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Anti-treaty Shopping: Limitation On Benefits Provisions

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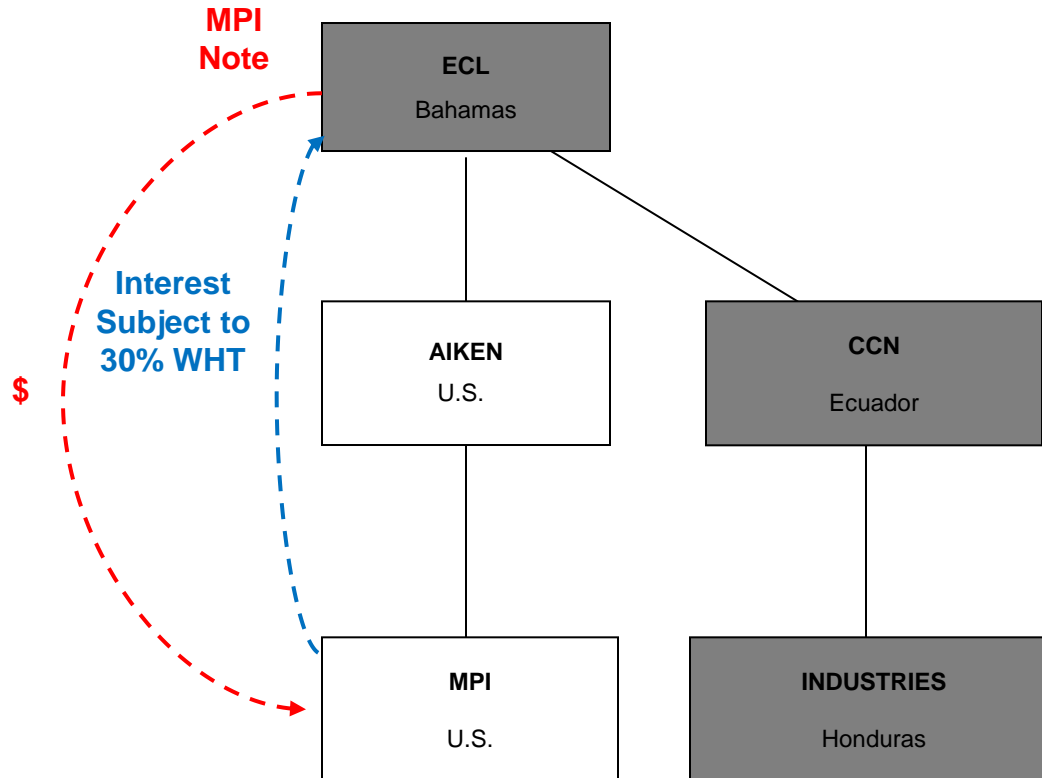
Overview

- Introduction
- Aiken Industries
- Typical LOB Provisions in U.S. Treaties
- U.S. Domestic Law (Non-Treaty) Limitations
- Conclusion

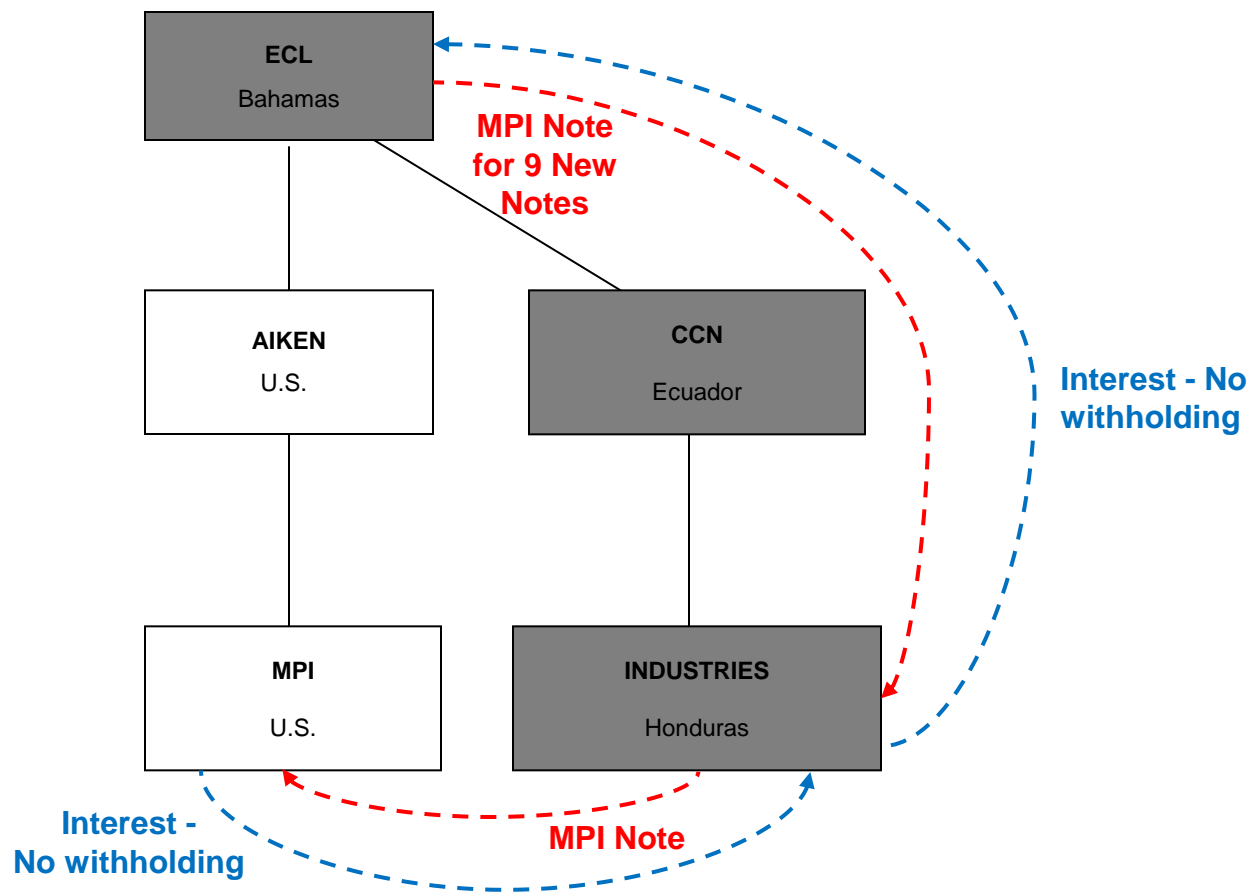
Introduction

- U.S. treaties generally provide explicit, objective rules to limit treaty benefits
 - Typically referred to as “limitation on benefits” or “LOB”
- Other treaty provisions that limit treaty benefits
 - Subject-to-tax
 - Transparent entities
 - Beneficial ownership
 - Anti-conduit rules
 - Dual residents
 - Special tax regimes

Aiken Industries v. Commr.



Aiken Industries v. Commr.



Aiken Industries v. Commr.

- Applicable Tax Treaty – No withholding on interest payments between U.S. and Honduras
- Issue – should Industries be ignored?
- Holding – U.S./Honduras Treaty did not apply to exempt interest paid by MPI since
 - Industries was a “collection agent”
 - A mere “conduit for the passage of interest payments from MPI to ECL”

TYPICAL LOB PROVISIONS IN U.S. TREATIES

Typical LOB Provisions in U.S. Treaties

- Two routes to qualification under LOB
 - Qualification of the taxpayer generally
 - Qualification with respect to a particular item of income
- Qualification of the taxpayer generally (companies)
 - Publicly traded company test, or
 - Ownership/base erosion test
- Qualification w/r/t a particular item of income (companies)
 - Derivative benefits test
 - Active trade or business test, or
 - Discretionary determination from the Competent Authority
- These are the “typical” provisions - the text of each treaty must be thoroughly analyzed

Publicly Traded Companies

- Test can be met by
 - Publicly traded companies or
 - Their subsidiaries
- Publicly traded companies
 - The “principal class of shares” is
 - Listed on a U.S. or foreign country “recognized stock exchange” and
 - Regularly traded on a “recognized stock exchange”
- Subsidiaries of publicly traded companies
 - At least 50% of vote and value is owned
 - By five or fewer publicly traded companies (as defined above)
 - Ownership may be indirect, as long as intermediate owners are residents of either U.S. or the foreign country

Ownership/Base Erosion Test

- “Ownership” portion of test:
 - On at least half the days of the taxable period
 - At least 50% of the tested party is owned by
 - Persons meeting one of several LOB tests
 - Test for public trading (but not subsidiary public trading) or
 - Certain other tests:
 - (pension funds, tax exempts, qualified governmental entities or individuals)
 - Ownership can be direct or indirect, but both vote and value are tested
- “Base erosion” portion of test:
 - Less than 50% of the person’s gross income for the taxable period is paid or accrued, directly or indirectly, to nonresidents of U.S. or applicable country
 - And is deductible in the tested party’s jurisdiction
 - Certain arm’s length payments are excluded

Derivative Benefits Test

- Ownership portion of test:
 - $\geq 95\%$ of company is owned by ≤ 7 “equivalent benef.s”
 - Both vote and value are tested
 - Ownership can be direct or indirect
- Base erosion portion of test:
 - $< 50\%$ of the person’s gross income for the taxable period
 - Is paid or accrued, directly or indirectly, to persons who are not “EBs”
 - And is deductible in the tested party’s jurisdiction
 - Certain arm’s length payments are excluded

Derivative Benefits Test – Definition of Equiv. Beneficiary

- To be an “equivalent beneficiary”
 - A person must be a resident of
 - An E.U. country, or
 - A party to NAFTA (Canada, Mexico, U.S.)
 - The person also
 - Must be entitled (under a treaty between the person’s country and the U.S.) to benefits that are at least equal to the benefits under the tested treaty

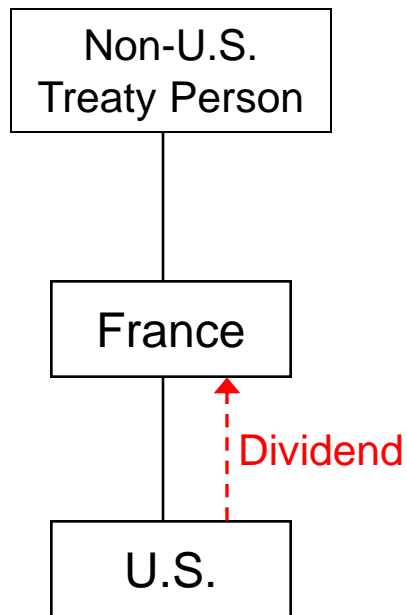
Active Trade or Business Test

- A resident of one of the states can qualify with respect to an item of income if the resident is engaged in the active conduct of a trade or business in that state and
 - the income from the other state is either “derived in connection with” or “incidental to” that trade or business
 - Exception for the business of making or managing investments for the resident’s own account, unless the activities are certain activities of a bank, insurance company or reg’d securities dealer
- The general rule for active trades or businesses will not provide benefits with respect to an item:
 - unless the trade or business in the residence state is substantial in relation to the trade or business activity in the source state.

Discretionary Determination

- “A resident of a Contracting State that [does not qualify under any other LOB paragraph] shall, nevertheless, be granted benefits of this Convention with respect to [an item of income, profit or gain] if the Competent Authority of the other Contracting State determines that the establishment, acquisition or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this convention.”

LOB example



- Does not meet LOB
 - Assumes failure under active trade or business test
- Result: 30% withholding

U.S. DOMESTIC LAW (NON-TREATY) LIMITATIONS

U.S. Domestic Law (Non-Treaty) Limitations

- U.S. anti-conduit regulations
 - I.R.C. §7701(I)
 - Treas. Reg. §1.881-3

- U.S. hybrid entity regulations
 - I.R.C. § 894(c)
 - Treas. Reg. §1.894-1

Conclusion

- The U.S. LOB rules tend to be relatively effective at limiting treaty shopping
- Downside is complexity
- Balance between effectiveness and administrability

Disclosure

This slide set does not constitute an opinion. Thus, the use of the terms “is,” “will,” “should,” or similar terms are not meant to convey an opinion on the tax consequences of the discussed transactions. If you request an opinion, the appropriate opinion level with respect to the transactions must be determined based on a further analysis of the facts and circumstances of an actual implementation, and after compliance with internal control procedures of Ruchelman P.L.L.C.

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