eJournal of Tax Research (2019) vol. 17, no. 1, pp. 1-34

After the flood: transparent and hybrid entities in Australian tax treaties after the MLI

Mark Brabazon SC[1]

Abstract

This article analyses the treatment of fiscally transparent entities (partnerships, trusts, check-the-box entities, etc) and their income under Australian tax treaties after the commencement of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Instrument, or MLI). It identifies the operation of article 3 of the MLI, its relationship with the OECD Model tax treaty and unresolved issues under the transparent entity clause of those
rent
entities including its current operation, changes under the MLI, and particular provisions that address some otherwise unresolved issues.

Key words: Tax treaties, fiscally transparent entities, hybrid entities,

1. INTRODUCTION

partnership, trust, estate or an entity that qualifies for US check-the-box transparency is capable of attracting treaty benefits as the income of a resident of a contracting state.

The ultimate impact of the MLI in relation to fiscally transparent entities remains to be seen.[6] Although a majority of MLI signatories have made or foreshadowed reservations against its provisions on that subject, a significant number of Australian treaties will

when the MLI was signed already deal with the subject in one way or another. Once the MLI is fully operative, that number will rise to 21.[7] This article identifies how each of

or dealing

with income of fiscally transparent entities after the flood of MLI modifications.

Section 2 describes the historical background to the provisions of the MLI and the 2017 update to the OECD *Model Tax Convention on Income and on Capital* (OECD Model)[8] with respect to the treatment of fiscally transparent entities and the potential impact of the MLI on Australian tax treaties. Section 3 outlines the relevant provisions of the OECD Model (2017) and the MLI and identifies corresponding choices available to MLI signatories. Section 4 notes some outstanding issues with respect to the application of the transparent entity clause and its interaction with other treaty provisions. Section 5 outlines the status of the relevant MLI provisions in the elections announced by signatories. Section 6 provides an overview of Australian treaties that already contain provisions dealing with transparent entities or that will acquire such provisions under the MLI. Section 7 considers in some detail each of the Australian treaties that already have such provisions, the manner in which they will be affected by the MLI, and particular provisions that differ from the basic OECD template and in some respects resolve outstanding issues concerning the application of the transparent entity clause and its interaction with other treaty provisions. Section 8 considers the impact of the MLI on those treaties which will acquire a transparent entity clause for the first time. Section 9 summarises the findings of the study.

2. Background

The centrality of treaties to international income taxation is largely due to the work of the League of Nations and the OECD.[9] The OECD Model now serves as a standard by

---

6

72(4/5) *Bulletin for International Taxation*

Bulletin for International Taxation 598.

7 Treaties with the United States, France, Japan, New Zealand and Germany (which already address the issue, discussed in sections 6 and 7) and with Argentina, Belgium, Chile, Fiji, Ireland, Mexico, the Netherlands, Norway, Poland, Romania, Russia, Slovakia, South Africa, Spain, Turkey and the United Kingdom (discussed in sections 6 and 8). The recently signed treaty with Israel, which is yet to come into force, also contains a transparent entity clause and will bring to 22 the number of Australian treaties affected by some form of transparent entity provision.

8 OECD, *Model Tax Convention on Income and on Capital*. Where a particular version is referred to, this is indicated by the relevant year of update. The present version dates from 21 November 2017 (OECD Model (2017)); the last preceding version dated from 26 July 2014 (OECD Model (2014)).

9

19(3) *Columbia Journal of Transnational Law* porate Integration, Tax Treaties and *Tax Law Review* 565, 567-

(1997) 46(5) *Duke Law Journal* 1021, 1066-1089; Reuven S Avireference to which bilateral treaties are negotiated and understood. Without some such model, the present international network of over 3,000 treaties could not have come into existence.

The application of tax treaties to fiscally transparent entities is now within the mainstream of treaty analysis,[10] but it was not always so. The OECD Model and its forebears focused historically on the income of individuals and corporations.[11] Partnerships, trusts, deceased estates and other entities dwelt

In the present decade, treaty issues relating to fiscal hybridity and transparency have been drawn into the work of the BEPS project. Implementing recommendations of the BEPS project under Action 2 on hybrids[14] and Action 6 on treaty abuse,[15] the 2017 update of the OECD Model has introduced a transparent entity clause as article 1(2), a saving clause as article 1(3), and a parenthetical qualification in article 23 A and B which excludes residence-country double tax relief to the extent that the other contracting state has purely residence-based taxing rights. Those changes each have counterparts in the MLI, which serves as a clearing house for the modification of existing treaties in order to implement treaty-related measures of the BEPS project and the 2017 update. The MLI was signed on 7 June 2017 and entered into force on 1 July 2018. It is in the process of taking effect for signatory jurisdictions and in relation to covered tax agreements between them as they deposit their instruments of ratification.[16]

Whether through the MLI directly, through the 2017 update of the OECD Model, or through the indirect impact of those instruments, the transparent entity clause and associated reforms may be expected to have a significant impact on actual tax treaties in the near to mid term and will raise a number of policy and interpretive questions.

OECD Model Article 1(2)	MLI Article 3(1)
For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.	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.

The transparent entity clause is not an obligatory core provision of the MLI. A signatory country may reserve against article 3 generally,[25] or against article 3(1) in respect of treaties that already contain provisions which in certain respects have an analogous operation and which the reserving country wishes to continue in operation.[26]

The saving clause of the OECD Model has two counterparts in the MLI, a general saving clause in article 11(1) and a contextual saving clause in article 3(3) which only affects the operation of the transparent entity clause:

OECD Model Article 1(3)	MLI Article 11(1)

MLI Article 3(3)

With respect to Covered Tax Agreements for which one or more Parties has made the reservation described in subparagraph a) of paragraph 3 of Article 11 (Application of Tax

Own Residents), the following sentence will be added at the
the provisions of this paragraph be construed to

The general saving clause follows the logic of the OECD Model, although the listed exclusions are somewhat wider. This difference reflects the fact that the MLI has to deal with actual treaties which may depart from the OECD Model, and the MLI exclusions accommodate some such departures. There is also a catch-all exclusion applicable to

own residents or provide expressly that the Contracting Jurisdiction in which an item of income arises has the exclusive right to tax that item of i [27] This expresses an underlying policy common to the OECD Model and the MLI, that the saving clause is not intended to negate those treaty benefits which deliberately address residence-based taxation.

The general saving clause is not a core provision, and either country may reserve against it.[28]

The contextual saving clause in MLI Article 3(3) is a fall-back provision.[29] A covered tax agreement only acquires that provision if it acquires a transparent entity clause under MLI article 3(1), but not a general saving clause under MLI article 11. It does not possess a list of exclusions, presumably because its effect is only to limit the operation of the transparent entity clause. It cannot be imagined, for instance, that the residence country of a partner in a fiscally transparent partnership could rely on the contextual saving clause to refuse relief under a conventional double tax relief article.

If a signatory to the MLI accepts article 3(1) but rejects article 11, there is no further option to reserve against article 3(3).

The parenthetical amendment to the double tax relief article of the OECD Model and the corresponding MLI provision, article 3(2), are materially identical[30] in their interaction with the transparent entity clause:

[27] MLI art 11(1)(j).
[28] MLI art 11(3)(a).
[29] See also OECD, *Explanatory Statement to the Multilateral Convention*, above n 24, [42], [154].
[30] See also ibid [41].

OECD Model Article 23 A (1), (2), 23B (1)	MLI Article 3(2)
allow taxation by that other State solely because the income is also income derived by a resident of that State [or because the capital is also capital owned by a re	2. Provisions of a Covered Tax Agreement that require a Contracting Jurisdiction to exempt from income tax or provide a deduction or credit equal to the income tax paid with respect to income derived by a resident of that Contracting Jurisdiction which may be taxed in the other Contracting Jurisdiction according to the provisions of the Covered Tax Agreement 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.

The OECD parenthetical and MLI article 3(2) exclude residence-country relief under the double tax relief article only to the extent that the right depends on the residence of its own taxpayer. Although both countries may tax on a residence basis under their domestic law, the treaty may recognise one or even both of them as entitled to tax on a source basis to some extent and thus support corresponding residence-country relief.[31] These provisions have been presented as a matter of clarification,[32]

Of the 27 jurisdictions that accept article 3 in whole or part, 12[48] have indicated reservation against article 11 with the consequence that, if article 3(1) is engaged, it is qualified by article 3(3), and five (Japan, Luxembourg, Malaysia, Ireland and the United Kingdom) have indicated reservation against article 3(2).

6. OVERVIEW OF AUSTRALIAN TREATIES

The Australian treaties that already include provisions dealing with the income of partnerships or other transparent entities or will acquire a transparent entity clause under the MLI are summarised in Table 2.

Table 2: Overview of Australian Treaties

Treaty	*Transparent entity clause or similar*	*Saving clause*	*DTR parenthetical*	*Other*
United States 1982, 2001 (not covered)	Art 4(1) (re partnerships, estates & trusts partial residence)	Art 1(3), (4)	No (cf Art 22, which Model)	
France 2006	Arts 4(5), 29(1), (2), Protocol (2) (France rejects MLI 3; Australia reserves under MLI 3(5)(d)))	No (France rejects MLI 11)	No (France rejects MLI 3)	
Japan 2008	Art 4(5) (Australia re î ate d œ Ł			

nd has yet to be legislated or to enter into force. It contains a transparent entity clause, a saving clause and a double tax relief parenthetical based on the OECD Model (2017).[49]

7. TREATIES WITH TRANSPARENT ENTITY PROVISIONS

This section considers the five Australian tax treaties that made provision for the income of partnerships or fiscally transparent entities before the MLI. It addresses the impact of the MLI, the effect of relevant treaty provisions and their relationship with the provisions of the OECD Model 2017.

7.1 Australia – United States

The Australia

The Australian extrinsic material is uninformative on how partial residence was supposed to work in the treaty.[53] The US view seems to be that it was intended generally to deliver treaty benefits to Australian or US resident partners in respect of their shares of partnership income. The US Technical Explanation of the treaty says that

> a partnership, estate or trust is a resident of Australia for purposes of the Convention only to the extent that the income it derives is subject to Australian tax as the income of a resident either at the level of the partnership, estate or trust or in the hands of a partner or beneficiary, or, if that income is exempt from Australian tax under the Treaty, it is exempt solely because it is subject to US tax.[54]

The partial residence approach was part of US treaty practice from the 1970s until 1995. Publication of the 1996 US Model marked the abandonment of that approach in favour of the transparent entity clause. In 1999 the OECD Partnership

although the proviso [in the treaty definition of a resident of the United States] is expressed negatively

when read as a whole, the proviso makes sense if it is directed at

concerned events in the 2007 income year, proceeded on the basis that Partnership Report principles embedded in OECD Commentary are material to the interpretation of the treat
appeal without casting doubt on the propriety of reference to that material,[80] which appears to have been accepted by the parties. Reference to Partnership Report principles may be justified on the basis that they entered the Commentary in 2000, before the last agreed revision of the treaty in 2001.

Alternatively, it may be justified if one takes the view that Australia and the United States are both parties to an imputed international agreement that the Commentaries apply on an ambulatory basis as updated from time to time.[81]

The question of beneficial ownership which affects some classes of income is separate from the attribution nexus mentioned above. The US view is that, when a source country is considering beneficial ownership, it applies the principles of its own domestic tax law relating to income attribution. This is by no means a universally held view.[82]

∉ In the case of dividend income derived through the entity by a corporate participant, is the requirement of direct holding in art 10(2)(a) or ownership of shares in art 10(3) inconsistent with holding and derivation through the entity?

The treaty stipulates lower (art 10(2)(a)) or zero (art 10(3)) source-country taxation of dividends if the person beneficially entitled is another company
at least 10 per cent (art 10(2)(a)) or, for twelve

representing at least 80 per cent (art 10(3)) of the voting power in the paying company. If a restrictive view is taken of partial residence, a US corporate partner may be locked out of enhanced treaty benefits. It will be recalled that the present article 10 dates from the 2001 protocol. The US Technical Interpretation of the protocol takes the view that direct holding can be traced through a fiscally transparent shareholder entity, which seems to imply that treaty benefits can be granted by reference directly to the participant, but it is not clear that a US partner would receive similar treatment in Australia.[83]

The result is unclear

The meaning and effect of the partial residence provisions cannot be stated with certainty. Even if, in many or most partnership cases, the principles of the OECD Partnership Report are treated as applicable as a matter of practical administration so that income attribution for purposes of access to treaty benefits is determined with reference to the tax law of the relevant residence country, the *Resource Capital Fund* cases show how unclear the rights of partnerships and their members presently are. There is no guidance on whether a similar principle would be applied to the income of trusts and estates, although the issue may be less pressing where the trust or estate is fiscally resident in the same country as the relevant beneficiary because the conditions for partial residence will likely be satisfied by the entity.

7.1.3 Other provisions

The treaty contains a saving clause such as the United States consistently requires.[84] Its double tax relief article differs from the OECD Model.

The concerns that motivated the parenthetical qualification of the double tax relief article in the OECD Model are addressed by the treaty, but not in exactly the same way. In the United States, the foreign tax credit is limited by reference to foreign income.[85] This principle is recognised by the treaty, which gives US double tax relief subject to the limitations of US tax law.[86] In the case of Australia, credit under the treaty only arises for US tax on US-sourced income and excludes tax on the basis of US citizenship or elective residence.[87] There is a special provision for US citizens who are residents of Australia.[88]

7.1.4 The treaty and the OECD Model

It is unfortunate that the partial residence provisions were not replaced at the time of the 2001 protocol. Owing to the difficulties that have been exposed with respect to partnerships, it has now become somewhat urgent that the partial residence provisions of the treaty be updated. The most obvious solution is to adopt the transparent entity clause which both countries apply in their contemporary treaties.

7.2 Australia – France

The Australia France Treaty (2006) is not affected by MLI article 3 because France has reserved against that article generally. Had that n
reservation would have prevented article 3(1) from taking effect or superseding articles 4(5), 29(1), (2) and protocol (2) of the treaty, which address certain cases relating to transparent or translucent partnerships.[89]

7.2.1 Treaty provisions

The treaty provisions applicable to partnerships are influenced by the particular French tax treatment of partnership income, which differs from the transparent or opaque tax treatments that apply in most other countries. Several classes of French partnerships and similar entities are considered to be fiscally translucent: entity-level income gives rise to tax liability on the part
rates, but the liability is incurred on behalf of the entity.[90]

to a
different set of conditions.

- in all respects as though those amounts had
been derived directly this is similar to the special condition that applies to Australian partners in an Australian partnership, but here it also applies to French partners. The
of Australia or France with
the third country. The thir

partner directly. The treaty does not say whi
though one might guess that it has the residence country in mind. The fourth condition is that the relevant information exchange must be possible between the relevant contracting state (Australia or France) and the third country.

For completeness, it may be observed that the treaty will acquire a double tax relief parenthetical in the terms of MLI article 3(2). The similarity between that provision and the parenthetical in the OECD Model (2017) is such that the corresponding Commentary on Article 23 should provide guidance, subject to resolving any difficulty arising from the fact that the 2017 update to the model and commentary were published in November 2017, after the signature of the MLI by most countries (including Australia and New Zealand), although before the deposit of any instruments of ratification and before its enactment in Australian domestic law.[120]

7.5 Australia – Germany

The Australia Germany Treaty (2015) is not affected by the MLI because neither party has nominated it as a covered tax agreement. The recommendations of the BEPS project were known or anticipated during the negotiation process and have been taken into account in the terms of the treaty.[121] The treaty and its contemporaneous protocol also recognise and seek to resolve a number of outstanding problems with the BEPS project recommendations and the post-BEPS OECD Model.

Article 1(2) of the treaty is materially indistinguishable from the transparent entity clause of the OECD Model (2017). The potential for uncertainty in the scope of its operation is reduced by article 23(3) and paragraph 7 of the protocol. Article 23(3) is a super-saving clause: it saves the operation of domestic anti-avoidance rules without providing (as the general saving clause does) for exclusions.[122] Paragraph 7 of the protocol deems a list of rules to have the requisite anti-avoidance character, including [123] Article 23(3) requires the competent authorities to consult for the elimination of any resulting double taxation, but not so as to give the taxpayer a right to initiate a mutual agreement process.[124] The rule is modelled on similar provisions in the Australia United Kingdom Treaty (2003),[125] to which the consultation requirement has been added as a safeguard. It may be that a super-saving cloml ! men _ y .

Article 1(2) leaves residence-residence double taxation unaddressed in a hybrid situation where the entity is non-transparent in its residence country and transparent in the residence country of a participant. Where double taxation results, paragraph 2 of the horities of the Contracting States shall consult each other pursuan taxpayer a right to initiate the mutual agreement process under article 25(1) but, being expressed in mandatory terms, goes further than the provision for discretionary consultation under article 25(3).[127]