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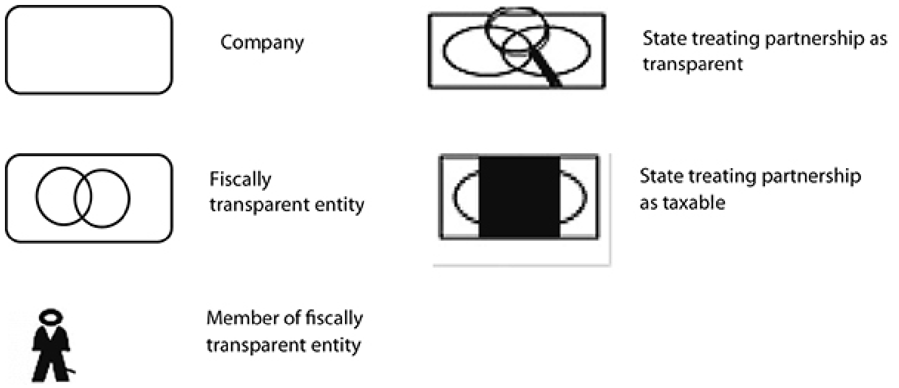
Obligation to provide double taxation relief in the case of *hybrid entities* under the 2017 OECD Model

PRERNA PESHORI

1. Introduction

Article 23A and 23B obligates the residence state to grant double taxation relief when the source state has taxed the income in accordance with the convention. [1] However, in the case of *hybrid entities* , the difference in the characterization of *entities* results in the conflict of the allocation of income to different taxpayers by two states, resulting in economic double taxation as well as double non-taxation. Therefore, it becomes complicated to determine as to whom the double tax relief is to be granted since the two states allocate the income to different taxpayers. Also, the application of different treaty provisions by the contracting state due to differences in their treatment under domestic tax law has resulted in qualification conflicts, giving rise to double taxation as well as double non-taxation.

In the 2017 update to the OECD Model Convention, the Commentary on Article 23A and 23B has now provided a section on double taxation relief in the case of *hybrid entities*by illustrating through various examples. The OECD has attempted to resolve the economic double taxation caused due to the allocation conflict, however, due to the new parenthetical text added to Article 23, it has expressly refused to resolve double taxation arising out of the residence-residence conflict. Therefore, it becomes imperative to analyze whether the residence-residence conflict needs resolution and, if yes, how the same can be resolved. Further, when the OECD takes the stance that source state follows the residence state principle for the allocation conflict, the same stance gets reversed for qualification conflict. Therefore,



This chapter extensively analyses the obligation to give double taxation relief under Article 23 in the case of *hybrid entities* and suggests an approach to resolve the double taxation. In this context, Section 2 gives some historical overview on the treatment of granting double tax relief to *hybrid entities* under Article 23 prior to BEPS. Section 3 discusses the interaction of Article 23 with the treaty entitlement clause under Article 1(2), and Section 4 discusses the interaction of Article 23 with the saving clause under Article 1(3). Section 5 provides a critical analysis of Article 23, the new parenthetical text added, and the addition to the OECD Model Commentary. Also, the treaty practices relating to double tax relief for *hybrid entities* is discussed extensively. Section 6 deals with double tax relief in the case of qualification conflicts and, finally, Section 7 deals with the timing issues arising in the case of *hybrid entities*. The author concludes the article by providing some solutions to avoid unintended double taxation (See Section 8).

2. Article 23A and 23B prior to the BEPS amendment

Article 23A and 23B deals only with the juridical double taxation when the same income is taxable in the hands of the same person by more than one state. [2] In 2000, the OECD Model Commentary addressed the economic double taxation resulting in the case of fiscally transparent *entities* due to conflict of allocation. The OECD Commentary provided that, in order to provide double taxation relief to the partner, the state of residence of the partner, to the extent it flows through the income of the partnership to the partner, it must also flow through the taxes paid by the partnership to the partners (but only to the extent the other state has taxed in a capacity of a source state). [3] This was based on Example 18 of the OECD Partnership Report. [4] Therefore, if the partners residence state ignores corporate status that is given to the partnership, it should likewise ignore it for purposes of the foreign tax credit. [5] This position is based on the assumption that the partnership residence state and the source state are the same [6] since the OECD Commentary does not provide for the resolution of double taxation arising due to residence-residence conflict.

Therefore, this situation does not apply in the triangular situations when the partners are resident in a third state and both the partners residence state as well as the partnership residence state tax solely on the basis of residence. If the partnership is considered as a PE of the partners, then the partners residence state would be required to grant the double tax relief for the taxes paid by the partnership.

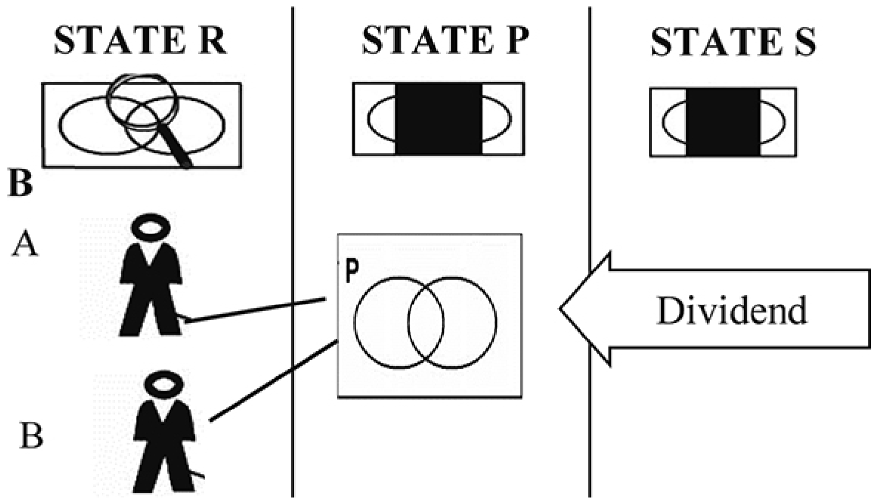
Also, it was unclear whether, in the reverse situation when the partners residence state is also the source state, then the partnership residence state would be obliged to grant double tax relief for the taxes paid by the partners. [7]

3. Interaction of Article 23A and 23B with Treaty Entitlement Clause Article 1(2)

3.1. Treaty Entitlement under Article 1(2)

The treaty entitlement clause under Article 1(2) determines who is entitled to the treaty benefit in the case of fiscally transparent *entities*. It extends the treaty benefit to the members of the fiscally transparent entity to the extent they are liable to tax in their residence state.

Due to application of Article 1(2), the issue becomes complicated in the triangular situation (dealt with in Example 9 of OECD Partnership Report) when the members are resident in third state that treats the entity as fiscally transparent whereas the entity residence state and the source state treats it as opaque. In such a situation, the source state would tax the income in the hands of the entity while such income will also be taxed in the residence state of the member as well as the entity. [8] The OECD Partnership Report states that the source state should respect both the treaties with the partnership residence state as well as the partners residence state and should limit its taxing rights by imposing the lowest rate of tax allowed under the two treaties. [9] Though, this paragraph was deleted in the OECD Model 2017, but, Article 1(2) would still require the source state to respect its treaty obligation with both the partners residence state and the partnership state. Therefore, if USD 1,000 dividend is paid by a company in State S, and the tax treaty between State P and State S provide for 5% withholding tax and that, between R and S, provide for 10% tax, then State S would have to respect the treaty obligations under treaty with both states and would apply the lowest tax rate of 5% under Article 10(2) of the P-S treaty. Assuming the tax rate under domestic law of State P and State R is 30%, then both states would tax on dividend income. However, the following issues arise with respect to credit obligation.



3.1.1. Dual Credit of taxes paid in Source State

When the taxes are paid in the source state by the entity and not by the members, the issue arises which state would grant the double tax relief under Article 23A/23B for the taxes paid in the source state. The tax treaties do not grant indirect tax credits [10] as, in the source state, credit of taxes is accrued to the entity and, therefore, the members may not be able to take the credit of taxes in their residence state. [11]

Assuming that State R allows indirect credit, this could also result in dual credit of taxes paid in the source state as State R as well as State P may both grant credit of taxes paid in State S of USD 5. However, as the income is also being taxed in both States, the credit can be granted in both states. [12] Further, if the members residence state flows through the income of the entity, it should also flow through taxes to the members. [13] If P is considered as a PE of the partners and if state R applies the credit method for business profits under the R-P treaty, then State R can give the credit of taxes paid in State P after reducing the credit of taxes paid in State S, i.e. State P would tax @ 30% and would grant the credit of 5% paid in State S, and State R would grant the credit of 25% tax paid in State P.

3.1.2. Residence-Residence Conflict

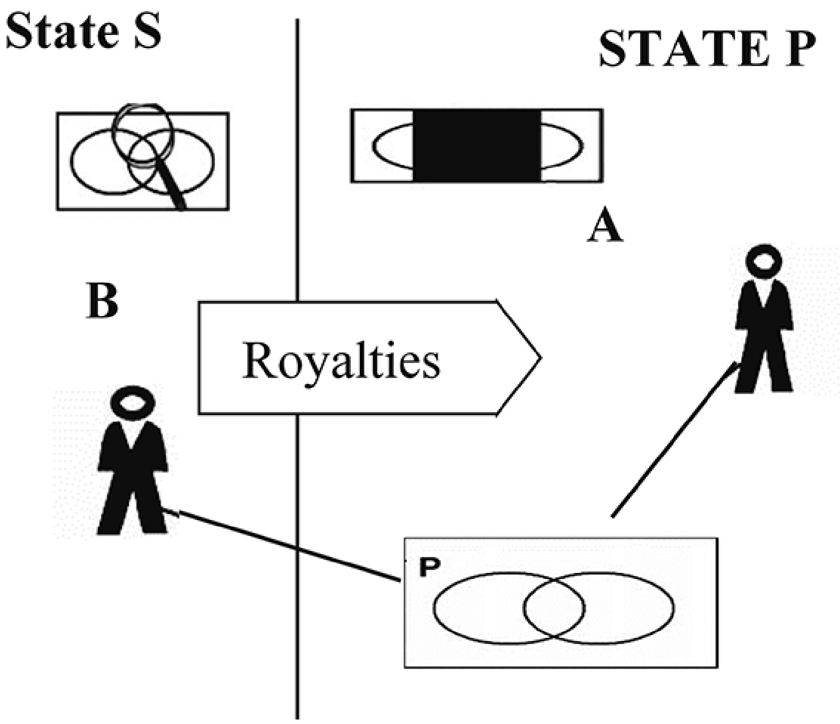
As both State R and State P allocate the income to their residents, this results in economic double taxation. The conflict goes beyond the residence-source principle and is based on the residence-residence principle as neither state taxes in the capacity of the source state except when the entity is regarded as a PE of the members A and B. However, if P is not regarded as a PE of A and B, there can be unrelieved double taxation as both states tax in the capacity of solely residence states. [14] The total tax liability in that case would be 25 +25 (assuming dual credit in State R and P) + 5 paid in State S = 55.

4. Interplay of Article 23A/23B with the Saving Clause Article 1(3)

The Saving clause in Article 1(3) preserves the right of the contracting state to tax its own residents. It provides that, when the source state is also a residence state of the member or the entity, its right to tax is not limited by the tax treaty.

Examples 16 [15] and 17 [16] of the OECD Partnership Report deals with the effect of the saving clause.

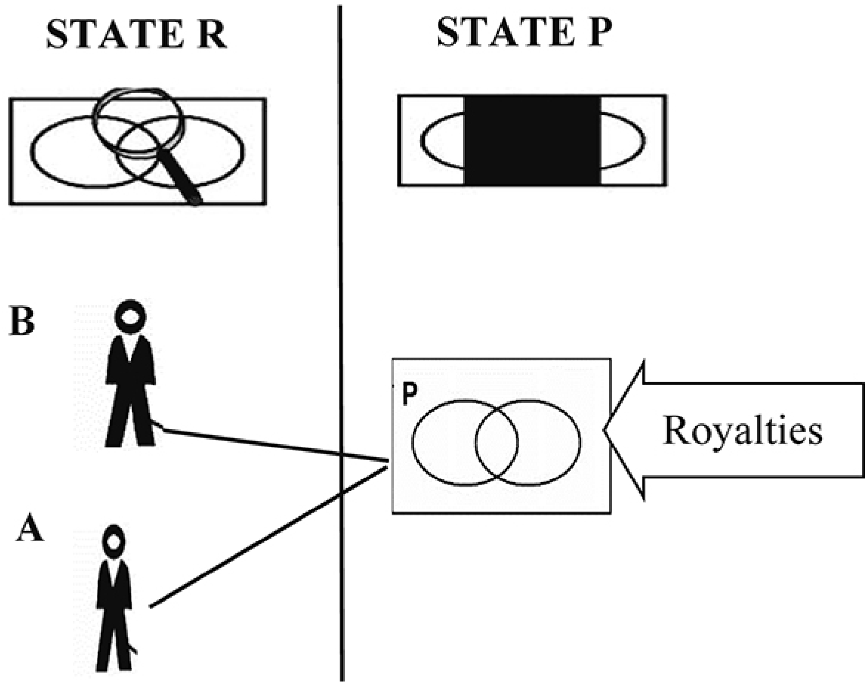
Example 16 of the OECD Partnership Report



P is a partnership established in State P having 2 partners, A and B. B is resident in State S, and A is resident in State P. P treats the partnership as taxable while S treats it as transparent. P receives royalties from State S that are not attributable to a PE in State S. As per Article 12 of the OECD Model, royalties shall only be taxable in the residence State P. Here, State S is a source as well as the residence state of partner B. Therefore, Article 1(3) limits the application of Article 1(2) and saves the right of State S to tax its own resident without any limitation.

Therefore, with respect to the share of Partner B, Article 12 would not apply, and Article 7 would apply whereby State S would have the unrestricted right to tax royalties pertaining to partner B. With respect to partner A, Article 12 will still apply.

Example 17 of the OECD Partnership Report



P is a partnership established in State P. A and B are P's partners who reside in State R. State P treats Entity P as a taxable entity while State R treats it as a transparent entity. P derives royalty income from State P that is not attributable to a PE in that state. Here, State P is the source as well as the residence state of partnership P. Article 1(3) limits the application of Article 1(2) and saves the right of State P to tax its own resident without any limitation of Article 12 which provides for residence-based tax. Here, by virtue of Article 7, State P shall have an unrestricted taxing right.

In both Examples 16 and 17, double taxation arises due to the fact that both the states tax in the capacity of the residence state. Therefore, it becomes important to determine whether, in such cases, double tax relief can be granted under Article 23.

5. Obligation of the residence state to give double taxation relief under Article 23A/23B

Prior to 2017, as highlighted under Section 2, the OECD only provided through its Commentary that a partner's residence state, if it flows through the income of the partnership to the partner, then it must also flow through the taxes paid by the partnership. There was no clarity with respect to double taxation relief regarding the residence-residence conflict.

Therefore, BEPS Action Plan 6 highlighted that Article 23A and 23B of the OECD Model only required a contracting state to relieve double taxation when the other state has taxed the income in the capacity of the source state or the state where the PE is located to which income is attributable. [17] To confirm this principle, the revised text was proposed under Article 23A/23B, and paragraph 11.1 and 11.2 was proposed to be added to the OECD Commentary on Article 23A and 23B.

Therefore, in line with recommendations under BEPS Action Plan 6, Article 23A/B of the OECD Model (2017) now reads as

"Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention *(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State)* , the first-mentioned State shall, […]" [18] (emphasis supplied).

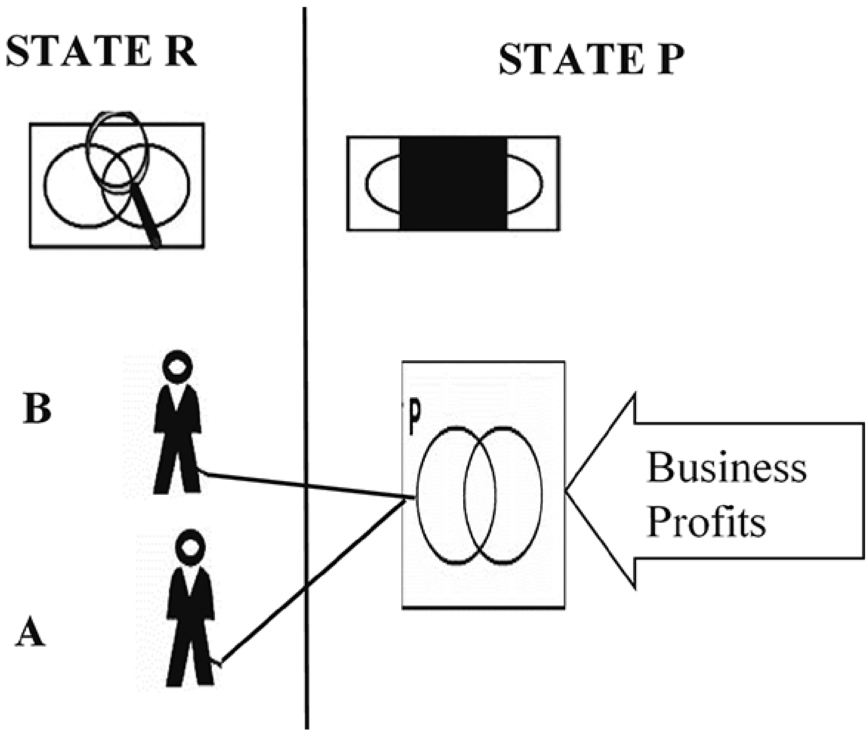
This is also now provided under Article 3(2) and Article 5 – Option C of the MLI.

Para 11.1 and 11.2 added to the Commentary on Article 23A/23B explains the effect of such an amendment. It clarifies that, when both states tax solely in the capacity of residence state, neither of them are reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer. [19] Therefore, double tax relief would be provided by the contracting state only when the taxation by the other state is in accordance with provisions of the convention and when the other state taxes in the capacity of the source state or the state where the PE is located. [20] The OECD Commentary provides that this result would have logically followed from the wording of Article 23A and 23B even in the absence of that phrase, however, the addition of the phrase removes any doubt in this respect. [21] Therefore, the OECD Model now aims at expressely resolving economic double taxation to the extent that the same income is taxed in the residence and the source state in the hands of two different taxpayers, but it does not resolve the economic taxation arising out of residence-residence conflict. In other words, Article 23A/23B does not resolve double taxation arising due to the application of Article 1(3).

To explain the effect of the ammendment, six examples have been added to the Commentary on Article 23A/23B, explaining in detail the obligation to give double taxation relief in the case of *hybrid entities*, which is analysed hereunder.

5.1. Resolving Economic Double Taxation

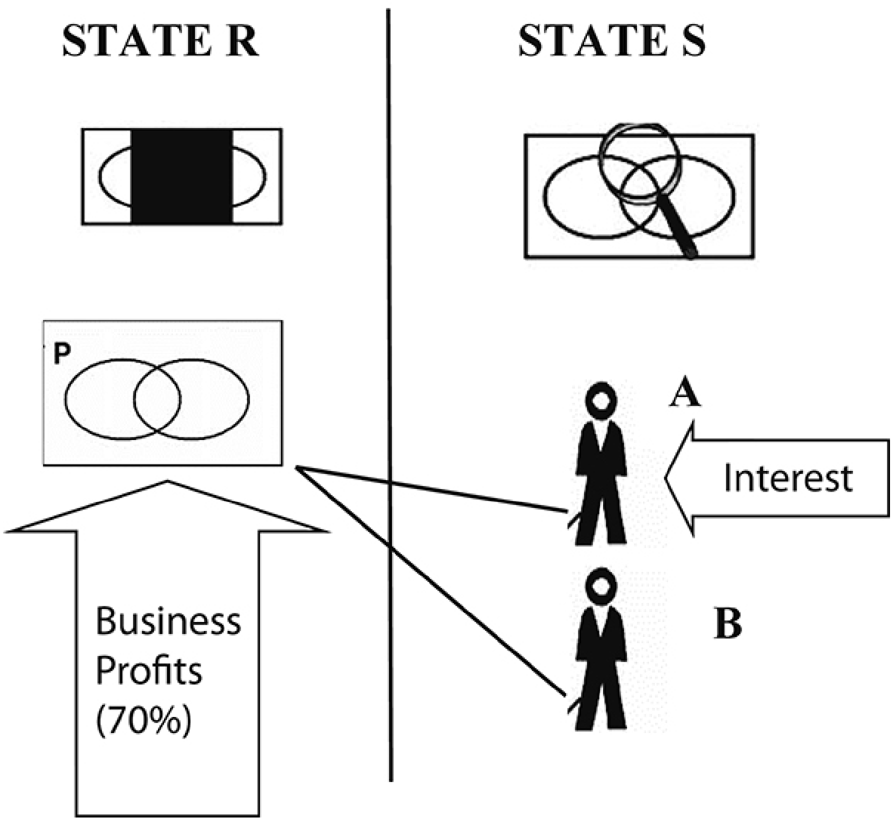
Example A [22]



Entity P, resident of State P is owned by persons resident in State R. State P treats the entity as taxable while State R treats it as transparent and allocates the income to its resident members. Entity P has earned business income which is attributable to the PE in State P. Therefore, State P is the source state of income, and it has unrestricted rights to tax its resident Entity P as per Article 1(3). However, State R is solely taxing in capacity of a residence state as per Article 1(2) and 1(3). Therefore, State P will not be obliged to provide double tax relief to Entity P in respect of tax paid in State R. State R should provide double tax relief to the members of Entity P in respect of tax paid in State P as it has taxed not solely on the basis of the residence of Entity P but also in the capacity of the state where the PE is located.

This example corresponds to Example 17 of the OECD Partnership Report discussed above with the only difference that, in Example 17, it was income in the nature of royalties. However, if the similar facts are applied to the royalties income, if the royalties are attributable to the PE in State P, then in that particular case, the provisions of Article 12(4) r.w. Article 7 would apply, which would have the same result. However, if the royalties were not attributable to the PE as in the case of Example 17, then there would have been double taxation as the source state is provided with no right to tax as per Article 12 of the OECD Model (2017), and both the states would not be obliged to give double taxation relief.

Example B [23]



Same facts as in example A except that 30% of the income derived through the entity is interest arising in State S that is attributable to a PE in State R with the rest of the income being business profits attributable to the PE in State R.

State R allocates the interest income to Entity P and asserts an unrestricted taxing right on it as per Article 1(2) and 1(3). According to it, State S should limit its taxing right up to 10% of the gross amount of interest as per Article 11(2).

State S allocates the interest to members resident in State S. It asserts the unrestricted taxing rights as per Article 1(3). Here, Article 7 would apply and since income is attributable to a PE in State R, State R may tax it.

Relief of double taxation with respect to the business profits other than the interest will be provided as described in Example A.

To resolve the double taxation with respect to interest income, the OECD Model Commentary provides that: i) State R will be required to provide a credit to Entity P under Article 23A(2) or 23B for the amount of tax paid in State S by the members as State S has taxed in the capacity of a source state under Article

11(2). The credit shall be the lower of either 10% of the gross amount of interest as per Article 11(2) or the tax payable in State R on that interest; ii) State S, on the other hand, will also be required to provide relief under Article 23 A or 23 B to the members of the entity since income is taxed by State R in accordance with the provisions of Article 7(1) as the PE state. If State S applies the exemption method of Article 23 A, State S will need to exempt the share of the interest attributable to the members. If State S applies the credit method under Article 23B, the credit shall be against the part of the tax payable in State S that exceeds the amount of tax that it would be entitled to levy under Article 11(2), and credit shall be given for the amount of tax paid in State R after the reduction of the credit that State R will grant for the tax payable in State S under Article 11(2).

Understanding this relief mechanism through the example.

a) If State S applies the credit method

Particulars	Example 1	Example 2
Taxability in State R – Entity Residence State		
Interest from State S	USD 100 [Attributable to PE in R]	USD 100 [Attributable to PE in R]
Tax rate in State R [i]	40%	25%
Tax in State S [ii]	30%	30%
Tax in State S as per Article 11(2) [iii]	10	10
Foreign tax credit in State R [iii]	10	10
Tax payable in State R [i-iii]	30	15
Taxability in State S – Members Residence State		
Income	USD 100	USD 100
Tax in State S [i]	30	30
Notional tax as source state under Article 11(2) [ii]	10	10
State S tax available for credit [iii]	20	20

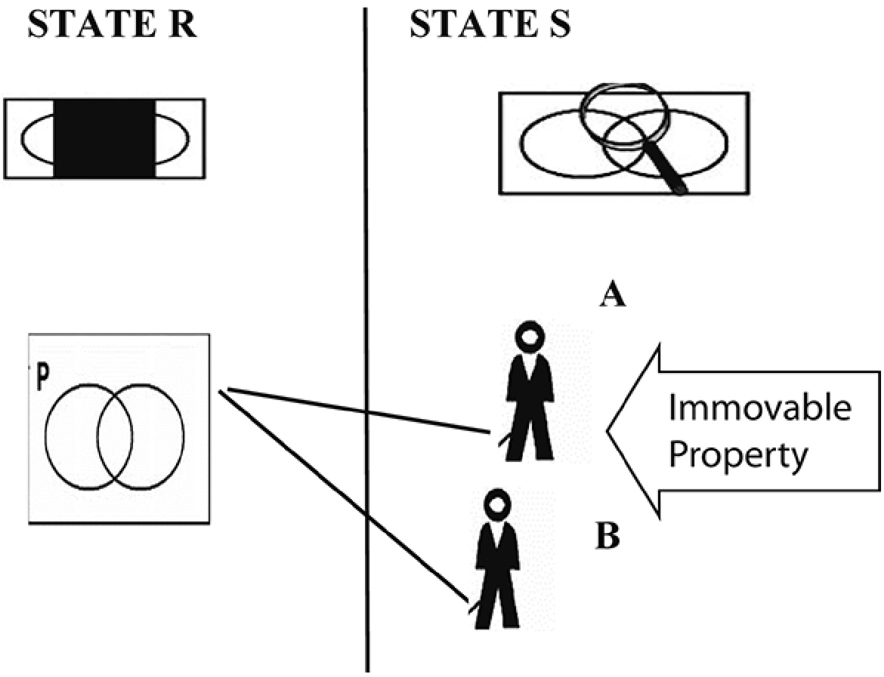
Particulars	Example 1	Example 2
State R tax after credit of State S tax [iv]	30	15
Foreign tax credit [V= iii/iv (lower)]	Credit would be the lower of (i) the tax paid in State R after providing credit of tax in S, i.e. 30 (40 – 10); or (ii) State S tax attributable to State R income (30) but limited to the difference between tax levied in State S in its capacity as residence state (30) and the tax levied in State S in its capacity as source state (10), i.e. 20; Therefore, the relief is restricted to 20.	Credit would be the lower of (i) the tax paid in State R after providing credit of tax in S, i.e. 15 (25 – 10); or (ii) State S tax attributable to State R income (30) but limited to the difference between tax levied in State S in its capacity as residence state (30) and the tax levied in State S in its capacity as source state (10), i.e. 20; Therefore, the relief is restricted to 15.
Tax payable in State R	30	15
Tax payable in State S	10	10 + 5 (20 – 15) =15
Total taxes in both states	40	30

Therefore, the economic double taxation is relieved to the extent that each state taxes in the capacity of the source state. Further, a minimum assured right to tax is granted to the primary source state as provided under the treaty as the interest arises in that state. Therefore, State S's right to tax as the source state of USD 10 under Article 11(2) is retained against which no foreign tax credit is allowed. Therefore, the final taxation in this example in both the states is equivalent to the highest tax rate in either of the states.

b) If State S applies the exemption method

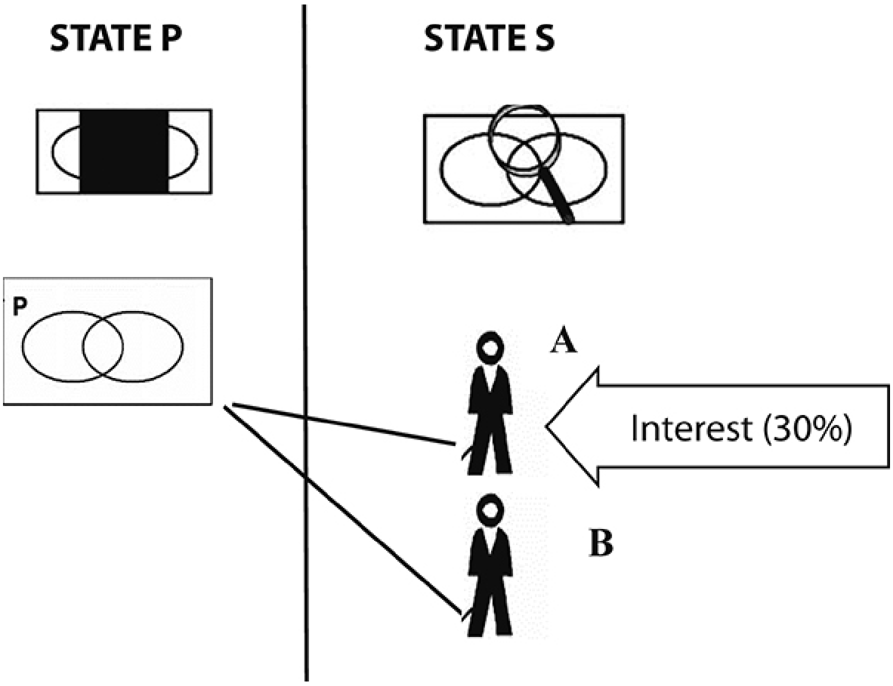
If State S applies the exemption method of Article 23A, State S will need to exempt the share of the interest attributable to the members that are residents of State S notwithstanding the fact that the income in question originally arises in State S. This prevents State S from levying tax on interest that arises in that state whereas, if it were paid to a resident of the other state, State S could have taxed such interest at the rates provided in Article 11(2). The OECD Commentary provides that contracting states finding this position unacceptable may include a provision according to which the state of residence would be entitled as the state of source of the dividends or interest to levy a tax on such income at the rates provided for in Article 10(2) or 11(2) notwithstanding the fact that it applies the exemption method. [24] The state where the PE is situated would give a credit for such a tax as per Article 23A and 23B.

Example C [25]



Same facts as in example A except that all of the income of the entity is derived from immovable property situated in State S. State S has an unrestricted right to tax the income of its residents as per Article 1(3). As per the provisions of Article 6(1), since the situs of immovable property is in State S, State S has the complete right to tax. State R also asserts an unrestricted taxing right as per Article 1(2) and 1(3). State R is obliged to provide the double tax relief to Entity P in respect of the tax paid in State S by the members as State S is the source state. On the other hand, State S is not required to provide relief to the members of Entity P in respect of the tax paid in State R by Entity P as it has taxed solely in its capacity of the residence state. The position remains the same whether or not the income is attributable to a PE in State R. [26] Therefore, if the income from immovable property is USD 100, and the State S tax rate is 30% and that of State R is 40%, State R would grant a credit of the entire 30% paid in State S by the participants.

Example D [27]



Same facts as in example A except that all of the income of the entity is interest arising in State S which is not attributable to the PE. State P, being the residence state of Entity P has an unrestricted right to tax its resident entity as per Article

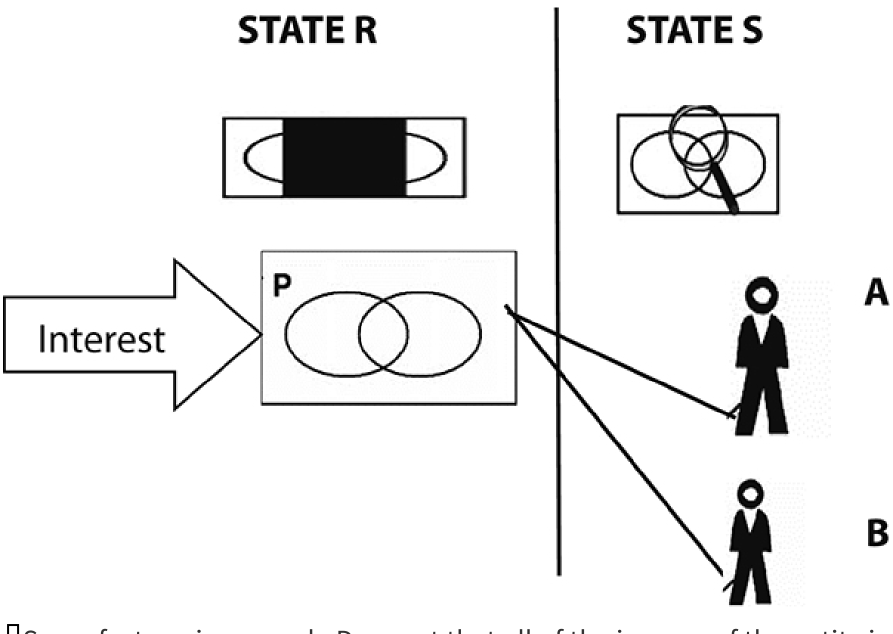
1(2) and 1(3). From the perspective of State P, State S has the limited right to tax under Article 11(2) as interest arises in State S. From the State S perspective, it has an unrestricted right to tax its resident members as per Article 1(3). As per Article 7, State S shall have exclusive taxing right as the income is not attributable to a PE in State P, unlike the case in Example B.

State S is not required to provide relief to the members in respect of the tax paid by Entity P in State P as State P taxes solely in the capacity of the residence state. On the other hand, State P must provide relief to Entity P in respect of the tax paid by the members in State S as it also taxes in the capacity of a source state under Article 11(2). However, the credit shall be limited to the lower of (i)10% of the gross amount of interest as provided under Article 11(2) or (ii) tax payable in State P. Therefore, if the interest income is USD 100, and State S tax rate is 30% and that of State P is 40%, State P would grant credit of only 10%. Therefore, there will be double taxation to the extent of taxes levied by State S in the capacity of the residence state. Total tax liability in both states would be 30 (40-10) in State P and 30 in State S = 60.

This example relates to Example 16 of the OECD Partnership Report described above except that the income was in the nature of royalties that were taxable only in the residence state as per Article 12 of the OECD Model (2017). State P will not be obliged to provide double taxation relief to Entity P for taxes paid in S. If royalties are attributable to the PE in State P, State S would have to grant the double tax relief of the taxes paid in the State P, notwithstanding the fact that the royalties originally arise in State S. The states may agree to give a limited right to tax to State S as the source state, and State P can give credit for the same. [28] However, this would practically pose a challenge as it would be difficult to distinguish between what was taxed as the entity's ordinary income for being considered a resident in State S and what corresponds to the taxation of royalty income. [29]

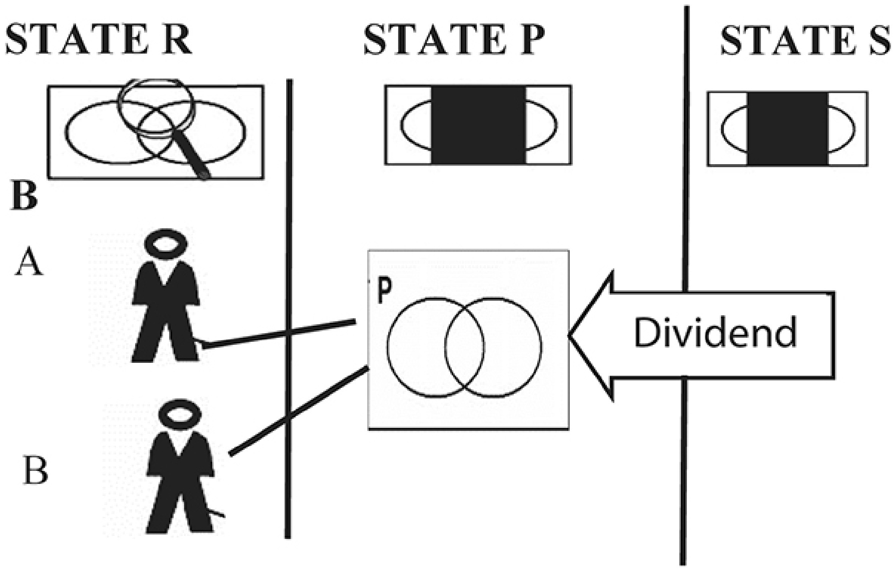
If the income was not attributable to PE, both the states would not have been obliged to grant double tax relief as it would have been residence-residence conflict, and there would have been double taxation.

Example E [30]



Same facts as in example D except that all of the income of the entity is interest arising in State R. From State R's perspective, it has an unrestricted right to tax as the residence state of Entity P as per Article 1(3). It has the exclusive right to tax as per Article 7(1) as income is not attributable to PE in State S. From State S's perspective, State S has an unrestricted right to tax as per Article 1(2) and 1(3). According to it, State R may tax up to 10% of the gross amount of the interest under Article 11(2). State R is not required to provide relief to Entity P in respect of the tax levied by State S on the members as State S taxes solely in its capacity as the residence state. State S is only required to provide relief of the lesser of: (i) 10% of the gross amount of the interest as per Article 11(2); or (ii) tax payable in State S on interest. State S would not grant credit for additional tax levied in State R as the interest is not attributable to the PE, and the only reason State R additionally taxes interest is because Entity P is a resident of State R. Therefore, if the interest income is USD 100, and State S's tax rate is 30% and that of State R is 40%, State S would grant a credit of only 10%. Therefore, there will be double taxation to the extent of taxes levied by State R in the capacity of the residence state. Total tax liability in both states would be 20 (30-10) in State S and 40 in State R = 60.

Example F [31]



Same facts as in example D except that all of the income of the entity is interest arising in a third State. This is similar to Example 9 of the Partnership Report. [32] State R and State P are not required to provide double taxation relief for taxes paid in both states as they are taxing solely in its capacity as the residence state. However, both State R and State P may be required to provide relief under the R-S treaty and P-S tax Treaty. Therefore, there could be dual credit of taxes paid in the source state.

It is not clear as to what extent the additions to the Commentary on Article 23 of the OECD Model (2017) can be used in tax treaties that do not include the new text. The Commentary adopts the position that the outcome of this text would have "logically flown" even in the absence of the phrase. [33] Also, before this provision, the position of the Commentary was that, if the state of residence of the partner flows through the income, it must also flow through tax paid by the partnership. [34] However the absence of an express intention to that effect in the provision of Article 23A/23B may still leave unresolved ambiguity.

Following is the summarised position under OECD Model to provide double tax relief:

Nature of Income	Entity State	Members State	Double Tax Relief
Dividend/Interest (not attributable to PE)	Source	Residence	Credit by the Member state up to limited rate provided under treaty.
	Residence	Source	Credit by the Entity state up to limited rate provided under treaty.

Nature of Income	Entity State	Members State	Double Tax Relief
Dividend/Interest (attributable to PE in entity state)	Residence	Source	Credit by the Entity state up to limited rate provided under treaty. Credit by the Member state of the tax paid in the Entity state (after considering credit of tax in Member state) against tax in Member state (excluding the tax charged in capacity of source state).
	Source	Residence	Credit by the Member State up to limited rate provided under treaty or exemption of entire PE profits in Member state.
Royalties (not attributable to PE)	Source	Residence	No relief
	Residence	Source	No relief
Royalties (attributable to PE in entity state)	Residence	Source	No relief by the entity state. Relief by the Member state for the taxes paid in Entity state.
	Source	Residence	
Business Income (income attributable to PE in source state)	Source	Residence	Relief by Member state
	Residence	Source	Relief by Entity state
Immovable Property	Source	Residence	Relief by the Member state
	Residence	Source	Relief by the Entity state

5.2. Resolving residence-residence conflicts

When both the states derive a nexus to tax solely from being the residence of a respective taxpayer, there is still unrelieved double taxation. Therefore, it becomes imperative to determine whether there should be double tax relief granted for such types of conflicts. Ideally, there seems to be no logic to exclude double taxation arising out of residence-residence conflict out of the purview of Article 23.

Certain tax treaties have attempted to resolve the residence-residence conflict. The Hong Kong-United Kingdom DTA [35] and Norway-United Kingdom DTA [36] flows through the taxes paid by the trustee in the hands of the beneficiary. The Australia-New Zealand Income Tax Treaty (2009) [37] provides for credit in the participant's state for tax paid in the entity residence state regardless of the source of the income. The Netherlands-Belgium tax treaty incorporates a reverse saving clause [38] that provides an indirect tax credit for the participants for the taxes paid by the entity and precludes the entity state to levy tax on the distribution of income to participants. [39] The Australia-Germany DTA (2015) requires the competent authorities to find an appropriate solution if there is resultant double taxation due to the transparent entity clause. [40]

The United Kingdom-United States DTA (2001) [41] attempts to resolve residence-residence double taxation by allocating the primary and residual taxing rights between two contracting states. It prioritizes the claim between the United Kingdom and the United States in the following order:

a) With respect to the income from real property, a claim of the source (situs) where real property is located is given priority. Therefore, double tax relief will be granted by the other state to its residents for the taxes paid by the resident of the state where immovable property is located;

b) primary taxing rights to the state in which the entity is a resident by requiring the members state to grant double tax relief for the taxes paid by the entity resident in the other state;

c) credit by the beneficiary residence state when trust is taxed in other state;

d) for the claims between the grantor residence state and the beneficiary residence state, the grantor residence state will be obliged to grant credit for the taxes paid in the beneficiary residence state.

The UK-US tax treaty also provides for resourcing rules of income to the United Kingdom in order for the United States to be able to credit the UK tax.

Further, to resolve double taxation resulting due to citizenship-residency conflict, the US-UK tax treaty provides for a novel method under Article 24(6) by deciding the priority of the claims of two states. It provides that, between the citizenship and residence state, the resident state shall have priority to retain taxing rights. Further, with respect to income sourced from third country, the United Kingdom (residence state) would not be obliged to grant the credit for US taxes on income sourced from a third country, and the United States (citizenship state) would grant credit for the taxes paid in the United Kingdom as well as in the third country. With regard to US source income, the taxing rights of the United States would be restricted to a reduced rate as provided under the treaty if they had been received by a UK resident who is not a US citizen. [42]

For example, if a US citizen resident in the United Kingdom receives portfolio dividends from sources within the United States, the foreign tax credit granted by the United Kingdom would be limited to 15% of the dividend as per Article 10(2)(b) even if the shareholder is subject to US net income tax because of his US citizenship. With respect to royalty or interest income, the United Kingdom would allow no foreign tax credit because it provides for residence based tax under Articles 11 and 12. [43] Thereafter, the United States will also provide credit of taxes in the United Kingdom (after considering credit of the US tax in UK). However, the credit shall be restricted to the lower of US tax/ UK tax, and the United States' right to tax as the source state would remain intact. This is similar to Example B explained above where both states were taxing in the capacity of the source state and the residence state.

The OECD Model does not relieve double taxation when both states tax in the capacity of the residence state. An analogy could be drawn from the UK-US DTA that attempts to resolve residence-residence conflict by prioritizing the claim of the entity state by requiring the participant state to grant double tax relief for taxes paid in the entity state. Further, in order to convert the residence-residence conflict into residence-source conflict, resourcing rules have been incorporated under the DTA so as to resource the income to the United Kingdom and grant the credit of taxes paid (which are otherwise in the nature of residence-based tax). These resourcing rules and similar article could be incorporated in the OECD Model to convert the residence-residence conflict into residence-source conflict and thereby relieve unintended double taxation.

It could also be argued that the relief should be provided in the entity state for the taxes paid by the participants in their residence state. However, the entity state may have to verify the tax treatment of participants in their own state resulting in complexity. [44]

Therefore, if the approach in line with the US-UK DTA is followed, then the participant state can grant the credit of the tax paid in the entity state. Resultantly, there would not be any double taxation arising out of the residence-

residence conflict. Therefore, if examples of the OECD Model Commentary are considered in light of the treatment granted under the US-UK DTA, the following observations can be made:

Example A	Here, the residence state of the participants is providing relief of the entire taxes paid by the entity as the entity state has the primary right to tax in the capacity of a PE state. Since this was residence-source conflict, therefore, there would be no change.
Example B	No change as both the states are residence as well as the source states.
Example C	No change as the entity state was required to give the relief of taxes paid in the participants state where immovable property is located. Since it was residence-source conflict, there would not be any change here.
Example D	Here, if the participant state would grant relief of the taxes paid in the entity state, the double taxation to the extent of residence-residence conflict would also get resolved. The total tax liability would then be 40 as State S would retain its right to tax as the source state and would grant the credit against the balance of 20 of the tax paid in the residence state of the entity (after the credit of participant state tax).
Example E	Here, if the participant state would grant relief of the entire taxes paid in the entity state, the double taxation to the extent of the residence-residence conflict would be resolved. The total tax liability would be then 40.
Example F	Here, if State R provides relief to the participants for the taxes paid in State P by the entity after considering a credit of taxes paid in State S, double taxation to some extent would be resolved. Total tax liability would be State R – 30 – 25 = 5; State P – 30 – 5 = 25; and State S = 5, i.e. 5 + 25 + 5 = 35. There will be some double taxation remaining if the tax in the participant state is greater than the foreign tax credit of taxes in the entity state. This may be resolved if credit would be allowed in the participants residence state of the taxes in the source state, however, that shall result in dual credit.

6. Obligation to give double taxation relief in case of qualification conflicts

6.1. Double taxation arising out of qualification conflicts

Conflict of qualification occurs due to differences in characterisation of the same income by the two states under different distributive rules due to differences in their domestic tax law. The qualification conflict arises due to references to the domestic tax law by virtue of Article 3(2). The OECD Model Commentary provides that, notwithstanding the qualification conflicts, the state of residence should grant double tax relief as the income is still being taxed in accordance with the provisions of the convention, as interpreted and applied by the state of source. [45] In the case of *hybrid entities*, the qualification conflict results also due to allocation conflict.

Article 23A/23B deals only with qualification issues arising out of differences in domestic law but does not deal with conflict of treaty interpretation and conflict of facts. In such a case, taxation is considered as not being taxed “in accordance with provisions of the convention”. [46]

Example 14 of the OECD Partnership Report [47]

Partner A, a resident of State R, alienates his interest in Partnership P (resident in State P). State R treats P as taxable and regards it as an alienation of shares in a company that could only be taxed in State R as per Article 13(5). State P treats Entity P as transparent and regards it as an alienation by the partner of the underlying assets of the business carried on by the partnership which should be taxable in State P as per Article 13(1)/(2). Therefore, the conflict arises due to a difference in treatment of the partnership under the domestic tax laws of the residence and source states. In such a case, the OECD Model Commentary and Partnership Report concludes that, notwithstanding the qualification conflict, State R must consider that State P has taxed the gain from the alienation “in accordance with the provisions of the Convention” and grant double tax relief under Article 23A/23B. [48]

If, however, in the above example, the conflict arises due to the fact that State P considers that the partnership has a PE in State P and, therefore, the gains should have been taxable under Article 13(2), but State R argues that there is no fixed place PE in State P and, therefore, Article 13(4) applies, such conflicts result from the different interpretation of facts. Also, if State P interprets the phrase “forming part of the business property” under Article 13(2) so as to include certain assets that would not fall within the meaning of that phrase, the conflict results from a different interpretation of the provisions of the convention that must be distinguished from the conflicts of qualification. [49]

The OECD’s approach of the residence state following the source state principle to resolve a qualification conflict is flawed. This principle is based on the fact that the state of residence only applies the treaty for granting double tax relief under Article 23. [50] However, characterisation of income is important from the perspective of both the residence state as well as the source state. Distributive rules are applied by both states as some of the distributive rules grant exclusive rights to the residence state. [51] The residence state also has to characterize the income for the purpose of applying Article 23A(1) or Article 23A(2) as a credit is granted for passive income whereas, for other categories of income, an exemption method is applied. [52] Therefore, obligating the residence state to follow the classification of the source state is incorrect. Therefore, Article 23 should expressly provide for situations in which both states apply different distributive rules under the treaty. [53]

6.2. Distinction in Qualification and Allocation Conflicts

The OECD follows contrasting approaches for the qualification and allocation conflicts where, for qualification conflicts, the approach is residence follow source and, for allocation conflicts, source follows residence state classification. Therefore, it becomes extremely difficult to determine the consequences when there are both conflicts occurring in a same situation. [54] M. Lang has explained this with following example [55] : A Croatian company has Austrian shareholders, and it earns interest income from Croatia. Croatia treats the company as taxable while Austria treats it as transparent. This results in an allocation conflict. Also, according to Austria, interest is taxable under Article 11 whereby Austria also had the right to tax, and Croatia had a limited right to tax. However, as per Croatia, interest income is taxable as per Article 21 since there is no cross-border relationship, and the entire income is only taxable in Croatia. This also results in a qualification conflict at the same time.

In this situation, as per Article 1(2) and 1(3), both states will tax the interest income, and there would be a residence-residence conflict. In such a case, Austria has to grant a limited credit of tax paid in Croatia in its capacity as the source state as per Article 11(2). If this is identified as a qualification conflict, the residence state must accept the qualification of the source state, and Austria would be obliged to either credit the entire taxes paid in Croatia or exempt the income. In such a situation, the qualification conflict arises due to an allocation conflict and not by reference to the domestic tax law under Article 3(2). However, if the approach as suggested above based on the US-UK tax treaty relief article is followed, then double taxation can be relieved completely irrespective of the qualification or allocation conflict as it requires the residence state of the members to flow through the taxes paid by the entity.

7. Obligation to give double taxation relief in case of timing issues

Due to allocation conflict, issues arise with respect to differences in timing of taxability of profits as states can tax profits at the time of generation as well as distribution. This is explained with Example 18 of the Partnership Report. Partnership P is a resident of State P which treats it as taxable and State R, the residence state of the partners, treats it as transparent. State P may tax the partnership's profits and may also tax the distribution of profits by the partnership to its non-resident partners within the limits of Article 10(2). State R may only tax the partner on his share of the partnership's income when the same is realized. [56]

The OECD Commentary states that, to the extent that the state of residence of the partner flows through the income of the partnership to the partner, it must also flow through the tax paid by the partnership to resolve double taxation. [57] With regard to tax levied by State P on the distribution, the OECD Commentary states that credit cannot be given for the tax paid in State P against tax levied in State R on the generation of profits as State R does not tax distribution. [58] If the partner's residence state follows the exemption method, the Partnership Report suggested that it should exempt the profits in Year 1 and tax at the time of distribution. [59] Therefore, for the example in which USD 100 is income arising in State P, the tax in State P is 20% and that in State R is 40%. Also, State P taxes the distributable profits (USD 80) at 10%. Therefore, the total tax would be 48 (40-20 + 20+ 8). If both states would have treated the entity as transparent or when the source state did not tax the distributions, the entire amount of taxes paid in the source state would have been creditable in the residence state of the partners. Therefore, this situation results in unresolved economic double taxation.

Article 1(2) determines who should be accorded a treaty benefit in the case of fiscally transparent *entities*. It does not obligate the source state to advance the same treatment as under its domestic tax law. Article 1(2) applies to income considered to be derived by or through an entity rather than income derived from a fiscally transparent entity. [60] The example in the OECD Partnership Report [61] merely speaks about whether the treaty requires the members residence state to give credit for the taxes on the distribution levied in the entity state. However, it does not provide any explanation as to whether the treaty could restrict the source state from taxing that income or distribution based on the qualification applied by the residence state of the member. [62] Also, the saving clause would not result in the application of a domestic tax principle of the source state to tax distribution in the hands of non-resident partners as Article 1(3) saves taxation only for residents and not for non-residents.

Therefore, to resolve the double taxation arising out of timing differences, either the countries can negotiate a reverse saving clause that precludes the entity state from taxing the distribution of profits in hands of shareholders. The countries could also negotiate an extended version of Article 1(3) expressly providing for saving the right of the contracting state to determine the manner of taxability of profits even in the case of non-residents. In that scenario, the residence should grant the credit of the taxes paid in the entity state on distribution. There could be issues with respect to the timing of credit, however, the same could be resolved through carry back provisions under the domestic tax law.

8. Conclusion

Although the OECD has made tremendous progress in terms of relieving double taxation especially resolving the economic double taxation in case of *hybrid entities*, the double taxation arising out of residence-residence conflict is left unresolved. The attempt of the OECD to explain the double tax relief mechanism in the case of *hybrid entities* through various examples in the Commentary is remarkable and provides required clarity. However, absent an express clause under Article 23 may generate differences in interpretation amongst the contracting states. Further, there is no reason why double taxation should not be eliminated in the residence-residence conflicts as the main purpose or aim of DTAs is to resolve double taxation. The UK-US DTA is a classic example of resolving residence-residence conflicts, and there are many other DTAs in which the contracting states expressly try to resolve the unintended double taxation. Therefore, a separate clause is proposed based on the US-UK DTA to resolve the double taxation arising when both states, by virtue of Article 1(2) and Article 1(3), tax solely based on the residence principle.

Also, in the case of a situation involving qualification as well as allocation conflicts, it becomes tricky to resolve the issue as the OECD takes contrasting stands in these scenarios. However, if the entire residence based economic double taxation is eliminated based on a similar clause as under the US-UK DTA, these scenarios would not be an issue. Further, the issues arising due to timing differences could be attempted to be resolved through a reverse saving clause or through extending the saving clause under Article 1(3) to non-residents, and the participant state would grant a credit of taxes on distribution levied in the entity state.

Though the OECD has attempted to provide resolution to the economic double taxation arising in the case of *hybrid entities*, there does not seem to be any rationale in leaving the residence-residence conflict outside the scope of Article 23. The treaty practices amongst the countries reflect that countries actually wish to resolve such unintended double taxation arising due to domestic tax law differences. Therefore, clarity from the OECD in this regard would be boon and may be an end to issues relating to double taxation arising in the case of *hybrid entities*.

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1 Commentary on Article 23A and 23B of the OECD Model Tax Convention on Income and on Capital (2017), para. 11.1.

2 Commentary on Article 23A and 23B of OECD Model (2017), para 1.

3 Commentary on Article 23A and 23B of OECD Model (2017), paras 69.2.

4 OECD, The Application of the OECD Model Tax Convention to Partnerships (OECD Publishing 1999) [hereinafter referred as 'OECD Partnership Report, 1999], para 134-139.

5 Commentary on Article 23A and 23B of OECD Model (2017), paras 69.2.

6 Christopher Bergedahl, *Hybrid Entities* and the OECD Model (2017): The End of the Road?, Bulletin for International Taxation (July 2018), p.5.

7 Christopher Bergedahl, Bulletin for International Taxation (July 2018), p.5

8 Refer Example 9 of the OECD Partnership Report 1999.

9 OECD Partnership Report 1999, para 74.

10 M.Lang argues that 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 & E. Pinetz, Case Studies on

Partnerships and Other *Hybrid Entities*, Bulletin for International Taxation, March 2014, p. 153.

11 General Report by Michael Lang and Claus Staringer, Cahiers de Droit Fiscal International by IFA, 68 th Congress IFA (Mumbai), 2014, p.41.

12 General Report by Michael Lang and Claus Staringer, IFA(2014), p.41.

13 Commentary on Article 23A and 23B of OECD Model (2017), para 69.2.

14 Discussed further in Section 5 infra.

15 OECD Partnership Report 1999 Example 16.

16 OECD Partnership Report 1999 Example 17.

17 OECD/G20, BEPS Action Plan 6 – Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Final Report (2015), para 64.

18 OECD Model (2017), Article 23A and Article 23B.

19 Commentary on Article 23A and 23B of OECD Model (2017), para 11.1.

20 Commentary on Article 23A and 23B of OECD Model (2017), para 11.1. the United States, France, and Luxembourg have made reservations against this. The position of the United States is that this is contrary to para 1 to the commentary on Article 23A/23B which provides that the intention is only to resolve juridical double taxation.

21 Commentary on Article 23A and 23B of OECD Model (2017), para 11.1.

22 Commentary on Article 23A and 23B of OECD Model (2017), para 11.2 Example A. See also Christopher Bergedahl, *Hybrid Entities* and the OECD Model (2017): The End of the Road?, Bulletin for International Taxation (2018), p.425., where he has explained with the diagramatic illustrations, the examples under the OECD Model Commentary.

23 Commentary on Article 23A and 23B of OECD Model (2017), para 11.2 Example B.

24 Commentary on Article 23A and 23B of OECD Model (2017), para 9.

25 Commentary on Article 23A and 23B of OECD Model (2017), para 11.2 Example C.

26 Christopher Bergedahl, Bulletin for International Taxation (2018), p. 428, argues that, from the perspective of State S, Article 6 would not apply as it is paid to a resident of the same state and that either Article 7 or Article 21 would apply. If Article 21 applies, then State S would also get an exclusive taxing right as the residence state and would not be obliged to grant relief under Article 23A/23B. However, if Article 7 would apply, and the income is attributable to the PE, then the situation becomes like Example B in which both of the States will be obliged to grant the double tax relief. However, para 74 to the Commentary on Article 7 provides that, when an enterprise of a contracting state derives income from immovable property through a PE situated in the other state, that PE may not tax that income if it is derived from immovable property situated in the first mentioned state or in a third state. This is also confirmed in para 9 to the Commentary on Article 23A and 23B.

27 Commentary on Article 23A and 23B of OECD Model (2017), para 11.2 Example D. See also Christopher Bergedahl, Bulletin for International Taxation (2018), p.423.

28 Commentary on Article 23A and 23B of OECD Model (2017), para 9.

29 See also Leopoldo Parada, Tax Treaty Entitlement and Fiscally Transparent *Entities*: Improvements or Unnecessary Complications? In J. Wheeler (ed), The Aftermath of BEPS, IBFD, Amsterdam (2020), p.15.

30 Commentary on Article 23A and 23B of OECD Model (2017), para 11.2 Example E. See also Christopher Bergedahl, Bulletin for International Taxation (2018), p.424.

31 Commentary on Article 23A and 23B of OECD Model (2017), para 11.2 Example F. See also Christopher Bergedahl, Bulletin for International Taxation (2018), p.424.

32 Refer supra section 3.1.

33 Commentary on Article 23A and 23B of OECD Model (2017), paras 11.1. See also Christopher Bergedahl, Bulletin for International Taxation (2018), p.449.

34 Commentary on Article 23A and 23B of OECD Model (2017), paras 69.2.

35 Convention between the Government of United Kingdom of Great Britain and Northern Ireland and the Government of Hong Kong special administrative region of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on income and on capital gains (June 21 2010), Article 20(2).

36 Convention between the Kingdom of Norway and 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 (March 14 2013), Article 20(2).

37 Convention between Australia and New Zealand for the Avoidance of Double Taxation (2009), Article 23(3).

38 Convention between the Kingdom of Belgium and the Kingdom of Netherlands for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with respect to taxes on income and on capital (2001) and its Protocol I (2001), para 2 and 4(b). It provides that the income and tax thereon of the company shall be considered as the income and tax of the participants in proportion to their entitlement to the company's capital. The participants in the company should be allowed a credit of the tax levied on the company in respect of this income (including any tax withheld at the source in third states) against the tax for which they are liable in respect of the same income and that the state of residence of the company waives possible taxation of the participants in this company who are residents of the other contracting state in respect of the profits distributed to them. See also Leopoldo Parada, In J. Wheeler (ed), The Aftermath of BEPS, p.13.

39 See Leopoldo Parada, Rivista di diritto finanziario e scienza delle finanze, LXXVIII, 1, I, 13-52 (2019), p.45. He has suggested inclusion under the OECD Model Commentary for the double tax relief mechanism based on the reverse saving clause as a step-out provision for the countries intending to provide relief for residence-residence conflicts, and they can opt out of Paragraph 11.1. However, mentioning it in the Commentary instead of a provision in the article may only serve as an interpretative tool and may not be suitable to resolve different country practices. Also, as the Commentary being soft law cannot be said to have a binding effect.

40 Agreement between the Federal Republic of Germany and Australia for the elimination of double taxation with respect to taxes on income and on capital and the prevention of fiscal evasion and avoidance (November 12 2015 Para. 2 of the Protocol), Article 25(3).

41 Convention between the Government of United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on income and on capital gains, Technical Notes to Article 24.

42 Technical Notes to US-UK Tax Treaty (2001).

43 Technical Notes to US-UK Tax Treaty (2001).

44 M. L. Brabazon, Application of Tax Treaties to Fiscally Transparent *Entities* – Global Tax Treaty Commentaries, IBFD.

45 Commentary to Article 23A and 23B of OECD Model (2017), para 32.3.

46 Commentary to Article 23A and 23B of OECD Model (2017), para 32.5.

47 OECD Partnership Report, 1999, para 106-109.

48 Commentary to Article 23A and 23B of OECD Model (2017), para 32.4.

49 OECD Partnership Report, 1999, para 108. Commentary to Article 23A and 23B of OECD Model (2017), para 32.5.

50 Stephan Kienberger, Avoidance of Double (Non-) Taxation and Article 23A and B Paragraph 1 OECD MC, in: Michael Lang/ Eva Burgstaller/ Katharina Haslinger (eds.) Conflicts of Qualification in Tax Treaty Law, Taxmann, p.317.

51 Stephan Kienberger, in: Michael Lang/ Eva Burgstaller/ Katharina Haslinger (eds.) Conflicts of Qualification in Tax Treaty Law, Taxmann, p.317.

52 Michael Lang, Qualification Conflicts – Global Tax Treaty Commentaries, IBFD.

53 Stephan Kienberger, in: Michael Lang/ Eva Burgstaller/ Katharina Haslinger (eds.) Conflicts of Qualification in Tax Treaty Law, Taxmann, p.318.

54 Michael Lang, Qualification Conflicts – Global Tax Treaty Commentaries, IBFD.

55 Michael Lang, Qualification Conflicts – Global Tax Treaty Commentaries, IBFD.

56 Commentary on Article 23A and 23B of OECD Model (2017), para 69.1.

57 Commentary on Article 23A and 23B of OECD Model (2017), para 69.2.

58 Commentary on Article 23A and 23B of OECD Model (2017), para 69.3.

59 OECD Partnership Report,1999, para 135.

60 Angelo Nikolakakis, Stéphane Austry, John Avery Jones (et.al), Some Reflections on the Proposed Revisions to the OECD Model and Commentaries, and on the Multilateral Instrument, with Respect to Fiscally Transparent *Entities*– Part 2, Bulletin for International Taxation (October 2017), p.559.

61 OECD Partnership Report,1999, Example 18.

62 Angelo Nikolakakis, Stéphane Austry, John Avery Jones (et.al), Bulletin for International Taxation (October 2017), p.557. Also R. Danon argues that the OECD Partnership Report is inconsistent here with its general recommendation. That is, if one considers that the notion of partnership distribution does not exist in the state of residence, it seems quite logical to contend that State R may not assign this income to a resident partner, Qualification of Taxable *Entities* and Treaty Protection, Bulletin for International Taxation (2014), p.196.