

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

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Abstract

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

Key words: Tax treaties, fiscally transparent entities, hybrid entities, base erosion and profit shifting (BEPS), multilateral instrument (MLI), partnerships, trusts

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1. INTRODUCTION

Any recent consideration of international tax is dominated by the Organisation for Economic Co-operation and Development (OECD)/G20 base erosion and profit shifting (BEPS) project, and any consideration of the tax treaty landscape by the consequent multilateral instrument on base erosion and profit shifting (MLI).¹ The BEPS project is a vast endeavour, drawing together and coordinating previously disparate areas of work. Its initial report concluded that BEPS was a serious problem for tax revenue, sovereignty and fairness in all countries and should be addressed by holistic and coordinated international action.² Key pressure areas included international hybrid mismatches and arbitrage and the effectiveness of anti-avoidance measures. The subsequent BEPS Action Plan³ proceeded to identify 15 'Actions' to be taken. Action 2 was to neutralise the effects of hybrid mismatch arrangements. Action 6 was to prevent treaty abuse, and was to be coordinated with the work on hybrids. Action 15 was to develop a multilateral instrument to kick-start the incorporation of treaty measures recommended under other Actions into actual tax treaties.

Although most of the work on Action 2 is concerned with double non-taxation engineered by exploiting mismatches between different domestic tax systems in the attribution of entity-level income (due to different characterisation or perception of the entity) or in the tax treatment of particular income (due to different characterisation of the interest or instrument that produces it),⁴ there are also treaty issues in this area. If access to treaty benefits in a source country is determined by reference to that country's domestic perception of fiscal attribution or the characterisation of an entity, but the other contracting state (in which the entity or a participant in it is resident) perceives those matters differently, the treaty may fail to avoid double taxation or may provide relief where there is no double taxation. These issues were previously addressed by the OECD Partnership Report,⁵ but only in relation to partnerships and without attracting the universal assent of OECD members. Other potentially hybrid entity types, such as trusts and check-the-box entities, were not covered. As discussed below, the treaty recommendations under Action 2 seek to generalise the principles of the Partnership Report to entities that are fiscally transparent in either contracting state (and hence potentially hybrid) and to embed those principles in substantive model treaty provisions. Unusually for the BEPS project, these recommendations address problems of double taxation as well as double non-taxation.

The MLI will modify a vast number of income tax treaties worldwide, including most Australian treaties. One of its subjects is the treatment of fiscally transparent entities and their income. The transparent entity clause, if implemented, prescribes the principles for determining whether income of such an entity – typically including a

¹ *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, adopted 24 November 2016, opened for signature 31 December 2016, initial signatures 7 June 2017 (entered into force 1 July 2018).

² OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing, 2013).

³ OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, 2013).

⁴ Mark Brabazon, 'Are We There Yet? International Implementation of Hybrid Mismatch Rules' (2019) 73(6/7) *Bulletin for International Taxation* 304.

⁵ OECD, *The Application of the OECD Model Tax Convention to Partnerships* (OECD Publishing, 1999), (Partnership Report).

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

The ultimate impact of the MLI in relation to fiscally transparent entities remains to be seen.⁶ Although a majority of MLI signatories have made or foreshadowed reservations against its provisions on that subject, a significant number of Australian treaties will still be affected. Five of Australia's 44 general income tax treaties that were in force when the MLI was signed already deal with the subject in one way or another. Once the MLI is fully operative, that number will rise to 21.⁷ This article identifies how each of Australia's existing treaties will be affected and considers the ground rules for dealing with income of fiscally transparent entities after the flood of MLI modifications.

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

2. BACKGROUND

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

⁶ On the uptake and impact of the MLI and its various provisions, see Johann Hattingh, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies' (2018) 72(4/5) *Bulletin for International Taxation* 234; Juan Angel Becerra, 'A Practical Approach to Determine the Influence of the OECD Multilateral Instrument on North American Tax Treaty Networks' (2017) 71(11) *Bulletin for International Taxation* 598.

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

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

⁹ See H David Rosenbloom and Stanley I Langbein, 'United States Tax Treaty Policy: An Overview' (1981) 19(3) *Columbia Journal of Transnational Law* 359; Hugh J Ault, 'Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices' (1992) 47(3) *Tax Law Review* 565, 567-568; Michael J Graetz and Michael M O'Hear, 'The "Original Intent" of US International Taxation' (1997) 46(5) *Duke Law Journal* 1021, 1066-1089; Reuven S Avi-Yonah, 'All of a Piece Throughout: The

reference to which bilateral treaties are negotiated and understood. Without some such model, the present international network of over 3,000 treaties could not have come into existence.

The application of tax treaties to fiscally transparent entities is now within the mainstream of treaty analysis,¹⁰ but it was not always so. The OECD Model and its forebears focused historically on the income of individuals and corporations.¹¹ Partnerships, trusts, deceased estates and other entities dwelt for many years on the fringes of tax treaties with little attention paid to them in the Model, although adaptations and ad hoc provisions may be identified in the treaties and treaty practice of particular countries.¹² US treaty policy has expressly addressed partnerships, trusts and estates since the 1970s and fiscally transparent entities since 1996.¹³ The treaty problems of partnerships were also addressed by the OECD Partnership Report, which attempted to standardise the treatment of that class of entities by changing the interpretation of the OECD Model. That attempt did not prove entirely successful as several significant jurisdictions were unwilling to adopt the interpretation which it advocated, but it did succeed in drawing international attention to a particular set of principles, largely inspired by US treaty practice, by which issues of hybridity and similar problems might be addressed.

Four Ages of US International Taxation' (2005) 25(2) *Virginia Tax Review* 313; C John Taylor, 'Twilight of the Neanderthals, or Are Bilateral Double Taxation Treaty Networks Sustainable?' (2010) 34(1) *Melbourne University Law Review* 268, 270-287; Sunita Jogarajan, *Double Taxation and the League of Nations* (Cambridge University Press, 2018).

¹⁰ See Mark Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities' in Richard Vann (ed), *Global Tax Treaty Commentaries IBFD* (Global Topics IBFD online, 2018); Angelo Nikolakakis 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' [2017] *British Tax Review* 295 (also, as Pts 1 and 2, in (2017) 71(9) *Bulletin for International Taxation* 475 and 71(10) *Bulletin for International Taxation* 553 respectively).

¹¹ See Ault, above n 9, and other works cited at n 9. The corporate and individual focus of the Models is also evident from later surveys of the treatment of partnerships and other entities: Alfred Philipp, 'General Report' in *Cahiers de Droit Fiscal International, Vol. 58b: Partnerships and Joint Enterprises in International Tax Law* (1973) I. 1; Kees van Raad, 'General Report' in *Cahiers de Droit Fiscal International, Vol. 73a: Recognition of Foreign Enterprises as Taxable Entities* (1988) 19; Michael Lang and Claus Staringer, 'General Report' in *Cahiers de Droit Fiscal International, Vol. 99b: Qualification of Taxable Entities and Treaty Protection* (2014) 17.

¹² See Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities', above n 10, section 1.2, and the General Reports cited in n 11.

¹³ Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities', above n 10, section 1.2; Richard O Loengard, Jr, 'Tax Treaties, Partnerships and Partners: Exploration of a Relationship' (1975) 29(1) *Tax Lawyer* 31. US treaty practice before 1976 was not entirely consistent, focusing sometimes on the residence of the entity and sometimes on the concept of an enterprise of one of the contracting states, and trying various formulae to deal with differences in the fiscal attribution by the contracting states of particular income of the entity. From 1976 to 1995, US treaties made use of a partial residence clause which sought to recognise fiscal attribution of income in the residence country of a partner or beneficiary in the treaty concept of residence of the entity. Some of the difficulties of this approach are considered in section 7.1 of this article. From 1996 onward, US treaty practice shifted to a transparent entity clause under which, if an entity was treated as fiscally resident in either contracting state, the status of its income as income of a resident depended on its fiscal attribution by the putative residence state to a resident of that state. The treatment of hybridity was thus generalised and linked to access to treaty benefits in respect of particular income. The fulcrum of its operation was fiscal attribution in a residence country. The post-1996 US transparent entity clause differs little from its OECD and MLI counterpart, discussed in section 3 of this article.

In the present decade, treaty issues relating to fiscal hybridity and transparency have been drawn into the work of the BEPS project. Implementing recommendations of the BEPS project under Action 2 on hybrids¹⁴ and Action 6 on treaty abuse,¹⁵ the 2017 update of the OECD Model has introduced a transparent entity clause as article 1(2), a saving clause as article 1(3), and a parenthetical qualification in article 23 A and B which excludes residence-country double tax relief to the extent that the other contracting state has purely residence-based taxing rights. Those changes each have counterparts in the MLI, which serves as a clearing house for the modification of existing treaties in order to implement treaty-related measures of the BEPS project and the 2017 update. The MLI was signed on 7 June 2017 and entered into force on 1 July 2018. It is in the process of taking effect for signatory jurisdictions and in relation to covered tax agreements between them as they deposit their instruments of ratification.¹⁶

Whether through the MLI directly, through the 2017 update of the OECD Model, or through the indirect impact of those instruments, the transparent entity clause and associated reforms may be expected to have a significant impact on actual tax treaties in the near to mid term and will raise a number of policy and interpretive questions.¹⁷

Apart from the MLI, five Australian tax treaties contain provisions which address the income of partnerships or transparent entities in one form or another. These are the treaties with the United States (1982, 2001), France (2006), Japan (2008), New Zealand (2009) and Germany (2015).¹⁸ Following ratification of the MLI by relevant counterparties, the number of treaties that contain or are subject to such provisions will rise to 21 (section 6 below).

Australia enacted the MLI as domestic law on 24 August 2018¹⁹ and deposited an instrument of ratification on 26 September 2018. It takes effect for Australia as a treaty from 1 January 2019. The commencement of its operation in relation to Australian tax

¹⁴ OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements: Action 2 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, 2015). Part II of the report addresses treaty issues.

¹⁵ OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances: Action 6 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, 2015).

¹⁶ Information in this article with respect to signatures and ratifications of the MLI and the reservations, notifications and elections made or provisionally indicated by signatories is taken from OECD, 'MLI Database - Matrix of options and reservations' (update 29 May 2019), <http://www.oecd.org/tax/treaties/mli-database-matrix-options-and-reservations.htm>. Entry into force and entry into effect of provisions discussed in this article are governed by MLI arts 34, 35.

¹⁷ See Nikolakakis et al, above n 10; Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities', above n 10; Hattingh, above n 6; Christopher Bergedahl, 'Hybrid Entities and the OECD Model (2017): The End of the Road?' (2018) 72(7) *Bulletin for International Taxation* 417; John Azzi, 'Impact of the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting on the Taxation of Fiscally Transparent Entities Under the Australia-UK Double Tax Agreement' [2018] *British Tax Review* 556; Carlo Garbarino, 'A Multi-Level Approach to "Treaty Entitlement" under the BEPS Project' (2018) 58(12) *European Taxation* 542; Martine Merten, 'Taxation of Investment Funds Following the OECD Base Erosion and Profit Shifting Initiative – Part 1' (2019) 73(2) *Bulletin for International Taxation* 76 and 'Taxation of Investment Funds Following the OECD Base Erosion and Profit Shifting Initiative – Part 2' (2019) 73(5) *Bulletin for International Taxation* 252; Kiran Jain, 'The OECD Model (2017) and Hybrid Entities: Some Opaque Issues and Their Transparent Solutions' (2019) 73(3) *Bulletin for International Taxation* 128.

¹⁸ Subsequent citation of tax treaties in the text of this article follows the format: Party-Party Treaty (year of signature, year of amending protocol (if any)). In footnotes, the word 'Treaty' is omitted. For full citations of current Australian treaties, see *International Tax Agreements Act 1953* (Cth) s 3AAA.

¹⁹ *Treasury Laws Amendment (OECD Multilateral Instrument) Act 2018* (Cth).

as affected by a particular covered tax agreement depends on the date when the other party deposits its instrument of ratification. Where the treaty counterparty has deposited by 30 September 2018, MLI-based amendments become operative in relation to Australian withholding tax from 1 January 2019 and in relation to other covered Australian taxation from 1 July 2019. This first batch includes Australia's treaties with Poland, Slovakia and the United Kingdom, which acquire a transparent entity clause under the MLI for the first time, and with France, Japan and New Zealand, which already deal with the topic in one way or another.

3. OECD MODEL AND MLI PROVISIONS

The 2017 update promotes the principles of the OECD Partnership Report into the text of the OECD Model and broadens them from partnerships to fiscally transparent entities generally. The first principle of the Partnership Report is that the initial nexus between particular income and a resident of a contracting state that is required for access to treaty benefits is determined from the perspective of the residence country. This is so, whether the resident is the entity or a participant in the entity. The test is both enabling and limiting. The principle is given effect by the transparent entity clause itself. With minor changes, the drafting is based on a similar clause in the 1996 US Model²⁰ and the 2006 US Model.²¹ The 2016 US Model has in turn adopted most of the OECD changes.²²

The second principle of the Partnership Report qualifies the first,²³ and corresponds to the saving clause which has long been part of US treaty practice. In US treaty practice and in the OECD Model (2017), the saving clause is not limited to the context of partnerships or, for that matter, transparent entities. It qualifies the operation of the transparent entity clause by preserving the taxing rights of a residence country from abrogation under the treaty, other than by the double tax relief article and other provisions that clearly have residence-country taxation in mind.

The transparent entity clause in the OECD Model (2017) and its counterpart in article 3(1) of the MLI are indistinguishable in their material terms:²⁴

²⁰ *United States Model Income Tax Convention of September 20, 1996* (1996 US Model) art 4(1)(d).

²¹ *United States Model Income Tax Convention of November 15, 2006* (2006 US Model) art 1(6).

²² *United States Model Income Tax Convention* (2016) (2016 US Model) art 1(6).

²³ OECD, Partnership Report, above n 5, [127], [128]; cf OECD Model, Commentary on Art 1 (2000) [6.1], superseded in 2017.

²⁴ See also OECD, *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (2016) [39], [40].

OECD Model Article 1(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.

MLI Article 3(1)

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

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

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

OECD Model Article 1(3)

This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.

MLI Article 11(1)

A Covered Tax Agreement shall not affect the taxation by a Contracting Jurisdiction of its residents, except with respect to the benefits granted under provisions of the Covered Tax Agreement:

[Sub-paragraphs (a) to (j) set out descriptively the kinds of residence-country taxation which are not saved by Art 11(1).]

²⁵ MLI art 3(5)(a).

²⁶ MLI art 3(5)(b)-(e) (though no signatory has yet made use of para (c) or (e)).

MLI Article 3(3)

With respect to Covered Tax Agreements for which one or more Parties has made the reservation described in subparagraph a) of paragraph 3 of Article 11 (Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents), the following sentence will be added at the end of paragraph 1: 'In no case shall the provisions of this paragraph be construed to affect a Contracting Jurisdiction's right to tax the residents of that Contracting Jurisdiction.'

The general saving clause follows the logic of the OECD Model, although the listed exclusions are somewhat wider. This difference reflects the fact that the MLI has to deal with actual treaties which may depart from the OECD Model, and the MLI exclusions accommodate some such departures. There is also a catch-all exclusion applicable to provisions 'which otherwise expressly limit a Contracting Jurisdiction's right to tax its own residents or provide expressly that the Contracting Jurisdiction in which an item of income arises has the exclusive right to tax that item of income'.²⁷ This expresses an underlying policy common to the OECD Model and the MLI, that the saving clause is not intended to negate those treaty benefits which deliberately address residence-based taxation.

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

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

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

The parenthetical amendment to the double tax relief article of the OECD Model and the corresponding MLI provision, article 3(2), are materially identical³⁰ in their interaction with the transparent entity clause:

²⁷ MLI art 11(1)(j).

²⁸ MLI art 11(3)(a).

²⁹ See also OECD, *Explanatory Statement to the Multilateral Convention*, above n 24, [42], [154].

³⁰ See also *ibid* [41].

OECD Model Article 23 A (1), (2), 23B (1)

... (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 [or because the capital is also capital owned by a resident of that State]) ...

MLI Article 3(2)

2. Provisions of a Covered Tax Agreement that require a Contracting Jurisdiction to exempt from income tax or provide a deduction or credit equal to the income tax paid with respect to income derived by a resident of that Contracting Jurisdiction which may be taxed in the other Contracting Jurisdiction according to the provisions of the Covered Tax Agreement shall not apply to the extent that such provisions allow taxation by that other Contracting Jurisdiction solely because the income is also income derived by a resident of that other Contracting Jurisdiction.

The OECD parenthetical and MLI article 3(2) exclude residence-country relief under the double tax relief article only to the extent that the other country's treaty taxing right depends on the residence of its own taxpayer. Although both countries may tax on a residence basis under their domestic law, the treaty may recognise one or even both of them as entitled to tax on a source basis to some extent and thus support corresponding residence-country relief.³¹ These provisions have been presented as a matter of clarification,³² and are not present in the US Model. UK case law had already reached a similar but not identical outcome in the absence of the parenthetical. In *Bayfine*, the Court of Appeal concluded that a taxing right as preserved under a conventional US saving clause, expressed not to affect the double tax relief article, did not count for the purposes of identifying taxation in accordance with the treaty for the purposes of the double tax relief article.³³ The point is to avoid duplicated or circular relief causing less-than-single taxation.

A country that accepts the principle of article 3 by lodging no general reservation, including one that reserves specifically against article 3(1) on the basis that the treaty already contains analogous provisions, is not bound to accept article 3(2) but may reserve specifically against that provision.³⁴

4. AN ELEGANT SOLUTION

The transparent entity clause (together with the saving clause and the double tax relief parenthetical) is an elegant solution to the problems posed by hybrid and transparent

³¹ See OECD Model, Commentary on Art 23 (2017) [11.1] – [11.2]; Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities', above n 10, section 4.6. Dual source and residence taxation may occur, for example, in some situations involving an entity-level permanent establishment (PE) in one country through which the entity derives dividend or interest income from payers resident in the other country.

³² OECD, *Action 6 – 2015 Final Report*, above n 15, [64]; OECD Model, Commentary on Art 23 (2017) [11.1].

³³ *Bayfine UK Ltd v HMRC* [2011] STC 717; (2011) 13 ITLR 747 [43].

³⁴ MLI art 3(5)(f).

entities. There are nevertheless some loose ends that would do well to be resolved. This section briefly notes a number of them which have been discussed at length elsewhere³⁵ and merit consideration in Australian treaties that already contain or will become subject to a transparent entity clause. These issues also appear at various points in the discussion of existing treaties in section 7.

Scope of operation: There is a question about the scope of operation of the transparent entity clause. Does it apply to controlled foreign company (CFC) rules?³⁶ More generally, what outbound investment regimes might it apply to? It has been suggested that the issue should be addressed by treaty negotiators directly.³⁷

Indirect treaty benefits: The transparent entity clause is intended to confer treaty benefits in cases where one contracting state taxes the entity and the other taxes a participant. Contracting states need to provide or recognise a procedure for the assertion of treaty claims in such cases.³⁸

PE attribution: There is a question whether the permanent establishment of a fiscally transparent entity is attributed, along with its income, to a participant in the entity for the purpose of applying the distributive articles of a tax treaty. Australian treaty practice addresses this in part through a trust PE clause. This does not sit well with the transparent entity clause; it has been argued that the issue is better addressed (as in US treaty practice) through the definition of an enterprise of a contracting state.³⁹

Beneficial ownership: The interaction between the transparent entity clause and the treaty concept of beneficial ownership remains unclear, mainly because the meaning of beneficial ownership has not been resolved. It has been suggested that a special definition would be useful, relating beneficial ownership to fiscal attribution in the relevant residence country in the context of the transparent entity clause.⁴⁰

Intercorporate dividends: The interaction between the transparent entity clause and treaty rules for intercorporate dividends, particularly any requirement that the claimant hold directly a percentage of the equity in the dividend-paying company, would benefit from clarification.⁴¹

Residence-residence issues: Residence-residence attribution conflicts can still cause anomalous double taxation. The transparent entity clause creates an opportunity to resolve the problem by including an additional clause in the double tax relief article.⁴²

³⁵ Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities', above n 10; see also Jain, above n 17.

³⁶ As argued (in certain contexts) by Daniele Canè, 'Controlled Foreign Corporations as Fiscally Transparent Entities: The Application of CFC Rules in Tax Treaties' (2017) 9(4) *World Tax Journal* online; cf Jain, above n 17.

³⁷ Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities', above n 10, sections 2.1.3, 2.2.4.

³⁸ Ibid section 2.2.3; cf section 7.1 below.

³⁹ Ibid section 4.3; cf section 7.4 below.

⁴⁰ Ibid section 4.4; cf section 7.4 below and Angelika Meindl-Ringler, *Beneficial Ownership in International Tax Law* (Wolters Kluwer, 2016).

⁴¹ Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities', above n 10, section 4.5; cf section 7.5 below.

⁴² Ibid section 4.6; cf Australia–New Zealand (2009) art 23(3) (section 7.4 below) and UK–US (2001) exchange of notes re art 24.

5. STATUS OF THE MLI PROVISIONS

The general status of the relevant MLI provisions as indicated by its signatory jurisdictions is summarised in Table 1.⁴³

Table 1: Status of MLI Provisions

MLI	Status	OECD Model	US Model
3(1)	27 signatories accepted or made only specific reservations 61 reserved generally	1(2)	1(6)
11(1) alt. 3(3)	15 of the 27 accepted 11(1) 12 default to 3(3)	1(3)	1(4), (5)
3(2)	21 accepted 5 reserved	23 A/B parenthetical	–

As of 29 May 2019, 88 jurisdictions had signed the MLI. Of these, 61 reserved or proposed to reserve against article 3 generally, including Canada, China, France, Germany, India and Italy. The remaining 27 signatories may be taken to accept its general principles, including Australia, the Netherlands, New Zealand, Russia and the United Kingdom. Of those jurisdictions, four (Chile, Ireland, Norway and Spain) have indicated a specific reservation against article 3(1) in respect of those (relatively few) treaties that already contain provisions which ‘address whether income derived by or through entities or arrangements that are treated as fiscally transparent under the tax law of either Contracting Jurisdiction’⁴⁴ and two (Australia and the Netherlands) have indicated such reservation where a treaty contains such a provision which also ‘identifies in detail the treatment of specific types of entities or arrangements’.⁴⁵ Broadly speaking, these countries accept the principle of article 3 and the implementation of an MLI transparent entity clause, except in identified cases where they prefer to persevere with existing provisions in certain identified treaties which, in their view, implement a more or less similar policy. Australia’s reservation preserves certain provisions of its treaties with France and Japan. None of the other specific reservations by any signatory affects an Australian treaty.

Sixty-five signatories indicated reservations against article 11 generally. Fifty-three indicated general reservations against both articles, 12 indicated general reservation against article 11 but not against article 3,⁴⁶ and eight indicated general reservation against article 3 but not against article 11.⁴⁷

⁴³ The first column identifies the MLI provision. The second column summarises its overall acceptance or rejection by signatories as indicated by 29 May 2019 (see n 16) and explained after the Table. The third and fourth columns identify corresponding provisions of the OECD Model (2017) and the 2016 US Model.

⁴⁴ MLI art 3(5)(b) (quotation from art 3(4)).

⁴⁵ MLI art 3(5)(d).

⁴⁶ Ireland, Israel, Japan, Luxembourg, Malaysia, the Netherlands, Nigeria, Papua New Guinea, South Africa, Spain, Turkey and Uruguay.

⁴⁷ China, Colombia, Gabon, India, Indonesia, Jamaica, Portugal and Senegal.

Of the 27 jurisdictions that accept article 3 in whole or part, 12⁴⁸ have indicated reservation against article 11 with the consequence that, if article 3(1) is engaged, it is qualified by article 3(3), and five (Japan, Luxembourg, Malaysia, Ireland and the United Kingdom) have indicated reservation against article 3(2).

6. OVERVIEW OF AUSTRALIAN TREATIES

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

Table 2: Overview of Australian Treaties

<i>Treaty</i>	<i>Transparent entity clause or similar</i>	<i>Saving clause</i>	<i>DTR parenthetical</i>	<i>Other</i>
United States 1982, 2001 (not covered)	Art 4(1) (re partnerships, estates & trusts — partial residence)	Art 1(3), (4)	No (cf Art 22, which ≠ OECD Model)	
France 2006	Arts 4(5), 29(1), (2), Protocol (2) (France rejects MLI 3; Australia reserves under MLI 3(5)(d))	No (France rejects MLI 11)	No (France rejects MLI 3)	
Japan 2008	Art 4(5) (Australia reserves under MLI 3(5)(d))	No (see section 7.3 below)	No (Japan rejects MLI 3(2))	
New Zealand 2009	MLI 3(1) (replaces Art 1(2))	MLI 11(1)	MLI 3(2)	
Germany 2015 (not covered)	Art 1(2), Protocol (2), (3)	No, but see EM	No	Special saving clause for anti-avoidance rules, with list (Art 23(3), Protocol (7)(1)(c))
Argentina 1999	MLI 3(1)	MLI 11(1)	MLI 3(2)	
Belgium 1977, 1984, 2009	MLI 3(1)	MLI 11(1)	MLI 3(2)	
Chile 2010	MLI 3(1)	MLI 11(1)	MLI 3(2)	
Fiji 1990	MLI 3(1)	MLI 11(1)	MLI 3(2)	

⁴⁸ Those mentioned in n 46.

<i>Treaty</i>	<i>Transparent entity clause or similar</i>	<i>Saving clause</i>	<i>DTR parenthetical</i>	<i>Other</i>
Ireland 1983	MLI 3(1)	MLI 3(3)	No (Ireland rejects MLI 3(2))	
Mexico 2002	MLI 3(1)	MLI 11(1)	MLI 3(2)	
Netherlands 1976, 1986	MLI 3(1)	MLI 3(3)	MLI 3(2)	
Norway 2006	MLI 3(1)	MLI 11(1)	MLI 3(2)	
Poland 1991	MLI 3(1)	MLI 11(1)	MLI 3(2)	
Romania 2000	MLI 3(1)	MLI 11(1)	MLI 3(2)	
Russia 2000	MLI 3(1)	MLI 11(1)	MLI 3(2)	
Slovakia 1999	MLI 3(1)	MLI 11(1)	MLI 3(2)	
South Africa 1999, 2008	MLI 3(1)	MLI 3(3)	MLI 3(2)	
Spain 1992	MLI 3(1)	MLI 3(3)	MLI 3(2)	
Turkey 2010	MLI 3(1)	MLI 3(3)	MLI 3(2)	
UK 2003	MLI 3(1)	MLI 11(1) (replaces Art 24)	No (UK rejects MLI 3(2))	Special saving clause for anti-avoidance rules, with list (Exch. of Notes (1)(d), (e))

The first column of Table 2 identifies each treaty by counterparty and the year of signature of the treaty and any later amending protocol. Unless otherwise noted in the first column, each has been nominated by both parties as a covered tax agreement under the MLI. The second column identifies the relevant partnership or transparent entity provision in or to be acquired by the treaty and notes relevant MLI reservations. References to provisions of the MLI are cited in the form ‘MLI [article and paragraph number]’; existing treaty provisions are cited as ‘Art [article and paragraph number]’. The third column similarly identifies the general saving clause in or to be acquired by the treaty. The fourth column identifies whether the double tax relief provision of the treaty is qualified by provisions along the lines of the parenthetical qualification in OECD Model (2017) article 23. The fifth column notes selected special measures relevant to the scope of a transparent entity provision.

The first five entries relate to treaties that already have a provision dealing with income of partnerships or other transparent entities, and are listed chronologically. The remaining entries relate to other treaties which will acquire a transparent entity clause under the MLI, and are listed alphabetically. The Australia–United Kingdom Treaty (2003) could arguably have been included in either category. Its particular provisions are discussed briefly in section 8.

Australia's tax treaty with Israel was signed on 27 March 2019 and has yet to be legislated or to enter into force. It contains a transparent entity clause, a saving clause and a double tax relief parenthetical based on the OECD Model (2017).⁴⁹

7. TREATIES WITH TRANSPARENT ENTITY PROVISIONS

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

7.1 Australia – United States

The Australia–United States Treaty (1982, 2001) is not affected by the MLI because the United States has not signed that instrument. The key provisions are the saving clause in article 1(3), (4), provisions of article 4(1) referring to partnerships, estates and trusts, and article 22 with respect to double tax relief.

7.1.1 *Partial residence provisions and treaty history*

The provisions that most directly address transparent entities are located in the residence article. Having defined the term 'person' to include a partnership, trust or estate,⁵⁰ the treaty defines a person other than an individual, a corporation or a corporate-taxed entity as a resident of Australia or the United States if it is so treated by the tax law of that country, but then carves out an exception by stipulating that, with the exception of certain Australian trusts that attract special Australian tax treatment, a partnership, trust or estate is not treated as resident save to the extent that its income is 'subject to [Australian / United States] tax as the income of a resident, either in [the hands of that person / its hands] or in the hands of a partner or beneficiary' or is exempt from tax in the residence country (in the case of Australia) solely because it is subject to tax in the United States or (in the case of the United States) other than because 'such person, partner or beneficiary' is not a US person for tax purposes.⁵¹ The meaning and effect of these partial residence provisions are ultimately rather unclear.

The wording of the treaty resembles but is not identical to that of the 1981 US Model, which defined a treaty resident as a person who, under the laws of the relevant contracting state, was liable to tax therein by reason of citizenship, residence etc, other than only on a source basis, but

in the case of income derived or paid by a partnership, estate or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.⁵²

⁴⁹ The text of Australia–Israel (2019) first became available after this article had been submitted for publication. It is not separately analysed here, although selected aspects are referred to.

⁵⁰ Australia–US (1982, 2001) art 3(1)(a), following the *United States Model Income Tax Treaty of June 16, 1981* (1981 US Model) art 3(1)(a).

⁵¹ Australia–US (1982, 2001) art 4(1)(a), (1)(b).

⁵² 1981 US Model art 4(1)(b).

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

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

The partial residence approach was part of US treaty practice from the 1970s until 1995. Publication of the 1996 US Model marked the abandonment of that approach in favour of the transparent entity clause. In 1999 the OECD Partnership Report substantially adopted the logic of the transparent entity clause in the context of partnership income and recommended its application in the interpretation of the OECD Model. That recommendation was carried into the Commentaries in 2000. The following year, the Australia–United States Protocol (2001) was signed. Treaty amendments included some minor changes to the residence article,⁵⁵ replacement of the dividends article,⁵⁶ provision for source-country taxation of PE-related capital gains,⁵⁷ and the addition of a clause reflecting Australia’s desire to make sure it could tax business income derived through a local trust PE.⁵⁸ This last provision was not expressed with reference to a trust as in the usual Australian trust PE clause, but with reference to a ‘fiscally transparent entity’.⁵⁹ That term was not defined or otherwise mentioned in the protocol, and the

⁵³ The Explanatory Memorandum to the Income Tax (International Agreements) Amendment Bill 1983 (Cth) contains two brief paragraphs on art 4, neither of which mentions partial residence.

⁵⁴ *United States Treasury Department Technical Explanation of the Convention between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (1983) ad art 4. Similarly, the Technical Explanation says that ‘a partnership, estate or trust is a resident of the United States for purposes of the Convention only to the extent that the income it derives either is subject to US tax as the income of a resident (either at the level of the entity or in the hands of a partner or beneficiary), or is exempt from US tax for reasons other than the recipient's not being a US person. Thus, a US person that qualifies as a tax-exempt organization under US law qualifies as a resident, and a recipient of tax-exempt income does not lose its status as a resident with respect to that income’.

⁵⁵ Australia–US Protocol (2001) art 3, inserting what is now art 4(1)(b)(ii) of the treaty and renumbering what is now art 4(1)(b)(iii).

⁵⁶ Australia–US Protocol (2001) art 6, replacing art 10. Cf US Department of the Treasury, *Technical Explanation of the Protocol Between the Government of the United States of America and the Government of Australia Signed at Canberra on September 27, 2001, Amending the Convention Between the United States of America and Australia with Respect to Taxes on Income Signed at Sydney on August 6, 1982* (2003) ad art 6, discussed further at n 83 below.

⁵⁷ Australia–US Protocol (2001) art 9, amending art 13. According to US Technical Explanation, Australia–US Protocol 2001, above n 56, ad art 9 with respect to substituted art 13(3), ‘A resident of Australia that is a partner in a partnership doing business in the United States will have a permanent establishment in the United States as a result of the activities of the partnership, assuming that the activities of the partnership rise to the level of a permanent establishment’.

⁵⁸ Australia–US Protocol (2001) art 4, inserting art 7(9). See Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 1) 2002 (Cth) [2.10], [2.11]; US Technical Explanation, Australia–US Protocol 2001, above n 56, ad art 4.

⁵⁹ According to Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 1) 2002 (Cth) [2.11], ‘[t]he term “fiscally transparent entity” has been used to cover any entity, not just trusts,

parties did not take the opportunity to replace the partial residence provisions of the treaty with a transparent entity clause. The overall flavour of the protocol and of the corresponding US Technical Explanation nevertheless seems consistent with the world view of the OECD Partnership Report and post-1996 US treaty policy.

This history also raises the question whether the principles of the Partnership Report are material to the interpretation of the treaty.⁶⁰

7.1.2 Interpretation of the partial residence provisions

A number of general interpretive questions arise from the partial residence provisions:

1. In order for a partnership, trust or estate to be recognised to any extent as treaty-resident in Australia or the United States, must the entity itself be ‘a resident of Australia’ or ‘resident in the United States’ for purposes of that country’s tax law, or is it sufficient that its income is, to the relevant extent, attributed to a resident partner or beneficiary?
2. Where a partner or beneficiary is treaty-resident in Australia or the United States and is treated by the tax law of that country as deriving entity-level income, is the partner or beneficiary or, derivatively, the relevant entity entitled to treaty benefits in the other country to the extent of such residence-country attribution on the basis that the partner or beneficiary is the resident referred to in applicable distributive rules of the treaty?

These should be considered against the background that US tax law has a concept of a domestic partnership,⁶¹ trust or estate⁶² and regards such an entity as a US person,⁶³ notwithstanding that it may be fiscally transparent in respect of some or all of its income.

Australia, by contrast, has a concept of a resident trust estate,⁶⁴ but no general concept of fiscal residence for a conventional (and fiscally transparent) general partnership. Australia generally classifies limited partnerships as corporate limited partnerships and

that may be taxed on a “look-through” basis (e.g. US limited liability companies treated as partnerships for US tax purposes)’.

⁶⁰ The issue is more complex than determining whether and how that extrinsic material can be used in interpreting a pre- or post-Partnership Report treaty that follows the OECD Model; see John F Avery Jones, ‘Treaty Interpretation’ in Richard Vann (ed), *Global Tax Treaty Commentaries IBFD* (Global Topics IBFD online) sections 3.10-3.12; Klaus Vogel, ‘The Influence of the OECD Commentaries on Treaty Interpretation’ (2000) 54(12) *Bulletin for International Taxation* 612; John F Avery Jones, ‘The Effect of Changes in the OECD Commentaries after a Tax Treaty is Concluded’ (2002) 56(3) *Bulletin for International Taxation* 102; Monica Erasmus-Koen and Sjoerd Douma, ‘Legal Status of the OECD Commentaries – In Search of the Holy Grail of International Tax Law’ (2007) 61(8) *Bulletin for International Taxation* 339. This is because the text of the treaty deals with fiscal transparency in a way that differs from the OECD Model and because the Partnership Report eschewed consideration of partial residence clauses as unpromising (above n 5, [45]-[46]).

⁶¹ Internal Revenue Code (IRC) s 7701(a)(4).

⁶² The corollary of IRC s 7701(a)(31), defining a foreign trust or estate. Cf 26 Code of Federal Regulations (CFR) s 301.7701-7(a)(2), defining a domestic trust.

⁶³ IRC s 7701(a)(30).

⁶⁴ *Income Tax Assessment Act 1936* (Cth) s 95(2). Deceased estates are treated as a species of trust for tax purposes, although they are generally non-transparent because the beneficiaries lack present entitlement to estate income until the estate is fully administered.

taxes them as companies,⁶⁵ although a foreign hybrid limited partnership is transparent.⁶⁶

Some aspects of these interpretive issues have arisen quite sharply in recent litigation concerning limited partnerships in the Resource Capital Fund stable, formed in the Cayman Islands with partners mostly resident in the United States. The partnership entities were non-resident corporate limited partnerships from the viewpoint of Australian tax law, and hence taxable as companies, but they were transparent foreign partnerships from the viewpoint of US tax law. The cases concerned Australian taxation of the partnerships on profits derived from the sale of shares in Australian mining companies and taxation appeals by the partnerships claiming relief under the treaty by reference to the residence of most of their partners. The cases are only discussed here for what they say about the interpretation of the partial residence provisions.

Treaty residence of the entity

The first question was resolved by Edmonds J at first instance in *Resource Capital Fund III LP v FCT*⁶⁷ and by a Full Court of the Federal Court in *FCT v Resource Capital Fund IV LP*,⁶⁸ in favour of a dual requirement for treaty residence, that the entity be resident in the relevant contracting state for the purposes of its domestic tax law and that its income be subject to tax in that country or exempt only on the basis described in the treaty. It followed that the limited partnerships in those cases were not US treaty residents. The contrary view, that the partial residence provisions create an independent basis for treaty residence of the entity, was the Commissioner's 'preferred position' in *Resource Capital Fund III*⁶⁹ and was supported by Davies J (dissenting on this point) in *Resource Capital Fund IV*.⁷⁰ Her Honour considered that,

⁶⁵ *Income Tax Assessment Act 1936* (Cth) Part III Div 5A.

⁶⁶ *Income Tax Assessment Act 1997* (Cth) s 830-10 stipulates criteria by which an entity that would otherwise be a corporate limited partnership is redesignated as a foreign hybrid limited partnership. Broadly speaking, the limited partnership must be established abroad and fiscally transparent in other relevant countries. It is automatically redesignated if it would otherwise attract Australian CFC tax treatment, i.e. if it would have been an 'attributable taxpayer' with an 'attribution percentage' greater than zero. It may also be redesignated in respect of a partner's interest at the partner's irrevocable election if certain other criteria are satisfied.

⁶⁷ *Resource Capital Fund III LP v FCT* (2013) 95 ATR 504, 15 ITLR 814 [55]-[60]. His Honour consequently found that the partnership was not a US resident for treaty purposes, but also held that Australia was not authorised by the Australia-US treaty to tax the partnership as distinct from the partners and (implicitly) that it forbade taxation of the partnership. The judgment was reversed by a Full Court in *FCT v Resource Capital Fund III LP* (2014) 225 FCR 290; 16 ITLR 876 on the basis that the treaty did not implicitly limit Australia to taxing the partners; the finding that the partnership was not a US treaty resident was not challenged on appeal.

⁶⁸ *FCT v Resource Capital Fund IV LP* [2019] FCAFC 51, [71]-[73] (Besanko, Middleton, Steward and Thawley JJ). At the time of writing, it is too early to know whether the case will go on to the High Court.

⁶⁹ *Resource Capital Fund III LP v FCT* (2013) 95 ATR 504, 15 ITLR 814 [56].

⁷⁰ *FCT v Resource Capital Fund IV LP* [2019] FCAFC 51, [232]-[242]. This does not imply that bare fiscal residence of the US partners was enough to produce corresponding partial residence of the entity: they still had to be subject to US tax on the relevant income, or the income had to be exempt on a basis other than that they were not US persons. The absence of evidence of these matters collaterally meant that the partnership was not proven to be a US treaty resident: see the majority judgment at [70]. The partners would also have had to satisfy the requirements of the limitation on benefits article. (As it happened, the Commissioner did not take the point at trial and was therefore precluded from running it on appeal: see the majority judgment at [70] and [78]-[80].)

although the proviso [in the treaty definition of a resident of the United States] is expressed negatively — ‘shall not be treated as a resident of the United States’ — when read as a whole, the proviso makes sense if it is directed at identifying when a partnership, estate of a deceased individual or trust is to be treated as a resident for the purposes of the DTA.⁷¹

Such an interpretation has some intuitive attractiveness. It facilitates entity-level claims for treaty benefits without having to involve the partners (or beneficiaries) and without being concerned about the fiscal residence or status of the entity, which may be based in a third country or may fail the general test of treaty residence on the basis (as would be true of a general partnership established in Australia and viewed from the perspective of Australian tax law) that an entity of the relevant kind is not capable of residence. It also more closely resembles the approach in post-1996 US treaties, the OECD Partnership Report and corresponding OECD Commentaries, and the OECD Model itself as amended in 2017, although it differs from those later instruments by using treaty residence as the fulcrum for its operation.

Be that as it may, the majority judgment in *Resource Capital Fund IV* is authoritative in Australia, subject to any further appeal to the High Court. It recognises a dual requirement in the partial residence provisions: the entity must be resident in the relevant contracting state for the purposes of its tax law, and its income must also be subject to tax in that country or exempt in that country only on the basis described in the treaty. And this, with respect, must be right. The wording of the treaty is intractable. This is particularly evident in the definition of Australian treaty residence, where the requirement of general tax-law residence is obviously separate from and antecedent to the proviso⁷² and certain classes of trust are excluded from the proviso, but not from the requirement of residence.⁷³

Treaty rights of the partners or beneficiaries

The second question initially requires consideration of whether the partial residence provisions constitute a code in relation to the capacity of partnership, trust or estate income to attract treaty benefits. The issue is whether the references to such income in art 4(1) carry a negative implication that such income can only attract treaty benefits with reference to the entity, and therefore only if and to the extent that the entity qualifies as a treaty resident. If the partial residence provisions are such a code, they exclude the possibility of treaty benefits for a US partner in a non-US partnership in respect of partnership income, regardless of whether the partnership is based (to use a neutral term) in Australia or in a third country. They also seem to exclude the possibility of such benefits for an Australian partner in a general partnership because Australian tax law does not regard the entity as resident or non-resident. It is inconceivable that the latter outcome was intended. Both outcomes are also contrary to the principles of the OECD Partnership Report and post-1996 US treaty policy.

An interpretation of the partial residence provisions as a code could avoid the inconvenient outcomes noted above if the condition relating to residence-country taxation were treated as an independent basis for residence of the entity instead of the

⁷¹ *FCT v Resource Capital Fund IV LP* [2019] FCAFC 51, [237].

⁷² Australia–US (1982, 2001) art 4(1)(a)(ii).

⁷³ Australia–US (1982, 2001) art 4(1)(a)(iv).

outer limits of residence otherwise established. For reasons noted earlier, however, the independent basis theory is not tenable.

The better view is that the partial residence provisions are not a code. If that is right, further questions arise. Can a partner or beneficiary participant in a partnership, trust or estate rely on his, her or its own treaty residence to claim benefits in relation to particular entity-level income? In principle the answer should be ‘yes’, but that leads to further difficulties.

- How is the treaty right of a partner or beneficiary to be exercised if the source country attributes the relevant income to the entity and the entity does not qualify as a treaty resident of the partner’s or beneficiary’s country?

When the *Resource Capital Fund III* case was before the High Court on the taxpayer’s unsuccessful special leave application, it was suggested that the problem could be resolved by the mutual agreement procedure⁷⁴ – hardly a satisfactory solution, as any remedy would require the cooperation of the revenue authorities.⁷⁵ The majority in *Resource Capital Fund IV* considered that each US resident partner was capable of invoking the treaty (assuming that other relevant requirements for treaty protection were made out),⁷⁶ but not for the purposes of the entity’s taxation appeal: this, it was said, could be done in recovery proceedings or ‘probably’ in proceedings for declaratory relief.⁷⁷ These suggestions are procedurally awkward and, more fundamentally, fail to address the conclusiveness of a notice of assessment outside the context of a taxation appeal.⁷⁸ It is no answer to say that the Commissioner could refrain from engaging the conclusiveness provision by not tendering the notice of assessment, because the partner has no way to compel the Commissioner to take that course. How US partners in such a situation may legally and practicably vindicate their rights under the treaty, adopted as it is into Australian statute law, remains something of a mystery.

- Is it necessary for the source country, or the residence country, or both contracting states to attribute the income in question to the treaty-resident partner or beneficiary?

Which country’s tax law determines the income attribution nexus for treaty purposes is problematic if Australia and the United States disagree about the attribution of particular income. In the case of partnership income under the principles of the OECD Partnership Report or income of a fiscally transparent entity under the transparent entity clause, where treaty benefits are claimed on the basis that the income is attributable to a treaty-resident participant, that nexus is determined by reference to the tax law of the participant’s residence country. The judgment of Edmonds J in *Resource Capital Fund III*⁷⁹, which

⁷⁴ *Resource Capital Fund III LP v FCT* [2014] HCATrans 235, 12-13.

⁷⁵ Richard Vann, ‘Australia: Hybrid Entities – Resource Capital Fund III LP Case’ in Michael Lang et al (eds), *Tax Treaty Case Law Around the Globe 2015* (IBFD Publications, 2016) 3.

⁷⁶ Such as the requirements of the subject to tax condition and the limitation on benefits article.

⁷⁷ *FCT v Resource Capital Fund IV LP* [2019] FCAFC 51, [73].

⁷⁸ *Taxation Administration Act 1953* (Cth) Sch 1 s 350-10(1) item 2; cf extensive case law on a predecessor provision, *Income Tax Assessment Act 1936* (Cth) s 177.

⁷⁹ *Resource Capital Fund III LP v FCT* (2013) 95 ATR 504, 15 ICLR 814.

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

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

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

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

The treaty stipulates lower (art 10(2)(a)) or zero (art 10(3)) source-country taxation of dividends if the person beneficially entitled is another company which inter alia 'holds directly' at least 10 per cent (art 10(2)(a)) or, for twelve months ending on the day of declaration of the dividend, 'has owned shares' representing at least 80 per cent (art 10(3)) of the voting power in the paying company. If a restrictive view is taken of partial residence, a US corporate partner may be locked out of enhanced treaty benefits. It will be recalled that the present article 10 dates from the 2001 protocol. The US Technical Interpretation of the protocol takes the view that direct holding can be traced through a fiscally transparent shareholder entity, which seems to imply that treaty benefits can be granted by reference directly to the participant, but it is not clear that a US partner would receive similar treatment in Australia.⁸³

⁸⁰ *FCT v Resource Capital Fund III LP* (2014) 225 FCR 290, 16 ICLR 876.

⁸¹ See commentary by Richard Vann in the ICLR report of *Resource Capital Fund III LP v FCT* (2013) 95 ATR 504, 15 ICLR 814. See also *Vienna Convention on the Law of Treaties*, opened for signature 23 May 1969, 1155 UNTS 331 (entered into force 27 January 1980) (Vienna Convention) art 31(2)(a), (3)(a), (b) and John Avery Jones, 'Treaty Interpretation' in Richard Vann (ed), *Global Tax Treaty Commentaries IBFD* (Global Tax Treaty Commentaries IBFD online) section 3.12.2.

⁸² See n 40 and corresponding text.

⁸³ The US Technical Explanation of the 2001 protocol does not directly refer to the OECD Partnership Report, above n 5, but supports the implicit recognition of transparency in relation to the look-through of a transparent shareholder entity: US Technical Explanation, Australia–US Protocol 2001, above n 56, ad art 6. The published ATO opinions on similar questions under other treaties are not readily reconciled. Contrast ATO ID 2011/14 (regarding shareholdings traced through a New Zealand limited partnership — that the shares are neither held nor held directly) with TD 2014/13 (regarding nominee shareholders) and ATO ID 2004/863 (regarding the tracing of a shareholding through a trust). Australia–Germany 2015 (section 7.5 below) confronts the issue more directly.

The result is unclear

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

7.1.3 Other provisions

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

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

7.1.4 The treaty and the OECD Model

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

7.2 Australia – France

The Australia–France Treaty (2006) is not affected by MLI article 3 because France has reserved against that article generally. Had that not been the case, Australia’s specific reservation would have prevented article 3(1) from taking effect or superseding articles 4(5), 29(1), (2) and protocol (2) of the treaty, which address certain cases relating to transparent or translucent partnerships.⁸⁹ As France has also reserved against article 11, the treaty does not acquire an MLI saving clause either.

⁸⁴ Australia–US (1982, 2001) art 1(3), (4).

⁸⁵ See IRC s 904.

⁸⁶ Australia–US (1982, 2001) art 22(1).

⁸⁷ Australia–US (1982, 2001) art 22(2).

⁸⁸ Australia–US (1982, 2001) art 22(4).

⁸⁹ For an overview of the treaty, see Tom Toryanik, ‘The New Treaty with France’ (2006) 12(5) *Asia-Pacific Tax Bulletin* 387.

7.2.1 Treaty provisions

The treaty provisions applicable to partnerships are influenced by the particular French tax treatment of partnership income, which differs from the transparent or opaque tax treatments that apply in most other countries. Several classes of French partnerships and similar entities are considered to be fiscally translucent: entity-level income gives rise to tax liability on the part of the entity's members at the members' personal or corporate rates, but the liability is incurred on behalf of the entity.⁹⁰ The separate legal personality of the entity in French law is considered sufficient to make its income taxable in France and fiscally attributable to the entity, though not to subject the entity to French corporation tax, yet the fiscal characteristics of the partners affect the rate and calculation of tax. In terms of the transparent entity clause of the OECD Model (2017), it has been argued that the entity would not be 'fiscally transparent' in France.⁹¹

The treaty does not deal exhaustively with the income of partnerships. It only deals with those particular permutations which the contracting states decided to cover.

The treaty initially distinguishes between entities by reference to their place of effective management. A 'partnership or group of persons' that has its place of effective management in France is addressed in articles 4(5) and 29(4) and paragraph (2) of the protocol. A 'partnership or similar entity' that has its place of effective management in Australia is addressed in article 29(1). A 'partnership' that has its place of effective management in a third country is addressed in article 29(2).

Article 4(5) qualifies a partnership or group as a treaty resident of France provided that all its members are personally liable to tax in France on their part of its profits. Australia accepts that such an entity is entitled to treaty benefits as a French resident, notwithstanding that Australia may regard it as transparent⁹² and attribute its income to its members. That is not the end of the matter, however. While all members must be personally liable to tax in France on their shares of partnership profits, they need not all be resident there. Australia protects its treaty position in respect of non-French members by special saving clauses. Article 29(4) preserves Australia's right to tax its own residents who are members of such an entity on their shares of entity-level profits, subject to treating those profits as sourced in France for the purposes of the double tax relief article.⁹³ Paragraph (2) of the contemporaneous protocol preserves Australia's right to tax 'a resident of a third State' who is such a member, provided that the entity is not subject to corporation tax in France,⁹⁴ and subject to Australia complying with the terms of any tax treaty with the member's residence country, 'it being understood that such partnership or group shall be treated as fiscally transparent for the purposes of entitlement to Australian tax benefits' under that other treaty.⁹⁵ To the extent that

⁹⁰ For greater detail, see Philippe Derouin, 'France' in Florian Haase (ed), *Taxation of International Partnerships* (IBFD Publications, 2014) 217.

⁹¹ Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities', above n 10, section 2.1.9.

⁹² Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 1) 2007 (Cth) [1.38].

⁹³ This responds to the risk to Australian taxation posed by the reasoning in *Padmore v IRC* (1989) 62 TC 352: see Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 1) 2007 (Cth) [1.284].

⁹⁴ An entity that is subject to corporation tax in France would be outside the scope of this article.

⁹⁵ The Explanatory Memorandum presents this 'fiscally transparent' qualification as a reservation of rights by Australia: Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 1) 2007 (Cth) [1.39]. It is difficult to see how recognition of the entity as a treaty resident with entitlement to

Australia exercises source taxing rights in respect of the income of a French translucent entity which Australia attributes to a non-French participant, Australia's taxing rights are generally saved from such diminution as might otherwise follow from recognising the entity as a French treaty resident.

Article 29(1) and (2) respond to France's observations on the Commentary on Article 1 of the OECD Model (2000) to the effect that, in the absence of special provisions, France would not recognise the members of a partnership that is not itself entitled to treaty benefits — such as a typical, fiscally transparent Australian partnership — as entitled to treaty benefits in respect of their participation in the partnership.⁹⁶

Article 29(1) only addresses the case of an Australian or French resident partner in a partnership or similar entity which, in addition to having its place of effective management in Australia, is 'treated in Australia as fiscally transparent' and is limited to the treatment of (entity-level) income, profits or gains which arise in Australia or France — a concept which, by special deeming,⁹⁷ includes those which are attributable to an entity-level permanent establishment in the country concerned. Further conditions attach in some permutations but, subject to those conditions, the outcome is essentially the same: the partner is entitled to treaty benefits in respect of his or her share of partnership income etc 'as though the partner had derived such amounts directly'.

For an Australian resident partner, the special condition is that his or her share of entity-level income etc 'is taxed in Australia in all respects as though such amounts had been derived by the partner directly'.⁹⁸ The expression 'taxed ... in all respects' is apt to create difficulties of interpretation and application, particularly where a partner's entitlement to flow-through losses, if incurred, is limited by reference to the level of his or her risk or contribution to the partnership.⁹⁹

For a French resident partner in the Australian-managed partnership, a special condition applies in respect of entity-level income etc arising in France: any such amounts as are taxed in Australia are treated for the purposes of double tax relief under the treaty in France as arising from sources in Australia.¹⁰⁰ This addresses the possibility that a French resident may participate in an Australian partnership through the partner's own Australian permanent establishment.¹⁰¹

Article 29(2) applies to Australian or French resident partners in a 'partnership' (there is no reference to a group of persons or a similar entity) that has its place of management in a third country, in which the entity is treated as fiscally transparent, in respect of their shares of partnership income etc arising in Australia or France. Article 29(2) replicates the basic structure of article 29(1), discussed above, delivering entitlement to treaty

benefits under the treaty with France could support an argument against fiscal transparency under a separate Australian treaty with a third country.

⁹⁶ OECD Model, Commentary on Art 1 (2000) [27.2]; Explanatory Memorandum to the, International Tax Agreements Amendment Bill (No. 1) 2007 (Cth) [1.274].

⁹⁷ Australia–France (2006) art 29(3).

⁹⁸ Australia–France (2006) art 29(1)(a). This provision only addresses income etc arising in France – there would be no point in addressing income arising in Australia.

⁹⁹ See Nikolakakis et al, above n 10, 322.

¹⁰⁰ Australia–France (2006) art 29(1)(b)(ii).

¹⁰¹ Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 1) 2007 (Cth) [1.280].

benefits ‘as though the partner had derived such amounts directly’, but is subject to a different set of conditions.

The first condition is that the tax system of the partner’s residence country treat the partner’s share of entity-level income etc ‘in all respects as though those amounts had been derived directly’ — this is similar to the special condition that applies to Australian partners in an Australian partnership, but here it also applies to French partners. The second is the absence of ‘contrary provisions’ in a tax treaty of Australia or France with the third country. The third is that the partner’s share of partnership income etc be ‘taxed in the same manner’, including as to its nature, source and timing, as if derived by the partner directly. The treaty does not say which country’s taxation it is referring to here, though one might guess that it has the residence country in mind. The fourth condition is that the relevant information exchange must be possible between the relevant contracting state (Australia or France) and the third country.

The treaty also contains a trust PE clause in its business profits article.¹⁰²

7.2.2 Comparison with the OECD Model

Within the scope of their operation and subject to stipulated conditions, the effects of the treaty provisions have significant similarities to those of the transparent entity clause and related provisions of the OECD Model (2017).

Although a French translucent entity would be non-transparent and taxable from a French viewpoint, it would be within the operation of the transparent entity clause if Australia treats it as transparent for the purpose of taxing an Australian resident participant. The entity itself, however, would be expected to qualify as a treaty resident of France, and French taxing rights would be preserved by the general saving clause. Australian taxing rights over its resident would be similarly preserved. From a practical viewpoint, France would be expected to have source taxing rights under the treaty with respect to most or all of the entity income that Australia attributes to its resident, even if France (as a matter of its domestic law) taxes on a residence basis. The double tax relief article would oblige Australia to give double tax relief commensurate with French source-taxing rights under the treaty.

The treatment under a notional treaty following the OECD Model (2017) of Australian source taxation of a third-country participant in a French entity is perhaps less obvious. The income in question would be recognised as income of a resident of France. It might be argued that (as under the actual treaty) Australia is not obliged to limit its taxation of the participant, since the participant is not a resident of either contracting state. This, however, is contrary to the approach taken under the transparent entity clause and (in a partnership context) under the OECD Partnership Report in circumstances where a source country attributes income to a third-country participant in an entity, which the source country regards as transparent in respect of that income, and the entity’s residence country attributes the same income to the entity itself, which it regards as non-transparent. In that case, a treaty following the OECD Model (2017) between the source country and the entity’s residence country recognises income of a resident of the entity’s

¹⁰² Australia–France (2006) art 7(8). Such clauses are discussed below in the context of the treaty with New Zealand: see text corresponding to n 112.

country.¹⁰³ Does it make any difference, then, that the person on whom France imposes tax liability, albeit on behalf of the entity, is the third-country participant? If not, the notional OECD-based treaty and the actual treaty diverge. This is a point which needs to be considered and addressed in negotiating future treaties with a country that employs a theory of translucency in its domestic tax law.

Within the scope of its operation, article 29(1) of the treaty with respect to Australian partnerships produces a result for treaty purposes — entitlement to treaty benefits ‘as though the partner had derived such amounts [i.e. his or her share of entity-level income etc] directly’ — that largely resembles the operation of the transparent entity clause. Limitation to partnerships and similar entities avoids the need to consider issues that are peculiar to trusts and estates. Differential transparency is unlikely to be a problem unless Australia and France disagree about whether particular entity-level income forms part of a particular partner’s share. In relation to an Australian partner, the requirement of Australian transparency of the entity is equivalent to the residence-country attribution requirement of the transparent entity clause, although it is not expressly tailored to the extent of residence-country attribution. Assuming that a French partner will be taxable in France on any income derived through an Australian-transparent partnership or similar entity, a similar result is achieved in relation to that partner. The treatment of income as if ‘derived ... directly’ may overcome one of the problems encountered under the transparent entity clause in relation to intercorporate dividends derived through a transparent entity.¹⁰⁴ In the case of a partnership, the imputation of an entity-level permanent establishment and the conduct of a business to the several partners and the recognition of beneficial ownership of partnership income are unlikely to be problematic, particularly with the direction to treat such income for treaty purposes in relation to a treaty resident partner as if ‘derived ... directly’.

Within the scope of its operation, article 29(2) with respect to third-country partnerships with French or Australian members is similar to article 29(1). The requirement for third-country transparency has no counterpart in the transparent entity clause. The conditions relating to residence-country taxation of the partner are somewhat stricter than those which apply under the transparent entity clause, particularly the requirement for similar tax treatment ‘in all respects’ as if the income in question had been derived directly.¹⁰⁵

7.3 Australia – Japan

The Australia–Japan Treaty (2008) is not affected by MLI article 3(1) or (3) because Australia has reserved specifically against article 3(1) on the basis of preserving article 4(5) of the treaty, although Japan would have accepted the replacement of that provision by MLI art 3(1) and (3). It is not affected by MLI art 11 because Japan has reserved

¹⁰³ Further, if there is a similar treaty between the source country and the participant’s residence country, and if that country attributes the income to the participant, treating the entity as relevantly transparent, the income is recognised under that treaty as income of a resident of the participant’s country. This requires the source country to provide treaty benefits to the extent stipulated by whichever treaty is more restrictive of its taxing rights. See Brabazon, ‘The Application of Tax Treaties to Fiscally Transparent Entities’, above n 10, sections 1.2.6, 4.4.4.

¹⁰⁴ See below, discussion of Australia–Germany (2015) protocol (3) at nn 128 and 129 and corresponding text.

¹⁰⁵ Regarding the similarity of nature, source and timing, see Brabazon, ‘The Application of Tax Treaties to Fiscally Transparent Entities’, above n 10, section 2.1 and Nikolakakis et al, above n 10.

against that article. It is not affected by MLI article 3(2) because Japan has reserved against that paragraph.

Article 4(5) of the treaty is similar in effect to the OECD transparent entity clause combined with a contextual saving clause, but is expressed at much greater length. Similar provisions are found in a number of other Japanese treaties,¹⁰⁶ although Japan has not sought to preserve these from replacement by MLI article 3(1). This suggests that Japan may be content to follow the wording of OECD Model article 1(2) in future treaties. It is something of an oddity that the wording in the treaty with Australia is preserved only by Australia's reservation. Be that as it may, there is little difference to pick between the two outcomes. The present provision represents a logical expression of the principles of the OECD Partnership Report in which the permutations of residence and fiscal attribution to which those principles may apply are addressed *seriatim*. It is reasonable to expect the future interpretation and application of article 4(5) of the treaty to be very similar or identical to those of MLI article 3(1) and (3).

The treaty also contains a trust PE clause in its business profits article.¹⁰⁷

7.4 Australia – New Zealand

The Australia–New Zealand Treaty (2009) is affected by MLI article 3(1), (2) and 11.

The treaty already contains a transparent entity clause as article 1(2).¹⁰⁸ That clause reflects the influence of US treaty practice and the transparent entity clause in the 2006 US Model, although the wording is slightly different. There is probably no difference of meaning between article 1(2) of the treaty and MLI article 3(1), which will replace it. There are also several treaty provisions that interact with article 1(2), and the question arises whether they will continue to interact in the same way with the new transparent entity clause. The governing principle is that the new clause applies in place of article 1(2) to the extent that the latter determines whether relevant income 'shall be treated as income of a resident of a Contracting Jurisdiction'.¹⁰⁹ Other provisions of the treaty are superseded only to the extent that they are incompatible with the new clause.¹¹⁰

Article 3(4) of the treaty deems dividend, interest or royalty income arising in one contracting state to be 'beneficially owned' by a resident of the other for purposes of the relevant distributive articles where it is derived by or through a trust and is subject to tax in that other state in the hands of a trustee. Beneficial ownership may be related to fiscal attribution, but it is consistently recognised as a separate question. Article 3(4) of the treaty will stand because it is not incompatible with MLI art 3(1). It has been argued elsewhere that this provision, which is distinctive of New Zealand treaty

¹⁰⁶ See e.g. Japan–US (2003, 2013) art 4(6).

¹⁰⁷ Australia–Japan (2008) art 7(9). Such clauses are discussed below in the context of the treaty with New Zealand: see text corresponding to n 112.

¹⁰⁸ 'In the case of an item of income (including profits or gains) derived by or through a person that is fiscally transparent with respect to that item of income under the laws of either State, such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income of a resident.'

¹⁰⁹ Under MLI art 3(6), both Australia and New Zealand have notified art 1(2) as the only provision of their mutual treaty falling within MLI art 3(4).

¹¹⁰ MLI art 3(6).

practice, could usefully be extended to define beneficial ownership by a wider class of entities and by their participants.¹¹¹

Article 7(7) of the treaty is a trust PE clause.¹¹² Such clauses are a distinctive feature of Australian and New Zealand treaty practice.¹¹³ Conditional on beneficial ownership by a resident of one contracting state of a share of trust-level business profits and a relevant trust-level PE in the other contracting state, the trust-level business and PE are *pro tanto* attributed to the beneficiary so as to permit taxation in the host country. These things go to the allocative criteria in the business profits article and are separate from the identification of income as that of a resident of a contracting state. The trust PE clause, which only applies to trusts and depends on the notoriously difficult concept of beneficial ownership, was originally designed as an aspect of Australian treaty practice in 1984; it was not designed with a transparent entity clause in mind and is not particularly well integrated with that clause.¹¹⁴ Nevertheless, it cannot be said to be incompatible with a transparent entity clause, either in the form of article 1(2) of the treaty or MLI article 3(1). This analysis is confirmed by the Explanatory Statement to the MLI.¹¹⁵ It follows that article 7(7) of the treaty also survives. Similar results may be expected in other Australian treaties that acquire a transparent entity clause under the MLI.

Article 23(3) of the treaty¹¹⁶ provides targeted relief against residence-residence double taxation in a way that is not attempted by the OECD Model. It operates expressly in conjunction with article 1(2) and addresses the case of a hybrid entity. In the context of residence-country taxation, where one contracting state taxes the entity and the other taxes a participant on the same item of income in accordance with article 1(2), it requires

¹¹¹ Brabazon, 'The Application of Tax Treaties to Fiscally Transparent Entities', above n 10, section 4.4.5. The wording suggested there is: 'For the purposes of Articles 10, 11 and 12, income that is considered to be income of a resident of a Contracting State under paragraph 2 of Article 1 shall be considered to be beneficially owned by a resident of that State to the extent that it is liable to taxation as such income in that State [and is not derived as agent or nominee for a non-resident]'

¹¹² The wording is as follows: 'Where:

(a) a resident of a Contracting State beneficially owns (whether as a direct beneficiary of a trust or through one or more interposed trusts) a share of the profits of a business of an enterprise carried on in the other Contracting State by the trustee of a trust other than a trust which is treated as a company for tax purposes; and (b) in relation to that enterprise, that trustee has or would have, if it were a resident of the first-mentioned State, a permanent establishment in the other State, then the business of the enterprise carried on by the trustee through such permanent establishment shall be deemed to be a business carried on in the other State by that resident through a permanent establishment situated in that other State and the resident's share of profits may be taxed in the other State but only so much of them as is attributable to that permanent establishment'. Corresponding provisions in other Australian treaties usually refer to beneficial entitlement rather than beneficial ownership, but no difference of meaning is suggested.

¹¹³ See Graham Hunt, 'New Zealand's Evolving Approach to Tax Treaties' (2008) 14(2) *New Zealand Journal of Taxation Law and Policy* 131, 160-161; Mark Brabazon, *International Taxation of Trust Income* (Cambridge University Press, 2019) section 8.3.10.1.

¹¹⁴ A more promising approach is to deal with the attribution of entity-level business structures in the definition of an enterprise of a contracting state. The trust PE clause is considered in greater detail in Brabazon, *International Taxation of Trust Income*, above n 113, section 8.3.10.

¹¹⁵ OECD, *Explanatory Statement to the Multilateral Convention*, above n 24, [45].

¹¹⁶ 'Where, in accordance with paragraph 2 of Article 1, an item of income is taxed in a Contracting State in the hands of a person that is fiscally transparent under the laws of the other State, and is also taxed in the hands of a resident of that other State as a participant in such person, that other State shall provide relief in respect of taxes imposed in the first-mentioned State on that item of income in accordance with the provisions of this Article.'

the participant's country to allow a tax credit. The logic and operation of article 23(3) can be transposed from the old to the new transparent entity clause without incompatibility because the two have the same logical structure and are practically indistinguishable. The only remaining question is whether, as a matter of interpretation, the express reference to article 1(2) should properly be read as a reference to its replacement. The MLI stipulates that the new provision is to 'apply in place of' and 'replace' the old one¹¹⁷ — in light of these words and the similarity between the old and new provisions, a conventional interpretation in good faith¹¹⁸ of both the original treaty and the MLI supports an inclusive reading of the reference in article 23(3) to article 1(2).

Australia has long taken the view that its tax treaties should not be interpreted as restricting the taxation of a country's own residents, leaving aside those provisions which clearly target residence-country taxation such as a double tax relief article. This reflects the essence of the second principle of the OECD Partnership Report, but is not limited to partnerships. Australian treaty practice has historically resisted the inclusion of a general saving clause for fear of an implication that its addition to new treaties might support an argument that older ones have a different meaning. Thus, in the Explanatory Memorandum to the Bill that carried the treaty into domestic law, Parliament was told:

Where the two countries allocate the income to different resident persons (for example, where one country considers that the income is derived by a resident entity, while the other country considers that the same income is derived by a resident who is a participant in that entity), both countries may tax the income in accordance with [article 1(2)]. Income derived from a country through an entity organised in that country will not be eligible for treaty benefits if the income is treated as derived by a resident entity under the tax laws of that country. In such case, the income would be regarded as domestic source income of a resident which, in accordance with normal treaty principles, would not be limited by the Convention. During negotiations, the two delegations noted that:

'It is understood that (this) paragraph shall not affect the taxation by a Contracting State of its residents.'¹¹⁹

Paradoxically, the treaty will acquire a fully-fledged saving clause under MLI article 11(1). This, together with the addition of article 1(3) to the OECD Model (2017), provides a convenient opportunity for Australia to jettison its former reluctance to express the principle of the saving clause in the text of its tax treaties. There is no difficulty in saying that the new clause makes express that which was formerly implied, but there will be a difficulty if Australia has to explain the absence of a general saving clause from future treaties negotiated at a time when the OECD Model includes such a clause. That confusion will be avoided by adopting the saving clause in new treaties. The terms of the 2019 treaty with Israel suggest that such a policy change may be happening.

¹¹⁷ MLI art 3(4), (6).

¹¹⁸ Vienna Convention art 31(1).

¹¹⁹ Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 2) 2009 (Cth) [2.25].

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

7.5 Australia – Germany

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

Article 1(2) of the treaty is materially indistinguishable from the transparent entity clause of the OECD Model (2017). The potential for uncertainty in the scope of its operation is reduced by article 23(3) and paragraph 7 of the protocol. Article 23(3) is a super-saving clause: it saves the operation of domestic anti-avoidance rules without providing (as the general saving clause does) for exclusions.¹²² Paragraph 7 of the protocol deems a list of rules to have the requisite anti-avoidance character, including Australia’s controlled foreign company and transferor trust rules.¹²³ Article 23(3) requires the competent authorities to consult for the elimination of any resulting double taxation, but not so as to give the taxpayer a right to initiate a mutual agreement process.¹²⁴ The rule is modelled on similar provisions in the Australia–United Kingdom Treaty (2003),¹²⁵ to which the consultation requirement has been added as a safeguard. It may be that a super-saving clause is becoming part of Australia’s treaty policy: a similar provision is included in the treaty with Israel, though without a special consultation requirement.¹²⁶

¹²⁰ See Katja Cejic, ‘The Commentaries on the OECD Model as a Mechanism for Interpretation with Reference to the Swedish Perspective’ (2017) 71(12) *Bulletin for International Taxation* 663, particularly the author’s summation of competing theories and discussion of *HFD 2016 ref. 23* (12 April 2016); Daniel W Blum, ‘The Relationship between the OECD Multilateral Instrument and Covered Tax Agreements: Multilateralism and the Interpretation of the MLI’ (2018) 72(3) *Bulletin for International Taxation* 131, 139. It seems unlikely that the particular sequence of events noted above will impede reference to the OECD Model, Commentary on Art 23 (2017). Cf nn 32–33 and corresponding text above.

¹²¹ Ludmilla Maurer et al, ‘A Brave New Post-BEPS World: New Double Tax Treaty Between Germany and Australia Implements BEPS Measures’ (2017) 45(4) *Intertax* 310; Michelle Markham, ‘The New Australia-Germany Income and Capital Tax Treaty (2015): A Tax Treaty for the Era of the OECD/G20 BEPS Initiative?’ (2017) 71(8) *Bulletin for International Taxation* 410.

¹²² ‘Nothing in this Agreement shall prevent the application of any provision of the laws of a Contracting State which is designed to prevent the evasion or avoidance of taxes. Where double taxation arises as a result of the application of any such provision, the competent authorities shall consult for the elimination of such double taxation in accordance with paragraph 3 of Article 25.’

¹²³ Cf Australia–UK (2003) Exchange of Notes (1)(d), (e) (nn 137, 138 below and corresponding text).

¹²⁴ The required consultation is under Australia–Germany (2015) art 25(3); contrast the taxpayer-initiated process under art 25(1). See also art 25(5).

¹²⁵ See nn 137 and 138 and corresponding text.

¹²⁶ Australia–Israel (2019) protocol (1).

Article 1(2) leaves residence-residence double taxation unaddressed in a hybrid situation where the entity is non-transparent in its residence country and transparent in the residence country of a participant. Where double taxation results, paragraph 2 of the protocol requires that ‘the competent authorities of the Contracting States shall consult each other pursuant to Article 25 to find an appropriate solution’. This does not give the taxpayer a right to initiate the mutual agreement process under article 25(1) but, being expressed in mandatory terms, goes further than the provision for discretionary consultation under article 25(3).¹²⁷

Paragraph 3 of the protocol seeks to clarify the interaction between the transparent entity clause and article 10(2)(a) and (3) of the treaty with respect to intercorporate dividends by stipulating that, where a contracting state fiscally attributes dividends ‘derived by or through a fiscally transparent entity or arrangement’ to its own resident, ‘Article 10 shall apply as if that resident had derived the dividends directly’. The apparent purpose of this is to ensure that, where the shareholder entity is not resident in the source country, the corporate status and percentage shareholding requirements of article 10(2)(a) for access to the lower dividend withholding rate or of article 10(3) for source-country exemption are determined by reference to the attributable taxpayer (entity or participant) in the residence country and that the interposition of an entity which the participant’s country treats as transparent does not fail the ‘holds directly’ requirement of those provisions.¹²⁸ Thus, the corporate status of the shareholder entity is immaterial if the residence country treats it as transparent in respect of the dividend,¹²⁹ but the non-corporate status of the shareholder entity from the perspective of the source country does not preclude the lower rate if the residence country perceives it as non-transparent and corporate in respect of the dividend. Although article 10(2)(a) of the treaty is not identical to the corresponding provision of the OECD Model (2014) or (2017) and article 10(3) has no Model counterpart, each of the three elements discussed above — corporate status, holding of shares and directness of holding — replicates an element of article 10(2)(a) of the Model. Paragraph 3 of the protocol may be considered as a template to clarify the interaction between the transparent entity clause and intercorporate dividend provisions of other treaties that acquire a transparent entity clause under the MLI or that are based on the OECD Model (2017).

The treaty also contains a trust PE clause in its business profits article.¹³⁰

The treaty does not contain a general saving clause, but the Explanatory Memorandum to the enacting Bill in Australia recites an understanding between the treaty negotiators similar to that referred to above between Australia and New Zealand.¹³¹

The treaty does not include a double tax relief parenthetical. No implication should be drawn from the omission. As the parenthetical was only proposed at a late stage of the work on BEPS Action 6, one cannot assume that the treaty negotiators considered it. It

¹²⁷ Australia–Germany (2015) art 25(1), (3) are materially similar to OECD Model (2017) art 25(1), (3).

¹²⁸ See Explanatory Memorandum to the International Tax Agreements Amendment Bill 2016 (Cth) [1.46] – [1.49], [2.211].

¹²⁹ Contrast *Re US S Corporation’s German Withholding Tax Status* IR 48/12; (2013) 16 ITR 428, which allowed a US S corporation to claim the lower intercorporate rate on German dividend income under Germany–US (1989) art 10(2)(a) notwithstanding that US tax law attributed that income to its shareholders, who were individuals. The result was undesirable from a policy viewpoint.

¹³⁰ Australia–Germany (2015) art 7(7).

¹³¹ Explanatory Memorandum to the International Tax Agreements Amendment Bill 2016 (Cth) [1.50].

was also regarded as a matter of clarification rather than substantive change to the Model, although the new text does appear to have made some changes to the way in which a double tax relief article would be interpreted in some countries without it.¹³²

8. TREATIES ACQUIRING TRANSPARENT ENTITY PROVISIONS

Of the 25 MLI signatories which, in addition to Australia, have not reserved generally against article 3, 19 have treaties with Australia which both parties have nominated as covered tax agreements. Three of those 19 covered tax agreements — the treaties with France, Japan and New Zealand, discussed in the previous section — already have provisions dealing with partnerships or transparent entities. Only one, the treaty with New Zealand, will have the existing provision replaced, and that change will make little or no practical difference. The remaining 16 treaties will all acquire a transparent entity clause for the first time under the MLI.

The 16 treaties fall into four groups:

- Those which acquire a general saving clause under MLI article 11(1) and a double tax relief parenthetical under article 3(2) — treaties with Argentina, Belgium, Chile, Fiji, Mexico, Norway, Poland, Romania, Russia and Slovakia.
- Those which acquire a contextual saving clause under MLI article 3(3) and a double tax relief parenthetical under article 3(2) — treaties with the Netherlands, South Africa, Spain and Turkey.
- One treaty which acquires acquire a general saving clause under MLI article 11(1) but no double tax relief parenthetical — the treaty with the United Kingdom.
- One treaty which acquires acquire a contextual saving clause under MLI article 3(3) but no double tax relief parenthetical — the treaty with Ireland.

The only notable point of difference between the general and contextual saving clauses in their impact on the income of transparent entities is the absence of a list of exclusions from the contextual clause. If the reasoning above is correct (section 3), this should make no practical difference. A potential difference has also been identified between the effect of a double tax relief article with and without the new parenthetical text or its MLI equivalent, but the difference is not a large one in policy terms.¹³³ The UK reservation against MLI article 3(2) makes little if any practical difference.¹³⁴

¹³² See nn 32-33 and corresponding text above.

¹³³ See nn 32-33 and corresponding text above.

¹³⁴ For a different view see Azzi, above n 17, 576, suggesting that double taxation would arise if a third-country limited partnership with UK partners and capital gains taxable in Australia (as in the *Resource Capital Funds* cases discussed in section 7.1.2, but substituting UK for US investors), but only because the United Kingdom reserved against MLI article 3(2). This argument encounters the objection that MLI article 3(2) has no effect but to remove an obligation to grant double tax relief. It may also be observed that tax imposed on a third-country entity by Australia as a source country and in accordance with the applicable treaty would ordinarily be creditable to its participants in the United Kingdom as their residence country, particularly given that Australia–UK (2003) art 22(2) allows credit against UK tax ‘computed by reference to the same income or chargeable gains’ as attracted the Australian tax and without requiring an identical taxpayer. Of greater significance may be the *Taxation (International and Other Provisions) Act 2010* (UK) s 33, which requires the UK taxpayer to have taken ‘all reasonable steps’ under the foreign law to minimise

The original Australia–United Kingdom Treaty (2003) contained an anti-*Padmore*¹³⁵ provision dealing with partnerships that are opaque in one contracting state and transparent in the other. Where the entity was entitled to treaty benefits, article 24 saved the right of the partners' country to tax its own residents on the partnership's income, but required that country to allow credit for tax in the partnership's residence country on the basis that such income was treated as having a source there. As neither country has opted to preserve article 24, it is replaced by the corresponding but wider provisions of the MLI.¹³⁶

The Australia–United Kingdom Treaty (2003) also contains a super-saving clause for anti-avoidance provisions,¹³⁷ expressly including transferor trust rules and either country's controlled foreign company rules.¹³⁸ If this provision were included in a treaty that also contained a transparent entity clause, it would govern the scope of operation of that clause by stipulating that the treaty, including the transparent entity clause, does not abrogate the protected rules. A transparent entity clause under MLI article 3(1) superseded the provisions of a covered tax agreement such as the Australia–United Kingdom Treaty 'only to the extent that those provisions are incompatible with' the transparent entity clause.¹³⁹ If the addition of a transparent entity clause to an existing treaty would be interpreted, leaving aside the super-saving rule, as applying to income that is taxed under such a rule, there is a sense in which the super-saving clause prevents the transparent entity clause from being fully effective in accordance with its terms and is arguably incompatible with it. The better view, however, is that the super-saving clause addresses a more fundamental question concerning the scope of the whole treaty, and that MLI article 3 is not intended to address or overcome limitations of that kind. On this view, the provisions are not relevantly incompatible.

the amount of foreign tax payable. Would this require the UK investors to solve the procedural conundrum of how to get their treaty rights recognised in Australia?

¹³⁵ *Padmore v IRC* [1989] STC 493, in which a UK partner in a Jersey partnership with no UK PE successfully resisted UK taxation on his share of the partnership's profit on the basis that the applicable treaty allocated exclusive taxing rights to Jersey. Unless counteracted, similar reasoning could have been applied to a UK partner in an Australian limited partnership. See Richard J Vann and J D B Oliver, 'The New Australia-UK Tax Treaty' [2004] *British Tax Review* 194, 199-200.

¹³⁶ The post-MLI synthesised text of Australia–UK (2003) (available at <https://www.ato.gov.au/law/view/document?DocID=MLI/MLI-UK-agreement&PiT=99991231235958> and <https://www.gov.uk/government/publications/australia-tax-treaties>) attributes this outcome to the operation of MLI art 11(4). MLI art 3(4) may also have a role to play, but nothing turns on this. It had previously been suggested that Australia–UK (2003) art 24 would survive the MLI but that art 3(2) (which confers the treaty status of a person on an Australian limited partnership that is fiscally opaque in Australia) would not (*Azzi*, above n 17, 567–568), however neither proposition appears sustainable.

¹³⁷ Vann and Oliver, above n 135, 216, 232 point to potential confusion arising from this provision, and suggest that its introduction may be related to the enhanced recognition of domestic anti-avoidance rules in the 2003 update of the Commentaries on the OECD Model – although the exchange of notes goes a good distance further than preserving the general anti-avoidance rules that were (and still are) recognised in the Commentaries as immune to abrogation by ordinary treaty provisions (cf OECD Model, Commentary on Article 1 (2017) [66]-[81]). It may also be significant that this was the first Australian treaty to include a fully operative non-discrimination article and that the treaty contained a similar reservation of anti-avoidance rules from the effect of that article.

¹³⁸ Australia–UK (2003) Exchange of Notes (1)(d), (e). Also in this category are thin capitalisation, dividend stripping, transfer pricing and conservancy rules. Compare Australia–Germany (2015) art 23(3) and protocol (7), discussed in section 7.5 above. The provisions of the latter treaty requiring the competent authorities to consult to find an appropriate solution if application of the super-saving clause results in double taxation have no counterpart in Australia–UK (2003). See also Australia–Israel (2019) protocol (1).

¹³⁹ MLI art 3(6).

In summary, the effect of importing a transparent entity clause into the 16 treaties discussed above should be to assimilate their treatment of transparent entities to that which applies under the OECD Model (2017), subject to the UK super-saving clause discussed above, the probably immaterial absence of explicit exclusions from the contextual saving clause in four treaties,¹⁴⁰ and the marginally significant absence of the double tax relief parenthetical from two treaties.¹⁴¹ Subject to those qualifications, the practical outcome should be similar to that under Australia's treaties with New Zealand and Germany, leaving aside refinements which presently remain peculiar to those treaties and address some of the loose ends identified in section 4.

9. CONCLUSION

The landscape of the treatment of transparent and hybrid entities under Australia's tax treaties will remain diverse after the MLI becomes fully operational. Twenty-three of the 44 general income tax treaties¹⁴² — just over half — will still not address the subject. They will continue as before. To the extent that the principles of the OECD Partnership Report have been adopted as a matter of interpretation by the parties to those treaties, those principles will provide guidance to the treatment of partnership income under those treaties.

Sixteen Australian treaties will acquire a transparent entity clause for the first time under the MLI. While there are some variations between them, the general effect will reflect the implementation of a transparent entity clause as in the OECD Model (2017) and a general or contextual saving clause. The principles of the Partnership Report will thus be elevated to the text of the treaty and broadened from partnerships to transparent entities generally. Tax administrators and taxpayers seeking to achieve a practical implementation of the transparent entity clause will need to consider a number of issues that remain unresolved in the application of that clause.

The treatment of transparent and hybrid entities under the five Australian treaties that already address such entities will be unaffected or very little affected by the MLI. Each has its own peculiarities. The Australia–United States Treaty (1982, 2001) addresses partnerships, trusts and estates in a partial residence provision, the effect of which is not entirely clear; it also addresses the broader class of fiscally transparent entities in the context of business profits associated with an entity-level PE. The Australia–France Treaty (2006) reaches an outcome which largely resembles that of the transparent entity clause within the sphere of its partnership-focused operation and subject to a number of explicit limitations. It deals with third-country participants in a translucent French partnership expressly, and in a way that may well not be achieved by the transparent entity clause without special modification. The Australia–Japan Treaty (2008) uses a different method of rule design and drafting to express what are essentially the same ideas as the transparent entity clause. The Australia–New Zealand Treaty (2009) already has a modern transparent entity clause, which will be notionally updated by the MLI. It includes a number of refinements, which will still apply post-MLI, and which go some way to address unresolved issues under the OECD Model (2017). The Australia–Germany Treaty (2015) is already a post-BEPS treaty. It includes a modern transparent entity clause and a number of refinements which differ from those in the Australia–New

¹⁴⁰ Those with the Netherlands, South Africa, Spain and Turkey.

¹⁴¹ Those with Ireland and the United Kingdom.

¹⁴² The number will rise to 45 when Australia–Israel (2019) enters into force.

Zealand treaty but which also address particular unresolved issues under the OECD Model (2017). Taken together, these provide some measure of useful guidance for the development of future treaty policy.

Based on the analysis in this article, it is suggested that future treaty negotiations may benefit from consideration of a number of adaptations. In short, from an Australian perspective, it would be appropriate:

- to embrace the saving clause (as in the new treaty with Israel);
- to address the intended scope of the treaty and the transparent entity clause directly (whether or not in the form of a super-saving clause, as has been done in slightly different ways in the treaties with the United Kingdom, Germany and Israel);
- to ensure that the contracting states provide a workable procedure to assert indirect treaty rights arising through the transparent entity clause;
- instead of using a trust PE clause, to define an enterprise of a contracting state in such a way as to recognise an entity-level PE of a fiscally transparent entity as belonging *pro tanto* to a participant within the scope of the transparent entity clause (following or adapting US treaty practice);
- to resolve the meaning of beneficial entitlement, at least in the context of the transparent entity clause (adapting New Zealand treaty practice);
- to resolve the ‘holds directly’ requirement in OECD Model article 10(2)(a) in the context of the transparent entity clause to follow the policy of that clause (as in the treaty with Germany); and
- to provide relief from anomalous residence-residence double taxation in the context of the transparent entity clause by special provision in the double tax relief article.

As the MLI does not constrain later amendments of covered tax agreements, these suggestions may be applied to the amendment of existing treaties as well as the negotiation of new ones.