2016 MODEL TREATY – L.O.B. REVISIONS

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IN GENERAL

While the U.S. Senate has not ratified a treaty since 2010, the Treasury Department released a revised U.S. Model Income Tax Convention on February 17, 2016 (the "2016 Model Treaty").[1] The 2016 Model Treaty is the baseline text used by the Treasury Department when negotiating tax treaties with other countries. The U.S. Model Income Tax Convention was last updated in 2006 (the "2006 Model Treaty").

The 2016 Model Treaty was not published with a technical explanation. However, the preamble, which accompanied the February release, provides that the Treasury Department plans to publish a technical explanation later this spring.

U.S. tax treaty negotiation policy is aimed at eliminating double taxation without creating opportunities for "treaty shopping." Treaty shopping arises when a person, or group of persons, who is not resident in the treaty country channels investments into the U.S. through a company that is resident in a treaty partner country but has no "real" nexus to that country. To prevent treaty shopping, the U.S. includes a limitation on benefits ("L.O.B.") provision in its income tax treaties. The L.O.B. provision provides that a resident of a foreign country cannot enjoy benefits under a treaty unless that resident is a "qualified person" or is otherwise entitled to claim benefits.

A draft version of the 2016 Model Treaty was released on May 20, 2015 (the "2015 Draft") for public comment. The 2015 Draft proposed changes to Article 22 (Limitation on Benefits) of the 2006 Model Treaty, and comments are reflected in the 2016 Model Treaty. In the 2016 Model Treaty, two new methods for satisfying the L.O.B. provision were added: a "derivative benefits" test and a "headquarters company" test. Additionally, a number of preexisting tests, from the 2006 Model Treaty, have been tightened to prevent abuse by third-country residence.

THE 2006 MODEL TREATY

Under the 2006 Model Treaty, there are four main categories under which a person (other than an individual, a non-for-profit organization, or a governmental body of one of the treaty countries) could qualify for treaty benefits. Generally, these categories include the following:

- A publicly traded company[2] – In order to meet this requirement, the company's principal class of stock must be traded regularly on a recognized exchange.

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[1] U.S. Department of the Treasury, U.S. Model Income Tax Convention, (Feb. 17, 2016).

[2] *Id.*, art. 22(2)(c)(i).

- A company that is a subsidiary or an affiliate of a publicly traded company[3] – In order to meet this requirement, 50% or more of the vote and value of the company's stock must be owned by five or fewer publicly traded companies that are qualified persons. Indirect ownership was allowed only through companies that are residents of either contracting state.

- A pension fund in which more than 50% of the beneficiaries, members, or participants are individuals resident in either the foreign country or the U.S.[4]

- A company that meets the "ownership/base erosion" test[5] – The ownership prong of this test requires that persons who are otherwise qualified persons under the treaty must own 50% or more of the vote and value of that company for at least half the year. The base erosion prong requires that disqualifying payments representing 50% or more of the company's gross income must not be made. Payments are disqualifying when they are (i) made to impermissible payees (*i.e.*, generally, payees other than individuals, governmental entities, tax-exempt entities, pension funds, and public companies that are residents of one of the contracting states and eligible for treaty benefits), (ii) tax deductible in the country of residence, and (iii) not arm's length payments made in the ordinary course of the company's business for services rendered or for the purchase of tangible property. Typically, payments that are caught in this base erosion prong are interest payments, royalty paymens, and fees for management services.

The 2006 Model Treaty also permits treaty benefits to be claimed by companies that are not qualified persons, but only for specific streams of income. Companies covered by this provision include

- a company that is actively engaged in a trade or business in its country of residence (generally, other than the business of making or managing investments for the resident's own account), but only with respect to income that is "derived in connection with" that trade or business or is incidental to that business;[6] and

- a company that is granted discretionary relief by the competent authority of the source country, based on a determination 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."[7]

REVISIONS MADE IN THE 2016 MODEL TREATY

Public Subsidiary Exception Modified

The 2016 Model Treaty modifies the regarding a subsidiary of a publicly traded company (i) to include a base erosion test and (ii) to allow for indirect ownership

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[3] *Id.*, art. 22(2)(c)(ii).

[4] *Id.*, art. 22(2)(d).

[5] *Id.*, art. 22(2)(e).

[6] *Id.*, art. 22(3).

[7] *Id.*, art. 22(4).

through a qualifying intermediate owner who is resident in a third state, but only if that state has a tax treaty with the country in which the income arises that includes provisions addressing special tax regimes ("S.T.R.'s") and notional interest deductions ("N.I.D.") similar to those in the 2016 Model Treaty (the "New Intermediate Ownership Rules"). Currently, no treaty includes such provisions.

The base erosion test in the 2016 Model Treaty is not applicable when the income for which treaty benefits are claimed is dividend income. Generally, a base erosion test provides that the company seeking treaty benefits may not, directly or indirectly, pay or accrue 50% or more of its gross income to impermissible payees in the form of payments that are deductible for tax purposes in the country of residence, not counting certain payments made in the ordinary course of business. The base erosion test in the 2016 Model Treaty expands the list of "bad payments" to include a payment made to a connected person that benefits from (i) an S.T.R. provision with respect to the payment or (ii) an N.I.D. provision in the residence state when the item of income is an interest payment. Additionally, the 2016 Model Treaty provides that, if the company seeking treaty benefits is a member with any other company in a tax consolidation, fiscal unity, or similar regime that requires members to share profits or losses or it shares losses with other companies pursuant to a group relief or other loss-sharing regime, the other company or companies must also meet the base erosion test. In other words, both the tested group of companies and the company receiving income must meet the base erosion standard.

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The list of permissible payees under the base erosion prong of the 2016 Model Treaty is the same one that appears in the standalone ownership/base erosion test of the 2006 Model Treaty; it includes individuals, governmental entities, public companies, tax-exempt entities, and pension funds resident in one of the contracting states. Arm's length payments made in the ordinary course of business for services or tangible property and, in the case of a tested group, intra-group transactions are not taken into account when making the determination.

Active Trade or Business Test Modified

The active trade or business test in the 2016 Model Treaty requires a factual connection between an active trade or business in the residence country and the item of income for which benefits are sought. Specifically, the income benefiting from the treaty must meet a new standard – whereby the income "emanates from, or is incidental to," a trade or business actively conducted by the resident in the residence state – rather than the former "derived in connection with" test. Unlike the 2015 Draft, the 2016 Model Treaty allows activities to be attributed from connected persons.

Further guidance will be included in the technical explanation that is expected to be released this spring. The guidance will likely address whether an item of income, in particular an intra-group dividend or interest payment, will meet this new "emanates" test. The preamble also provides an example: Dividends and interest paid by a commodity-supplying subsidiary acquired by a parent whose business in the residence state depends on a reliable source for that commodity would meet the emanates test, whereas payments between two companies that are merely in similar lines of business would not be sufficient to meet this test.

The public is invited to send examples of income for potential inclusion in the technical explanation until April 18, 2016. Unless the provisions are changed after public

comments, the mere expansion of a business on a lateral basis from the treaty partner to the U.S. may not be sufficient meet the active trade or business exception in the absence of active management by the parent.

Additionally, the 2016 Model Treaty specifies additional activities that are excluded from the active trade or business test: (i) operating as a holding company; (ii) providing overall supervision or administration of a group of companies; (iii) providing group financing (including cash pooling); and (iv) making or managing investments, unless carried on by a bank, insurance company, or registered securities dealer in the ordinary course of its business as such.

Derivative Benefits Test Added

While the 2006 Model Treaty did not provide for a derivative benefits test (only a standalone ownership/base erosion test, on which the derivative benefits test is based), a form of this test is included in existing U.S. tax treaties with most countries and Canada.[8] However, existing treaties limit third-country ownership to seven or fewer "equivalent beneficiaries," meaning residents of a member country of the E.U. or N.A.F.T.A. (the North American Free Trade Agreement).

The derivative benefits clause in existing U.S. treaties generally allows a company that cannot otherwise qualify for treaty benefits to obtain treaty relief if

- the company is at least 95% owned by shareholders that are residents of other countries having a comprehensive income tax treaty with the U.S. (a "Shareholder Treaty");
- the Shareholder Treaty would allow the shareholders to claim treaty benefits with respect to the underlying income if it was paid directly to them; and
- with respect to dividends, interest or royalties, the benefits accorded to the shareholders under the Shareholder Treaty are equal to, or better than, the benefits the company will obtain under the treaty in issue.

This posed a problem under the 2015 Draft for holding companies in one country owned by individuals resident in a second country having a treaty with the U.S. With regard to dividends, individuals are eligible only for a 15% withholding tax, not a 5% withholding tax or an exemption. A similar problem existed for corporations owning less than 10% of the holding company. This has now been eliminated.[9]

The 2016 Model Treaty adds a derivative benefits clause to the model L.O.B. article. This new provision accomplishes the following:

- It removes the geographic restriction found in the derivatives benefit provision of existing treaties.
- It allows a corporation owned by individuals and others to benefit from the withholding tax applicable to the shareholder if payments were made diretly to the shareholder.

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[8] *E.g.*, a derivative benefits provision was added to the Germany-U.S. Income Tax Treaty in a 2006 protocol, which amended Article 28 (the L.O.B. provisions) to include a new Article 28(3).

[9] *2016 Model Treaty*, art. 10(6).

- If a corporation is engaged in the active conduct of a trade or business in its country of residence that is substantial in relation, and similar or complementary, to the trade or business in the U.S., the individual is treated as if he or she were a company for purposes of the rate equivalency test.

In addition, the derivative benefits test includes a base erosion test, that is similar to the test applicable to a subsidiary of a publicly traded company. Consequently, the base erosion test must be met by the group as a whole and not just the company seeking benefits.

Headquarters Company Category Adopted

The 2016 Model Treaty adds a new test allowing a company that qualifies as a "headquarters company" to claim treaty benefits for dividends and interest paid by members of its multinational group. This test requires that the company's "primary place of management and control" must be in its country of residence. This is a heavier burden to meet than the existing test, which looks to the exercise of supervision and administration functions in the country of residence. According to the preamble, the presence in the treaty country of strategic, financial, and operational policy decision-making for a multinational group establishes sufficient nexus to that country with respect to dividends and interest.

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To qualify as a headquarters company, the multinational group must consist of companies resident in at least four countries, all engaged in the active conduct of a trade or business and certain income tests must be met. A base erosion test must be met that is comparable to other provisions within the L.O.B. article.

It should be noted that treaty benefits for headquarters companies are capped in the 2016 Model Treaty. A headquarters company is entitled to benefits only with respect to dividends and interest paid by members of its multinational corporate group. In the case of interest, withholding tax is not eliminated; rather, it is capped at 10%.[10]

CONCLUSION: PLAN WITH THE 2016 MODEL TREATY IN MIND

The 2016 Model Treaty signals the latest view on treaty and protocol negotiation. Some of its changes are helpful, such as the addition of a derivative benefits clause and a headquarters exception. However, other changes will be problematic for certain taxpayers, such as adding a base erosion test in some cases and an active trade or business test that may be more difficult to meet. Moreover, reflecting the complexities of a post-B.E.P.S. world, provisions in the 2016 Model Treaty are drafted in a Byzantine manner to ensure prevention of abuse by aggressive planners.

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[10] *Id.*, art. 11(2)(f).

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