Report No. 1327

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

CERTAIN PROPOSED REVISIONS TO THE U.S. MODEL TAX CONVENTION

AUGUST 19, 2015

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REPORT ON CERTAIN PROPOSED REVISIONS TO THE U.S. MODEL TAX CONVENTION

I. INTRODUCTION

This report[1] of the Tax Section of the New York State Bar Association sets forth comments on certain recently proposed revisions to the U.S. Model Tax Convention (the "Proposed Revisions" to the "Model"). There are five separate Proposed Revisions: (1) new rules applicable to "special tax regimes;" (2) new rules addressing certain subsequent changes in law; (3) revisions to the Limitation on Benefits ("LOB") Article; (4) new rules addressing payments to expatriated entities; and (5) new rules addressing so-called "exempt permanent establishments." This report will discuss the first two proposals; a later report will discuss the remaining proposals.

The report is divided into four parts. Part I is this Introduction. Part II summarizes the first two Proposed Revisions. Part III is a summary of our recommendations. Part IV is a discussion of the issues and our recommendations.

II. SUMMARY OF PROPOSED REVISIONS

A. Special Tax Regimes

The operational rules applying the new concept of "special tax regimes" ("STRs") are found in new subparagraphs in Articles 11 (Interest), 12 (Royalties) and 21 (Other Income).[2] The treaty text version of the operational rules provides that treaty benefits will be denied with respect to one of these items of income if the recipient, resident of the other Contracting State, is

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[1]. The principal author of this report is Kimberly Blanchard. Helpful comments were received from Andrew Braiterman, Robert Cassanos, Steven Dean, Peter Faber, Michael Farber, Stephen Land, Richard Reinhold, Michael Schler, Stephen Shay, David Sicular and Gordon Warnke. The assistance of Sarah Gordon is gratefully acknowledged. This report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] The term Other Income is used throughout this report to refer to items covered under the Other Income Article of a treaty; in the Model, Article 21.

related to the payor of such income and "is subject to" an STR in its residence State with respect to such income. The Technical Explanation uses slightly different wording: Treaty benefits will be denied if the recipient "benefits from" an STR. As drafted, the rules appear to be self-executing, as there is no procedure for either State to notify the other, or its own taxpayers, in the event a new STR is adopted.

Proposed new Article 3, Paragraph 1(l) provides the definition of an STR. An STR is any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to an item of income, including through reductions in the tax rate or the tax base. With respect to interest, the term includes notional deductions that are allowed with respect to equity (the "NID rule"). There are seven exceptions to this definition, such that an STR will not include any legislation, regulation or administrative practice: (1) the application of which does not disproportionately benefit interest, royalties, Other Income, or any combination thereof; (2) that, with respect to royalties, requires substantial activities that are not of a mobile nature to be conducted in the residence State; (3) that implements the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises); (4) that applies principally to persons that exclusively promote religious, charitable, scientific, artistic, cultural or educational activities; (5) that applies principally to persons substantially all the activity of which is to provide or administer pension or retirement benefits; (6) that facilitates collective investment through collective investment vehicles that are marketed primary to retail investors, are widely-held, hold real property or a diversified portfolio of securities, or any combination thereof, and that are subject to investor-protection regulation in the State in which the investment entity is established; or (7) that the Contracting States have agreed shall not constitute an STR because it does not result in a low effective rate of taxation. With respect to the first exception, the

Technical Explanation provides that notwithstanding this exception, the provision of notional deductions with respect to equity will always be considered to disproportionately benefit interest.

The Technical Explanation states that the new STRs Proposed Revision is consistent with the tax policy considerations that are relevant in deciding whether to enter into a tax treaty, the goal of which is to prevent double taxation in order to facilitate cross-border investments and transactions. Where one Contracting State levies no or low income tax, the need to alleviate double taxation is no longer present and thus the benefit of treaty protection is no longer necessary. The Technical Explanation refers to this policy as articulated in the commentary to the OECD Model Treaty. However, the policy is equally if not more relevant to U.S. domestic treaty policy reflected in the Model as promulgated from time to time; we assume that the reference to the OECD Model in the Technical Explanation was intended to persuade other countries to accept the premise of the STR proposal and to tie it into the larger OECD project concerned with best practices under tax treaties generally.[3]

B. Subsequent Changes in Law

The second Proposed Revision addressed in this report is the proposal found in new Article 28 of the Model, entitled "Subsequent Changes in Law." This proposal is separate from, albeit somewhat related to, the STR proposal. The Technical Explanation explains that because the main objective of a treaty is the avoidance of double taxation, certain subsequent changes in the domestic law of either Contracting State that result in lower taxation could reduce the risk of meaningful double taxation (and increase the risk that the treaty gives rise to

[3] See Action Item 6 of the OECD's BEPS project. The OECD explanation of Action item 6 states that the STR and subsequent changes of law Proposed Revisions discussed in this Report were advanced by the United States in connection with Action Item 6 as a means of addressing the OECD's hesitations concerning the inclusion of a derivative benefits clause in the LOB article.

unwarranted instances of low or no taxation). In some cases, subsequent changes in law can call into question the appropriateness of continued application of the treaty.

If either of the two triggers described below is met, Article 28 provides that certain other provisions of the Model may cease to have effect, specifically Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 21 (Other Income). Under Article 28(4), the Contracting State that did not trigger the provision by reducing its rates etc. may notify the offending Contracting State through diplomatic channels that it will cease to apply the enumerated treaty articles. Only after that notice is provided will the provisions of such Articles cease to apply. Importantly, those articles will cease to apply in *both* Contracting States.

The first trigger is met if, after signing the treaty, the general rate of tax applicable in either Contracting State falls below 15% with respect to substantially all of the income of resident companies.[4] The Technical Explanation explains that the general rate of tax applicable to business profits generally (or to so-called "trading income" broadly defined) shall be treated as applying to "substantially all" income, even if narrow categories of income (such as income from portfolio investments) is excluded. It adds that a reduced tax rate that applies only to capital gains is not within the scope of this rule.

Subsequent to the release of the text of the Proposed Revisions, a representative of the Treasury Department stated publicly that the first trigger might be modified. Rather than applying only when a country's general rate of tax falls below the 15% rate, the rule would be triggered if the country's rate of tax fell below the lesser of 15% or some percentage, say 60%, of the other country's generally-applicable rate.

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[4] Parallel rules apply to individuals, but these provisions will not be covered in this report.

The second trigger is met if, after signing the treaty, either Contracting State provides an exemption from taxation to resident companies for substantially all foreign source income (including interest and royalties). The Technical Explanation states that this trigger is intended to cover "pure territorial" regimes in which income from sources outside a Contracting State is exempt from tax solely by reason of its source being outside such State, and that the rule was not intended to cover tax systems exempting foreign source dividends or business profits from permanent establishments. It indicates that the "substantially all" requirement is met where, for example, 95% of income from foreign sources is exempt from tax, but 5% remains taxable as a proxy for the disallowance of allocable deductions.

In determining the general rate of company tax or the highest marginal rate of individual tax, changes in domestic law that have the same effect as a reduction in a statutory rate, such as the allowance of deductions based on a percentage of what otherwise would have been taxable income, will be taken into account. On the other hand, taxes that are imposed at the company level only when the company distributes earnings, and taxes that are imposed at the shareholder level, shall not be taken into account when determining the general rate of company tax.

The Technical Explanation to this proposal states that neither a gap nor an overlap is intended as between the two new proposed rules. Thus, if an across-the-board tax reduction triggers Article 28's change in law provisions, then only Article 28, and not the STR rules, would apply.

III. SUMMARY OF THE REPORT'S RECOMMENDATIONS

Our recommendations are as follows.

In respect of the general STR rule:

1. It should be clarified that the STR rules do not apply to business income.

2. It should be clarified that an STR arises only where there is a permanent reduction of a country's tax rate or base or, at a minimum, taxation is unusually deferred.

3. It should be clarified whether the STR rules apply generally to any recipient of an item of interest, royalties or Other Income from a related party where an STR is generally in effect, or only to the extent that the particular recipient benefits from the STR in question. We think that where an administrative practice, such a ruling policy, amounts to an STR, the operational rules should apply only where the recipient benefits from the practice.

4. It should be clarified how the exception for regimes benefitting royalties applies where the particular payee does or does not meet the substance requirements thereof.

5. We believe that the STR rules will be difficult to administer absent a requirement that a Contracting State provide advance notice of its determination that a regime adopted by the other country is an STR. We therefore recommend that notice and consultation procedures similar to those contained in proposed Article 28 be added to the STR rules.

6. It should be clarified that the STR rules to apply to Other Income only where the STR benefits the particular type of Other Income being paid. It would be helpful to clarify whether the rules apply to Other Income only when the item of Other Income would be deductible in the source state, but on balance we do not believe this limitation should be adopted.

7. The STR rules of the Model should incorporate a precise definition of the term "related person." We set forth several alternatives for that definition, and believe that the alternative chosen should be consistent with the purpose of the related person limitation.

8. We suggest that the STR rules incorporate one or more *de minimis* exceptions.

In respect of the NID rule:

1. Because the operation of an NID rule does not in fact disproportionately benefit interest, if the NID rule is retained in the Model we believe that it should be limited to finance companies, appropriately defined. Where a company engages in a finance business and also one or more other unrelated businesses, we suggest that the NID rule be applied on a pro rata basis.

2. We recommend that the NID rule apply only to NID regimes that provide for a deduction with respect to what the residence country treats as equity. For similar reasons, the NID rule should not apply to timing differences.

With respect to Subsequent Changes in Law:

1. We believe it should be made clear that in measuring another country's tax rate, only that country's rules should apply. Thus, for example, the exclusion of any lower rate on capital gains should be provided even if that country defines capital gains differently from the manner in which the Code does. The tax rate test should be applied to the country's headline tax rate, not to an effective rate calculated using U.S. timing and base principles.

2. We suggest that Treasury consider modifying the first trigger to remove any reference to an absolute tax rate, making the trigger a function of only a significant rate reduction. We also suggest that Article 28 should test only the reduction in one country's rate as compared to any closely concurrent reduction in the other country's rate.

3. The Technical Explanation's explanation of the term "substantially all foreign income" should be clarified to eliminate any inference that a traditional territorial regime could be considered one that meets this trigger.

4. We recommend that Treasury consider eliminating the proposed rule that would deny treaty benefits reciprocally where Article 28 is triggered.

IV. DISCUSSION

A. General Observations

The two Proposed Revisions discussed in this report reflect treaty policy choices going to the "durability" of treaties. We do not often comment upon Treasury's policy choices, and therefore this report takes a somewhat different approach than do most of our more technical reports. This report will begin with some overarching considerations that we believe should be taken into account in considering the merits of including in the Model the STR and subsequent changes in law Proposed Revisions. It will then make certain suggestions about how the Proposed Revisions might be modified to better achieve what we believe to be Treasury's policy goals, while giving due consideration to how these rules might operate in practice.

These two Proposed Revisions can be seen to represent a departure from historic U.S. tax treaty policy. The United States has long resisted, and for the most part continues to resist, the inclusion of vague or ambiguous standards in its tax treaties. For example, the United States has resisted the incorporation of a "main purpose" or "principal purpose" test for combatting the practice of treaty shopping, preferring instead to employ a more objective LOB approach.

This historic preference for objective rules is grounded, we think, in two realities. First, eschewing subjective, intent-based tests in tax treaties is intended to preclude our treaty partners from applying the treaty in what many might consider an arbitrary way. Second, the United States enforces its cross-border withholding rules through a private intermediary system that relies upon voluntary compliance, backed up with penalties imposed on withholding agents. Unlike other countries, the United States does not require withholding at the outset followed by a

government-intermediated refund system. There are good reasons that the United States employs such a system, including that being such a large country with such global markets, it would be virtually impossible to administer a government-intermediated withholding system. Because our rules expect and require private parties to enforce withholding tax rules, including taking account of treaty reductions of the 30% U.S. withholding rate, it is imperative that the rules set forth in our tax treaties be clear.

We also observe that including these types of provisions in the Model may tend to make it more difficult to persuade other countries to enter into a tax treaty with the United States. While we understand that this may have been intended, we think the benefits of including these new provisions in the Model should be carefully weighed against the disadvantages that U.S. taxpayers may suffer from having fewer tax treaties to rely upon as they conduct global business operations.

We are aware that the United States' representatives to the OECD "BEPS" project offered similar proposals to the OECD working group on Action Item 6, "Treaty Abuse." According to the most recent OECD draft, the STR and subsequent change of law provisions were offered as a means of addressing the working group's concerns with including a derivative benefits provision in the U.S.-style LOB article of the OECD model treaty. However, these provisions apply across the board. For this reason, and the reasons described elsewhere herein, we think it incumbent upon the Treasury Department to craft these Proposed Revisions in a manner such that they do not detract from U.S. treaty policy of providing clear and administrable rules.

B. New Proposals Concerning Special Tax Regimes

1. General STR Rule

a. Scope

The STR rules operate on an item-by-item basis. They apply only to payments of interest, royalties or Other Income. They do not apply to payments of dividends, presumably because dividends are not deductible and therefore cannot have the effect of reducing the source country's tax base.

We note that interest, royalties, and items of Other Income can be part of business profits not subject to the rules of Articles 11, 12 or 21. Since such items would not be subject to those Articles, but would be subject only to the Business Profits Article of a treaty, the Proposed Revisions do not affect their tax treatment. Thus, for example, if a regime accords special benefits to active interest income such as that earned by banks, that regime would not be subject to the STR rules. We assume that the exclusion applies whether or not one country to a treaty would agree with the other country's treatment of income as business income. We note that the Technical Explanation excludes from the definition of an STR certain tax holidays and other regimes applicable to business income generally, including Section 199 of the Code. It might be clarified that these statements do not create a negative inference that a regime benefiting only business income might constitute an STR.

It might also be clarified that an STR generally arises only where the reduction of a country's tax base is permanent and not merely a matter of timing. For example, the fact that a particular country does not tax interest until it is actually paid, rather than when it economically accrues, should not be regarded as an STR. Treasury may wish to consider whether excessive deferral over a period of many years could be deemed to be an STR.

While it is clear to us that the STR rules apply on an item-by-item basis, it is not clear whether the rules were intended to apply to any related-person payment of a covered type when an STR is in effect (the "Across the Board" approach), or only where the recipient of such payment actually benefits from the STR (the "Actual Benefit" approach). Another way of posing the question is whether it is the item of income that must be subject to an STR, or only the recipient of the income that is benefitted by the STR. The "subject to" language of the treaty text itself could be read to support the Across the Board interpretation, although it is phrased in terms of the "resident," and not the "income," being subject to an STR. The "benefits from" language of the Technical Explanation seems more clearly to suggest that the Actual Benefit approach may have been intended.

The choice between these two approaches can affect both the outcome of a particular case and the manner in which the rules are to be enforced. Consider the case in which a Contracting State adopts a rule that provides for a significantly reduced rate of tax on interest income, but only for taxpayers meeting certain income or other conditions. If a resident of that State receives an item of interest income from a related person in the other Contracting State, but is itself not among the class of taxpayers to whom the rate reduction applies, whether treaty benefits are denied will depend on which interpretation of the rule is applied. Moreover, in enforcing these rules, if the Actual Benefit approach is adopted, the withholding agent would need to know the facts of the recipient's particular case, whereas under the Across the Board approach the withholding agent would need to know only that the STR existed. Accordingly, we suggest that the Technical Explanation clarify which approach was intended.

We note that the definition of an STR includes "administrative practice," and the Technical Explanation makes clear that the term is intended to include ruling practices. If an

administrative practice takes the form of rulings that affect only a handful of taxpayers, we think it should not be regarded as an STR for purposes of denying treaty benefits to other taxpayers who do not benefit from the practice. We considered the possibility of treating such a practice as an STR only where the practice is generally available to all comers, but on balance we think such an approach would be difficult to administer. We recommend that, regardless of whether the Across the Board or Actual Benefit approach is adopted generally, a ruling practice be treated as an STR only with respect to taxpayers who actually receive the benefits of a ruling.

A related issue involves the exception from the definition of STR that applies to royalties. The text of the definition seems to ask whether a particular regime "satisfies a substantial activity requirement," not whether a particular person satisfies that requirement. If a Contracting State has enacted a patent box regime that incorporates a substantial activity requirement, but the particular recipient of a royalty does not meet that requirement, one might assume that the STR will not apply to it (although this should be clarified). However, if the patent box legislation itself does not incorporate a substantial activity requirement, but the recipient of a royalty in fact does conduct very substantial activities in its state of residence, it is unclear to us whether the payor must withhold tax as if no treaty benefit is allowable.

b. Reporting mechanisms

For a country to be able to enforce the STR rules, it needs to have a means of learning when the other country has adopted a new STR. The current text of the Model does not require one country to notify the other if a new STR is adopted. Each Contracting State should be required to notify the other of the adoption of a new STR, including any administrative practice amounting to an STR. Our treaties already require each country to notify the other when there has been any significant change of law; this requirement could be expanded to encompass STRs. Following such notice, the Contracting States should be required to negotiate with each

other in an effort to avoid the loss of treaty benefits. The proposed rules in Article 28 could be adapted to this purpose.

More generally, we are concerned that there are no procedures set out for the administration of the STR rules. Although the Model contemplates that the Contracting States would specify in the treaty itself those regimes that are and are not STRs, this procedure does not address later-adopted STRs. This could lead to a situation in which each individual withholding agent would be responsible for determining whether its payee benefitted from an STR. We do not think this is acceptable in a self-policing system like that used in the United States. Accordingly, we believe that whenever one Contracting State determines that a new regime adopted by the other is an STR, it should be required to publish a formal notice of that determination, in a manner similar to the manner in which the Internal Revenue Service publishes notice of listed transactions or transactions of interest. We recommend that such notice announce a prospective effective date, such as 90 days after the notice is issued, before withholding agents are required to take the STR into account with respect to any affected related-person payments. In any event, the text of the Model should clearly state whether the disallowance of treaty benefits becomes effective upon publication of the notice, or only after a specified period during which the Contracting States have agreed to attempt to resolve the issue.

Finally, if the Actual Benefit approach applies, either generally or in respect of a ruling practice, a means of identifying those taxpayers actually benefitting from an STR would need to be put into place. Of course, because the STR rules apply only between related parties, in practice a withholding agent might be deemed to know when the payee of an item benefits from an administrative practice amounting to an STR, at least assuming that the related person threshold is set high enough. But this might not always be true. Therefore, we recommend that

the recipient of a treaty-reduced rate of withholding be required to certify (e.g. on a Form W-8) to a related withholding agent that it is not entitled to the benefits of an STR with respect to the payment.

c. Other Income

The application of the STR rules to Other Income is somewhat unclear, given that treaties typically characterize many different types of income as Other Income. Suppose that a given treaty treats both guarantee fees and annuity payments as Other Income. We are not sure whether the STR proposals would be implicated, for example, if a country adopted an STR that disproportionately benefitted guarantee fees, but the item of Other Income being paid was an annuity. We suspect that this was not intended, and that the STR rules would be implicated only if the country of residence adopted an STR that related to the specific type of Other Income being paid.

Given that items of interest and royalties are usually deductible, we considered whether the STR rules should apply to an item of Other Income only if that item is deductible in the source country. However, we observe that certain items included within the category of Other Income might be subject to mandatory capitalization rules in the source state. Depending on the asset into which the item is capitalized, the tax benefit derived from its payment could be realized in a very short period of time, over a very long period of time, or not at all. It would be difficult to make these determinations on an item-by-item basis. Thus, we do not recommend making the STR definition turn on whether the item is deductible or effectively deductible. We do however believe that a regime that applies with respect to Other Income should not be

deemed to be an STR to the extent that the payment of the item in question is properly treated as a nondeductible dividend in the source state.[5]

d. Definition of "related person"

We think it is important that the STR rules include a definition of the term "related person." The Model provides that terms not defined therein are to be defined under the law of the State applying the particular provision in question. However, U.S. tax law does not provide a single definition of the term "related person." In addition, we think that for purposes of applying the STR rules, the term "related person" should be defined in the treaty itself so that the two countries party to the treaty do not adopt differing definitions of the term. Moreover, as stated in the general observations above, U.S. withholding tax rules operate on a self-assessment model, such that a withholding agent should be able to determine with certainty whether it is, or is not, related to the payee.

The choice of the definition will depend upon the reason for limiting the STR rules to payments between related persons. If the reason is related to base-stripping concerns, the best analogy would be to the definition of related person used in Sections 163(j) and 512(b)(13) of the Code, each of which looks to the ownership of more than 50% of the equity interests in another person, taking into account customary indirect and constructive ownership rules. Section 512(b)(13) measures more than 50% by vote or by value. Section 163(j) incorporates the general definition of related person contained in Sections 267(b) and 707(b)(1), which looks to the ownership of 50% or more by value and is by far the most commonly used definition of the term related person in the Code. Recently-issued Notice 2015-54, addressing

[5] *See Tulia Feedlot*, *Inc. v. U.S.*, 513 F.2d 800 (5th Cir. 1975) (treating a guarantee fee as a dividend).

transfers of property to partnerships having related foreign partners, also incorporates the test of Sections 267(b) and 707(b)(1).

The OECD's hybrids report, issued as one of its actions under the BEPS initiative, uses a 25% threshold for relatedness. We note, however, that the reason the hybrids report is limited to payments involving related parties is primarily attributable to a decision that the hybrid rules should apply only to the extent parties can make affirmative use of hybrid entities or instruments. That concern does not seem to be relevant in the context of STRs.

If the reason that the STR rules are limited to payments between related persons is that only related persons could be expected to know whether the payee benefits from an STR, the threshold might be set lower. We note that Section 951(b) under the controlled foreign corporation rules incorporates a 10% voting ownership threshold. The use of a 10% voting test may relate to the fact that a person who owns less than 10% of the voting power of a corporation may not be in a position to get information concerning whether the foreign corporation has certain types of income. We think this threshold may be too low for purposes of the STR rule, in part because it may be too low to ensure that the withholding agent would in fact have knowledge of the existence of an STR benefitting the payee. Many of our concerns about the scope and practical application of the STR rules are mitigated by the fact that the rules are limited in their application to payments between related persons. However, if our recommendation that the payee certify in advance that it is not subject to an STR is adopted, this would appear to be less of a concern.

We note that the definition of portfolio interest also incorporates a 10% threshold. That rule, however, seems designed primarily to distinguish portfolio investors from strategic or "control" investors and does not use the term related person. Unless the purpose of the STR

rules is simply to collect more withholding tax, the relevance of the portfolio interest rule is not obvious. We would point out that if the definition of related person in the STR rule were *less than* 10%, a foreign payee of U.S. source interest subject to the STR rules would often be better off foregoing treaty benefits and claiming the portfolio interest exemption.[6]

Article 9 of the Model is concerned with transfer pricing between or among associated enterprises. Given the subject matter of Article 9, it is unsurprising that the concept of relatedness there is much broader than most definitions used in the Code, and comports with the approach to relatedness used in Section 482 of the Code. Thus, the Model speaks in terms of an enterprise of a Contracting State who "participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State." We do not believe that this broad definition of "relatedness" should be used for purposes of the STR rules. The STR rules do not implicate transfer pricing. Moreover, they are to be enforced by withholding, and a withholding agent requires certainty.

Whatever definition of "related person" is adopted for purposes of the STR rules, we think it should be limited to those rules and not apply more generally. We note that the Technical Explanation of the tax treaty between the United States and Canada specifically states that the definition of "related person" used in Article IX thereof is not controlling of the definition that may be assigned to the same term in Article XXI thereof.

e. *De minimis* exceptions should be added

We believe that the STR rule should incorporate one or more *de minimis* exceptions. Unlike the subsequent change of law provisions of Article 28, the STR rules do not contain a threshold tax reduction. They require only that the rate be "preferential." Technically,

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6 This would not be the case if, for example, the interest were contingent interest not qualifying for the portfolio interest exemption.

a rate preference of 0.1% could be captured by that definition. While we realize that it is unlikely that a country would enact an STR providing only *de minimis* benefits disproportionately to interest, royalties or Other Income, incorporating a *de minimis* rule would make the rule more administrable by taking minor tax law changes off the table. This is of particular concern if the STR rules are intended to be self-executing; if our suggestion to apply the STR rules only after notice is adopted, there would presumably be little reason to fear a hair-trigger application of the definition.

What is defined as *de minimis*, or immaterial, for this purpose might be framed in terms of an objective, numerical test. As one example, the Model might provide that if a regime has the effect of reducing the tax on an item of interest income by 5% or less than the generally-applicable rate (a term used in proposed Article 28 of the Model), it will not be treated as an STR.[7] Another approach would be to provide that any preferential rate that is not below 15% is not an STR. Some of our members believe that there should be fairly liberal bright-line *de minimis* exceptions to avoid any uncertainty in the application of these rules. Others would support a general test of materiality with a safe harbor for STRs resulting in a rate reduction below some percentage threshold.

We do not think that the incorporation of one or more *de minimis* rules would tempt countries into creeping right up to, but not crossing, the line so defined. There is little reason for a country to adopt a special tax regime if the net effect of the regime is insignificant. Presumably, an insignificant benefit would be accorded only if there were some larger reason to adopt the regime, unrelated to providing specific tax benefits.

[7] We note that the Technical Explanation of the Model would not treat the 3% tax rate reduction provided by Section 199 of the Code as an STR, on the basis that Section 199 does not disproportionately affect interest, royalties or Other Income. But another basis for excluding that section from the definition of STR might be that it is *de minimis*.

2. NID Rule

The proposed STR rules contain a specific rule relating to NID regimes. The definition of an STR includes the following sentence: "With regard to interest, the term special tax regime includes notional deductions that are allowed with respect to equity." The Technical Explanation further states that notwithstanding the general exception from the definition of an STR that applies where a regime does not disproportionately benefit interest or another covered item of income, "the provision of notional deductions with respect to equity will always be considered to disproportionately benefit interest." Thus, for example, to the extent that a pharmaceutical company located in a country that has a NID regime is capitalized with equity capital, we understand that it could receive U.S. source royalties with full treaty benefits, but if it receives U.S. source interest, the NID rule would apply so as to disallow treaty benefits for such interest payment.

We question whether this is an appropriate result. For the reasons set out below, we recommend that the NID rule be limited to companies that conduct a business, substantially all of the income of which is interest and other financing income. Otherwise, we would question why an NID regime should be considered to benefit solely interest income, given that the NID regimes that we are aware of benefit all items of income equally.[8] An NID regime operates by allowing a deduction to the issuer of equity, based on some percentage of equity capital. The percentage is usually set to equal what the country believes to be a risk-free rate of return.

Treasury may believe that a NID should be treated as disproportionately benefitting interest given the history of Belgium's NID regime. Belgium adopted a NID after its

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[8] Very few countries have adopted a true NID regime, although we understand that several countries are considering the adoption of such a regime. Cyprus, for example, has recently announced its intention to adopt an NID regime. See "Reform Proposals Include Notional Interest Deduction," Tax Notes Int'l, July 20, 2015, at p. 202. We understand that Luxembourg is also considering such legislation.

coordination center regime, designed to attract financing and treasury centers by providing a very low rate of tax on net interest income, was ruled to be in violation of European harmful practices rules. There is no question that one purpose of the Belgian NID is to provide a low effective rate of tax on finance income; the first of several examples of how the NID operates set forth in a Belgian government website involves a group financing company.[9] However, in order to comply with European rules, Belgium was required to, and does, provide a NID for all equity capital of all types of corporations; the benefit of the NID is not limited to finance companies or to companies that earn interest. The later examples on the website make this clear.

It is true that any pure NID regime that does not impute taxable income to the holder in respect of the NID, functions as a disguised tax rate reduction. It is also true that any tax reduction, even one not specifically benefitting interest or royalties, will have the practical effect of "disproportionately" benefitting interest or royalties as applied to a particular taxpayer that in fact earns only interest or royalties. And a deduction for notional interest might not be captured by other rules applicable to back-to-back financings, by thin capitalization rules, by conduit rules or by the base erosion test of a typical U.S.-style LOB article in a treaty. Nevertheless, we do not believe that the foregoing observations are sufficient to conclude that a NID rule disproportionately benefits interest as applied to all taxpayers.

A NID regime can represent a legitimate policy choice to eliminate the bias toward debt capitalization. One reason countries enact a NID is to strengthen corporate balance sheets in times of stress. Another reason that countries enact NID regimes is to encourage the formation of new business. Italy targets its NID regime at new equity to encourage

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[9] See http://www.minfin.fgov.be/portail2/belinvest/downloads/en/publications/bro_notional_interest.pdf

entrepreneurs.[10] The current U.S. administration has proposed a NID regime as part of its CFC minimum tax legislative proposal.[11]

It is possible that Treasury believes that a NID disproportionately benefits interest on the ground that finance companies earn income by charging a spread on lending, and that spread is typically a low rate of return tied to the risk-free return on capital. The theory may be that in the case of a finance company, the NID comes close to zeroing out the company's net income, or at least that the amount of the NID would be expected to closely correlate with the amount of the finance company's pre-NID rate of return. This would not be true for an operating business that would normally expect to earn a higher, risky rate of return. But an operating company, because it takes risk, can also operate on a small margin or even suffer losses. In such a case, the benefit of an NID regime might be greater than the benefit a finance company might derive. We do not believe that this theory justifies applying the NID rule to companies other than finance companies.

The NID rule in the Model suffers from several ambiguities and uncertainties, many of which would fall away if (possibly as intended) the rule were limited to finance companies. To begin with, we assume (and it should be made clear) that the NID rule is intended to apply only to regimes that provide a notional deduction on what the taxing country views as equity. We therefore assume that the NID rule does not apply where the country in question characterizes capital as debt, even if such capital would be characterized as equity under U.S. tax principles. We think that the language used in BEPS Action Item 6 to describe the same rule is clearer. That language provides "[w]ith regard to financing income, the term special tax

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[10] For recent changes to Italy's rules tightening their application, *see* "Italy: Guidelines for NID Anti-Avoidance Rules," J. Tax'n 22 (August 2015).

[11] JCT Report (JCS-3-11), "Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal" (June 2011).

regime includes notional interest deductions that are allowed *without regard to liabilities for such interest.*"

Second, we think that the Technical Explanation of the NID rule should clearly state that the rule does not apply to mere timing differences. We note that the Technical Explanation provides that no current U.S. tax rule would be treated as an STR. It follows that the NID rule was not intended to apply to a regime that provides a deduction for interest in advance of actual payment, or for OID. In this regard, we note that there are two basic types of NID regimes. Some countries, such as Belgium, allow a notional interest deduction without regard to actual payment, with the result being that the holder of equity in the issuing corporation reports no interest or dividend income. Other countries, such as Brazil, permit a deduction with respect to equity, but only when a payment is made, and tax the payment to the equity owner.[12] The Brazilian NID could therefore be characterized as a mere timing difference. We question whether this type of regime should be covered by the rule. In any event, this should be clarified.

Finally, neither the language of the Model nor the Technical Explanation suggests how to determine the amount of any interest paid to a related party to be attributed, if at all, to the amount of the NID. In the case of a pure finance company, this issue does not arise, because it can be assumed that 100% of its income is interest. This is one reason that we recommend that the NID rule be limited to finance companies. In the case of other companies that derive interest as part but not all of their income, we have identified below several different approaches that could be applied to attribute interest to a NID. The illustrations below use Belgium's NID regime for illustrative purposes. Under that regime, a corporation is allowed to deduct each year an amount equal to a percentage of its equity capital, which percentage is calculated using

[12] See Malherbe & Vettori, "Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared," European Tax Studies No. 1/2010.

essentially the long-term bond rate; we will assume a rate of 3%, which is close to current practice. For purposes of the illustrations below, assume that the Belgian corporation earns 1,000 of interest from a related party and earns 4,000 of other business income, such that it has total income of 5,000. Assume that its NID is 700.

1. Under the first approach, the entirety of the interest payment would not be entitled to treaty benefits. In this example, 1,000 of interest would be denied treaty benefits, even though it exceeds the amount of the NID.

2. Under the second approach, an amount of interest to the extent of the amount of NID would not be entitled to treaty benefits; in this example, 700 of interest would be excluded from treaty benefits but 300 would be entitled to such benefits.

3. Under a third, pro rata, approach, the amount of interest not entitled to treaty benefits would be equal to the ratio of interest income to total income, multiplied by the amount of NID. Since the ratio in this example is 20%, 20% of the NID, or 140, would be denied benefits with the remaining 560 entitled to such benefits.

4. A fourth approach would be to allocate the amount of NID to business income first, such that interest is only subject to the rule to the extent there is excess NID. In this example, all of the interest would be entitled to treaty benefits, because the amount of the NID is fully absorbed by business income. A possible objection to this approach might be that a company could acquire a small business that would generate enough income to absorb the NID. If the amount of business income is very significant, a safe harbor could be employed, such that the rule would not be applicable and all amounts of interest would be entitled to treaty benefits.

5. Rather than testing income, the payment could be allocated based on assets held to produce interest income. For example, treaty benefits would be disallowed on

interest received, but only up to the NID on the capital of the company invested in interest bearing assets.

A final approach, which we do not recommend, would be to apply a principal purpose test. Under that approach, the NID rule would apply only if a company were created to take advantage of an NID rule in order to lower its tax rate. The reason we do not recommend this approach is that it is subjective and thus difficult to apply in practice. Moreover, to our knowledge no NID regimes are elective.

The first alternative seems to us inappropriate. It would disallow all benefits for interest even if all the other income earned by the recipient company were operating income. It would also seem arbitrary to deny treaty benefits to interest income but not to other types of income that can be said equally to benefit from a NID. As among the other alternatives, we think it would be most consistent with the approach of limiting the NID rule to finance businesses to adopt a pro rata approach such as that set out in alternative 3 or 5. In effect, such an approach would treat the company as if it operated two separate businesses, applying the NID rule only to the finance business.

We also note that all the alternatives other than the first one require that the withholding agent have sufficient knowledge about the recipient to withhold the correct amount. Even taking into account that the rule applies only to payments between related persons, who might be presumed in most circumstances to have access to the relevant facts, a withholding agent will not know the correct amount to withhold without guidance as to which of the above allocations methods applies. Also, the withholding agent may not know all the relevant facts at the time a payment is made. We suggest that the Model incorporate certain presumptions that

can be applied in such cases. For example, the parties could use the ratio from a prior year or period in order to make the calculation.

C. New Article 28: Subsequent Changes in Law

New Article 28 provides a procedure for terminating certain treaty benefits in the event of a change in law made by a treaty country subsequent to the time that the treaty enters into force. That procedure can be triggered by two types of changes in law. The first is where the general rate of tax falls below 15% with respect to substantially all income of a resident. The second trigger occurs when a country exempts substantially all foreign source income, including interest and royalties, from tax.

We appreciate the motivation behind this new proposal. Countries should not enter into treaties in cases where the potential for double taxation is not present. If a treaty is entered into at a time when both countries impose tax – typically based on source and on residence - and subsequently one country ceases to impose residence based tax, the treaty should be renegotiated. Yet the dynamics in such a situation would normally be that the country that ceased to impose residence-based tax would not be motivated to renegotiate the treaty, because it would desire source-based treaty benefits for its residents to continue. In this situation, the other country will not wish to accord treaty benefits to residents of the tax-reducing country, given that they are no longer subject to double taxation. But that country will not wish to abrogate the treaty altogether, since by doing so it could cause its own residents to become subject to double taxation. (The tax-reducing country would in most cases continue to levy source tax on nonresidents.) Proposed new Article 28 would address this hypothetical conundrum by denying treaty benefits for dividends, interest, royalties and Other Income. It would, importantly, leave unaffected the benefits accorded to business profits.

Treasury has explained the need for Article 28 as a tool that is less drastic than abrogating an entire treaty. The approach can be analogized to the "intermediate sanctions" rules added to Section 4958 of the Code in 1996. Before those rules were added to the Code, the government had no alternative to revoking a charity's exemption when the charity engaged in an "excess benefit transaction." Section 4958 was designed to give the government a remedy less draconian than complete revocation of exemption. In the same way, Article 28 can be seen as less draconian than complete termination of a treaty.

1. The First Trigger

The first trigger, because it turns on an objective numerical formula, can be made fairly clear so long as one can determine a country's generally applicable tax rate. The Technical Explanation states that the tax rate to be tested is one that applies to ordinary income, excluding capital gains. It should be clarified that the distinction between ordinary income and capital gain items is to be determined under the law of the taxing country. We also think it would be useful to stipulate whether Article 28 is intended to apply where a country reduces its tax rate not all at once, but over a period of years.

We believe that the tax rate to be tested should be the "headline" rate, rather than an effective tax rate that takes into account U.S. tax principles. In particular, we would not recommend that the tested rate be determined in the manner that Section 954(b)(4) provides with respect to the high-taxed income exception from subpart F income.[13] We assume that when the United States decides to enter into a treaty with another country, it does not undertake to examine closely all of the timing and base differences between U.S. and foreign law, but looks

[13] The Section 954(b)(4) approach to determining the effective rate of tax is referred to in the Model's Technical Explanation of the triangular permanent establishment issue. The rule there serves the purpose of ensuring that the tax base is not eroded, whereas the rule here asks only whether a country has reduced its tax rate by too wide a margin.

mainly to the headline rate. The rule should not be different when measuring a reduction of that rate.

Treasury could consider an anti-abuse rule to cover the case where, hypothetically, a treaty partner retains a high headline rate but makes it applicable only over an unrealistically high threshold. For example, a country might configure its bracket schedules such that taxable income up to $1 billion is taxed at 10%, with taxable income over that amount being subject to tax at a 20% rate. If the facts and circumstances suggest that the 20% bracket was intended not to apply to any significant number of taxpayers, the 20% bracket should be ignored.

We do not pretend to know whether the 15% rate, or the lower of 15% and some percentage of the source country rate, is the correct place to set the bar. We note that many countries currently impose tax at rates in the range of 15-20%. We suggest that Treasury consider modifying the first trigger to remove any absolute tax rate and make the trigger a function of only a significant rate reduction as compared with the prevailing headline rate in effect when the treaty was signed. We think this would be consistent with the policy of the rule. The United States should be presumed to approve of a treaty partner's rate structure when it enters into a treaty. If the treaty partner reduces its generally applicable rate by a significant margin, it may make sense to question whether the treaty should be re-evaluated.

Given the international trend to reduce corporate income tax rates, and the fact that this is being discussed in the United States as well, we wonder whether Article 28 should test only the reduction in one country's rate as compared to the reduction in the other country's rate. If both countries reduce their headline rate by the same percentage, it may be inappropriate to invoke Article 28.

2. The Second Trigger

The second trigger in Article 28 asks whether a treaty country has adopted an expansive form of territoriality. At its most expansive, a territorial regime would exempt from local tax all income of residents arising outside the residence country, including passive income such as interest on foreign accounts. The rationale for terminating treaty benefits for nonbusiness income in such cases is that there is no possibility of double taxation where the country of residence has unilaterally ceded its jurisdiction to tax income earned outside its borders.

As we understand it, this trigger is not intended to apply to the "ordinary" territorial regimes that exist in many countries today, including in countries with which the United States has extant treaties. The Technical Explanation states that the rule is not intended to apply to "taxation systems under which only foreign source dividends or business profits from foreign permanent establishments are exempt."[14] Rather, the trigger would be implicated only where a country exempts all income, including passive, nonbusiness income, from tax. The theory is that since the United States does not, as a policy matter, enter into tax treaties where there is no possibility of double taxation, any extant treaty should be abrogated to the extent benefits would be provided in respect of items of income that the other country determines not to tax.

We understand the policy underlying new Article 28, but we have some concern over how a country would apply the "substantially all foreign source income" test. The Technical Explanation states that this phrase is intended to include a regime under which 95% of

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[14] We note that a separate new provision in the Model, not addressed in this Report, would cut back on the tax benefits accorded to foreign permanent establishments. If a treaty country were to define the term "permanent establishment" very broadly, this could have the effect of exempting even income that the United States might regard as passive, nonbusiness income.

foreign source income is exempt, with 5% being taxed as a proxy for the disallowance of allocable deductions. We find this passage in the Technical Explanation confusing. The foreign tax regimes we are aware of which exempt 95% of foreign source income from tax are traditional territorial regimes, not regimes that exempt passive portfolio income.[15] There is no need for a proxy for allowable deductions where no deductions would in any case be provided, which is invariably the case for passive, nonbusiness income. This passage thus seems to suggest that Article 28 could be applied to traditional territorial regimes, which we believe was unintended. If what was intended was that 95% constitute "substantially all," we think that should be stated without reference to proxies for disallowed deductions.

3. Reciprocity

Although we hesitate to comment on Treasury's policy choices, we think that the dynamics of Article 28 are skewed by the rule that turns off treaty benefits to residents of both Contracting States. This rule, which is not mirrored in the STR rules, seems to us unfairly to punish residents of the country that has not acted in a manner inconsistent with the assumptions of the treaty. It also unfairly punishes the country in which they reside by increasing the amount of foreign taxes paid to the offending country and thereby increasing the amount of credit for foreign taxes that the "innocent" country would be expected to provide.

While it can be said that the residents of neither country would have been entitled to treaty benefits had the subsequent change been in force upon signing of the treaty (because no treaty allowing those benefits would have been entered into), we do not necessarily believe that this observation has relevance to how the new subsequent change proposal ought to operate. It may be that Treasury feels that Article 28 would not prove acceptable to other countries absent

[15] The Camp proposal for a modified territorial regime included this 5% proxy.

the reciprocal termination of benefits. We are not sure this is the case. It seems to us that if any country accepts the inclusion of Article 28 in a treaty, acceptance of its logical premise would require that the benefits of the treaty be denied only to residents of the country that has surrendered residence-based tax jurisdiction. Treasury may also wish to consider whether the U.S. Senate is less likely to ratify a treaty that provided for reciprocal denial of benefits.