

Public Discussion Draft

# **BEPS ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS**

(Treaty Issues)

19 March 2014 – 2 May 2014



Comments on this note should be sent electronically (in Word format) by email to [taxtreaties@oecd.org](mailto:taxtreaties@oecd.org) before 5.00pm on 2 May 2014 at the latest.

It is the policy of the OECD to publish all responses (including the names of the responders) on the OECD website.

*This document does not necessarily reflect consensus views of either the Committee of Fiscal Affairs or of WP1 regarding the issues it addresses. Rather it reflects preliminary consideration of the issues since the publication of the Action Plan and seeks to identify issues for public comment. It is considered that stakeholder comments are essential to advancing this work.*

## TABLE OF CONTENTS

Introduction.....	4
1. Ensuring that dual resident entities are not used to obtain the benefits of treaties unduly .....	5
2. Ensuring that transparent entities are not used to obtain the benefits of treaties unduly .....	6
3. Interaction between the recommendations included in the WP11 Discussion Draft and the provisions of tax treaties .....	10

**TREATY ISSUES RELATED TO THE WORK ON ACTION 2  
(NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS)**

**Introduction**

1. Action 2 of the BEPS Action Plan (Neutralise the effects of hybrid mismatch arrangements) reads as follows:

*The BEPS report calls for the development of “instruments to put an end to or neutralise the effects of hybrid mismatch arrangements and arbitrage”. Hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for instance, creating two deductions for one borrowing, generating deductions without corresponding income inclusions, or misusing foreign tax credit and participation exemption regimes. Country rules that allow taxpayers to choose the tax treatment of certain domestic and foreign entities could facilitate hybrid mismatches. While it may be difficult to determine which country has in fact lost tax revenue, because the laws of each country involved have been followed, there is a reduction of the overall tax paid by all parties involved as a whole, which harms competition, economic efficiency, transparency and fairness.*

***ACTION 2***

***Neutralise the effects of hybrid mismatch arrangements***

*Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.*

2. Since BEPS concerns related to hybrid instruments and entities arise from mismatches in domestic laws, the main outcomes of the work on Action 2 are expected to result from the work of Working Party 11 (WP11) on recommendations regarding the design of domestic rules to neutralise the effect of hybrid instruments and entities. These are the subject of a discussion draft that is released separately (the “WP11 Discussion Draft”).

3. This note complements the WP11 Discussion Draft and deals with the parts of Action 2 that indicate that the outputs of the work on that action item may include “changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly” and that stress that “[s]pecial attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention.”

4. This note first examines treaty issues related to dual-resident entities (section 1). It then includes a proposal for a new treaty provision dealing with transparent entities (section 2). Section 3 addresses the issue of the interaction between the recommendations included in the WP11 Discussion Draft and provisions of tax treaties.

5. At the outset, it should be noted that a number of proposals resulting from the work on Action 6 (Preventing Treaty Abuse), which are included in another discussion draft (the “Treaty Abuse Discussion Draft”), will play an important role in ensuring “that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly”. The following proposals included in that other discussion draft are of particular relevance:

- Limitation on benefits rules.
- Rule aimed at arrangements one of the main purposes of which is to obtain treaty benefits.
- Rule aimed at dividend transfer transactions (*i.e.* to subject the lower rate of tax provided by Art. 10(2)*a*) or by a treaty provision applicable to pension funds to a minimum shareholding period).
- Rule concerning a Contracting State’s right to tax its own residents.
- Anti-abuse rule for permanent establishments situated in third States.

#### **1. Ensuring that dual resident entities are not used to obtain the benefits of treaties unduly**

6. Action 2 refers expressly to possible changes to the OECD Model Tax Convention to ensure that dual resident entities are not used to obtain the benefits of treaties unduly.

7. The change to Art. 4(3) of the OECD Model Tax Convention that is included in the Treaty Abuse Discussion Draft will address some of the BEPS concerns related to the issue of dual-resident entities by providing that cases of dual treaty residence would be solved on a case-by-case basis rather than on the basis of the current rule based on place of effective management of entities, which creates a potential for tax avoidance in some countries. The proposed revised version of Art. 4(3) that is put forward in that other discussion draft reads as follows:

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

8. This change, however, will not address all BEPS concerns related to dual-resident entities. It will not, for instance, address avoidance strategies resulting from an entity being a resident of a given State under that State’s domestic law whilst, at the same time, being a resident of another State under a tax treaty

concluded by the first State, thereby allowing that entity to benefit from the advantages applicable to residents under domestic law without being subject to reciprocal obligations (e.g. being able to shift its foreign losses to another resident company under a domestic law group relief system while claiming treaty protection against taxation of its foreign profits). That issue arises from a mismatch between the treaty and domestic law concepts of residence and since the treaty concept of residence cannot simply be aligned on the domestic law concept of residence of each Contracting State without creating situations where an entity would be a resident of the two States for the purposes of the treaty, the solution to these avoidance strategies must be found in domestic law. Whilst such avoidance strategies may be addressed through domestic general anti-abuse rules, States for which this is a potential problem may wish to consider inserting into their domestic law a rule, already found in the domestic law of some States,<sup>1</sup> according to which an entity that is considered to be a resident of another State under a tax treaty will be deemed not to be a resident under domestic law.

9. Also, the change to Art. 4(3) will not address BEPS concerns that arise from dual-residence where no treaty is involved. Figure 8 of the WP11 Discussion Draft illustrates a dual consolidation structure where BEPS concerns arise from the fact that two States consider the same entity as a resident to which each country applies its consolidation regime. In such a case, the same BEPS concerns arise whether or not there is a tax treaty between the two States, which indicates that the solution to such a case needs to be found in domestic laws. It should be noted, however, that if a treaty existed between the two States and the domestic law of each State included the provision referred to in the preceding paragraph, it is likely that the entity would likely be a resident under the domestic law of only one State, *i.e.* the State of which it would be a resident under the treaty.

*Comments are invited on the preceding analysis of tax treaty issues related to dual-resident entities and, in particular, on the possible domestic law change described at the end of paragraph 8 above.*

*Please note, however, that any comments on the proposed change to Art. 4(3) of the OECD Model Tax Convention referred to in paragraph 7 above should be made in response to the discussion draft on Action 6 (Preventing Treaty Abuse) and not in response to this discussion draft.*

## **2. Ensuring that transparent entities are not used to obtain the benefits of treaties unduly**

10. The 1999 OECD report on *The Application of the OECD Model Tax Convention to Partnerships* (the Partnership Report) contains an extensive analysis of the application of treaty provisions to partnerships, including in situations where there is a mismatch in the tax treatment of the partnership. The main conclusions of the Partnership Report, which have been included in the Commentary of the OECD Model Tax Convention, seek to ensure that the provisions of tax treaties produce appropriate results when applied to partnerships, in particular in the case of a partnership that constitutes a hybrid entity.

11. The Partnership Report, however, did not expressly address the application of tax treaties to entities other than partnerships. In order to address that issue, as well as the fact that some countries have found it difficult to apply the conclusions of the Partnership Report, it is proposed to include in the OECD Model Tax Convention the following provision and Commentary, which will ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the

---

1. See subsection 250(5) of the *Income Tax Act* of Canada and section 18 of the *Corporation Tax Act 2009* of the United Kingdom.

Partnership Report. This will not only ensure that the benefits of tax treaties are granted in appropriate cases but also that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity as the income of one of its residents.

*Replace Article 1 of the Model Tax Convention by the following (additions to the existing text appear in bold italics):*

*Article 1*  
PERSONS COVERED

1. This Convention shall apply to persons who are residents of one or both of the Contracting States.

2. *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. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State's right to tax the residents of that State.]<sup>1</sup>*

*Add the following paragraphs 26.3 to 26.16 to the Commentary on Article 1 (other consequential changes to the Commentary on Article 1 would be required):*

***Paragraph 2***

***26.3 This paragraph addresses the situation of the income of entities or arrangements that one or both Contracting States treat as wholly or partly fiscally transparent for tax purposes. The provisions of the paragraph ensure that income of such entities or arrangements is treated, for the purposes of the Convention, in accordance with the principles reflected in the 1999 report of the Committee on Fiscal Affairs entitled "The Application of the OECD Model Tax Convention to Partnerships".<sup>2</sup> That Report therefore provides guidance and examples on how the provision should be interpreted and applied in various situations.***

***26.4 The Report, however, dealt exclusively with partnerships and whilst the Committee recognised that many of the principles included in the Report could also apply with respect to other non-corporate entities, it expressed the intention to examine the application of the Model Tax Convention to these other entities at a later stage. As indicated in paragraph 37 of the Report, the Committee was particularly concerned with "cases where domestic tax laws create intermediary situations where a partnership is partly treated as a taxable unit and partly disregarded for tax purposes." According to the Report***

***Whilst this may create practical difficulties with respect to a very limited number of partnerships, it is a more important problem in the case of other entities such as trusts. For this reason, the Committee decided to deal with this issue in the context of follow-up work to this report.***

---

1. Please note that a proposal included in the Treaty Abuse Discussion Draft would make that sentence unnecessary.  
2. Reproduced in Volume II of the full-length version of the OECD Model Tax Convention at page R(15)-1.

26.5 Paragraph 2 addresses this particular situation by referring to entities that are “wholly or partly” treated as fiscally transparent. Thus, the paragraph not only serves to confirm the conclusions of the Partnership Report but also extends the application of these conclusions to situations that were not directly covered by the Report.

26.6 The paragraph not only ensures that the benefits of the Convention are granted in appropriate cases but also ensures that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity or arrangement as the income of one of its residents. The paragraph therefore confirms the conclusions of the Report in such a case (see, for example, example 3 of the Report). Also, as recognised in the Report, States should not be expected to grant the benefits of a bilateral tax convention in cases where they cannot verify whether a person is truly entitled to these benefits. Thus, if an entity is established in a jurisdiction from which a Contracting State cannot obtain tax information, that State would need to be provided with all the necessary information in order to be able to grant the benefits of the Convention. In such a case, the Contracting State might well decide to use the refund mechanism for the purposes of applying the benefits of the Convention even though it normally applies these benefits at the time of the payment of the relevant income.

26.7 The following example illustrates the application of the paragraph:

*Example: State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.*

26.8 The reference to “income derived by or through an entity or arrangement” has a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State as to who derives that income for domestic tax purposes and regardless of whether or not that entity or arrangement has legal personality or constitutes a person as defined in subparagraph 1 a) of Article 3. It would cover, for example, income of any partnership or trust that one or both of the Contracting States treats as wholly or partly fiscally transparent. Also, as illustrated in example 2 of the Report, it does not matter where the entity or arrangement is established: the paragraph applies to an entity established in a third State to the extent that, under the domestic tax law of one of the Contracting States, the entity is treated as wholly or partly fiscally transparent and income of that entity is attributed to a resident of that State.

26.9 The word “income” must be given the wide meaning that it has for the purposes of the Convention and therefore applies to the various items of income that are covered by Chapter III of the Convention (Taxation of Income), including, for example, profits of an enterprise and capital gains.

26.10 The concept of “fiscally transparent” used in the paragraph refers to situations where, under the domestic law of a Contracting State, the income (or part thereof) of the entity or arrangement is not taxed at the level of the entity or the arrangement but at the level of the persons who have an interest in that entity or arrangement. This will normally be the case where the amount of tax payable on a share of the income of an entity or arrangement is determined

*separately in relation to the personal characteristics of the person who is entitled to that share so that the tax will depend on whether that person is taxable or not, on the other income that the person has, on the personal allowances to which the person is entitled and on the tax rate applicable to that person; also, the character and source, as well as the timing of the realisation, of the income for tax purposes will not be affected by the fact that it has been earned through the entity or arrangement. The fact that the income is computed at the level of the entity or arrangement before the share is allocated to the person will not affect that result.<sup>1</sup> States wishing to clarify the definition of “fiscally transparent” in their bilateral conventions are free to include a definition of that term based on the above explanations.*

*26.11 In the case of an entity or arrangement which is treated as partly fiscally transparent under the domestic law of one of the Contracting States, only part of the income of the entity or arrangement might be taxed at the level of the persons who have an interest in that entity or arrangement as described in the preceding paragraph whilst the rest would remain taxable at the level of the entity or arrangement. This, for example, is how some trusts and limited liability partnerships are treated in some countries (i.e. in some countries, the part of the income derived through a trust that is distributed to beneficiaries is taxed in the hands of these beneficiaries whilst the part of that income that is accumulated is taxed in the hands of the trust or trustees; similarly, in some countries, income derived through a limited partnership is taxed in the hands of the general partner as regards that partner’s share of that income but is considered to be the income of the limited partnership as regards the limited partners’ share of the income). To the extent that the entity or arrangement qualifies as a resident of a Contracting State, the paragraph will ensure that the benefits of the treaty also apply to the share of the income that is attributed to the entity or arrangement under the domestic law of that State.*

*26.12 As with other provisions of the Convention, the provision applies separately to each item of income of the entity or arrangement. Assume, for example, that the document that establishes a trust provides that all dividends received by the trust must be distributed to a beneficiary during the lifetime of that beneficiary but must be accumulated afterwards. If one of the Contracting States considers that, in such a case, the beneficiary is taxable on the dividends distributed to that beneficiary but that the trustees are taxable on the dividends that will be accumulated, the paragraph will apply differently to these two categories of dividends even if both types of dividends are received within the same month.*

*26.13 By providing that the income to which it applies will be considered to be income of a resident of a Contracting State for the purposes of the Convention, the paragraph ensures that the relevant income is attributed to that resident for the purposes of the application of the various allocative rules of the Convention. Depending on the nature of the income, this will therefore allow the income to be considered, for example, as “income derived by” for the purposes of Articles 6, 13 and 17, “profits of an enterprise” for the purposes of Articles 7, 8 and 9 (see also paragraph 4 of the Commentary on Article 3) or dividends or interest “paid to” for the purposes of Articles 10 and 11. The fact that the income is considered to be derived by a resident of a Contracting State for the purposes of the Convention also means that where the income constitutes a share of the income of an enterprise in which that resident holds a participation, such income shall be considered to be the income of an enterprise carried on by that resident (e.g. for the purposes of the definition of enterprise of a Contracting State in Article 3 and paragraph 2 of Article 21).*

---

1. See paragraphs 37-40 of the Report.

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

*26.15 The paragraph only applies for the purposes of the Convention and does not, therefore, require a Contracting State to change the way in which it attributes income or characterises entities for the purposes of its domestic law. In the example in paragraph 26.7 above, whilst paragraph 2 provides that half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B, this will only affect the maximum amount of tax that State A will be able to collect on the interest and will not change the fact that State A's tax will be payable by the entity. Thus, assuming that the domestic law of State A provides for a 30 per cent withholding tax on the interest, the effect of paragraph 2 will simply be to reduce the amount of tax that State A will collect on the interest (so that half of the interest would be taxed at 30 per cent and half at 10 per cent under the treaty between States A and B) and will not change the fact that the entity is the relevant taxpayer for the purposes of State A's domestic law.*

*[26.16 The last sentence of the paragraph clarifies that the paragraph is not intended to restrict in any way a State's right to tax its own residents. This conclusion is consistent with the way in which tax treaties have been interpreted with respect to partnerships (see paragraph 6.1 above). That sentence does not, however, restrict the obligation to provide relief of double taxation that is imposed on a Contracting State by Articles 23 A and 23 B where income of a resident of that State may be taxed by the other State in accordance with the Convention, taking into account the application of the paragraph].<sup>1</sup>*

*Comments are invited on the above proposal for the inclusion, in the OECD Model Tax Convention, of a new provision and Commentary dealing with transparent entities.*

### **3. Interaction between the recommendations included in the WP11 Discussion Draft and the provisions of tax treaties**

12. The WP11 Discussion Draft includes various recommendations for the domestic law treatment of hybrid financial instruments and hybrid entity payments and identifies the following possible issues related to the interaction between these recommendations and the provisions of tax treaties (paragraph 9 of the WP11 Discussion Draft):

The Action Item also calls for special attention to be given to the interaction between the domestic rules and the OECD Model Convention. The potential for conflict between domestic hybrid mismatch rules and the outcomes provided for under the OECD Model Convention depends, to a significant extent, on the manner in which the domestic rule goes about neutralising the tax consequences under the arrangement. Hybrid mismatch solutions that focus on denial of deductions in the payer state and/or forcing the inclusion in the payee state are domestic law solutions imposed

---

1. Please note that a proposal included in the Treaty Abuse Discussion Draft would make that paragraph unnecessary.

on domestic taxpayers and, at first glance, would not appear to implicate the taxing rights of other states. The provisions of the OECD Model Convention may be implicated, however, if a hybrid mismatch solution involves the imposition of tax on a non-resident with no permanent establishment in the taxing state. Further there may be concerns about the potential application of anti-discrimination provisions in the OECD Model Convention.

13. The following paragraphs deal with each of these issues.

*Rules providing for the denial of deductions*

14. Apart from the rules of Articles 7 and 24, the provisions of tax treaties do not govern whether payments are deductible or not and whether they are effectively taxed or not, these being matters of domestic law as correctly noted in the above-quoted paragraph 9. The possible application of the provisions of Article 24 with respect to the recommendations set out in the WP11 Discussion Draft is discussed below; as regards Article 7, paragraph 30 of the Commentary on that Article is particularly relevant:

30. Paragraph 2 [of Article 7] determines the profits that are attributable to a permanent establishment for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2 of Article 7, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed as long as there is conformity with the requirements of paragraph 2 and the other provisions of the Convention. Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 3 of Article 24 ...

*Imposition of tax on a non-resident with no permanent establishment in the taxing state*

15. Paragraph 9 of the WP11 Discussion Draft correctly notes that “[t]he provisions of the OECD Model Convention may be implicated, however, if an anti-hybrid solution involves the imposition of tax on a non-resident with no permanent establishment in the taxing state.” In fact, however, it would appear that the WP11 Discussion Draft only contemplates the imposition of tax by a jurisdiction in circumstances where the recipient of the payment is a resident of that jurisdiction or maintains a permanent establishment in that jurisdiction and since the allocative rules of tax treaties generally do not restrict the taxation rights of the State in such circumstances, any interaction between the recommendations in the WP11 Discussion Draft and the provisions of tax treaties will generally relate to the rules concerning the elimination of double taxation (Articles 23 A and 23 B of the OECD Model Tax Convention).

16. The following two recommendations included in the WP11 Discussion Draft deal with the elimination of double taxation by the State of residence:

- “Any jurisdiction that grants an exemption for dividends under domestic law should deny the benefit of such exemption if such dividends are deductible in the payer State”.
- “Any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should introduce rules that would restrict the benefit of such relief in proportion to the net taxable income under the arrangement”.

17. As explained below, these recommendations do not appear to raise any issues with respect to the application of Articles 23 A and Articles 23 B of the OECD Model Tax Convention.

### *Exemption method*

18. As regards Articles 23 A (Exemption Method), paragraph 2 of that Article provides that in the case of dividends (covered by Article 10 of the OECD Model Tax Convention), it is the credit method, and not the exemption method, that is applicable. The recommendation that “[a]ny jurisdiction that grants an exemption for dividends under domestic law should deny the benefit of such exemption if such dividends are deductible in the payer state” should not, therefore, create problems with respect to bilateral tax treaties that include the wording of Article 23 A.

19. It is recognised, however, that a number of bilateral tax treaties depart from the provisions of Article 23 A and provide for the application of the exemption method with respect to dividends received from foreign companies in which a resident company has a substantial shareholding. This possibility is expressly acknowledged in the OECD Model Tax Convention (see paragraphs 49 to 54 of the Commentary on Articles 23 A and 23 B).

20. Problems arising from the inclusion of the exemption method in tax treaties with respect to items of income that are not taxed in the State of source have long been recognised in the OECD Model Tax Convention (see, for example, paragraph 35 of the Commentary on Articles 23 A and 23 B). Whilst paragraph 4 of Article 23 A<sup>1</sup> may address some situations of hybrid mismatch arrangements where a dividend would otherwise be subject to the exemption method, many tax treaties do not include that provision. At a minimum, therefore, States that wish to follow the recommendation included in the WP11 Discussion Draft but that enter into tax treaties providing for the application of the exemption method with respect to dividends should consider the inclusion of paragraph 4 of Article 23 A in their tax treaties, although these States should also recognise that the provision will only provide a partial solution to the problem. A more complete solution that should be considered by these States would be to include in their treaties rules that would expressly allow them to apply the credit method, as opposed to the exemption method, with respect to dividends that are deductible in the payer State. These States may also wish to consider a more general solution to the problems of non-taxation resulting from potential abuses of the exemption method, which would be for States not to include the exemption method in their treaties. Under that approach, the credit method would be provided for in tax treaties, thereby ensuring the relief of double taxation, and it would be left to domestic law to provide whether that should be done through the credit or exemption method (or probably through a combination of the two methods depending on the nature of the income, as is the case of the domestic law of many countries).

### *Credit method*

21. As regards the application of the credit method provided for by paragraph 2 of Article 23 A and by Article 23 B, the recommendation that relief should be restricted “in proportion to the net taxable income under the arrangement” appears to conform to the domestic tax limitation provided by that method. As noted in paragraphs 60 and 63 of the Commentary on Articles 23 A and 23 B, Article 23 B leaves it to domestic law to determine the domestic tax against which the foreign tax credit should be applied (the “maximum deduction”) and one would normally expect that this would be the State of residence’s tax as computed after taking into account all relevant deductions:

---

1. “4. The provisions of paragraph 1 [*of Article 23 A*] shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.”

60. Article 23 B sets out the main rules of the credit method, but does not give detailed rules on the computation and operation of the credit. ... Experience has shown that many problems may arise. Some of them are dealt with in the following paragraphs. In many States, detailed rules on credit for foreign tax already exist in their domestic laws. A number of conventions, therefore, contain a reference to the domestic laws of the Contracting States and further provide that such domestic rules shall not affect the principle laid down in Article 23 B.

63. The maximum deduction is normally computed as the tax on net income, *i.e.* on the income from State E (or S) less allowable deductions (specified or proportional) connected with such income...

22. It is recognised, however, that double non-taxation situations may arise in the application of the credit method by reasons of treaty or domestic law provisions that either supplement, or depart from, the basic approach of Article 23 B (Credit Method) of the OECD Model Tax Convention. One example would be domestic law provisions that allow the foreign tax credit applicable to one item of income to be used against the State of residence's tax payable on another item of income. This is another situation where Contracting States should ensure that their tax treaties provide for the elimination of double taxation without creating opportunities for tax avoidance strategies.

*Comments are invited on the preceding analysis of the interaction between the recommendations of the WP11 Discussion Draft and the treaty provisions concerning the elimination of double taxation.*

*Comments are invited, in particular, on the approaches put forward in paragraphs 20 and 22 concerning potential solutions to the issues raised by treaty provisions for the elimination of double taxation.*

#### *Concerns about the potential application of anti-discrimination provisions in the OECD Model Convention*

23. The basic thrust of the draft recommendations set out in the WP11 Discussion Draft is to ensure that payments are treated consistently in the hands of the payer and the recipient and, in particular, to prevent a double deduction or deduction without a corresponding inclusion. These recommendations do not appear to raise any issue of discrimination based on nationality (Art 24(1)). They also do not appear to treat permanent establishments differently from domestic enterprises (Art 24(3)), to provide different rules for the deduction of payments made to residents and non-residents (Art. 24(4)) or to treat domestic enterprises differently based on whether their capital is owned or controlled by residents or non-residents (Art. 24(5)).

24. The reason for the “concerns about the potential application of anti-discrimination provisions” to which the WP11 Discussion Draft refers is probably due to the fact that some of the recommendations included in that discussion draft may impact payments to non-residents more than they will impact payments to residents. This, however, is not relevant for the purposes of Article 24 as long as the distinction is based on the treatment of the payments in the hands of the payors and recipients. The fact that a mismatch in the tax treatment of an entity or payment is less likely in a purely domestic context (*i.e.* one would expect a country to be consistent in the way it characterises domestic payments and entities) cannot be interpreted as meaning that rules that are strictly based on the existence of such a mismatch are treating payments to non-residents, or to non-resident owned enterprises, differently from the way payments to residents, or resident-owned enterprises, are treated under domestic law.

25. The following excerpts from the Commentary on Article 24 are of particular relevance in that context:

- *As regards all the provisions of Art. 24:* “The non-discrimination provisions of the Article seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions. For that reason, the Article should not be unduly extended to cover so-called “indirect” discrimination.” (paragraph 1)

“Also, whilst the Article seeks to eliminate distinctions that are solely based on certain grounds, it is not intended to provide foreign nationals, non-residents, enterprises of other States or domestic enterprises owned or controlled by non-residents with a tax treatment that is better than that of nationals, residents or domestic enterprises owned or controlled by residents ...” (paragraph 3)

- *As regards Art. 24(3):* “That principle, therefore, is restricted to a comparison between the rules governing the taxation of the permanent establishment’s own activities and those applicable to similar business activities carried on by an independent resident enterprise. It does not extend to rules that take account of the relationship between an enterprise and other enterprises (*e.g.* rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership) since the latter rules do not focus on the taxation of an enterprise’s own business activities similar to those of the permanent establishment but, instead, on the taxation of a resident enterprise as part of a group of associated enterprises.” (paragraph 41)

- *As regards Art 24(4):* “This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident.” (paragraph 73)

- *As regards Art. 24(5):* “Since the paragraph relates only to the taxation of resident enterprises and not to that of the persons owning or controlling their capital, it follows that it cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises (*e.g.* rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership).” (paragraph 77)

“...it follows that withholding tax obligations that are imposed on a resident company with respect to dividends paid to non-resident shareholders but not with respect to dividends paid to resident shareholders cannot be considered to violate paragraph 5. In that case, the different treatment is not dependent on the fact that the capital of the company is owned or controlled by non-residents but, rather, on the fact that dividends paid to non-residents are taxed differently.” (paragraph 78)

26. For these reasons, and subject to an analysis of the precise wording of the rules that would be drafted and in particular, of the definitions of “hybrid” and “hybrid payment”, the recommendations set out in the WP11 Discussion Draft do not appear to raise concerns about a possible conflict with the provisions of Article 24 of the OECD Model Tax Convention.

*Comments are invited on the preceding analysis of the interaction between the recommendations of the WP11 Discussion Draft and the provisions of Article 24 of the OECD Model Tax Convention.*