early all U.S. income tax treaties include a “Limitation on Benefits” (“LOB”) Article that generally requires a resident of a foreign country that is party to a U.S. income tax treaty (a “treaty country”) to have one of certain specified connections to such country (or possibly the United States or certain other treaty countries) in order to access such treaty. The LOB Article is intended to limit the ability of third-country residents to engage in “treaty shopping” by establishing legal entities in treaty countries with which they otherwise have no meaningful connection.

The LOB Article includes a number of objective tests. 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 treaty country that satisfies any of the applicable objective tests is entitled to the benefits of the applicable U.S. income tax treaty, and no inquiry is made into any possible treaty shopping purpose of the entity or its owners. Technical issues can arise regarding the application of the objective tests, but they are mercifully straightforward in the sense that they do not require us to divine any person’s subjective motivations.

If none of the objective tests are met, life gets more complicated. Most if not all LOB Articles include an “escape hatch” pursuant to which the competent authority of one “Contracting State” may choose to grant treaty benefits to a resident of the other Contracting State that does not meet any of the objective LOB tests.

For example, Article 22(6) of the U.S.-Switzerland Income Tax Treaty (the “Swiss Treaty”) provides that “A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income arises so determines after consultation with the competent authority of the other Contracting State.”
This provision itself does not prescribe the standard to be applied by the competent authority, but the Technical Explanation to the Swiss Treaty (the “Swiss TE”) provides guidance as follows:

Paragraph 6 provides that a resident of one of the Contracting States that is not otherwise entitled to the benefit of the Convention may be granted benefits under the Convention by the competent authority of the other Contracting State. This discretionary provision is included in recognition of the fact that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country resident in an enterprise of a Contracting State is warranted by sound business practice or long-standing business structures and does not necessarily indicate a motive of attempting to derive unintended Convention benefits.

The competent authority of a State will base a determination under this paragraph on whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person’s operations, has or had as one of its principal purposes the obtaining of benefits under the Convention. Thus, persons that establish operations in one of the States with a principal purpose of obtaining the benefit of the Convention ordinarily will not be granted relief under paragraph 6. [Emphasis added.]

Thus, the Swiss TE establishes that the test for discretionary treaty benefits under the Swiss Treaty is whether the entity seeking treaty benefits has been established, acquired, or maintained, or whether its operations are conducted, with “a principal purpose” of obtaining treaty benefits.

Under other U.S. income tax treaties, this “principal purpose test” (sometimes referred to as a “PPT”) is express within the LOB Article itself. For example, Article 23(6) of the U.S.-U.K. Income Tax Treaty (the “U.K. Treaty”) provides as follows:

A resident of a Contracting State that is neither a qualified person nor entitled to benefits with respect to an item of income, profit or gain under paragraph 3 or 4 of this Article shall, nevertheless, be granted benefits of this Convention with respect to such item if the competent authority of the other Contracting State determines that the establishment, acquisition or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the other Contracting State shall consult with the competent authority of the first-mentioned State before refusing to grant benefits of this Convention under this paragraph. [Emphasis added.]

It should be emphasized that, in order for an entity to be disqualified under the PPT, it is not necessary that the entity be organized or maintained with “the” principal purpose of securing treaty benefits; rather, the disqualification applies whenever “one of” the principal purposes (i.e., “a” principal purpose) is obtaining treaty benefits. Given the United States’ aversion to treaty shopping, the desire to disqualified applicants who are not “pure of heart” is understandable. However, the level of purity required by the PPT, under which even one “bad” purpose among many precludes relief, is excessive.

For example, suppose a promotor within the European Union wishes to organize a fund, in the form of a corporation or other limited liability entity, to make portfolio investments in U.S. stocks for the benefit of individuals and entities that are largely EU residents entitled to the benefits of various U.S. income tax treaties.

The promotor could establish the fund in the Cayman Islands, but then the dividends would unquestionably be subject to U.S. withholding tax at a 30% rate. This would be foolish, if there is a possibility of forming the fund in an EU country and obtaining a reduced U.S. withholding tax rate, so let’s suppose that the promoter quite rationally deems the Cayman Islands to be a non-starter. Suppose further that, upon consideration of numerous EU options, the promotor decides upon a Luxembourg company. The choice of a Luxembourg company instead of some other EU company is based entirely on business (and EU tax) considerations.

From a business perspective, it seems reasonable for the EU promotor to consider the fund in the EU; and, as noted above the choice of a Luxembourg company, as opposed to all of the other EU options, had nothing whatsoever to do with U.S. taxes. Unfortunately, however, the establishment of the fund in Luxembourg would likely be viewed as tainted by the threshold decision to seek U.S. treaty benefits by avoiding the Cayman Islands, and thus would likely run afoul of the PPT.

Amusingly, perhaps, there should theoretically be no problem satisfying the PPT if the promotor of the fund was asleep at the wheel and never even thought about U.S. treaty benefits. However, proving a negative can
be quite difficult, and the U.S. competent authority ("USCA") may understandably be skeptical when the promoter claims he never thought about U.S. withholding tax (before then thinking to request discretionary relief).

The example above is illustrative of a major problem with the PPT. In virtually any scenario where a choice is made about where to establish an entity, passing the PPT test will be a tall order. Unless the USCA can be convinced that U.S. treaty benefits were never even considered, which will typically seem implausible, discretionary treaty benefits will typically be denied.

Due in part to uncertainties as to what relief may be available to a taxpayer who is denied discretionary treaty benefits, we have only one case addressing application of the PPT. The PPT under the Swiss Treaty was addressed relatively recently in Starr International Co., Inc. In Starr, the District Court for the District of Columbia considered Starr’s claim that the denial of discretionary benefits under Article 22(6) of the Swiss Treaty (the “Denial”) was arbitrary and should thus be set aside under the Administrative Procedure Act (the “APA”). Before elaborating, a brief description of the factual background seems in order.

Starr was originally incorporated as an insurance company, under the laws of Panama, in 1943. By 1970, it had relocated management and control to Bermuda. In 1970, it swapped its insurance business for stock in AIRCO, which later merged with AIG, and also underwent a reorganization. Pursuant to the reorganization, nonvoting stock possessing virtually all of the economic value of the outstanding stock of Starr was issued to a charitable trust (whose ultimate beneficiary was a New York foundation) and the voting stock that was retained by the shareholders had virtually no economic value. In 1978, when AIRCO merged with AIG, Starr became AIG’s largest shareholder.

In 2004, Starr moved its residence to Ireland. The administrative record includes strong indications that this move was tax motivated, and this seems particularly plausible because the dividends paid by AIG to Starr increased very substantially in 2003. Starr apparently qualified for the benefits of the U.S. income tax treaty with Ireland (the “Irish Treaty”) under one of the objective tests in the Irish LOB Article.

In 2005, Starr began planning for another move, in order to address certain litigation risks (at least as explained by Starr). According to a decision matrix prepared in 2009 that may have reflected Starr’s analysis at the time (the “Matrix”), eleven jurisdictions were considered as possible homes. The Matrix included eleven rows, one for each jurisdiction, and four columns, one for each of four criteria, i.e., local tax, U.S. tax, litigation risk, and charities regulation.

The Matrix characterized the U.S. tax factor in Switzerland as “bad,” presumably reflecting the fact that a reduced rate of dividend withholding tax would not be available absent a discretionary grant of treaty benefits by the USCA. Nevertheless, Starr ultimately chose Switzerland, and the move was complete by the beginning of 2007. During 2007, the year at issue in the case, Starr’s voting stock was owned by twelve individuals, ten of whom were U.S. citizens. There was also certain preferred stock owned by two U.S. individuals.

Starr argued in the first instance that it should qualify for a discretionary grant of treaty benefits, because the LOB Article of the Swiss Treaty was intended solely to deter treaty shopping by third-country residents, and most of Starr’s stock was owned by U.S. persons (e.g., the New York foundation that is the ultimate beneficiary of the charitable trust, and the U.S. individuals who own most of the voting stock).

Alternatively, Starr argued that it could not have had a principal purpose of obtaining the benefits of the Swiss Treaty, because it was already entitled to a reduced rate of U.S. dividend withholding tax under the Irish Treaty, the move to Switzerland could not have resulted in a lower rate of U.S. dividend withholding tax, and moreover the only possible change to Starr’s treaty position is that it could have suffered an increased rate of U.S. dividend withholding tax if the benefits of the Swiss Treaty were denied. Starr also cited the Matrix, which indicated that the U.S. tax situation in Switzerland was less favorable than in Ireland and several of the other jurisdictions that were under consideration.

The USCA was not persuaded by Starr’s arguments and issued a final determination letter on October 13, 2010 (the “Denial Letter”). The Denial Letter explained that, under the circumstances, the USCA could not “conclude that obtaining treaty benefits was not at least one of the principal purposes for moving Starr’s management, and therefore its residency, to Switzerland.” In support of this conclusion, the Denial Letter highlighted the following (paraphrased) four considerations:

- Starr’s original incorporation in Panama and management and control in Bermuda suggest the original structure may have been developed with tax avoidance purpose in mind and/or with a purpose of avoiding the provision of information on Starr’s activities to the IRS.
- Starr’s relocation to Ireland and movement of management out of Bermuda a relatively short time before the receipt of substantial dividends from AIG
further suggests that Starr was seeking to avail itself of the Irish Treaty on those contemplated dividends.

- The transitory nature of Starr’s location in Ireland, which may or may not have been intentionally transitory, and its subsequent movement to Switzerland, further suggests its intention of organizing in a treaty jurisdiction to avail itself of a reduced rate of withholding on U.S. source dividends.

- Starr is largely controlled by U.S. individuals and such control is not in accord with recent development of U.S. policy on acceptable corporate ownership for LOB purposes. 9

Starr objected to the Starr Denial on the ground that none of the four circumstances described in the Denial Letter relates to treaty shopping and thus such circumstances should be irrelevant to the discretionary treaty benefits analysis. 10

With respect to the first three circumstances, relating to Starr’s previous history of organization and residence, Starr apparently argued that, because they predated the move from Ireland to Switzerland, they are irrelevant to the discretionary benefits inquiry. The Court disagreed, noting that “there is nothing in the Article 22(6) standard that limits the historical lens through which the Competent Authority may make a ‘principal purpose’ determination.” 11

The Court further stated that “the question was not simply why Starr chose Switzerland over Ireland, but rather why Starr chose Switzerland over any other jurisdiction where it might have moved.” 12 In this regard, the Court found that the Matrix undermined, rather than supported, Starr’s argument. According to the Court (quoting the Government’s brief): “Starr’s acknowledgement that ‘U.S. Tax’ was one of four key criteria that the company analyzed in deciding on a jurisdiction shows that it constituted [a] principal consideration[!]” in Starr’s calculus.” 13 The Court did not need to consider, and did not comment on, whether U.S. tax considerations were more important than other considerations in Starr’s thought process.

Starr also objected to the USCA’s treating its U.S. ownership as an adverse factor. As explained by the Court: “In Starr’s view, ‘[l]owing the [Competent Authority] to apply legal standards that were not identified in the treaty itself or in the accompanying guidance would be tantamount to granting the [Competent Authority] unfettered discretion in deciding whether to grant treaty benefits.’ Pl’s Cross-MSG 47.” However, the Court disagreed, noting that Starr’s argument “greatly overstates the case. Article 22(6) bestows significant discretion on the Competent Authority to sift treaty shoppers from non-treaty shoppers, and that surely includes permission to take stock of current legal standards and policies.” 14

While Starr may not be the best poster child for taxpayers who are pure of heart, the factors considered by the USCA, and the broad deference granted by the Court, serve to emphasize the difficulties faced by taxpayers seeking such relief. It would appear that virtually any facts that the USCA may choose to consider are fair game, even if they’re over 60 years old, such as the incorporation of a predecessor in Panama in 1943.

Moreover, given the Court’s “permission to take stock of current legal standards and policies[,]” the USCA may deem certain facts—such as U.S. ownership—to be indicative of treaty shopping even if the applicable treaty, the associated technical explanation, and other contemporaneous guidance provide no warning that this would be the case.

Furthermore, the USCA does not have the burden of proving the taxpayer’s nefarious treaty-shopping purpose. Given the seemingly minimal degree of judicial scrutiny, virtually any rational explanation for why the taxpayer has failed to make its case would seem sufficient.

If this didn’t set the bar for taxpayers high enough, the Denial Letter included a further explanation that may set it far higher.

Moreover, in our view, Article 22(6) of the U.S.-Swiss Treaty was designed to provide relief to a taxpayer that can make a strong case that, while coming within the spirit of an available [Limitation on Benefits] provision, it narrowly misses the mechanical tests associated with that provision. 15

If this is truly the position of the USCA, it is both arbitrary and infuriating. As discussed above, a PPT test is highly problematic, but at least it allows taxpayers to make their case. If nothing else, they can hold out hope that the USCA will listen to them, apply reasonable standards, and make their decisions in good faith.

For many taxpayers seeking discretionary treaty benefits, however, all hopes of being treated fairly will evaporate if the USCA deems the PPT to embody a secret “near miss requirement” pursuant to which only taxpayers who “narrowly miss” an objective test—and come within its perceived “spirit”—need to apply. The PPT is an extraordinarily silly test, and the USCA may understandably find it frustrating to apply, but that does not justify imposing an arbitrary near miss requirement.

In addition to the evident unfairness of such a requirement, it may not be obvious when a taxpayer who has narrowly missed meeting an objective test should
be viewed as having come within its spirit. For example, suppose that a corporate resident of “Fredonia” is 49% owned by qualifying residents of Fredonia, but the U.S.-Fredonia Income Tax Treaty imposes a 50% ownership requirement. Is 49% within the spirit of 50%? If so, why didn’t the treaty simply impose a 49% ownership requirement?

For better or for worse, the PPT prescribes an inquiry into the purposes for which the entity seeking discretionary treaty benefits was organized and maintained. Until and unless the PPT is replaced by a more rational test, the USCA simply needs to live with it, just as taxpayers do.

It is tempting to dismiss the Denial Letter’s assertion of a near miss requirement as an aberration. In this regard, the USCA may have felt strongly about denying treaty benefits to Starr, and may have thought it necessary to “pad” the Denial Letter with additional justifications for the Denial. Unfortunately, however, I am aware of another instance—involving a different treaty—in which the USCA also appears to have asserted the existence of a near miss requirement as a basis for denying a taxpayer discretionary treaty benefits.

If the USCA persists in this approach, it may be necessary for the courts to get involved, and even with a highly deferential standard of review, it seems entirely possible that they will. In Starr, the Court ducked the issue on the ground that “the statement was made as an aside, after the Competent Authority had applied the ‘principal purpose’ standard in order to reach its determination.”

Accordingly, the Court took the view that “[w]hether the ‘near-miss’ concept accurately describes the scope of Article 22(6) is therefore beside the point.”

In this regard, it may be worthwhile to note a significant procedural distinction. The Starr case addressed Starr’s claim that the Denial was arbitrary and capricious, and should therefore be set aside, under the APA. The Court took this approach because it had previously decided (after some vacillation) that the “political question doctrine” prevented the Court from awarding treaty benefits and therefore prevented Starr from bringing a refund claim.17

Recently, the Court of Appeals for the District of Columbia Circuit reversed the Court on this issue, holding that the political question doctrine did not apply and that the APA claim should be dismissed, because Starr can pursue a claim for refund after all.18 The “arbitrary and capricious” standard that applies under the APA, and that was applied by the Court in Starr, may not be the precise standard that applies in the context of a refund claim where the APA is inapplicable.19 Nevertheless, it would be unrealistic to expect a materially more robust standard of review.

The USCA should rightly be criticized for even contemplating a near-miss requirement, but the bigger issue is that the PPT is a terrible test. Expecting taxpayers to totally disregard treaty benefits in establishing their structures is unreasonable, and even the purest of heart may be unable to adequately prove such a negative. Indeed, the near-miss requirement may well reflect the USCA’s discomfort in applying the PPT.

For the most part, the objective LOB tests in most U.S. income tax treaties have been sufficiently reasonable that most taxpayers have not needed to resort to the PPT. Unfortunately, however, the trend may be towards stricter objective tests.20 If stricter objective tests are put in place, the utter unworkability of the PPT will become more obvious. Stay tuned.

ENDNOTES

1 However, certain other rules restricting treaty access in specific circumstances may nevertheless apply. Just to name two examples, there are “anti-hybrid” regulations that disallow treaty benefits for certain income earned through hybrid entities, and “anti-conduit” regulations that disallow treaty benefits in certain circumstances involving, among other things, back-to-back loans. See Reg. §§1.894-1(d) & 1.881-3.

2 Other LOB Articles are generally comparable.

3 The above assumes that the fund is not fiscally transparent for purposes of the tax laws of any country in which any shareholder of the fund is a resident. If the fund were fiscally transparent under the tax laws of a country in which a shareholder is a resident, then such resident might be entitled to the benefits of the income tax treaty between such country and the United States with respect to such resident’s share of the dividends earned by the fund.

4 Of course, this is not necessarily the only problem. Pursuant to Revenue Procedure 2015-40, 2015 IRB 236 (8/12/15), §3.06(d), competent authority relief will be provided only if the entity seeking treaty access has a “substantial non-tax nexus” to its country of residence. Moreover, pursuant to section 3.06(e) of the Revenue Procedure, relief typically will not be granted in several scenarios, e.g., if the applicant or any affiliate benefits from a “special tax regime” or if the applicable item of income would enjoy “double non-taxation”. The propriety of these rules is open to question.

5 However, the analysis may be more favorable if it can be demonstrated that each possible country that might have been considered is a treaty country and the U.S. income tax treaty of the country ultimately selected is no more favorable (in any relevant respect) than the U.S. income tax treaty of any other country that might have been selected.


7 However, since the Matrix was created in 2009, after the fact, this entry may merely reflect Starr’s desire to have considered Switzerland an undesirable tax jurisdiction.

8 Starr at 5493.

9 Starr at 5493–5494. While the U.S. policy referenced above was not explained in the
Denial Letter, the Court’s opinion indicates that this was a reference to the IRS’s “discovery of abusive structures whereby U.S. individuals invest in the United States by structuring transactions through tax havens, including treaty countries, which impose little or no tax on such arrangements.” Starr at 5502.

Starr also argued that certain of the underlying factual conclusions are not supported by the record.

Starr at 5502.

Emphasis in original.

Starr III at 5501.

Footnote in original omitted.

As set forth in Starr, at 5502. The bracketed details were supplied by the Court.

Starr, at 5502.

Starr International Co., Inc., 117 AFTR 2d 2016-628 (DC Dist Col), February 2, 2016. In very general terms, relief under the APA is permitted only when other relief (such as the ability to bring suit for a refund) is unavailable.


Id. The Court of Appeals recognized that the Court had already addressed the merits of the Denial under the standards of the APA but stated “because we remand this case to the District Court to proceed as a tax refund claim, we leave it to the District Court in the first instance to consider Starr’s arguments in the context of the tax refund action.”

The 2016 U.S. Model Income Tax Treaty indicates many changes that would make treaty access more restrictive than under existing treaties. Fortunately, perhaps, it has been quite a few years since the U.S. Senate ratified any income tax treaties, so we have no treaties that resemble the 2016 U.S. Model Income Tax Treaty.