

Update

U.S. Treasury Attempts to Influence OECD'S BEPS Initiative via Proposed Changes to U.S. Model Treaty

The United States has been criticized on more than one occasion for failing to be a meaningful participant in the OECD's multi-pronged initiative to address base erosion and profit shifting (BEPS). Some commentators have even gone so far as to accuse the United States of actively working against the BEPS project in an attempt to minimize its impact on the United States and U.S. multinationals.¹ Contrary to this perception, however, five draft updates (the Proposed Changes) to the U.S. Model Income Tax Convention (the U.S. Model Treaty) released on May 20, 2015, signal an attempt on the part of Treasury to become more actively involved in (and perhaps even strong-arm) the BEPS conversation.

Released just two days before the OECD issued its revised discussion draft (the 2015 Treaty Draft) on BEPS Action 6: Prevent Treaty Abuse (Action 6) and shortly before the United States was scheduled to meet with the OECD in June, the Proposed Changes are (in the words of Henry Louie, deputy to the International Tax Counsel – Treaty Affairs) designed to “influence the debate at the OECD.”² The content of the Proposed Changes has also, in turn, clearly been influenced by the various perspectives articulated in the OECD's reports on Action 6.³ Treasury, it seems, has recognized that the operation of the existing U.S. treaty network can at times operate to facilitate BEPS, and the Proposed Changes are a direct attempt to combat those abuses.⁴

¹ See e.g. Lee Sheppard, “International Changes the United States Shouldn't Have Made” (2014) 76:7 Tax Notes Intl 739 at 739 (“The United States is not serious about taxing U.S. multinationals on their foreign income and does not need the revenue. This fundamental understanding is amply demonstrated by the U.S. attitude toward the base erosion and profit-shifting project, which is a polite pretense of participation with quiet undermining.”); Antony Ting, “The Politics of BEPS – Apple's International Tax Structure and the US Attitude Towards BEPS” (2015) 69 Bull Intl Tax [forthcoming in 2015] (“It appears that the primary objective of U.S. involvement in the BEPS project is not to avoid double non-taxation, but to minimize the impact of the project on the country and its MNEs.”)

² See “U.S. Proposes Changes to Model Tax Treaty Meant to Influence BEPS Talks”, *Bloomberg BNA* (21 May 2015), online: <<http://www.bna.com/us-proposes-changes-n17179926965>>.

³ OECD, “Revised Discussion Draft - BEPS Action 6: Prevent Treaty Abuse” (22 May 2015), online: <<http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-6-prevent-treaty-abuse.pdf>>.

⁴ Caplin & Drysdale, “Treasury Proposes Significant Changes to U.S. Model Tax Treaty” (26 May 2015), online: <<http://capdale.com/treasury-proposes-significant-changes-to-us-model-tax-treaty>> (quoting Danielle Rolles, International Tax Counsel: “When we take a step back and look at our tax treaties, [they are], in fact, facilitating double non-taxation”).

Since the U.S. Model Treaty stakes out the United States' preferred positions in treaty negotiations, it is an important document not only as a reflection of what future U.S. treaties may contain, but more generally as an expression of U.S. tax treaty policy.⁵ Accordingly, BEPS-related changes to the U.S. Model Treaty can be regarded as an important bellwether for more general U.S. international tax trends.

If adopted, the Proposed Changes would add new provisions to the U.S. Model Treaty that are intended to target the use of U.S. treaties to facilitate "double non-taxation" or "stateless income" and to make U.S. treaties more responsive to changes in treaty partners' domestic laws that may result in low effective rates of overall taxation. The Proposed Changes also include provisions designed to further discourage so-called "inversion" transactions, in which U.S. companies typically interpose new non-U.S. parent companies and engage in various strategies designed to strip earnings out of the United States or otherwise lower effective rates of U.S. tax.

More specifically, the five sets of Proposed Changes address (i) "exempt permanent establishments;" (ii) "special tax regimes;" (iii) subsequent changes in law; (iv) the Limitation on Benefits (LOB) provisions common to more recent U.S. treaties; and (v) "expatriated entities," each of which is discussed in more detail herein. Some of these Proposed Changes have already been incorporated in the OECD's 2015 Treaty Draft as U.S.-initiated proposals to be considered further, and we will likely have more visibility on how successful Treasury's efforts to influence the OECD have been in the near term – the OECD Working Party responsible for Action 6 is scheduled to meet again from June 22-26, 2015, when it will be asked to produce a final version of its report.

Treasury has invited comments on the Proposed Changes within the next 90 days and hopes to issue a new version of the U.S. Model treaty by year end.⁶ It will ultimately be up to the United States and its treaty partners, however, to decide how, and to what extent, these Proposed Changes or their progeny will be incorporated into actual treaties, and further changes could result from that process. Nevertheless, the issuance of the Proposed Changes suggests that Treasury is at least aware that it may need to take an active part in the BEPS discussion if it is to succeed in negotiating with partner jurisdictions (like Canada) that have been more enthusiastically involved in the OECD's BEPS project since the beginning.

⁵ See David Rosenbloom and Joseph Brothers, "Reflections on the Intersection of U.S. Tax Treaty Policy, U.S. Tax Reform, and BEPS" (2015) 78:8 Tax Notes Intl 759.

⁶ See "Treasury Hoping to Release Final U.S. Model Treaty by Year End", *Bloomberg BNA* (19 June 2015), online: <<http://www.bna.com/treasury-hoping-release-n17179927896/>>.

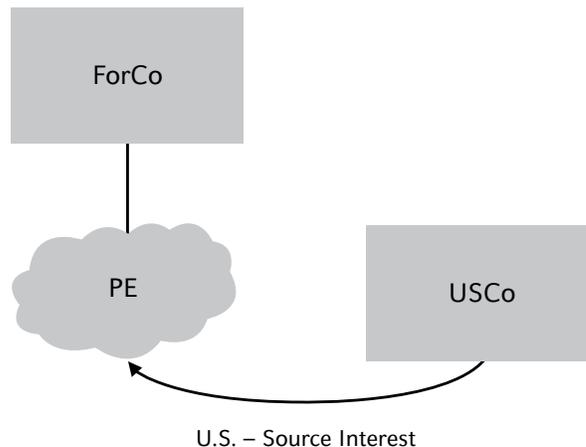
Exempt Permanent Establishments

The first of the Proposed Changes essentially provides that, where an enterprise in one country (the Residence Country) derives income from another country (the Source Country) and the Residence Country treats that income as attributable to a permanent establishment (PE) located outside of the Residence Country (the PE Country), benefits that would otherwise apply under the treaty would be denied if either:

- the profits of the PE are subject to a combined aggregate effective rate of tax in the Residence Country and the PE Country that is less than 60% of the general rate of company tax in the Residence Country; or
- the PE Country does not have a comprehensive tax treaty in force with the Source Country (unless the Residence Country otherwise includes the income in its tax base).⁷

The proposed rule contemplates Source Country competent authority relief from the application of the rule in certain circumstances.⁸

Take, for example, a treaty-eligible company resident outside the United States (ForCo) that sets up a PE in a third country that receives interest payments from a U.S. corporation (USCo).



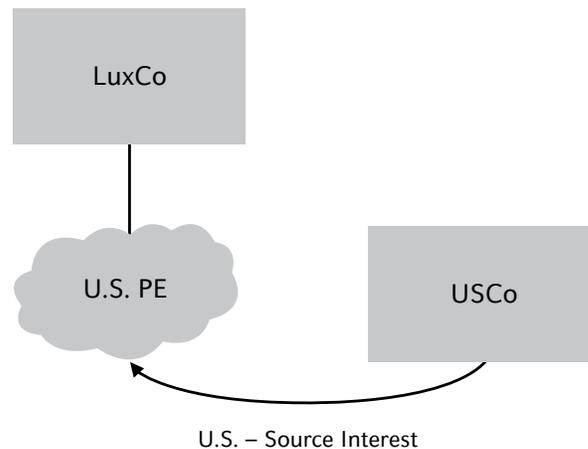
In this scenario, a USCo might utilize the provisions of the treaty between the U.S. and ForCo's country of residence to apply a reduced rate of withholding tax to the payment of the U.S.-source interest. If neither ForCo's country of residence nor the PE jurisdiction imposes a meaningful amount of tax on the profits of the PE, the interest income is

⁷ U.S. Department of the Treasury, "Proposed Treaty Rule Addressing So-Called 'Exempt Permanent Establishments'" (20 May 2015), online: <<http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Exempt-Permanent-Establishments-5-20-2015.pdf>> at 1.

⁸ *Ibid.*

effectively exempt from tax, resulting in just the type of double (or really triple) non-taxation or stateless income that the Proposed Changes and the OECD's BEPS initiatives are designed to address. If this Proposed Change were incorporated into the relevant treaty, however, the reduced rate of U.S. withholding on the interest payment would instead be denied because the combined aggregate effective rate of tax in ForCo's country of residence and the PE jurisdiction on the profits of the PE would presumably be less than 60% of the general rate of corporate tax in ForCo's country of residence.

The Proposed Change is essentially a revision of the "triangular PE" provisions contained in the LOB articles of many more recent U.S. treaties. Unlike those existing provisions, however, the Proposed Change could also apply in a two-country scenario. Assume, for example, that a Luxembourg corporation (LuxCo) that is exempt from tax under Luxembourg's statutory exemption regime sets up a U.S. PE that receives U.S.-source interest income but that is not treated as being engaged in a U.S. trade or business (and is therefore not subject to tax) under U.S. domestic law.



LuxCo might use the provisions of the U.S.-Luxembourg treaty to claim a reduced rate of withholding on the interest payment, even though the profits of the PE would also be free from Luxembourg tax, again resulting in double non-taxation. Because the combined aggregate effective rate of U.S. and Luxembourg tax on the PE's profits would be less than 60% of the general rate of corporate tax in Luxembourg, however, the Proposed Change would similarly deny the exemption from U.S. withholding tax on interest otherwise afforded under the U.S.-Luxembourg treaty.

This Proposed Change appears to be directly targeted at specific tax minimization strategies identified by the OECD's BEPS initiative (particularly in light of the recent Luxembourg tax ruling leaks).⁹ While the OECD's 2015 Treaty Draft took note of

⁹ See, e.g., Alison Fitzgerald and Marina Walker Guevara, "New Leak Reveals Luxembourg Tax Deals for Disney, Koch Brothers Empire", *The International Consortium of Investigative Journalists* (9 December 2014), online: <<http://www.icij.org/project/luxembourg-leaks/new-leak-reveals-luxembourg-tax-deals-disney-koch-brothers-empire>>.

Treasury's Proposed Change regarding exempt PEs,¹⁰ the 2015 Treaty Draft proposes a differently worded provision. The OECD's proposed rule would instead apply only to PEs situated in third countries, and would only apply where the PE profits are exempt from taxation in the residence state.¹¹ Further, in contrast to the U.S. proposal, the OECD proposes to continue to provide limited treaty relief in respect of some specific types of income (dividends, interest or royalties) caught by the third country PE rule.¹² Finally, the OECD's rule would generally not apply where the income in question is derived in connection with or is incidental to the active conduct of a business carried on through the PE – a carve-out not included in the U.S. proposal.¹³

Special Tax Regimes

Under the second Proposed Change, treaty benefits for interest, royalties or “other income” beneficially owned by a resident of one country (the Residence Country) and paid by a related person in the other country (the Source Country) would be denied treaty benefits if the resident is subject to a “special tax regime” with respect to that income in the Residence Country at any time during the taxable period in which the payment is made.¹⁴ Special tax regime is broadly defined as “any legislation, regulation, or administrative practice that provides a preferential effective rate of taxation,” although there are several exceptions for preferential regimes that:

- do not disproportionately benefit interest, royalties or other income (i.e., that are generally applicable to all income and available across industries);
- in the case of royalties, require that substantial activities not of a mobile nature be conducted in the Residence Country;
- implement the principles of the business profits or associated enterprises articles (e.g., APAs, MAPs, etc.);
- apply principally to (i) charitable organizations; (ii) pension funds; or (iii) certain collective investment vehicles; or
- are excluded via diplomatic notes exchanged by the treaty partners.¹⁵

¹⁰ OECD, *supra* note 3 at para 106.

¹¹ *Ibid* at para 107.

¹² *Ibid*.

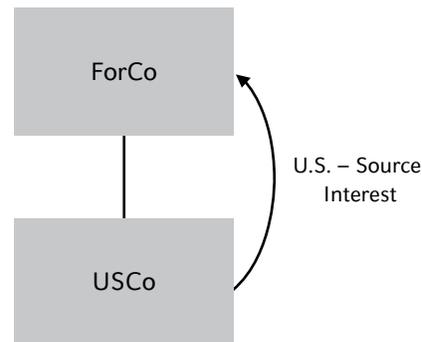
¹³ *Ibid*.

¹⁴ U.S. Department of the Treasury, “Proposed Treasury Rules Addressing ‘Special Tax Regimes’” (20 May 2015), online: <<http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Special-Tax-Regimes-5-20-2015.pdf>> at 5-6 [*Special Tax Regimes*].

¹⁵ *Ibid* at 1.

Danielle Rolfes, International Tax Counsel, has noted that Treasury would likely refrain from defining “special tax regime” further, given the difficulty in determining, “at the time of negotiation, all of the ways that a country might give preferences.”¹⁶ The Proposed Change, however, allows treaty partners to specify particular regimes that they agree are “special tax regimes,” although the list is not intended to be exhaustive given that the provision must be able to respond to new preferential regimes that might come into force after a treaty is negotiated in order to function properly.¹⁷

Imagine a non-US company (ForCo) that receives U.S.-source interest payments from a related U.S. corporation (USCo).



Under the Proposed Change, if the U.S. source interest payments are subject to a special tax regime in ForCo’s country of residence, treaty benefits (e.g., a reduced rate of U.S. withholding on interest) would be denied.

The Technical Explanation issued in conjunction with the Proposed Changes notes that the provisions are consistent with the principles articulated in the introduction to the OECD Model Commentary, as modified by the BEPS initiative, which provides that “[s]tates should also consider whether there are elements of another state’s tax system that could increase the risk of non-taxation, which may include tax advantages that are ring-fenced from the domestic economy.”¹⁸ The OECD’s 2015 Treaty Draft presents, as a proposal from “the Delegate from the United States,” a provision that looks much like the Proposed Change regarding special tax regimes.¹⁹ One notable difference, however, is that while the Proposed Change treats notional deductions allowed with respect to equity (common in European countries) as a special tax regime even if (notwithstanding the exception for regimes that do not disproportionately benefit interest, royalties or other income) such notional deductions are part of the country’s generally applicable tax system,²⁰ the OECD’s 2015 Treaty Draft instead speaks of “notional interest deductions

¹⁶ Caplin & Drysdale, *supra* note 4.

¹⁷ *Special Tax Regimes*, *supra* note 14 at 1-2.

¹⁸ *Ibid* at 2.

¹⁹ OECD, *supra* note 3 at paras 50–53.

²⁰ *Special Tax Regimes*, *supra* note 14 at 3.

that are allowed without regard to liabilities for such interest.”²¹ It is not yet clear, however, whether the difference in wording implies a different substantive scope for the rule.

Interestingly, the OECD’s proposed special tax regimes rule appears in the context of a discussion of whether sufficient safeguards can be introduced into treaties so that the inclusion of a derivative benefits clause in the proposed LOB article would not facilitate BEPS.²² That the U.S. delegate is reported to have offered up the special tax regimes rule as such a safeguard highlights the dual function of Treasury’s Proposed Changes – seemingly intended to both prevent U.S. treaties from being used for BEPS (to the extent the changes are reflected in future U.S. treaties) and to convince other OECD members that an objective, U.S.-style LOB article with a derivative benefits clause is an effective tool for combating treaty abuse, even without the backstop of a subjective principal purpose test.

Subsequent Changes in Law

The third Proposed Change would allow one treaty partner to unilaterally terminate the application of the dividend, interest, royalties and other income articles of the treaty with respect to payments made to residents of either treaty country if, after the treaty is signed, (i) the general rate of company tax or highest rate of individual tax (taking into account generally available deductions based on a percentage of taxable income) in the other treaty partner falls below 15% with respect to substantially all of the income of its residents; or (ii) the other treaty partner provides an exemption for its residents for substantially all foreign source income (e.g., taxation on a territorial basis).²³ The Technical Explanation clarifies that a rate reduction below 15% can be considered to have occurred with respect to “substantially all of the income” of the residents of a contracting state even if narrow categories of income, such as income from passive activities or portfolio investments, are excluded from such rate reduction.²⁴ A country would not, however, be considered to provide an exemption to its residents from tax on substantially all foreign source income if it introduces a participation exemption regime. Reduced capital gains tax rates are similarly outside the scope of the Proposed Change, as are taxes applicable to a company only when it makes distributions, or applicable only to shareholders.²⁵

If a treaty partner decides to terminate the application of the dividend, interest, royalties and other income articles, it would be required to notify the other treaty partner via diplomatic channels, and, after six months, the suspension would go into effect.²⁶ Even though unilaterally implemented, the suspension of benefits is reciprocal, affecting

²¹ OECD, *supra* note 3 at para 53.

²² *Ibid* at para 48.

²³ U.S. Department of the Treasury, “Proposed Article Addressing Subsequent Changes in Law” (20 May 2015), online: <<http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Subsequent-Changes-in-Law-5-20-2015.pdf>> at 1 [Subsequent Changes].

²⁴ *Ibid* at 2.

²⁵ *Ibid* at 3.

²⁶ *Ibid* at 4.

residents of both countries. Treaty partners are then supposed to consult with each other to amend the treaty to restore “an appropriate allocation of taxing rights.”²⁷

In recognition of the fact that treaties are difficult to negotiate and update, this Proposed Change (like the special tax regimes proposal described above), is designed to prevent changes in a country’s domestic laws from giving rise to new opportunities for BEPS.²⁸ According to Robert B. Stack, Deputy Assistant Secretary for International Tax Affairs, “[t]he draft provisions ... reflect the fact that the tax regimes of our treaty partners are more likely to change over time than they have in the past, and that they sometimes change in ways that encourage ... BEPS by multinational firms. Treaties exist to eliminate double taxation, not create opportunities for BEPS.”²⁹

The subsequent changes and special tax regime provisions also appear to work symbiotically, and a regime that does not rise to the level of a subsequent change may nevertheless be a special tax regime.³⁰ For example, a major change that has the result of lowering overall tax rates in a treaty partner jurisdiction might be a subsequent change that would allow the other treaty partner to suspend preferential rates on income under the treaty across the board, whereas a less drastic change that disproportionately benefits particular classes of income might be a special tax regime that would turn off treaty benefits for that particular type of income. Importantly, though, the special tax regime provisions appear to operate automatically, while the subsequent changes provisions require affirmative action through diplomatic channels. In Danielle Rolfes’ words, the subsequent changes proposal is intended to be “less nuclear than terminating a tax treaty,” while still leading to serious consequences if a treaty partner aggressively lowers its domestic tax rates to attract mobile income.³¹

Like the Technical Explanation with respect to special tax regimes, the Technical Explanation to the subsequent changes provisions explains that the rule is consistent with the principles articulated in the introduction to the OECD Model Commentary, as modified by the BEPS initiative.³² The OECD’s 2015 Treaty Draft, in turn, presents as a proposal from the United States a streamlined version of the subsequent changes Proposed Change.³³ Like the U.S. proposal with respect to special tax regimes, the OECD presents the subsequent changes proposal as a potential safeguard against treaty abuse by means of a derivative benefits clause. Unlike the Treasury’s Proposed Change, though,

²⁷ *Ibid* at 4.

²⁸ *Ibid* at 2.

²⁹ U.S. Department of the Treasury, Press Release, “Treasury Releases Select Draft Provisions for Next U.S. Model Income Tax Treaty” (20 May 2015), online: <<http://www.treasury.gov/press-center/press-releases/Pages/j110057.aspx>>.

³⁰ *Subsequent Changes*, *supra* note 23 at 4-5.

³¹ Caplin & Drysdale, *supra* note 4.

³² *Subsequent Changes*, *supra* note 23 at 2.

³³ OECD, *supra* note 3 at para 53.

the version of the subsequent changes provision being proposed by the OECD would only apply if the treaty partner exempted substantially all foreign source income of its residents, and not if the treaty partner merely reduced the general tax rate on income of its residents below a specified threshold.³⁴

Limitation on Benefits

The fourth Proposed Change would amend several provisions of the existing LOB article in the U.S. Model Treaty. Among other changes, this proposal would, for the first time, add a “derivative benefits” test to the U.S. Model Treaty, although derivative benefits tests have already been included in most recent U.S. treaties that have been negotiated since the U.S. Model Treaty was last updated in 2006.

Broadly speaking, a derivative benefits test typically allows a company that is a resident of one treaty country to claim treaty benefits that might otherwise be denied under the LOB article if:

- the company is at least 95% owned directly or indirectly by seven or fewer “equivalent beneficiaries” (the Ownership Test); and
- less than 50 percent of its gross income is paid in the form of deductible payments to persons that are not equivalent beneficiaries (the Base Erosion Test).³⁵

An equivalent beneficiary is generally:

- a resident of any country entitled to the benefits of a U.S. tax treaty (which itself contains an LOB clause) if such resident would be entitled to a tax rate that is at least as low as the rate being claimed if such resident had received the income directly; or
- a resident of the same country as the company claiming benefits that is entitled to the benefits of the treaty.³⁶

When compared to the similar derivative benefits provisions currently in force in U.S. treaties, however, the derivative benefits test in the Proposed Change contains several important differences that could significantly restrict the ability of a company to qualify. For example, the Ownership Test under this proposal would require that, in the case of indirect ownership by equivalent beneficiaries, all intervening entities between the equivalent beneficiary and the entity attempting to qualify under the derivative benefits test be “qualifying intermediate owners,” whereas no such requirement is currently imposed.³⁷ To be a qualifying intermediate owner, the intermediate entity must generally

³⁴ *Ibid.*

³⁵ U.S. Department of the Treasury, “Proposed Limitation on Benefits Article” (20 May 2015), online: <<http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Limitation-on-Benefits-5-20-2015.pdf>> [Limitation on Benefits] at para 4.

³⁶ *Ibid* at para 6(e).

³⁷ *Ibid* at para 4(a).

(i) be resident in a country that has a tax treaty with the United States that includes a special tax regimes provision; and (ii) qualify for benefits under that treaty that are no worse than those claimed by the entity attempting to qualify for derivative benefits.³⁸ Of course, no current U.S. treaties contain special tax regimes provisions. Accordingly, if and until such special tax regimes provisions are broadly adopted, the proposed derivative benefits test would be of limited benefit to entities indirectly (as opposed to directly) owned by equivalent beneficiaries.

The proposed addition of a qualifying intermediate owner condition to the derivative benefits clause reflects BEPS concerns expressed by the OECD. The OECD's 2015 Treaty Draft and prior reports and drafts relating to Action 6 are suffused with a concern over the granting of treaty benefits to persons that are ultimately owned by "good" treaty investors but through a chain of one or more intermediate owners residing in tax havens.³⁹ This concern has been expressed, for instance, in the context of granting treaty benefits for income or gains earned within private equity (and other "non-CIV fund") ownership structures. Treasury's proposed addition of a qualifying intermediate owner condition to the derivative benefits clause in the U.S. Model Treaty can be seen as responsive to this concern.

The Base Erosion Test, which, as noted above, generally requires that less than 50% of the company's gross income be paid in the form of deductible payments to persons that are not equivalent beneficiaries, would also be made more onerous if the Proposed Change is adopted, including by way of the following:

- the denominator of the base erosion fraction (i.e., gross income) would generally be reduced by dividend income that is effectively exempt from tax;
- the numerator of the base erosion fraction (i.e., deductible payments made) would, in addition to looking to payments made to persons that are not equivalent beneficiaries, look to payments made to equivalent beneficiaries that benefit from a special tax regime; and
- the taxpayer's "tested group" (generally, its consolidated or loss-sharing group) would also need to meet the Base Erosion Test.⁴⁰

Furthermore, the Proposed Change would add a similar Base Erosion Test to the LOB provision that generally allows subsidiaries of publicly traded companies to qualify for treaty benefits, making it more difficult for such companies to qualify under that test as well.⁴¹

³⁸ *Ibid* at para 6(f).

³⁹ *See, e.g.*, OECD, *supra* note 3 at para 44.

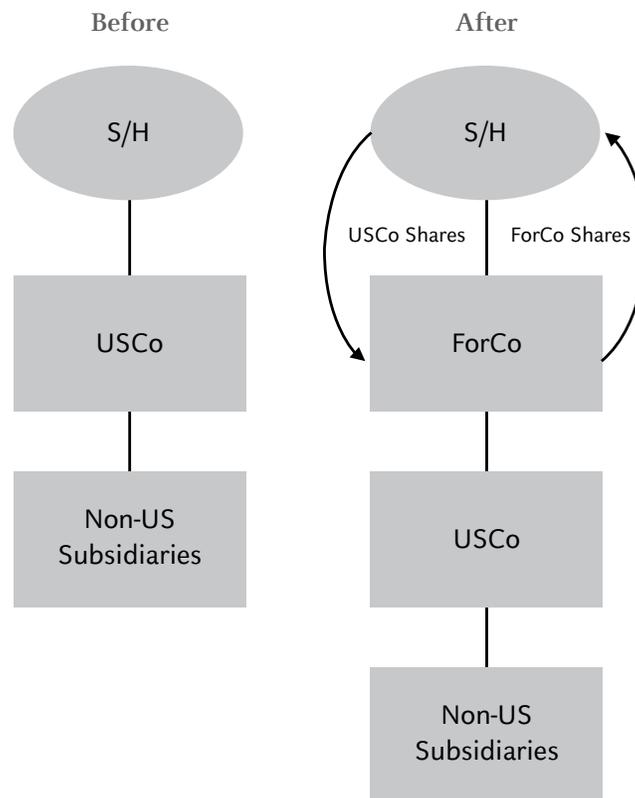
⁴⁰ *Limitation on Benefits, supra* note 35 at para 4(b).

⁴¹ *Ibid* at para 2(d).

In addition, the Proposed Change would eliminate a special test for pure holding or financing companies under the “active trade or business” test, even if they are related to companies having substantial in-country activities.⁴² A footnote explains that Treasury believes the derivative benefits test is the more appropriate standard for determining whether such holding companies and financing entities should be entitled to treaty benefits.⁴³ While seemingly subtle, the practical application of this change would make it significantly more difficult for holding companies and financing companies that hold U.S. investments through tiers of intermediate entities (which would need to be tested for qualifying intermediate owner status) to qualify for treaty benefits.

Expatriated Entities

The fifth Proposed Change provides specific provisions dealing expressly with U.S. companies that are treated as expatriated entities under the U.S. “anti-inversion” rules. At its most basic, an “inversion transaction” typically involves a foreign corporation (ForCo) directly or indirectly acquiring a U.S. corporation (USCo).



⁴² *Ibid* at para 3(a).

⁴³ *Ibid* at para 3(c), n 2.

More specifically, the U.S. anti-inversion rules under Section 7874 of the U.S. Internal Revenue Code (the Code) typically apply if:

- ForCo (the surrogate foreign corporation) acquires, directly or indirectly, substantially all of the properties of USCo (the expatriated entity);
- after the acquisition, at least 60% of the stock of ForCo is owned by former shareholders of USCo; and
- the corporate group that includes ForCo does not have “substantial business activities” in the jurisdiction in which ForCo is organized.⁴⁴

If the anti-inversion rules apply and former USCo shareholders hold more than 60% but less than 80% of the stock of ForCo, then USCo generally becomes subject to tax on its “inversion gain” for a 10-year period (and certain other adverse tax consequences may result). If the anti-inversion rules apply and former USCo shareholders hold 80% or more of the stock of ForCo, then ForCo is treated as a U.S. corporation for all purposes under the Code.⁴⁵

The Proposed Change, if adopted, would impose additional adverse tax consequences on inverted companies by denying treaty benefits for dividends, royalties, interest and other income paid by the expatriated entity (i.e., USCo) for a period of 10 years.⁴⁶ Notably, the Proposed Change does not apply to the surrogate foreign corporation (i.e., ForCo). On this basis, the Proposed Change appears targeted primarily at inverted companies where former USCo shareholders hold at least 60% but less than 80% of the stock of ForCo, rather than ForCos treated as U.S. corporations by virtue of 80% or more ownership. (Such latter types of ForCos would not be subject to U.S. withholding tax on payments made from USCo to ForCo, since the United States would treat ForCo as a U.S. corporation pursuant to Section 7874.) The Proposed Change also does not address the question of whether U.S. treaties can apply to reduce the rate of U.S. withholding tax on payments made by a ForCo that is treated as a U.S. corporation under the inversion rules. Presumably, then, the intent of the Proposed Change is to introduce additional disincentives to “semi-inversions” that result in at least 60% but less than 80% ownership and to cripple the earnings stripping transactions that might still be possible in the case of a semi-inverted company (albeit in a less tax-efficient manner than prior to the enactment of Section 7874). Treasury has made statements suggesting that, although not currently so limited, the Proposed Change could be restricted to payments to related parties.⁴⁷

⁴⁴ I.R.C. § 7874(a)(2)(B).

⁴⁵ I.R.C. § 7874(b).

⁴⁶ U.S. Department of the Treasury, “Proposed Treasury Rules Addressing Payment by ‘Expatriated Entities’” (20 May 2015), online: <<http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Payments-by-Expatriated-Entities-5-20-2015.pdf>>.

⁴⁷ PWC International Tax Services, “US Treasury Proposes Fundamental Changes to US Model Income Tax Convention” (21 May 2015), online: <http://www.pwc.com/en_US/us/tax-services/publications/insights/assets/pwc-us-treasury-proposes-changes-us-model-income-tax-convention.pdf> at 3.

Final Thoughts

Despite the United States' clear effort to become more involved in the BEPS discussion that the Proposed Changes represent, Treasury officials have continued to express frustration with the BEPS project, suggesting that the OECD's initiative has been moving too quickly and producing unworkable rules.⁴⁸ As Robert Stack has noted, the United States is "extremely disappointed in the output and our collective failure in the BEPS project to do more and do better work than we've done."⁴⁹

Not included in the Proposed Changes but expected in future revisions to the U.S. Model Treaty are provisions designed to resolve disputes between tax authorities through mandatory binding arbitration.⁵⁰ Treasury officials have been vocal in suggesting that the United States wants its treaty partners to agree to such mandatory binding arbitration, although some countries have been reluctant to do so.⁵¹

The fact that Treasury chose to respond to BEPS concerns through the issuance of changes to the U.S. Model Treaty rather than other forums is also consistent with its view that the multilateral treaty being developed under the OECD's BEPS initiatives – a project in which the United States has not participated – may be unnecessary to accomplish the BEPS objectives and of limited benefit to the United States.⁵² Treasury's decision to address BEPS through its own treaty network is also consistent with its general rejection of the kinds of domestic-only responses to BEPS being implemented in other countries, including the United Kingdom's diverted profits tax and its proposed Australian analogue.⁵³

In all, the Proposed Changes suggest that, when it comes to the global conversation taking place with respect to BEPS, the United States has taken its seat at the table. It is unlikely, though, that this will be the last statement we hear on the subject.⁵⁴

⁴⁸ Lee A Sheppard and Stephanie Soong Johnston, "U.S. 'Extremely Disappointed' in DPT and BEPS Output, Stack Says", *Tax Notes Today* (11 June 2015) (Tax Analysts).

⁴⁹ *Ibid.* See also, Andrew Velarde, "Delaying Tax Reform Expands Impact of BEPS on U.S., Camp Argues", *Tax Notes Today* (11 June 2015) (Tax Analysts).

⁵⁰ U.S. Department of the Treasury, *supra* note 29.

⁵¹ Sheppard and Johnston, *supra* note 48.

⁵² *Ibid.*

⁵³ *Ibid.*

⁵⁴ The author wishes to recognize the contributions of Matias Milet, Paul Seraganian and Taylor Cao to this Update, which would not have been possible without their helpful insights and assistance.

Update

June 22, 2015

page 14

For more information about this topic, please feel free to contact Michael Radolinski.

This Update was authored by:

Michael Radolinski mradolinski@osler.com 212.991.2559

This memorandum is a general overview of the subject matter and cannot be regarded as legal advice. Subscribe to a full range of updates at osler.com. You can unsubscribe at any time at osler.com or <http://unsubscribe.osler.com>. © Osler, Hoskin & Harcourt LLP

counsel@osler.com
osler.com

Toronto
Montréal
Calgary
Ottawa
New York

OSLER

Osler, Hoskin & Harcourt LLP