Treaties

By Michael J. Miller

Accessing U.S. Income Tax Treaties: Current Trends in the Limitation on Benefits Article

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As U.S. treaty policy evolves, the Treasury is constantly considering, and reconsidering, what requirements should be satisfied before a resident of a foreign country should be allowed to enjoy the benefits of a U.S. income tax treaty. In recent years, the Limitation on Benefits (LOB) articles have become more restrictive in some respects and more permissive in others. Some of these trends are discussed below.

Background

A person generally will be entitled to the benefits of an income tax treaty between the United States and a foreign country (each typically referred to as a "State" or a "Contracting State") only if, among other requirements, such person (1) is a resident of a Contracting State within the meaning of the treaty, and (2) satisfies the requirements of the LOB article of the treaty.[1]

The LOB article is premised upon the view that a resident of a Contracting State must have some further connection to that country in order to benefit from that Contracting State's income tax treaty with the United States. Thus, the LOB article limits the ability of third-country residents to engage in "treaty shopping" by establishing legal entities in either the United States or a foreign country to obtain the benefits of a U.S. income tax treaty.

Each LOB article sets forth a number of objective tests. A resident of a Contracting State that satisfies any of those objective tests generally is entitled to the ben-

Michael J. Miller is a Partner in Roberts & Holland LLP, New York, New York. Mr. Miller is a co-author of the BNA Portfolio on U.S. Income Tax Treaties—the Limitation on Benefits Article.

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efits of the applicable income tax treaty, regardless of whether such resident was formed or availed of for a tax-avoidance purpose.[2] The common objective tests include (1) a public company test, (2) an ownership and base erosion test, (3) an active trade or business test, and (4) in some cases, a derivative benefits test. A resident of a Contracting State that fails to satisfy any of the objective tests may be granted treaty benefits by the applicable competent authority.

Discussion

The specific requirements imposed under each of the objective tests set forth above vary, sometimes significantly, from treaty to treaty. To a degree, this reflects the differing objectives of different treaty partners and the fact that each treaty is the unique product of various compromises and trade-offs. Nevertheless, certain discernable trends clearly appear to indicate an evolution in U.S. treaty policy. Some of these trends are discussed below.

Stricter Public Company Test

Pursuant to the "public company test," a corporation that satisfies certain public trading requirements and a base erosion test generally qualifies for treaty benefits. Under Article 22(2)(c)(i) of the 1996 U.S. Model Treaty, the public company test is satisfied if "all the shares in the class or classes representing more than 50 percent of the voting power and value of the company are regularly traded on a recognized stock exchange" in either Contracting State.

Notably, this provision does not impose any "same country" listing or trading requirement. Thus, in the case of any treaty comparable to the 1996 U.S. Model Treaty, a resident of one Contracting State can satisfy the public company test solely through trading on a recognized stock exchange in the other Contracting State. Moreover, the corporation need not have any connection to its own Contracting State other than such connection as is required to make it a resident of that Contracting State.

The public company test of the 2001 U.S.-U.K. Income Tax Treaty is similar and, in fact, a bit more lenient. Pursuant to Article 23(2)(c)(i), a corporate resident of either Contracting State satisfies the public company test if its principal class of shares is (1) listed on a recognized stock exchange in either the United States or the United Kingdom, and (2) regularly traded on one or more recognized stock exchanges around the world.[3] Thus, not only is there no same country listing or trading requirement, but the trading requirement can be satisfied through regular trading on a third-country exchange.

A great many LOB articles include tests similar to the tests found in the 1996 U.S. Model Treaty or the 2001 U.S.-U.K. Income Tax Treaty. As reflected in these treaties, the Treasury Department has historically been relatively unconcerned about the risk that a public company might be used for treaty-shopping purposes. In the last several years, however, the public company test appears to have tightened considerably.

The public company test in the 2004 Protocol to the 1992 U.S.-Netherlands Income Tax Treaty (the "2004 Dutch Protocol") broke ranks with prior LOB articles by requiring a public company to have a meaningful connection to the Contracting State of which it is a resident.

As amended by the 2004 Dutch Protocol, the public company test of Article 26(2)(c)(i) is satisfied only if:

- the company's principal class of shares (and any disproportionate class of shares) is (1) listed on a recognized stock exchange located in either State, and (2) regularly traded on one or more recognized stock exchanges worldwide; and
- the company has a "substantial presence" in its State of residence.

A company will be considered to have the requisite substantial presence in its State of residence if it satisfies either a two-part trading test or a management and control test.[4]

The two-part trading test will be satisfied if the aggregate volume of trading in the company's stock on recognized stock exchanges in its "primary economic zone" is (1) not less than the aggregate volume of trading in such company's stock on recognized stock exchanges located in the State of which it is not a resident, and (2) not less than 10 percent of total worldwide trading in such company's stock.[5]

The management and control test will be satisfied if the company's "primary place of management and control" is in its State of residence.[6] A company's primary place of management and control will be considered to be located in its State or residence "only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that State than in any other state and the staffs conduct more of the day-to-day activities necessary for preparing and making

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those decisions in that State than in any other state."[7] Thus, for example, merely jetting off for Board meetings a few times a year will not cut it.[8]

At least equally noteworthy is the public company test included in the 2004 Protocol to the 1984 U.S.-Barbados Income Tax Treaty (the "2004 Barbados Protocol"). Under the 2004 Barbados Protocol, a corporation can satisfy the public company test only if its principal class of shares is:

- listed on a recognized stock exchange located in the Contracting State of which the company is a resident;
- primarily traded on a recognized stock exchange located in the Contracting State of which the company is a resident or, in the case of a company that is resident in Barbados, primarily traded on the Barbados Stock Exchange, the Jamaica Stock Exchange or the Trinidad Stock Exchange; and
- regularly traded on one or more recognized stock exchanges. For purposes of these tests, a "recognized stock exchange" is limited to certain exchanges in the United States, the Jamaica Stock Exchange, the Trinidad Stock Exchange, and any other stock exchange agreed upon by the competent authorities of the Contracting States.[9]

Therefore, among other requirements, a Barbados corporation that wishes to qualify under the public company test must be listed on the Barbados exchange and must be primarily traded in Barbados, Jamaica or Trinidad. These strict listing and trading requirements (which few companies are likely to satisfy) apply even if the Barbados corporation is managed and controlled from Barbados.

The harshness of this public company test appears to be driven not only by tax treaty policy but also by certain considerations unique to Barbados. A number of publicly traded domestic companies engaged in very well publicized inversion transactions, established (or purported to establish) residency in Barbados, and used the Barbados treaty to minimize U.S. tax on their domestic business operations.[10] The 2004 Barbados Protocol apparently was designed to limit the tax benefits of such inversion transactions by making it virtually impossible for inverted public companies to claim such treaty benefits.[11]

A number of more recent LOB articles pull back a bit from the high water mark set in the 2004 Barbados Protocol and more or less resemble the provision of the 2004 Dutch Protocol. For example, under the 2005 Protocol to the 1994 U.S.-Sweden Income Tax Treaty (the "2005 Swedish Protocol"), a company will satisfy the public company test if its principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges worldwide and the company satisfies either a trading test or a management and control test.[12]

The trading test will be satisfied if the company's principal class of shares is primarily traded on a recognized stock exchange located in its State of residence or any other recognized stock exchange within certain qualifying jurisdictions.[13] The 2005 Swedish Protocol does not use the term "primary economic zone," as used in the 2004 Dutch Protocol, but the concept appears to be identical.[14]

The management and control test is similar to that of the 2004 Dutch Protocol. Thus, the company's primary place of management and control must be located in its Contracting State of residence; and this is essentially the primary location where executive officers and senior management exercise day-to-day responsibility for making strategic, financial and operational policy decisions for the company (and its subsidiaries).[15]

> A company will be considered to have the requisite substantial presence in its State of residence if it satisfies either a two-part trading test or a management and control test.

More recently, the 2006 Protocol to the 1999 U.S.-Denmark Income Tax Treaty (the "2006 Denmark Protocol"), 2006 Protocol to the 1989 U.S.-Germany Income Tax Treaty (the "2006 German Protocol"), and 2006 U.S.-Belgium Income Tax Treaty all include similar provisions.[16] In the case of the 2006 German Protocol, however, the trading test can only be satisfied through trading on a German exchange.[17]

The 2006 U.S. Model Treaty has a public company test that is substantially similar to the test set forth in the German Protocol.[18] Thus, under any treaty corresponding to the 2006 U.S. Model Treaty, a public company residing in a Contracting State could satisfy the trading requirement only if its principal class of shares is primarily traded on one or more recognized stock exchanges in the *same* Contracting State.[19]

Presumably, the formulation set forth in the model is only a starting point for treaty negotiations. Sub-

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ject to the overall give-and-take of the negotiation process, it seems likely that the Treasury Department will continue to consider provisions that allow a resident of the other Contracting State to satisfy the trading requirement through trading within its primary economic zone. This would appear more likely where such Contracting State is fairly small and lacks a particularly robust exchange.

Stricter Ownership and Base Erosion Test

An entity that is a resident of a Contracting State generally qualifies for treaty benefits under the "ownership and base erosion test" if (1) a specified percentage of beneficial interests in such entity is owned by certain residents of the Contracting States, and (2) it erodes no more than a specified percentage of its gross income through certain deductible payments to certain persons.

Under Article 22(2)(f) of the 1996 U.S. Model Treaty, an entity generally satisfies the ownership and base erosion test if (1) on at least half the days of the taxable year certain residents of either Contracting State that are entitled to treaty benefits under certain provisions of the LOB article own, directly or indirectly, at least 50 percent of each class of shares or other beneficial interests in the entity,[20] and (2) less than 50 percent of the entity's gross income for the taxable year is paid or accrued, directly or indirectly, to third-country residents in the form of payments that are deductible for income tax purposes in the entity's State of residence.[21]

Subject to certain variations, a great many U.S. income tax treaties have an LOB article including a fairly similar ownership and base erosion test. Under any of these treaties, a foreign corporation can satisfy the ownership and base erosion test even if all of its equity is owned by (and all of its gross income is eroded through deductible payments to) residents of the United States. Indeed, such generous provisions are particularly helpful when U.S. persons need a "treaty holding company" in order to create qualified dividend income.[22]

In the last few years, however, the United States has signed a number of treaties and protocols that take a less liberal approach. Under the 2004 Barbados Protocol, for example, an entity that is a resident of a Contracting State can satisfy the ownership and base erosion test only if (1) on at least half the days of the tax year, certain qualified residents of the *same* Contracting State own, directly or indirectly, more than 50 percent of the shares of other beneficial interests in the entity,[23] and (2) less than 50 percent of the entity's gross income is paid or accrued, directly or indirectly, to persons who are not qualifying residents of the *same* Contracting State in the form of payments that are deductible under the tax laws of such Contracting State (excluding arm's-length payments in the ordinary course of business for services or tangible property).[24]

As discussed above, the 2004 Barbados Protocol was in significant part a reaction to certain very public inversion transactions and, therefore, is a bit of a special case. Accordingly, the strict test adopted therein to prevent abuse of the Barbados treaty may not itself reflect a change in U.S. treaty policy. Indeed, as of the date this article was written, it does not appear that any subsequent treaty characterizes all payments by a resident of one Contracting State to residents of the *other* Contracting State as base eroding payments.[25]

Since 2004, however, a slew of new LOB articles permit a resident of a Contracting State to satisfy the ownership prong of the ownership and base erosion test only through ownership by qualified residents of the *same* Contracting State. Thus, for example, a foreign corporation cannot use U.S. ownership to satisfy the ownership prong of the ownership and base erosion test under the 2005 Swedish Protocol, 2006 German Protocol, 2006 Denmark Protocol or 2006 U.S.-Belgium Income Tax Treaty.[26]

Indeed, the 2006 U.S. Model Income Tax Treaty imposes a "same country" requirement for purposes of the ownership prong of the ownership and base erosion test.[27] In contrast with other portions of the model treaty that may be characterized as generally representing merely a "starting point" for the U.S. negotiation process, it appears that this requirement will now be a standard (if not universal) feature of U.S. income tax treaties.

More Prevalent Derivative Benefits Test

Under some U.S. income tax treaties, a company that does not otherwise satisfy any of the LOB tests may nevertheless qualify for treaty benefits, pursuant to a "derivative benefits test," if, among other requirements, a specified percentage (typically 95 percent) of its shares is owned by seven or fewer "equivalent beneficiaries"[28] and a base erosion test is satisfied.[29]

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For example, Article 23(3) of the 2001 U.S.-U.K. Income Tax Treaty provides as follows:

> 3. Notwithstanding that a company that is a resident of a Contracting State may not be a qualified person, it shall be entitled to the benefits of this Convention otherwise accorded to residents of a Contracting State with respect to an item of income, profit or gain if it satisfies any other specified conditions for the obtaining of such benefits and:
>
> a) shares representing at least 95 percent of the aggregate voting power and value of the company are owned, directly or indirectly, by seven or fewer persons who are equivalent beneficiaries; and
>
> b) less than 50 percent of the company's gross income for the taxable or chargeable period in which the item of income, profit or gain arises is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments that are deductible for the purposes of the taxes covered by this Convention in the State of which the company is a resident (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank, provided that where such a bank is not a resident of a Contracting State such payment is attributable to a permanent establishment of that bank located in one of the Contracting States).

Historically, relatively few LOB articles have included a derivative benefits test. More recently, however, it appears that derivative benefits tests are far more common, but only in the case of treaties with countries within the EU. For example, such a test is included in the 2004 Dutch Protocol, 2005 Swedish Protocol, 2006 German Protocol, 2006 Denmark Protocol, and 2006 U.S.-Belgium Income Tax Treaty.[30]

Under the derivative benefits test set forth in all of these LOB articles, a company not otherwise entitled to benefits will qualify if (1) shares possessing at least 95 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) are owned by seven or fewer "equivalent beneficiaries," and (2) the company satisfies a base erosion test.

Under all of these LOB articles, an "equivalent beneficiary" generally means any person that:

- is a resident of a member state of the EU, any state of the EEA, a party to NAFTA, or, in some cases, Switzerland (each, a "Qualifying Country");
- is entitled to the benefits of a comprehensive income tax treaty between such Qualifying Country and the Contracting State from which treaty benefits are claimed and satisfies certain LOB requirements (even if that treaty has no LOB article); and
- in the case of dividends, interest, royalties and possibly certain other items, would be entitled, under the treaty between the Qualifying Country and the Contracting State in which the income arises, to a rate of tax with respect to the particular class of income or the particular item for which benefits are claimed that is "at least as low as" the rate provided for under the treaty between the Contracting States.[31]

Notwithstanding the prevalence of derivative benefits provisions in U.S. income treaties with EU countries, it presently appears unlikely that this approach will be extended outside the EU. Indeed, the European focus of the provision is particularly emphatic in light of the fact that, apart from the inclusion of parties to NAFTA, all equivalent beneficiaries must be European.

From a policy perspective, it would seem appropriate to include a derivative benefits provision in all U.S. income tax treaties, but clearly we haven't gotten there yet. The policy arguments notwithstanding, the Treasury Department may consider application of the derivative benefits to be administratively burdensome.[32] Unsurprisingly, the 2006 U.S. Model Treaty does not contain a derivative benefits provision.

Conclusion

Every treaty is different, but recent trends clearly indicate that concerns about treaty abuse have moved U.S. treaty policy toward stricter ownership requirements for companies seeking to access U.S. income tax treaties under the public company test or the ownership and base erosion test. These trends may be of particular interest to taxpayers crafting their cross-border structures on the basis of old LOB provisions that may soon be updated. Tax planners that are not aware of these trends, and thus fail to plan accordingly, may do their clients a disservice.

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ENDNOTES

[1] There are a few older U.S. income tax treaties that do not contain LOB articles, including most notably the 1979 U.S.-Hungary Income Tax Treaty. For a detailed discussion of planning opportunities involving older treaties without LOB articles, *see* Jeffrey L. Rubinger, *Tax Planning With U.S. Income Tax Treaties Without LOB Provisions*, 36 TAX MGMT. INT'L J. No. 3 (Mar. 9, 2007).

[2] Note, however, that, in addition to the requirements set forth in the objective tests, some U.S. income tax treaties contain "backstop provisions" designed to put the brakes on treaty benefits in certain potentially abusive situations. For example, pursuant to provisions addressing so-called "triangular arrangements," a resident of one Contracting State may not be entitled to treaty benefits with respect to certain income arising in the other Contracting State if such income is attributable to a permanent establishment in a third state and if an income tax treaty between the other Contracting State and the third state exempts such income from tax in the other Contracting State.

[3] For this purpose, Article 23(7) defines the term "recognized stock exchange" to include major stock exchanges in Ireland, Switzerland, Amsterdam, Brussels, Frankfurt, Hamburg, Johannesburg, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto and Vienna.

[4] Art. 26(8)(d).

[5] Art. 26(8)(d)(i). For this purpose, the primary economic zone of the Netherlands includes the member states of the EU and the EEA; the primary economic zone of the United States includes the states party to NAFTA. Art. 26(8)(e)(ii).

[6] Art. 26(8)(d)(ii).

[7] Art. 26(8)(e)(iii).

[8] As noted in the Technical Explanation: "This test should be distinguished from the 'place of effective management' test which is used in the OECD Model and by many other countries to establish residence. In some cases, the place of effective management test has been interpreted to mean the place where the board of directors meets."

[9] *See* 1984 U.S.-Barbados Income Tax Treaty, as amended by 2004 Barbados Protocol, Art. 22(1)(c)(i). To date, the competent authorities have not agreed upon any additional exchanges.

[10] Section 7874 of the Internal Revenue Code of 1986, as amended (the "Code"), which includes a number of "anti-inversion" rules, was not enacted until several months after the 2004 Barbados Protocol was signed.

[11] Fans of the 2004 Barbados Protocol will also be aware that it added a significant "backstop provision" to the LOB article. Pursuant to Article 22(6) of the 1984 U.S.-Barbados Income Tax Treaty, as amended by the 2004 Barbados Protocol, the benefits of the dividend, interest, and royalty articles are denied to any person that is entitled to income tax benefits under the provisions of a "special tax regime" such as the International Business Companies Act. One of the reasons why Barbados has been a popular destination for inverted corporations is the availability of relatively minimal taxation under the IBC regime. Under the stricter LOB article, a Barbados company that managed to satisfy the rigorous public company test would nevertheless be denied the most desirable treaty benefits (*i.e.*, a reduced rate of withholding tax on certain payments from U.S. affiliates) it were an IBC. For a further discussion of the 2004 Barbados Protocol, *see* Michael J. Miller, *Pending Protocol Will Prevent Inverted Corporations From Accessing the Barbados Treaty*, 33 TAX MGMT. INT'L J., at 643 (Nov. 12, 2004).

[12] 1994 U.S.-Sweden Income Tax Treaty, as amended by 2005 Swedish Protocol, Art. 17(2)(c)(i).

[13] Art. 17(2)(c)(i).

[14] In the case of a Swedish company, the qualifying jurisdictions include the member states of the EU and the EEA, and also Switzerland. In the case of a U.S. company, the other specified jurisdictions include any state that is a party to NAFTA.

[15] Art. 17(7)(f).

[16] The 2006 Denmark Protocol, 2006 German Protocol and 2006 U.S.-Belgium Income Tax Treaty have not yet been ratified.

[17] *See* 1989 U.S.-Germany Income Tax Treaty, as modified by 2006 German Protocol, Art. 28(2)(c)(aa). In the case of the Danish and Belgian provisions, Swiss trading does not qualify. *See* 1999 U.S.-Denmark Income Tax Treaty, as modified by 2006 Denmark Protocol, Art. 22(2)(c)(i) and 2006 U.S.-Belgium Income Tax Treaty, Art. 21(2)(c)(i).

[18] Art. 22(2)(c)(i).

[19] Alternatively, the public company could qualify by satisfying the management and control test.

[20] In addition, each intermediate owner must qualify for the benefits of the treaty under certain provisions of the LOB article.

[21] Payments that are attributable to a permanent establishment situated in either State are also disregarded.

[22] Pursuant to Code Sec. 1(h)(11), a dividend from a foreign corporation can constitute qualified dividend income if, among other

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Endnotes

requirements, the foreign corporation is entitled to the benefits of a U.S. income tax treaty, including satisfaction of any LOB requirements. Thus, where income is earned through a foreign operating company that is not entitled to the benefits of a U.S. income tax treaty, it may be desirable to form a foreign holding company that is entitled to treaty benefits. Dividends from the holding company may constitute qualified dividend income, even though dividends from the operating company would not. Depending upon the availability and scope of the participation exemption in the country in which the holding company is formed, and certain other considerations, the use of the holding company may not result in a significant amount of foreign tax. For a discussion of such structures, *see* Howard J. Levine & Michael J. Miller, Anti-Deferral and Anti-Tax Avoidance, *Accessing the 15-Percent Maximum Rate for Dividends from Qualified Foreign Corporations: Uncertainties and Opportunities*, J. Tax'n Global Trans., Winter 2004, at 5.

[23] In the case of indirect ownership, each intermediate owner must be a resident of such Contracting State.

[24] U.S.-Barbados Income Tax Treaty, as amended by 2004 Barbados Protocol, Art. 22(1)(d).

[25] Note, however, that a payment to a resident of either Contracting State *will* be treated as a base eroding payment unless such resident is entitled to treaty benefits under certain specified provisions of the LOB article.

[26] *See* 1994 U.S.-Sweden Income Tax Treaty, as modified by 2005 Swedish Protocol, Art. 17(2)(e)(i); 1989 U.S.-Germany Income Tax Treaty, as modified by 2006 German Protocol, Art.28(2)(f)(aa); 1999 U.S.-Denmark Income Tax Treaty, as modified by 2006 Denmark Protocol, Art. 22(2)(f)(i); and 2006 U.S.-Belgium Income Tax Treaty, Art. 21(2)(e)(i).

[27] Art. 22(2)(e)(ii).

[28] Not every treaty uses this term.

[29] Some derivative benefits provisions also require some amount of ownership by residents of a Contracting State. *See* 1994 U.S.-Mexico Income Tax Treaty, Art. 17(1)(g).

[30] *See* 1992 U.S.-Netherlands Income Tax Treaty, as modified by 2004 Dutch Protocol, Art.26(3); 1994 U.S.-Sweden Income Tax Treaty, as modified by 2005 Swedish Protocol, Art. 17(3); 1989 U.S.-Germany Income Tax Treaty, as modified by 2006 German Protocol, Art.28(3); 1999 U.S.-Denmark Income Tax Treaty, as modified by 2006 Denmark Protocol, Art. 22(3); and 2006 U.S.-Belgium Income Tax Treaty, Art. 21(3).

[31] In the case of income beneficially owned by a U.S. company and arising in the other Contracting State, however, the derivative benefits provisions typically deems the "as low as" requirement to be satisfied if the equivalent beneficiary is a resident of a member state of the EU.

[32] The requirement in most derivative benefits provisions that the requisite stock ownership be held by no more than *seven* equivalent beneficiaries appears to confirm the apparent preoccupation with minimizing the burdens of administration.

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