Overview

On May 20, 2015 the Treasury released draft updates to the U.S. Model Income Tax Convention (the “Model Treaty”). The Model Treaty was last updated in 2006.¹

¹ On February 17, 2016, after this session report was written, the IRS released a final version of the Model Treaty. The panelists at this session were discussing the draft version of the Model Treaty released in May 2015 and not the final version released in February 2016.
There are five sets of proposed revisions:

- Special Tax Regimes
- Subsequent Changes in Law
- Triangular (Permanent Establishment) Provision
- Expatriated Entities
- Limitations on Benefits Clause

The proposed revisions were released in draft form in anticipation of issuing the first revision of the Model Treaty in 10 years, as well as a revised technical explanation.

This session covered the five proposed revisions with commentary by Quyen Huynh, Treasury associate international tax counsel. Speaking generally about the new proposed updates to the Model Treaty, Huynh stated that it was unusual for the Treasury to release draft versions of the Model Treaty, specifying that the 2006 model was released “fully baked” with no advanced draft version. By releasing a draft version for this year’s proposal, she stated, the Treasury intended to influence OECD discussions regarding action 6 of the base erosion and profit-shifting project, which covers treaty abuse.

**Special Tax Regimes**

The Model Treaty currently provides that interest, royalties and other income not otherwise covered in the treaty are taxed only in the contracting state of residency (“Home Country”) of the person who beneficially owns the income and are not taxable in the contracting state of the person making the payment (the “Source Country”). The new “special tax regimes” or “STR” provision would deny benefits for interest, royalties and other income if the beneficial owner of the income is related to the payor and benefits from a “special tax regime” on that income in its Home Country. If treaty benefits are denied, the Source Country would retain its right to tax the income under its domestic law.

A “special tax regime” means any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit, including through reductions in the tax rate or the tax base. With regard to interest, the term special tax regime includes notional deductions that are allowed with respect to equity.

Professor Allison Christians (McGill University) noted that the STR provision is not a new idea and has been in the U.S.-Luxembourg income tax treaty since 1962. She also emphasized that the STR regime focuses on three types of income (interest, royalties and “other income”), unlike the Subsequent Changes in Law provision, as discussed below. Huynh, the Treasury representative, confirmed that the STR rule was intended to be a narrow rule targeting special tax measures that create permanent tax differences through base reductions or tax rate reductions.

In light of the carveout for tax regimes that the contracting states have agreed shall not constitute an STR, Professor Christians inquired whether the provisions were meant to be self-executing upon the enactment of a new law. Huynh replied that the STR provision would be self-executing in the event that one contracting state enacted an STR. There is no notice requirement if one contracting state discovers a suspected STR in another contracting state. Also, the Treasury has not contemplated whether it would publish lists of STRs. Since an STR may include the practice of issuing private rulings, Huynh noted that it would be difficult for the Treasury to keep a list of special tax regimes.

Huynh indicated that no current provisions in U.S. law are classified as STRs. Also, the two contracting states may agree that a law (or regulation or administrative practice) is not an STR for this purpose because it does not result in a low effective rate of taxation.

**Subsequent Changes in Law**

The proposed Subsequent Changes in Law provision addresses the possibility that future changes to the domestic laws of one or both of the contracting countries could create unintended instances of low or no taxation. If the new article applies, then the treaty provisions on dividends, interest, royalties and other income “may” cease to have effect for payments to individuals in either contracting state.
Professor Christians noted that this provision differs from the STR provision in several ways. First, the STR is only applicable to interest, royalties and “other income,” while this provision also applies to dividends. Second, this provision would switch off treaty benefits for both parties, while the STR provision only switches off benefits for a recipient who benefits from the special tax regime. Third, this provision is not self-executing. Instead, it would take effect six months after the date of a written notification through diplomatic channels.

Therefore, the Subsequent Changes in Law provision allows one contracting state to incentivize another contracting state to discuss the changes in their domestic law that may bring unintended consequences in the context of the treaty. On the other hand, one treaty party cannot unilaterally switch off the entire treaty due to this provision.

Professor Christians asked Huynh to comment on the differences between the two proposed provisions. Huynh indicated that this provision was intended to facilitate treaty negotiations; to maintain treaties as enduring and dynamic documents; and to achieve their main objective, which is to mitigate against double taxation and not to create instances of double non-taxation.

**Triangular (Permanent Establishment) Provision**

Under certain U.S. treaties, subject to an active business exception, the reduction in withholding tax under certain articles of the treaty is limited to 15 percent if the income in question is derived by permanent establishment of the enterprise that is located in a third country and the income is not subject to a combined effective tax rate under the laws of the Home Country and the country of the permanent establishment equal to at least 50 percent or 60 percent of the general rate of taxation in the Home Country. The Treasury Department proposes a new paragraph in Article 1 (General Scope), which is intended to address a situation in which a resident of the Home Country earns income from the Source Country through a permanent establishment outside of the Home Country.

The new paragraph completely denies benefits of the treaty in respect of any item of income under two circumstances. First, the treaty benefits would be denied if the profits of the permanent establishment are subject to an aggregate combined effective rate of tax in the Home Country plus the other country where the permanent establishment is located equaling less than 60 percent of the general rate of company tax applicable in the Home Country.

Second, the new paragraph would also apply if the country where the permanent establishment is located is a country without a comprehensive income tax treaty in force with the Source Country, unless the treaty with the Home Country includes the income attributable to the permanent establishment in its tax base.

If the new paragraph is applied to deny the tax benefits of the treaty, tax shall be applied in accordance with the domestic law of the Source Country. However, the competent authority of the Source Country may nevertheless grant the benefits of the treaty with respect to a specific item of income, if such a grant is justified in light of the reasons why the resident did not satisfy the requirements of the paragraph.

This provision was intended to target a situation such as the following example. A foreign resident establishes a permanent establishment (under its laws) in a jurisdiction that does not recognize the permanent establishment or that taxes it at a low rate. The income attributable to the permanent establishment is exempt from tax by the foreign country (Home Country), either pursuant to an income tax treaty or the Home Country domestic law. The resident of the foreign country lends funds into the United States through the permanent establishment, which is an integral part of the foreign resident. Therefore, interest received by the foreign resident with respect to loans issued by the permanent establishment would be (without the 2015 Model Treaty update) entitled to exemption from U.S. withholding tax under the treaty, subject to little tax in the state of the permanent establishment, and exempt from tax in the foreign state.

Huynh emphasized the addition of the requirement that the branch be in a jurisdiction
with a double tax agreement with the Source Country in order to avoid loss of treaty benefits even if the 60 percent test is met. In addition, she noted that the Treasury did not pick up an active trade or business carveout which appears in some current treaties. She also noted that the proposed rule does not require a true “triangular” case because it could still apply if the branch were located in the Source Country. Finally, the proposal includes discretionary relief by the competent authorities.

**Expatriated Entities**

This proposed update is intended to reduce tax benefits achieved through corporate inversions. It imposes full withholding on dividends, interest, royalties and “other income” paid by entities that are defined as expatriated entities under Section 7874(a)(2)(A) of the Internal Revenue Code, which deals with inversions. Under that Code Section, non-U.S. companies that acquire substantially all of the properties of a domestic entity may be subject to severe tax penalties when a certain percentage of their shareholders are former shareholders of that same domestic entity.

With regard to this anti-inversion provision, the panelists only noted that there would be no grandfathering exception.

**Limitations on Benefit Clause**

**Base Erosion Element for Subsidiaries of Publicly Traded Company**

First, the proposal adds a base erosion requirement for a subsidiary of a publicly traded company to qualify under the Limitations on Benefits clause. Namely, in order to qualify for treaty benefits, less than 50 percent of the subsidiary’s income may be deductible either to persons that are not residents of either contracting state that are entitled to benefits under the treaty or to persons that meet this requirement but that benefit from a special tax regime with respect to the deductible payment. However, the limitation does not apply to deductible payments that are arm’s length payments in the ordinary course of business for services or tangible property. Huynh commented that this change was made in order to curb treaty abuse that was implemented through the use of subsidiaries. Dividends are excepted from this rule.

The proposed change also added the concept of the “tested group.” Not only would income of the subsidiary have to qualify, but its tested group’s income would also have to qualify. The term “tested group” means the resident of the contracting state that is applying the test, as well as its intermediate owners that are in its consolidated group and resident in the same country.

**Active Trade or Business Limitation**

A resident of a contracting state may qualify for treaty benefits through an active trade or business conducted by the resident itself or by a connected person. The new proposed rule states that an active trade or business of a connected person will allow the resident to qualify for the treaty only to the extent that the resident and the connected person are engaged in the same or complementary lines of business. The Treasury explained in a footnote that it intended for holding companies to have to qualify or not under the derivative benefits rule rather than the active trade or business rule.

Huynh commented that the main reason for this change is that under the current rules, a financing company could qualify although it did not have significant activity in the treaty state. The Treasury believed that it would be more appropriate for a holding company or finance company to qualify under the derivative benefits test because, in essence, those companies are deriving their treaty eligibility based on another company’s entitlement to benefits under a treaty.

**Derivative Benefits Test**

The derivative benefits test under the Limitation on Benefits article has been included in many U.S. treaties with EU and NAFTA countries but only now will be included in the Model Treaty. It can apply when a company is owned, at least 95 percent of vote and value, by seven or fewer persons entitled to equivalent treaty benefits (such owners referred to as “equivalent beneficiaries”) and less than 50 percent of its gross income (and the tested group’s income) is reduced by
deductible payments (subject to certain exceptions for payments at arm’s length for services or tangible property) to persons other than equivalent beneficiaries. This rule recognizes that multinational companies may have operations spread among many subsidiaries around the world. The owners under this rule do not have to be resident in an EU or NAFTA country, as currently; the owner may be resident in any treaty country (other than the Source Country).

The panel noted that a very substantial change to the provision is the clear inability of a Source Country resident to be a qualified owner. For example, under the provision, a U.S. owner is not a permissible owner for purposes of the seven or fewer test where the United States is the Source Country (and a U.S. subsidiary of a publicly traded U.S. parent company is not a permissible payee under the base erosion prong). The panel also questioned the need for intermediary owners in the ownership chain to each be a qualified equivalent beneficiary.

Huynh commented that the base erosion element of the derivative benefits test found in other current U.S. treaties was modified to align this test with the other base erosion rules in the 2015 Model Treaty.

**Competent Authority Review**

The current Model Treaty allows a resident to apply for subjective relief if it does not meet the objective tests of the Limitation on Benefits provision. It requires that the resident determine that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this convention. The new 2015 proposal adds a requirement for a substantial nontax nexus to the company’s state of residence.

Granwell commented that under the current provisions, the taxpayer would file a request with information showing that it should qualify for the treaty even though it did not fall under a particular provision. He stated that, historically, the response from the competent authorities generally takes substantial time. In response to Granwell’s question about the reason for this addition, Huynh stated that after speaking to the competent authorities, it was revealed that they already examine the nontax nexus of the resident to the contracting state. In the interest of transparency for the taxpayer, this language was added to the proposed Model Treaty to help the taxpayer frame its requests.