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International Tax ADVISORY ■

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U.S. Treasury Proposes Changes to U.S. Model Income Tax Treaty

The U.S. Treasury recently proposed a number of major changes to the U.S. Model Income Tax Treaty (the "U.S. Model"), last updated in 2006. Suggested updates include provisions to address special tax regimes and subsequent changes in law. Additionally, the Treasury recommendations target inverted corporations and low-taxed permanent establishment (PE) structures. The proposals also include pervasive updates to the limitation on benefits (LOB) article. Overall, the proposals to the U.S. Model reflect three chief aims of the Treasury: to bolster domestic law attacks on perceived abuses on the treaty front, to incorporate certain policy considerations of the base erosion and profit shifting (BEPS) initiative of the Organisation for Economic Co-operation and Development (OECD), and to update the U.S. Model for certain practices in existing treaties. The Treasury has requested comments to the released proposals by September 15, 2015.

Special Tax Regimes

The Treasury recommends adding the term "special tax regime" to Article 3 (General Definitions). A special tax regime is "any legislation, regulation, or administrative practice that provides a preferential effective rate of taxation to [an item of income or profit], … including through reductions in the tax rate or the tax base." In the case of interest, the term also includes "notional deductions that are allowed with respect to equity." The definition would exclude laws, rules or practices that (1) do not "disproportionately benefit" interest, royalties or other income; (2) satisfy a substantial activity criterion with respect to royalties; (3) implement Article 7 (Business Profits) or Article 9 (Associated Enterprises) principles; (4) apply principally to persons that exclusively promote religious, charitable, scientific, educational, cultural or artistic activities; (5) apply principally to persons substantially all of whose activity is providing or administering pensions or retirement benefits; (6) facilitate investment in entities that are marketed primarily to retail investors, widely held, holding real property or a diversified portfolio of securities (or a combination thereof), and subject to investor-protection regulation in the contracting state where the entity is established; or (7) the contracting states have agreed will not constitute a special tax regime.

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New paragraphs in Article 11 (Interest), Article 12 (Royalties) and Article 21 (Other Income) would provide exceptions to exclusive residence state taxation of the respective type of income—permitting the source state to tax the income under its domestic law—when the beneficial owner is related to the payor and benefits from a special tax regime. The special tax regime concept would also be incorporated into various provisions of the Treasury's proposed Article 22 (LOB). The technical explanation states that the new provisions are consistent with BEPS principles and policy concerns set out in the introduction to the 2014 OECD Model Tax Convention on Income and Capital. The technical explanation further notes that (currently) no U.S. legislation, regulation or administrative practice applicable to interest, royalty or other income would qualify as a special tax regime.

Subsequent Changes in Law

The Treasury has proposed adding a completely new Article 28 (Subsequent Changes in Law). According to the technical explanation, this article, while taking into account the contracting states' desire to allocate taxing rights to alleviate double taxation, recognizes that subsequent changes to the domestic laws of one or both states could reduce the risk of double taxation, increase the risk of double non-taxation (or low taxation) under the treaty, and thus call into question the propriety of the allocation of taxing rights under the treaty. The proposed article would suspend, six months after written notice from the other contracting state, the application of the dividends, interest, royalties and other income articles if the general rate of corporate tax or highest marginal individual tax rate, as applicable, falls below 15 percent in either country or if either country provides an exemption from tax for substantially all foreign source income.

Expatriated Entities

To address the perceived abuse of inverting corporations, the Treasury recommends adding new provisions to Article 10 (Dividends), Article 11 (Interest), Article 12 (Royalties) and Article 21 (Other Income). The new paragraphs to these articles generally provide that the United States may tax under its domestic law dividends, interest, royalties and other income paid by an expatriated entity for a period of 10 years from the date the acquisition of the entity is completed. "Expatriated entity" and related terms in the new provisions would be defined by reference to Section 7874 of the Code.

Permanent Establishments

The Treasury proposes to add to Article 1 (General Scope) a paragraph that would deny treaty benefits for source state income attributable to a PE if (1) the aggregate effective tax rate in the PE state and residence state is less than 60 percent of the general applicable tax rate in the residence state, or (2) the PE is in a third jurisdiction that does not have a comprehensive income tax treaty with the source state. If treaty benefits are denied under the provision, which applies reciprocally, the relevant income would be taxed under the source state's domestic law. The principles of Section 954(b) would be used to determine whether the aggregate effective tax rate meets or exceeds the threshold. The accompanying technical explanation illustrates that the provision could apply even in a case where the U.S. and its treaty partner disagree about whether activity within one of the contracting states constitutes a PE, if the relevant income is not taxed at or above the prescribed threshold (taking into account tax paid to the U.S. and to the treaty partner). If a treaty resident is denied benefits under the proposed paragraph, the competent authority of the source state may nevertheless grant treaty benefits if justified under the circumstances.

Limitation on Benefits

Among the Treasury's recommendations is to "replace" Article 22 (LOB). In actuality, the LOB rules under the current U.S. Model are largely retained. Residents that are individuals, contracting states (and political subdivisions or local authorities thereof), certain publicly traded companies, pension funds established in a contracting state, and organizations established and maintained exclusively for religious, charitable, scientific, educational, cultural or artistic purposes are still considered "qualified persons" and generally entitled to treaty benefits under the same conditions as exist in the 2006 U.S. Model. The proposed LOB article also largely retains, though with modifications, the ownership and base erosion test and active business test for persons other than individuals.

There are six major changes in the proposed LOB rules, along with related updates to the terms defined for purposes of the LOB article. First, the Treasury adds a base erosion condition for subsidiaries of publicly traded companies to be considered qualified persons. Second, the Treasury has added a derivative benefits test. A resident company would be entitled to benefits even if it is not a qualified person if (1) at least 95 percent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and (2) the company satisfies the base erosion condition. Overall, the "new" derivative benefits test is consistent with the terms of similar LOB provisions under existing U.S. treaties, such as Article 28 of the German treaty and as described in a Memorandum of Understanding to the Swiss treaty.

The third and fourth key changes affect the base erosion condition itself, which was already a component of the ownership and base erosion test in the 2006 U.S. Model and, under the Treasury's proposals, would apply to subsidiaries of publicly traded corporations and as part of the new derivative benefits test. The updated base erosion condition incorporates the special tax regime concept, reflecting the view that base erosion occurs not only when certain deductible payments are made to persons that are not (certain types of) qualified persons, but also when such payments are made to otherwise qualified persons that benefit from a special tax regime with respect to the payments. The Treasury has specifically invited comments on whether an exception should apply for payments in respect of financial obligations to unrelated banks in applying the base erosion condition, as it appears throughout the proposed LOB article. The other change to the base erosion condition is that the condition would apply not only to the resident company, but also to a "tested group." As defined in the last paragraph of the proposed article, the tested group includes the resident company applying the base erosion condition and any intermediate owner of the resident that is both a resident of the same contracting state and a member with the resident of a tax consolidation or similar group regime that allows the sharing of profits and losses.

The fifth major change is to the active business test, which otherwise largely tracks the current U.S. Model. Under the Treasury's recent proposals, a resident would be treated as conducting the business activities of a related person, for purposes of applying the active business test, only to the extent that the resident and the related person "are engaged in the same or complementary lines of businesses."

The sixth major change is to the "catch-all" competent authority exception to the more specific LOB provisions. Article 22(4) of the 2006 U.S. Model states that if a resident of a contracting state is not a qualified person or otherwise entitled to treaty benefits with respect to an item of income (e.g., under the ownership and base erosion or active business test), the competent authority of the source state "may, nevertheless, grant the benefits … if it determines 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 "principal purpose test"). The corresponding provision in the proposed LOB article provides that the source state's competent authority may nevertheless grant benefits "if such resident demonstrates a substantial nontax nexus to its State of residence and" does not meet the principal purpose test. Aside from adding the "substantial nontax nexus" language, the recommended provision makes it clear that the taxpayer has the onus to show it should be entitled to treaty benefits (though as a practical matter, taxpayers typically bear this burden already).

Finally, the last paragraph of the proposed article includes new defined terms generally corresponding to the other substantive modifications to the LOB rules. "Equivalent beneficiary" and "qualified intermediate owner" are defined for purposes of the derivative benefits test and modified base erosion condition. The last paragraph of the proposed article also defines "gross income" as determined in the residence state for the relevant period, except that (1) in determining benefits under Article 10 (Dividends), gross income does not include dividends that are "effectively exempt from tax" in the residence state "through deductions or otherwise," and (2) a tested group's gross income does not include income received or accrued from persons within the same tested group.

Interestingly, despite its significant changes, the proposed LOB article was not accompanied by a draft technical explanation because, according to the Treasury, the article's rules are "objective and mechanical in nature and thus are self-explanatory."

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