Kluwer International Tax Blog

Analysis of the New US Model Tax Treaty

William Byrnes (Texas A&M University Law) · Thursday, February 25th, 2016

After a decade, the Treasury Department issued a new U.S. Model Income Tax Convention (the "2016 Model"), which is the baseline text the Treasury Department uses when it negotiates tax treaties (last updated in 2006). The 2016 Model includes a number of new provisions intended to more effectively implement the Treasury Department's longstanding policy that tax treaties should eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.

- **Preferential Tax Regimes**: The 2016 Model *does not allow* a reduction of withholding taxes on payments of highly mobile income—income that taxpayers can easily shift around the globe through deductible payments such as royalties and interest—that are made to related persons that enjoy low or no taxation with respect to that income under a preferential tax regime. To protect against treaty abuse, the 2016 Model contains rules that deny treaty benefits on deductible payments of highly mobile income that are made to related persons that enjoy low or no taxation with respect to that income under a preferential tax regime.
- **Article 11 (Interest)** includes a new rule that would allow a treaty partner to tax interest arising in that country in accordance with domestic law if the interest is beneficially owned by a related person that benefits from "notional interest deductions" (NID).
- **New Article 28 (Subsequent Changes in Law)** obligates the treaty partners to consult with a view to amending the treaty as necessary when changes in the domestic law of a treaty partner draw into question the treaty's original balance of negotiated benefits and the need for the treaty to reduce double taxation.
- **Corporate Inversions**: The 2016 Model also includes measures to reduce the tax benefits of corporate inversions. Specifically, it denies reduced withholding taxes on U.S. source payments made by companies that engage in inversions to related foreign persons.
- **Required Arbitration**: The 2016 Model contains rules requiring that such disputes be resolved through mandatory binding arbitration. The "last best offer" approach to arbitration in the 2016 Model is substantively the same as the arbitration provision in four U.S. tax treaties in force and three U.S. tax treaties that are awaiting the advice and consent of the Senate.
- **Article 22 (Limitation on Benefits)** has been updated to prevent so-called "treaty shopping" by third-country residents that are not intended beneficiaries of the treaty. The 2016 Model includes two new tests – a "derivative benefits" test and a "headquarters company" test. In addition, a number of the preexisting LOB tests have been tightened to prevent abuse by third-country residents.
- **Triangular PEs**: The 2016 Model also includes a rule (located in new paragraph 8 of Article 1 (General Scope)) that is a revised version of the "triangular permanent establishment" rule that

has been included in some of the United States' income treaties since the 1990s. The new version of the rule addresses income treated by a residence country as attributable to a permanent establishment and subject to little or no tax, as well as income that is excluded from the tax base of the residence country and attributable to a permanent establishment located in a third country that does not have a tax treaty with the source country.

BEPS Inclusion in Model Treaty

The 2016 Model incorporates certain other BEPS recommendations for the first time:

- A revised preamble for tax treaties that makes clear the intentions of the treaty partners that the purpose of a tax treaty is the elimination of double taxation with respect to taxes on income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.
- A rule intended to protect against contract-splitting abuses of the twelve-month permanent establishment threshold for building sites or construction or installation projects.
- A twelve-month ownership requirement for the five-percent withholding rate for direct dividends, with refinements in the 2016 Model to impose a twelve-month residence requirement to prevent companies from circumventing the ownership period as well as to allow the payee company to take into account certain prior ownership.

The New Special 'Preferential' Tax Regime ("STR"s)

Consistent with the G20-OECD Base Erosion and Profit Shifting (BEPS) initiative, the new U.S. Model STR provisions are intended to mitigate instances of double non-taxation whereby a taxpayer uses provisions in the tax treaty, combined with special tax regimes, to pay no or very low tax in either treaty country. However, the new provisions also reflect the United States' preference for addressing BEPS concerns through changes to objective rules that apply on a prospective basis, rather than introducing subjective standards that could call into question agreed treaty benefits or applying wholly new concepts to prior years.

U.S. Treasury has stated that it is inappropriate for tax treaties to reduce U.S. statutory withholding rates on deductible U.S. source payments when the related income is subject to no or very little tax. The current ability of foreign-parented companies to engage in these types of transactions creates strong incentives to erode the U.S. tax base and gives foreign-parented companies an advantage over U.S.-parented companies, which cannot use these regimes to avoid paying tax on their U.S. income.

To address this unintended result, the 2016 Model denies treaty benefits for payments of interest, royalties, and certain guarantee fees between related parties if the beneficial owner of the payment benefits from a special tax regime with respect to the payment. However, the STR provisions only applies in limited cases when the resident benefits from an STR with respect to a particular related-party interest payment, royalty payment, or guarantee fee that is within the scope of Article 21 (Other Income).

The 2016 Model provides that the STR provisions will only apply when the payee is a "connected person" with respect to the payor of the income and provides a definition of that term.

The definition of STR provides an *exclusive list of the circumstances* in which a statute, regulation, or administrative practice will be treated as an STR. To qualify as an STR, the regime must provide preferential treatment to interest, royalties, or guarantee fees as compared to income from sales of goods or services. Such preferential treatment must be in the form of either a preferential rate for such income, a permanent reduction in the tax base with respect to such income (as compared to preferences that merely defer the taxation of income for a reasonable period of time), or a preferential regime for companies that do not engage in an active business in the residence state.

The 2016 Model provides an exception for STRs that are generally expected to result in a rate of taxation that is at least 15 percent, or 60 percent of the general statutory rate of company tax in the source country, whichever is lower.

New U.S. Corporate Inversions Provisions

The new 2016 Model corporate inversion provisions deny reduced withholding taxes on U.S. source payments made to related foreign persons by companies that engage in inversions. However, the new provision will apply only when the beneficial owner of a dividend, interest payment, royalty, or guarantee fee characterized as other income is a *connected person* with respect to the expatriated entity. Second, to provide certainty about the scope of the rule notwithstanding any future changes to U.S. law, the 2016 Model fixes the definition of "expatriated entity" to the meaning it has under Internal Revenue Code section 7874(a)(2)(A) as of the date the bilateral tax treaty is signed. Third, the 2016 Model provides that, under certain circumstances, preexisting U.S. subsidiaries of the foreign acquirer would not be considered expatriated entities for purposes of the treaty.

Limitation of Benefits New Provisions

(1) Active Trade or Business Test
Article 22 (Limitation on Benefits) has been updated and includes several tests that further tighten when a tax resident may seek the benefits of a U.S. tax treaty to reduce withholding: (1) an "active-trade-or-business test", (2) a "derivative benefits" test and (3) a "headquarters company" test. In addition, a number of the preexisting LOB tests have been tightened to prevent abuse by third-country residents.

The first limitation test is on the ability of connected companies to aggregate their activities for purposes of satisfying the LOB test that grants benefits with respect to income that is derived by a company in connection with the active conduct of a trade or business in its country of residence (the active-trade-or-business test). An active-trade-or-business test of the 2016 Model requires a factual connection between an active trade or business in the residence country and the item of income for which benefits are sought. Specifically, the 2016 Model requires that the treaty benefitted income "emanates from, or is incidental to," a trade or business that is actively conducted by the resident in the residence state.

- An example that the Treasury Department stated that it may include in the forthcoming technical explanation is dividends and interest paid by a commodity-supplying subsidiary that was acquired by a company whose business in the residence state depends on a reliable source for the commodity supplied by the subsidiary. Under this example, such dividends and interest would be considered to emanate from the active trade or business of the parent. Another possible example could involve dividends and interest paid by a subsidiary that distributes products that were manufactured by the parent company in its state of residence. In contrast, the mere fact that two companies are in similar lines of businesses would not be sufficient to establish that dividends or interest paid

- Another possible example could involve dividends and interest paid by a subsidiary that distributes products that were manufactured by the parent company in its state of residence. In contrast, the mere fact that two companies are in similar lines of businesses would not be sufficient to establish that dividends or interest paid between them are related to the active conduct of a trade or business.

(2) Derivative Benefits Test

The 2016 Model allows companies to qualify for treaty benefits under a "derivative benefits" test, which is based on a broader concept of the longstanding "ownership-and-base erosion" test (contained in paragraph 2(f) of Article 22 of the 2016 Model). While a form of derivative benefits is included in most existing U.S. tax treaties with countries in the European Union, those treaties limit third-country ownership to seven or fewer "equivalent beneficiaries," which generally must be resident in a member country of the European Union or North American Free Trade Area trading blocs. In contrast, the derivative benefits rule in the 2016 Model contains no such geographic restriction, instead requiring only that 95 percent of the tested company's shares be owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries.

Under all derivative benefits provisions in existing U.S. tax treaties, in order to qualify as an equivalent beneficiary with respect to income referred to in Article 10 (Dividends), 11 (Interest), or 12 (Royalties), a third-country resident must be entitled, either under a comprehensive convention for the avoidance of double taxation between its country of residence and the source country or otherwise, to a rate of tax with respect to the particular category of income that is less than or equal to the rate applicable under the tax treaty pursuant to which benefits are being claimed. Companies that fail to satisfy this rate comparison test are not entitled to treaty benefits, and therefore are generally subject to 30-percent gross basis withholding tax on U.S. source payments of dividends, interest (other than interest of a portfolio nature), and royalties. The 2016 Model instead entitles a resident of the treaty partner to the highest rate of withholding to which its third-country resident owners would be entitled.

(3) Headquarter Company Test

The 2016 Model requires a headquarters company to exercise primary management and control functions (and not just supervision and administration) in its residence country with respect to itself and its geographically diverse subsidiaries. The headquarters company rule in the 2016 Model also differs from existing headquarters company rules by including a base erosion test. Furthermore, a headquarters company is only entitled to benefits with respect to dividends and interest paid by members of its multinational corporate group; in the case of interest, this benefit is limited to a 10-percent cap on withholding in the source state, which is consistent with the general rate of withholding on interest that is permitted under the OECD's Model Income Tax Convention.

The new headquarters company test is analogous to the active-trade-or-business test in paragraph 3 of Article 22, which (as described above) generally entitles a company to treaty benefits without regard to the residence of its owners when the company derives income from the source state that emanates from, or is incidental to, such company's trade or business in the residence country.

Forthcoming Technical Explanations

The Treasury Department is preparing a detailed technical explanation of the 2016 Model, which it plans to release this spring.

To make sure you do not miss out on regular updates from the Kluwer International Tax Blog, please subscribe here.

This entry was posted on Thursday, February 25th, 2016 at 12:05 am and is filed under Tax Treaties
You can follow any responses to this entry through the Comments (RSS) feed. You can skip to the end and leave a response. Pinging is currently not allowed.