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Eradicating Double Non-Taxation: A Comparative Analysis of the 2016 U.S. Model Income Tax Convention and OECD/G20 BEPS Action 6

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INTRODUCTION

On February 17, 2016, the Treasury Department released a revised U.S. Model Income Tax Convention (the ''2016 Model Treaty''). Since the U.S. model treaty was last updated a decade ago by the United States Model Income Tax Convention of November 15, 2006 (the ''2006 Model Treaty''), it was greeted with intense interest by the international tax community. The technical explanation is expected to be issued at any time, but it had not been issued at the time this publication went to press. However, a preamble to the 2016 Model Treaty was issued at the time of its release and it offers insights into the direction and objectives of the Treasury.

The preamble states: ''The 2016 Model [also] includes a number of new provisions intended to more clearly implement the Treasury Department's longstanding policy that tax treaties should eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.''

The 2016 Model Treaty contains a number of significant new provisions and departures from the 2006 Model Treaty. The new model also has substantively revised many key provisions from the 2006 Model Treaty. While the Treasury Department may describe these changes as merely implementing a longstanding policy, they reflect a dramatic shift in the approach and emphasis of the 2016 Model Treaty compared to its predecessor. In particular, the 2016 Model Treaty reflects a number of moves in the direction of the 2015 Final Report of the OECD/G20's Base Erosion and Profit Shifting Project on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances).[1] However, the 2016 Model Treaty differs from the OECD/G20 report, and from the language proposed in 2015 for a new U.S. Model Income Tax Convention, in a number of ways as well. Some of these changes may indicate further crackdowns against treaty-based tax avoidance deemed abusive, but others suggest that the 2015 proposals from the Treasury Department and the OECD/G20 may have gone too far with the formulation of vague, broad standards that could lead to draconian consequences.

This article individually examines these new provisions in light of the 2006 Model Treaty, the OECD/G20 2015 proposals, and the language proposed by the Treasury Department in 2015 to consider trends and implications for the future of tax treaties.

LIMITATION ON BENEFITS

A taxpayer is considered to be ''treaty shopping'' when it channels its investments into the United States through a company that is resident in a treaty partner country, but the taxpayer has no substantial nexus to that country. The 1981 Model Income Tax Convention was the first U.S. model treaty to include a Limitation on Benefits (''LOB'') provision (Article 22), which was created to prevent treaty shopping. The LOB provisions in the subsequent U.S. model treaties (1996 and 2006) were changed only incrementally until the issuance of the 2016 Model Treaty, which significantly altered the longstanding LOB framework. The 2016 Model Treaty generally provides that a resident of a foreign country is not en-

[1] OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

titled to benefits under a treaty unless that resident is a ''qualified person'' or is otherwise explicitly permitted to claim benefits.

The 2006 Model Treaty does allow treaty benefits to be claimed by companies that are not qualified persons under specific limited circumstances.[2] If it is not a qualified person under the 2006 Model Treaty, the company must be actively engaged in a trade or business in its country of residence (other than the business of making or managing investments for its own account), but only with respect to income that is ''derived in connection with'' that trade or business or is incidental to that business.[3] However, this exception applies only if the company's trade or business activity in the state of residence is substantial as compared to its trade or business activity in the other country.[4] Additionally, a company may be entitled to treaty benefits in the discretion of the competent authority of the source country, based on a determination that the establishment, acquisition or maintenance of the company and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty.

The 2016 Model Treaty modifies these LOB rules in a number of ways, of which the most substantial are discussed in the subsections that follow.

Subsidiary of a Public Company

Unlike the 2006 Model Treaty, the 2016 Model Treaty requires a public company's subsidiary to meet a base erosion test in order to be eligible for treaty benefits as a qualified person.[5] The test applies to the tested group, as well as to the company being tested. The base erosion test provides that a company does not satisfy the public company subsidiary test if it directly or indirectly pays (or causes to be accrued) 50% or more of its gross income to impermissible payees in the form of payments that are deductible for tax purposes in the country of residence.[6] Impermissible payees include: (1) any person that is not a resident of a treaty country entitled to benefits as an individual, government entity, public company, pension fund, or charity; (2) any persons connected with the company who are eligible for a special tax regime (discussed below in Section IV) with respect to a deductible payment; and (3) with respect to any interest payments, a connected person eligible for a notional interest deduction (discussed below) with respect to equity.[7] Payments taken into account in the numerator for this 50% test do not include certain payments made in the ordinary course of business.[8] The new base erosion test does not apply to treaty benefits with respect to dividend income.[9] This base erosion test is substantially the same as the one proposed by the Treasury Department in 2015,[10] and is also fairly similar to the analogous provision proposed by the OECD/G20.[11] However, one important distinction of the new base erosion test is that it applies to both the company and the ''tested group,'' defined to include any company that is consolidated for income tax purposes, or otherwise shares tax losses, with the tested company.[12]

Moreover, there are notable differences as compared to the OECD/G20 language. First, the OECD/G20 language applies the ownership and base erosion test even for determining eligibility for treaty benefits with respect to dividends. Second, the ''impermissible payees'' are more narrowly enumerated in the OECD/G20 proposals, including only persons who are not residents of a treaty country entitled to benefits as an individual, government entity, public company, pension fund, or charity. Payments to payees eligible for special tax regimes or notional interest deductions do not count toward the 50% trigger for limiting treaty benefits, unlike in the 2016 Model Treaty.

The inclusion of connected persons who benefit from special tax regimes or notional interest deductions as impermissible persons in the 2016 Model Treaty, however, may reflect a greater concern by the Treasury Department than the OECD/G20 regarding

[2] Under the 2006 Model Treaty, a ''qualified person'' is a resident that fits into one of the following general categories: (i) an individual resident of the Contracting State; (ii) the government of the Contracting State or any political subdivision of the Government; (iii) a publicly traded company, or a company that is a subsidiary or an affiliate of a publicly traded company; (iv) a tax-exempt organization; (v) a pension fund in which more than 50% of the beneficiaries, members, or participants are residents; or (vi) a company that meets the ownership/base erosion test. Under this test, 50% or more (by both vote and value) of the shares must be owned, directly or indirectly, by residents of the same contracting state as the company seeking treaty benefits (the ownership prong), and less than 50% of the income for the taxable year must be paid or accrued to persons who are not residents of either contracting state entitled to benefits (the base erosion prong). *See* 2006 U.S. Model Income Tax Convention, Art. 22(2).

[3] *Id.*, Art. 22(3)(a).

[4] *Id.*, Art. 22(3)(b).

[5] 2016 U.S. Model Income Tax Convention, Art. 22(2)(d)(ii).

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] The apparent addition of a third category of impermissible person not included in the 2015 proposal is merely a conforming change reflecting the fact that notional interest deductions are no longer considered a special tax regime in the 2016 Model Treaty as was proposed in 2015.

[11] OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, at p. 30.

[12] 2016 U.S. Model Income Tax Convention, Art. 22(7)(g).

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these regimes. While special tax regimes are more narrowly defined in the 2016 Model Treaty than in the OECD/G20 proposal (discussed below in Section IV), the definitions were nearly identical when the Treasury Department first proposed the new language in 2015.

Qualifying Intermediate Owners

The 2016 Model Treaty seemingly expands public company subsidiaries' eligibility for treaty benefits by allowing for them to be indirectly owned by public companies through ''qualifying intermediate owners'' that are not resident in either treaty country.[13] The 2006 Model Treaty requires all intermediate owners to be residents in one of the two treaty countries.[14] A qualified intermediate owner is defined to include any resident of a state that has a tax treaty with the country in which the income arises if that treaty includes provisions addressing special tax regimes and notional interest deductions which are analogous to the 2016 Model Treaty provisions.[15]

The OECD/G20 proposal offers a contrasting pair of more extreme alternatives. The base language in that proposal imposes no restrictions on the residency of intermediate owners, while additional bracketed language limits intermediate owners to residents of the same treaty country as the taxpayer seeking treaty benefits.[16] The official commentary says of the bracketed language that some countries ''consider that this last requirement is unduly restrictive and prefer to omit it,''[17] suggesting that the OECD/G20 view a same-country-only approach as the default. The 2016 Model Treaty also takes a more relaxed position than the language the Treasury Department proposed in 2015, which required that a qualified intermediate owner be eligible for equivalent or better treaty benefits for the relevant type of income, rather than merely be eligible for a treaty which addresses special tax regimes and notional interest deductions similarly. Thus, compared to prior Treasury Department language and to the apparent default rule under the OECD/G20 proposal, the 2016 Model Treaty takes a more taxpayer-friendly approach.

Since there is no treaty currently in force which includes the special tax regime and notional interest deduction provisions required for intermediate owners that are treaty country residents to qualify as qualified intermediate owners, the practical benefit of this provision will depend on how many countries agree to incorporate treaty provisions analogous to those of the 2016 Model Treaty. While the OECD/G20 has also proposed language addressing special tax regimes and notional interest deductions, there are sufficient differences between the 2016 Model Treaty and the OECD proposals (as discussed further below) that it may not be entirely clear whether a treaty based on the OECD/G20 language permits a given treaty country's residents to be considered qualifying intermediate holders. Clarifying this ambiguity is something that should be considered in the technical explanation of the 2016 Model Treaty or, at least, when writing (and providing technical explanations for) actual treaties based on the 2016 Model Treaty.

Active-Trade-or-Business Test

The underlying principle of the active trade or business test is that a taxpayer which is not generally eligible for treaty benefits as a qualified resident under the LOB provisions should nonetheless be entitled to treaty benefits with respect to any specific items of income that are connected with an active trade or business in the taxpayer's own country of residence. The logic of this exception is that there should be no treaty shopping concern where the income is attributable to a trade or business in the taxpayer's country of residence. The 2016 Model Treaty restricts the active-trade-or-business exception to income that ''emanates from [or is incidental to]'' the trade or business,[18] whereas the 2006 Model Treaty requires only that the income be ''derived in connection with [or be incidental to]'' the relevant trade or business.[19] The preamble to the 2016 Model Treaty indicates that the purpose of this change is to ''require a factual connection'' between the income and the trade or business, and that the technical explanation of the 2016 Model Treaty is expected to provide guidance on the meaning of the phrase ''emanates from'' and how it differs from the ''derived in connection with'' language in the 2006 Model Treaty.

In addition, in the 2016 Model Treaty certain activities are explicitly stated to not be trades or businesses: (i) operating as a holding company; (ii) providing overall supervision or administration of a group of companies; (iii) providing group financing (including cash pooling); and (iv) making or managing investments other than as a bank, insurance company, or registered securities dealer in the ordinary course of

[13] 2016 U.S. Model Income Tax Convention, Art. 22(2)(d)(i).

[14] 2006 U.S. Model Income Tax Convention, Art. 22(2)(c)(ii).

[15] 2016 U.S. Model Income Tax Convention, Art. 22(7)(f)(i).

[16] *See*, OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, at p. 30.

[17] *Id.*, at p. 31 (¶26).

[18] 2016 U.S. Model Income Tax Convention, Art. 22(3)(a).

[19] 2006 U.S. Model Income Tax Convention, Art. 22(3)(a).

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business.[20] Of these categories, only making or managing investments (unless as a bank, insurance company, or registered securities dealer) was explicitly excluded from trade or business status in the 2006 Model Treaty, and only when done for the taxpayer's own account.[21]

In the preamble to the 2016 Model Treaty, the Treasury Department expresses its concern that the previous active-trade-or-business rules were sufficiently broad to allow treaty shopping, by allowing intragroup income to benefit from the active trade or business of a connected person located in a treaty jurisdiction even though such income was not actually linked to the connected person's active trade or business. (Activities of persons connected to a resident of a treaty country are generally deemed to be conducted by the treaty country resident.[22]) The language proposed by the Treasury Department in 2015 took a substantially different approach to this concern than does the 2016 Model Treaty, however, instead restricting the ability to attribute activities of a connected person to a resident of a treaty country. Under the 2015 proposal, attribution between connected persons would have been prohibited unless both persons engaged in the same or complementary lines of business. Per the preamble to the 2016 Model Treaty, the change in approach reflects a determination that dividing activities among connected persons does not give rise to concern about treaty shopping. The 2016 Model Treaty's "emanates from" requirement is in most cases a more taxpayer favorable approach than the "same or complementary lines of business" requirement proposed in 2015, though both are stricter than the 2006 Model Treaty's language. Commentary and examples in the technical explanation of the 2016 Model Treaty should however provide further clarity.

Regardless of how much more lenient the active-trade-or-business test is from the earlier 2015 proposal, it will be stricter than the OECD/G20 language, which is generally consistent with the language in the 2006 Model Treaty.[23] The fact that the Treasury Department has moved toward greater restriction in this area where the OECD/G20 apparently sees no further tightening as necessary offers an interesting contrast, as the 2016 Model Treaty and 2015 OECD/G20 proposals have substantially overlapped in areas of concern (as discussed throughout this article).

Derivative Benefits Test

First introduced in the 2015 Treasury Department proposed language, Article 22(4) of the 2016 Model Treaty adds a derivative benefits provision to the LOB article, which significantly broadens eligibility for treaty benefits based on ownership-and-base-erosion principles as compared with Article 22(2)(a) of the 2006 Model Treaty.[24] The ownership-and-base-erosion test in the 2006 Model Treaty treats a taxpayer as a qualified person for LOB purposes if that taxpayer is at least 50% owned (by both vote and value) by qualified persons (not including subsidiaries of public companies) and passes a base erosion test similar to the base erosion test for subsidiaries of public companies (discussed in detail above; briefly: less than 50% of gross income accrued or paid to impermissible persons, excluding for this purpose certain arm's-length payments made in the ordinary course of the payor's trade or business).

The new derivative benefits provision supplements this test with a broader rule providing treaty benefits to a taxpayer resident in a treaty country, even if not a qualified person, as long as two requirements are met: 95% of the vote and value of the tested company's shares is ultimately owned by seven or fewer equivalent beneficiaries,[25] and a less restrictive base erosion test is satisfied.[26] The ownership and base erosion requirements for the derivative benefits test must be met at a time when the benefit sought would be accorded, and on at least half of the days of a 12-month period beginning or ending on the date when the benefit would be accorded.[27]

This base erosion test is less restrictive because equivalent beneficiaries are considered permitted persons unless they are equivalent beneficiaries solely due to the "headquarters exception"[28] or they are connected persons who benefit from a special tax regime or notional interest deduction with respect to the payment. "Equivalent beneficiary" is a much broader category of persons than the "qualified persons" required under the ownership-and-base-erosion test, as it includes residents of third countries entitled to comparable treaty benefits.[29] Residents of the treaty country from which benefits are sought may count as

[20] 2016 U.S. Model Income Tax Convention, Art. 22(3)(a).

[21] 2006 U.S. Model Income Tax Convention, Art. 22(3)(a).

[22] *See* 2016 U.S. Model income Tax Convention, Art. 22(3)(c). *See also* 2006 U.S. Model Income Tax Convention, Art. 22(3)(c).

[23] *Compare* 2006 U.S. Model Income Tax Convention, Art. 22(3) *with* OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, at p. 37.

[24] The equivalent provision of the 2016 U.S. Model Income Tax Convention is found at Art. 22(2)(f).

[25] 2016 U.S. Model Income Tax Convention, Art. 22(4)(a). Note also that any intermediate owners must be qualifying intermediate owners, using the definition discussed under the "qualifying intermediate owners" heading above.

[26] *See* 2016 U.S. Model Income Tax Convention, Art. 22(4)(b).

[27] 2016 U.S. Model Income Tax Convention, Art. 22(4).

[28] 2016 U.S. Model Income Tax Convention, Art. 22(5).

[29] *See* 2016 U.S. Model Income Tax Convention, Art. 22(7)(e).

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equivalent beneficiaries for up to 25% of the total ownership of the taxpayer seeking treaty benefits.[30]

The 2016 Model Treaty's provisions on dividends,[31] interest,[32] and royalties[33] also modify the effective definition of an equivalent beneficiary with respect to those categories of income. Those provisions provide that, if a person fails to be an equivalent beneficiary because the tax rate applicable to the relevant income category under the putative equivalent beneficiary's treaty is higher than the rate under the taxpayer's treaty, the taxpayer will not altogether be denied treaty benefits. Instead, the taxpayer will still be entitled to a partial rate reduction under the taxpayer's treaty equal to the reduction that would be available under the equivalent beneficiary's treaty. Prior to this change, if the equivalent beneficiary's treaty provided for even slightly reduced benefits relative to the taxpayer's treaty, the taxpayer would receive no treaty benefits whatsoever. This prior language created a ''cliff effect'' whereby a marginal reduction in benefits under the equivalent beneficiary's treaty, or a marginal increase in benefits under the taxpayer's treaty, could totally eliminate the taxpayer's eligibility for benefits by causing the benefits under the equivalent beneficiary's treaty to be greater.

The 2016 derivative benefits test is much more liberal than the language the Treasury Department proposed in 2015, which did not count any ownership by residents of the source country (the country from which treaty benefits are sought) toward the 95% equivalent beneficiary ownership requirement. The resolution of the ''cliff effect'' in this context by counting source country ownership up to 25% is a notable improvement, avoiding results where even a slight difference in benefits between treaties leads to a taxpayer receiving no treaty benefits at all. The OECD/G20 proposed treaty language includes a derivative benefits provision with substantially the same terms as the 2016 Model Treaty, so taxpayers can hope to see such provisions become commonplace in the future.[34] The 2015 OECD/G20 proposal does not include the language that avoids the cliff effect, but perhaps future OECD/G20 proposals will do so.

Headquarters Test

The 2016 Model Treaty also adds a new provision, which entitles a ''headquarters company'' that is not a qualified person under Article 22(2) to treaty benefits with respect to dividends and interest paid by members of its multinational group.[35] To qualify as a headquarters company, six requirements must be met:

- The company's ''primary place of management and control'' must be in its country of residence.[36]
- The company's corporate group must consist of companies residing in at least four different jurisdictions, each of which engages in an active trade or business in its jurisdiction, and the group's trades or businesses in at least four different countries (or groups of countries) must each generate at least 10% of the group's gross income.[37]
- No single country other than the residence of the headquarters company may contribute 50% or more of the group's gross income through trades or businesses carried on there.[38]
- No more than 25% of the company's gross income is derived from the source country (the country from which treaty benefits are sought).[39]
- In its country of residence, the company is subject to the same tax rules as persons qualifying for treaty benefits under the active-trade-or-business rules of the LOB provision.[40]
- The company satisfies the same base erosion test as the second prong of the Article 22(2)(f) ownership-and-base-erosion test.[41]

The second, third, and fourth requirements may be met either for the current year or by averaging the preceding four taxable years.

The preamble to the 2016 Model Treaty indicates that the Treasury Department added this provision with the intent that it be analogous to the active-trade-or-business test, but that it cover the activity of making decisions for the corporate group. However, the Treasury Department concluded that only dividend and interest payments by group members are sufficiently related to the headquarters company's activities of supervision and management to be entitled to treaty benefits. It is also notable that the OECD/G20 proposal has no equivalent to the headquarters company provision. It remains to be seen whether future OECD/G20 proposals will add one, will allow them

[30] 2016 U.S. Model Income Tax Convention, Art. 22(7)(e)(iii).

[31] 2016 U.S. Model Income Tax Convention, Art. 10(6).

[32] 2016 U.S. Model Income Tax Convention, Art. 11(3).

[33] 2016 U.S. Model Income Tax Convention, Art. 12(3).

[34] OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, at p. 42 (detailed version).

[35] 2016 U.S. Model Income Tax Convention, Art. 22(5).

[36] 2016 U.S. Model Income Tax Convention, Art. 22(5)(a).

[37] 2016 U.S. Model Income Tax Convention, Art. 22(5)(b).

[38] 2016 U.S. Model Income Tax Convention, Art. 22(5)(c).

[39] 2016 U.S. Model Income Tax Convention, Art. 22(5)(d).

[40] 2016 U.S. Model Income Tax Convention, Art. 22(5)(e).

[41] 2016 U.S. Model Income Tax Convention, Art. 22(5)(f).

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to treat their activities as an active trade or business, or will simply deny them any treaty benefits (as is currently the case[42]).

SUBSEQUENT CHANGES

The 2016 Model Treaty introduces an entirely new Article 28 not found in the 2006 Model Treaty, ''Subsequent Changes in Law.'' This provision is triggered by either country lowering its corporate tax rate to the lesser of 15% of corporate net income and 60% of the corporate tax rate imposed by the other country. It is also triggered if either country exempts substantially all foreign source income (including interest and royalties) from taxation. Once such a change in a treaty country's domestic tax law occurs, the two countries are obligated to discuss amendments to the treaty to ''restore an appropriate allocation of taxing rights.''[43] If the countries do not reach an agreement, the country that did not lower its tax rate or exempt substantially all foreign source income may choose to stop applying the provisions of the treaty exempting dividends (Article 10), interest (Article 11), royalties (Article 12), and other income (Article 21). In this case, the other country will no longer be obligated to apply the aforementioned articles either.

The 2016 Model Treaty's Article 28 is quite similar to the language in the OECD/G20 proposal.[44] The OECD/G20 provision would apply when a treaty country provides an exemption to either resident companies[45] or resident individuals[46] from taxation ''for substantially all foreign source income (including interest and royalties),'' allowing the other country to determine that treaty benefits will no longer apply to dividends, interest, royalties, and other income in either country.[47]

With respect to the thresholds for triggering the suspension of treaty benefits, the 2016 Model Treaty language is both more and less aggressive than the OECD/G20 language. On the more aggressive side, the 2016 Model Treaty article would apply to any rate reductions below the nontrivial thresholds of 15% of income and 60% of the other country's rate. In addition, the 2016 Model Treaty language also includes the trigger for an exemption of substantially all income which is specifically foreign source income, which is the sole trigger in the OECD/G20 proposed language.

In other respects, the proposed Article 28 takes a less aggressive approach compared to either the OECD/G20 proposal or the language Treasury proposed in 2015, which more closely mirrored the OECD/G20 language. As discussed in the preamble to the 2016 Model Treaty, the current language responds to commenters concerned about how the version of Article 28 proposed in 2015 would apply to taxation of individuals (as the OECD/G20 provisions also do) by explicitly limiting the change in law provision to corporate taxation. According to the preamble, concerns regarding taxation of individuals are sufficiently addressed elsewhere in the 2016 Model Treaty. In addition, unlike the language proposed in 2015, Article 28 now requires consultation between the countries before one country can unilaterally disallow treaty benefits, another softening or delaying measure not found in the OECD/G20 proposal. Finally, the 2016 Model Treaty added the second prong to its rate trigger requiring that a country's tax rate must be lowered to less than 60% of the other country's corporate tax rate. This addition reflects the possibility that both the United States and treaty counterparties will lower their corporate rates substantially, a possibility the 2015 proposal had not considered.[48] Nevertheless, Article 28 represents a notable departure from the 2006 Model Treaty in that it allows one country to unilaterally terminate some treaty obligations (those governing dividends, interest, royalties and ''other income'') while retaining the remaining treaty benefits, including not only other tax benefits for its residents (such as exemption from taxation on certain real estate and business profits by the other country) but also exchange of information and administrative assistance (Article 26). This contrasts with the 2006 Model Treaty, in which treaty benefits could be changed only by mutual consent or by total withdrawal from the treaty.

This provision may reflect an increased sensitivity of Treasury to the potentially rapid pace of change in foreign tax law relative to the rate at which new treaties can be ratified in the United States. While Article 28 in the 2016 Model Treaty still requires consultations toward an ''amendment'' (presumably requiring ratification by the Senate), it is possible that Treasury

[42] OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, at p. 38.

[43] 2016 U.S. Model Income Tax Convention, Art. 28(1).

[44] OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, at p. 98 (''Proposal 2'').

[45] *Id.*, ¶1.

[46] *Id.*, ¶2.

[47] *Id.*, ¶3.

[48] The United States would have to lower its corporate income tax rate to less than 25% for the new language to affect whether Article 28 is triggered. The preamble clarified that Treasury did not intend to indicate that corporate tax rates below 15% are inappropriate, only to test for a change in the balance of benefits to the countries' corporations.

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could subsequently move toward provisions allowing for even quicker responses to changes on foreign laws or newly arisen concerns about areas of potential abuse. For example, future provisions could provide for certain mutually agreed changes that would automatically be incorporated into the terms of the treaty or for additional rights of the United States (or its treaty partners) to turn off particular treaty provisions in situations giving rise to abuse concerns. Article 28 also indicates a broadening of Treasury's intended arsenal for dealing with potential base erosion, directly targeting counterparty countries' rate reductions or broad exemptions of foreign source income.

SPECIAL TAX REGIMES

The 2016 Model Treaty imposes a new restriction on benefits with respect to interest,[49] royalties,[50] and guarantee fees[51] by providing that treaty benefits will not be available with respect to income in these categories if the income is received from a connected person and subject to a ''special tax regime'' (STR) in the treaty country in which the beneficial owner resides. An STR is generally defined as ''any statute, regulation or administrative practice'' in a treaty country that either (A) results in a preferential tax rate for any of the aforementioned categories of income (or any combination thereof), relative to income from the sales of goods or services, (B) permanently reduces the tax base with respect to any of the aforementioned categories without a comparable reduction of the tax base with respect to income from sales of goods or services, or (C) provides a preferential tax rate or reduced tax base for substantially all of a company's income, or substantially all of its foreign source income, if it does not engage in an active trade or business in that country.[52]

There are three exceptions to STR status incorporated in the definition of STR: (i) any preferential rate or base reduction for royalties conditioned on research and development activities in the country;[53] (ii) any preferential rate or base reduction ''generally expected'' to result in a tax rate of at least 15%, or at least 60% of the corporate tax rate in the other country;[54] and (iii) any preferential rate or base reduction that applies principally to pension funds, charitable organizations, or collective investment vehicles[55] will not be STRs. Furthermore, any statute, regulation, or administrative practice is not an STR until the two countries have consulted and one country has identified the other country's statute, regulation, or administrative practice as meeting the other requirements to be an STR.[56] Finally, STR treatment will not actually begin until 30 days after a treaty country publicly identifies the other country's STR as such.[57]

As in other areas, in response to comments the 2016 Model Treaty takes a less aggressive approach than did the 2015 proposal, but still moves to significantly restrict benefits perceived as inappropriate or excessive in a way the 2006 Model Treaty did not. The 2015 proposal would have broadly defined any statute, regulation, or administrative practice providing a reduced effective tax rate on any item of ''income or profits'' as an STR, subject only to specified exceptions. The 2016 Model Treaty provides a detailed list of requirements for a regime to be an STR (including a requirement that any STR be specifically and publicly identified as such) rather than a list of exceptions from a broad definition.

Similarly, under the Treasury Department's 2015 proposal, the provisions relating to interest, royalties and dividends stated that treaty benefits would be denied for any payment beneficially owned by a resident of the other treaty country ''that is related to'' the payor if that resident benefitted from an STR with respect to that category of payment. Thankfully, this was modified in the 2016 Model Treaty, which triggers denial of benefits in this context only when the beneficial owner is a ''connected person'' with respect to the payor. Unlike the vague and broad ''related to'' standard, a payor and payee are connected only if they have 50% common ownership or, even if not, if there is actual control or actual common control.[58]

The exception to STR status for preferential regimes that are generally expected to result in tax of at least 15% of income, or 60% of the other country's corporate tax rate, also mitigates the breadth of the STR rules. In a significant procedural softening of the STR regime, the requirements for consultation and 30 days' notice before a statute, regulation, or administrative practice is treated as an STR were also added.

Another change to the STR regime compared to the 2015 proposal is that the 2016 Model Treaty removes notional interest deductions (NIDs) with respect to equity from the definition of an STR. A NID is a provision in a tax regime which allows companies to deduct amounts from their taxable income that are calculated based on the value of their equity multiplied

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[49] 2016 U.S. Model Income Tax Convention, Art. 11(2)(c).

[50] *Id.*, Art. 12(2)(a).

[51] *Id.*, Art. 21(2)(a).

[52] *Id.*, Art. 3(1)(l)(i).

[53] *Id.*, Art. 3(1)(l)(ii).

[54] *Id.*, Art. 3(1)(l)(iii).

[55] *Id.*, Art. 3(1)(l)(iv).

[56] *Id.*, Art. 3(1)(l)(v).

[57] *Id.*, Art. 3(1)(l).

[58] *Id.,* Art. 3(1)(m). If the 50% ownership standard is not met, the existence of actual control or actual common control would be determined ''based on all the relevant facts and circumstances.''

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by a specified interest rate, mitigating or eliminating the tax advantage of debt financing relative to equity financing. Instead of treating a tax regime that permits NIDs as an STR, the 2016 Model Treaty includes a specific provision within the interest rules under which interest arising in one treaty country and beneficially owned by a resident of the other treaty country may be taxed in the country where it arises if the beneficial owner of the interest is a ''connected person'' with respect to the payor and benefits from notional deductions in the beneficial owner's state with respect to amounts treated as equity.[59] According to the preamble to the 2016 Model Treaty, this change is intended to be ''a more focused approach.''

As noted in the preamble to the 2016 Model Treaty, the STR provisions reflect the OECD/G20's attack on base erosion by ensuring that if certain types of income (generally, types of income that can be easily shifted between jurisdictions) are untaxed or only lightly taxed in the jurisdiction of their beneficial owners' residence, the income will not also be exempt from taxation in another jurisdiction where they are earned. However, the 2016 Model Treaty's STR provisions are in significant ways narrower than the language proposed by the OECD/G20, which would apply to any item of income or profit (including, in the case of NIDs and possibly other items, reductions in the taxable base that would reduce the effective rate on income without a corresponding expense or liability), rather than specified categories of income, and contains eight broad exceptions.[60] As the foregoing summary suggests, the language proposed by Treasury in 2015 more closely aligned with the OECD/G20 proposal. The 2016 Model Treaty addresses concerns about breadth and ambiguity by providing a narrower, more explicit rule.

As with Article 28's provisions regarding subsequent changes in law, the STR rules are notable for allowing a treaty signatory to unilaterally terminate certain parts of the treaty for certain items while preserving other treaty benefits. The key difference between these provisions is that the STR regime is significantly more narrow in its application (requiring multiple conditions to be met, and subject to multiple exceptions), but allows a treaty country to unilaterally disallow treaty benefits without giving up anything in return. By contrast, if a treaty country exercises the broader authority to terminate the application of treaty provisions for interest, dividends, royalties, and other income, the other country has the right to impose a reciprocal denial of treaty benefits. In the OECD/G20 language, the reciprocal termination is not elective, but automatic.

PERMANENT ESTABLISHMENTS

Among its new restrictions on treaty benefits, the 2016 Model Treaty also denies treaty benefits in the case of certain ''triangular permanent establishment'' structures in which a resident of a treaty country claims benefits under the treaty with respect to income derived in the other treaty country, but is also largely exempt from taxation in the residence country because the income is attributed to a permanent establishment outside the residence country.[61] Similar provisions already exist in a number of United States treaties.[62] While such provisions are called ''triangular'' because the permanent establishment is generally in a third country, the 2016 Model Treaty also contemplates the possibility that the permanent establishment could be in the country denying treaty benefits. For example, a resident of a treaty partner may conduct activities in the United States not rising to the level of a trade or business in the United States, but which give rise to interest income. The treaty partner's domestic law considers the income to be derived by a permanent establishment in the United States and exempts the interest income from foreign taxation under its territorial tax regime. In the absence of the permanent establishment rule, this income would also be exempt from United States taxation under the treaty as interest income earned by a treaty partner resident not effectively connected with a United States trade or business.[63] While the provision in the 2016 Model Treaty is worded reciprocally, it would affect only United States treaty benefits under current law because the United States does not take a territorial approach and instead taxes United States residents on their income from foreign permanent establishments.

The 2016 Model Treaty contains nearly the same provisions on permanent establishments as did the language proposed in 2015. Among the few substantive differences are two which echo changes in the STR and subsequent-changes provisions. First, the level of taxation low enough to trigger suspension of treaty benefits has been modified. The 2015 proposed language would terminate treaty benefits where the profits attributable to the permanent establishment

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[59] *Id.*, Art. 11(2)(e).

[60] OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, at pp. 96–97.

[61] 2016 U.S. Model Income Tax Convention, Art. 1(8).

[62] *See, e.g.,* 2006 United States-Belgium Income Tax Treaty at Art. 21(6), 2007 United States-Bulgaria Income Tax Treaty at Art. 21(5), 1989 United States-Germany Income Tax Treaty (as amended by the 2006 protocol) at Art. 28(5).

[63] U.S. Treasury Explanation of 2015 Proposed Model Income Tax Convention, Art. 1(7).

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were taxed at a rate less than 15%, or where the permanent establishment is located in a country that does not have a comprehensive tax treaty with the residence country, unless the residence country taxes the permanent establishment's income. The 2016 Model Treaty generally retains the same two-prong test but modifies the first prong, like other provisions keyed off of a 15% tax rate in the 2015 proposal, so as not to trigger where the tax rate is less than 15% but still at least equal to 60% of the general corporate tax rate in the country of residence.[64] A second change lies in the exception clause, which allows a treaty country to continue to grant treaty benefits to a resident of the other treaty country if it determines that treaty benefits are justified in light of the reasons that the taxpayer triggered the permanent establishment rule.[65] Unlike the 2015 proposed language, but as in the definition of an STR[66] and the subsequent-changes provisions,[67] the 2016 Model Treaty supplements this exception to the triangular permanent establishment rules with a requirement that the two country's competent authorities consult before an exception is granted or denied.[68]

As noted above, the OECD/G20's 2015 proposed language on triangular permanent establishment reflects the same 60%-of-corporate-rate standard for low tax rates found in the 2016 Model Treaty.[69] Unlike the 2015 proposal and 2016 Model Treaty language, however, the OECD/G20 proposal is purely "triangular" — it does not address a case where a resident of one treaty country claims benefits with respect to income earned by a permanent establishment located in the other treaty country and not taxed in that treaty country. The rule in the 2016 Model Treaty is also broader in its scope, completely denying treaty benefits to any income that meets the trigger. The OECD/G20 proposal, like many existing permanent establishment provisions in treaties, contemplates only a cap on the rate of source state tax imposed on dividends, interest, and royalties when the rule is triggered (and full normal taxation only for other income). Unlike the broad but discretionary rule for exceptions with consultation in the 2016 Model Treaty, the OECD/G20 language provides automatic but narrower exceptions, for income derived in connection with or incidental to the active conduct of a business (other than certain investment businesses) carried on through the permanent establishment and for royalty income derived from intangible property produced or developed through the permanent establishment.

Thus, whereas in connection with the STR and subsequent-changes rules the 2016 Model Treaty seemed to generally moderate the pressure against tax avoidance in relation to the 2015 proposed language and the OECD/G20 proposals, the 2016 Model Treaty provisions denying treaty benefits to income that escapes tax in both the country of residence and the permanent establishment jurisdiction are more aggressive than the comparable provisions in either the 2015 Treasury proposed treaty amendments or the OECD/G20 proposal. These triangular permanent establishment rules preserve the substance of the 2015 United States proposals, rejecting the bright-line exceptions of the OECD G20 proposal. Compared to the latter, the only obviously favorable provision of the 2016 Model Treaty language for taxpayers is that a tax rate of at least 15% will be acceptable even if that rate is less than 60% of the residence country's corporate tax rate.

CONCLUSION

Although the details vary among the provisions described above, there is a clear overall thrust to the changes in the 2016 Model Treaty: the Treasury Department's historic focus on eliminating double taxation has shifted to a focus on eliminating double non-taxation. While this shift reflects the OECD/G20's concerns of the past few years crystallized in Action 6 of the BEPS Project, the devil is in the details. Perhaps when the technical explanation is issued, a softer interpretation of the more severe provisions will carry the day. We can only wait and see. For now, it appears that with the global climate shifting to prevent double non-taxation, the United States has gone with the zeitgeist, albeit with its own twists.

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[64] 2016 U.S. Model Income Tax Convention, Art. 1(8)(a).

[65] *Id.*, Art. 1(8) (flush language). The only example provided of an extenuating circumstance that might prompt a treaty country not to apply the permanent establishment rule under this exception is where the tax rate thresholds are not met due to the existence of losses.

[66] *Id.*, Art. 3(1)(l)(v).

[67] *Id.*, Art. 28.

[68] *Id.*, Art. 1(8).

[69] OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, at pp. 75–76.

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