Questions Remain on BEPS, U.S. Model Treaty Changes

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BNA Snapshot

Development: Work on proposed changes to U.S. model treaty continues as OECD prepares to issue final report on BEPS project.

Takeaway: Practitioners waiting to see how differences, similarities will play out.

Next: OECD report expected in September; Treasury asks for comments on model treaty changes by mid-September.

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By Alison Bennett

Aug. 14 — As work on the U.S. model treaty continues alongside the OECD's base erosion and profit shifting project, questions remain on how similarities and differences between the two will play out, practitioners told Bloomberg BNA in a series of interviews.

“It's not clear whether, as taxpayers, we're going to have to deal with multiple regimes,” said Fred Murray, a managing director at Grant Thornton LLP in Washington. “There may be a turbulent time while we're sorting all this out.”

The Treasury Department released five proposed treaty changes for comment in May, with two provisions intended to prevent tax avoidance through special tax regimes and through changes in law enacted after a treaty takes effect.

A third would rein in the tax benefits of inversion transactions by denying treaty benefits to some payments made by expatriated entities, while a fourth provision would tighten a provision intended to limit benefits if certain tests aren't met. A fifth would deny treaty benefits to certain types of multi-country transactions involving permanent establishments (98 DTR G-6, 5/21/15).

Treasury International Tax Counsel Danielle Rolfes said in June that the government was hoping to release a finished copy of the model treaty by the end of the year and asked for comments by mid-September.

A final BEPS report is also expected in September—the culmination of two years of negotiations among many countries on a host of provisions intended to take aim at cross-border tax evasion. With some provisions of BEPS headed for possible inclusion in the Organization for Economic and Cooperation's own model treaty, it remains to be seen whether that final report or the OECD tax convention will reflect the U.S.'s work so far, practitioners said.

U.S. Going Down Own Path?

If the U.S. doesn't agree and continues with model treaty provisions that don't reflect what the OECD is doing, that could be an example of the U.S. heading down its own path, said John L. Harrington, a partner at Dentons in Washington.

“Certainly the proposed changes to the U.S. model treaty and BEPS are linked. To the extent that the types of changes the U.S. is proposing are consistent with the OECD model, the closer the two are, the less difference it makes what your starting point is,” said Harrington, a former Treasury international tax counsel.

However, it is possible that other countries aren't going to be inclined to accept the U.S. changes, and “to the extent that their work isn't being reflective of the U.S. model treaty, it's like the U.S. is going its own way,” he said.

Murray said that the timing of the proposed U.S. changes might have been an effort by the U.S. to stake out a position in the BEPS talks. “It may well be an indication of what the U.S. is willing to accept,” the Grant Thornton practitioner said.

He noted that other regimes, such as the Foreign Account Tax Compliance Act and the OECD's common reporting standard, may complicate things further. Both of those involve reporting of bank accounts to governments. Those are additional efforts to improve global tax transparency.

Treasury Openness Praised

Several practitioners praised Treasury's decision to release the five changes in proposed form in order to get comment—an action never done as the U.S. worked on updating its model treaty in the past.

Treasury's Rolfes said in June that the government was already working on refining the changes, and said in crafting those changes, Treasury took a “harder road” in trying to ensure clearer standards throughout the treaty instead of taking the approach that “we're not going to respect any result that is not, in our minds, the appropriate result,” or withdrawing a zero rate of withholding.

For example, she said, Treasury took a narrow path on defining a problematic “special tax regime” put in place after a treaty is implemented—narrower than the definition being looked at as part of BEPS.

The proposed Treasury definition would apply only to a reduction in the tax rate or the tax base and is intended to address situations where mobile income, such as interest or royalties, is disproportionately benefited, Rolfes said. It only applies to payments between related parties—a feature the U.S. has been pushing in the BEPS version of the provision.

Practitioners said caution needs to be taken in defining a special regime that doesn't sweep in tax rules that weren't intended to give taxpayers improper treaty benefits.

Details Unclear

Kimberly S. Blanchard, a partner with Weil, Gotshal & Manges LLP in New York, said it remains unclear whether a special tax regime would be triggered payee by payee or otherwise. She said it would be wise for the U.S. to put in a de minimis provision to avoid an overly broad sweep, and said it could be very complicated if, for example, another country lowers its interest rates for certain residents, but not for all residents.

Questions remain as to how the Internal Revenue Service would even become aware that another country has a “special” tax regime, Blanchard said.

Steve Nauheim, a managing director with PricewaterhouseCoopers LLP in Washington, said the lack of an objective definition of a special tax regime could have a chilling effect on cross-border trade and investment—something treaties are supposed to encourage.

Low Taxes Discouraged

Nauheim said putting such a provision in a model treaty sends a message that may discourage other countries from reducing taxes on U.S. multinationals. “Ultimately, the fisc pays for that in the foreign tax credit if taxes go up,” he said.

He also criticized proposed changes that would reduce the benefits available for some corporate inversions. The change is intended to prevent post-expatriation earnings-stripping transactions that often accompany such inversions.

Nauheim said he believes the provision would cut out “a whole panoply of people who are not treaty shopping.” Inversions are a domestic tax policy concern that should be handled through domestic legislation, not through treaties, he said.

Limitations on Benefits

While some criticized changes being proposed to the limitation on benefits provision in the U.S. model treaty, others praised the U.S. for its advocacy of the concept during BEPS discussions.

The U.S. has been opposed to the BEPS approach of seeking out tax evasion using a test of whether a transaction has a “principal purpose” of avoidance—one with significant support among BEPS negotiators, Blanchard said.

“The U.S. has been pushing very hard for an LOB provision and against the principal purpose test,” she said. "Many don't like it and they don't understand it. The U.S. has been put in the position of trying to drag them into the LOB world."

Philip D. Morrison, counsel with McDermott, Will & Emery LLP in Washington, said the U.S. Treasury has "done a great job" of persuading the OECD to go with a blended approach that combines a modified LOB approach with an anti-abuse test. The most recent discussion draft unveiled by the OECD featured such an approach, although it is too soon to say what will be reflected in the final report.

"That was critical to get that done," he said. "Treasury should be patted on the back for getting OECD approval for going the route they've been going for 20 years."

Concerns

That said, Morrison and others said there are concerns about some of the changes Treasury is proposing to the existing limitation on benefits provision in the current model treaty.

A key problem is the change being proposed that will make it harder to meet the active trade or business test. Morrison said as proposed by Treasury, the test would now be unavailable for finance, intellectual property licensing or holding companies in the residence country that are related to an operating company with a substantial trade or business in that country—but don't have active businesses themselves.

However, he said there is one pro-taxpayer proposal in the LOB changes proposed by Treasury. The change would make a derivatives benefits provision available to all equivalent beneficiaries, not simply those in a particular trading bloc.

Outlook

Several practitioners said the U.S. model changes leave open the question of whether other countries will be willing to accept them in future treaty negotiations.

"To what extent would other countries be willing to agree if these provisions have a negative impact on their residents?" said Joseph Calianno, partner and International Technical Tax Practice Leader at BDO in Washington. "It's something we obviously need to look at."

Dentons' Harrington said he, too, thinks there could be a price in other treaty negotiations. "There's a question of what other countries would agree to," he said. "Even if the U.S. could get this, what's the cost?"

H. David Rosenbloom, a member of Caplin & Drysdale in Washington, said the U.S. should try to bridge what he sees as the gap between the statutory rules and the treaty rules as the process moves forward. "We now have two sets of rules," he said.

Rosenbloom said he thinks the U.S. should join the growing movement toward source-based taxation, where income from cross-border transactions is taxed where it is earned, rather than where the taxpayer who receives the income resides.

“If we don't, we're going to be in the position of not being able to tax much,” he said. “My view would be to take a hard look at our policies.”

To contact the reporter on this story: Alison Bennett in Washington at abennett@bna.com

To contact the editor responsible for this story: Cheryl Saenz at csaenz@bna.com