# PwC comment letter on United States Model Treaty

*September 29, 2015*

## In brief

PwC recently submitted comments concerning proposed changes to the US Model Income Tax Treaty. The comment letter is included below as submitted.

## In detail

September 12, 2015

The Honorable Mark Mazur
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: **Comments Concerning Proposed Changes to the U.S. Model Income Tax Treaty**

Dear Mr. Secretary:

PricewaterhouseCoopers LLP (PwC) appreciates the opportunity to comment on Treasury's proposed changes to the U.S. Model Income Tax Treaty. The proposals represent fundamental changes in U.S. income tax treaty policy. We commend Treasury for providing the public with an opportunity to offer comments hand perspectives on the proposed changes. The United States remains a global driver of tax policy as a consequence of its critical role in the flow of cross-border trade and investment throughout the world. Accordingly, any shift in U.S. tax treaty policy should be measured, well considered, and consistent with the fundamental policies underpinning tax treaties and the critical role that tax treaties play in facilitating cross-border trade and investment and the growth of the global economy.

Historically, the substantive goal of tax treaties has been to allocate taxing rights between two countries. The policies supporting this goal include providing certainty with respect to a taxpayer's cross-border activities, relieving double taxation, and reducing the potential for excessive taxation.[i] Tax treaties also have served to create a mechanism to address treaty disputes between treaty partners, to facilitate exchange of information between tax authorities, to ensure that cross-border investors do not suffer discrimination in application of the tax laws of a country, and to address other, more specialized situations (e.g., coordinating the taxation of pension benefits, social security benefits, and alimony and child support payments in the cross-border context).[ii]

To allocate taxing rights effectively between two countries, a tax treaty must set out clear and administrable rules. Accordingly, a tax treaty's effectiveness should be evaluated against whether its rules are clear, whether they can be practically applied, whether they are adequately tailored to particular policy concerns, and whether they could disrupt the normal course of cross-border investment.

For example, the so-called "main purpose" tests in the Italy and Slovenia tax treaties were criticized as inconsistent with historical U.S. treaty policy because they were "subjective, vague, and [would] add uncertainty to the treaty."[iii] According to the Joint Committee on Taxation, the uncertainty embedded within the "main purpose" tests is harmful because it "can create planning difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty." In the case of both treaties, the Senate Foreign Relations Committee's approval of the treaty was conditioned on the removal of the main purpose test. The efficacy of Treasury's proposed changes to the U.S. Model Treaty should be measured against this same framework: whether they are clear; whether they can be practically applied; whether they are adequately tailored to particular policy concerns; and whether they disrupt the normal course of cross-border trade and investment.

On the basis of our experience advising multinational companies with respect to treaty matters, we offer a number of observations and recommendations on Treasury's proposed changes to the U.S. Model Treaty. We recognize that some of the proposed changes respond to policy concerns, such as so-called "double non-taxation." However, as we explain in detail below, these proposed changes would not fully address the policy concerns, but would add uncertainty to cross-border investment and thus could disrupt the normal operations of multinational entities, both U.S.-based multinational entities investing abroad and foreign-based entities investing in the United States. Importantly, attempting to achieve these goals through one-by-one revisions to U.S. tax treaties would be a lengthy, inefficient process.

The Senate Foreign Relations Committee has in the past articulated the need to involve Congress before fundamental shifts in U.S. treaty policy. The 1999 Senate Foreign Relations Committee Report on the treaty with Italy, in discussing the proposed inclusion of the main purpose test, states in part:

> The inclusion of such tests in the specific articles of the proposed treaty represents a fundamental shift in U.S. treaty policy. As a general matter, such changes in policy should be made only after careful consideration of whether circumstances warrant such a change, and whether the proposed change is appropriate. The Treasury Department should engage in meaningful consultations with the Congress when proposing to make such a policy shift. The Committee is concerned that such consultations did not occur in this instance, and that the Committee has not been afforded an opportunity to weigh the relevant policy considerations (including whether a need for such a provision exists) and to evaluate alternative approaches with respect to the proposed new tests.[iv]

The proposed changes to the U.S. Model Treaty would represent a fundamental shift in policy, calling for Treasury to engage in meaningful discussions with Congress prior to adopting the changes. In our view, several of the proposed changes are unlikely to be agreed to by treaty partners and several, particularly some that could have the effect of constraining future U.S. tax legislative policy, are likely to be of significant concern to the U.S. Senate.

With these concerns noted, we offer below our perspective on each proposed change in the context of the principles underlying treaty policies and the ways in which multinational entities operate.

### *I. Non-Limitation on Benefits Proposals*

These proposals include changes that would address special tax regimes, partial terminations, expatriated entities, and exempt permanent establishments (PEs). As we explain more fully below, most of these proposals represent a fundamental shift away from well-established tax treaty policy by significantly increasing uncertainty and the potential for double or excessive taxation of cross-border investment.

Importantly, the proposals would leave broad discretion to one tax authority to accept or reject treaty benefits based on imprecise standards, including in two proposals assessing whether the treaty partner's domestic legislation violates the stated standards. In the event that these proposals were adopted in a significant number of treaties, each treaty partner would be entitled to make these judgments independently, likely leading to inconsistent application of the rules and significant uncertainty for taxpayers.

We respectfully suggest that the policy concerns behind the proposals are best addressed through legislation. Treaties are uniquely unsuited for this role given the length of time it would take to implement the changes and the need to reach bilateral agreement on how each standard is formulated. We note that there are currently pending before the U.S. Senate seven bilateral income tax agreements reflecting negotiations over five years. At this pace, by the time there could be a meaningful set of treaties embodying these proposals, there well might have been changes in policy that would require an equal amount of time to remove or modify them.

### *A. Special Tax Regimes*

Treasury proposes to deny treaty benefits for interest, royalties, or other income[v] that benefit from a "special" tax regime in the recipient's country of residence. Treasury has indicated that this restriction focuses on related-party income that is deductible in one country and taxed at preferential effective tax rates in the other country.

Under the proposal, a special tax regime is defined as any legislation, regulation, or administrative practice (such as a tax ruling practice provided to taxpayers by a government) 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. Exceptions to the definition include regimes that do not disproportionately benefit interest, royalties, or other income; regimes regarding royalties that satisfy a substantial activity requirement; regimes that implement the principles of the treaty's business profits or associated enterprises articles (e.g., advance pricing agreements); certain nonprofit exemptions; certain pension and retirement benefit exemptions; regimes aimed at certain collective investment vehicles; and any regime designated by an agreement of the contracting states.

For decades, U.S. tax treaty policy has focused on identifying the "right amount" of U.S. tax. This goal manifests itself in using tax treaties to determine who has the right to tax certain income: the source country or the residence country. Now, proposed U.S. tax treaty policy appears to reflect a proposition that the United States will reduce U.S. withholding taxes only if the treaty partner fully taxes that income – not whether the income is within the taxing jurisdiction of the treaty partner.

The proposal does not seem to work as an appropriate response to the perceived abuse, which appears to be reduced taxation or so-called "double non-taxation." Similar to the exempt PE proposal, discussed below, this proposal may be aimed at particular abusive situations, but its scope is sweeping in terms of the treaty provisions it impacts (*i.e.*, the dividend, interest, royalties, other income, and limitation on benefits provisions), the taxpayers impacted, and the definition of a special tax regime. If reduced taxation or double non-taxation is a policy concern for the U.S. tax regime, we believe it would be better addressed through domestic tax policy set by Congress, in coordination with the Administration.

We believe the Model Treaty is not the appropriate tool to address Treasury's policy concern for several reasons. First, changing the U.S. Model Treaty is an inefficient way to address this domestic tax policy concern because treaties are inherently more difficult to change than domestic tax policy. If views on how to address special tax regimes were to change, Treasury would have to renegotiate the treaties that then would include its prior views of special tax regimes.

Effecting domestic tax policy by changing the U.S. Model Tax Treaty ultimately would harm multinational entities by providing the United States and our treaty partners the ability to deny treaty benefits under vague standards concerning whether a treaty country has created or implemented a special tax regime. This result would conflict with the goal of certainty that has been a bedrock of U.S. tax policy for decades.

This approach also would require the U.S. Congress to consider whether a domestic policy change could be considered a special tax regime by each of its treaty partners. If it were determined to be so, then making that domestic policy change would harm multinational entities by allowing treaty partners to deny treaty benefits to those entities benefitting from the regime.

Consider, for example, the consequences to multinational entities if this proposed change were included in a U.S. tax treaty and the U.S. Congress enacted a tax regime to encourage investment in U.S. intangible property (as has recently been proposed in the Congress). Congress's later decision to enact such a tax regime could trigger a loss of treaty benefits for multinational entities that were the intended beneficiaries of the legislation. In addition to the multitude of challenges inherent in changing domestic tax policy, Congress might have to consider whether a foreign tax official would view that change as creating a special tax regime because it did not meet the imprecise substantial activity standard.

The proposed change would raise numerous questions where targeted tax legislation on an administrative measure is adopted, as is often the case in the United States. For example:

- What constitutes an "administrative practice?" Notwithstanding the statement in the Technical Explanation that the United States currently does not have any special tax regimes, in the eyes of a foreign tax official, could that term include: the Internal Revenue Manual policies of general application by agents; IRS industry guidelines; IRS pre-filing agreements; IRS closing agreements; or IRS agreements not to contest taxpayer positions on an identified issue?
- How much of a reduction in tax or tax base would be required to find a special tax regime? Would a three-percent rate differential,

such as flows from the section 199 deduction, be treated as triggering the harsh consequences of a finding of a special tax regime?

- What if the taxpayer is subject to, but does not benefit from, a special regime (e.g., due to losses)?
- If a notional interest deduction that applies to all income is preferential, what other tax provisions that apply to all income but may disproportionately impact the taxation of dividends, interest, or royalties would be preferential?
- What constitutes "substantial activity" with respect to royalties? Would the special tax regimes lead to imposition of withholding tax on royalties that benefit from foreign patent box regimes, even where these regimes are not considered harmful tax practices under the recent BEPS agreement on Action 5?
- When will advance pricing agreements and other procedures or practices based on the arm's-length principle be viewed by a treaty partner as violating the arm's-length principle, and who will decide?
- What is a regime that "principally" applies to persons that "exclusively" promote religious, charitable, scientific, artistic, cultural, or educational activities? Would a foreign tax official view section 501 as satisfying this standard, or would the official be concerned that out of 29 provisions in section 501(c) that confer tax-exempt status, only one directly covers these activities?
- Would an IRS ruling that an organization has section 501(c) tax-exempt status be subject to scrutiny by foreign tax officials as potentially a special tax regime?
- Does the exclusion for collective investment vehicles that are "marketed primarily to retail investors" include funds that are marketed exclusively to a category of institutional investors or to so-called fund of funds?
- If Congress gives targeted tax relief to taxpayers affected by natural disasters, could a foreign tax official treat this as a special tax regime?[vi]

Injecting uncertainties directly into the determination of whether and how to make cross-border investments cuts against a fundamental principle of U.S. tax treaty policy.

In addition, a determination by IRS that a special tax regime exists would trigger the excessive 30-percent rate of tax on gross income (which may be confiscatory if net income is less than 30 percent). As noted above, a cornerstone of U.S. tax treaty policy has been reducing the potential for excessive taxation. The consequences flowing from a determination under this proposed change would erode this cornerstone of U.S. tax treaty policy.

If this proposed change is included in the U.S. Model Treaty, it should be substantially narrowed, and should exclude "other income" or explain Treasury's concern within that category and limit the scope to that concern. Finally, we urge that these proposed changes with respect to special tax regimes should not, as has been proposed, be incorporated into the limitation on benefits article, for the reasons further discussed below.

### *B. Partial Terminations*

The proposed changes would provide treaty partners the right to partially terminate a treaty for benefits under the dividends, interest, royalty, and other income articles if there has been a substantial reduction in the normal rate of taxation in either country after the treaty has entered into effect. The current proposal calls for the right of a treaty partner to partially terminate the treaty if the other treaty partner reduces its corporate income tax rate below 15 percent for substantially all income of a corporate resident, or exempts substantially all offshore income from tax. We understand that Treasury may consider revisions to this approach, such as a percentage reduction in the existing income tax rate. This proposal appears directed at limiting tax competition. While we appreciate Treasury's concern about tax competition, we do not think it is advisable or technically feasible to attempt to isolate the U.S. economy from it. In any event, we do not believe it should be a goal of tax treaties to compel a minimum level of foreign taxation.

In addition to the 15-percent objective (albeit arbitrary) trigger for a partial termination, the proposed changes allow a reduction in the tax base to trigger the partial termination. This proposed change injects further uncertainty into the determination of whether and how to make a cross-border investment. Furthermore, allowing a foreign tax authority to make such a subjective determination as to whether U.S. persons should continue to receive treaty benefits not only would affect those U.S. persons, it would affect future U.S. tax legislation setting a lower the U.S. tax rate. Would a foreign tax authority treat a split rate or other corporate integration system – as has been proposed in the past for the United States – as a substantial reduction in tax? If so, a treaty partner with partial termination provisions could terminate treaty benefits for business entities and investors. It is this type of uncertainty that traditional U.S. tax treaty policy has been developed to avoid.

The Technical Explanation to these proposed changes explains this shift on the basis that tax treaties are mainly concerned with the avoidance of double taxation. Thus, according to the explanation, if one treaty partner does not tax income, there can be no double taxation. Although a fundamental purpose of tax treaties is avoiding double taxation, another fundamental purpose is avoiding excessive taxation. By allowing the partial termination of a treaty based on a subsequent change in a tax treaty partner's domestic laws, Treasury appears to treat addressing so-called "double non-taxation" as more significant than reducing the likelihood of excessive taxation. If Treasury views a treaty partner's subsequent reduction in the tax burden of its own residents as inappropriate, we believe the proper course of action should be treaty renegotiation, not unilateral partial termination.

The Technical Explanation also suggests that if a country were to move to a territorial system, there would be no need for reductions in tax on dividends, interest, royalties, and other income. This view assumes that the country's territorial system would use source rules consistent with the U.S. source rules. One fundamental tenet of U.S. tax treaties is that they are necessary because two independently developed tax systems will have inconsistent or conflicting standards and definitions, leading to double taxation. A territorial system that exempts U.S.-source royalties only mitigates double taxation if the treaty partner uses the same sourcing rules for royalties as the United States; even so, that leaves the potential of excessive taxation with high rates of tax on gross income.

Further, treating the adoption of a territorial system of taxation as a trigger for the right of the treaty partner to partially terminate the treaty constrains legislative action by Congress should it decide that a territorial system would be preferred for the United States. In addition, if a treaty partner adopts a territorial system for taxing its residents, or substantially lowers its tax rate but maintains high withholding taxes on income paid to non-residents, a partial termination by the United States would penalize businesses receiving income from the treaty partner even though they do not benefit from the lower taxation of the treaty partner's residents.

For the reasons discussed above, we believe the proposed changes' inclusion of other income is overbroad. We are unaware of another category of income that should raise concerns. Before implementing the proposed changes, Treasury should explain why other income would be included in the proposed changes and should consider limiting its scope accordingly.

### *C. Exempt Permanent Establishments*

The proposed changes to the U.S. Model Treaty also would deny treaty benefits for income that is exempt from residence-country taxation because it is allocable to an "exempt permanent establishment" in another country and either (1) the profits of that PE are subject to a combined aggregate effective rate of tax of less than 60 percent of the general rate of company tax applicable in the residence state, or (2) the PE 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 in appropriate circumstances.

In our experience, business enterprises generally would prefer to operate in subsidiary form rather than branch form. Often, however, local laws, regulations, administrative practices, or other non-tax considerations drive the decision to operate in branch form. The proposed changes concerning exempt PEs are motivated by a specific practice that Treasury wants to curtail and should be tailored to address that concern. The proposed changes, in effect, penalize a treaty partner for choosing an exemption system rather than a credit system to alleviate double taxation (and would penalize the United States if Congress decided to move to an exemption system). If some form of these proposed changes were to be made, we recommend the change should be limited to mobile income (i.e., dividends, interest, and royalties).

Current treaty policy excepts from the triangular branch rule income derived in connection with or incidental to the active conduct of a trade or business in the PE jurisdiction. This policy recognizes that where there is a substantial business nexus to the PE jurisdiction, the use of a branch is not motivated by treaty-shopping considerations. The new proposal would reverse these policies. Subjecting income to potential excessive taxation where there is a substantial business nexus to the PE jurisdiction would not be appropriate. Because the perceived abuse is restricted to mobile income, the remedy should be equally tailored; i.e., it should not apply to business profits, locally developed or enhanced intellectual property, or other non-mobile income.

The proposed changes would use standards such as "effective rate" and "general rate" rather than, as under current policy, the tax actually paid compared to the tax that would have been paid if there were no PE, adding further complexity and uncertainty. The measure of whether there has been a substantial reduction in tax should be based on the gross amount of income paid to the recipient, not on the portion attributable to the PE. That is, if the taxpayer receives $100 of interest income and substantially reduces the tax by allocating a portion to a PE, the test should be based on the tax actually paid on the $100 compared to the tax that would have been paid had there been no allocation to the PE.

Application of the exempt PE concept to income attributable to a PE in a jurisdiction that does not have a tax treaty with the United States would go beyond the abuse Treasury is targeting. By definition, this new concept would only apply where there has been no substantial tax reduction; if there were, the remedies above already would apply. Hence, this proposal would penalize a resident of a treaty partner that has had no significant tax reduction by reason of operating in branch form in a third jurisdiction. Treasury officials have indicated that this provision would be intended to encourage countries to enter into treaties with the United States. At times, however, the United States may not be prepared to enter into a treaty with a given jurisdiction, and even when willing to negotiate a treaty, the length of time it takes to do so and for the treaty to be ratified would mean it would be years before the new treaty comes into effect. As a policy matter, taxpayers should not be penalized for the limitations of the treaty process.

One argument that may appear to speak in favor of the rule for PEs in countries that do not have treaties with the United States is that if the branch in the non-treaty country were in corporate form, it would not be able to get treaty benefits because it is not resident in a country with which the United States has a treaty. Accordingly, the United States should not give relief from double taxation under a treaty where the non-U.S. tax imposed on the income is not imposed by a treaty partner. However, if this were the correct conclusion, then the same policy should argue in favor of granting treaty benefits to branches in treaty countries even if the branch owner is not a resident of a treaty country.

Another concern is that this rule would condition granting treaty benefits on whether the income is included in the treaty resident's tax base. Thus, if the treaty partner includes the branch income in its tax base but gives a tax credit for taxes paid to the branch's jurisdiction, treaty benefits are available; however, if the treaty partner uses an exemption system, no benefits are available, even though the results may be the same. No policy rationale would support this distinction.

These proposed changes would increase the potential for excessive taxation. The associated penalty is application of the 30 percent tax on gross income, which can be confiscatory in nature. The proposal would move away from the reduced rate that policymakers have approved in recent treaties. Allowing the taxpayer to seek a discretionary grant of benefits appears to recognize that the proposed approach should be tempered. If the discretionary grant process was practical, timely, and effective, this might be an acceptable curb on the sweeping nature of these proposed changes. The competent authority process in practice, however, can prove to be inefficient, lengthy, and uncertain. Moreover, the shortcomings of the competent authority process are magnified by the lack of guiding principles – e.g., what it means to say the denial is "not justified."

### *D. Expatriated Entities*

These proposed changes would deny treaty benefits for income received from U.S. subsidiaries of inverted companies. These changes provide that any dividend, interest, royalty, or other income payments made by an "expatriated entity" within 10 years of that entity's expatriation event would be taxed in accordance with U.S. domestic law, notwithstanding the other provisions of the treaty (i.e., treaty benefits for such payments would be denied). For this purpose, "expatriated entity" would be defined as in section 7874(a)(2)(A) – generally a U.S. entity where substantially all its assets are acquired (including indirectly through a stock acquisition of the U.S. entity) after March 4, 2003, by a non-U.S. corporation, where there is at least 60 percent and less than 80 percent continuity of interest by the former interestholders in the domestic entity (subject to detailed rules of application).

These proposed changes run counter to the foundational tax treaty policy of certainty because of concerns that are a domestic tax policy matter that the U.S. Congress previously addressed through legislation. We believe the proper forum to address this concern is legislation, not changes to U.S. treaty policy.

The 2006 U.S. Model Treaty included several provisions aimed at inverted entities. Since then, only a handful of income tax treaties with these provisions have entered into force; several more have been negotiated and are awaiting ratification. However, experience shows that using treaty policy is an inefficient and ineffective means by which to address this domestic tax policy concern because the policy can only be implemented one treaty at a time; thus, it could take more than a decade to implement the policy in sufficient treaties as to be effective. Further, using the proposed approach would mean that businesses considering cross-border investments would not have the certainty necessary to make such an investment decision.

The proposed provision is overbroad in that it would apply to all payments made by expatriated entities, including payments to unrelated persons. While the withholding obligation falls on the payor of the income, the tax ultimately is on the recipient of the payment. Thus, if a bank lends to an unrelated U.S. borrower, and if that borrower is an expatriated entity or subsequently becomes an expatriated entity, the bank suffers the 30-percent tax, not the expatriated entity. While a well-advised bank could protect itself through gross-up provisions, the result would be an increased cost of capital to the expatriated entity – it would be forced to borrow from U.S. financial institutions instead, and less foreign capital would be invested in the United States. There is no apparent policy justification for extending the expatriated entities provisions to payments to unrelated persons, unless the goal is to indirectly penalize expatriated entities by restricting their efficient access to capital. Such a provision likely would have the effect of restricting efficient access to foreign capital for all U.S. companies, even those that are not expatriated, as foreign lenders would have to negotiate appropriate additional terms into the loan agreements. Finally, this provision would penalize foreign persons that made a long-term lending commitment to a U.S. company that expatriates after the commitment is made if the agreement lacked appropriate terms and conditions.

To summarize, Treasury's non-LOB proposed changes to the U.S. Model Treaty would shift the foundational policies of tax treaties to advance certain domestic tax policy issues more appropriately addressed in the legislative arena. Such changes would create impediments to cross-border trade and investment and could disrupt the normal course of business for multinational entities.

### *II. Limitation on Benefits Proposals*

The limitation on benefits (LOB) article of U.S. tax treaties fulfills an important role of policing inappropriate access to treaty benefits by residents of third jurisdictions that are not a party to the treaty or that could not have received equal benefits under another treaty. The LOB article sets forth a set of objective criteria for establishing that there is sufficient nexus to the residence jurisdiction to overcome the concern of treaty shopping. It is equally important, however, that the LOB article not block access to treaty benefits for treaty residents that are not engaged in treaty shopping, either through overly restrictive or unnecessarily complex rules.

The current version of the LOB article includes limitations that are aimed at domestic policy concerns, but that may have the effect of denying treaty access to companies that neither trigger the domestic policy concerns nor are engaged in treaty shopping. The proposed LOB article would add to these shortcomings through further restrictions in virtually every test for treaty eligibility, which, as we detail below, would deny access to treaty protections for a wide spectrum of companies that are not treaty shopping and should be entitled to the protections accorded by the treaty.

Multinational businesses, in our experience, spend significant resources determining their eligibility for treaty benefits. In many cases, it may be readily apparent that there is no treaty shopping concern, but the restrictions nonetheless may result in denial of treaty benefits. If the proposed new restrictions are included in a treaty, we believe that a significant number of businesses that clearly should qualify for treaty benefits no longer would be eligible without undertaking a corporate restructuring that may not be achievable due to non-tax factors.

Below we provide detailed comments on several of the proposed tests for treaty eligibility. By way of introduction to those details, we note some common themes that underlie many of the comments that follow.

*Not taking into account how multinational enterprises operate.* The typical multinational enterprise includes hundreds, if not thousands, of affiliated entities established for a wide variety of reasons, including regulatory restraints, creditors' rights protections, labor and social legislation, regional holding structures, and organization by business units. Some of the multiplicity is required by local law and other dictates, and some is elective based on the most efficient organizational structure. Oftentimes the multiple entities exist on account of mergers or acquisitions. Although rationalization of a corporate structure is often a post-merger or acquisition goal, the process can be time-consuming and expensive, and nontax roadblocks may prevent completion. The proposed restrictions do not take how businesses operate into account and thus could cause inappropriate loss of treaty benefits or force companies to reorganize into less business efficient structures.

*Artificial restrictions due to intermediate owner tests.* The current Model Treaty includes restrictions on intermediate owners in both the subsidiary of a publicly traded company test and the ownership/base erosion test, requiring each intermediate owner to meet specified criteria. The proposed Model Treaty would add a similar but stricter restriction to the derivative benefits test. These intermediate owner rules would place restrictions on the eligibility of indirectly owned entities to qualify for the protections of the treaty that many, if not most, will be unable to meet.

No tax policy rationale has been articulated for these proposed intermediate owner restrictions. The only explanation we have heard offered is that deductible items may be paid to the intermediate owner or income may be deferred from taxation by the jurisdiction of the ultimate owner. However, most countries do not tax direct investment dividends, so there is no real deferral with respect to dividends. As to the ability to pay deductible payments to the intermediate owner, this does not relate to the position of the recipient in the ownership chain; the recipient could just as readily be a sister company. The base erosion test already part of treaties, as well as other anti-abuse rules such as the anti-conduit rules, should adequately address the concern. The only payment that requires the recipient to be directly in the chain of ownership is a dividend payment, which is not deductible by the payor and, therefore, does not reduce the tax base in the tested company's resident jurisdiction.

*Impractical base erosion rules.* The proposed Model Treaty would perpetuate the treatment of many payments to local entities that are not publicly traded as made to "bad" recipients. This is because while publicly traded companies are good recipients of base eroding payments, their subsidiaries are not. In many cases, the publicly traded company is not an operating company but rather serves as the holding company for its operating subsidiaries. Moreover, companies that qualify for treaty benefits under the ownership/base erosion test, or – in the case of the base erosion component of the derivative benefits test – companies that would qualify for equivalent treaty benefits under a derivative benefits test are also treated as bad recipients of base eroding payments. This is so notwithstanding that these companies do not present a base erosion concern because they would have qualified for the same treaty benefits if they had received the U.S. income directly. The resulting problem that companies could inappropriately fail the base erosion test is magnified by the lack of a provision in the proposed changes to except payments to banks from being base eroding payments, even though many existing treaties do so. As a result, any company that would borrow from a bank could fail the base erosion test because it is not a realistic expectation that the publicly traded parent company of the bank – which is likely a holding company and may not have the banking license – will directly advance the loans, rather than the operating subsidiary.

These shortcomings, combined with the further restrictive rules on base erosion discussed in more depth below, mean that the base erosion test frequently would cause subsidiary companies that are not treaty shopping to fail to qualify for treaty benefits. A properly tailored base erosion test serves a legitimate purpose, but the proposed tests would go add an unnecessary barrier to eligibility for treaty benefits.

### *A. Publicly Traded Company Test*

The proposed U.S. Model Treaty's publicly traded company test would retain the requirement of the 2006 U.S. Model Treaty that a publicly traded company must meet a substantial presence test by either being: (1) primarily traded on an exchange in its country of residence or (2) primarily managed and controlled there.

We understand that this requirement was added to the 2006 U.S. Model due to a specific concern about corporate inversions. However, these restrictions affect many companies that are not inverted companies and are not treaty shopping, and disproportionately affect companies resident in smaller countries. We therefore urge the substantial presence test be dropped from the U.S. Model Treaty.

Companies resident in one country may have stock listed on exchanges in other countries for a variety of reasons unrelated to treaty shopping. Exchanges such as the London and New York stock exchanges provide liquidity and access to capital that smaller exchanges do not. Some institutional investors have restrictions permitting investment only when companies are listed on certain exchanges. Listing on certain exchanges also may be necessary for a company's stock to be included in index funds. Particularly where the company is resident in a country whose exchanges do not provide the capital access and liquidity of the larger exchanges, the company may not be principally traded in its country of residence.

We believe the policy prior to the 2006 Model Treaty provided an appropriate method to prevent companies with little nexus to a country from benefitting from the publicly traded companies test by circumscribing the exchanges that would be treated as "recognized" stock exchanges on a treaty-by-treaty basis and requiring that the shares be regularly traded. At the very least, we recommend that trading on other regional exchanges (such as other European exchanges in the case of a European company) be counted in the numerator of the test.

The alternative method for qualification – that the corporate group be primarily managed and controlled in its country of organization – may be difficult to satisfy because the test is vague and does not take into account the realities of global business operations. Many multinationals operate in multiple jurisdictions with significant management functions in those jurisdictions. Multinationals may find it more efficient to align group management among regional lines, or among lines of business that have regional focus. These multinationals may not satisfy the primarily managed requirement, but it is unlikely to be the case that the company is using its residence country for treaty shopping purposes.

The highly limiting substantial presence test not only affects companies that should qualify under the publicly traded test but also inappropriately limits the ability of subsidiaries to qualify under either the subsidiary of publicly traded test or the derivative benefits test. We therefore urge that the substantial presence test be dropped.

### *B. Subsidiary of Publicly Traded Company Test*

The proposed LOB article would retain the intermediate ownership requirement of the 2006 U.S. Model Treaty and would add a new base erosion test similar to the ones included in the ownership/base erosion test and the derivative benefits test, discussed below.

Our concerns with the intermediate ownership provisions are discussed above. Similarly, we refer to our prior discussion of general concerns with the base erosion test, but provide more specific comments here. We question the need to add a base erosion test to the subsidiary of publicly traded company test, as the base erosion test is not necessary to deter treaty shopping, which we believe should be the principal focus of the LOB article. If a publicly traded company should be granted treaty benefits, as always has been the policy since the development of a comprehensive LOB article, then it should not matter whether that company operates directly in its resident jurisdiction or, as is common, operates through subsidiaries in that country. The base erosion test is necessary in the ownership/base erosion test and derivative benefits test because of the possibility that a company may nominally be owned by residents of a treaty jurisdiction, but in practice the income of the company actually is owned by nonresidents. However, the significant burdens associated with listing a company on a stock exchange and the requirement that the company be regularly traded mean that it is unlikely that a subsidiary of a publicly traded company resident in the same jurisdiction as its parent would be set up to accommodate this type of treaty abuse.

Our other specific comments on the base erosion test here apply equally to the base erosion tests contained in the ownership/base erosion test and the derivative benefits test. These new restrictions would add significant complexity and compliance burdens and result in denial of treaty protections to companies that are not treaty shopping.

Excluding dividends from gross income would not give due recognition to how multinational entities operate. The base erosion test focuses on whether a substantial portion of a company's income has been diverted through base-eroding payments. Dividends are a part of the income. We see no rationale for a position that if a business operates in single-entity form, all of its operating income benefits, yet if it were to operate through a subsidiary it would not. In both cases, the underlying operating income is taxable. Any exclusion at the parent level is directed at avoiding double taxation at the corporate level and should not make the base erosion test more restrictive for group structures than for single-entity structures. In our experience, single-entity structures for any sizeable business operating internationally are rare.

Incorporating the special tax regimes provisions into the base erosion test may make these tests more difficult to administer, particularly in the case of third-party payments. While we are sympathetic to the concern that base-eroding payments can be made in such a way as to be non-taxable to the recipient and understand the need for base erosion tests generally to apply to third-party payments. We are concerned that the breadth and vagueness of the special tax regimes article would make this provision unadministrable. If base-eroding payments are made to unrelated persons, the burden on the payor to perform diligence on each payment recipient to determine whether the recipient is subject to a special tax regime with respect to the payment could be particularly onerous. As noted in our discussion of the special tax regimes proposal, when the income in question is sourced with the treaty partner, it would be the judgment of the treaty partner whether an intermediate subsidiary, for example, of a U.S. parent, is benefiting from a special tax regime, including U.S. tax measures.

Similarly, requiring companies that are part of a consolidated group, fiscal unity, loss-sharing group, or similar regime to satisfy two separate base erosion tests – one at the separate-company level and one at the fiscal unity level – would lead to unnecessary complexity and could result in inappropriate loss of treaty benefits. We recommend that only one base erosion test should apply, whether that test is at the group level or at the individual entity level. Where a treaty partner has a consolidation or similar regime, it could potentially be appropriate for entities that are part of such a group to be tested at the group level, rather than at the individual company level. On the other hand, depending on the nature of the regime, an individual entity test may be more appropriate. We recommend that in negotiating a treaty, Treasury seek to customize the base erosion test of the treaty in a way that takes into account the particulars of the treaty partner's consolidation or similar regime, if any.

### *C. Ownership/Base Erosion Test*

The proposed U.S. Model Treaty's ownership/base erosion test would retain the provision in the 2006 U.S. Model Treaty that only qualified residents of the same country as the company's residence country be counted as "good" owners, rather than residents of both treaty countries (as was the rule in the 1996 U.S. Model Treaty and currently is the rule in a number of U.S. income tax treaties). The proposed U.S. Model Treaty also would retain the restrictive intermediate ownership requirements of the 2006 U.S. Model and add the new more restrictive base erosion tests. Our concerns with both of these have been detailed above.

We understand that the rule in the 2006 U.S. Model Treaty treating residents of the source State as "bad" owners for purposes of the ownership/base erosion test was directed at a purely domestic policy concern, i.e., corporate inversions. However, this more restrictive rule has the effect of significantly hindering joint ventures. For example, where a publicly traded U.S. company and a publicly traded company resident in a treaty partner enter into a joint venture, there would be no flexibility as to which country the joint venture entity could be resident in – it would have to be the country of the majority partner. However, in this example, there would be no treaty shopping regardless of which country is chosen for the joint venture.

Artificially restricting in which country the joint venture could be resident would mean that tax considerations around the treaty would dictate residence, rather than business considerations. This approach handicaps U.S. parties to the joint venture from negotiating for a controlling interest, since the cost could be loss of treaty benefits for the joint venture entity. Accordingly, this restrictive ownership rule again displaces the historical foundations of the LOB article in favor of a focus on a domestic policy concern unrelated to treaty shopping. This puts at risk a fundamental purpose of tax treaties – the elimination of artificial impediments to cross-border investments.

We ask Treasury to clarify that taxpayers are permitted (but not required) to use prior-year information for testing purposes. While we generally believe current-year tests provide the most accurate measure of whether a taxpayer satisfies the requirements of a treaty, the need for certainty argues in favor of electing to use prior-year results. Otherwise, a taxpayer may not be able to determine whether it qualifies for treaty benefits at the time it receives a payment, i.e., at the time it needs to tell withholding agents whether and at what rate to withhold.

### *D. Derivative Benefits Test*

For the first time, the proposed changes would include a derivative benefits test in the U.S. Model Treaty. Unlike current derivative benefits tests, which require equivalent beneficiaries to be residents of Europe or North America, the proposed test would expand the definition of an equivalent beneficiary to include a resident of any state if (1) the resident is entitled to benefits under a comprehensive tax treaty with the source State that would be at least as favorable as those being claimed if that resident had received the income directly and (2) the resident qualifies for treaty benefits as an individual, a government, a publicly traded company, a pension fund, or a nonprofit.

We applaud Treasury for adding this test to the U.S. Model Treaty and for removing the geographic restrictions. However, we are concerned that the test, as proposed, would be impractical in light of how multinational entities operate. At the outset, we note our concerns with including an intermediate ownership test and with the more restrictive base erosion tests discussed above.

However, there is a particularly problematic additional restriction in the intermediate ownership provision of the derivative benefits test. To be a qualifying intermediate owner, inter alia, the income tax treaty between the intermediate owner's residence State and the source State of the income must include provisions addressing special tax regimes analogous to the provisions included in the reference treaty. This requirement is unnecessary, as the intermediate entity is not the one seeking treaty benefits. Notably, this rule does not ask whether any intermediate owner actually benefits from a special tax regime with respect to any relevant income, but only requires the treaty in question to contain the provisions. As a result, if the United States incorporates this requirement into a treaty, the derivative benefits test would not apply to residents of either country that have intermediate ownership until the income tax treaties between the source State and every residence State of intermediate entities are renegotiated.

This problem is illustrated by the following example:

> The United States renegotiates its income tax treaty with Country A to include the proposed LOB article. A company resident of Country A receives U.S. source income. The company is owned by a company resident in Country B, which is owned by a company resident in Country C, which is owned by a publicly traded company resident in Country D that is an equivalent beneficiary. The United States has income tax treaties in force with each of Countries A, B, C, and D.
>
> The result is that under the proposed LOB provisions, the company resident of Country A cannot qualify for treaty benefits under the derivative benefits test until the United States renegotiates its treaties with Country B and Country C.

We submit that conditioning the applicability of the derivative benefits test on the United States renegotiating its other treaties is not a realistic approach, even if the United States intends to so renegotiate and thinks this eventually will occur. Moreover, this provision would apply equally to U.S. entities seeking treaty relief from foreign taxes – i.e.,, the treaty partner would have to renegotiate *its* treaties with any jurisdictions of intermediate ownership for the indirect U.S. subsidiary of a publicly traded third country parent to qualify under this test. We think it is unrealistic to expect our treaty partners to be motivated to add such provisions to their other tax treaties.

In a similar vein, we urge dropping the proposed requirement that in order for an intermediate entity to be a "qualifying" intermediate entity, the tax treaty between the resident country of the intermediate entity and the source state provide equal or more favorable benefits as the treaty being applied. We explained above our view that the intermediate entity rule is not justified on a policy basis in any of the tests applied to subsidiaries.

The current rule, and the rule that has always been applied, in the derivative benefits test looks only to the treaty benefits that would have been accorded to the ultimate owner on the sound reasoning that, if the ultimate owner could have obtained equivalent benefits by a direct investment in the source country, using the treaty between the source country and the residence country of the tested company does not result in obtaining treaty benefits that could not otherwise have been obtained. The fact that an intermediate entity could not have obtained the same benefits is not relevant; that entity is not receiving treaty benefits and can only benefit from income derived by the tested company by reason of being in the chain of ownership through non-deductible dividends paid by the tested company. Adding this further restriction – requiring that every entity in the chain of ownership (and there commonly will be multiple intermediate owners for legitimate non-tax reasons) be entitled to equivalent benefits – would severely restrict the utility of the derivative benefits test.

We ask Treasury to clarify how the rate comparison test in the equivalent beneficiary definition would apply. The rate comparison for qualifying intermediate owners compares the rates in one treaty with the rates in the other. For equivalent beneficiaries, however, the test would be whether the equivalent beneficiary would have been entitled to at least an equally generous test if it had received the income directly. We believe the better formulation would be a comparison of rates in the two treaties for the same category of income; if the rates in the two treaties are equivalent, the equivalent beneficiary principle would be satisfied.

More recent U.S. treaties, such as the treaty with Germany, clarify that in the case of dividend payments, where the applicable rate depends on the percentage ownership of the dividend payor, an equivalent beneficiary is treated as if it owned the same interest in the company paying the dividend as the actual treaty claimant owns. We recommend that the U.S. Model Treaty include a similar clarification. In light of its inclusion in more recent U.S. treaties, its absence might imply a change in policy.

We also suggest that the U.S. Model Treaty allow the rate comparison test to apply in such a way that if the equivalent beneficiary qualifies for an income tax treaty but the rate of tax is higher than the rate in the reference treaty, treaty benefits still may be obtained, but at the higher rate. For example, assume a publicly traded company resident in a country that has a treaty with the United States that provides for a 10-percent rate of tax on interest owns a company resident in another country that has a treaty with the United States that provides an exemption from tax for interest. With respect to interest received by the lower-tier company, it is clear that its owner is not eligible for equivalent benefits. However, the appropriate result should be that the treaty still would apply to reduce the withholding tax to 10 percent.

Moreover, we ask Treasury to clarify that when the treaty in a potential equivalent beneficiary's country of residence does not have a comparable LOB article, in determining whether the equivalent beneficiary would have qualified for benefits under the treaty between the source State and the State of residence of the income recipient, not only should the equivalent beneficiary be treated as if it were a resident of the State of the income recipient, but other consistent adjustments also should be made, such as substituting local stock exchanges in the equivalent beneficiary's residence State for the exchanges listed in the other treaty. This clarification could be made in the Technical Explanation.

Extending the rate comparison test to business profits, capital gains, and other income would add what is likely a difficult, controversial test never before used. For example, each treaty partner may apply different methods for determining the attribution of profits to a PE; we submit that fact should not be a basis for denying application of the derivative benefits test. Finally, we recommend that an equivalent beneficiary include a person who would have qualified for benefits under the active trade or business test of a treaty if such person had received the income directly.

### E. Active Trade or Business

The proposed changes to the active trade or business provisions of the LOB article would not allow attribution of trade or business activities of related parties to an affiliate unless the affiliate also is engaged in a trade or business. As a result, holding companies and finance companies would not be able to qualify for treaty benefits under this test no matter how significant the group's overall operations in the residence State. The proposed LOB article indicates that Treasury views the derivative benefits test as the appropriate test for holding and finance companies.

The proposed changes do not reflect how multinational entities operate and would disrupt their normal course of business. The trade or business test is premised on the sound principle that an enterprise with a substantial active business presence in the residence country is not in that country for treaty shopping purposes. If this is the case, it should not matter whether the company operates through subsidiaries or uses holding companies to separate various lines of business or to separate group holding or financing functions.

U.S. treaties with a trade or business test generally recognize that business enterprises may separate certain functions for valid business reasons. Accordingly, these treaties permit the business activities of operating affiliates to be attributed to a non-operating local affiliate for purposes of claiming treaty benefits with respect to (and only with respect to) income earned by the non-operating affiliate that is connected to the business conducted in the residence country. The proposal to limit attribution to an affiliate that itself is an operating business inappropriately would deny treaty benefits.

The abuse at which this restriction is aimed has not been clearly articulated. This rule would necessitate companies currently using the active trade or business test to restructure or lose treaty benefits. There are often significant non-tax barriers, such as local regulatory regimes, to restructuring.

Allowing the attribution of business activities to a holding company is not an open door for the holding company to claim treaty benefits, as the treaty benefits apply only to income connected to the qualifying trade or business. The connectivity test is a meaningful restriction on access to treaty benefits requiring detailed analysis of what is the same or similar business and how to allocate indirect payments such as dividends and interest between qualifying income and non-qualifying income of the payor.

The statement in the proposed LOB article that holding and finance companies should use the derivative benefits test rather than the active trade or business test does not take into account that the active trade or business test is particularly important to private companies, such as family-owned companies or companies owned by private equity investors. Even in the context of publicly traded companies, the derivative benefits test would not cover many holding company structures.

### F. Discretionary Grant of Treaty Benefits

The LOB article recognizes that the objective tests in the article may block treaty access for some companies and therefore permits such companies to request a discretionary grant of treaty benefits from the competent authority of the country whose tax is implicated (generally the source State). While, in theory, this safety net should provide appropriate access, experience with the competent authority process shows that it can be inefficient and therefore not a workable solution. Requests for competent authority grants can take several years to make their way through the process with uncertain results.

The U.S. competent authority historically has viewed its discretion not to grant benefits as broad; the standards it uses have not been well articulated in the past and have changed from time to time. However, income tax treaties to which the United States is a party explicitly provide that the competent authority may grant treaty benefits if it determines that the establishment, acquisition, or maintenance of the person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the particular treaty.

If the proposed LOB article were implemented in tax treaties in its proposed form, the additional restrictions likely would lead to a significant increase in the need to rely on the discretionary grant of benefits. This would not be a tenable result; in addition to creating additional administrative burdens for taxpayers and the competent authority, the discretionary grant of treaty benefits would be unlikely to meet real-time business needs and likely could result in inconsistent treatment.

In addition to the existing standard, the proposed LOB article would require a taxpayer to demonstrate a substantial nontax nexus to the taxpayer's residence state. This additional requirement raises questions. For example, would the competent authority require the taxpayer to demonstrate that it could not have been resident in any other jurisdiction except for the residence country? While a substantial nontax nexus to a country certainly is one factor that may indicate a lack of treaty shopping motive, it should not be a necessary condition.

For example, assume a person resident in a country that has a treaty with the United States and that would qualify for the benefits of the treaty would like to pursue a business opportunity in the United States. If the person set up a corporation in his or her state of residence, the corporation could qualify for treaty benefits. However, in order to pursue the business opportunity, the person obtains financing from an unrelated party, resident in a different treaty jurisdiction but that also could obtain treaty benefits. Because the financing party regularly uses entities in a specified third country for a variety of reasons, including confidence in the country's well-developed legal system, favorable creditor's rights laws and corporate governance rules, and the professional support available in that country, the financing party requires the joint venture to be set up in the third country. The third country has a treaty with the United States, but the treaty does not include a derivative benefits test. In this example, it is clear that the third country was not used for the purpose of obtaining the benefits of the treaty. However, it is unclear whether the joint venture could demonstrate a substantial nontax nexus with the third country. Examples such as this demonstrate why requiring a showing of a substantial nontax nexus – as opposed to considering it as one of the factors in determining whether benefits should be granted – would lead to denying treaty benefits in inappropriate circumstances.

Aggravating the current obstacles to competent authority grants is the recent issuance of Revenue Procedure 2015-40, which sets forth the standard that the U.S. competent authority will use to evaluate discretionary grants. The Revenue Procedure incorporates several new limitations on discretionary grants of treaty benefits that are not part of existing treaties, including the substantial nontax nexus standard, as well as taking into account potential double non-taxation and whether special tax regimes may apply

We are concerned that the Revenue Procedure represents unilateral implementation in existing treaties of several of the proposed changes to the Model Treaty by way of administrative guidance, without the benefit of public comment (because the limitations were not included in the draft Revenue Procedure). We believe addition of new limitations on the discretionary grant of treaty benefits that are not part of existing treaties and go beyond the text of what the Senate actually ratified is inappropriate.

The Revenue Procedure does not include in the stated standards the one guiding principle set forth in every treaty that has a discretionary grant provision – namely, the principal purpose standard described above. Not only do the limitations make an already inefficient and impractical process more so, we question the authority for abandoning a standard that is part of current treaties. That standard was negotiated and agreed to by each of the treaty partners with the understanding that it would be applied by the other partner in determining whether to grant treaty benefits, and was approved by the Senate when ratifying each treaty. While the U.S. competent authority clearly has discretion to grant treaty benefits, we are concerned that such unilateral action amounts to a treaty override that may be replicated by our treaty partners.

In our discussion of the derivative benefits test, we suggested allowing a tested company to apply the rate available to its ultimate parent if that rate is less favorable than the rate in the treaty being applied. If that suggestion is not adopted, we would suggest as an alternative that competent authority be authorized to approve application of the higher rate in the course of a discretionary grant of treaty benefits.

### *III. Conclusion*

We commend Treasury's continuing efforts to improve the U.S. Model Treaty and appreciate the opportunity to offer comments on the proposed changes. As discussed, we have concerns with a number of the changes.

We recognize that the changes stem from the need Treasury sees to address shortcomings in the international tax rules, but we believe the proposals in the aggregate would test the viability of the U.S. tax treaty network. While low or no withholding on income can accommodate planning to achieve "double non-taxation," it would be unfortunate if the solution were a return to the withholding taxes that have presented historical barriers to cross border trade and investment. We believe using tax treaties for such purposes would undermine a fundamental reason tax treaties exist – the removal of artificial barriers to cross-border trade and investment. The proposals would restrict access to the benefits and protections of tax treaties to an overly limited group of residents of the treaty partner in contradiction of fundamental treaty goals.

We welcome the opportunity to discuss this matter with you and would be pleased to answer any questions. Should you have any questions, please contact Steve Nauheim (202-414-1524) or Oren Penn (202-414-4393).

Respectfully submitted,

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i See Opening Statement of Robert B. Stack, Treasury Deputy Assistant Secretary (International Tax Affairs), to the Senate Committee on Foreign Relations, 113th Cong. (2014), Doc. 2014-15339, reprinted 2014 TNT 119-45.

ii See id.

iii See Explanation of Proposed Income Tax Treaty Between the United States and the Republic of Slovenia, Joint Committee on Taxation (JCS-11-99).

iv S. Exec. Rpt. 106-8 (Nov. 3, 1999).

v Throughout this letter, references to "other income" are to income addressed in the "Other Income" article of income tax treaties.

vi Note that the European Commission recently ruled that tax breaks given to Italian companies that were affected by natural disasters constituted state aid.