2016 MODEL TREATY – B.E.P.S. & EXPATRIATED ENTITIES

Authors
Sheryl Shah
Elizabeth V. Zanet

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INTRODUCTION

The Treasury released a revised version of the U.S. Model Income Tax Convention (the "Model Treaty") on February 17, 2016 ("2016 Model Treaty"). The 2016 Model Treaty includes many technical improvements developed during tax treaty negotiations and implements efforts to eliminate double taxation while fighting base erosion and profit shifting ("B.E.P.S.").

TACKLING B.E.P.S.

In order to effectively tackle B.E.P.S. under the G-20/O.E.C.D. initiative (the "B.E.P.S. Project"), many of the deliverables call for legislative reform and incorporation into tax treaties. B.E.P.S. Action 6 specifically looks at treaty abuse and the role treaties have played in triggering non-taxation. The 2016 Model Treaty reflects the Treasury's preference for addressing B.E.P.S. through changes in objective rules applied prospectively. Although certain O.E.C.D. recommendations were already a part of the Model Treaty (such as, *e.g.*, comprehensive limitation on benefits provisions), the 2016 Model Treaty incorporates other recommendations for the first time.

The 2016 Model Treaty directly states that both treaty partners aim to eliminate double taxation of income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. Eliminating double taxation maintains a competitive global economy, but taxpayers have often taken advantage of these measures to ensure that no tax is paid in either of the contracting states. While eliminating double taxation has always been the objective of the bilateral tax conventions, expressing a clear intent to counteract non-taxation or reduced taxation through evasion or avoidance declares the need for balance in order to achieve broader fiscal policy goals.

The 2016 Model Treaty incorporates a rule to protect against contract-splitting abuses of the 12-month permanent establishment ("P.E.") threshold for building, construction, or installation projects. Contract splitting occurs when an enterprise divides a contract into several parts, each covering a period of less than 12 months and attributed to a different company, all of which are, however, owned by the same parent company. By so doing, the company avoids creating a P.E., and thus, paying tax as a resident.

The 2016 Model Treaty contains a 12-month ownership and residence requirement for companies to qualify for the 5% withholding rate for direct dividends. This addresses the practice of companies changing residence for the purpose of qualifying for the lower rate.

It is worth noting that the 2016 Model Treaty has not adopted the other B.E.P.S. Project recommendations with respect to P.E.'s, *e.g.*, the revised rules related to dependent and independent agents and the exemption for preparatory and auxiliary activities under B.E.P.S. Action 7 ("Action 7"). Action 7 stresses the need to update the definition of a P.E. in order to prevent artificial avoidance of P.E. status through the use of intermediary agents and the performance of preparatory and auxiliary activities.

Under the 2016 Model Treaty, a P.E. is established when a nonresident company has a fixed place of business or a dependent agent concluding contracts on its behalf in a foreign country. Companies may avoid creating a P.E. through their agents (without materially changing the functions performed in the country) by changing the terms of contracts, thus showing that these agents did not conclude and bind the principal. In addition, there is a carve-out rule for independent agents, whereby no P.E. is created if the agent is found to be legally and economically independent and acting in the ordinary course of business.

Action 7 proposes that where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business. Action 7 recommends that a P.E. should be deemed to be created when, on behalf of an enterprise, a person both (i) has and habitually exercises an authority to conclude contracts and (ii) habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. These may be contracts (i) in the name of the enterprise; (ii) for the transfer of ownership of, or the granting of the right to use, property that is owned by the enterprise, which the enterprise has the right to use; or (iii) for the provision of services by the enterprise. A P.E. would be created under these circumstances unless the activities of such person are exercised through a fixed place of business that would not be considered to establish a P.E. This proposal maintains the exclusion for independent agents, but the carve-out rule does not apply to exclusive independent agents that are closely related to the enterprise and are not considered independent agents by virtue their activities.

"Exceptions to the creation of a P.E. for certain activities... have changed the way business is conducted by limiting the core activities being performed in a country to those that can be deemed as preparatory or auxiliary."

The O.E.C.D. Model Tax Convention on Income and on Capital (the "O.E.C.D. Model Treaty") provides exceptions to the creation of a P.E. for certain activities – generally activities considered to be preparatory or auxiliary. These exceptions have changed the way business is conducted by limiting the core activities being performed in a country to those that can be deemed as preparatory or auxiliary, *i.e.*, not the types that create a P.E. These exceptions have often led to the fragmentation of cohesive operating businesses into smaller, separate operations so that each unit is merely engaged in preparatory or auxiliary activities that avoid creating a P.E.

Action 7 proposes limiting the exemption for preparatory and auxiliary activities. It provides a more selective test than the O.E.C.D. Model Treaty and excludes a number of fixed places of business, which should not be treated as P.E.'s because the business activities exercised through these places are merely preparatory or auxiliary. These provisions prevent the creation of a P.E. in a state if the enterprise only carries out activities that are purely preparatory or auxiliary in nature an ensure that preparatory or auxiliary activities carried on at a fixed place of business are viewed in the light of other complementary operations that are part of a cohesive business.

The Treasury has said it will continue to look at the P.E. recommendations under the B.E.P.S. Project and the concerns raised by the O.E.C.D.

EXPATRIATED ENTITIES

The Model Treaty aims to reduce the tax 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," as defined under the Internal Revenue Code ("Code").

Under Code §7874(a)(2)(A) the term "expatriated entity" generally means (i) the domestic corporation or partnership with respect to which a foreign corporation is a surrogate foreign corporation, and (ii) any U.S. person who is related to a domestic corporation or partnership described in (i) above. A "surrogate foreign corporation" is an acquiring foreign corporation or foreign publicly traded partnership that has acquired a U.S. corporation or partnership under the rules described in Code §7874(a)(2)(B).

An expatriated entity is one that has been acquired by a foreign entity in a country where the business activities are not substantial when compared to those of the affiliated group. However, the shift of ownership residency may offer lower withholding taxes or certain other tax benefits.

Under the 2016 Model Treaty, the Model Treaty provisions (discussed above) will apply only when the beneficial owner of a dividend, interest payment, royalty, or guarantee fee is a connected person with respect to the expatriated entity.

Further, the definition of expatriated entity is fixed to the definition under Code §7874(a)(2)(A) as of the date a treaty is signed, in order to match the scope with any future changes to the Code.

Under certain circumstances, pre-existing U.S. subsidiaries of a foreign acquirer would not be considered expatriated entities.

POLICY IMPLICATIONS

As noted above, the Treasury has decided not to adopt the O.E.C.D. recommendations regarding dependent and independent agents and exemptions for preparatory and auxiliary activities at this point. It should be remembered that any changes to the Model Treaty should be globally understood and uniformly applied by the contracting states. Action 7 addresses the challenges that countries create for P.E.'s in the jurisdictions where they operate. However, the directive still leaves open a number of questions, such as the scope of the P.E. test. The Treasury is not willing to adopt these P.E. rules before creating a common global understanding and developing ways to ease the compliance burdens that Action 7 could create.

While the revisions regarding expatriated entities generally restrict treaty benefits, the 2016 Model Treaty also exempts previously existing U.S. subsidiaries under certain conditions. Pre-existing U.S. subsidiaries of the foreign acquirer would not be considered expatriated entities for purposes of denying treaty benefits unless the entities join in filing a U.S. consolidated return with the domestic entity, or another entity connected to the domestic entity, after the domestic entity has been acquired. This exemption recognizes that expatriated entities may be multinational corporations with genuine business reasons for having U.S. subsidiaries. By allowing for this concession, the 2016 Model Treaty attempts to balance measures taken to combat B.E.P.S. against the real business operations of multinational corporations.