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US Model Treaty 2016: What does it say about the US and BEPS?

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Sunday, February 21st, 2016

Model tax treaties do matter. The OECD and UN Models constitute precedent books with standard clauses that contracting states can follow or adapt to suit their particular circumstances. The US Model treaty, in contrast, is a statement of intent. The preamble to the revised 2016 US Model Income Tax Convention released by the US Treasury Department on February 17, 2016, states that the US Model "is the baseline text the Treasury Department uses when it negotiates tax treaties."

The 2016 US Model is 70 pages long compared to 43 pages for its 2006 predecessor (the 2015 OECD Model is 21 pages). Add to this, the proposed multilateral instrument and we see an exponential increase in the sheer volume of tax treaty law in the 21st Century. As with other areas of domestic tax law, the increased volume and complexity, interpretation and application of treaties seems destined to demand increased specialist expertise.

US influence on BEPS proposals
In several respects previous US models have informed on the outcome of the treaty related work product of BEPS. The proposed OECD limitation on benefits article is derived almost entirely on the US approach. This reliance on US policy has flowed through to the OECD BEPS Action 6 (Treaty Abuse) final report which acknowledged that the US 2016 Model was not finalised, and, that the OECD proposals on a draft LOB should be regarded as potentially open to revision in light of US developments.

Other traditional features of US treaty policy, such as reserving the right to tax its own citizens as if the treaty had not taken effect, and ignoring the place of effective management to resolve dual residence of persons other than individuals, have found their way into BEPS proposals.

Permanent establishments
The divergence between the US and the OECD in treaty policy is the widest in relation to permanent establishment and business profits. In updating its Model, the US has declined to follow the "Authorised OECD Approach" to the attribution of profits reflected in the OECD 2010 Model. Despite the title, the AOA is controversial among OECD member countries and even the UK has had mixed success in getting the new OECD Article 7 into its recent treaties.

Most noteworthy is that the new US Model does not give effect to BEPS Action 7. The traditional permanent establishment definition is maintained by the US. The only minor exception is a rule to address when the twelve-month period for construction or installation permanent establishment is exceeded. This failure to extend taxing rights to commissionaire relationships or to persons who merely negotiate as opposed to conclude contracts is likely to cause difficulties when renegotiating treaties with those states that are keen to reverse the effect of European successive supreme court decisions that commissionaires are not agency permanent establishments under the existing wording of art 5(5) of the existing OECD Model. In its last discussion draft on the meaning of permanent establishment, the OECD accepted that it was not possible to reach a common view on the situations dealt with in those court decisions. In the same vein, the restrictions on independent agency in the case of connected persons in art 5(6) proposed in the BEPS Action 7 final report are not accepted in the US Model.

Similarly, the changes to the exceptions to permanent establishment for preparatory or auxiliary activities are not adopted in the US Model. Again the BEPS Action 7 final report hints at a lack of consensus on this issue, by offering the traditional version of art 5(4) as an alternative.

Rejection of the anti-fragmentation rule for activities of closely related parties that are individually preparatory or auxiliary but collectively may not be, signals not only a divergence of view on the necessity to address this issue, but also disapproval of regimes like the UK diverted profits tax which seek to achieve the same result under domestic law in relation to "avoided PEs".

Hitherto, there has been a high degree of convergence in permanent establishment definitions in tax treaties. This convergence has reduced the incentive for treaty shopping for permanent establishment protection from source state taxation. Diversity of treatment increases that incentive.

Changes in domestic tax law

One of the strengths of international treaties as an instrument for regulating the allocation of taxing rights between states is that treaties normally endure for a number of years, with the result that states cannot change or increase the tax on international transactions and investment unilaterally and with the frequency that domestic law changes are made. This brings a degree of stability which fosters cross-border trade. Within this framework, the extent to which changes can be made by domestic law, without breaching international obligations is typically limited to changes in definitions permitted by art 3(2) of the OECD Model.

The 2016 US Model now addresses an entirely different kind of change, that is, the decrease in tax or the introduction of tax incentives under domestic law that impact on international transactions and investment. A new Article 28 deals with subsequent changes in law resulting in a corporate tax rate less that 15 percent or 60 percent of the existing general statutory rate of company tax. Such a change requires the treaty partners to consult with a view to amending the treaty. The stated reason is that such changes may draw into question the treaty's original balance of negotiated benefits and the need for the treaty to reduce double taxation. Although this signals when a renegotiation is needed, since parties are always able to terminate treaties on notice, it exerts pressure on states to think about treaty consequences when seeking to make their domestic tax laws more attractive.

Harmful tax practices

In similar vein interest and royalties will be subject to domestic rates of tax if the recipients benefit from a "special tax regime" where such items are taxed in the residence state at preferential rates of less than 15 percent or 60 percent of the existing general statutory rate of company tax on income from sales of goods or services. This appears aimed at intellectual property box and finance box type regimes that are becoming increasingly common and the subject of OECD BEPS Action 5 (Harmful tax practices).

During the last decades, bilateral tax treaties have shown a remarkable consistency with the OECD Model. Although the BEPS Action plan called for a coordinated approach, the outcome may well be greater diversity in tax treaties. Rather than taking the tax effects out of decision making in international trade and investment, the tax effect may have a greater influence.

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