U.S. TREASURY ANNOUNCES NEW U.S. MODEL INCOME TAX CONVENTION

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On February 17, 2016, the Treasury Department released a revised U.S. Model Income Tax Convention (the "2016 Model Treaty") – the baseline from which the U.S. initiates treaty negotiations.

Many of the revised provisions reflect current negotiating positions developed in actual tax treaty negotiation sessions, and on the whole, the 2016 Model Treaty should be seen as a natural progression, as taxpayers and treaty partner countries have also adapted to existing treaties. Other provisions are new and are designed to limit double non-taxation in addition to double taxation, reflecting the global attack on cross-border tax planning led by the O.E.C.D.

While a prudent planner will wish to review and compare the entire 2016 Model Treaty with its predecessor, several notable provisions are outlined below:

- The 2016 Model Treaty contains provisions designed to attack special tax regimes that provide attractive tax results for highly movable income such as interest, royalties, and guarantee fees. These regimes were created to eliminate the need for back-to-back payments after anti-conduit rules were adopted by the U.S. and other countries.

- The new Article 28 (Subsequent Changes in Law) is a provision that calls for notification and consultation with a view to amending a treaty 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. While the addition may be interpreted as a bold move in support of the O.E.C.D.'s B.E.P.S. initiative, it is unlikely to produce significant results, as long as the treaty partner's tax rate does not dip below 12.5%. The U.S. has income tax treaties in effect with Ireland and Cyprus, where the headline rate for each is 12.5%. It also has a treaty with Malta where the tax rate is 5% after a refund of corporate tax that is triggered by a dividend payment. The U.S. has not indicated that it would to initiate action against the U.K., where the headline rate of corporate tax is scheduled to be reduced to 17% in 2020. Comparatively, the U.S. corporate tax rate can be as high as 35% at the Federal level and around 40% when most state taxes are taken into account. The tax on distributed profits in the U.S. will add another 30% on the after-tax earnings that are distributed – about 12%, if the combined Federal and state rate is 40%.

- The 2016 Model Treaty adopts a series of highly technical provisions designed to tighten the tests under Article 22 (Limitation on Benefits) in an effort to curb cross-border tax planning that circumvents the Limitation on Benefits article in existing treaties. These provisions may be harmful to sophisticated multinational businesses. The provisions also contain an expansion of the derivative benefits provision, which applies principally to dividends when the

treaty resident is owned by an individual who would be an equivalent beneficiary but for the lower withholding tax rates or exemption for intercompany direct investment dividends. This is a beneficial provision. Whether the revisions are beneficial or harmful for taxpayers, added complexity is evident in Article 22, as the various tests for qualifying taxpayers or income streams have become multifaceted.

- The 2016 Model Treaty would reduce the benefits of corporate inversions by denying treaty benefits for U.S. withholding taxes on U.S.-source dividends, interest, royalties, and certain guarantee fees paid by U.S. companies that are "expatriated entities." An expatriated entity is an entity with a foreign charter, but because it or a predecessor in interest was at one time a U.S. corporation, it continues to be treated as a U.S. corporation when certain conditions are met regarding the composition of the shareholder group. For a period of ten years, treaty benefits are denied to payments by expatriated entities when the recipient is "connected" with the expatriated entity. Payments made to unconnected persons benefit from the treaty. While U.S. tax law defining an inversion may change from time to time, the definition under the 2016 Model Treaty relies upon U.S. law applicable on the date of signature of an income tax treaty. Subsequent modifications are to be ignored.
- The 2016 Model Treaty expands Article 25 (Mutual Agreement Procedure) to provide for mandatory binding arbitration. In doing so, it follows four treaties that have been submitted and await the advice and consent of the Senate. These treaties have been blocked at the level of the Senate Foreign Relations Committee for several years.
- The overall B.E.P.S. initiative policy of preventing double non-taxation is elevated to a principal purpose of the 2016 Model Treaty. However, not all of the recommended permanent establishment provisions have been adopted. In that regard, a speaker at a conference once commented on the O.E.C.D. obsession with double non-taxation in the following way: It is better that 100 taxpayers incur double taxation than that one aggressive taxpayer pays too little.[1]

This month, *Insights* explores these provisions of the 2016 Model Treaty in the articles that follow.

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[1] Benjamin Franklin, letter to Benjamin Vaughan, March 14, 1785, in *The Writings of Benjamin Franklin, Volume 9*, ed. Albert H. Smyth, (1906), p. 293. Mr. Franklin was echoing Voltaire.

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