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by Mark Stone

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SPECIAL REPORT

LOB Provisions in the 2015 Draft U.S. Model Tax Treaty

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In this report, the author examines proposals by the U.S. Treasury Department, which were released without a technical explanation, to modify the U.S. model treaty provisions that affect the limitation on benefits article.

The author believes that given the rules-based nature of the LOB article, new rules are needed as taxpayers find ways around the old ones and as the nature of what Treasury believes to be treaty abusive — such as low resident state tax treatment of income — evolves. The author discusses the provisions, with examples, and tries to make sense of them. In the end, he finds that the size and complexity of the LOB proposals suggest that a principal purpose test approach is worth considering.

On May 20 the U.S. Treasury Department released for public comments five proposed changes to the 2006 U.S. Model Income Tax Convention in lieu of issuing a complete revised model.[1] The five proposals focus on different aspects of perceived treaty abuse.

According to Treasury, new proposed article 1(7) provides ''more robust rules on the availability of treaty benefits for income that is not subject to tax by a treaty partner because it is attributable to a permanent establishment located outside the country.'' New draft article 3(1)(l) defines the phrase ''special tax regime'' as a special low rate of tax, with exceptions, resulting from legislation, regulation, or administrative practice in the resident state on an item of income. Draft articles 11(2)(c), 12(5)(a), and 21(3)(a) are the operative provisions that deny treaty benefits for related-party payments benefiting from a special tax regime.

The next set of provisions — articles 10(9), 11(2)(d), 12(5)(b), and 21(3)(b) — apply to expatriated entities and are designed to deny treaty benefits paid by those entities, whether to related or unrelated persons, during the 10 years set forth in Internal Revenue Code section 7874(d)(1). New proposed article 28 would adopt a novel approach in denying treaty benefits under the withholding tax articles, in lieu of withdrawing entirely from the treaty, if after the treaty is signed the individual or corporate tax rate in the resident state falls below 15 percent, or if the state adopts a territorial system exempting substantially all foreign-source income.

The four proposals were issued with the usual Treasury technical explanation to flesh out the meaning of the treaty language and to provide the rationale for its issuance.

The fifth proposal addresses changes to the broader treaty abuse provision, treaty shopping, and is known to all U.S. international tax lawyers as the limitation on

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[1] *See* Kristen A. Parillo and Andrew Velarde, ''U.S. Treasury Proposes Dramatic Changes to Model Treaty,'' *Tax Notes Int'l*, May 25, 2015, p. 691; Philip D. Morrison, ''Proposed Model Treaty Provisions: Making Sense and Nonsense,'' 44 *TM Int'l J.* 491 (Aug. 14, 2015); New York State Bar Association Tax Section, ''Comments on Proposed Changes to U.S. Model Income Tax Convention Provisions on 'Special Tax Regimes''' (Aug. 19, 2015); and American Bar Association, ''Comments on Certain

(Footnote continued in next column.)

Select Draft Provisions of the U.S. Model Income Tax Convention Released by the Treasury Department on May 20, 2015'' (Nov. 10, 2015).

benefits article in article 22 of the 2006 U.S. model that is found in most U.S. tax treaties. The fifth proposal is extensive but unlike the other four, Treasury gave no technical explanation for it because ''the rules are objective and mechanical in nature and thus are self-explanatory.'' Many of the changes are useful loophole closers, some tie into new proposals for special tax regimes found in other 2015 model treaty proposals, some add benefits, and some delete benefits. Treasury should issue an explanation, despite its statement, that the changes are self-explanatory.[2]

I. A Short History of the LOB Rationale

The United States has long been concerned that residents of non-treaty countries could obtain tax treaty benefits from their investments in the United States by routing their investments through an entity formed and resident in a treaty country. To combat that abuse, the United States has included LOB provisions in its income tax treaties dating back to 1970.[3]

On the other hand, the United States recognizes that third-country residents may have legitimate business reasons for forming an entity resident in a treaty country.[4] One of the cornerstones of the U.S. LOB treaty approach is avoiding the difficulty of determining the subjective reasons why a third-country resident uses a resident country entity and to adopt instead objective, rules-based tests to determine if a person is sufficiently economically connected to a resident country through the entity to warrant treaty benefits.[5]

The next sections analyze the rules-based changes in the 2015 Treasury LOB proposals. While the focus is on the changes to the 2006 U.S. model, because the derivative benefits provision was not included in that model and has been included in several European and North American treaties since 1992 and is part of the U.S. negotiating arsenal, I compare the 2015 proposals with existing treaty provisions using the 1992 Netherlands-U.S. tax treaty, one of the earliest and most comprehensive treaties.

At the conclusion of the analysis, we are also left to consider whether another set of rules — no matter how well intended and how much they may close up loopholes, expand benefits, and otherwise meet Treasury's policy goals — leaves us with an article almost impossible to apply short of subjecting it to a yet-to-be-adopted computer-generated commercial tax program.

II. 2015 LOB Treasury Proposal: Summary

A. Comparison With the 2006 U.S. Model

In addition to adding a derivative benefits paragraph, summarized in the following comparison summary discussion, the 2015 proposals make several changes to the base erosion test, limit access to the active trade or business qualification, add a new requirement for competent authority grants, clarify that qualified-person testing occurs when benefits are accorded, and add several group company terms that must be absorbed along with terms already in the treaty.

1. Base Erosion

Below are the changes to the base erosion test under the 2015 proposals:

- Public company subsidiaries would be subject to the base erosion test, except for benefits under article 10 (dividends).
- Base erosion would be applied not only on a resident company basis, but also on a modified consolidated (tested group) basis for all purposes of the article in which the base erosion test applies (public company, private company, and derivative benefits).
- Except for determining benefits under article 10, base erosion gross income excludes exempt dividends and some intercompany income for all purposes of the article.
- For all purposes of the article, payments to otherwise qualifying recipients base erode if those payments benefit from a special tax regime.
- Treasury seeks comments on whether payments for interest and other items arising under financial obligations to an unrelated bank should be excluded from base erosion.

2. Other Changes

- The ''active trade or business connected person'' attribution benefit would be limited to those entities in the same or complementary lines of business.
- A competent authority benefit claimant must affirmatively demonstrate a substantial nontax nexus to the state.
- Qualified person testing occurs when benefits are accorded.
- New terms ''tested group'' and ''qualifying intermediate owner'' are added to the lexicon for group entities, and the definition of ''connected person'' is changed.

[2] More likely, Treasury simply ran out of time; its goal was to issue all the proposals at or about the same time action 6 of the OECD base erosion and profit-shifting project was issued (May 22).

[3] Treasury Office of Tax Policy, ''Earnings Stripping, Transfer Pricing, and U.S. Income Tax Treaties'' (Nov. 28, 2007), at 52-53.

[4] *Id.*

[5] *Id.*

B. Derivative Benefits and the Dutch Treaty

- The geographic locus of eligible equivalent beneficiaries is expanded.
- Each direct and indirect owner of the resident company between the equivalent beneficiary and the resident company must be a qualifying intermediate owner, replete with treaty eligibility and special tax regime requirements.
- The base erosion test is applied on a tested group basis and is subject to special tax regime restrictions on deductible payments.
- Equivalent beneficiaries who are individuals must be liable to tax currently on foreign-source income.
- The vague ''as favorable as'' requirement for benefits under article 7 (business profits), article 13 (gains), and article 21 (other income) is added to the existing ''as low as'' test for withholding tax benefits.

III. LOB Changes to 2006 U.S. Model

A. Base Erosion — Background

The base erosion provisions form one leg of the 50/50 ownership base erosion test for resident entities that are not otherwise specifically enumerated in the LOB article as a qualified resident (qualified person). In short, the test denies treaty benefits to nonpublic entities at least 50 percent owned, by vote or value, by third-country residents, or that disburse at least 50 percent of their gross income in the form of specific deductible payments, exclusive of arm's-length ordinary course payments for tangible property or services, to third-country residents or nonqualifying residents.[6]

The base erosion provisions in the 2006 model modified the 1996 U.S. model income tax convention, which did not limit base erosion payments to essentially mobile income such as interest and royalties, but included all deductible arm's-length payments, including those for tangible property and services. Thus, from a taxpayer's standpoint, the 2006 model is an improvement.

The 1996 model further provided that base erosion payments are those made to nonresidents, thus any payment to a resident would not base erode under the treaty language.[7] Concerned that the term ''resident'' included a nonpublic company that might itself base erode, and thus be ineligible for treaty benefits under the LOB article, the technical explanation to the 1996 model stated that payments to a resident are not considered base eroding ''to the extent that these recipients do not themselves base erode to nonresidents.'' The difficulty of determining whether unrelated resident recipients of those payments are base eroding likely led to the change in the 2006 model.

The 2006 model takes a different tack in addressing potential base erosion of a resident recipient of payments. It does not treat a resident entity that is not a public company as eligible to receive payments from a similar nonpublic entity seeking to qualify under the base erosion test. Thus, whether a treaty nonpublic recipient itself base erodes is irrelevant under the 2006 model,[8] making the 2006 model less favorable to taxpayers than the 1996 model.

Finally, the 2015 base erosion provisions are broader than conduit provisions. It is not merely base-eroding payments to a party relatively involved in the source country to third-country transactions that give rise to nonqualifying treaty status, but also payments to any person not resident in the treaty country or otherwise qualifying.[9]

B. Base Erosion — 2015 Proposals

1. Base Erosion Expanded to Some Subsidiaries

Under the 2006 model, the base erosion provisions apply neither to public companies nor to their subsidiaries.[10] The 2015 proposals add base erosion requirements for public subsidiary qualification under the LOB article but exclude the requirement for benefits under article 10.[11] That proposal is questionable. Treasury states the reason for exempting public companies from both the ownership test and the base erosion requirements in a 2007 report to Congress:

> Because widely held corporations are not likely vehicles for treaty shopping, several U.S. tax treaties also granted benefits to corporations publicly traded on a recognized stock exchange, as prescribed in the particular treaty. This ''publicly traded'' test, which has evolved over time as discussed below, has become one of the fundamental components of modern LOB provisions.[12]

If Treasury is not concerned with treaty shopping for qualified public companies, why would it be concerned about subsidiaries of those companies? Suppose, instead, that the public company operated through a branch rather than a separate wholly owned

[6] 2006 U.S. model technical explanation. In the derivative benefits paragraph, base erosion forms the second leg of the 50/50 ownership base erosion test.

[7] 1996 model article 22(2)(f)(ii).

[8] 2006 model article 22(2)(e)(ii), which limits good payments to residents qualifying as an individual, a state, a public company, or a pension or charitable fund.

[9] Whether payments to unrelated persons should base erode is a policy decision not addressed in this article.

[10] I do not discuss the specific requirements to meet public company status under the 2006 model and assume for this article that the company is so qualified. *See* 2006 U.S. model article 22(2)(c)(i).

[11] 2015 model article 22(2)(d)(ii).

[12] *See* Treasury report, *supra* note 3, at 53.

entity. That kind of structure would not be subject to base erosion testing under the proposed changes. How would that be any different from the subsidiary scenario in terms of potential to treaty shop? Perhaps the concern is that because nearly 50 percent of the public subsidiary may be owned by third-country residents, those investors could strip all the income out of the treaty state through erosion payments to themselves or others outside the treaty country. If that is the rationale, it is not convincing because all the subsidiary's income could be stripped out to third-country residents even if the subsidiary was wholly owned by the public company.

A good policy reason for including a base erosion requirement for a public subsidiary that has nonqualifying shareholders, whether resident or nonresident, could be determined more easily if Treasury would provide a technical explanation for the base erosion requirement for a public subsidiary. I see no justification for its imposition on a wholly owned public subsidiary and cannot see where a line on nonpublic ownership can be drawn short of 50 percent, at which point the current rule under article 22(2)(f)(ii) of the 2015 model would apply.

The proposal, however, is not without precedent in treaty practice. Treaties with Barbados, Luxembourg, and Malta have a base erosion requirement for public subsidiaries.[13] There is no discussion in any of the technical explanations to the agreements regarding why those treaties are outliers. However, if a public subsidiary fails to qualify for treaty benefits under those respective LOB provisions, all benefits are lost, including those otherwise available under article 10, in contrast with the 2015 proposals.

In that regard, it would also be helpful if any technical explanation to the 2015 proposals set forth the reason for excepting article 10 dividend payments from base erosion requirements.[14]

2. Base Erosion — Tested Group

The 2015 model proposals use base erosion provisions in three separate settings. In addition to the basic, unchanged nonpublic company 50/50 test in the 2006 model, the provisions are also used for the new public company subsidiary test and in the derivatives benefits paragraph added as part of the 2015 proposals. Under the 2015 proposals in each of the three settings, a company's gross income and payments would be measured not only for those items, but also on any tested group basis of which the company forms a part. Thus, in a tested group scenario, two base erosion tests must be met: the first with the resident entity claiming treaty benefits and separately with all members of the tested group. In both tests, the gross income and deductible payments are measured on a resident company and tested group basis.

Tested group is defined as the resident applying the base erosion test, and any intermediate owner that is both a resident of the same contracting state and a member with the tested resident of a tax consolidation regime or similar group that allows members of the group to share profits or losses.[15] A literal reading indicates that only the resident and intermediate owner take into account their gross income for the year. Other members of the group, such as sibling or subsidiary members, would not be included. It is sort of a ''consolidated light.'' To avoid doubt, the provision adds that ''there is no 'tested group' if the tested resident has no intermediate owner.'' Thus, if the parent company is resident, the consolidated subsidiaries' gross income is not part of the gross income computation under the base erosion test.

Two simple examples highlight the consolidated light approach I believe was taken in the 2015 proposals:

- **Example:** Base-eroding royalty payments (assuming the only such base-eroding payments) by a tested resident subsidiary with a consolidated parent company would be tested against the subsidiary's gross income first and then separately with the gross income and separate base-eroding payments of its immediate parents and other intermediate owners that form part of the consolidated group. Other members of that group, such as siblings or subsidiaries of the tested resident, would not be included.
- **Example:** Royalty payments by the ultimate parent of the group described in the example above are tested against that parent's gross income. Because that parent has no intermediate owner, no other company is tested because there is no tested group.

Treasury does not make clear why it adopted the consolidated light approach. It would seem reasonable to include the gross income and base-eroding payments of all members of a consolidated or similar group to avoid gaming the provisions. That is, even if the tested company makes no base-eroding payments, it is still possible that its parent, siblings, or subsidiaries will make those kinds of payments and strip all income out of the resident state. In a June 26, 2006, report to Treasury, entitled ''Limitation on Benefits Provisions and Section 1(h)(11),'' the New York State Bar Association Tax Section recommended that approach. Treasury

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[13] Barbados article 22(1)(c)(ii)(b), Luxembourg article 24(2)(e), and Malta article 22(2)(c)(ii)(B).

[14] There are exceptions for article 10 benefits in two separate provisions of the 2015 proposals. Besides the public subsidiary base erosion exception, base erosion disqualification does not apply to article 10 benefits under the exempt dividend exclusion of article 22(6)(h) of the 2015 model.

[15] 2015 model article 22(6)(g).

should issue a technical explanation on that point so that practitioners may determine its policy reasoning and comment on whether the policy is sound.

3. Excludes Some Dividends and Intercompany Income

Base erosion is calculated by first computing the gross income of the tested entity and tested group, and then determining whether at least 50 percent of that gross income is paid out to nonresidents and other nonqualifying persons. Thus, the higher the gross income, the less likely base erosion will arise. Under the 2015 proposals, gross income does not include, except for article 10 purposes, dividends effectively exempt from tax in the tested person's state, whether through deductions or otherwise. Gross income also does not include intercompany income from the same tested group.[16] The exclusion for intercompany tested group income is sensible and perhaps should be expanded to all intercompany consolidated income.[17]

Regarding effectively exempt dividends, a technical explanation from the U.S. Treasury Department might be in order. Is Treasury referring to a typical participation exemption common in Europe? What about foreign-source dividends that are fully taxable but creditable, perhaps putting them in a similar after-tax position to that of the participation exemption? Or is the concern with a domestic dividend deduction in the residence state similar to IRC section 243?[18]

It would also be helpful to understand why the dividend effective exemption does not apply to article 10 benefits. If elimination of effectively exempt dividend income serves the policy of more accurately measuring base erosion, why would article 10 benefits survive?

4. Some Payments to Qualified Persons Base Erode

The special tax regime construct of the 2015 model proposal is designed to further the goal, more fully discussed in the OECD's base erosion and profit-shifting project, that a treaty should not foster double nontaxation. If the resident state generally imposes no or low tax on income, the source state may find no need to enter into a treaty because there is no risk of double taxation.[19] Also, if the resident state imposes a generally sufficient tax rate but provides for an effective low rate for the specific payment eligible for treaty benefits or otherwise measured under the treaty, then that payment should also be subject to treaty restrictions. That specific payment treatment is the focus of the special tax regime.

The 2015 model uses the special tax regime provisions for three purposes. The first applies to deny treaty withholding tax benefits under articles 11 (interest), 12 (royalties), and 21 (other income), but not article 10 (dividends) for related-party payments.[20] It is clear Treasury is attacking income-stripping concerns in the source state under that use. In the LOB base erosion setting, the special tax regime serves a broader purpose of denying all benefits to a qualified person, including article 10,[21] when deductible payments subject to a special tax regime are made to an otherwise qualified person by treating those payments as base eroding. Payments to both related and unrelated persons count for that purpose.[22] If the payments subject to the special tax regime bring the qualified person's percentage in gross income base erosion to at least 50 percent, the person will not be a qualified person under the LOB article.[23] The base erosion use of the special tax regime applies for all three base erosion provisions of the 2015 U.S. model proposals.[24]

A qualified person may have some difficulty determining whether a payment is subject to a special tax regime because the special regime includes not only legislative preferential rates, but also, as the technical explanation provides, preferential rates obtained by private rulings. In the 2015 model withholding tax setting, that may not be too hard to determine because only payments to related persons are subject to the restriction. In the LOB setting, however, special tax regime payments can also be made to unrelated persons. Treasury should provide in a technical explanation whether every recipient of a deductible payment must provide to the treaty resident a W-8-type form or whether some presumption can be made that no such special tax regime arises without knowledge.

5. Comments Sought on Exceptions for Some Payments

The 2006 model and most tax treaties except from the base erosion computation arm's-length ordinary

[16]2015 model article 22(6)(h). That does not exempt all intercompany income, just those in the limited tested group described in this article.

[17]Whether nonconsolidated intercompany income should also be excluded is beyond the scope of this article. It is easy to envision a scenario in which a nonconsolidated parent makes a payment (for example, for interest on a loan from a tested subsidiary) to the tested subsidiary to increase its gross income with the goal of avoiding base erosion disqualification.

[18]If IRC section 243 is the model, would all the dividend income be excluded, or just the 70 to 100 percent as set forth in the comparable legislation?

[19]Others would argue it is no business of the source state regarding how the resident state taxes its residents; rather, the source state's goals should be to encourage investment. I do not

(Footnote continued in next column.)

join the fray in this article, but note that for the withholding tax provisions in the 2015 model, payments must be to related parties for the restrictions to apply.

[20]2015 U.S. model articles 3(1)(l), 11(2)(c), 12(5)(a), and 21(3)(a).

[21]Except in the case of public subsidiaries, discussed earlier.

[22]The third purpose is for qualifying intermediate owner derivative benefits treaty provisions, discussed later.

[23]Computed at both the qualified person and tested group level.

[24]2015 model article 22(2)(d)(ii) (public subsidiary), 22(2)(f)(ii) (private company), and 22(4)(b) (derivative benefits).

course payments for tangible property or services. Treasury seeks comments on whether an exception should also be made for all three base erosion purposes (public subsidiary, private company, and derivative benefits) for payments for financial obligations to an unrelated bank. Limited as it is to unrelated banks, the suggestion seems noncontroversial. Base erosion is designed not only to ensure that a resident-country entity is subject to tax in its jurisdiction, but also to prevent a third-country, non-treaty-eligible entity from using an unrelated treaty-eligible resident entity to indirectly obtain benefits from the source state. If Treasury is concerned with the indirect use of the treaty, it is difficult to envision a scenario in which a non-treaty-country bank, in order to make a loan to an unrelated U.S. borrower, could contract with a resident country entity without running afoul of the anti-conduit regulations.[25] The proposal itself is not without precedent in treaty practice and should be noncontroversial.[26]

C. Other Changes — 2015 Proposals

1. *Active Trade or Business Connection*

A resident entity that fails to meet the qualified person or equivalent beneficiary test will still be eligible for treaty benefits for items of income from the source state that are connected to an active trade or business of the resident entity in the entity state.[27] If the source-state income arises from a related person, the resident-state business must be substantial compared with the source-state business.[28] Under the 2006 model, for all three active trade or business requirements (active trade or business; derived in connection with; and, if required, substantial) a resident may treat as its own activities, activities in the state by a 50 percent or more resident-related person or by a resident that controls, is controlled by, or an affiliate if both are under common control.[29]

The active trade or business test was adopted in recognition that:

> A third-country resident that establishes a ''substantial'' operation in the other State and that derives income from a similar activity in the United States would not do so primarily to avail itself of the benefit of the Treaty. . . . It is considered unlikely that the investor would incur the expense of establishing a substantial trade or business in the other State simply to obtain the benefits of the Convention.[30]

[25]Reg. section 1.881-3.

[26]*See*, *e.g.*, Belgium treaty article 21(2)(e)(ii) and Denmark treaty article 22(2)(f)(ii).

[27]2006 model article 22(3)(a).

[28]2006 model article 22(3)(b).

[29]2006 model article 22(3)(c).

[30]1996 model technical explanation.

The 2006 model added that attribution rule, but it has been part of treaty practice since the 1992 Netherlands-U.S. tax treaty.

While there is no technical explanation in any of the treaties providing the reasoning for allowing the borrowing of attributes of related parties, it appears self-evident. If the third-country resident has substantial investments in the state, it should not matter whether it is done through one company or several. That person would not be in the state simply to obtain tax treaty benefits.

The 2015 proposals scale back the full borrowing of related-party attributions, providing that attribution applies only to those entities in the same or complementary line of business.[31] Treasury defends that restriction by noting that the addition of the term ''derivative benefits'' in the 2015 model sets forth the appropriate standard for determining whether a holding company or financing entity qualifies for benefits.[32] But as the following four examples demonstrate, the logical extension of that premise is that there is no need for the active trade or business test with a treaty containing a derivatives benefit paragraph. To date, no treaty with a derivatives benefit provision and an attributed trade or business test contains that type of restriction.

- **Example 1: Unrelated-party payment, same line.** Resident company A is in the business of worldwide licensing of a pharmaceutical patent it developed 10 years ago that does not rise to the level of an active business under the IRC section 367 regulations. Resident company B is a large operation actively engaged, within the meaning of the section 367 regulations, in research and development of products in a line of business similar to that of A, and has commercialized some of its patents or know-how through related resident and nonresident entities. Resident company C owns and operates a hotel chain in several countries, including the resident state, with a valuable brand name. Resident holding company D owns 100 percent of the shares of A, B, and C. D, in turn, is owned by a group of Brazilian investors. A receives a royalty payment from a large, unrelated U.S. pharmaceutical company (U.S. Pharma) for the license of its patent in the United States. A's business is not substantial compared with U.S. Pharma:

  — In the absence of connected to, A is not entitled to treaty benefits because it is not actively engaged in business.

  — Under the 2006 model, A can attribute B's active business in the same line of business and qualify.

[31]2015 model article 22(3)(c).

[32]2015 model article 22(3)(c), note 2.

— Under the 2015 proposed model, A still may qualify because it and B are in the same line of business and thus it can attribute B's activities.

- **Example 2: Related-party payment, same line.** Same facts as above except U.S. Pharma is a subsidiary of A and B is substantial compared with U.S. Pharma:

— In the absence of connected to, A is not entitled to treaty benefits because it is both not actively engaged and not substantial.

— Under the 2006 model, A can attribute the needed active and substantial requirement from B.

— Under the proposed 2015 model, A may still qualify and attribute both the active and substantial requirement from B because both are in the same line of business.

- **Example 3: Unrelated-party payment, different line.** Same facts as Example 1 except C owns some public shares in U.S. Pharma and receives U.S.-source dividend payments from U.S. Pharma:

— In the absence of connected to, C is not entitled to treaty benefits because it is not in the same line of business as U.S. Pharma.

— Under the 2006 model, C should qualify for benefits based on attribution from B's active business in the same line.

— Under the proposed 2015 model, C would not qualify for treaty benefits because it and B are in different lines of business (pharmaceutical research and licensing and hotel), so it cannot attribute B's activities.

- **Example 4: Related-party payment, different line.** Same facts as Example 3 except U.S. Pharma is a wholly owned subsidiary of D:

— In the absence of connected to, D is not entitled to treaty benefits because it is not engaged in business in the resident state.

— Under the 2006 model, D should qualify based on attribution of B's active and substantial business in the same line.

— Under the proposed 2015 model, D would not qualify because it and B are in different lines of business (pharmaceutical research and licensing and holding), so it cannot attribute B's substantial activities.

The 2015 model states that the reason for the restriction on related-party active trade or business attribution is because it adopts the derivative benefits test, which is more appropriate for holding or financing companies.[33] There is a twofold problem with that reasoning.

First, as shown in Example 3, the restriction is not limited to holding companies or financial entities. In that example, the group has substantial business in the residence state and the recipient of the income is a major real estate concern, not a holding company or financial entity.

Second, Treasury's stated reason conflicts with prior policy. In a 2007 report to Congress, Treasury summarized the purpose for the LOB article and the reason why some entities are not objectively treaty-shopping instruments. In short, Treasury recognized that third-country residents may establish entities in treaty countries for legitimate business purposes, and the LOB provisions are designed to determine whether those persons are sufficiently economically connected to the treaty state to warrant benefits. Three qualifying standards were developed: the ownership base erosion test,[34] the public company test,[35] and the active trade or business test.[36] The derivative benefits test adopts the position that a third-country resident would not form a treaty-country entity for tax purposes because she could obtain equivalent benefits from her resident state treaty with the United States. However, she may not have any economic activity in the treaty state beyond a holding company structure. Her connection with the treaty state is derivative, not direct. While treaty benefits may be the same, it is also possible that the treaty state's tax provisions are more beneficial than the third-country laws regarding the source-state income received, and thus, her motives for using a treaty-country entity may not be solely business related.

In examples 3 and 4, the D group has substantial business activity in the treaty state. In addition to a significant high-tech business, it owns and operates the most permanent of tangible property: real estate. To give primacy to the derivative benefits test, as worthy as it is, over the active trade or business test seems misguided.

2. Competent Authority Proposal

The proposal imposes a new requirement on a taxpayer as a condition of obtaining competent authority approval. The establishment, acquisition, or maintenance of the resident entity and conduct of operations must not have as one of its principal purposes obtaining treaty benefits, and the taxpayer also must affirmatively demonstrate a substantial nontax nexus to the

[33]2015 model article 22, note 2.

[34]That standard in effect recognizes that under the treaty, most owners are resident and subject to tax in the resident state. The standard permits significant slippage for ownership by almost 50 percent by third-country residents.

[35]That standard recognizes that a bad motive would be hard to impute to a widely held group of owners.

[36]Of the three, that standard provides the most direct showing of economic activity in the resident state. The requirement that that activity be connected to the source-state income, although longstanding, is something that might be examined at a later date.

resident state. That requirement does not appear to be reflected in any existing treaty. While there is no explanation of its purpose, the same language is used in Rev. Proc. 2015-40, 2015-35 IRB 236, issued three months after the 2015 model and setting forth the new procedure on request for competent authority. For example, section 3.06(2)(d) of the revenue procedure states that a substantial nontax nexus cannot be established by an intent to take advantage of favorable domestic laws of the treaty country,[37] including the existence of a tax treaties network. The negative example suggests that that test is not intended as a major impediment to competent authority approval for any person with a real business reason for entering the resident state.

Even so, some uncertainty arises. For example, will the substantial nontax nexus requirement make a legacy resident holding company ineligible for competent authority approval when its shares are acquired by a third-state resident?

- **Example:** A public Japanese company acquires a Dutch holding company (Holdco) from a U.S. seller. Holdco owns several U.S. subsidiaries.

Under the 2006 model, Holdco may be able to argue that its establishment, acquisition, maintenance, or conduct of operations did not have a principle purpose of acquiring treaty benefits, as further proved by similar treaty benefits under the Japan-U.S. tax treaty.

The 2015 proposed U.S. model competent authority provision requires Holdco to further establish a substantial nontax nexus.

Is merely holding U.S. subsidiaries sufficient? Suppose Holdco owns several non-U.S. entities but does not rise to the level of a headquarters company. Suppose it also acts as a financing entity for a group of companies. What if Holdco holds resident company entities engaged in diverse lines of business that do not rise to the level of an active trade or business, or was chosen because of favorable intellectual property law protection afforded by the resident treaty country state?

A technical explanation to the competent authority restriction, with examples as to its intended scope, would provide helpful comments on that proposal.

3. *Other Non-Derivative Benefits-Based Proposals*

The 2015 model clarifies that qualified person testing occurs when benefits are accorded. It also provides new group entity terms — ''tested group'' and ''qualifying intermediate owner'' — and redefines the phrase ''connected to,'' all of which will join the 2006 model terms.[38] While the terms may be admirable, it seems the intended result of detailed objective standards could get lost in complexity.

IV. Derivative Benefits and the Dutch Treaty

The 2006 model does not contain a derivative benefits provision, but that type of provision has been part of treaty practice for over 20 years with North American and EU member treaty partners. While the derivative benefits provisions of those treaties are similar, I chose the Netherlands-U.S. treaty as one of the earliest and most comprehensive with which to compare the 2015 model proposals.

A. Geographic Restrictions Lifted

Permitting equivalent beneficiaries to reside in any country with which the United States has a comparable tax treaty is the biggest benefit in the 2015 model for derivative benefits. Current treaties that permit derivative benefits are only in force in certain EU and NAFTA countries — largely because of requirements of EU law — but then restrict equivalent beneficiaries to the same EU and NAFTA countries. In a May 21, 2008, report to Treasury and the U.S. Senate Foreign Relations Committee, entitled ''Proposals Regarding the 'Derivative Benefits' Provisions Found in the LOB Article of Certain U.S. Income Tax Treaties,'' the New York City Bar Association proposed just such a change to treaty policy.[39] More recently, the OECD BEPS initiative proposed worldwide equivalent beneficiary qualification, in all likelihood to ensure that non-EU countries would adopt derivative benefits.

A simple example demonstrates the expansion of coverage.

- **Example:** Japanco, a publicly traded Japanese company, owns all the stock of Dutchco Holding, which in turn owns all the stock of U.S. Sub. Under the Netherlands-U.S. treaty, Dutchco is not a qualified person because Japanco is not resident in the EU, EEA, or NAFTA and hence cannot be an equivalent beneficiary.

Under the 2015 proposed model, because the United States and Japan have a tax treaty, Japanco may qualify for equivalent beneficiary status, which in turn may make Dutchco eligible for treaty benefits.

B. Each Intermediate Owner Must Be a QIO

Neither the Dutch treaty nor any treaty in force with a derivative benefits paragraph requires that intermediate owners be otherwise effectively qualified as equivalent beneficiaries. That is in contrast to the general rule under the base erosion test that each intermediate owner be a resident of the treaty state. The 2015 model proposes requiring that each intermediate owner be a qualifying intermediate owner (QIO) for derivative

[37]Does Treasury mean favorable tax laws in this example?

[38]Including ''controlled by,'' ''associated enterprises,'' ''special relationship,'' ''owned directly or indirectly,'' ''immediate owner,'' ''connected to,'' and ''related person.''

[39]*See Tax Notes Int'l*, July 7, 2008, p. 43.

benefits.[40] Failure of the intermediate owner to qualify as a QIO means the ultimate owner will not be an equivalent beneficiary, generally resulting in failure to meet the LOB requirements.[41]

A QIO is defined as an intermediate owner resident in a state that has a comprehensive tax treaty with the United States that provides withholding benefits at least as low as those in the resident treaty state and article 7, 13, and 21 benefits at least as favorable as those in the resident treaty state.[42] That looks a lot like the description of an equivalent beneficiary, except that the QIO treaty with the United States must also contain an equivalent special tax regime provision. The definition is not concerned with whether a payment would in fact be subject to a special tax regime in the QIO state. Thus, for example, a payment of interest to the resident treaty state entity, whether by a related or unrelated person, that is not subject to a special tax regime in the QIO state[43] would be ineligible for treaty derivative benefits if the QIO state-U.S. treaty failed to include special tax regime provisions for interest. Nor is the consequence of the QIO treaty requirement on special tax regime provisions limited to special regime payments. If the provisions are not in the QIO treaty, then payment of dividends, compensation, or other treaty benefits would not be allowed because the ownership test of paragraph 4(a) of article 22 regarding derivative benefits could not be met.

No such special tax regime treaty language requirement is imposed on the equivalent beneficiary.[44] Is that an oversight and, in a larger sense, is that complexity needed? The QIO requirement is seemingly meant to address an equivalent beneficiary that parks income in a tax haven subsidiary when controlled foreign corporation or equivalent antiabuse domestic legislation is absent in the equivalent beneficiary state. A similar policy was put in place in connection with the conduit financing regulations and the perceived misuse of disregarded entities.[45] The parking concerns can be alleviated in large part by adopting the recommended 2015 model provisions without the added complexity of the special tax regime treaty requirement for QIOs.

The strict QIO requirements call into question the base erosion application of payments to QIOs. Under proposed article 22(4)(b), payments to nonequivalent beneficiaries base erode. QIOs are not equivalent beneficiaries even though they have all the treaty-shopping restrictions built into them. Not including QIOs as "good" payees of the resident state entity for base erosion purposes may have been an oversight, unless the concern, as expressed in the 2006 U.S. model, is that a QIO may base erode its income.

C. Individual Tax Liability

A provision calling out for technical explanation is 2015 model article 22(6)(e)(i)(A), which states that for an individual, but not an entity, to be an equivalent beneficiary, he must be liable to tax on foreign-source income on a current basis, not on a remittance basis. That provision appears to be BEPS driven.

D. Restrictions on Business Profits

All treaties containing derivative benefits provide that for dividend, interest, and royalty withholding purposes, the equivalent beneficiary state must include in its treaty with the United States withholding rates at least as low as those in the resident state. That is clearly designed to ensure the equivalent beneficiary has equivalent treaty benefits in its home state and is not treaty shopping.

The 2015 model proposal expands the equivalent requirements to other benefits and includes business profits, gains, and other income under article 21.[46] The new restriction is consistent with the allowance of treaty benefits only for equivalent benefits, but the standards may require some explanation or replacement. In determining whether such benefits are equivalent, the 2015 model uses an "at least as favorable as" standard. The "as low as" standard for withholding tax benefits is easy to apply because it is a fixed, bright-line percentage number. The at least as favorable as standard requires explanation regarding both how it is to be applied and the specific concern Treasury has with business profits.[47]

Perhaps the business profits concern was intended to measure the difference in profits attributed to a permanent establishment in the United States from an accounting regime used in the resident state treaty versus the one used in the equivalent beneficiary state treaty.[48]

[40]A similar rule was proposed in the 2013 Spanish protocol. The proposed Spanish protocol does not include the special tax regime treaty requirements or the "as low as" requirements of equivalent beneficiaries.

[41]2015 model article 22(4)(a).

[42]*Id.* at article 22(4)(a) and 22(6)(f).

[43]If a related-party interest payment is subject to a special tax regime in the resident treaty state, it would be ineligible for treaty benefits under the non-LOB provisions of 2015 model article 11(2)(c).

[44]Although the special tax regime provisions apply to any base-eroding payments made to an equivalent beneficiary. 2015 model article 22(4)(b).

[45]Reg. section 1.881-3(a)(2)(C); and T.D. 9562.

[46]Reference to article 21 was intentional, designed to show the benefit targeted is the withholding tax benefit under article 21 rather than a more general concept of other income.

[47]Because other income effectively has a withholding rate of either 30 percent, if the code applies, or 0 percent, if the treaty article applies, perhaps this category of income should more appropriately be added to the existing "at least as low as" standard for the withholding tax provisions.

[48]On an equivalent-beneficiary-by-equivalent-beneficiary basis in the case of multiple beneficiaries in different states.

That is, if the accounting under the resident state treaty results in a lower profit attribution than the accounting under the equivalent beneficiary state treaty, the threshold would not be met. What result follows? Does it revert to effectively connected income accounting, and is that any different in some circumstances than the treaty accounting used? In a July 14, 2015, report, entitled ''Tax Treaty Consistency Principle,'' the NYSBA Tax Section explained treaty accounting methods, discussing the authorized OECD approach adopted in some treaties, as well as the 2006 U.S. model. If comparison of accounting methods in the resident state with that of the equivalent beneficiary state was the intent, it may be difficult to apply in practice.

Maybe the concern was nothing more than the use of specific PE exemptions in the resident state treaty not found in the equivalent beneficiary state treaty. That is, if the resident state treaty allows exemptions for some construction site work and the third-country treaty does not, that would be a much easier comparison to make. In that case, the business profits under the resident state treaty would be zero while the business profits in the third-country treaty would be an amount above that. Net losses would not change the result in the equivalent beneficiary state because the use of those losses would at best reduce subsequent income to zero. In the resident state, the income attributed to the PE would always be zero.

V. Conclusion

The policy goals in the 2015 model proposals seem designed to close perceived base-eroding loopholes, trim active trade or business attribution, stop the parking of income in the use of derivative benefits, adopt a more rigorous competent authority standard, further restrict derivative benefits for nonwithholding items, and expand derivative benefits geographically. To accomplish those goals, the U.S. Treasury introduced three separate uses of a new term — ''special tax regime'' — and required us to guess somewhat regarding what the ''at least as favorable'' standard is all about, to try and remember the proper use of the term ''tested group'' with other existing intercompany related terms, and to hope to see if certain requirements — such as base-eroding payments to QIOs and inclusion of other income in the at least as favorable standard — will be reversed.

Treasury has long opposed the principle purpose test favored by many members of the OECD.[49] The detailed new rules are the natural consequence of Treasury's desire to cure what clever taxpayers have constructed. As taxpayers begin to plan around those new rules, we may see additional provisions.[50] I think Treasury has done a good job closing some loopholes and expanding benefits in appropriate cases.[51] However, I remain concerned that while well intentioned, the rules may not be easy for taxpayers, withholding agents, and their respective counsel to follow, largely negating Treasury's work.[52]

This report focuses only on Treasury's proposed 2015 model LOB provisions and not on other provisions that might have been included. For example, I did not consider the elimination of the cliff consequences for the as low as derivative withholding tax benefits.[53] I leave to the reader consideration of other LOB suggestions to make to Treasury. ◆

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[49]Recognizing the shortcomings of subjective antiabuse rules, the United States has developed a series of objective tests, known as limitation on benefits provisions; Treasury report, *supra* note 3, at 53. For a general description of the principle purpose test and a comparison with an LOB rule, see OECD, ''Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report.''

[50]For example, will the new attribution restrictions in the active trade or business test be circumvented by simply running the source-state income to the good recipient in the related-party group?

[51]Lifting geographic limitations in the derivative benefits paragraph and tentatively permitting bank payment costs under base erosion are two examples.

[52]Based solely on personal experience and anecdotal evidence, the IRS does not spend much, if any, energy auditing LOB issues, but rather relies on the private bar to police the provisions. Therefore, it is important that practitioners (and, of course, withholding agents and taxpayers generally) understand the provisions.

[53]The 2008 New York City Bar report, *supra* note 39, suggested that the higher equivalent beneficiary treaty rate be used in lieu of total loss of treaty rate benefits but recognized administrative complexity if different equivalent beneficiary state owners with different rates were involved. In light of the detailed new proposals, complexity no longer seems to be Treasury's concern, so perhaps that proposal should be considered.