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U.S. Treasury Releases New Model Tax Treaty

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The U.S. Treasury has released a revised model bilateral income tax treaty (the 2016 Model Treaty) which is a significant update to the 2006 model treaty. The United States uses its model tax treaty as the baseline text when it negotiates tax treaties.

The 2016 Model Treaty contains numerous changes, many of which are not substantive, but instead reflect technical improvements developed in bilateral tax treaty negotiations. Revised versions of draft provisions Treasury circulated for comment in May 2015 are among the substantive changes and additions reflected in the 2016 Model Treaty. These provisions address:

- **Special Tax Regimes (STR)** – The STR provision denies treaty benefits on payments of royalties, interest and certain guarantee fees paid to a related party that enjoys low or no taxation with respect to that income under an STR. The definition of an STR has been narrowed (as compared to a draft version of this provision released in May 2015) to provide an exclusive list of cases in which a statute, regulation or administrative practice is treated as an STR. In the 2016 Model Treaty, an STR is generally defined as a regime that subjects interest, royalties or guarantee fees to preferential tax treatment, as compared to income from sales of goods or services. An STR also includes a preferential regime for companies that do not engage in an active business in the residence state. Specific exceptions from STR treatment are included for collective investment vehicles and real estate investment trusts that are designed to achieve a single level of current tax (at either the entity level or the shareholder level). An exception is also included for preferential regimes that are generally expected to result in a tax rate that is at least (i) 15% or (ii) 60% of the general statutory rate of company tax in the source country, whichever is lower. In contrast to the May 2015 draft of the STR provision, foreign regimes that offer “notional interest deductions” are not treated as an STR. In lieu of STR treatment, the 2016 Model Treaty now contains a standalone provision which provides that the treaty does not apply to payments of interest to a “connected person” if such person benefits from notional deductions with respect to amounts treated as equity by the jurisdiction in which the beneficial owner of the interest income is resident.
- **Expatriated Entities** – These provisions deny treaty benefits for U.S. withholding taxes on U.S. source dividends, interest, royalties and certain guarantee fees paid by a U.S. company that is an “expatriated entity” under the anti-inversion rules in the U.S. Internal Revenue Code during the ten-year period after the company undergoes a corporate

expatriation transaction. These provisions are keyed off of the U.S. domestic rules regarding inversions as in effect at the time the new treaty is signed.

- **Limitation on Benefits (LOB)** – Generally, the LOB provision is intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between the U.S. and another country by limiting treaty benefits to treaty residents that meet one of a series of objective tests, designed to establish a meaningful connection to the residence country. The 2016 Model Treaty substantially revises the 2006 model treaty's LOB provision. Among other changes, the 2016 Model Treaty includes for the first time in a U.S. model tax treaty a derivative benefits test, extending treaty benefits to a company meeting no other LOB test if 95% of the company's shares are owned, directly or indirectly, by seven or fewer "equivalent beneficiaries" in comparable treaty jurisdictions and a base erosion test is satisfied. Some form of a derivative benefits test is already included in the U.S.-Canada treaty and most existing U.S. tax treaties with countries in the European Union.
- **Subsequent Changes of Law** – This provision requires the U.S. and its treaty partner to consult to determine if amendments to the treaty are necessary to restore an appropriate allocation of taxing rights between the two countries, consistent with the purpose of the treaty to eliminate double taxation without creating opportunities for non-taxation. It is intended to address situations, for example, where one of the treaty partners changes its overall corporate tax system to no longer impose significant tax on cross-border income of resident companies. The provision explicitly provides that, after such consultations fail to progress, a treaty partner may issue a diplomatic note stating that it will cease to grant certain benefits under the treaty for payments to companies. The provision is triggered if a treaty partner's general rate of company tax falls below the lesser of either 15%, or 60% of the other country's general rate of company tax.
- **Triangular Permanent Establishment (PE) Rule** – This provision (a form of which has been included in some U.S. tax treaties since the 1990s, but not the U.S.-Canada treaty) limits treaty benefits with respect to income treated by a residence country as attributable to (i) a permanent establishment subject to a combined effective tax rate of less than 60% of the residence country's general rate of company tax or (ii) a permanent establishment located in a third country that does not have a tax treaty with the source country unless the income is included in the tax base of the residence country.
- **Mandatory Binding Arbitration** – The 2016 Model Treaty includes mandatory binding arbitration (the "last best offer" approach) for the resolution of disputes between tax authorities. The model provision is substantively similar to that contained in four U.S. tax treaties in force (including the U.S.-Canada treaty) and three U.S. tax treaties that are awaiting the advice and consent of the Senate.

The preamble to the 2016 Model Treaty notes that the new model incorporates a number of recommendations from the OECD-G20 BEPS initiative, including a revised preamble that makes clear that the purpose of a tax treaty is the elimination of double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or

avoidance. The preamble also notes, however, that the 2016 Model Treaty did not adopt BEPS recommendations regarding permanent establishment thresholds, notably the revised rules related to dependent and independent agents and the exemption for preparatory and auxiliary activities, citing a concern that any modifications to these treaty provisions be consistently administered by treaty partners.

The 2016 Model Treaty provisions are not directly applicable to existing U.S. tax treaties, but they do provide notice to taxpayers of the trajectory of U.S. tax treaty policy on a going forward basis. The 2016 Model Treaty is noteworthy, in that it stands as a clear re-affirmation of the U.S. position that BEPS concerns are most effectively addressed through objective rules (such as LOB or STR requirements) rather than subjective measures (such as open-ended "principal purpose" tests). It remains to be seen whether this position will influence treaty policy in other OECD countries.

Many substantive aspects of the changes included in the 2016 Model Treaty remain unclear and require further development, which is frequently provided through a supporting technical explanation. The U.S. Treasury indicated that it plans to release a detailed technical explanation of the 2016 Model Treaty this spring and invites comment on a number of issues raised by the new model treaty. The deadline for public comments is April 18, 2016.