

MEMO# 29027

May 28, 2015

Treasury Department Releases Proposed Model Tax Treaty Revisions

[29027]

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TO: TAX MEMBERS No. 13-15

INTERNATIONAL MEMBERS No. 18-15

ICI GLOBAL TAX COMMITTEE No. 17-15 RE: TREASURY DEPARTMENT RELEASES PROPOSED MODEL TAX TREATY REVISIONS

The U.S. Department of the Treasury has released [proposed revisions](#) to the U.S. Model Tax Convention. The new draft provisions are intended to address concerns regarding base erosion and profit shifting (“BEPS”) by multinational firms, including corporate inversions. The Treasury Department is accepting comments on the proposed revisions.

The Treasury Department has proposed the following changes:

[Proposed Treaty Rule Addressing So-Called “Exempt Permanent Establishments”](#). The Treasury Department is proposing to add a new paragraph to Article 1 (General Scope) of the model tax treaty. It is intended to deal with the treatment of income in situations where a resident of a Contracting State (“Country A”) earns income from the other Contracting State (“Country B”) through a permanent establishment (“PE”) situated outside of Country A, and the resident is subject to a significantly lower tax rate with respect to the income attributable to the permanent establishment.

The new paragraph would provide that when an enterprise of Country A derives income from Country B that is treated as attributable to a PE situated outside Country A, the tax benefits that otherwise would apply under the tax treaty would not apply to that income if either (a) the profits of the PE are subject to a combined aggregate effective rate of tax in Country A and the state in which the PE is situated of less than 60 percent of the general rate of company tax applicable in that Country A, or (b) the state in which the PE is situated does not have a comprehensive income tax treaty in force with the Contracting State from which the benefits of the treaty are being claimed. Any income to which this new paragraph would apply would be subject to tax under the domestic law of the Contracting State from which benefits are being claimed, notwithstanding any other provision of the treaty.

[Proposed Treaty Rules Addressing Payments by “Expatriated Entities”](#). This proposal would add several new paragraphs that are intended to reduce the tax benefits achieved through

corporate inversions by imposing full withholding taxes on dividends, interest, royalties and other income paid by “expatriated entities,” as defined in section 7874(a)(2)(A) of the Internal Revenue Code. In general, the provisions would permit the U.S., notwithstanding the other provisions of the tax treaty, to tax such payments by an expatriated entity under U.S. tax law for a period of ten years, beginning on the date on which the acquisition of the domestic entity (as defined in section 7874(a)(2)(A)(i)) is completed.

[Proposed Treaty Rules Addressing “Special Tax Regimes”](#). This proposal would add a new Article 3 to the model treaty, defining the term “special tax regime” with respect to an item of income. It would mean any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit, with certain exclusions. In the case of interest, the term would include any legislation, regulation or administrative practice that provides notional deductions with respect to equity. The term would not apply if the application of such legislation, regulation or administrative practice does not disproportionately benefit interest, royalties or other income (i.e., it is generally applicable to income and available across industries).

Articles 11 (Interest), 12 (Royalties), and 21 (Other Income) would deny treaty benefits to items of income if the resident of the other Contracting State beneficially owning the interest, royalties, or other income, is related to the payor of such income and benefits from a special tax regime in its residence State with respect to the particular category of income. The Contracting State in which the item of income arises thus would retain its right to tax the income under its domestic law if the resident benefits from a regime in the residence State with respect to the item of income that results in low or no taxation.

[Proposed Limitation on Benefits Article](#). Treasury is proposing amendments to Article 22 (Limitation on Benefits) of the model treaty. Specifically, the changes would add a base erosion prong to the “subsidiary of a publicly traded company” test under paragraph 2. Under this change, a company would not be a qualified person if 50 percent or more of the company’s gross income, and 50 percent or more of the tested group’s gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by the treaty in the company’s Contracting State of residence (but not including arm’s length payments in the ordinary course of business for services or tangible property), either to persons that are not residents of either Contracting State entitled to the benefits of the treaty under Article 22, or to persons that meet this requirement but that benefit from a “special tax regime” in their Contracting State of residence with respect to the deductible payment.

The proposed changes also would add a “derivative benefits” test in paragraph 4 of Article 22. Pursuant to this provision, a company that is a resident of a Contracting State would be entitled to a benefit under the treaty, regardless of whether the resident is a qualified person, if:

- (a) at least 95 percent of the aggregate vote 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” (as newly defined in the Article in paragraph 6(e)); and
- (b) 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 purposes of the taxes covered by the treaty in the company’s Contracting State of residence, 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.

This rule is a taxpayer-favorable rule that is intended to provide another method for qualifying for treaty benefits, recognizing that multinational companies may have operations spread among many subsidiaries around the world.

[Proposed Article Addressing Subsequent Changes in Law](#). The Treasury Department is proposing a new Article 28 (Subsequent Changes in Law), which would address situations in which subsequent changes to the domestic laws of one or both of the Contracting States could increase the risk that the tax treaty could give rise to unintended instances of low or no taxation. Such changes also could affect the intended allocation of taxing rights originally negotiated between the two States. The new Article 28 would provide that if, at any time after the signing of the tax treaty, either Contracting State enacts certain changes to domestic law that could implicate the terms of the treaty, certain benefits of the treaty would no longer have effect. If so, the Contracting States would discuss amending the treaty to restore an appropriate allocation of taxing rights.

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