US Treasury proposes fundamental changes to US Model Income Tax Convention

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In brief

On May 20, 2015, the US Department of Treasury released proposed revisions to the US model income tax convention (the Model). Treasury has requested comments from the business community and other interested stakeholders with respect to these proposals within 90 days.

The Model was last updated in 2006 and is accompanied by a technical explanation that describes in part the objectives of the Model's provisions and how those provisions are intended to apply. The Model serves as a template for future US tax treaties and protocols. Additionally, revisions to the Model may influence the international community's discussion of approaches to treaty abuse and harmful tax practices with respect to the Organization for Economic Cooperation and Development's (OECD) ongoing work regarding base erosion and profit shifting (BEPS).

Treasury's proposed revisions address certain aspects of the Model by modifying existing provisions and introducing entirely new provisions. Specifically, the proposed revisions target (1) exempt permanent establishments, (2) special tax regimes, (3) expatriated entities, (4) the anti-treaty shopping measures of the limitation on benefits article, and (5) subsequent changes in treaty partners' tax laws. The proposals are accompanied by technical explanations.

In detail

Background

A principal goal of US tax treaties is to minimize the double taxation of cross-border income and excessive taxation. To this end, US tax treaties generally provide for the reduction or elimination of source country taxation with respect to cross-border transactions. This relief generally includes a reduction, in whole or in part, in US federal income tax imposed on fixed or determinable annual or periodical (FDAP) income and limitations on the extent to which US federal income tax may be imposed on income effectively connected with a US trade or business (ECI). Benefits under a US tax treaty generally are reserved to residents of a contracting state which has sufficient nexus with that state. Most US tax treaties include a limitation on benefits article that sets forth relatively objective tests, one of which a taxpayer must satisfy in order to qualify for treaty benefits. These tests generally provide treaty benefits to a resident of a contracting state if that resident is an individual, a government, a publicly traded company, a subsidiary of a publicly traded company, a pension or nonprofit organization, or an entity that satisfies an ownership-base erosion test. In certain circumstances treaty benefits will also be afforded to

a resident of a contracting state if that resident satisfies an active trade or business test, satisfies a derivative benefits test, or obtains discretionary relief from the relevant competent authority.

The Model sets forth a template US tax treaty that serves as the starting point for Treasury's negotiations with foreign governments to enter into a new (or amend an existing) tax treaty. Consequently, the Model helps define Treasury's tax treaty policy. The Model is not, however, self-executing. Rather, Treasury must negotiate new tax treaties and protocols with its treaty partners, and those treaties and protocols must incorporate the revised Model's provisions, before any provisions in the Model can become effective.

An additional aspect of the Model's proposed revisions is the potential impact on OECD discussions regarding BEPS. The OECD's BEPS initiative, aimed at ensuring that profits are taxed where economic activities generating the profits are performed and where value is created, includes action items with respect to preventing the granting of treaty benefits in inappropriate circumstances (Action 6) and countering harmful tax practices (Action 5). As Treasury continues to participate in discussions around this work, its proposed revisions to the US Model, and comments received from stakeholders with respect to treaty policy, may impact the conclusions reached by the OECD working groups.

Shortly after issuance of the proposed revisions, Treasury officials explained that a principal focus of the proposals is to limit the availability of treaty benefits where according those benefits furthers transactions in which income is subject to double non-taxation – so called, stateless income. Because of the fundamental changes that are reflected in the proposals, Treasury took the unusual step of making them available to the public as a discussion draft in order to receive input from stakeholders.

Disallowance of treaty benefits for income attributable to 'exempt permanent establishments'

The proposed revisions set forth a new paragraph 7 to article 1 of the Model, disallowing treaty benefits with respect to income derived by a resident of a contracting state if that income is attributable to a permanent establishment situated outside of the residence state and either (1) the profits of that permanent establishment are subject to a combined aggregate effective rate of tax of less than 60% of the general rate of company tax applicable in the residence state, or (2) the permanent establishment is situated in a country with which the United States does not have a comprehensive income tax treaty in force, unless the income is also included in the residence state's tax base. A taxpayer would be able to seek relief from this rule from the relevant competent authority if the benefits grant is justified in light of the reasons the taxpayer did not satisfy this rule.

This new exempt permanent establishments rule is similar to a triangular branch rule included in many in-force US tax treaties. Unlike the triangular branch rule, however, the exempt permanent establishments rule would also apply to branches situated in a contracting state (e.g., US branches). The exempt permanent establishments rule also differs from the triangular branch rule in that (1) the allowable reduction in tax threshold has been raised to 60% and is now tested by comparing the effective rate of tax imposed to the generally applicable rate in the residence state, (2) the exempt permanent establishments rule applies to branches located in non-treaty jurisdictions irrespective of whether there has been a significant reduction in tax, (3) the exempt permanent establishments rule does not provide for an active trade or business exception, and (4) the exempt permanent establishments rule completely (rather than partially) disallows treaty benefits.

Denial of treaty benefits for income subject to a special tax regime

The proposed revisions set forth a new paragraph 1(l) to article 3 of the Model, defining a 'special tax regime,' and companion provisions in articles 11 (Interest), 12 (Royalties), and 21 (Other Income) that disallow treaty benefits for interest, royalties, and other income derived from a related person if the recipient is subject to a special tax regime.

A 'special tax regime' is defined as any legislation, regulation, or administrative practice that provides a preferential effective rate of tax to the tested income, including through reductions in the tax rate or the tax base, unless an exception applies. This can include notional interest deductions and administrative ruling practices. The technical explanation makes clear that no US legislation, regulations, or administrative practices currently satisfy the definition of a special tax regime.

Seven exceptions exist to the definition of a special tax regime: (1) regimes that do not disproportionately benefit interest, royalties, or other income; (2) regimes regarding royalties that satisfy a substantial activity requirement; (3) regimes that implement the principles of articles 7 (Business Profits) or 9 (Associated Enterprises) (e.g., advance pricing agreements); (4) certain nonprofit exemptions; (5) certain pension and

retirement benefit exemptions; (6) regimes aimed at certain collective investment vehicles; and (7) any regime designated by the agreement of the contracting states.

Where an income recipient is subject to a special tax regime, treaty benefits will only be disallowed with respect to interest, royalties, or other income if the special tax regime applies with respect to that class of income. The technical explanation treats interest income as always benefiting from notional interest deductions.

The proposal includes a provision for a non-exclusive listing of regimes agreed to by the parties as a special tax regime. A Treasury official left open the possibility that the parties could agree to an all-inclusive list for statutory and regulatory measures, but not for less formal measures, such as via rulings.

Denial of treaty benefits for payments made by US companies that are expatriated entities

The proposed revisions set forth new provisions in articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 21 (Other Income) which provide that any dividend, interest, royalty, or other income payments made by an expatriated entity within ten years of that entity's expatriation event will be taxed in accordance with US domestic law notwithstanding the other provisions of the treaty. Consequently, expatriated entities would be disallowed treaty benefits with respect to all payments of dividends, interest, royalties, and other income for ten years following their expatriation. In a briefing session, a Treasury official left open the possibility that the measure could be restricted to payments to related parties.

The technical explanation provides that the term 'expatriated entity' has the same meaning as defined in Section 7874(a)(2)(A). The technical explanation also provides that an expatriation event will occur on the date on which the requirements of Section 7874(a)(2)(B) are first satisfied, described as the date on which the acquisition of the domestic entity is completed.

Further restrictions on treaty eligibility under the limitation on benefits article

The proposed revisions make several changes to the limitation on benefits article of the 2006 Model. First, a derivative benefits test is included in the Model for the first time. Under this derivative benefits test, a taxpayer could claim treaty benefits if it is at least 95% owned, directly or indirectly, by 'equivalent beneficiaries' and it satisfies a base erosion test. For this purpose, an equivalent beneficiary is defined as either (i) a resident of any state if entitled to benefits under a comprehensive US tax treaty that would be no worse than those being claimed if that resident had received the income directly, or (ii) a qualified resident of the taxpayer's residence state. In either case, the tested resident will only be an equivalent beneficiary if it satisfies the limitation on benefits article of the relevant treaty as an individual, a government, a publicly traded company, or a pension or nonprofit. In contrast to current US treaty policy, an equivalent beneficiary need not be resident of the same economic zone as the taxpayer claiming treaty benefits (e.g., NAFTA or the EU). Where a taxpayer claiming treaty benefits is indirectly owned by equivalent beneficiaries, each intermediate owner must qualify for benefits no worse than those claimed under a comprehensive US tax treaty that includes provisions addressing special tax regimes.

Second, the proposed revisions add a base erosion requirement to the subsidiary of a public company test. Unlike other base erosion requirements, this requirement does not apply with respect to benefits claimed under article 10 (Dividends). The proposed revisions would require each intermediate owner between the tested company and the public company to be a resident of either state.

Third, the proposed revisions modify the base erosion requirements found in the subsidiary of a public company test, ownership-base erosion test, and derivative benefits test in several ways. First, gross income is defined to exclude dividend income that is effectively exempt from tax, except when relevant for determining benefits under article 10 (Dividends). Second, in addition to the taxpayer satisfying the base erosion test, the taxpayer's tested group (generally defined as a consolidated group or loss-sharing group) must satisfy the base erosion test. Third, deductible payments will be considered base eroding payments, even if made to persons entitled to benefits under the treaty, if the recipient is subject to a special tax regime. Fourth, the exception for certain arm's length payments in the ordinary course of business has not been extended to payments with respect to financial obligations to a bank, subject to further consideration by Treasury. In the briefing session, questions were raised concerning the policy justification for the restrictions on intermediate owners, as well as the policy of treating payments to subsidiaries of publicly traded companies as base eroding. Treasury officials indicated they would consider those comments.

A fourth change to the Model's limitation on benefits article appears in the discretionary grant of relief paragraph. This paragraph was modified to require a demonstration of a substantial nontax nexus to the taxpayer's residence state, in addition

to demonstrating that neither its establishment, acquisition, or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of treaty benefits.

Ability of Treasury to partially terminate a treaty based on subsequent changes in law

Finally, the proposed revisions set forth a new article 28 concerning subsequent changes in law. Under the new article, if at any time after the signing of the treaty the general rate of company tax applicable in either contracting state falls below 15% with respect to substantially all of the income of resident companies, or either contracting state provides an exemption from taxation to resident companies for substantially all foreign source income, the provisions of Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 21 (Other Income) may cease to have effect if the other contracting state provides six-months' notice of such cessation. A separate, similar rule applies to subsequent changes in the highest marginal rate of tax applicable to individuals.

The takeaway

Treasury's proposed revisions to the Model represent some of the most significant changes in US tax treaty policy in decades. The release of these proposed revisions as a discussion draft provides taxpayers and other stakeholders with an important opportunity to offer suggestions and concerns to Treasury. But time is of the essence. Treasury has requested comments in 90 days. However, in light of ongoing discussions at the OECD with respect to BEPS, taxpayers and other stakeholders may wish to provide comments as soon as possible.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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