International Tax

United States Tax Alert

July 10, 2015

Treasury Releases Draft Amendments to the 2006 U.S. Model Income Tax Convention

Contacts

Harrison Cohen
harrisoncohen@deloitte.com

Gretchen Sierra
gretchensierra@deloitte.com

Christine Piar
cpiar@deloitte.com

Matthew Etzl
metzl@deloitte.com

On May 20 the U.S. Treasury Department released five draft amendments to the 2006 U.S. Model Income Tax Convention (the U.S. Model) as well as draft Technical Explanations (TEs) of most of the amendments. The proposals cover:

- Income earned through tax-favored or non-treaty-country permanent establishments
- Interest, royalties, and "other income" that benefit from "special tax regimes"
- Revision of the Limitation on Benefits article
- Payments made by expatriated entities
- Post-signing changes in the laws of a Contracting State that remove the threat of double taxation.

To some extent, the draft amendments provide insight into changes to the OECD Model Tax Convention (the OECD Model) that the Treasury is advocating in its role as U.S. delegate to the G20/OECD Base Erosion and Profit Shifting (BEPS) Project. This alert summarizes key features of the draft U.S. Model amendments.

I. Tax-Favored and Non-treaty-country Permanent Establishments

Treasury proposes to add a provision to Article 1 (General Scope) of the U.S. Model that would impose an expanded version of the "triangular rule" generally found in U.S. treaties negotiated with "exemption countries"[1] starting with the 1993 protocol to the 1992 U.S.-Netherlands treaty. Triangular rules deny treaty benefits when there are three countries involved (hence the name "triangular"): (1) the residence country (one of the Contracting States) of the taxpayer, (2) the source country (the other Contracting State) of the income, and (3) a third country, not one of the Contracting States, where the taxpayer carries on business through a permanent establishment (PE) to which the income is attributable according to residence country tax law.

Proposed Article 1(7)

[1] By exemption country, we mean a country that has a participation exemption or similar system that exempts the income of a foreign PE.

If the taxpayer's residence country treats an item of income of the taxpayer as attributable to a PE *outside the residence country* (and thus, not *necessarily* in a *third* country), there would be two situations in which the proposed new U.S. Model provision (Article 1(7)) would generally deny treaty protection from taxation by the country in which the income is derived. The first situation would be one in which the income is subject to a combined aggregate effective rate of tax in the residence country and in the PE country that is less than 60% of the general rate of company tax in the residence country (Article 1(7)(a)). The second situation would be one in which (i) the residence country does not include income attributable to the PE in its tax base, (ii) the PE is situated in a (third) country, and (iii) there is no income tax treaty between the source country and the third country (Article 1(7)(b)).

The competent authority of the Contracting State where the income is derived *may* grant benefits with respect to a specific item of income, notwithstanding that Article 1(7) generally denies those benefits, but only if "such grant of benefits is justified in light of the reasons such resident did not satisfy the requirements" of Article 1(7).

Unlike the triangular rules in most U.S. treaties in force, proposed Article 1(7) does not offer second-best withholding tax rates (namely, 15%) for dividends, interest and royalties "caught" by the rule. Nor does the proposal provide a self-executing exception from the rule for income derived in connection with, or incidental to, the active conduct of a trade or business carried on through the PE.

The TE of proposed Article 1(7) provides an example of Article 1(7)(a)'s application in a non-triangular case, where the United States is the location of both the source of the income and the PE. In the example, U.S.-source interest is earned by a resident of the other Contracting State. The interest is not effectively connected with the conduct of a trade or business in the United States, but the residence country treats the interest as attributable to a U.S. PE.

> If the combined aggregate effective rate of tax on the profits treated as attributable to the [PE], taking into account taxes paid both in the United States and in the other Contracting State is less than 60% of the general rate of company tax applicable in the other Contracting State, the provisions of subparagraph 7(a) would be triggered. Thus, the U.S. source interest paid to the resident of the other Contracting State would be subject to tax in accordance with domestic law of the United States.

This example highlights an ambiguity in Article 1(7)(a): although not expressly stated therein, presumably the drafters intended that the numerator of the tax disparity ratio should be determined under the assumption that Article 1(7)(a) is *in*applicable. Otherwise, in the non-triangular case, the statement of the rule would suffer from a circularity that would nullify the rule's practical effect.

II. Special Tax Regimes

Treasury would amend Articles 11 (Interest), 12 (Royalties), and 21 (Other Income) of the U.S. Model to provide that payments made to a person subject to a "special tax regime" (herein referred to as an STR) with respect to such income would be taxable as provided under the source country's internal law. The proposals for those articles would read:

> [interest] [royalties] [other income] arising in a Contracting State and

> beneficially owned by a resident of the other Contracting State that is related to the payor of the [interest] [royalties] [income] may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident is subject to a special tax regime with respect to [interest] [royalties] [other income] in its Contracting State of residence at any time during the taxable period in which the [interest is] [royalties are] [other income is] paid.

The proposal would add a new subparagraph ℓ) to paragraph 1 of Article 3 (General Definitions) of the U.S. Model to include a definition of "special tax regime" as follows:

> The term "special tax regime" with respect to an item of income or profit 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. However, the term shall not include any legislation, regulation or administrative practice:
>
> i) the application of which does not disproportionately benefit interest, royalties or other income, or any combination thereof;
>
> ii) that, with regard to royalties, satisfies a substantial activity requirement;
>
> iii) that implements the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises);
>
> iv) that applies principally to persons which exclusively promote religious, charitable, scientific, artistic, cultural or educational activities;
>
> v) that applies principally to persons substantially all of the activity of which is to provide or administer pension or retirement benefits;
>
> vi) that facilitates investment in entities that are marketed primarily to retail investors, are widely-held, that hold real property (immovable property), a diversified portfolio of securities, or any combination thereof, and that are subject to investor-protection regulation in the Contracting State in which the investment entity is established; or
>
> vii) that the Contracting States have agreed shall not constitute a special tax regime because it does not result in a low effective rate of taxation.

A protocol would also specify particular legislation, regulations and/or administrative practices of the contracting states that the negotiators agree are, and are not, STRs.

The STR proposal is similar, but not identical, to a proposal made to Working Party 1 on Tax Conventions and Related Questions (WP1) by the Delegate for the United States to the BEPS Project, and discussed in the "revised discussion draft" on Action 6: *Prevent Treaty Abuse* that was released by the OECD on May 22. (See United States Tax Alert dated June 5, 2015.) The TE of Article 3(1)(ℓ) makes it clear that no U.S. legislation, regulations, or administrative practices that apply with respect to interest, royalty or other income would satisfy the definition of STR. The TE also provides examples of foreign tax regimes that would or would not be STRs. For example, if a taxpayer obtains a ruling providing that its foreign source interest income will be subject to a low rate of taxation in the residence State, and that rate is lower than the rate that generally would apply to foreign source interest income received by residents of that State, the administrative practice under which the ruling is obtained would be an STR.

On the specific exceptions to STRs listed in the numbered clauses of Article 3(1)(ℓ), the TE provides further elaboration. The TE provides that clause i)

> generally applies to the exemption of income attributable to permanent establishments in other states. However, the exception will not apply if the residence State administers such exception in a manner that is reasonably expected to disproportionately benefit interest, royalties or other income by, for example, treating such income as attributable to a foreign permanent establishment in circumstances in which the state in which the permanent establishment is situated would not be expected to tax the income.

The TE provides that Article 3(1)(ℓ)(ii) covers measures designed to encourage, and that "in fact require substantial activities that are not of a mobile nature to be conducted in the residence State." Thus, consistent with the general direction of the 2014 Deliverable on Action 5 of the BEPS Project, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance,* "patent box" or other legislation that provides preferential tax treatment for payments received with respect to intellectual property is not a special tax regime "if the tax benefit provided by the regime is limited (including by a proportionality rule) to income that is attributable to the activities of developing the intellectual property that occurred in the residence State." The TE adds the following sentence in brackets: "It is anticipated that the substantial activity exception would be interpreted consistent with any standards promulgated by the Forum on Harmful Tax Practices."[2] Another example of a regime that is within the exception of Article 3(1)(ℓ)(ii) is a special economic zone that is intended to stimulate, and "in fact requires, investment in manufacturing."

The TE of Article 3(1)(ℓ)(iii) states that the practice of entering into advanced pricing agreements (APAs) under Article 25 (Mutual Agreement Procedures), or unilateral APAs in the case of the United States, is not an STR. However, a ruling practice that is inconsistent with the arm's length standard, or the "Authorized OECD Approach" for attribution of profits to a PE described in the OECD's "2010 Report on the Attribution of Profits to Permanent Establishments," may be an STR.

III. Proposed Revision of the Model Limitation on Benefits Article

---

[2] The OECD's Forum on Harmful Tax Practices (FHTP) was created in 1998 to distinguish "good" tax incentives to encourage economic development from "harmful" tax regimes. In the BEPS Action Plan, the FHTP was tasked under Action 5, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*, with providing, among other things, recommendations for preferential regimes. The 2014 BEPS deliverable on Action 5 recommends a "modified nexus approach" to defining substantial activities to be required under a preferential IP, or "patent box," regime. See United States Tax Alert dated September 19, 2014 for a discussion of this report and the modified nexus approach. An explanatory paper released February 20, 2015 entitled "Agreement on Modified Nexus Approach for IP Regimes" describes further amendments that were subsequently endorsed by all the OECD and G20 countries.

Treasury would revise Article 22 (Limitation on Benefits) of the U.S. Model, and the revised version would include several significant changes discussed below. No "advance draft" of the TE of the proposed revision was released with the proposed revised Article 22.

A. Changes involving the base erosion rules

Like the Limitation on Benefits article in the current U.S. Model, the proposed LOB article would have an ownership/base erosion test and a subsidiary of a publicly traded company test. Unlike Article 22 of the current U.S. Model, (a) the subsidiary of a publicly traded company test in the proposed revised Article 22 would have a base erosion prong (in this respect, the proposed model provision would be similar to the corresponding provision of the 1996 U.S.-Luxembourg treaty), and (b) a derivative benefits test (which generally has its own base erosion prong) would be included in the proposed revised Article 22.

The base erosion prongs of each of these three tests referred to above in the proposed revised Article 22 would have features never seen before in U.S. treaties or the U.S. Model. For example, a person would satisfy the proposed base erosion prong of the ownership/base erosion test in proposed Article 22(2)(f) only if less than 50% of the person's gross income, *and less than 50% of the "tested group's" gross income,* is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by the treaty in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property), *either* to persons that are not residents of either Contracting States entitled to the benefits of the treaty under Article 22(2)(a) (an individual), 22(2)(b) (a government), 22(2)(c) (publicly traded company), or 22(2)(e) (pension fund) *or to persons that meet this requirement but that benefit from an STR in their Contracting State of residence with respect to the deductible payment*.

Tested group

The term "tested group" would be defined to mean the resident that is applying the base erosion rules under the relevant LOB test (the "tested resident"), and any "intermediate owner" of the tested resident that is both a resident of the same Contracting State and a member, along with the tested resident, of a tax consolidation regime or similar group regime that allows members of the group to share profits or losses. To determine whether a tested group is "base eroding," gross income would not include intra-group income.

It is not clear what the term "intermediate owner" includes in the case of a subsidiary of a publicly traded company in which both the subsidiary and the publicly traded company reside in the same country; but under one reading, the term "intermediate owner" would *exclude* the publicly traded company.

Definition of "gross income"

Except where relevant for determining benefits under Article 10 (Dividends), the term "gross income" for purposes of applying a base erosion test to a company or other person would *exclude* dividends effectively exempt from tax in the person's Contracting State of residence (e.g., dividends exempt under a participation regime).

Thus, a leveraged foreign holding company that receives U.S. source dividends from its U.S. subsidiaries could treat these and other dividends as part of its "gross income" when determining whether its foreign tax deductions for interest expense were sufficiently low to permit the holding company to claim treaty protection from 30% U.S. tax on the dividends, even if the holding company is exempt from residence country tax on the dividends. However, the dividend income would *not* "count" as gross income in the context of claiming treaty protection from U.S. tax on the holding company's U.S. source interest, royalty, or other income of any type *other than* dividends.

B. A Model Derivative Benefits Test

Article 22, as Treasury proposes to revise it, would include a derivative benefits test similar to those found in post-1995 U.S. treaties with European countries. It would not require ultimate owners of the company claiming treaty benefits under the proposed model derivative benefits test to reside in EU or NAFTA countries, and its base erosion test would, as indicated above, refer to the "tested group," to STRs, and to gross income as defined above.

Qualifying intermediate owners

Derivative benefits tests have both an ownership prong and a base erosion prong. The proposed model version of the derivative benefits test would impose a "qualifying intermediate owner" test in its ownership prong to cover cases of *indirect* ownership (of the company claiming treaty benefits) by seven or fewer equivalent beneficiaries. None of the derivative benefits tests in U.S. treaties now in force impose *any* requirements on intermediate owners (but see the not-yet-ratified 2013 protocol to the U.S.-Spain income tax treaty, which requires that an intermediate owner be a resident of a member state of the EU or a party to NAFTA).

The term "qualifying intermediate owner" would be defined to mean a resident of a country that has, among other things, a comprehensive income tax treaty with the source country (the country from whose internal-law taxes the company claiming treaty benefits is seeking protection). This would mean that an intermediate owner could not be a resident of the source country, or a non-resident of all the countries that have treaties with the source country, and still be a "qualifying" intermediate owner. In addition, even if the intermediate owner's residence country *did* have a comprehensive income tax treaty with the source country, that alone would not be sufficient to make the intermediate owner "qualifying." The third-country treaty would also have to *include provisions addressing STRs* analogous to the proposed U.S. Model STR provisions described above, *and* would have to provide for treaty benefits comparable to those sought by the company seeking treaty protection.

To define whether benefits are "comparable," the proposed U.S. Model version of the derivative benefits test would treat slightly differently two groups of three types of income. With respect to the first group (dividends, interest, and royalties), the third-country treaty with the source country would have to provide "a rate of tax" with respect to the particular category of income for which benefits are being claimed "that is at least as low as the rate applicable under" the treaty between the source country and the residence country of the company seeking treaty benefits. (For purposes of this clause, any reduced rates of tax that are available by virtue of a state's membership in an economic bloc would also be taken into account.) With respect to the second group of income types (business profits, income from real property, and “Other income”), the third-country treaty with the source country would have to provide “benefits that are at least as favorable as the benefits that are being claimed under” the treaty between the source country and the residence country of the company seeking treaty benefits.

Equivalent beneficiaries

To the definition of “equivalent beneficiary” found in recent U.S. treaties, the proposed revised Article 22 would add a provision taking into account any reduced rates of tax that are available by virtue of a state’s membership in an economic bloc, and would add a comparable benefits test for business profits, income from real property, and “Other income.” Both additions would be similar to the rules described above in the definition of “qualified intermediate owners.”

The category of equivalent beneficiary designed for residents of the Contracting States themselves (as opposed to third-country residents) would, under the proposed revised Article 22, have a *same-country* requirement which is not typical of derivative benefits provisions in the U.S. treaties in force. Under the proposed revision, being a resident of a Contracting State, and meeting one of the specified LOB tests, would not be sufficient to qualify an equivalent beneficiary. A further requirement would be that the State of which the equivalent beneficiary is a resident must be the *same* State as the residence State of the company claiming treaty benefits under the derivative benefits test.

C. Restriction on Attribution of Activities under the Active Trade or Business Test

The current U.S. Model, and many U.S. treaties, permit a taxpayer to meet the active trade or business test vicariously through a connected person’s active conduct of a trade or business in the taxpayer’s residence country. In the revised Article 22, Treasury would restrict the taxpayer’s ability to do so: under the revision, the taxpayer would be deemed to conduct activities conducted by a connected person “only to the extent both persons are engaged in the same or complementary lines of business.” A footnote to the revised provision indicates that it is designed to prevent a holding company or a financing entity from resorting to the active trade or business test in order to satisfy Article 22, and would force such a company to resort instead to the derivative benefits test.

This proposal is similar to a proposal made by the U.S. Delegate to WP1 and discussed in the May 22 discussion draft on Action 6.

D. Substantial Nontax Nexus for Purposes Discretionary Relief

Under the U.S. Model, the competent authority of one country has discretion to grant treaty benefits to a resident of the other country that cannot satisfy any of the self-executing tests in Article 22, if the competent authority determines that neither the establishment, acquisition, maintenance, nor the conduct of the resident’s operations had as one of its principal purposes the obtaining of benefits under the treaty. Treasury would add to this list of criteria for competent authority relief the requirement that the resident demonstrate “a substantial nontax nexus to its State of residence.”

IV. Expatriated Entities

Section 7874(a) imposes a floor (equal to "inversion gain") under the taxable income of any U.S. person that is an "expatriated entity," as defined in section 7874(a)(2)(A), for a period that does not end until at least the end of the 10-year period following completion of the relevant "inversion."[3] Treasury would amend Articles 10, 11, 12, and 21 of the U.S. Model to permit the United States to supplement such treatment by applying internal law to the income described in those articles that is received by *any* treaty-country resident, if the income was received *from* an expatriated entity during the 10-year period starting when the expatriation was completed.

V. Subsequent Changes in Law

Treasury would add an Article 28 (Subsequent Changes in Law) to the U.S. Model, giving each Contracting State the option to notify the other State that it will cease to apply Articles 10, 11, 12, and 21 to individuals or companies, effective six months after the notification, if, after the treaty is signed, one of the States changes its individual or corporate income laws, as the case may be, in one of two ways. The first type of triggering change would be a tax rate reduction to below 15%. For companies, this would be a reduction of the general company income tax rate to a rate less than 15%. In the case of individuals, the change would be a reduction of the highest marginal rate of individual income tax to a rate less than 15%. The second type of triggering event would be the exemption from taxation of resident companies or resident individuals for substantially all foreign source income (including interest and royalties).

The TE of Article 28 explains that the phrase "substantially all foreign source income" would include a regime where 95% of foreign source income is exempt from tax and 5% remains taxable as a proxy for the disallowance of allocable deductions. Adoption of a tax regime where only foreign source dividends or business profits from permanent establishments are exempt from tax would *not,* however, trigger the provision.

Proposed Article 28 would thus add a third option to the two that now exist when the United States believes that a country with which it had negotiated a treaty sufficiently changes its tax laws so as to warrant a different set of (or no) U.S. tax concessions: 1) terminate all of its provisions until a renegotiated treaty can be agreed to, preventing any of the treaty provisions from applying in the meantime, or 2) leave all of the provisions in place until a renegotiated treaty can be agreed to, while allowing taxpayers to continue to claim all of the benefits of the treaty.

The TE of Article 28 states that a Contracting State's general rate of company tax or highest marginal rate of individual income tax excludes reduced rates for narrow categories of income, including those applied to portfolio investments, passive activities, or capital gains. However, generally-available deductions or other similar mechanisms that result in a general rate of company tax or highest

---

[3] An expatriated entity is any U.S. person that meets one of the following criteria: (1) it is a domestic corporation with respect to which a foreign corporation that meets certain criteria (a "surrogate foreign corporation") made an acquisition of substantially all of the domestic corporation's properties; (2) it is a domestic partnership substantially all of whose properties constituting a trade or business were acquired by a foreign surrogate corporation; or (3) it is any U.S. person that is related to a domestic corporation or partnership in the first two categories.

marginal rate of individual income tax below the 15% threshold *would* be taken into account for this purpose, and a tax that applies to a company only upon a distribution by the company, or that applies to shareholders, will not be taken into account in determining the general rate of company tax.

VI. Conclusion

If these proposals were to become part of U.S. treaties in the future, they would mark a significant change in law.

However, the U.S. Model is not a treaty. It is a public notice to the treaty negotiators of other countries, and to the U.S. Congress and the public generally, of what Treasury's opening position is likely to be in any income tax treaty negotiation with a potential treaty country, or a country that seeks to revise a treaty in force.

Moreover, the amendments to the U.S. Model proposed by the Treasury on May 20 are only proposals, and will not become part of the U.S. Model unless and until Treasury has received comments from interested parties and determines that the proposals should be incorporated into the U.S. Model. It is relatively unusual for Treasury to publicize potential U.S. Model revisions and to invite comments from the public on the provisions it proposes to adopt. It was not done prior to the release of the 1996 and 2006 U.S. Models, and we believe that the last time it was done was in 1981, when a draft Limitation on Benefits article was released for public comment.

Thus, even though Treasury has made these significant proposals public, that act alone cannot change the law. Before U.S. Model provisions like those proposed can be inserted into a treaty that is now in force, they would have to be agreed to not only by the Administration and the Senate, but also (and before the Senate has its final say) by the other country that is the party to that treaty. Only then, and after any transition period, would the new proposals directly affect taxpayers' U.S. tax liabilities. In the meantime, they provide a glimpse into Treasury's thinking on BEPS.