Client Alert

Current Issues Relevant to Our Clients

July 10, 2015

Treasury Releases Proposed Updates to U.S. Model Treaty

On May 20th, the IRS released draft updates to the U.S. Model Income Tax Convention (the "Model Treaty"). The Model Treaty was last updated in 2006. The Treasury Department invites comments on the proposed treaty rules, which will be taken into account as the Treasury Department works to finalize the revisions.

Background

The U.S. Model Treaty is the baseline text used by the Treasury Department when it negotiates tax treaties. This update is meant to ensure that the United State is able to maintain the balance of benefits already negotiated within its treaty network, even if the tax laws of treaty partners may change overtime. It is also intended to deny treaty benefits to companies that change their tax residence in inversion transactions.

The proposed updates: (1) change the rules regarding Permanent Establishment to prevent residents of third countries from inappropriately obtaining the benefits of a bilateral tax treaty, (2) impose full withholding on payments made by expatriating entities, (3) add a new definition of "special tax regime," (4) revise the limitations on benefits article and (5) enable some treaty benefits to be disabled if domestic tax law changes affecting tax rates are made after a treaty is signed.

Permanent Establishment

Under the current Model Treaty, business profits of an enterprise of a contracting country (the "*Home Country*") are taxable only in the Home Country unless the enterprise carries on business in the other contracting country (the *"Source Country"*) through a permanent establishment in the Source Country. The Treasury Department proposes a new paragraph in Article 1 (General Scope), which is intended to deal with a situation where a resident of the Home Country earns income from the Source Country through a permanent establishment outside of the Home Country.

The new paragraph denies the tax benefits of the treaty under two circumstances. First, the treaty benefits would be denied if the profits of the permanent establishment in the situation above are subject to an aggregate combined effective rate of tax in the Home Country plus the other country where the permanent establishment is located of less than 60 percent of the general rate of company tax applicable in the Home Country. Second, the new paragraph would also apply if the country where the permanent establishment is located in a country without a comprehensive income tax treaty in force with the Source Country, unless the treaty with the Home Country includes the income attributable to the permanent establishment in its tax base.

If the new paragraph applies to deny the tax benefits of the treaty, tax shall be applied in accordance with the domestic law of the Source Country. However, the competent authority of the Source Country may nevertheless grant the benefits of the treaty with respect to a specific item of income, if such a grant is justified in light of the reasons why the resident did not satisfy the requirements of the paragraph.

Expatriated Entities

This proposed update is intended to reduce tax benefits achieved through corporate inversions. It imposes full withholding taxes on dividends, interest, royalties and "other income" paid by entities that are defined as expatriated entities under Section 7874(a)(2)(A) of the Internal Revenue Code, which deals with inversions. Under that Code Section, non-U.S. companies that acquire substantially all of the properties of a domestic entity may be subject to severe tax penalties when a certain percentage of their shareholders are former shareholders of that same domestic entity.

In general, the updated Model Treaty provisions would permit the U.S. to tax such payments by an expatriated entity under U.S. tax law for ten years, beginning on the date on which the acquisition of the domestic entity is completed.

"Special Tax Regimes"

Generally, the Model Treaty currently provides that interest, royalties and other income not otherwise covered in the treaty is taxed only in the state of residency of the person who beneficially owns the income (the Home Country). This update proposes a change to those three types of income so that treaty benefits would be denied if the beneficial owner of the income is related to the payer and benefits from a "special tax regime" on that income in its state of residence. If treaty benefits are denied, the Source Country would retain its right to tax the income under its domestic law.

A "special tax regime" means any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit, including through reductions in the tax rate or the tax base. With regard to interest, the term special tax regime includes notional deductions that are allowed with respect to equity.

The Technical Explanation provides the following example of a situation in which the new provision would apply. If a taxpayer obtains a ruling providing that its foreign source interest income will be subject to a low rate of taxation in the Home Country, and that rate is lower than the rate that generally would apply to foreign source interest income received by residents of that state, the administrative practice under which the ruling is obtained is a special tax regime. The Technical Explanation also states that this new proposal is consistent with the OECD Base Erosion and Profits Shifting initiative. In particular, although the intention of tax treaties is to reduce the risk of double taxation, if the Home Country has a low effective rate of taxation or no tax on a certain income, the result is a risk of non-taxation. When a Source Country enters into an income tax treaty restricting its right to tax elements of income, it does so on the understanding that these elements of income are taxable in the other state.

However, there are several exceptions to the definition of special tax regime. For example, the update would not apply if the application of such legislation, regulation or administrative practice does not disproportionately benefit interest, royalties or other income.

Proposed Limitation on Benefits Article

The Treasury also proposes a replacement Limitation on Benefits (*"LOB"*) article. The replacement article has several changes from the current article. For example, the proposal adds a base erosion requirement to the "subsidiary of a publicly traded company" test under paragraph 2. Currently, the Model Treaty allows a company that is at least 50 percent owned by five or fewer companies that are regularly traded on a recognized stock exchange to qualify for treaty benefits under the LOB article. The proposed update would also require that less than 50 percent of the company's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for the purposes of the taxes covered by the treaty in the company's Home Country (but not including arm's length payments in the ordinary course of business for services or tangible property). To be counted as deductible, the payments must be deductible either to persons that are not residents of either contracting country entitled to the benefits of the treaty under the LOB article, or to persons resident in a contracting country, but that benefit from a "special tax regime" in their Home Country with respect to the deductible payment. This income requirement does not apply to benefits under Article 10 (Dividends).

A "derivative benefits" test is also added to paragraph 4 of the LOB Article. Regardless of whether the company would otherwise be a qualified person under the LOB Article, a company would be entitled to a benefit under the treaty if it meets two tests. This rule is favorable for taxpayers and recognizes that multinational companies may have operations spread among many subsidiaries around the world. The two requirements are:

(1) At least 95 percent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and

(2) less than 50 percent of the company's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments (but not including arm's length payments in the ordinary course of business for services or tangible property) that are deductible for purposes of the taxes covered by Model Treaty in the company's Home Country, either to persons that are not equivalent beneficiaries or to persons that are equivalent beneficiaries but that benefit from a special tax regime in their state of residence with respect to the deductible payment.

The "tested group" generally means the resident that is applying the test and any intermediate owner of the resident that is a resident of the Home Country as the tested resident and a member of a tax consolidation regime. The term "equivalent beneficiary" generally means a resident of any state that would be entitled to all the benefits of an income tax treaty between its state and the Source Country. With some exceptions, a "qualifying intermediate owner" is an intermediate owner that is a resident of a state that has an income tax treaty with the Source Country that has a provision analogous to the provision addressing special tax regimes.

The Treasury does not anticipate releasing an advance draft technical explanation of the revised LOB article, since, it says, the rules are objective and mechanical in nature and "thus are self-explanatory."

Subsequent Changes in Law

Finally, the Treasury is proposing the addition of a new article (Subsequent Changes in Law), which would address the possibility of future changes to the domestic laws of one or both of the contracting countries which could increase the risk that the tax treaty could create unintended instances of low or no taxation. These changes might also affect the negotiated allocation of taxing rights between the two states. The new article would apply if the general corporate rate of either contracting country falls below 15 percent, if the highest marginal individual tax rate of either contracting country falls below 15 percent, or if either country provides an exemption from taxation for resident individuals or companies for substantially all foreign source income. If the new article applies, then the provisions on dividends, interest, royalties and other income may cease to have effect.

For More Information

For more information, please contact Paul Carman (312.845.3443), Christie Galinski (312.845.3431), your primary Chapman attorney or visit us online at chapman.com.