JONES DAY

JUNE 2015

COMMENTARY

U.S. Treasury Department Releases Proposed Model Treaty Provisions

On May 20, 2015, the U.S. Treasury Department released for public comment draft updates to the U.S. model income tax convention and its accompanying Technical Explanation (collectively, the "Model Treaty"), which was last updated in 2006. The Model Treaty is the template that Treasury uses as its starting point in negotiating U.S. bilateral tax treaties and protocols, thereby representing Treasury's view of tax treaty policy. The proposed changes address: (i) special tax regimes; (ii) payments from expatriated entities; (iii) exempt permanent establishments; (iv) revisions to the Model Treaty's limitation on benefits provision; and (v) subsequent changes in law.

Some of these provisions are intended to avoid instances of income that Treasury believes are not taxed sufficiently by either country (e.g., "stateless income"), consistent with the OECD/G20 Base Erosion and Profit Shifting ("BEPS") Project (notably, Action 6 of the BEPS Project). Other provisions are intended to reduce the tax benefits from a corporate inversion. The five sets of proposed changes are discussed below.

Denial of Treaty Benefits if Recipient is Subject to a Preferential Tax Regime

Treaty benefits would be denied to recipients of interest, royalties, and certain other income if such recipients are related to the payor and subject to a "special tax regime" with respect to the item of income resulting in a low effective rate of taxation. The proposal generally defines a "special tax regime" with respect to a particular item of income as "any legislation, regulation, or administrative practice that provides a preferential effective rate of taxation" for such income item, with seven exceptions for permissible preferential regimes.

One such exception is for preferential regimes that do not disproportionately benefit interest, royalties, or other income. To satisfy this criterion, the legislation, regulation, or administrative practice must be generally applicable to income and available across industries. Notably, with regard to interest income, notional deductions that are allowed with respect to equity in certain European countries are considered a special tax regime, even if such

notional interest deduction is part of the general tax regime. The proposal states that a preferential regime will be impermissible if, for example, the residence state treats interest, royalties, or other income as attributable to a foreign permanent establishment ("PE") in circumstances in which such foreign jurisdiction would not be expected to tax the income.

A second exception is for royalties satisfying a substantial activity requirement. The proposal's Technical Explanation states that such in-state substantial activities must "not be of a mobile nature." Moreover, a permissible preferential tax regime for payments received with respect to intellectual property must require the activities of developing the intellectual property to occur in the residence state. The proposal's Technical Explanation includes bracketed language stating that this exception will be interpreted consistently with the standards promulgated by the OECD's Forum on Harmful Tax Practices. The OECD announced in February 2015 (Action 5 of the BEPS Project) that consensus has been reached on the underlying principle of the modified nexus approach proposed in its September 2014 report, with an agreement on several open questions to be concluded by June 2015.

Payments from Expatriated Entities

The proposal continues Treasury's effort to minimize the tax benefits of inversion transactions by generally denying treaty benefits (i.e., imposing full withholding) for dividends, interest, royalties, and other income payments made by an "expatriated entity" within 10 years of its expatriation. An "expatriated entity" is defined by reference to the anti-inversion rules in section 7874 of the Internal Revenue Code. Therefore, an expatriated entity is any domestic corporation if: (i) a foreign corporation acquires substantially all of the properties held by the domestic corporation; (ii) after the acquisition, at least 60 percent of the stock of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation; and (iii) after the acquisition, the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the country where such entity is organized.

Exempt Permanent Establishments

The proposal would change the General Scope (Article 1) of the Model Treaty to prevent certain types of multi-country business arrangements from obtaining treaty benefits. Specifically, if a resident of one contracting state earns income from the other contracting state, but the law of the recipient's resident jurisdiction treats such income as being attributable to a PE outside of such resident jurisdiction, treaty benefits would be denied if: (i) the PE's profits are subject to a combined aggregate rate of tax in the jurisdiction where it is situated and the resident contracting state of its owner of less than 60 percent of the rate of company tax generally applicable in the resident contracting state of the owner; or (ii) the state where the PE is situated does not have a comprehensive income tax treaty in force with the contracting state from which treaty benefits are claimed. Competent authority relief would be available if the grant of treaty benefits is justified in light of the reasons why the taxpayer could not satisfy this rule.

This proposed change appears to target certain tax planning strategies under existing U.S. tax treaties; such strategies have been identified by the OECD/G20 BEPS Project and have attracted public scrutiny following the recent leaks of tax rulings issued by Luxembourg. The proposal includes a revised version of a triangular PE provision that has commonly appeared in U.S. limitation on benefits provisions negotiated in recent U.S. tax treaties and protocols but also covers so-called deemed U.S. PE structures.

Revisions to Limitation on Benefits Provision

The proposal would make several modifications to the Model Treaty's limitation on benefits provision. These modifications would introduce a derivative benefits test allowing a company that is a resident of a contracting state to claim treaty benefits if: (i) the company is at least 95 percent-owned by seven or fewer "equivalent beneficiaries"; and (ii) less than 50 percent of its gross income is paid or accrued in the form of deductible payments to persons that are not equivalent beneficiaries or to equivalent beneficiaries that benefit from

a special tax regime with respect to the payment. For this purpose, an "equivalent beneficiary" is: (i) a resident of any state entitled to all of the benefits of a U.S. tax treaty as an individual, government, publicly traded company, or pension or nonprofit, provided that such resident would be entitled to a treaty rate that is at least as low as the rate being claimed if such resident had received the income directly; or (ii) a resident of the same contracting state as the company claiming benefits that is entitled to the benefits of the treaty as an individual, government, publicly traded company, or pension or nonprofit.

Although introducing this derivative benefits test may be seen as taxpayer-favorable, the proposal includes elements that are less favorable than similar derivative benefits provisions in existing U.S. tax treaties. For example, the proposal imposes requirements on intermediate owners when a company seeks to qualify under the derivative benefits test. Moreover, the base erosion test excludes several types of otherwise permissible deductions, including payments to recipients benefiting from a special tax regime.

The proposal also inserts a base erosion test into the "subsidiary of a publicly traded company" test. Finally, the proposal would eliminate an application of the active trade or business test for pure holding or financing companies, even if they are related to companies having substantial in-country activities. The 2006 Model Treaty did not include this restriction on attribution. A footnote in the proposal explains that the derivative benefits test is the more appropriate standard for determining whether a holding company or financing entity qualifies for treaty benefits.

Subsequent Changes in Law

The proposal would introduce a new article to the Model Treaty providing that treaty provisions with respect to dividends, interest, royalties, and other income may cease to have effect upon six-months' prior notice from either contracting state if, after the treaty is signed, (i) the general rate of company tax applicable in either contracting state falls below 15 percent with respect to substantially all of the income of companies resident in the contracting state; or (ii) either contracting state provides an exemption from taxation to resident companies for substantially all foreign-source income.

This proposed change could preempt a possible response by certain jurisdictions that would otherwise consider lowering their statutory tax rates if they are forced to terminate existing preferential tax regimes that provide for low effective tax rates.

Conclusion

These proposed changes to the Model Treaty represent significant departures from prior Treasury treaty policy. They would not, however, immediately affect taxpayers. Even if Treasury issues a revised Model Treaty by its targeted date at the end of 2015, it could be some time before any version of these proposals is implemented in a tax treaty or protocol. In particular, the proposed changes with respect to special tax regimes and exempt permanent establishments would target certain tax planning strategies under existing U.S. tax treaties. Such implementation would require a time-consuming renegotiation of such treaties unless a multilateral instrument to modify bilateral tax treaties were agreed to by multiple countries at a single time, the feasibility of which is being explored by the OECD/G20 (Action 15 of the BEPS Project).

As noted earlier, Treasury has requested public comment on the proposed changes. In light of Treasury's revised Model Treaty target date and the ongoing OECD/G20 BEPS Project, comments to the proposed changes should be made soon. Although not drafted as a separate proposal, the press release accompanying the proposed changes indicates that Treasury also intends to include a new article in the Model Treaty requiring disputes between tax authorities to be resolved through mandatory binding arbitration.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent to our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Raymond J. Wiacek
Washington
+1.202.879.3908
rjwiacek@jonesday.com

Joseph A. Goldman
Washington
+1.202.879.5437
jagoldman@jonesday.com

Karl L. Kellar
Washington
+1.202.879.3824
klkellar@jonesday.com

Lodewijk Berger
Amsterdam
+31.20.305.4218
lberger@jonesday.com

Patrick J. Browne, Jr.
Washington
+1.202.879.5457
pbrownejr@jonesday.com