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COMMENTARY

Treasury Publishes Updated Model Income Tax Treaty

On February 17, 2016, the U.S. Treasury Department published a revised model income tax convention (the “New Model Treaty”) to replace the prior 2006 version. (Treasury also expects to publish a Technical Explanation to provide additional guidance this spring.) Model tax treaties generally serve as Treasury’s opening position when negotiating bilateral income tax treaties with other countries. The New Model Treaty differs from prior versions for its emphasis on not simply preventing double taxation but also preventing and policing instances of double nontaxation and perceived treaty abuses. The policies underlying this new, more restrictive New Model Treaty are part of a larger shift in the international tax landscape, including, in particular, the OECD’s Base Erosion and Profit Shifting (“BEPS”) Project.

While the New Model Treaty includes technical corrections and existing Treasury policies already reflected in more recent U.S. tax treaties, it also contains a number of significant departures from the status quo. Treasury previewed the most significant of these changes last May when it released drafts of five new provisions (the “2015 Drafts”). All of these new provisions appear in the final New Model Treaty, although they have generally been fleshed out to provide more detail and modified (to varying degrees) to incorporate comments received from the public. As a general matter, most of the changes—with only a few exceptions—will have the effect of making it more difficult for taxpayers to qualify for treaty benefits. Also notable, although not unexpected, is Treasury’s rejection of a number of the recommendations contained in the final BEPS Project report. For example, the New Model Treaty does not generally treat commissionaire arrangements as giving rise to permanent establishments, nor does it include a general anti-abuse rule denying treaty benefits if one of the “principal purposes” of a transaction is to obtain treaty benefits.

As a practical matter, the release of the New Model Treaty does not immediately affect existing U.S. tax treaties. Its new provisions have no effect until incorporated into new or amended treaties, and this is likely to take several years, as each existing treaty will need to be renegotiated. This delay may be further exacerbated by the U.S. Senate’s current disinclination to ratify tax treaties. (Due to a political stalemate, none has been ratified since 2010.) Although the United States has agreed to participate in the development of a multilateral instrument intended to streamline and expedite the modification of existing bilateral tax treaties in order to implement the changes mandated by the BEPS Project, it is not anticipated that the United States will actually sign on to such an instrument.

Although not likely to be effective in the short term, these proposals in the New Model Treaty are nevertheless significant, as they indicate Treasury's most recent viewpoint and are likely to be included in future U.S. tax treaties or protocols to existing treaties. Accordingly, prudent taxpayers planning cross-border transactions that rely on existing treaty benefits would be well-advised to keep these proposals in mind. The most important of these key changes include new or modified provisions addressing: (i) special tax regimes, (ii) anti-inversion rules, (iii) triangular permanent establishments, (iv) limitation on benefits, (v) subsequent changes in law, and (vi) mandatory binding arbitration.

Special Tax Regimes

One set of new provisions would deny basic treaty benefits for certain related-party payments of highly mobile income if the recipient benefits from a "special tax regime" on such income in its country of residence. Consistent with the BEPS Project, these provisions are intended to eliminate opportunities for low or no taxation. Article 3 of the New Model Treaty generally defines a special tax regime as any statute, regulation, or administrative practice that results in low (or no) effective taxation due to a reduced tax rate or tax base for interest, guarantee fees, and/or royalties (assuming insufficient nexus between the royalties and related research and development). To be deemed a special tax regime requires a country to impose an effective tax rate of less than the lesser of (i) 15 percent or (ii) 60 percent of the general corporate tax rate applicable in the other country. Such a preferential tax rate would also be considered a special tax regime if it applies to substantially all of a company's income (rather than singling out only select types of mobile income) if the company can benefit from the rate without actively engaging in a trade or business. The definition of special tax regime does carve out certain exceptions, however, including for pension funds, charitable organizations and certain collective investment vehicles such as RICs and REITs.

Although the introduction of the special tax regime rules reflects a significant departure from the 2006 version, the New Model Treaty's definition of "special tax regime" is considerably narrower than the one that appeared in the 2015 Drafts. Further, in response to comments to the 2015 Drafts, Treasury also added a (sensible) requirement for consultation with the treaty partner and written public notice before any statute, regulation, or administrative practice could be treated as a special tax regime.

The United States proposed substantially similar "special tax regime" language for inclusion by the OECD as part of the BEPS Project, and the final Action 6 report (preventing treaty abuse) adopted draft proposals based on the 2015 Drafts. Presumably the revised language of the New Model Treaty will also be taken into consideration by the OECD in negotiation of the multilateral instrument under Action 15. Accordingly, even if the United States never signs onto the multilateral instrument and the U.S. Senate never ratifies another treaty, U.S.-based multinational corporations may still find themselves subject to treaties containing special tax regime rules sooner rather than later.

Anti-Inversion Rules

The new anti-inversion provisions contained in the New Model Treaty represent another step in Treasury's ongoing effort to disincentivize inversions by U.S. companies by generally denying treaty benefits on certain payments of dividends, interest, royalties, and guarantee fees made by an expatriated entity within 10 years of its expatriation. In contrast to the 2015 Drafts, the New Model Treaty limits the denial to related-party payments. The New Model Treaty defines an "expatriated entity" by cross reference to the anti-inversion rules in section 7874 of the Internal Revenue Code. (In general, an expatriated entity under section 7874 is a foreign corporation that acquired substantially all of the assets of a U.S. corporation if, after such acquisition: (i) at least 60 percent of the stock of the foreign corporation is held by former shareholders of the U.S. corporation and (ii) the foreign corporation (or its affiliates) does not have substantial business activities in the country in which it is incorporated.)

In order to provide certainty about the scope of these rules, the New Model Treaty fixes the definition of "expatriated entity" to its domestic statutory definition as of the date the relevant U.S. tax treaty is signed (in order to insulate it from future legislative changes). As a practical matter, it is not clear whether Congress will allow a treaty to preemptively override future legislation. What is clear, however, is that suffering full U.S. withholding for 10 years will affect the cost–benefit analysis for doing an inversion.

Triangular Permanent Establishments

The new triangular permanent establishment ("PE") provision contained in Article 1 addresses the treatment of income in situations in which a resident of one treaty country (residence country) earns income from the other treaty country (source country) through a PE situated outside of the residence country (usually in a third state), and such income is subject to significantly lower (or no) tax than it would have been if it had been earned in the residence country. The New Model Treaty generally denies treaty benefits for such income: (i) if the aggregate effective tax rate imposed on the income by the residence country and PE country is less than the lesser of 15 percent or 60 percent of the general corporate tax rate in the residence state; or (ii) if the residence country does not tax the income attributable to the PE, and the PE is situated in a third country that does not have a comprehensive income tax treaty with the source state.

For example, assume the United States has an income tax treaty with country T but has no treaty with country NT. ForeignCo is a resident of country T and has a PE in country NT. Although country T imposes a general corporate income tax of 20 percent, it does not impose tax on income earned through PEs located outside of country T. Country NT does not impose an income tax. Under these circumstances, if a U.S. company were to pay interest to ForeignCo's PE, the interest income would not be subject to tax in either country T or country NT. Accordingly, this new provision would deny treaty benefits with respect to the interest payment.

A number of more recent U.S. tax treaties already include similar rules denying benefits for triangular PE arrangements in the Limitation on Benefits provisions. This new rule, however, is broader and appears in the General Scope provision, thus removing the affected income from the scope of a treaty entirely. Note that this provision affects all types of income (i.e., it is not limited to only highly mobile income) and does not contain an active business exception similar to the ones found in some of the current U.S. tax treaties with comparable triangular PE rules.

Limitation on Benefits

The New Model Treaty contains a number of revisions to the Limitation on Benefits ("LOB") rules in Article 22. In general, although a few additions are "pro-taxpayer," these new rules, as well as the modifications to the existing rules, are principally designed to prevent treaty shopping abuses by making it more difficult for third-country residents to qualify for benefits under a U.S. tax treaty. For example, although new derivative benefits and headquarters tests were added, they are generally more limited than the similar derivative benefits and headquarters provisions contained in existing U.S. tax treaties due to the addition of a restrictive base erosion component. This base erosion test was also newly added to the existing publicly traded subsidiary test, and the base erosion component of the existing ownership/base erosion test was similarly made more restrictive.

Additionally, although Treasury broadened the scope of entities that can potentially qualify as equivalent beneficiaries (under the derivative benefits test) and intermediate owners (under the various ownership-based tests) by removing the geographical restrictions—i.e., previously only entities resident in a treaty country or an EU/NAFTA member country were permissible—any such geographically diverse owners are now subject to a number of additional restrictions. Critically, one of these new restrictions requires that any such intermediate owners be resident in a country that has in effect a comprehensive tax treaty containing rules addressing special tax regimes and notional interest deductions. The current count of such treaties is zero. Accordingly, these more "relaxed" definitions have no effect in practice (yet) and are likely intended more as inducement for treaty partners to adopt similar provisions in their treaties.

Finally, the New Model Treaty makes discretionary LOB relief by a competent authority expressly contingent on a taxpayer having "substantial nontax nexus" to its residence state. Even though this new standard is not yet part of any existing U.S. tax treaty, the Internal Revenue Service has already indicated its intention to use this standard when evaluating discretionary grants under current treaties—i.e., it will substitute this new standard when making discretionary LOB determinations, as well as require that the relevant income not benefit from any special tax regimes or double nontaxation.[1]

Subsequent Changes in Law

Treasury added Article 28 to the New Model Treaty to address situations in which, after a treaty is signed, one of the countries changes its corporate tax system to no longer impose significant tax on cross-border income—either by adopting a territorial tax system or reducing the statutory corporate tax rate below the lesser of (i) 15 percent or (ii) 60 percent of the general corporate tax rate applicable in the other country. If such a change in law were to occur, following the requisite consultation and provision of notice, treaty benefits would cease to have effect for payments of dividends, interest, royalties, and other income. This rule represents a retreat from the harsher version that appeared in Treasury's 2015 Drafts, which was not limited to corporate tax laws, did not first require consultation, and would have been triggered solely by a drop in a country's tax rate below 15 percent (regardless of the other country's tax rate).

In general, Treasury's position is that such a fundamental change of law could call into question the original balance of negotiated benefits and the extent to which the treaty remains necessary to eliminate double taxation (while increasing opportunities for low or no taxation). It is likely this new rule reflects Treasury's concern that certain treaty partners that currently use rulings or other special regimes to attract foreign investment may ultimately adopt low(er) rates across the board in response to the BEPS Project and the European Commission's ongoing state aid investigations. Practically speaking, this provision appears aggressively designed to try to discourage treaty partners from doing this in the first place—or to at least force them to take the treaty consequences into consideration before making such changes to domestic law.

Mandatory Binding Arbitration

Treasury has been a consistent and outspoken advocate in recent years for the use of mandatory binding arbitration for resolving disputes between treaty partners. Indeed, Treasury made its case (albeit somewhat unsuccessfully) to the OECD as part of the BEPS Project, and seven existing U.S. tax treaties already contain similar provisions. Article 25 of the New Model Treaty memorializes Treasury's preference for this approach and provides detailed guidance on how the mechanisms of such a "last best offer" arbitration process would work. The inclusion of this new provision comes as no surprise. Indeed, Treasury is also currently participating in the development of a multilateral instrument as part of the BEPS Project principally to advance this preference for mandatory binding arbitration.

Other Changes

The New Model Treaty contains a number of additional changes, including:

- Denying treaty benefits for related-party interest payments if the recipient benefits from notional deductions with respect to amounts the residence state treats as equity;[2]
- Introducing 12-month holding and residency requirements for the 5 percent withholding rate on dividends;
- Increasing certain exemption thresholds for income earned by students, artists, and athletes; and
- Fleshing out the definition and treatment of pension funds, including the addition of a protocol that will enable treaty partners to expressly define what qualifies as a pension fund in each country.

1 *See* Rev. Proc. 2015-40, 2015-35 I.R.B. 236.

2 In the 2015 Drafts, tax regimes that permitted notional interest deductions ("NIDs") with respect to equity were treated as "special tax regimes." The New Model Treaty no longer treats such regimes as special tax regimes and instead more narrowly addresses Treasury's underlying concern with NIDs—i.e., that interest income benefitting from a NID is often subject to little (or no) taxation—by permitting the source country to (also) tax the interest beneficially owned by a related person benefitting from a NID.

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