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Hybrid Entities and Conflicts of Allocation of Income Within Tax Treaties: Is the New Article 1(2) OECD Model [Article 3(1) MLI] the Best Solution Available?

Abstract

The benefits of a tax treaty are generally granted to persons who are residents in one of the Contracting States. The determination of the tax residence status is, nevertheless, not always an easy task, being particularly problematic when referring to the residence status of entities whose tax characterization differ in each one of the Contracting States giving rise to conflicts of allocation of income. As a remedy to the above, the OECD has introduced a new Article 1(2) within the OECD Model, whose text is also replicated in Article 3(1) MLI. This provision, which reproduces the principles already settled within the 1999 OECD Partnership Report and uses a wording mirroring Article 1(6) US Model, is presented as the most effective manner to deal with the use of hybrid entities within the context of tax treaties. However, this is far from true. As argued by the author, Article 1(2) OECD Model –and by extension Article 3(1) MLI– is not properly designed to coexist with other attribution rules within tax treaties, especially with regard to the beneficial ownership requirement of Articles 10, 11 and 12 OECD Model. Accordingly, it maintains an unjustified preference for the interests of the State of residence over the State of source generating concerns especially for developing (source) countries. As stressed in this work, a better solution might be perhaps found outside the treaty context, specifically through the use of a domestic rule that coordinates the characterization of entities for tax purposes. Such a solution would not only eliminate any potential hybrid entity mismatch before the application of a treaty, but also it would indirectly provide more consistent tax treaty outcomes without the need of replacing or modifying the wording of Article 1(2) OECD Model.