] Arnold, supra note 31, at 2.



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underline this idea of reciprocity, even though in practice such reciprocity may still be considered more arguable.[37]

### 3.2. The Tax Policy Assessment

This Section elaborates now on the argument of how the MLI has been unable to align with any of the tax policy baselines that inform this analysis, contradicting the main purpose of tax treaties —the avoidance of double taxation— as well as reinforcing an unequal distribution of taxing powers between residence and source states.

#### 3.2.1. Cohesion with tax treaty objectives

The lack of cohesion with the main and traditional objective of tax treaties is quite evident when the new MLI provision on tax treaty entitlement —Article 3(1) MLI — interacts with those provisions protecting the rights of the source state to tax their own residents ––*saving clause* of Article 3(3) or Article 11 MLI— giving rise to situations of unrelieved double taxation.[38]

Let me use the same example of Figure 1 to elaborate on this argument. We will assume again, therefore, a situation where P is an entity established in State S, and owned equally by A and B, both residents in State R. Whilst State R considers entity P as a tax transparent entity, State S considers the same entity P as a taxable entity. Accordingly, entity P receives royalties from the use of an intangible located also in State S, and which are not attributable to a PE of A and B in State S. Finally, we will assume that both countries have a bilateral tax treaty in force, and that both signed and ratified the MLI making no reservations on Article 3(1), adopting also the simplified version of the saving clause— Article 3(3) MLI.

[37] For example, some countries may play more often the role of source rather than resident states. This could ultimately make us conclude that the idea of reciprocity is less applicable in practice.

[38] Parada, supra note 14, at 34-38.



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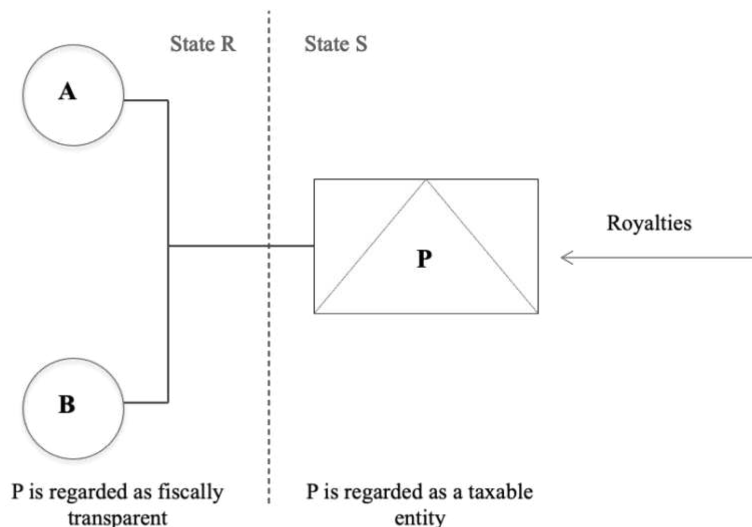


*Figure 2: HEMs and cohesion with tax treaty objectives*

We know so far that by application of Article 3(1) MLI, A and B are those who shall receive the benefits of the tax treaty between States R and S, assuming for this purpose that A and B are also the beneficial owners of those royalties.[39] However, the story does not end here. According to Article 3(3) MLI —simplified version of the *saving clause*— State S could also tax the royalties at the level of entity P. However, taxation in this case would not occur by application of the treaty, but rather due to the right of State S (source state) to tax its own residents. Since entity P is a taxable entity in that state, that is, regarded as a resident for tax purposes, State S will also tax the amount of royalties, generating a double taxation outcome.[40]

As a consequence of the above, one might conclude that A and B are entitled to relief from double taxation. However, the MLI clearly states in Articles 3(2) and 5-Option C that no relief from double taxation will proceed when the taxation at source is the exclusive result of the right of the source state to tax its own residents.[41] The OECD Commentary on Article 23A and 23B also confirm this. In particular, paragraph 11.1 clarifies that the phrase *"except to the extent that these provisions allow taxation by that*

[39] Supra Section 2.3 (explaining the functioning of Article 3(1) MLI).
[40] Supra Section 2.2 (explaining that the purpose of the saving clause is to protect the right of the source state to tax their own residents regardless of the effect of the treaty).
[41] Supra Section 2.2.



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*other State solely because the income is also income derived by a resident of that State"* actually means that "both States are not reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer".[42] This also coincides with the OECD Partnership Report's majority opinion addressing a similar hypothetical example.[43]

Although a strict interpretation of Article 23 OECD MC should provide us a similar result, that is, no relief from double taxation, it is undeniable that from a policy perspective this outcome is unsatisfactory.[44] It also contradicts the traditional main object and purpose of tax treaties, which is the avoidance of double taxation.[45] Indeed, beyond a formalistic approach that tax treaties only relieve cases of juridical double taxation, no real motive could reasonably serve to justify this outcome. This is perhaps the reason why, in practice, some countries actually decide to grant a relief,[46] or why the OECD Partnership Report minority's opinion disagreed with the idea of leaving this (economic) double taxation outcome entirely unrelieved.[47] Yet, the legal limitation is evident, and unless a modification to the MLI is made, this double taxation outcome becomes a permanent sunk cost.

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[42] Paragraph 11.1 of the Commentary on Articles 23A and 23B OECD MC.

[43] OECD Partnership Report, supra note 9, para. 131.

[44] In reference to the strict interpretation of Article 23 OECD MC in cases involving hybrid entities and the application of the saving clause, Michael Lang argues: "I am not convinced about the legal basis for such an indirect tax credit, even though it eliminates double taxation. It might be difficult to interpret article 23 so extensively that an indirect credit has to be granted". Opinion of M. Lang in the conference "Practical Problems of Tax Treaty Interpretation and Application", held in Vienna on 21 Oct. 2013, and summarized in: K. Dziurdz, D. Fuentes and E. Pinetz, *Case Studies on Partnerships and Other Hybrid Entities,* 68 Bull. Intl. Taxn. 3 (2014), at 153.

[45] Arnold, supra note 31. In this regard, see also Parada, supra note 14, at 41 (adhering to the idea that the double taxation outcome should be prevented, although recognising that this is not possible from the simple interpretation of Article 23 OECD MC).

[46] See the examples mentioned at *supra* Section 3.1.

[47] The OECD Partnership Report's minority opinion provided that the source state (State S in our example in fig. 1) should provide a relief from double taxation by allowing the residence state (State R in our example in Fig. 1) to exercise exclusive taxation on the royalties in the hands of the partners (A and B). OECD Partnership Report, supra note 9, para. 132.



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### 3.2.2. Equal distribution of taxing powers

But the MLI has not only failed to keep cohesion with the traditional tax treaty objective of avoiding double taxation. Indeed, it has also reinforced a more unequal distribution of taxing powers between residence and source states. This is evident when we consider the interaction between the new MLI provision of tax treaty entitlement and some specific allocative rules within treaties, particularly Articles 10, 11, and 12 OECD MC and the beneficial ownership requirement.[48]

Let me illustrate the above using the following example. We will assume a triangular scenario in which YCo is an entity incorporated in State Y, which is owned by partners A and B, who are residents in State X. YCo has also a subsidiary in State Z (ZCo) and receives interest payments from that subsidiary due to an intergroup loan, which is perfectly arm's length. Let us assume also that YCo is considered a taxable entity in State Y and Z, whilst it is regarded as a tax transparent entity in State X. YCo is not regarded a PE in State Y for tax treaty purposes either.[49] In addition, we will assume that the treaty entered into by State X and State Z provides for a reduced withholding tax of 5 per cent at source, whilst the treaty entered into by State Y and State Z provides for a reduced

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[48] This issue has been stressed in the past in reference to the OECD MC as an "unjustified preference for the state of residence". See Parada, supra note 11, at 345-349. See also, Nikolakakis et al., supra note 11, at 335. For the concept of beneficial owner, see, e.g. C. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* (IBFD, 1999); R. Fraser and 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*, World Tax J. 2 (2010); M. Lang, et al. (eds), *Beneficial Ownership: Recent Trends* (IBFD, 2013), and A. Meindl-Ringler, *Beneficial Owner in International Tax Law* (Kluwer Law International, 2016).

[49] If State X regarded YCo as a PE —assuming they have a tax treaty in force—, there will be no double taxation relief for the taxes imposed at the level of YCo in State Y. Similarly, if the same situation is analysed from the perspective of a trust, being the trust and the settlor residents in State Y 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. For this example, see R. Danon, *Qualification of Taxable Entities and Treaty Protection*, 68 Bull. Intl. Taxn. 4/5, 198-199 diagram 7 (2014).



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withholding tax of 10 per cent. Finally, we will assume that all countries involved have signed and ratified the MLI without reservations on Article 3(1) MLI.

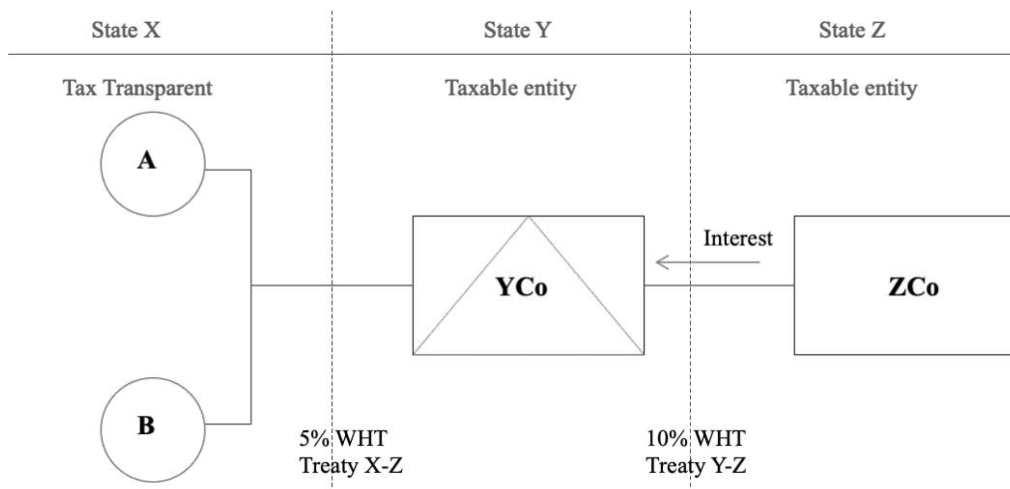


*Figure 3: HEMs and equal distribution of taxing powers (triangular example)*

In any triangular situation, such as the one suggested above, the relevant matter is to consider which tax treaties are potentially applicable. As noted already in the facts of this hypothetical, YCo is not a PE of A or B in state Y. Therefore, we can undoubtfully conclude that the treaty between states X and Y is not applicable.[50] Consequently, we have only two other options available, that is, the treaty between states X and Z and/or the treaty between states Y and Z. The tax treaty between states Y and Z is applicable since a resident in state Y receives interest from state Z (source state). Accordingly, both states consider YCo as a taxable entity. Therefore, there is no need to look at Article 3(1) MLI to conclude that the treaty is applicable. On the other hand, the treaty between states X and Z becomes applicable by the enforcement of Article 3(1) MLI, which provides that A and B should be those receiving the benefits of this particular tax treaty.[51]

Nevertheless, the story does not end here. As stressed already in this work, Article 3(1) MLI only answers the question of "who is entitled" to the benefits of a tax treaty.

[50] This is a residence-residence situation. Therefore, it is out of the scope of tax treaties.
[51] Supra Section 2.1.



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Therefore, it is necessary to consider now the specific attributive rules within the tax treaty to complete the tax treaty analysis.

In the case of interest, as well as dividends and royalties, the source state will grant a reduced withholding tax only to the extent that a resident in the other contracting state, receiving the interest payments, is also the *beneficial owner* of the interest.[52] This issue is more or less undisputable in the case of the tax treaty between state Y and state Z, which considers YCo as a taxable entity. Indeed, and unlike YCo acts as a nominee, agent, or conduit company, it is evident that no major discrepancy will arise with regard to treating YCo as the beneficial owner of the interest, ultimately obliging the source state Z to apply a reduced withholding tax of 10 percent in application of the treaty.[53] However, the issue is rather different regarding the treaty between states X and Z. In this case, the only options to avoid a conflictive outcome between the two states with regard to who is the beneficial owner of the income are basically two. First, to interpret Article 3(1) MLI extensively, that is, disregarding the fact that YCo is still seen as a taxable entity in the source state, and interpreting that the beneficial ownership test shall be carried out exclusively on partners A and B. Second, to presume that A and B are the beneficial owners of the interest, regardless of any considerations in the source state on this matter.[54]

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[52] For the concept of beneficial owner, see references at supra note 48. Whether the determination of the beneficial owner is a residence or source state's exclusive task is also subject to debate. For those who support a determination of the beneficial ownership status exclusively by the residence state, see Brabazon, Global Tax Treaty Commentaries IBFD, supra note 11, at sec. 4.4.2 (arguing that beneficial ownership may be taken to reflect residence state attribution). See also, D. Sanghavi, *BEPS Hybrid Entities Proposal: A Slippery Slope, Especially for Developing Countries*, 85 Tax Notes International 4, 361 (2017) (raising doubts on why the OECD commentary suggests that the beneficial owner should be determined exclusively in accordance with the tax principles of the source state). In contrast, see Parada, supra note 4, at 17 (arguing that the determination of the beneficial ownership should not be affected by Article 1(2) OECD MC, and should be done exclusively based on the source state's qualification and attribution rules). Similarly, see Nikolakakis et al., supra note 17, at 334.

[53] Let us remember that the OECD Commentaries does not define "beneficial owner" but tells us basically that whoever is not a nominee, agent or conduit company should be considered the beneficial owner of the income. This is because the term "beneficial owners" was included in Articles 10, 11 and 12 OECD MC to clarify the phrase "paid to a resident". With regard to interest (used in our example), see OECD Commentary on Article 11, paras. 9, 9.1, 10, 10.1 and 10.2.

[54] For those arguing to consider the interest of the source state in the determination of the beneficial owner, see Parada, supra note 4, at 17, and Nikolakakis et al., supra note 11, at 334.



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In either case, the source state has no say on the issue, reflecting a questionable preference for the residence state.[55]

Moreover, in our triangular case, we have to consider that two tax treaties are potentially applicable, but only one withholding tax can be exercised. Therefore, it is reasonable to ask what is the withholding tax rate that ultimately applies to both treaties. The original approach adopted in the 1999 OECD Partnership Report, as well as the subsequent modifications of the OECD Commentaries, provided that the interest payments should be taxed at the lowest withholding tax rate with regard to the two potentially applicable treaties.[56] However, this position evidently plays against the source state's interests.[57] Some might argue that in the inverse situation, i.e., the case in which the treaty between states X and Z offers a higher withholding tax rate in comparison to the treaty between states Y and Z, the position of the source state is protected. Yet, this is only partially correct. Indeed, granting the source state the possibility to apply a higher withholding tax between the two potentially applicable treaties creates a more favourable case for the source state, but the preference for the residence state to determine the beneficial owner does not disappear. In other words, the source state still has no say on this matter.[58]

Therefore, if one agrees that tax treaties embrace —at least theoretically— the idea of allocating taxing rights among contracting states in an equal manner in order to avoid double taxation, it is evident that the MLI fails to do so. This is not only reflected in the design of Article 3(1) MLI itself, which already denotes a preference for the residence state's interests, but also, and more importantly, when this provision interacts with the particular allocative rules of Article 10, 11, and 12 OECD MC. In this latter case, the preference for the residence state becomes even more evident, because it rests any relevance to what the source state must say regarding the beneficial owner of the income,

55 Parada, supra note 11, at 347 (arguing as regards a similar example that "winners and losers in the tax treaty equation can be clearly identified").

56 OECD Commentary on Article 1, para 6.5 (version 2014).

57 Paragraph 6.5 of the Commentary on Article 1 has been deleted from the 2017 OECD Model. However, considering the non-binding nature of the OECD Commentaries, nothing prevents that countries still interpret these situations according to the old OECD Commentaries.

58 See also, in this regard, the analysis of an enhanced "deemed beneficial owner" rule at *infra* Section 4.2.



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contradicting not only the nature of this requirement, but also some well-settled tax treaty practice on the contrary.[59] Ultimately, and as argued somewhere else, this imbalance preference for the residence state may raise further interpretation conflicts that could derive in the inapplicability of Article 3(1) MLI in all those hybrid entity transaction cases in which the payments of dividends, interest, or royalties are involved.[60]

## 4. Prospective Alternatives

This Section explores now three prospective alternatives that may not only help with restoring cohesion and equality in the distribution of taxing powers within tax treaties, but also add certainty and simplicity to the interpretation of the MLI and the issues related to hybrid entity mismatches. These alternatives include the following: i) a "reverse saving clause", ii) an enhanced (deemed) beneficial owner rule, and iii) a coordination of entities' classification rule within the MLI.[61]

### 4.1. A "reverse saving clause" to avoid double taxation

As stressed already, the MLI demonstrates a lack of cohesion with the traditional tax treaty objective of avoiding double taxation. This is particularly evident when the new MLI provision on tax treaty entitlement interacts with those provisions protecting the rights of the source state to tax their own residents (*saving clause*), giving rise to situations of unrelieved double taxation.[62] Therefore, and for the purpose of restoring the cohesion

[59] For example, it is a well-settled practice in the United States that the beneficial owner is determined exclusively based on the domestic rules in the source state. Article 11 para. 1 of the US Technical Explanations of the 2006 US Model provides: "[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". Similarly, some 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, Tax Treaty Case Law IBFD.

[60] Parada, supra note 11, at 354 (Fig. 5).

[61] The alternatives have the advantage that they all can be simultaneously applied as they address different concerns. However, the scope of the first two alternatives is considerably reduced if the third alternative (coordination rule) is actually implemented, as it will be explained below. Infra Section 4.3.

[62] Supra Section 3.2.1.



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with tax treaty objectives, and consequently some tax treaty coherence, this author proposes introducing a modification to the current MLI options of saving clause, which shall recognise now the mutual obligation of the contracting states to relieve double taxation, that is, a "reverse saving clause".[63] This alternative is not only more aligned with the ultimate aim of tax treaties, but also recognises the tax treaty practices followed by some countries around the world already.[64]

#### 4.1.1. Implementation

In practice, Article 11(2) MLI —detailed *saving clause*—shall be modified introducing a new paragraph, which could read as follows:

> "Paragraph 1 shall apply in place of or in the absence of provisions of a Covered Tax Agreement stating that the Covered Tax Agreement would not affect the taxation by a Contracting Jurisdiction of its residents. *However, where a resident company is subject to tax as such in a Contracting State but the income or capital of this company is, in the other Contracting State, taxed as income or capital of the participants in this company because the income is also income derived by a resident of that State, the Contracting States shall agree that the income and the capital of the company shall be considered as the tax, income and capital of the participants in this company in proportion to their entitlement to the company's capital in order to avoid double taxation".*

Similarly, the text of Article 3(3) MLI —simplified *saving clause*— shall be modified as follows:

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[63] The author has proposed a similar solution in the past, although strictly in the context of bilateral tax treaties. Such a proposal had the characteristic of being introduced through a modification of the OECD Commentaries, and had also a voluntary nature. See Parada, supra note 14, at 44-52 (arguing for a "optional reverse saving clause" within the OECD Model"). As such, that proposal differs from the current one, which is offers as a mandatory provision within the MLI. See Infra Section 4.1.1.

[64] Supra Section 3.1.



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"With respect to Covered Tax Agreements… the following sentence will be added at the end of paragraph 1: "In no case shall the provisions of this paragraph be construed to affect a Contracting Jurisdiction's right to tax the residents of that Contracting Jurisdiction*, bearing also in mind the mutual obligation of the Contracting States to avoid double taxation".*

Two other modifications to the MLI will be required in order to ensure the practical application of this proposal. First, both Article 3(3) and 11 MLI shall become minimum standards.[65] That is, signatory countries should not be provided the option to make a full reservation on either of these articles, unless they already have a similar provision in their bilateral treaties, which also include the new obligation to relief double taxation when taxation occurs due to the application of the saving clause.[66] Second, the text of Articles 3(2) and 5 Option C MLI shall also be modified as to recognise the new obligation to provide double taxation relief in circumstances when the taxation at source is the exclusive result of the right of the source state to tax its own residents.[67] Similarly, paragraph 11.1 of the Commentary on Article 23A and 23B of the OECD commentaries shall be amended, deleting any references to the fact that contracting states are not reciprocally obliged to provide double taxation relief when the taxation occurs exclusively due to the right of the states to tax its own residents.[68] For this purpose, a paragraph similar to the one proposed for Article 11 MLI above could be added to the OECD commentaries.

#### 4.1.2. Tax Policy Implications

There are two important policy implications if this proposal is finally implemented. First, the cohesion with the tax treaty objective of avoiding double taxation is restored. This is evident since tax treaties ultimately aim to mitigate double taxation, an idea that is

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65 Article 3(3) and 11(2) MLI are not minimum standards. *Supra* Section 2.2.

66 In other words, countries could be allowed to make a partial reservation if they demonstrate that they already have in force a provision similar to that proposed here. This is already possible under Article 11(3)(b) MLI and Article 3(5) letter b) to g) MLI.

67 Both provisions confirm that there is no obligation to relief double taxation. *Supra* Section 2.2.

68 Supra Section 3.2.1.



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intrinsically embodied within the functioning of tax treaties as a preferred tool to divide taxing powers among countries.[69] This aim, as already stressed in this work, goes beyond the formalistic distinction between juridical and economic double taxation, or the legitimate question on whether countries ultimately sign tax treaties having as a unique purpose the avoidance of double taxation.[70] Indeed, it is well recognised by the tax treaty practice where countries already include a reverse saving clause or a MAP as a way to provide double taxation relief precisely in the case of taxation based on the residence status of the taxpayer by the application of the saving clause.[71] Second, it reinforces the required certainty and flexibility in the interpretation of tax treaties, aligning them with their ultimate goal. This is quite relevant because if tax treaties represent the good will of two countries to limit their sovereign taxing rights ultimately to avoid double taxation, they should be flexible enough to accept that, in some cases, this double taxation may derive from income being taxed twice in the hands of two different taxpayers, and that there are no serious policy reasons that could justify leaving the solutions to these double tax cases exclusively to domestic provisions or isolated practices of some countries.[72] This proves to be particularly important in cases involving hybrid entity mismatches in the tax treaty context.

### 4.2. An enhanced (deemed) beneficial ownership rule

Another of the policy concerns stressed in this work is that the MLI has reinforced a more unequal distribution of taxing powers between residence and source states. This is particularly evident when we consider the interaction between the new MLI provision of tax treaty entitlement and the allocative rules of Articles 10, 11, and 12 OECD MC, particularly in reference to the beneficial ownership requirement. Indeed, and as demonstrated already in Section 3.2.2 above, the preference for the residence state in that case becomes even more evident than just looking at Article 3(1) MLI in isolation, preventing the source state from any say regarding who is the beneficial owner of the

[69] Baker, *supra* note 29
[70] *Supra* Section 3.1.
[71] See examples at *supra* Section 3.1, and reference at footnotes 31, 32 and 33 above.
[72] Parada, supra note 14, at 48-49.



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income. This does not only contradict the nature of the beneficial ownership requirement, but also gives rise to new interpretation conflicts.[73]

This issue has been well addressed by the international tax literature in the past, where commentators have raised concerns regarding a potential interpretative clash between the tax treaty entitlement rule on tax transparent entities and the specific allocative rules in a tax treaty.[74] As the matter appears to be difficult to solve unless a pragmatic view is taken, commentators have felt inclined to follow pragmatic solutions. One of them would be to presume that a particular resident is, under certain circumstances, also the beneficial owner of the income. This is what some authors have denominated a "deemed beneficial owner".[75]

Although this author has — with good reasons for that— criticised this approach in the past, he also recognises that a pragmatic view is the only feasible way to avoid interpretative conflicts, restoring also part of the imbalance preference for the residence state.[76] Therefore, he gives support to this solution here, although adding an important caveat for its implementation, which will be explained below.

#### 4.2.1. Implementation

In brief, and as mentioned already, the proposal for a deemed beneficial owner is based on the idea of preventing the inapplicability of Article 3(1) MLI, and it is divided into two steps.[77] The first step requires the source state to determine if the entity is an agent, nominee, or other intermediary. In other words, to determine whether or not the entity is the beneficial owner of the income received. If the response is positive, the source state should skip that entity and look directly to the owner of that entity. If the owner for which

[73] Supra Section 3.2.2.
[74] Nikolakakis et al., supra note 11, at 333-334. See also, Parada, supra note 11, at 349 et seq.
[75] Nikolakakis, supra note 11, 333-339.
[76] Parada, supra note 11, at 262-264 (criticising the excessive pragmatism of this proposal, as well as the use of deemed rules).
[77] Id., at 255-262.



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the entity is a nominee, agent, or other intermediary is considered as a taxable entity,[78] Article 3(1) MLI would not come into play.[79] In contrast, if the owner is a nominee, agent, or other intermediary for another fiscally transparent entity, then Article 3(1) MLI would be in play as regards to that other fiscally transparent entity.[80]

The second step applies only to the extent that the entity is regarded as fiscally transparent and is not considered as a nominee, agent, or other intermediary. Similarly, it applies when the entity is a nominee, agent, or other intermediary for another fiscally transparent entity.[81] Therefore, the first issue is to determine whether the entity is considered as fiscally transparent from the perspective of the source or residence state. If the entity is regarded as fiscally transparent from the source state's perspective, but it is considered a taxable entity by the residence state, then the source state must consider the entity as the beneficial owner of the income.[82] In contrast, if the residence state considers the entity as fiscally transparent, then one should take a look at the members of the entity. If the members are tax residents of the residence state, then the source state must consider those residents as the beneficial owners, unless that resident is considered a nominee, agent, or other intermediary.[83] If the resident is indeed a nominee, agent, or other intermediary, then the step requires a scrutiny of the principal. If the principal is a resident of the residence state and also a taxable entity from the residence state's perspective, then the source state should consider that the beneficial owner requirement is satisfied. In the other way around, if the principal is not a resident of the residence state and it is considered as

[78] It is not specified in the proposal, but this author assumes that the consideration of tax opaque or fiscally transparent refers to the consideration of the State of residence, even though the determination of nominee, agent or other intermediary is done from the perspective of the source state.

[79] Nikolakakis et al., supra note 11, at 336.

[80] The wording is confusing, but it seems to state that Step 2 of the proposal must be applied.

[81] Nikolakakis et al., supra note 11, at 336.

[82] "…the source state should be required to apply the treaty as if the beneficial owner is the entity, regardless of the legal nature of the entity or the effect of that in the source state's normal application of the beneficial owner principles". Id.

[83] It is correct to affirm in this case that if the resident is not regarded as a nominee, agent or other intermediary, it will coincide with the source state's determination of the beneficial owner. However, this is the result of the tax characterization of the entity by both states as fiscally transparent, because if both states agree that the entity is fiscally transparent, it is almost impossible that they conflict as regards to who is the beneficial owner and also the person being entitled to the benefits of the treaty.



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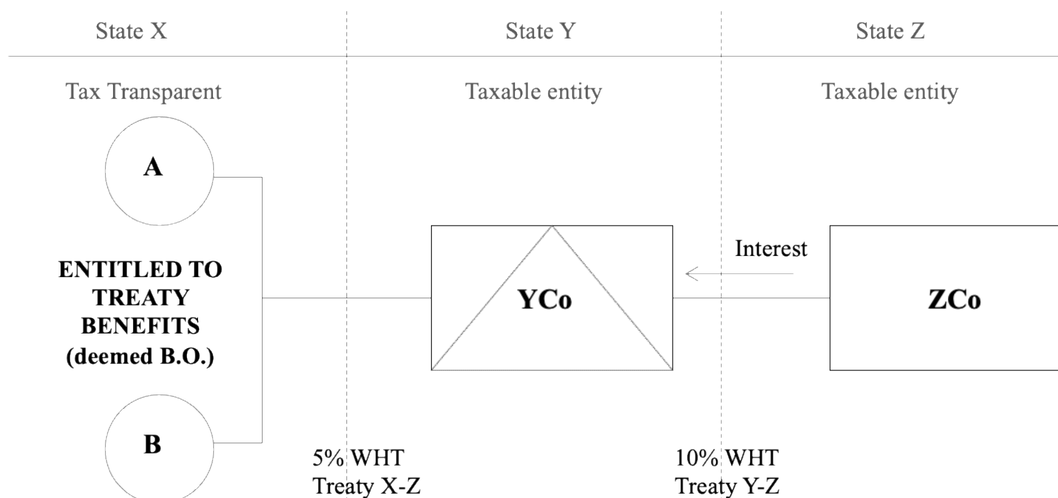
a taxable person (tax opaque) from the perspective of the residence state, then the beneficial owner requirement is not satisfied.[84]

Let me illustrate the outcome of this proposal using the example in Figure 3. If we recall the triangular scenario there, we concluded that the treaty between states X and Z is applicable by the enforcement of Article 3(1) MLI, which provides that A and B should receive the benefits of this tax treaty. However, that provision must be complemented by the specific allocative rule in Article 11 of the applicable treaty, which requires that A and B are also the beneficial owner of the income. This creates a problem since the characterisation of entity YCo in the example does not change. Therefore, country Z continues to be a taxable entity, and would arguably just agree that A and B are the beneficial owners of the income.[85]

Nevertheless, if the deemed beneficial ownership rule applies, it is the residence state's characterisation of the entity YCo which prevails, obligating the source state Z to look at the owners of YCo to determine the who is the beneficial owner of the income. Since both owners, A and B, are residents in State X, they will be presumed to be also the beneficial owners of the income too.




84 This is exactly the same solution provided in the tax treaty between Canada and the United States. See Convention between Canada and the United States of America with respect to Taxes on Income and on Capital of 26 Sep. 1980 (As amended through 2007), Articles IV (6) and IV (7).

85 Infra Section 3.2.2.



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*Figure 4: An enhanced (deemed) beneficial owner*

It is evident that this solution (a "deemed beneficial owner") does not solve the compromised position of the source state directly. On the contrary, one could reasonably argue that it worsens the position of the source state, reinforcing that of the residence state. Indeed, if we consider our triangular example, the source state Z would be hypothetically obliged to apply the lower withholding tax rate with regard to the two applicable tax treaties here.[86] For this reason, this author proposes that the deemed beneficial owner solution is applied with a small but important caveat, which is that in triangular situations such as the one used in this work, the deemed beneficial ownership rule is applied only to the extent that the treaty between the source state and the residence state of the owners (Z and X in our example) provides for a higher withholding tax rate than the tax treaty between the source state and the state of residence of the entity (Z and Y in our example). If this caveat is considered, we could ensure that the source state applies at least the higher withholding tax rate. This would restore —only partially— the imbalance generated by the interaction of Article 3(1) MLI and the beneficial ownership requirement in Article 11 of the applicable treaty.

#### 4.2.2. Tax Policy Implications

It is evident that including a deemed beneficial ownership does not solve *per se* the unequal distribution of taxing powers generated by the interaction of the new tax treaty entitlement rule in Article 3(1) MLI and the specific allocative rules on interest, dividends, and royalties. However, it mitigates it. Indeed, if applied with the caveat proposed in Section 4.2.1 above, the position of the source state improves in comparison to its application without the caveat, even if this small improvement is not enough to confirm that an adequate balance between residence and source states now exists.[87] In addition, one should also consider that the parallel implementation of a coordination rule

[86] OECD Commentary on Article 1, para. 6.5 (version 2014), eliminated in the 2017 OECD MC. See also the analysis at supra Section 3.2.2.

[87] The source state Z should still be obligated to apply the treaty with X and Y. However, it could retain more revenues since it will apply a higher withholding tax rate.



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for the classification of entities within the MLI will naturally reduce the scope of application of the deemed beneficial ownership alternative.[88] Therefore, solving entirely the tax treaty imbalance is actually not needed at this point either.

In addition, there are two other important tax policy consequences that arise with the implementation of a deemed beneficial ownership rule. First, legal certainty. Indeed, and as recognised by some commentators already, the potential interpretation conflicts that the interaction of Article 3(1) MLI and the specific allocative rules on interest, dividends, and royalties might ultimately imply that the relevance of the new provision of tax treaty entitlement for tax transparent entities is reduced to zero.[89] This is probably not what the proponents of this provision had in mind.[90] However, it is also true that the concept of beneficial owner is not the clearest tax treaty notion either. Hence, recognising the potential interpretation conflict and providing a deemed rule to solve it may ultimately grant certainty to the interpretation of tax treaties. Second, it is undeniable that pragmatism can bring some simplicity, too. This is strictly connected with the idea of providing both taxpayers and tax administration a clear application and interpretation of the new rule of tax treaty entitlement —Article 3(1) MLI— and its interaction with the rest of the allocative rules within tax treaties, particularly with those requiring a resident to be also the beneficial owner of the income. In fact, the clearer the interaction between these provisions, the easier for both taxpayers and tax administration to apply the particular tax treaty. There are no doubts that a deemed rule may contribute in this regard, also serving as a good example of positive pragmatism in tax law.[91]

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[88] Infra Section 4.3

[89] Nikolakakis, supra note 11, at 335; Parada, supra note 11, at 357.

[90] Nikolakakis, supra note 11, at 301-302.

[91] Pragmatism in tax law is not always good, though. For example, an excessive pragmatism in a context different than this could bring us to odd unprincipled outcomes, as it happens with the idea of "full taxation" and "fiscal-fail safe rules". For the concept of full taxation, see R. Mason, *The Transformation of International Tax*, Am. J. Int'l Law 114:3 (2020) (who originally argued that BEPS reflects and effectuates full taxation, serving also to support what she denominates "fiscal fail-safe rules", or provisions linking the taxation in one country with the tax outcomes in another country). See also, N. Noked, *Defense of Primary Taxing Rights* 40 Va. Tax Rev. 341 (2020) (arguing for a 'defensive primary taxing right tax' which would follow the full taxation approach proposed by Ruth Mason); S. Moyal, *Back to Basics: Rethinking Normative Principles in International Tax,*73 Tax Lawyer 1(2019) (arguing for a broader interpretation of single taxation in order to set a minimum effective tax rate); I. Grinberg, *The New International Tax Diplomacy*, The Georgetown Law Journal 102:1137



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### 4.3. A coordination rule for the classification of entities

Although all the previous alternatives explored in this work may help restoring cohesion with the tax treaty aim of avoiding double taxation, providing also some basis for an adequate tax treaty balance between residence and source states, none of them truly attend to the original nature of the issues related to hybrid entity mismatches. That is, the disparities among countries as regards to the tax characterisation of entities. Therefore, this Section elaborates on the idea to use the coordinative-multilateral nature of the MLI to target the core of hybrid entity mismatches: disparities. The proposal is simple and consists in introducing a provision within the MLI, which coordinates the characterisation of entities for tax purposes, eliminating the hybrid entity mismatch in its origin. For this purpose, particular details regarding the implementation of a provision of this nature are addressed, including also the policy implications of it.[92]

#### 4.3.1. Implementation

As noted already, the proposal aims to introduce a provision that coordinates the classification of entities among contracting states using the MLI as a coordination platform. In particular, a new paragraph shall be added to Article 3(1) MLI, providing for the coordination in the characterisation of entities following the tax characterisation given in the "home country" of the entity, that is, the country where all the necessary legal formalities required for the entity's establishment are fulfilled.[93] The new paragraph could read as follows:

(2016) (stressing the influence of BEPS in the shaping of the international tax governance). In contrast, see L. Parada, *Full Taxation: The Single Tax Emperor's New Clothes*, 24 Florida Tax Rev. (2021-forthcoming) (arguing that, although rhetorically attractive, full taxation is still conceptually inconsistent).

[92] This proposal is inspired in the proposal for a "reactive coordination rule", which was proposed in the tax literature as a domestic solution to deal with hybrid entity mismatches domestically. The current proposal builds upon some elements of this original proposal, with the difference that it uses the MLI as an implementation (coordination) platform rather than attending purely to domestic law. For the proposal for a reactive coordination rule, see Parada, supra note 5, at 353-398.

[93] Parada, supra note 5, at 355 (explaining that the "home country" is where all legal formalities of establishment are fulfilled).



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*"Where according to the rules of a State, a different tax characterisation is given to the same entity, the tax characterisation given to the entity by the State where the entity is legally organized shall be followed by the other State, but only to the extent the State where the entity is legally organised has a tax treaty in force with all relevant States".*

Coordinating the characterisation of entities in the "home country" has some practical advantages. First, it deviates from the traditional tax treaty distinction between residence and source, which may bring its own problems to achieve coordination. For example, it is not a surprise to anyone that an entity could be resident in more than one state at the same time, or that in a triangular case the source state will not coincide with that where the entity is legally organised. In contrast, the "home country" — or the country governing the formalities of constitution—will be in essence only one jurisdiction, avoiding interpretation issues.[94] This proves to be true even in cases of legal entities organized at a supranational level, such as the European Company (SE),[95] the European Cooperative Society (SCE),[96]or the European Economic Interest Grouping (EEIG).[97] Although these legal forms are to a large extent governed by uniform EU law, they are still partly regulated by the national provisions of the MS of incorporation.[98] Secondly, it is evident that a coordination provision within the MLI would solve the hybrid entity mismatch regarding the characterisation of a particular entity among the tax treaty partners, reducing the scope of Article 3(1) MLI to those cases in which the source or residence country, in a bilateral context, treats their own domestic entities as tax transparent.[99] Therefore, both in light of simplicity and coherence the "home country" appears still as a superior option.

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94 Id.

95 EU: EC Regulation 2157/2001, Official Journal L 204/01.

96 EU: EC Regulation 1435/2003, Official Journal L 207/03.

97 EU: EEC Regulation 2137/1985.

98 L. Cerioni, *Cross-Border Mobility of Companies in the European Union: Tax Competition and Increased Scope for the CCCTB following Cartesio,* 64 Bull. Int'l Taxn. 12, 636 (2010). See also, J.J.A.M. Korving and L.W.D. Wijtvliet, A Consideration of the European Foundation: Alle Menschen warden Spender, 67 Bull. Int'l Taxn. 9 (2013).

99 See "bilateral example" and "triangular example" at infra Sections 4.3.1.1 and 4.3.1.2.



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It is also important to highlight at this point that the reference to "entity" used in the proposed text shall be understood in a broader perspective. That is, as including also any other arrangement, regardless of the legal position taken by a country as to who derives the income from that entity and whether or not the entity or arrangement has legal personality according to the rules of a specific jurisdiction. In other words, the use of the word "entity" is not limited to "legal entities" and comprehends also other investment vehicles.[100] Similarly, the proposal includes a sort of anti-tax treaty abuse measure that denies the application of the coordination provision in cases where the tax characterisation to be followed corresponds to that of a third state different from the residence of the entity's owners or the source state of the income. In those cases, the provision will apply only to the extent both resident and source states have a tax treaty in force with the "home country" of the entity, avoiding issues of cherry picking. This issue is further explained in relation to the triangular example below.[101]

#### 4.3.1.1. Bilateral example

Let me illustrate the application of the provision using the example of Figure 1.[102] If we recall, the example describes a situation where P is an entity established in State S, and owned equally by A and B, both residents in State R. Whilst State R considers entity P as a tax transparent entity, State S considers the same entity P as a taxable entity. Accordingly, entity P receives royalties from the use of an intangible located also in State S, and which are not attributable to a PE of A and B in State S. In that example of Figure

[100] A *legal entity* can generally be understood as "a body having legal existence separate from its owners or participants […], such that is capable of having its own rights and incurring its own liabilities." IBFD Glossary, available online at the IBFD Tax Research Platform, accessed on 24 Jan. 2017. The author also recognizes that the term "arrangement" can generate its own interpretative problems, as it happened with Article 1(2) OECD MC. This is why it is avoided in the main text of this proposal, despite of the fact that it is included in Article 3(1) MLI, as well as in Article 1(2) OECD MC. For the discussion on the term "arrangement" included in Article 1(2) OECD MC, see Parada, supra note 11, at 236. See also, E. Schaffer, "Chapter 5: Implications of BEPS Action 2 and its Relevance for the Application of Article 17 of the OECD Model", in M. Lang, *Domestic Attribution of Income and Taxation of International Entertainers and Sportspersons: Theory and Practice of Art. 17 OECD Model Convention* (IBFD, 2017) (who explains that the term arrangement actually denotes an idea of flexibility so as to include not only traditional legal entities).

[101] Infra Section 4.3.1.2.

[102] Supra Section 2.3.



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1, we also assumed that both countries have a bilateral tax treaty in force, and that both signed and ratified the MLI making no reservations on Article 3(1), and adopting also the simplified version of the saving clause— i.e., Article 3(3) MLI.

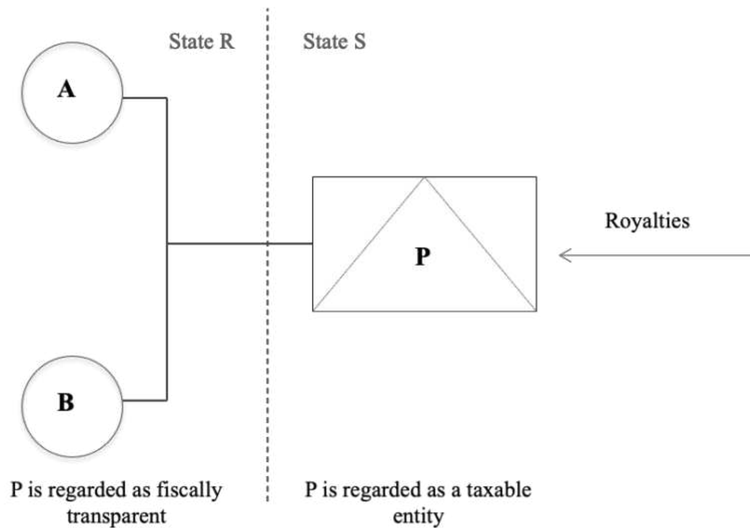


*Figure 5: MLI coordination rule (ex-ante bilateral example)*

If we consider now that Article 3(1) MLI also includes a new paragraph providing for a coordination in the characterisation of entity P in its "home country" (which in our case coincide with the source country S), we arrive to the conclusion that the tax treaty between the two countries is no longer relevant. In other words, this transaction becomes a pure domestic concern.

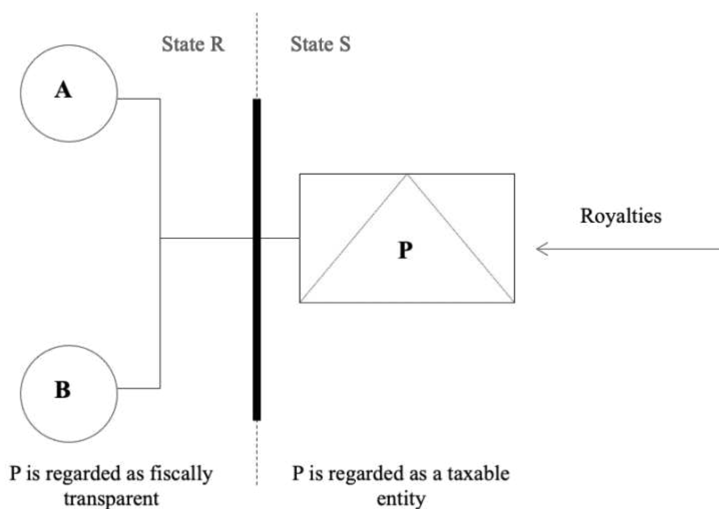


*Figure 6: MLI coordination rule (ex-post bilateral example)*



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This outcome, which *a priori* might appear disadvantageous, since the benefits of the tax treaty are no longer granted, in reality it is not such. On the contrary, it restores the logic from the source state's perspective, which during the whole transaction recognises P as a taxable entity, and see the transaction as a domestic one. Indeed, the tax characterisation of the entity at source state still remains a matter of domestic law, and it does not change by the application of Article 3(1) MLI. In other words, Article 3(1) MLI only alters the dynamic of granting treaty benefits, giving priority to the tax characterisation of the entity in the residence state of the owner. However, that does not mean that the source state, in practice, modifies its domestic law to recharacterise the entity established in its own territory.[103]

Similarly, and from the residence state's perspective, it is not a bad outcome either. In fact, state R will recognise now that if the contracting state where the entity is organised considers the entity as a taxable entity (state S), that characterisation shall be followed by the other contracting state. Therefore, this new coordination provision does not only eliminate the hybrid entity mismatch, but it also puts on evidence that the benefits of the treaty were indeed never really required. Indeed, now that this transaction proves to be a pure domestic concern for both contracting states, nothing prevents the source state taxing the royalties at the level of entity, which is a resident taxable entity in that state. Accordingly, nothing prevents that those royalties are also included as CFC income in the state of residence of the owners A and B. The potential double taxation arising should not be a concern at all because most of the countries around the world provides for domestic relief in these cases.[104] In contrast, it is interesting to compare that if Article 3(1) MLI applied granting the benefits of the treaty to A and B, state S (source state) would still be capable of taxing the royalties received through entity P, although not by application of the treaty, but rather by the fact of having a resident in state S. Yet, the double taxation outcome arising in this case would remain unrelieved, contradicting the

[103] Parada, supra note 11, at 364 (arguing regarding a similar example concerning Article 1(2) OECD MC that the result is a "fairer one from the perspective of the source state").

[104] Just as an example from US legislation: IRC section 960 provides for a Foreign Tax Credit (FTC) as regards taxes paid at the level of the foreign subsidiaries. If a Corporation claims the credit, the applicable provision is IRC section 902. Likewise, the deemed FTC under section 960 is available for taxes paid by subsidiaries until the sixth tier.



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very purpose of tax treaties.[105] Therefore, the application of the coordination provision indirectly prevents that outcome, simplifying the whole transaction, and making it more desirable.

Other examples could be included here.[106] However, in essence, the premise will always be the same: the dynamic of granting or denying tax treaty benefits in case of tax transparent entities will be now determined *a priori* by the coordination achieved by residence and source countries with regard to the tax treatment of an entity. This does not mean that Article 3(1) MLI becomes useless. On the contrary, it remains relevant for all those bilateral cases, where an entity is considered as tax transparent by all contracting states due to the application of the coordination of entities rule. In such a case, both contracting states will have to adhere to such treatment (tax transparent), making Article 3(1) MLI fully operational.[107] In other words, it is the scope, and not the utility of Article 3(1) MLI, which is reduced by the proposed coordination provision.

#### 4.3.1.2. Triangular example

Let me illustrate now the application of the coordination provision using the example of Figure 3 again. This example involves a triangular situation, where YCo is an entity incorporated in State Y and owned by A and B, who are residents in State X. YCo holds a subsidiary in State Z (ZCo) and receives interest payments from that subsidiary. Whilst YCo is considered a taxable entity in State Y and Z, it is regarded as a tax transparent entity in State X. YCo is not regarded a PE in State Y for tax treaty purposes. We will also assume different withholding tax rates with regard to the applicable treaties. Whilst the treaty entered into by State X and State Z provides for a reduced withholding tax of 5 per cent at source, the treaty entered into by State Y and State Z provides for a reduced

[105] Supra Section 3.2.1 (analysis of the interaction between Article 3(1) MLI and the saving clause).

[106] Parada, supra note 5, at 374-385 (including a variety of bilateral example in reference to the "reactive coordination rule" proposed).

[107] This is easy to understand because even if both countries consider the entity as tax transparent, that is not enough to say that this entity is a resident for tax treaty purposes. Therefore, Article 3(1) MLI is still relevant because provides that the relevant residents to consider will be the owners of the entity, who could claim the benefits of the tax treaty if the requirements of the particular allocative rule were also met.



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withholding tax of 10 per cent. Finally, we assumed that all countries involved have signed and ratified the MLI without reservations on Article 3(1) MLI.

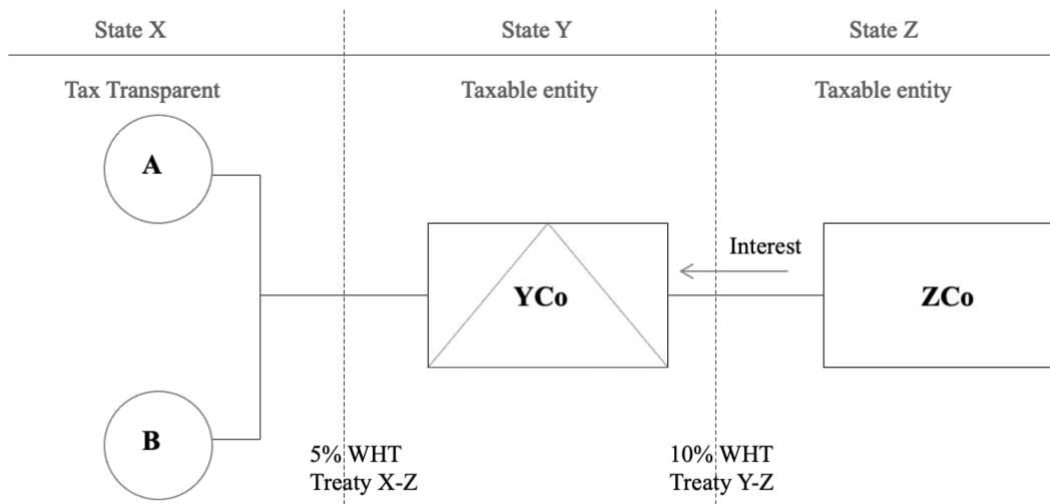


*Figure 7: MLI coordination rule (ex-ante triangular example)*

This triangular case left us two important lessons regarding the unequal balance in the allocation of taxing powers between residence and source states. First, the application of the treaty between states X and Z, unlike the treaty between states Y and Z, is the direct result of Article 3(1) MLI, which provides that A and B should receive the benefits of that treaty. That is, it is the tax characterisation in the residence state of the partners A and B which triggers the application of the treaty. Second, whilst Article 3(1) MLI grants the benefits of the treaty to A and B, the final answer regarding granting/denying the tax treaty benefits corresponds to the specific allocative rule in the treaty (Article 11 of the applicable treaty in our case). This could drive to a potential interpretative conflict between Article 3(1) MLI and the specific requirement stated in Article 11 of the treaty X-Z, which requires that A and B are the beneficial owners of the interest payments.[108]

Let us consider now that Article 3(1) MLI also includes a new paragraph providing for a coordination in the characterisation of entity P in its "home country". In this case, the three states involved shall treat YCo as a taxable entity, which is the tax treatment given in the country where this entity was legally organised. As a result of this, Article 3(1)

[108] Supra Section 3.2.2.



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MLI will have no relevance anymore. In other words, only the tax treaty between States Y and Z will be applied.

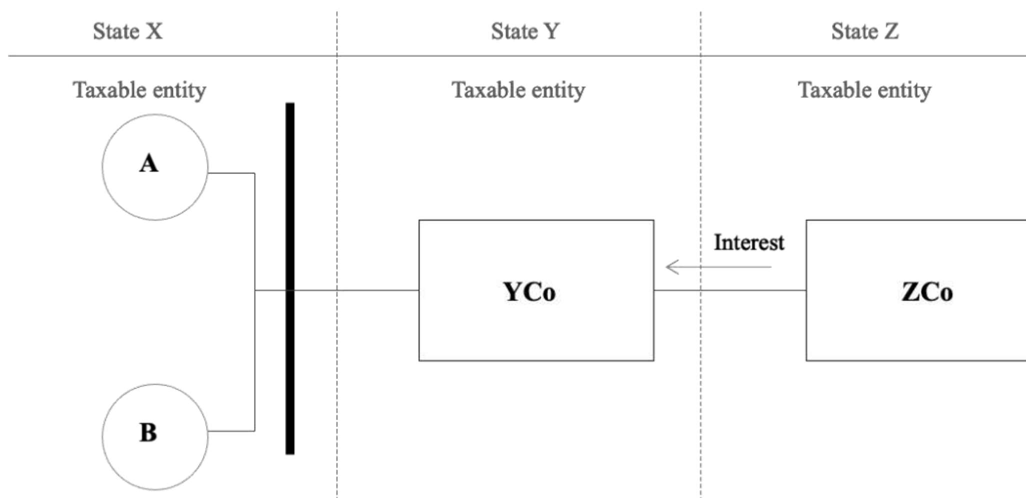


*Figure 8: MLI coordination rule (ex-post triangular example)*

The outcome provided by the application of the coordination provision in this triangular case is certainly fairer from the source state's perspective, and at least neutral from the residence state's perspective. Indeed, from the source state perspective, State Z will no longer be obligated to limit its taxing rights at source just because the tax characterisation in the country where the partners of an entity are located is different from that given to the entity in the country where this is legally organized, and which coincide with that of the source state.[109] Similarly, any interpretative conflicts between the new MLI provision on tax treaty entitlement and the specific allocative rules requiring a resident to be also the beneficial owner of the income —affecting the source states' interests— will indirectly be avoided.[110] From a residence state's perspective, the outcome appears to be at least neutral when compared to that when Article 3(1) MLI applied. In fact, the residence state of A and B (State X) can still tax the interest received by YCo, now considered as taxable entity, as CFC income in the hands of A and B. Accordingly, A and

[109] This is indeed the main effect of Article 3(1) MLI. *Supra* Sections 2.1. and 3.2.2.

[110] Supra Section 3.2.2.



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B will still be granted a relief from the taxation.[111] Therefore, and although the position of the residence state has not improved, it has not been negatively affected either.

As well as in the case of bilateral examples, plenty of variations can be assumed in other triangular situations.[112] However, all of them work under the same premise, which is that granting or denying tax treaty benefits in cases of tax transparent entities will now depend on the coordination regarding the tax treatment of an entity. Yet, there is still a caveat to consider here.

As noted already in this work, and unlike bilateral situations, triangular cases could generate more concern about abusive practices, particularly about choosing a third state, different from that of residence of the owners or source state, to establish an entity and to indirectly get the benefits of a tax treaty.[113] To avoid this outcome, this author proposes to trigger the application of the coordination provision in these cases only if that third state —where the entity is legally organised— has a tax treaty in force with both the residence state of the owners and the source state of the income. This could be done including a particular reference in the explanatory statements of the MLI and the commentaries of the OECD MC. However, the non-binding nature of these instruments could serve no purpose in the end.[114] This is why the author suggests the inclusion of the following text directly in Article 3(1) MLI:

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[111] As noted already, the relief from double taxation is a general practice associated to CFC legislation. See, for example, the case of the United States, supra note 104.

[112] For example, Parada, supra note 5, at 386-395.

[113] The concern is relevant and should be addressed. Otherwise, the residence country of the owner of an entity in a triangular case similar to Figure 3 (State X and Z) could simply use a third state (Y) to set up a partnership (or any tax transparent vehicle) and get the benefits of the treaty with Z.

[114] Regarding the non-binding nature of the OECD commentaries (which could be equally applicable to the MLI statements), see, for example, D. Ward et al., *The Interpretation of Income Tax Treaties with Particular Reference to the commentaries on the OECD Model*, 18 (IBFD, 2005) (arguing that the commentaries are not intended to be binding). See also, H. Pijl, *The OECD Commentary as a Source of International Law and the Role of the Judiciary*, 46 Eur. Taxn. 5, 224 (2006) (arguing that the commentaries cannot be considered to be a binding source of international law); F. Engelen, *Some Observations on the Legal Status of the Commentaries on the OECD Model*, 60 Bull. Intl. Taxn. 3 (2006) (agreeing with the non-binding nature, but suggesting that OECD members and parties of a treaty would be bound by conduct to interpret and apply a treaty in accordance with the commentaries); C. West, *OECD Commentaries in Tax Treaties: A Steady March from "Soft" Law to "Hard" Law?*, 9 World Tax J. 1 (2017) (analysing cases in which a treaty or a protocol expressly referred to



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"*…but only to the extent the State where the entity is legally organised has a tax treaty in force with all relevant States*".[115]

This phrase should act as a stopgap to prevent cherry picking behaviours from taxpayers in triangular cases, where the State where the entity is legally organised does not coincide either with the resident state of the owners of that entity or where the income is sourced.[116]

#### 4.3.2. Tax Policy Implications

The inclusion of a provision in the MLI that coordinates the characterisation of entities for tax purposes has plenty of policy advantages. First, it addresses all the concerns stated in this work with regards to the new MLI provision on tax treaty entitlement and tax transparent entities, if not directly at least indirectly. Indeed, as demonstrated already, the application of a coordination rule reduces the scope of application of Article 3(1) MLI, which also indirectly reduces the conflicts between this provision and the specific allocative rules of Article 10, 11, and 12 OECD MC.[117] In other words, it may help restore the imbalance between residence and source states generated by Article 3(1) MLI.[118] Second, and although it does not directly address the lack of cohesion with the tax treaty objective of avoiding double taxation generated by the interaction of Article 3(1) MLI and the saving clause, it does so indirectly. In fact, as seen in the bilateral example above, a coordination provision restores the logic from the source state's perspective in regard to the tax treatment of an entity established in that state, making the transaction a pure domestic concern. This indirectly avoids the odd result derived from the interaction

them as an interpretational rule); A. Navarro, *International Tax Soft Law Instruments: The Futility of the Static vs Dynamic Interpretation Debate*, 48 Intertax 10, 849 et seq. (2020) (challenging the allegedly attributed hierarchy of the OECD commentaries vis-`a-vis other non-binding interpretation materials, such as scholarly work).

115 The expression *"all relevant States"* tries to catch triangular situations where more than one treaty is potentially appliable.

116 Supra note 113.

117 Supra Section 4.3.1.

118 Supra Section 3.2.2.



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between Article 3(1) MLI and the saving clause, and the unrelieved double taxation produced.[119]

But this is not all. A coordination provision reinforces three other particular tax policy aims that are embodied in its design: simplicity, coherence, and ease of administration. Indeed, a provision, such as the one proposed, provides a simple way of coordinating the characterisation of entities for tax purposes among countries, avoiding hybrid entity mismatches. This is achieved under the simple premise that the origin of the mismatch is no other than the disparities among countries regarding how to treat entities for tax purposes, [120] which connects us with the second policy aim associated to this proposal: coherence. A coordination rule does not only target the core of the issue regarding hybrid entity mismatches, but also coordinates the despair tax characterisation of the entity with that given originally in the country where the entity is legally organised. This has total logic, in my view, because if a reaction should be produced to avoid the hybrid mismatch, this should come from the State that originated the mismatch, that is, the one that qualified an entity differently from its country of origin.[121] Moreover, the proposal for a coordination provision avoids excessive reliance upon foreign laws and unnecessary contingencies with regard to the outcomes of hybrid transactions, which is the essence of the current rules targeting hybrid entity mismatches worldwide.[122] Finally, it is undeniable that such a proposal is a step forward towards easing transaction costs both for taxpayers and tax administrations. Indeed, pursuing coordination in the tax characterisation of an entity, as per the one given in its country of legal organisation, reduces the complexities associated to different domestic tax characterisation rules in light of the dynamics of granting or denying tax treaty benefits.

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[119] Supra Section 4.3.1 in relation to Section 3.2.1.

[120] Parada, supra note 5, at 184 (arguing that hybrid and reverse hybrid entities are simply the result of domestic decisions on how to treat domestic and foreign entities for tax purposes).

[121] Similarly, Lüdicke states: "It is primarily for the state which qualifies foreign entities differently from their home state to introduce anti-hybrid mismatch rules […]". J. Lüdicke, *"Tax Arbitrage" with Hybrid Entities: Challenges and Responses*, 68 Bull. Intl. Taxn. 6/7, 317 (2014). See also, Parada, supra note 5, at 359.

[122] Parada, supra note 5, at 360.



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In spite of the above, one should also recognise that this proposal may raise two important potential criticisms. First, using the MLI as a coordination tool reduces the possibilities of hybrid entity mismatches only in those cases where the countries involved in a hybrid transaction have a tax treaty in force. Therefore, it addresses the problem only partially. Second, some might rightfully argue that it is unlikely that countries agree to limit their sovereignty to characterise entities for tax purposes. Although the first criticism is correct, it is not enough to disregard the fact that a scenario with a coordination provision within the MLI is definitely more desirable that one without it. As for the second criticism, it seems to be completely unfounded. Indeed, countries have demonstrated since the very origin of tax treaties the willingness to limit their domestic sovereignty even to tax certain items of income. Why should they not be willing to limit their capacity to characterise foreign entities for tax purposes? Indeed, *a priori*, the level of domestic sovereignty compromised appears to be lower in comparison to that of taxing an item of income. Yet, this is an issue that will require a high-level of (political) persuasion, particularly when some influential countries still pursue elective domestic rules to characterise entities for tax purposes.[123]

## 5. Conclusions

This article has argued that, from a tax policy perspective and strictly related to the dynamic of granting/denying tax treaty benefits in cases involving hybrid entity mismatches, the MLI has not been what one would call a success. Indeed, the MLI has been incapable of keeping cohesion with the main object and purpose of tax treaties, also reinforcing a more unequal distribution of taxing powers between residence and source states. In light of these concerns, the article has explored three prospective alternatives that could not only restore the lack of cohesion and equality within tax treaties, but also add certainty and simplicity to the interpretation of the MLI and the issues related to

[123] The U.S. "check-the-box" system is perhaps the best example of it. For a brief summary of the U.S. elective system, see Parada, supra note 5, at 129-156. See also, for example, K. Mullis, *Check-the-Box and Hybrids: A Second Look at Elective U.S. Tax Classification for Foreign Entities*, 64 Tax Notes Int'l 5 (2011); S. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 35 Hofstra L. Rev. 405 (2005); M. Gianni, *International Tax Planning After Check-the-Box*, 2 J. Passthrough Entities 39 (1999).



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hybrid entity mismatches. The alternatives presented do not attempt to be unbeatable solutions, but rather to serve the purpose of guiding us on how we could put the MLI to the service of old coordination problems, such as the one related to hybrid entity mismatches. This is precisely where the novelty of this work relies upon, and perhaps the necessary step to stop conceiving the MLI just as a mere instrument to simplify the modification of bilateral tax treaties worldwide, but instead as a true multilateral-coordination instrument.

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