2016 MODEL TREATY – SPECIAL TAX REGIME PROVISIONS

Authors
Christine Long
Stanley C. Ruchelman

Tags
Double Non-taxation
Notional Interest Deduction
Special Tax Regimes
Tax Treaties
U.S. Model Income Tax Treaty

The U.S. Treasury Department issued a revised U.S. Model Income Tax Convention on February 17, 2016 ("2016 Model Treaty") that, among other things, implements new provisions to address special tax regime issues and prevent situations of double non-taxation. A special tax regime provides preferential tax treatment (usually in the form of a low or zero tax rate) for payments of interest, royalties, or other similar, highly-mobile income to taxpayers that reside in the relevant jurisdiction. The 2016 Model Treaty enumerates the circumstances in which a reduction in the U.S. statutory withholding rates on deductible payments to a treaty resident will be denied because the resident benefits from a particular special tax regime.

The Treasury Department has targeted the provision on special tax regimes to prevent erosion of the U.S. tax base without an offsetting tax in the country of residence. This is viewed to be unfair to existing U.S. corporations and incentive for U.S. businesses to undergo inversions to foreign corporations. The special tax regime provisions also reflect the concerns of the O.E.C.D. in connection with double non-taxation, a target of the B.E.P.S. initiative.[1]

The previous Model Treaty, which was issued in 2006 ("2006 Model Treaty"), did not have express provisions dealing with the problems of double tax avoidance caused by special tax regimes. In May 2015, the Treasury Department invited the public to comment on a draft of the revised Model Treaty (the "2015 Draft"), which added new special tax regime provisions that were not in the 2006 Model Treaty. Overall, the comments on the 2015 Draft conveyed that the term "special tax regime" was too expansive, the provisions were too ambiguous as to when treaty benefits and reductions of withholding taxes would be denied, and public notification should be required before implementing provisions of a particular special tax regime so that taxpayers may properly apply the treaty.[2] The 2016 Model Treaty addresses these comments and more carefully defines the application of special tax regime provisions.

SPECIAL TAX REGIME PROVISIONS

The 2016 Model Treaty's special tax regime provisions only apply to particular payments of interest, royalties, or guarantee fees from a related or connected party to a resident of a treaty country that benefits from a special tax regime. The special tax regime provisions are defined in Article 3 (General Definitions) and apply to Article 11 (Interest), Article 12 (Royalties), and Article 21 (Other Income) of the 2016 Model Treaty.

---

1 U.S. Department of the Treasury, *Preamble to 2016 U.S. Model Income Tax Convention*, (Feb. 17, 2016), p. 2.

2 *Id.*

The term “special tax regime” is a new addition to the Model Treaty. A special tax regime means any statute, regulation, or administrative practice related to a tax covered by the treaty that meets all of the following conditions:[3]

- It results in one or more of the following benefits for a resident of the country:
  - Preferential taxation for interest, royalties, guarantee fees, or any combination of those items, as compared to income from sales of goods or services
  - A permanent reduction in the tax base with respect to the above categories of income by allowing
    - an exclusion from gross receipts,
    - a deduction without corresponding payment or obligation,
    - a deduction for dividends paid or accrued, or
    - taxation that is inconsistent with the principles of the business profits and permanent establishment articles in that a preferential tax rate or permanent reduction in the tax base is available to companies that do not engage in an active business in the resident treaty country.[4]
  - Other similar tax benefit applied to substantially all of a company’s income or substantially all of a company’s foreign source income for companies that do not engage in the active conduct of a trade or business in the country of residence
- For patent or innovation box regimes, the preferential rate of taxation or permanent reduction in the tax base does not condition the tax benefits on research and development activities within the state of residence.
- The special tax regime is generally expected to result in a rate of taxation that is less than lower of the following to rates:
  - 15%
  - 60% of the statutory rate of corporation tax that is generally applied

The 2016 Model Treaty’s special tax regime provisions expressly do not apply to pension funds, charitable organizations, or collective investment vehicles such as U.S. regulated investment companies and U.S. real estate investment trusts that are designed to achieve a single level of current tax at either the entity level or shareholder level.[5]

The 2016 Model Treaty requires that a written public notification be issued by a country that implements a special tax regime provision. The country must first consult with, then notify the other treaty country of its intention to implement such

---

[3] *Id.*; U.S. Department of the Treasury, *U.S. Model Income Tax Convention*, (Feb. 17, 2016), art. 3(1)(l).

[4] *2016 Model Treaty*, art. 3(1)(l)(i).

[5] *Id.*, art. 3(1)(l)(iv).

provision through a diplomatic note before issuing the public notice. Such provision cannot be treated as a special tax regime until 30 days after the public notification is issued.[6] The public notification requirement was added in response to comments on the 2015 Draft.

EFFECT OF THE SPECIAL TAX REGIME PROVISIONS

Articles 11, 12, and 21 pertaining to interest, royalties, or guarantee fees, respectively, limit treaty benefits when a special tax regime applies to the recipient of income. Thus, the 2016 Model Treaty provides that:

> Interest, royalties, or guarantee fees arising in a treaty country and beneficially owned by a resident of the other treaty country that is a connected person with respect to the payor of such interest, dividend, or guarantee fee, may be taxed in the first-mentioned country in accordance with domestic law if such resident benefits from a special tax regime with respect to such income.

"Special tax regime provisions will only apply when the payee is a 'connected person' with respect to the payor of the income of interest, royalties, or guarantee fees."

These special tax regime provisions will only apply when the payee is a "connected person" with respect to the payor of the income of interest, royalties, or guarantee fees. The term "connected person" is used instead of "related to the payor" (found in the 2015 Draft) in response to concerns about the special tax regime provisions being too expansive. The term "connected person" is defined as follows:

> [T]wo persons shall be 'connected persons' if one owns, directly or indirectly, at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) or another person owns, directly or indirectly, at least 50 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.[7]

EXCEPTIONS TO THE PROVISIONS

Notional Interest Deductions

Tax regimes that provide a notional interest deduction with respect to equity are not treated as special tax regimes. However, Article 11, which pertains to interest income, allows a treaty country to tax interest when the interest is beneficially owned by a connected person and the connected person benefits from a notional interest deduction based on equity. This change represents a more focused approach to addressing the policy concern that interest income that benefits from a notional interest regime is often subject to little or no tax because (i) at the level of the lender a notional interest deduction applies in the country of residence on equity,

---

6 *2016 Model Treaty*, art. 3.

7 *Id.*, art. 3(1)(m).

and (ii) the parent of the investor benefits from a participation exemption with respect to dividends.[8]

Moreover, use of notional interest regimes has been a favorite way for certain planners to circumvent the anti-conduit financing rules of U.S. tax law.[9] Those rules attack back-to-back financing arrangements that are designed to reduce U.S. tax. Many income streams are caught by the anti-conduit rules, including interest-in/interest-out transactions, royalties-in/royalties-out transactions, and interest-in/fixed-dividends-on-preferred-stock-out transactions all looked at from the point of view of the entity receiving payments from the U.S. However, interest-in/ordinary-common-stock-dividends-out transactions are not among the listed transactions that are caught, presumably because common stock dividends paid by the recipient of U.S.-source interest income ordinarily is not viewed as abusive. However, when the dividend-out leg is accompanied by a notional interest deduction on equity capital, the tax base in the country where the recipient of U.S.-source interest is resident has been reduced in a way that violates the spirit of the anti-conduit rules.

Exempt and Fiscally Transparent Entities

The special tax regime provisions do not apply to pension funds, charitable organizations, collective investment vehicles that are tax transparent, or other entities that are tax transparent. An entity is not tax transparent if tax is deferred for more than one year.

CONCLUSION

The new provisions implemented in the 2016 Model Treaty combat the problem of double non-taxation by denying treaty benefits for payments of interest, royalties, and certain guarantee fees between connected parties if the beneficial owner of the payment benefits from a special tax regime with respect to the payment.

---

8 *Preamble to the 2016 Model Treaty*, p. 3.

9 Treas. Reg. §1.881-3.