

TAX LAW AND ESTATE PLANNING SERIES
Tax Law and Practice
Course Handbook Series
Number D-466

Basics of International Taxation 2016

Co-Chairs

Linda E. Carlisle
John L. Harrington

To order this book, call (800) 260-4PLI or fax us at (800) 321-0093. Ask our Customer Service Department for PLI Order Number 144628, Dept. BAV5.

Practising Law Institute
1177 Avenue of the Americas
New York, New York 10036

20

International Tax Developments:
Observations on the New U.S. Model Treaty
(April 22, 2016) (PowerPoint slides)

Michael H. Plowgian

KPMG LLP

Catherine G. Schultz

National Foreign Trade Council (NFTC)

If you find this article helpful, you can learn more about the subject by going to www.pli.edu to view the on demand program or segment for which it was written.

International Tax Developments
Observations on the
New U.S. Model Treaty

April 22, 2016

Notices

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

2016 U.S. Model Income Tax Treaty

- Starting point for U.S. treaty negotiations
- Last updated in 2006
 - Initial draft released on May 2, 2015 with request for comments (2015 Draft Model Treaty)
 - Provides U.S. Treasury Department's current treaty policy positions
 - Provides a useful Technical Explanation
 - Technical Explanation to 2016 Model Treaty expected (at time of writing) to be released in Spring 2016
- Current Proposed Treaties/Protocols awaiting U.S. Senate approval
 - Chile (Treaty), Hungary (Treaty), Japan (Protocol), Luxembourg (Protocol), Poland (Treaty), Spain (Protocol), Switzerland (Protocol), Vietnam (Treaty/Protocol)

STR – Denial of Treaty Benefits

- STR provision denies treaty benefits for certain deductible payments of highly mobile income made to connected persons.
 - General rule denies reduction in withholding on payments of interest (*Article 11*), royalties (*Article 12*), and other income (*Article 21*) (e.g., guarantee fees) received from “connected persons” when the beneficial owner of the payment pays little or no tax on the related income as a result of an STR (*defined in Article 3*).
- 2016 Model Treaty revises STR rules included in 2015 Draft Model Treaty to limit and clarify their application.

STR – Modifications to Provision

- 2016 Model Treaty modifies the STR provision in the 2015 Draft Model:
 - Narrows scope of provision
 - Revises definition of STRs to provide exclusive list of circumstances in which statute, regulation, or administrative practice is treated as an STR
 - Removes notional interest deductions (NID) based on equity
 - But interest article rate reduction disallowed if payee benefits from a NID
 - Introduces “connected person” concept
 - Adds 15%/60% general statutory rate benchmark
 - Prospective application after 30 days following issuance of a written public notification
 - Reformats exceptions

LOB – Active Trade or Business Test

- New Active Trade or Business Test replaces “derived in connection with” prong with “emanates from” an active trade or business.
 - The technical explanation will provide guidance on when an item of income, in particular an intra-group dividend or interest payment, is considered to “emanate from” the active trade or business of a resident.
 - Mere fact that two companies are in similar lines of businesses would not be sufficient to establish that dividends or interest paid between them are related to the active trade or business.
 - Downstream or Upstream connection may be acceptable
 - Parallel businesses may no longer be acceptable

LOB – New Derivative Benefits Test

- A resident company shall be entitled to treaty benefits if on at least half the days of a 12-month period commencing or ending on the date when the benefit otherwise would be accorded:
 - At least 95% of the aggregate vote and value of its shares (and at least 50% of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer “equivalent beneficiaries”; and
 - In the case of indirect ownership, each intermediate owner must be a “qualifying intermediate owner”

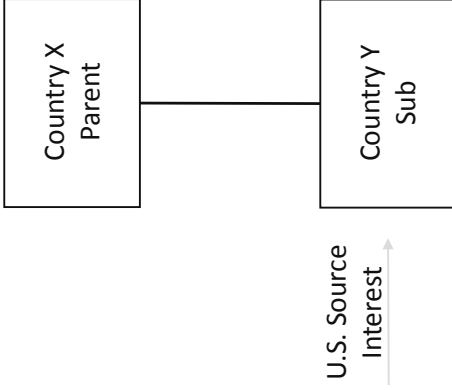
LOB – New Derivative Benefits Test (continued)

- Less than 50% of the company's gross income, and less than 50% of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible (other than arm's-length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions) for resident state tax purposes to:
 - Non-equivalent beneficiaries;
 - Persons that are equivalent beneficiaries only by reason of satisfying the headquarters test;
 - To persons that are equivalent beneficiaries that are connected persons with respect to the resident and that benefit from a special tax regime with respect to the deductible payment; or
 - With respect to a payment of interest, to persons that are equivalent beneficiaries that are connected persons with respect to the resident and that benefit from notional deductions.

LOB – New Derivative Benefits Test (continued)

- Article 22(7)(e) defines the term “equivalent beneficiary” as:
 - A resident of any state if:
 - The resident is entitled to all treaty benefits between its resident state and the source state because it is a “qualified person” by reason of being described in subparagraph (a) (an individual), (b) (a contracting state), (c) (a publicly traded company), or (e) (a tax-exempt entity).
 - A wholly-owned subsidiary of a publicly traded company is not an equivalent beneficiary!
 - With respect to dividends, interest or royalties, withholding tax rate between source state and equivalent beneficiary’s resident state must be the same or better than withholding tax rate under the treaty.
 - No longer a cliff effect if flunk this derivative prong
- A resident of the same state as resident seeking benefits if that resident is described in subparagraph (a), (b), (c), or (e) of paragraph 2 and if the resident satisfies the derivative prong with respect to interest or dividends.
- A resident of the source state that is described in subparagraphs (a), (b), (c), or (e) of paragraph 2 provided that all such residents’ ownership of the aggregate vote and value of the payee seeking to satisfy the derivative benefits test does not exceed 25%.

LOB – New Derivative Benefits Test (continued)

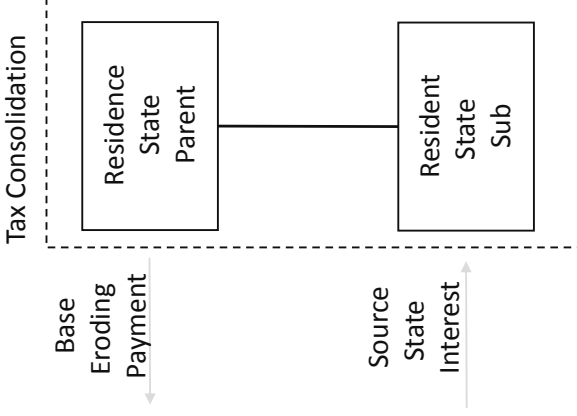


- Country X Parent satisfies the publicly traded company test in LOB article of the US-Country X Treaty.
- US-Country X Treaty provides for a 10% rate of interest withholding.
- Country Y Sub receives US source interest from a connected person.
- US-Country Y Treaty exempts interest from withholding tax.
- May Country Y Sub benefit from a 10% rate of interest withholding tax under the Derivative Benefits Test (provided the base erosion prong is satisfied)?

LOB – New Tested Group Provision

- Tested group rules apply to the base erosion prong in the following LOB tests:
 - Subsidiary of a Publicly Traded Company Test
 - Ownership / Base Erosion Test
 - Derivative Benefits Test
 - Headquarters Test
- Article 22(7)(g) provides tested group means:
 - The tested resident and any company that:
 - Participates as a member with the tested resident in a tax consolidation, fiscal unity, or similar regime that requires members of the group to share profits or losses; or
 - Shares losses with the tested resident pursuant to a group relief or other loss sharing regime in the taxable year.

LOB – New Tested Group Provision (continued)

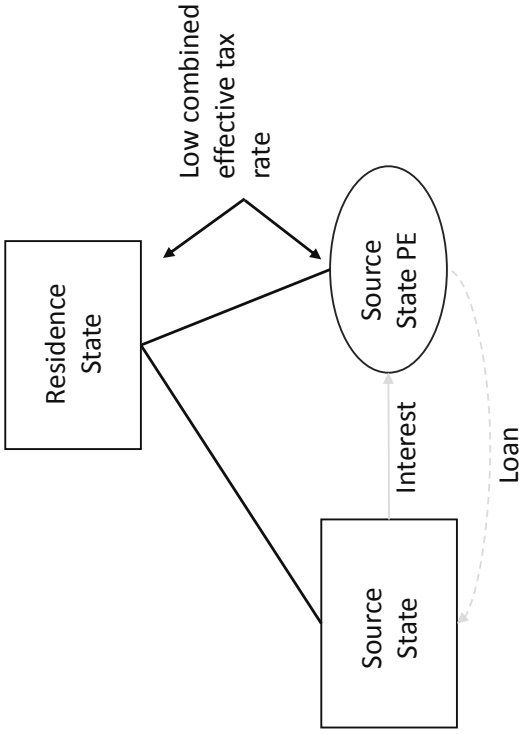


- Residence State Parent and Resident State Sub file a consolidated return in Residence State.
- Residence State Parent makes base eroding payments to non-Resident State payee.
- Resident State Sub receives Source State interest income.

LOB – New Gross Income Provision

- Article 22(7)(h) provides “gross income” is determined in person’s residence state.
- Gross income excludes dividends that are effectively exempt from tax in person’s resident state, whether through deduction or otherwise.
 - Does not apply when claiming benefits under Article 10 (Dividends)
- A tested group’s gross income does not take into account transactions between companies within the tested group.
 - Exception for taxable portion of any dividends

PE Provision



- Residence State views income as earned by Source State PE and provides an exemption on branch remittances.
- Source State views income as earned by Residence State.
- Residence-Source State Treaty exempts interest from Source State withholding tax.
- If combined effective tax rate of Residence State and PE State is less than the lesser of (i) 15% or (2) 60% of the general statutory rate of company tax in the residence state:

→ Treaty benefits denied

PE Provision (cont.)

- Triangular/exempt PE provision turns off treaty benefits for income attributable to a PE located either in (i) source state, or (ii) 3rd jurisdiction if income is subject to little or no tax in any jurisdiction.
 - Article 1(8)
 - Allows competent authority of source state to grant treaty benefits with respect to a specific item of income if such grant is justified in light of the reasons the resident did not satisfy the requirements of the provision
 - 2016 Model Treaty generally tracks May 2015 draft, but
 - Threshold for low tax changed from “less than 60% of general company tax rate in residence state” → **less than the lesser of (i) 15% or (ii) 60%** of general company tax rate in residence state
 - Source country competent authority may not grant or deny request without first consulting with residence country competent authority

Select Miscellaneous Provisions

- Revised preamble
 - Makes clear the purpose of a treaty is to eliminate double tax without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance
- 5% rate of dividend withholding (Article 10(2)(a))
- Requires for 12-month period ending on date of dividend entitlement is determined:
 - Beneficial owner has been a company resident of the resident state or a “qualifying third state,” and
 - Stock carrying at least 10% of the vote and value of the payor was owned directly by the beneficial owner or a “qualifying predecessor owner.”

Select Miscellaneous Provisions

- Expatriated entities
 - No U.S. withholding relief for dividends, interest, royalties, and certain guarantee fees received by a connected person for 10 years after expatriation
 - Fixes the definition of “expatriated entity” to the meaning it has under U.S. tax law under IRC section 7874(a)(2)(A) as of date treaty is signed
 - Preexisting U.S. subsidiaries of foreign acquirer generally not considered expatriated entities for this purpose
- Subsequent changes in law (Article 28)
 - Triggered if other State’s general corporate income tax rate falls below the lesser of either 15% or 60% of source state’s generate statutory rate of corporate tax
 - Requires treaty partners to consult to restore an appropriate allocation of taxing rights
 - If consultations are not successful, treaty partner may notify through diplomatic channels that the dividend, interest, royalties, and other income articles no longer apply.
 - Effective for payments six months after written public notification

NOTES