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corporate
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taxation

THE 2016 MODEL INCOME TAX TREATY

A SERIES OF ARTICLES FROM INSIGHTS SPECIAL EDITION VOL. 3 NO. 11 A YEAR IN REVIEW

- U.S. Treasury Announces New U.S. Model Income Tax Convention
- Special Tax Regime Provisions
- L.O.B. Revisions
- Mandatory Arbitration
- B.E.P.S. & Expatriated Entities

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

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Tags
B.E.P.S.
Double Non-taxation
Expatriated Entity
Limitation on Benefits
Mandatory Arbitration
Special Tax Regimes
Tax Treaties
U.S. Model Income Tax Treaty

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.

[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.

2016 MODEL TREATY – SPECIAL TAX REGIME PROVISIONS

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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.

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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

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[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,

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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.

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

9 Treas. Reg. §1.881-3.

2016 MODEL TREATY – L.O.B. REVISIONS

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Tags
Limitation on Benefits
Tax Treaties
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Withholding Tax

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.

"The base erosion test in the 2016 Model Treaty expands the list of 'bad payments' to include a payment made to a connected person."

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.

"The 2016 Model Treaty adds a new test allowing a company that qualifies as a 'headquarters company.'"

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).

2016 MODEL TREATY – MANDATORY ARBITRATION

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Action 14
B.E.P.S.
Mandatory Arbitration
O.E.C.D. Model Treaty
Tax Treaties
U.S. Model Income Tax Treaty

In the newly released U.S. Model Income Tax Convention ("2016 Model Treaty"), a provision was made for "mandatory arbitration" to resolve disputes. The mandatory arbitration provision is designated in Article 25 (Mutual Agreement Procedure).

IN GENERAL

In general, competent authority provisions in most U.S. tax treaties require that parties attempt to resolve treaty disputes between themselves, but generally, they do not mandate an agreement. The 2016 Model Treaty, along with several newly-signed U.S. tax treaties, includes a mandatory arbitration provision. However, most existing treaties contain arbitration provisions that are non-binding.

The U.S. believes that a mandatory arbitration provision will incenti*vize* parties to resolve their disputes before the actual arbitration proceeding. Based on results from the U.S.-Canada Income Tax Treaty, the I.R.S. estimates that 80% of the cases that were scheduled for arbitration were settled in advance due to that treaty's mandatory arbitration provision. The U.S. estimates that mandatory arbitration will resolve disputes in six to nine months, a timeframe which is considerably faster than current alternative treaty dispute resolution options.

2016 MODEL TREATY HIGHLIGHTS

Local Law

The 2016 Model Treaty contains language that supersedes procedural limitations in domestic law. Additionally, collection procedures are suspended during the arbitration period.[1]

Mandatory Arbitration Process

The arbitration board is comprised of three members who may only consider resolutions presented by the parties. The board may not provide its own resolution to the dispute.

In order to submit a case to arbitration, the following conditions must be satisfied:

- Tax returns have been filed for the years in question with one of the treaty countries.
- Two years have passed since the commencement date of the case, unless

1 U.S. Department of the Treasury, U.S. Model Income Tax Convention, (Feb. 17, 2016), art. 25(2).

the competent authorities agree to a different date.

- The taxpayer has submitted a written request to proceed to binding arbitration.
- A decision on the matter has not already been made by a tribunal or a court.[2]

Appeal Process

Should the taxpayer disagree with the arbitration panel's decision, the taxpayer will have 45 days to appeal the ruling.[3] The taxpayer may then proceed with other alternative dispute resolution procedures, such as court litigation or voluntary amnesty programs.

COMPARISON TO OTHER U.S. TAX TREATIES

Canada

The U.S.-Canada Income Tax Treaty contains many of the same elements of the 2016 Model Treaty, with some significant differences. First, both Canada and the U.S. must agree that the subject matter is suitable for arbitration. Subject matter suitable for arbitration is explicitly enumerated in the 2010 memorandum of understanding between the two countries.[4] Secondly, rules concerning the appeals process are not explicit in the U.S.-Canada treaty or its protocols, contrary to the 2016 Model Treaty, which specifically describes these matters.

Germany

The U.S.-Germany Income Tax Treaty has an arbitration clause similar to the one established in the Canadian treaty. However, the U.S.-German arbitration process is much more detailed than the one established under the Canadian treaty. While the German treaty provides for the composition of the arbitration board in a manner similar to the 2016 Model Treaty, it does not mention the appeals process in the same detailed manner.[5]

O.E.C.D. Model Treaty

The O.E.C.D. includes a mandatory arbitration article in its 2014 O.E.C.D. Model Tax Convention on Income and on Capital (the "O.E.C.D. Model Treaty").[6] Under the O.E.C.D. Model Treaty, a party is able to apply for mandatory arbitration if an issue has not been resolved within two years from the presentation of the matter

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2 *Id.*, art. 25(7).

3 *Id.*, art. 25(9)(k).

4 Memorandum of Understanding Between the Competent Authorities of Canada and the United States of America, art. 26(6)(b), Nov. 8, 2010.

5 U.S. Department of the Treasury, *Technical Explanation of the Convention and Protocol Between the United States of America and the Federal Republic Of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and Capital and to Certain Other Taxes*, (1989), art. 25.

6 O.E.C.D., *Model Tax Convention on Income and on Capital: Condensed Version 2014*, (Paris: O.E.C.D. Publishing, 2014), art. 25(5).

to the competent authority. Similar to the new U.S. provisions, the O.E.C.D. Model Treaty states that mandatory arbitration cannot occur if the matter is resolved by a court or tribunal in advance of arbitration. The decision is binding on both parties, notwithstanding procedural time limits in the domestic country of either state.

A key difference between the O.E.C.D. Model Treaty and the 2016 Model Treaty is the appeals process and the composition of the arbitration board. While these matters are explicitly described in the 2016 Model Treaty, the O.E.C.D. Model Treaty allots the actual process and structure to the competent authorities of each treaty country.

"A key difference between the O.E.C.D. Model Treaty and the 2016 Model Treaty is the appeals process and the composition of the arbitration board."

B.E.P.S. CONCERNS REGARDING MANDATORY ARBITRATION

Action 14 of the O.E.C.D.'s B.E.P.S. Action Plan acknowledges several concerns with regard to mandatory arbitration clauses. Firstly, mandatory arbitration removes national sovereignty through the superseding effect of treaties over domestic procedural limitations. Secondly, the power of mandatory arbitration boards may be too broad and some countries may wish to constrain an arbitrator's power over certain issues. Practitioners should note that the U.S. has demonstrated a similar concern, as evidenced by this exact limitation in the arbitration clause of the U.S.-Canada treaty.

CONCLUSION

Based on recently signed U.S. tax treaties, the mandatory arbitration clause will be an essential part of U.S. tax treaties going forward. Practitioners should focus on details relating to the composition of the arbitration panel and the appeals process. These two provisions often result in the biggest divergence between the 2016 Model Treaty and an actual effective treaty when signed.

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

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Tags
Action 6
Action 7
B.E.P.S.
Connected Person
Expatriated Entity
O.E.C.D. Model Treaty
Premanent Establishment
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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.

About Us

We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

The private client group of the firm also advises clients on matters related to domestic and international estate planning, charitable planned giving, trust and estate administration, and executive compensation.

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act.

Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

Disclaimer

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