

## Corporate Tax - USA

### Treasury proposes significant changes to model tax treaty

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#### Introduction

On May 20 2015 the Treasury Department released five proposed changes to the US Model Income Tax Treaty. The changes represent part of an extensive and ongoing overhaul of this document, which was last updated in 2006. According to the Treasury Department, the proposed revisions are intended to ameliorate the problem of so-called 'stateless income' and to influence the work of the Organisation for Economic Cooperation and Development's Base Erosion and Profit Shifting Project, which is due to release its final report on tax treaty abuse soon.

The proposals were introduced at a meeting of the District of Columbia Bar's Taxation Section. Treasury Department International Tax Counsel Danielle Rolfes remarked at the meeting that "when we take a step back and look at our tax treaties, [they are], in fact, facilitating double nontaxation". Rolfes indicated that the Treasury Department had considered and ultimately rejected the possibility of addressing this problem through a general anti-abuse rule, but opted instead for a targeted approach. The release of these provisions differs from past revisions of the US model in two ways. First, the changes have been released as drafts, with the Treasury Department seeking public comment on the new rules. Second, past releases have been of the entire US model as opposed to this piecemeal approach. The Treasury Department has indicated its intention to release the completely revised US model by the end of the year, but apparently does not intend to issue any other proposed changes in draft form. It would be easier to assess the overall impact of the proposed changes in the context of the entire revised US model.

#### Exempt permanent establishments

A typical tax avoidance strategy involves a treaty-eligible foreign company setting up a permanent establishment in a third country that imposes little or no tax on the permanent establishment's income. This strategy also requires that the company's country of residence refrain from taxing the income earned by the permanent establishment, which may result from either an exemption provision in the residence country's domestic law or a tax treaty between that country and the third country. If the permanent establishment earns US source income that is subject to little or no US tax under the treaty between the United States and the residence country, and that income is also subject to little or no tax in both the residence country and the third country, "double [or, indeed, triple] nontaxation" will have been achieved because the income would be subject to low or zero taxation by the country of source, the country of residence and the jurisdiction in which the permanent establishment is located. The permanent establishment need not be located in a third country; the strategy can work equally well if the permanent establishment is located in the country of source. For example, a Luxembourg permanent establishment located in the United States that is not engaging in a US trade or business will be subject neither to Luxembourg tax (because of its statutory exemption system) nor to US tax (because there is no US trade or business).

Proposed Paragraph 7 of Article 1 is intended to stymie this scheme. The paragraph states that when a resident derives income from the other state and the residence state's domestic law attributes that income to a permanent establishment located outside the company's country of residence, the treaty benefits that would ordinarily apply are inapplicable if:

- the permanent establishment's profits are subject to a combined, aggregate, effective tax rate of less than 60% of the generally applicable corporate tax rate in the residence state; or
- the state in which the permanent establishment is situated does not have a comprehensive income tax treaty with the residence state (unless the residence state includes the permanent establishment's income in its tax base, in which case this prong does not apply).

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## Expatriated entities

The revisions are targeted at so-called 'corporate inversions' and the earnings-stripping transactions that often accompany them. The new draft paragraphs – which are to be inserted into Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income) – provide that the United States reserves the right to tax income paid by any "expatriated entity" in accordance with its domestic law for a period of up to 10 years following expatriation, notwithstanding treaty provisions reducing or eliminating source-based withholding on such income.

The draft technical explanation of the provision defines 'expatriated entity' by reference to Internal Revenue Code Section 7874(a)(2)(A). In general, that section states that where a domestic entity has been acquired by a foreign parent and there is significant continuity of ownership between the domestic entity's former shareholders and the foreign entity's new shareholders, the domestic entity is an "expatriated entity".

## Special tax regimes

These draft paragraphs generally provide that if interest, royalties or "other income" is paid between related parties and the recipient is "subject to a special tax regime" in its country of residence with respect to that item of income, the source country may tax the category of income in accordance with its domestic law notwithstanding the treaty.

The phrase 'special tax regime' is not defined in any detail in the draft paragraphs themselves; proposed Paragraph 1 of Article 3 states cursorily that it "means any legislation, regulation, or administrative practice that provides a preferential effective rate of taxation" on the relevant item of income. The paragraph fleshes out the definition by providing a list of provisions that would not qualify as 'special tax regimes'. These include charitable exemptions, preferences relating to retirement and pension administration, and preferential rates on royalties that entail a 'substantial activity' requirement, among others.

According to the Treasury Department, no existing US legislation, regulations or administrative practices that apply with respect to interest, royalty or other income satisfy the definition of a 'special tax regime'. At the meeting Rolfes stated that the Treasury Department would likely refrain from defining 'special tax regime' with any greater specificity, explaining that the department would not be able to "put [its] finger on, at the time of negotiation, all of the ways that a country might give preferences".

## Limitation on benefits article

The limitation on benefits article has also been substantially revised. The most noteworthy change is the addition of an 'equivalent beneficiary' test. Under this test, a company is treaty eligible if it is at least 95% owned by seven or fewer equivalent beneficiaries and if it satisfies a base erosion test.

The definition of 'equivalent beneficiary' comprises two elements. First, the owner must be entitled to all the benefits of a comprehensive double-tax treaty with the United States (if benefits are being claimed against US tax) or the other treaty country (if benefits are being claimed against the other country). For the purposes of gauging an entity's entitlement to treaty benefits, a limitation on benefits clause is imputed to treaties that currently lack one. Second, in the case of passive income (interest, royalties and dividends), that same double-tax treaty must entitle the owner to a maximum withholding rate on the relevant category of income that is "at least as low" as the rate specified in the US model. Finally, with respect to income governed by Articles 7 (Business Profits), 13 (Gains) or 21 (Other Income), the owner must be entitled to benefits under its treaty that are "at least as favorable" as the benefits granted under the US model.

In the case of putative equivalent beneficiaries which own companies indirectly, all intermediate owners must be "qualified". The definition of 'qualified intermediate owner' is similar to – yet slightly more permissive than – the equivalent beneficiary test.

Other significant changes to the limitation on benefits article include:

- adding a 'base erosion' requirement for a company to qualify for benefits by virtue of its status as a subsidiary of a publicly traded company;
- applying the base erosion test to the company's consolidated group;
- imposing a 'special tax regime' exception to the acceptable payments rule under the base erosion test; and
- changing the definition of 'gross income' under the base erosion test so as to exclude exempt dividend income.

## Subsequent changes in law

This new draft article provides that certain changes to the domestic law of either treaty country will cause some of the provisions of the treaty to be inoperative. Paragraphs 1 and 2 of the article state that if the highest marginal rate of taxation for individuals or business entities falls below 15% in either treaty country, or if either country elects to exempt individual or corporate foreign-source income from taxation, then Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income) will no longer be effective for individuals or companies, as the case may be.

The technical explanation provides that the 'special tax regime' provision above is intended to apply in cases of specific exemptions or preferences, but that this article is applicable to broader exemptions or rate reductions.

Rolfes stated at the meeting that the provision is "less nuclear than terminating a tax treaty [altogether]", but that it would still lead to serious consequences if either treaty partner were to lower its domestic tax rates aggressively in an effort to attract mobile income.

Since the US model typically represents the United States' opening position in treaty negotiations, these new provisions will likely have a significant impact on the content of US tax treaties going forward. Multinational businesses need to be aware that tax structures that work under existing treaties could be rendered obsolete or ineffective as these rules are incorporated into the US treaty network.

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