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America's Next Tax Model

The Treasury recently released a revised U.S. Model Income Tax Convention (the "2016 Model"), the U.S. starting point for bilateral treaty negotiation, last updated a decade ago. In May 2015, the Treasury circulated several proposed changes in draft form. Those proposals generally survive in the 2016 Model, although the Treasury has made a number of modifications in response to comments on the draft provisions. (For more background on the 2015 proposed changes, see our previous advisory, "U.S. Treasury Proposes Changes to U.S. Model Income Tax Treaty.") In addition to updated rules addressing "special tax regimes," subsequent changes in law and inverted companies, the 2016 Model makes significant changes to Article 22 (Limitation on Benefits, or LOB) and adopts mandatory binding arbitration to resolve certain disputes between the tax authorities.

The Treasury's continued focus on international tax evasion, particularly through anti-treaty abuse measures, is clear. Less clear is whether the 2016 Model's provisions will find favor with treaty partners. The new model treaty has received praise for including a mandatory binding arbitration provision and reducing the complexity and scope of certain provisions proposed last May, but the 2016 Model is still fairly complicated. While policy concerns of the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit-shifting (BEPS) initiative pervade the model treaty, many fear that the 2016 Model's intricacy (particularly LOB) may prevent its provisions from meaningfully informing the development of the multilateral instrument recommended by the BEPS initiative (much less having the U.S. provisions adopted).

Special Tax Regimes

The 2016 Model would deny treaty benefits for deductible payments of certain types of income on which the beneficial owner pays little or no tax due to a special tax regime (STR), rules clearly informed by the BEPS project. In response to comments to the draft proposals, the Treasury has tightened the application of the STR rules. The STR provisions would apply only to cases where the beneficial owner receives interest, royalties or guarantee fees within the scope of Article 21 (Other Income) and is a "connected person" (defined, in general, as connection by at least 50 percent ownership) of the payor. The definition of STR has been refined to an exclusive list of circumstances that provide preferential treatment for these three types of income relative to income from the sale of goods or services.

Another important change requires that the country invoking the STR provisions notify the other country through diplomatic note (after consultation) and issue a written public notice. While the 2016 Model abandons the proposal to treat "notional interest deduction" regimes as STRs, Article 11 (Interest) now allows taxation under the source country's domestic law if the beneficial owner is a related person that benefits from such deductions. The revised model clarifies exceptions from the STR rules and introduces an exception for preferential regimes that are generally expected to result in a rate of tax that is at least a 15 percent rate or 60 percent of the general corporate rate in the source country, whichever is lower.

Subsequent Changes in Law

The Treasury has added new Article 28 (Subsequent Changes in Law) to the 2016 Model to deal with situations where a treaty partner alters its overall tax scheme to not impose significant tax on resident companies' cross-border income. The article's scope is now limited to changes affecting the taxation of companies (while discrete rules throughout the model address benefits to individuals taxed on a remittance, fixed fee, *forfeit* or similar basis). The treaty partners must consult to determine if treaty amendments are needed to restore the allocation of taxing rights consistent with the treaty's purpose. Only if these consultations fail may a treaty partner issue a diplomatic note indicating that it will no longer grant certain benefits for payments to companies. In contrast to the 2015 draft's 15 percent rate trigger, the 2016 Model states that Article 28 is triggered if a treaty partner's general rate of company tax falls below the lower of a 15 percent rate or 60 percent of the other country's general rate of company tax.

Expatriated Entities

The Treasury's anti-inversion fervor finds voice in the 2016 Model through provisions denying benefits on U.S. source dividends, interest, royalties and certain guarantee fees paid by "expatriated entities" (as defined in the Code). To address comments to the draft proposals, the Treasury made three key revisions. First, these rules will only apply if the beneficial owner of the income is a "connected person" of the expatriated entity. Second, the 2016 Model freezes the definition of "expatriated entity" to its meaning under Code Section 7874(a)(2)(A) on the date a given treaty is signed. Third, under certain circumstances, preexisting U.S. subsidiaries of the foreign acquiring company will not be treated as expatriated entities for treaty purposes.

Limitation on Benefits

The 2016 Model's LOB article contains significant changes compared to the last model treaty, adding complexity to what was already considered a complicated set of rules, to fight "treaty shopping." While many changes were previewed as draft proposals last May, such as the new derivative benefits test, the Treasury has made a number of revisions in the 2016 Model to reflect comments, such as adding a new headquarters company test.

Active business test

In 2015, the Treasury proposed limiting the ability of connected companies to aggregate activities to satisfy the LOB test granting benefits for income derived in connection with the active conduct of a business in the residence country (the "active business test"). Changing tack, the 2016 Model reflects the Treasury's determination that the concern with the test is not attributing activities among connected persons but rather the "derived in connection with" standard for benefited income. Under the new model, there must be a factual connection between an active business in the residence country and the income for which treaty benefits are sought—specifically, the income must "emanate from" or be incidental to a business actively conducted by the resident in the residence country. Meanwhile, the new model restores the ability to attribute activities from connected persons.

Derivative benefits test

As advertised in the May 2015 proposals, the 2016 Model includes a derivative benefits test, a provision appearing in several existing U.S. treaties. The test requires that (1) 95 percent of the tested company's stock be owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries and (2) a base erosion condition be met. The Treasury refined the new test in several ways to address comments as well as its own concerns. The 2016 Model allows certain qualified persons in the source country to be treated as equivalent beneficiaries so long as such persons do not own more than 25 percent of the tested company. A more friendly change is the elimination of the "cliff effect," a situation in which a company would be denied benefits entirely if the equivalent beneficiaries were not all entitled to a tax rate on the relevant income (dividends, interest or royalties) less than or equal to the applicable rate under the treaty. Instead, the treaty partner resident would be entitled to the highest rate of withholding that would apply to its third-country owners. Also helpful is the new model's treatment of certain individuals as companies for purposes of the test's rate comparison, which allows a company to receive the lower withholding rate for dividends paid to companies so long as the tested company has sufficient substance in its country of residence.

Intermediate ownership

In contrast to the derivative benefits test in existing treaties, however, the 2016 Model restricts intermediate ownership to companies resident in the same country as the tested company or a country that has in force with the source country a comprehensive income tax treaty with rules concerning STRs and notional interest deductions (similar to those in the 2016 Model). This intermediate ownership rule also applies for purposes of the LOB test for subsidiaries of publicly traded companies and the general ownership-base erosion test.

Headquarters company test

In the 2016 Model, the Treasury has obliged comments to the 2015 draft proposals and added an LOB test for headquarters companies of multinational corporate groups. The test is based on similar provisions in some existing U.S. treaties, but with several critical alterations. An HQ company is only entitled to benefits for interest and dividends paid by members of its multinational group, with a 10 percent rate cap for interest. To qualify for benefits, an HQ company must exercise primary management and control functions (not simply supervision and administration) in its residence country for itself and its subsidiaries. (The Treasury believes that locating the strategic, financial and operational decision making in a given country established adequate nexus to permit benefits for interest and dividends—in contrast to the potentially broader application of the active business test.) The HQ company test in the new model also includes a base erosion component.

Mutual Agreement Procedures

A completely new, and much-praised, update in the 2016 Model is to Article 25 (Mutual Agreement Procedure). This article now contains rules requiring certain disputes between the treaty partners to be handled through mandatory binding arbitration. The "last best offer" approach in the new model is substantially similar to provisions in four existing U.S. treaties and three awaiting Senate ratification.

Conclusion

A number of the provisions in the 2016 Model are sharp departures from the norms of prior OECD model conventions as well as prior U.S. models. Negotiations with would-be treaty partners on the new model's baseline terms, especially LOB, could be fierce as countries look to balance creating an attractive economic picture (including a robust treaty network) with BEPS-related tax avoidance concerns. In the meantime, the Treasury has promised a technical explanation to the 2016 Model sometime this spring.

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