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Treasury Proposes Significant Changes to U.S. Model Tax Treaty

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

The proposals were introduced at a May 20 meeting of the District of Columbia Bar's Taxation Section. Danielle Rolfes, Treasury's International Tax Counsel, 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 Treasury 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, which are discussed below, differs from past revisions of the U.S. Model in two ways. First, the changes have been released as drafts, with Treasury seeking public comment on the new rules. Second, past releases have been of the entire U.S. Model as opposed to this piecemeal approach. Treasury has indicated its intention to release the completely revised U.S. 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 U.S. Model.

I. Exempt Permanent Establishments

A typical tax avoidance strategy involves a treaty-eligible foreign company setting up a Permanent Establishment (PE) in a third country that imposes little or no tax on the PE's income. This strategy also requires that the company's country of residence refrain from taxing the income earned by the PE, 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 PE earns U.S. source income that is subject to little or no U.S. tax under the treaty between the U.S. 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 PE is located. The PE need not be located in a third country; the strategy can work equally well if the PE is located in the country of source. For example, a Luxembourg PE located in the United States that is not engaging in a U.S. trade or business will be subject neither to Luxembourg tax (because of its statutory exemption system) nor to U.S. tax (because there is no U.S. trade or business).

A proposed paragraph 7 of Article 1 is intended to stymie this scheme. The paragraph states that when: (1) a resident derives income from the other state; and (2) the residence state's domestic law attributes that income to a PE located outside the company's country of residence, then the treaty benefits that would ordinarily apply are inapplicable if: (a) the PE'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 (b) the state in which the PE is situated does not have a comprehensive income tax treaty with the residence state (unless the residence state includes the PE's income in its tax base, in which case this prong does not apply).

II. Expatriated Entities

These 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 ten 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). Very generally, 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."

III. Special Tax Regimes

These draft paragraphs generally provide that if interest, royalties, or "other income": (1) is paid between related parties; and (2) the recipient is "subject to a special tax regime" in its country of residence with respect to that item of income, then 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 (l) 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." Those 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 Treasury, no current U.S. 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 May 20 meeting, Rolfes stated that Treasury 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."

IV. Limitation on Benefits Article

The Limitation on Benefits (LOB) article has also been substantially revised. Probably 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 U.S. tax) or the other treaty country (if benefits are being claimed against the other country); for purposes of gauging an entity's entitlement to treaty benefits, an LOB 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 U.S. 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 U.S. Model.

In the case of putative equivalent beneficiaries who 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 LOB Article include: (1) 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; (2) applying the base erosion test to the company's consolidated group; (3) imposing a "special tax regime" exception to the acceptable payments rule under the base erosion test; and (4) changing the definition of "gross income" under the base erosion test so as to exclude exempt dividend income.

V. Limitation on Benefits Article

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 percent 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 (detailed in (3), 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 May 20 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 aggressively lower its domestic tax rates in an effort to attract mobile income.

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

For more information concerning this Alert, please contact a member of Caplin & Drysdale's International Tax/Transfer Pricing Group.

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