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Classification of hybrid entities

NOTE ON COORDINATION RULES AS A SOLUTION TO TAX ARBITRAGE

Summary

At its seventh annual session the Committee noted in its report that[1]:

"With the latest update of the United Nations Model Convention completed, the Committee considered that it would be useful to examine a series of issues by having papers presented for discussion at the eighth session, in 2012. The question of whether to create subcommittees or working groups would be considered as part of that discussion. In that regard, the Committee decided that:

- Victor Thuronyi would provide a paper on hybrid entities, focusing on the classification of non-resident entities […]"

This note has been prepared by Mr. Victor Thuronyi in response to that mandate.

[1] Report of the seventh annual session, E/2011/45, at paragraph 118.

COORDINATION RULES AS A SOLUTION TO TAX ARBITRAGE

Victor Thuronyi[2]

I. Introduction

International tax arbitrage refers to a situation where a given transaction is treated for tax purposes differently by the countries concerned by the transaction, and the taxpayer or taxpayers involved take advantage of that inconsistent treatment to reduce their overall tax burden. There is a considerable discussion in the literature as to whether tax arbitrage represents a problem or not.[3] The basic argument that there is no problem is that, as long as all the taxpayers involved are complying with the law, no state involved has reason for complaint. Moreover, given the fact that tax systems of different states differ from each other, arbitrage is bound to arise as part of normal tax planning.

Inconsistency in tax rules can also lead to the opposite problem: double taxation. A simple example of this is the treatment of an individual as a resident by two countries, each of which taxes the individual on worldwide income.

A more practical approach than discussing whether arbitrage or double taxation is undesirable in the abstract may be to examine specific rules and explore the possibility of harmonizing or coordinating them. One example might be the rule defining resident individuals. If each country had the same rule, then it would be unlikely for a given individual to be considered a resident of more than one country. As countries have different rules, some being fairly broad, dual residence for an individual becomes more likely. Countries have typically preferred to deal with this issue in treaties. If an individual is a resident of two countries with a treaty, the treaty will normally have a tie-breaker rule under which only one of the countries ends up being able to exercise residence-based jurisdiction. At least in the case of residence of individuals, countries typically have made a determination that it would not be desirable for more than one country to treat a given individual as a resident, if this can be done via a treaty. Moreover, residence definitions found in domestic law typically exercise restraint, and are fashioned in such a way that dual residence will rarely result. Thus, many countries use as a primary test presence in the jurisdiction for more than half of a year. This kind of test makes it unlikely that an individual will be treated as a resident by more than one country. The problem of residence definition, then, is addressed first by a fair amount of harmonization of domestic law – not an absolute harmonization but an approximation that reduces cases of double residence. Second, a treaty mechanism exists to eliminate the remaining cases of double residence for treaty partners.

I will assume – in line with legislative actions taken by various countries in the past decade or so – that many countries are interested in doing something about reducing arbitrage opportunities, at least in respect of certain types of transactions.[4] The purpose of this paper is simply to examine the technical issue as to whether tax coordination rules might be a better way of dealing with arbitrage than ad hoc anti-abuse rules (I explain below what I mean by "coordination rules"). I discuss several possible coordination rules in detail.

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2 This paper is based on an article published in Tax Notes International on March 22, 2010. The views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management, nor to the United Nations or any organ thereof.

3 *See generally* Reuven Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (2007); Diane Ring, One Nation among Many: Policy Implications of Cross-Border Tax Arbitrage, 44 Boston Coll. L. Rev. 79 (2002); H. David Rosenbloom, *International Tax Arbitrage and the "International Tax System,"* 53 Tax L. Rev. 137, 153 (2000); Daniel N. Shaviro, ''Money on the Table: Responding to Cross-Border Tax Arbitrage,'' 3 *Chi. J. Int'l L.* 317 (2002); Philip West, Antiabuse Rules and Policy: Coherence or Tower of Babel, Tax Notes Int'l 1161 (March 31, 2008); Mitchell Kane, Strategy and Cooperation in National Reponses to International Tax Arbitrage, 53 Emory L.J. 89 (2004); Rosenzweig, Harnessing the Costs of International Tax Arbitrage, 26 Va. Tax Rev. 555 (2007).

4 I assume, in other words, that at least in respect of certain arbitrage opportunities, governments might in principle be interested in cooperating in the manner described in Kane, supra note 1, at 168. This article discusses the mechanics of how such cooperation could be effected.

Inconsistent characterization of entities and transactions facilitates cross-border tax planning and leads to complexity in international taxation as countries try to deal with what they perceive as abusive transactions. As long as national tax systems differ, there will always be scope for tax arbitrage, and it would be impossible to remove it completely. This article suggests, though, that the adoption of coordination rules for basic tax building blocks would go a long way to both simplifying international tax rules and minimizing abuse.

Harmonization of rules (i.e. all countries adopt the same rules) would be the most comprehensive way of dealing with arbitrage. However, harmonization risks being overbroad and unduly ambitious. Most transactions to which a country's tax rules apply are domestic. Countries do not need to change their domestic rules in all respects in order to eliminate cross-border inconsistencies.[5] They just need to adopt rules for coordinating how their domestic rules apply to cross-border transactions (this is what I mean by a coordination rule). The general approach suggested for such a coordination rule is for all countries to follow the domestic law characterization of a given country in respect of a given cross-border transaction or entity. This general approach is similar to the choice-of-law rules that apply in the private international law area (sometimes called conflict of laws). How to identify that country is discussed below. This approach minimizes disruption to domestic rules. It is also more flexible than harmonization, since domestic rules can change over time without affecting the integrity of the international coordination mechanism.

The suggested approach is much simpler than solutions that are targeted to specific abuses.[6] Specific anti-abuse rules are inevitably complex to formulate, often uncertain in application, and only partially effective. By contrast, the approach suggested here would provide general rules for basic tax building blocks that would apply in all cases. The resulting system would be simpler and more transparent than the rules we have today.

This article therefore refrains from focusing on specific transactions that might be considered as abusive. Instead, an attempt is made to construct a more solid legal base for tax systems by specifying coordination rules. Each country can then adopt additional specific anti-avoidance rules if needed.

II. Legal mechanism

The proposed coordination rules could be implemented by a variety of mechanisms, including a multilateral treaty, a directive (for the EU), or unilateral legislation. A unilateral approach might be the most flexible and most easily adopted – in fact, some countries have already adopted unilateral rules dealing with cross-border arbitrage transactions (see discussion below). Unilateral action could bring benefits immediately (as soon as one or more countries adopt the rule), although it would be fully effective only if adopted by a substantial number of countries. (The efficacy of unilateral action that is not emulated by other countries will of course vary depending on the subject matter, so it is difficult to generalize.) Importantly, it would not be necessary for all countries to agree in order for unilateral measures to work. Of course, unilateral measures risk not being uniform and could accordingly be more complex in application than a multilateral solution. Moreover, any measures involving lists (for example, lists of types of corporate entities) are more easily maintained and updated on a multilateral basis.

A multilateral treaty embodying one or more coordination rules would suffer from the usual disadvantages of multilateral treaties. Negotiations would likely be time consuming, and even if a

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5 In other words, in general, countries can if they wish maintain unchanged their tax rules as they apply to purely domestic transactions. The U.S., for example, under this proposal could keep its check-the-box rules unchanged insofar as they apply to U.S. entities.

6 See section III (J) below.

treaty were negotiated, it might take a long time for individual countries to sign and ratify the treaty. Importantly as well, in such a technical area, there is a risk that a treaty would end up suffering from technical errors. These might be difficult to correct given that the consent of the treaty signatories would be required.

Instead of a legally binding rule, a more flexible mechanism to adopt a coordination rule would be a non-binding recommendation made by an expert body, such as the OECD's Committee on Fiscal Affairs or the UN's Committee of Experts on International Cooperation in Tax Matters. Both groups enjoy the advantage of access to numerous country representatives who are familiar with the technical issues and who could debate and agree on a recommendation. Governments would then be free to adopt the recommendation or not as they choose. If the nature of the coordination rule is such that it would provide benefits even in the absence of universal adoption, this might be the most attractive route.

III. Entity classification

A. In general

An important and pervasive cross-border arbitrage issue involves entity classification, and arises because countries classify business entities inconsistently. The consequences of the inconsistent classification differ depending on the nature of the transaction. This article is not the place for a discussion of the specifics; I am assuming that readers are familiar with various transactions that raise problems – there might for example be an issue in applying tax treaties or determining foreign tax credits, there might be payments treated by one country as deductible interest paid by one entity to another, which are ignored by another country. As a simple example,[7] suppose that a Country B corporation sets up a Country A entity as the 100% owner of a Country A corporation. Suppose that the Country A entity is treated as a corporation by Country A but as a pass-through entity by Country B. Suppose further that the Country A corporation pays a dividend to the Country A entity, and that the Country A entity pays the dividend in the form of interest on a loan from the Country B corporation. Country A allows a deduction for the interest, while Country B treats the payment received by the Country B corporation as a dividend which qualifies for a participation exemption (Country B disregards the loan because the country A entity is not treated as a separate entity). The interest paid by the Country A entity may further qualify for a zero or low tax rate under the tax treaty between Country A and Country B.

A solution to the general problem of inconsistent classification would be for countries to adopt a rule that classifies an entity as a corporation for income tax purposes if it is a per se corporation (i.e. an entity of a type included on a list of per se corporations) or is treated as a resident corporation for corporate income tax purposes in any country.[8] In the above example, Country B would treat the Country A entity as a corporation, because that is what Country A does, and would accordingly treat the payment received from this entity as fully taxable interest.

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7 The example is borrowed from Ring, *supra* note 2, at 99-100.

8 I make no claim to the originality of this idea. A similar general approach was suggested, for example, in John Avery-Jones et al., Characterization of Other States' Partnerships for Income Tax, 56 Bull. Int'l Fiscal Doc. 288, 314-20 (2002). An ABA Tax Section report proposed to "classify a foreign business entity as a corporation if the entity is subject to an entity-level income tax (under U.S. foreign tax credit principles) under the law of its country of tax residence," and otherwise, classify the foreign business entity as a pass-through entity. See A.B.A., *Report of the Task Force on International Tax Reform*, 59 Tax Law. 649, 669 (2006). The main differences between the ABA formulation and the proposal formulated here are that the ABA proposal does not explain what happens if there is more than one country of tax residence, and does not contain a "per se" rule. Similarly, Gijsbert Fibbe has proposed an EU directive under which an entity would generally be treated as opaque if it is treated as a resident corporation in an EU state. See Gijsbert Fibbe, EC law aspects of hybrid entities (2009). Lokken, Whatever Happened to subpart F?: U.S. CFC Legislation After the Check-the-Box Regulations, 7 Fla. Tax Rev. 185 (2005) also proposes a solution that is similar to that advocated here.

Exactly how classification of an entity as a corporation would be expressed for purposes of a country's tax laws depends on the terminology used by the specific country. For most common law countries, it will suffice to say that the entity is considered a corporation. In many civil law countries, it will be appropriate to say that the entity is treated as a "legal person." The specific wording needs to be worked out in the context of each country's corporate income tax law. Colloquially, one can refer to an entity being treated as "opaque". The references in this article to treatment as a corporation are intended to be synonymous to treatment as opaque.

Note that this proposed rule creates a bias in favor of an entity being treated as a corporation: all it takes is for one jurisdiction to treat that entity as a resident corporation – other jurisdictions would defer to this classification. The main reason for structuring the rule this way is that it is simple: in case more than one country considers an entity as resident, but the countries view that entity (as being opaque or transparent) differently, the conflict between them can be resolved without assigning a unique residence: classification as an entity always trumps. From a compliance point of view, once an entity files a tax return as a resident corporation in a given jurisdiction, the entity will know that all other jurisdictions that have adopted this coordination rule will treat it as a corporation. This rule should be easy for taxpayers to understand and comply with.

Incidentally, this would allow the U.S. to maintain a check-the-box regime, but only with respect to U.S. entities. This would preserve the administrative benefits of check-the-box, i.e. to achieve certainty in entity classification, while removing abuse in respect of cross-border transactions.

Under the proposal, an entity is treated as a corporation if :

(a) it is a per se corporation; or
(b) it is –
    (i) subject to corporate income tax by a country; and
    (ii) considered a resident by that country.

B. Per se corporations

The check-the-box regulations treat certain entities as corporations without the possibility of making a check-the-box election.[9] The classification is based on the type of entity – i.e. its legal form (what it is called). The companies included on the list are stock companies. The per se approach relies on legal form and lists certain entity types as automatically opaque, without having to determine in the particular case how foreign law is applied to that entity. All you need to know is the entity's type and state of incorporation.

The proposal would be to adopt such a list approach. The major benefit of this approach is to simplify operation of the rule in practice. Moreover, given that virtually all jurisdictions today would classify stock companies as corporations, the list approach would maximize the consistency of the cross-border rule with domestic law. Put another way, it would remove the possibility that the cross-border coordination mechanism might *reduce* the degree of harmonization in entity classification that we observe today.[10]

The list of per se corporations could be expanded from that currently found under the U.S. check-the-box rules. First, an effort should be made to include as many jurisdictions as possible. Second, one could go beyond listing just stock companies, and include other entities on the list by reference to their treatment for tax purposes in their state of incorporation. This should be done only upon confirmation

[9] Treas. Reg. sec. 301.7701-2(b)(8).

[10] Without a list, an entity incorporated in a jurisdiction that has no corporate income tax would be treated as transparent if no other jurisdiction treated it as a resident. If only a few countries adopt the cross-border coordination mechanism, then they would treat the entity as transparent, while countries that did not adopt the coordination mechanism would continue treating such an entity as opaque.

that a particular type of entity formed in that state will be treated as a resident for corporate income tax purposes and will in all cases be subject to corporate level tax.

Per se corporation treatment should extend only to entities that are in fact subject to a corporate level tax in their home country. Thus, a U.S. corporation that makes an S election should not be treated (by other countries) as a per se corporation, since it is not subject to corporate tax by the U.S. On the other hand, the requirement that the entity be taxable as a corporation should not apply to corporations formed in countries that do not have a generally applicable corporate tax. For these countries, the legal form of the corporation (as opposed to the tax treatment) would suffice for its characterization. This is a bright-line rule for convenience. It establishes a somewhat arbitrary line between a country with no corporate tax and one that imposes a corporate tax at a very low rate. The line has to be drawn somewhere. It should not provide scope for abuse: an entity that is not a per se corporation, that is established in a country without a corporate tax, and that is not treated as a resident in any other country will be treated as transparent (even though it might, for example, have limited liability), but this treatment will be consistent by all countries, so there should be no confusion as to the applicable rules and no arbitrage opportunities. On the other hand, if the entity takes a legal form that puts it on the per se list, then it will be treated as an opaque entity in all jurisdictions.

C. Concept of being subject to corporate income tax

To apply the proposed rule, we need to ascertain whether being subject to corporate income tax is a well defined concept. The vast majority of countries have a tax that is readily identifiable as corporate income tax, but for those that do not, there should not be a problem because an entity (other than a per se corporation) formed in such a country would be treated as transparent, assuming it is not treated as a resident corporation anywhere else.

There is also the problem of exempt entities. Exempt entities are in some countries subject to tax at the entity level on certain types of income (for example, unrelated business income). Because of this potential tax liability at the entity level, such an entity should be considered as subject to corporate level tax without further question. Even if a country exempts charitable entities completely from income tax, we could still consider the entity to be treated as a corporation if it were potentially subject to tax (in other words, if it would be taxable as an entity were it to fail the qualifications for being exempt). Similarly, an exempt entity could be considered taxable as a corporation if it meets a general definition of corporation in the country's corporate income tax law.

In the case where an entity benefits from a specific tax exemption, i.e. there is a provision naming the entity or describing a class of entities that is not subject to tax (for example, a corporation deriving all its income from farming), the test would be: would the entity be taxable as a corporation if the exemption were removed? For example, a Central Bank is typically a legal entity and would be taxable as a corporation if it were not exempted by name in the corporate income tax law.

In general, subjection to corporate income tax should be determined not by the label that a country applies (labels can differ) but by whether the country taxes the entity's profits at the entity level. For example, India taxes both general partnerships and LLPs at a flat rate at the entity level, with no additional tax on the partners.[11] This should be considered as a corporate tax. If, however, a country were to impose a withholding tax at the entity level, with subsequent tax on the partners (with a credit allowed for the tax withheld), that should not be considered an entity level tax. Likewise if (as in the Slovak Republic) a final withholding tax on certain income is imposed at the entity level, with other income generally flowing through to the partners, that should not cause the partnership to be considered as opaque for tax purposes. (The dividing line might be that if *all* the income of certain partners is taxed at the entity level, while the income of other partners is taxed in their hands, the entity could be treated as partially opaque (see below) whereas if only *certain types of income* (e.g. income

[11] See Harshal Shah and Parul Jain, Indian Budget 2009, 55 Tax Notes International 260 (July 27, 2009).

from capital) are subject to final withholding tax, that should not lead to treatment of the entity as opaque.)

Sometimes taxation as a corporation is elective. In France, certain partnerships can elect to be subject to corporate income tax. This is a well-defined situation: if an entity makes the election, it should be treated as opaque under the proposal because it is in fact subject to entity-level tax. Likewise, a U.S. entity that makes a check-the-box election to be treated as transparent should be treated as transparent by other countries (unless it is considered as resident for tax purposes in another country and treated by that country as opaque).

Another possibility is that a country treats an entity as a corporation, but transparent at the election of the shareholders (S corporation in the U.S.). Such entities should not be regarded as subject to corporate tax, and therefore should be treated as transparent by other countries, unless they are treated as a resident company in another jurisdiction. This is because even though they may have a corporate label, taxation is effectively at the shareholder level; the flow-through treatment of the entity for tax purposes (hence, the absence of a corporate-level tax) should be the determining factor.

Another situation is that the entity's home country treats it as partially opaque. For example, in the Czech Republic, limited partnerships are treated as opaque only to the extent of the limited partners' interests; the interests of general partners are taxed at the level of the partners. There are similar entities in Germany and France. It should be feasible for other countries to treat such entities as opaque only to the extent that they are so treated in their home country. This treatment (i.e. as partially opaque and partially pass-through) seems appropriate because it reduces the differences between different tax systems and hence reduces the scope for arbitrage.

D. Concept of residence for corporate tax purposes

Most countries do divide taxpayers into residents and nonresidents. Some countries (like Austria and Germany) refer to limited and unlimited tax liability; those entities with unlimited tax liability are effectively treated as residents. Countries with a purely territorial tax system may not have a concept of residence for corporate income tax purposes. This is because such countries do not distinguish between residents and nonresidents. For such countries we can fall back on the private law rule that generally looks to a corporation's place of incorporation as its home. Thus, if an entity is incorporated in a state with territorial taxation (no concept of residence in the corporate income tax), and is treated as a separate entity under the tax law of this state, then we can consider it as being a resident of this state (and as being opaque). For example, under this approach a company formed under the laws of Hong Kong would be treated as opaque if it is treated as a separate entity for purposes of Hong Kong income tax, even though Hong Kong income tax law does not treat it as "resident" since that concept is not relevant for Hong Kong income tax purposes. Of course, if the company is on the per se list then the list will take care of the issue.

A few countries treat a permanent establishment of a nonresident as a separate entity which is a resident taxpayer.[12] Even though the tax law may consider the PE to be a separate entity, for purposes of the proposal, this rule should be ignored, and just considered as a drafting mechanism for taxing a nonresident on the income of its branch. That is, where a resident corporate entity exists for tax purposes solely because it is a branch of a nonresident, the branch would not be regarded as a resident entity for purposes of the rule. The result would be that other countries would treat the branch as part of the nonresident entity (characterization of that entity as opaque or transparent would depend on characterization by that entity's residence country). This approach makes sense because treatment of a PE as a separate entity is rather unusual, and it would be least confusing to maintain the existing rules

[12] E.g., Peru, Income Tax Law (Texto Unico Ordenado de La Ley Del Impuesto a La Renta), article 7(e).

for the vast majority of countries. Moreover, the resulting inconsistency in treatment would not give rise to arbitrage opportunities.

E. Tie-breaker rule in treaties

The entity classification rule should be applied before the application of any tie-breaker rules in treaties. Thus, for example, in a case where State A considers an entity to be a partnership while State B considers the entity to be a resident corporation, the first step would be for State A to apply the rule and treat this entity as a corporation because of the classification by State B. After this, a treaty tie-breaker rule might apply, which might cause the corporation to be treated as a resident of either State A or of State B. (Notice that in the case where the corporation ends up being a resident of State A, it will end up being treated as a corporation rather than a partnership. In this case, State A's law looks to that of State B even though in the final analysis the entity ends up not being a resident of State B, due to the application of the tie breaker.)

F. Entity which no jurisdiction treats as opaque and as a resident

The negative implication of the rule is as important as the positive implication. If a business entity is not treated as a resident for corporate income tax purposes anywhere, then the entity would be treated as transparent by all jurisdictions. In the most usual situation, this will arise because the entity is treated as transparent under the tax laws of the jurisdiction where it is formed, but there is also the situation where an entity is formed under the laws of a given jurisdiction, but is not treated as resident for corporate tax purposes in that jurisdiction (perhaps because the jurisdiction does not have a corporate income tax), and it is not a resident anywhere else. Of course, the entity would be treated as opaque if it is a per se corporation.

The result may seem odd. In the case of an entity that is not on the list of per se corporations, but is formed in a country without an income tax, treating it as transparent may seem unusual, but it is feasible. By definition, no country taxes this entity as a resident. If all countries treat it as transparent, there will be consistent treatment.

G. Procedure and change in classification

There is also the problem that an entity might be formed in a jurisdiction where it is transparent but that another country (e.g. China) treats the entity as resident under a managed and controlled test. At the time of filing its return, suppose that the entity takes the position that it is a transparent entity and is not resident in China (because the entity believes that as a factual matter it is not managed and controlled in China). This case is not likely to be so frequent and the best answer is probably to let the chips fall where they may and if China eventually imposes tax on the entity as a corporation, it should be treated as a corporation by other countries, even if this would require potential amendment of returns elsewhere.

Of course an entity could also shift from being transparent to being opaque if its place of residence shifts. Effectively this would be like the reincorporation of the entity in the new residence country.

H. Trusts

For the avoidance of doubt, it might be specified that a trust that is taxed on a partial flow-through basis (i.e. trustees taxed on capital gains or taxed on other income retained by the trust until its distribution or allocation to beneficiaries) is not considered as subject to an entity-level tax for that reason. This is because this is not *corporate* income tax. Of course, a type of trust that is taxed as a business entity (no flow-thru to the owners) would be considered as taxable as a corporation.

I. Discussion

The approach is to some extent a negative one: an entity that is not treated as a resident corporation by any jurisdiction will be considered transparent. This approach allows the rule to be relatively simple. We do not need to define the universe of business entities or specify the tax treatment of entities such as trusts or partnerships. Unless a trust is treated as a resident corporation (which is possible, if it is a business trust), it is simply outside the scope of the rule. The rule classifies corporations, but does not answer all questions about how non-corporate entities are to be treated. Thereby, the rule can be formulated in a relatively simple manner.

For the U.S., application of the rule would require restricting the check-the-box regulations to domestic entities only (for this purpose, an entity that is treated as a resident company in another country would not be considered a domestic entity). If a U.S. entity elects to be treated as a corporation under the check-the-box rules, other countries would follow that treatment. By contrast, for foreign entities, the U.S. would simply look to see whether the entity is treated as a corporation in its home country.

The proposal has a general bias in favor of treating an entity as opaque. Thus, if an entity is formed in one state (where it is transparent) but is treated as resident in another state (where it is opaque), all states adopting the proposal would regard the entity as opaque.

J. Current legislation on hybrid entities

Several countries have dealt with hybrid entities in legislation or in treaties. Some of these rules lead to a similar result to what is being advocated here. Some of the solutions are more targeted. My contention is that the proposal advocated here would be more effective and simpler to administer than the piece-meal approach that is typically found in legislative responses to hybrid entities.

Australia in 2004 enacted rules dealing with foreign hybrids.[13] It is not my intention to attempt a detailed analysis of these rules, but the basic picture is that the rules are very close to the proposal I am making in this paper, although formulated somewhat differently. Essentially, Australia treats as partnerships certain foreign entities which it would otherwise treat as companies under its own domestic rules. The rules apply only to nonresident entities. The rule was actually adopted as a pro-taxpayer amendment to deal with defects in how the Australian CFC rules applied to certain hybrids (primarily UK and US limited partnerships).[14] The Australian amendment is interesting in that it

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13 Division 830 of the Income Tax Assessment Act 1997.

14 See Bills Digest No. 32 (2003-04), Taxation Laws amendment Bill (No. 7) 2003. As explained to me by Prof. Lee Burns of the University of Sydney, the main impetus for the foreign hybrid rule was problems under the CFC rules, particularly with limited partnerships formed in the US and UK. Under Australian tax law, limited partnerships are treated as companies and, therefore, a foreign limited partnership could be a CFC. The taxing rules for CFCs differ depending on whether the CFC is a resident of a listed country (list of 7 countries including the US and UK) or an unlisted country (everywhere else). The residence of the CFC is determined according to the tax law of the relevant foreign country and if a foreign company has no residence under any country's tax law it is treated as a resident of an unlisted country by default. In broad terms, the problem that emerged was that a US or UK limited partnership was not treated as a resident of the US or UK under US or UK tax law, as the case may be, because they were taxed as look throughs and not as separate entities in those countries. Consequently, US and UK limited partnerships ended up as residents of an unlisted country by default. This meant that (1) the CFC could never pass the active income test (one of the conditions is that the CFC has to be resident of particular country), (2) it was subject to the broader income inclusions applicable to unlisted countries; and (3) it could not access the de minimis exemption, which is applicable only to listed country CFCs. The other problem related to double tax relief. In calculating CFC income (which is done according to Australian tax law), a deduction is allowed for foreign tax paid by the CFC. If a deduction for foreign tax is allowed and the Australian taxpayer is a company, the taxpayer can then gross up and credit. In technical terms, a CFC was allowed a deduction only for foreign tax that it paid. The problem was that the partners not the partnership paid the US or UK tax and, therefore, no deduction was allowed. If no deduction was allowed, then there could be no gross-up and credit. This meant that there was no tax relief at all for the US or UK tax. The foreign hybrid rules avoid this outcome by treating the partnership as a look through if the foreign country also treats it as a look through so that the partner is the taxpayer and can get relief for the foreign tax paid.

According to Burns, there is a nice logic to the reform in that it ensured consistency in entity classification by giving priority to the foreign country's classification. This amendment was explicitly directed at fixing the problem for shows that the removal of inconsistent treatment by different countries is not in all cases to be viewed as an anti-abuse rule. Rather, the rule can be seen as a relatively neutral rule that allows different tax systems to interact with each other in a smoother manner. It is also interesting to note that the problem arose in the CFC context, which is not surprising, because by definition the CFC rules deal with entities that are not resident taxpayers. When these rules attempt to legislate in respect of foreign entities, they make certain assumptions about how these entities are taxed by foreign countries. If those assumptions prove wrong, because an entity is a hybrid, the rules tend not to work. Instead of the rather complex route of trying to specifically fix the CFC rules, the Australian experience corroborates that a more general approach of removing hybridity leads to a more elegant solution.

Denmark enacted rules specifically targeted at the U.S. check-the-box rules under which Denmark follows the treatment provided by the U.S. in respect of a U.S.-owned Danish company.[15] These rules apply where the Danish company elects to be treated as transparent for U.S. tax purposes. The proposal is in the same spirit as the one made in this paper, although the result happens to be the opposite, since under my proposal the U.S. would treat any opaque Danish resident entity as opaque. In other words, instead of Denmark conforming its tax treatment to the U.S. treatment, the U.S. would conform to the Danish treatment.

Sweden follows a “similarity approach” under which the foreign tax treatment of an entity is relevant to its classification for Swedish tax purposes.[16] In particular, an entity is treated as transparent by Sweden if it is transparent in the country where it is domiciled.[17] The Swedish approach is therefore close to the approach advocated here, although differing in some respects.

The UK enacted legislation in 2005 aimed at tax-avoidance transactions using cross-border arbitrage.[18] The legislation would deny deductions in the case of certain tax-motivated transactions involving hybrid entities. It would not, however, generally recharacterize entities in the manner proposed here, and its scope is therefore much narrower.

The fifth protocol to the US-Canada treaty, which was finalised in 2007, contains provisions targeted at hybrid entities.

K. Possible statutory language

There follows some draft model statutory language. It assumes unilateral implementation. Naturally, the language would have to be adjusted to the circumstances of each country adopting it.

Section XX. Classification of Foreign Business Entity as Corporation or Partnership

1. For purposes of this law, the term “corporation” includes an entity that is described in subsection 3.

Australian taxpayers. The outcome, though, was that Australian resident partners were then subject to look through taxation under the ordinary partnership rules that do not contain any deferral rules in relation to active and comparably taxed income as was the case under the CFC rules. For corporate partners this was not a major problem as they could access the branch profits exemption (assuming that the partnership’s operations in the US or UK amounted to a permanent establishment, which it usually would). The branch profits exemption is structured to replicate the CFC outcome with active income and comparable tax exemptions. For other partners (such as individuals), the change meant that they lost the deferral benefit particularly of active income, so they were worse off unless they restructured. So the amendment turned out not to be uniformly pro-taxpayer.

15 See Ole Steen Schmidt, The Scope of the New Danish Anti-check-the-box Regulations, 55 Tax Notes International 939 (Sept. 14, 2009); Nikolaj Bjornhom and Arne Riis, Denmark Cracks Down on Reverse Hybrid Entities, 50 Tax Notes International 979 (June 23, 2008).

16 See Jesper Barenfeld, Taxation of Cross-Border Partnerships (2005).

17 See id. at 302.

18 See Finance (No. 2) Act 2005, sections 24-31.

2. A business entity that is formed under the laws of a foreign country and that is not described in subsection 3 is treated for the purposes of this law as a partnership.

3. An entity is described in this subsection if it is –

a. on the list of per se corporations published by the [name of agency]; or

b. subject to corporate tax by any country which treats it as resident by reason of being incorporated in the country, having its place of effective management in the country, or having a similar connection to the country.

4. If an entity that is treated as a resident of a country within the meaning of subsection 3(b) has more than one class of owners and if the income attributable to one or more classes of owners is taxed in the hands of the owners, while the income attributable to another class or classes of owners is taxed at the entity level, the entity is treated as being described in subsection 3(b) in respect of the portion taxable at the entity level.

5. An entity that is exempt from tax in a given country but that would be subject to corporate income tax at the entity level in the absence of such exemption is treated as being subject to corporate tax.

6. For purposes of subsection 3, an entity is treated as resident in a given country if that country imposes tax on a territorial basis only, has no definition of resident company or the like in its corporate income tax law, and treats the entity as a separate entity for income tax purposes.

7. An entity that files a tax return or takes other steps that are consistent with being taxed as a resident corporate taxpayer in a given country is treated as being described in subsection 3, until such time as a final determination is made that the entity is not a resident taxpayer.

8. If an entity described in subsection 3(a) makes an election to be taxed on a flow-through basis in a country where it is treated as a resident, then the entity is not treated as described in subsection 3(a) for purposes of subsection 1.

IV. Hybrid instruments

A coordination rule concerning cross-border hybrid instruments could complement the entity classification rule. The general rule is easy to state: an instrument issued by a corporation is treated as equity if it is so treated by the corporation's state of residence. For this rule, a tie-breaker is needed, because a unique state of residence must be identified. If we adopt the tie-breaker in the OECD Model, the result is that the characterization by the state where the corporation's effective management is located will govern.

Some countries have enacted rules against hybrid instrument transactions. For example, since 2007, Denmark disallows an interest deduction on debt that is treated as equity by a foreign-related creditor.[19] Similarly, under article 8b of the corporate income tax act, Germany denies an exemption for an equity instrument if a deduction is allowed to the issuer.

[19] See Nikolaj Bjornhom and Arne Riis, Denmark Cracks Down on Reverse Hybrid Entities, 50 Tax Notes International 979 (June 23, 2008).

The rule will not deal with all questions concerning cross-border transactions involving corporate equity. For example, it does not deal with the question of who is treated as the owner of particular shares. Nor does it deal with derivatives.

From a procedural point of view, taxpayers could be subject to reporting requirements and consistency rules, i.e. the two sides to a transaction (the issuer and holder of an instrument) should be required to characterize it consistently and perhaps report this characterization to the other party and the other party's tax authorities. Similar consistency rules should apply to cross-border leases (see below).

V. Cross-border leases

In the case of a cross-border lease, I suggest a rule under which treatment of the transaction as a finance lease (whereby the lessee is treated as the owner of the property for tax purposes) prevails over classification according to legal form. In such a case, a country applying a legal form rule generally for domestic law purposes would reclassify a lease according to the treatment in the country where the other party to the lease is resident for income tax purposes, if that country characterizes the lease as a finance lease. This means that a lease involving two legal form jurisdictions would be unaffected.

On a technical level, the rule could state that a lease of tangible property involving a lessor and lessee resident in two different countries would be treated as a finance lease (lessee is treated as the owner of the property), if either the jurisdiction where the lessor is resident or the jurisdiction where the lessee is resident so treats it. In the case where property is used by a permanent establishment of the lessee in a given country, that country would be treated as the country of residence of the lessee for purposes of this rule. Similarly, where the lease is effectuated as part of the business operations of a permanent establishment of the lessor in a given country, that country would be treated as the country of residence of the lessor for purposes of the rule. In either of these permanent establishment situations, the home country of the lessor or lessee would also follow the characterization of the transaction under the rule.

There are, of course, other alternatives to coordinating rules for characterization of cross-border leases. (For example, one could apply the approach of the country where the nominal lessor is located.) However, this one is suggested because it should be relatively simple to apply and because it leads to the greatest conformity between tax accounting and financial accounting. (In other words, similarly to the bias of the entity classification rule in favor of classification as a corporation, there is a bias here in favor of classification as a finance lease.) The rule would allow parties to "shop" by sourcing the lease in a permanent establishment of the lessor in a jurisdiction which treats the transaction as a finance lease. However, this means that the transaction would be taxable there, and would presumably not confer a particular tax planning advantage, since the transaction would be treated consistently in all jurisdictions concerned. As discussed above, parties to the lease should be required to report it on their tax returns on a consistent basis.

VI. Other issues

A similar choice-of-law approach could be applied in fashioning coordination rules for other issues, but I stop the analysis at these three (hybrid entities, hybrid instruments, and hybrid leases), since these should suffice to illustrate the basic approach, and constitute a large portion of cross-border transactions that present tax arbitrage problems.

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