November 10, 2015

The Honorable John Koskinen
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The Honorable Mark Mazur
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Dear Messrs. Koskinen, Mazur, and Wilkins:

Enclosed please find comments on certain select draft provisions of the U.S. Model Income Tax Convention released by the Treasury Department on May 20, 2015 (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

CCs: Erik H. Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
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November 10, 2015

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AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION  

COMMENTS ON CERTAIN SELECT DRAFT PROVISIONS OF THE U.S. MODEL INCOME TAX CONVENTION RELEASED BY THE TREASURY DEPARTMENT ON MAY 20, 2015

These comments (the “Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Michael J. Miller of the Section’s U.S. Activities of Foreigners and Tax Treaties Committee (the “Committee”). Substantial contributions were made by Mary C. Bennett, Peter H. Blessing, Aaron H. Junge, and Maarten van der Weijden. The Comments were reviewed by David G. Shapiro, the Last Retiring Chair of the Committee. The Comments were further reviewed by William B. Sherman of the Section’s Committee on Government Submissions, Alan I. Appel, the Section’s Council Director for the Committee, and Peter H. Blessing, the Section’s Vice Chair (Government Relations).

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: November 10, 2015
# TABLE OF CONTENTS

**EXECUTIVE SUMMARY** .................................................................................................................. 3  
**DISCUSSION** .................................................................................................................................. 4  
I.  Overview .......................................................................................................................................... 4  
II. Comments on Draft LOB Article .................................................................................................... 4  
   A.  Active Trade or Business Test ..................................................................................................... 4  
   B.  Derivative Benefits Test .............................................................................................................. 6  
      1.  Background ............................................................................................................................... 6  
      2.  Comments .................................................................................................................................. 7  
         a.  Replacing at least as low as requirement with a “higher of” test ........................................... 7  
         b.  Treating source country residents as equivalent beneficiaries ........................................... 9  
         c.  Attribution issues ..................................................................................................................... 11  
            i.  Full vs. proportionate attribution ......................................................................................... 11  
            ii. Clarification of applicable rate ......................................................................................... 12  
            iii. Application to individual owners .................................................................................... 15  
         d.  Elimination of seven or fewer limitation ................................................................................. 17  
   C.  Intermediate Owner Residence Requirements ............................................................................ 18  
III. Comments on Low-Taxed PE Provision ......................................................................................... 21  
IV.  Special Tax Regime Provisions ...................................................................................................... 21  
   A.  Overview ...................................................................................................................................... 21  
   B.  Comments ..................................................................................................................................... 22  
V.  Expatriated Entity Provisions .......................................................................................................... 23
EXECUTIVE SUMMARY


The Draft Model Treaty sets forth numerous changes designed to restrict access to U.S. income tax treaties, so as to ensure that such treaties, which are intended to prevent double taxation, are not instead used to promote double non-taxation. Key among these changes are a more restrictive (in most respects) limitation on benefits (“LOB”) article and new anti-abuse provisions that disallow treaty benefits (i) for certain income earned though a permanent establishment outside the taxpayer’s country of residence, (ii) for certain types of income taxed under a special tax regime, (ii) for certain payments by expatriated entities, and (iv) in the event of certain changes in law.

We are very supportive of Treasury’s objective of preventing treaty abuse and, for the most part, we support the specific provisions set forth in the Draft Model Treaty to achieve this objective. There are, however, several instances in which the draft provisions may restrict treaty access in a manner that is disproportionately burdensome to taxpayers engaging in legitimate business transactions. In those instances, the Comments propose modifications to the Draft Model Treaty. We have also proposed certain clarifications to the “at least as low as” requirement of the “derivative benefits” test that would now be included for the first time in a U.S. Model Income Tax Convention.
DISCUSSION

I. Overview

On May 20, 2015, Treasury released certain provisions of the Draft Model Treaty. Key among these changes are an updated LOB article and new anti-abuse provisions that disallow treaty benefits (i) for certain income earned through a permanent establishment outside the taxpayer’s country of residence, (ii) for certain types of income taxed under a special tax regime, (iii) for certain payments by “expatriated entities,” and (iv) in the event of certain changes in law. The Comments address a number of these provisions below.

II. Comments on Draft LOB Article

Pursuant to Article 122 (Limitation on Benefits) of the Draft Model Treaty (the “Draft LOB Article”), treaty access would be more limited than under the U.S. Model Income Tax Convention Of November 15, 2006 (the “2006 Model Treaty”). Certain of the key changes, or other notable aspects of the Draft LOB Article, are addressed below.

A. Active Trade or Business Test

Like the 2006 Model Treaty, the Draft LOB Article includes an active trade or business (“ATB”) test. Pursuant to the ATB test, a resident of a Contracting State that is not a qualified person will be accorded treaty benefits as to an item of income if (1) such person is engaged in the active conduct of a trade or business in such Contracting State, and (2) such item of income is derived in connection with, or is incidental to, such trade or business. For this purpose, both the 2006 Model Treaty and the Draft LOB Article provide an attribution rule pursuant to which activities conducted by persons “connected to” the treaty resident may be deemed conducted by such resident.

However, the Draft LOB Article introduces a new and very substantial restriction. Under the Draft LOB Article, “a resident seeking to qualify for benefits under this paragraph will be deemed to conduct activities conducted by a connected person only to the extent both persons are engaged in the same or complementary lines of business.” Notably, Treasury has not provided a technical explanation setting forth its rationale for the new restriction. The Draft LOB Article includes a footer stating that Treasury “does not anticipate releasing an advance technical explanation of revised Article 22, since the rules are objective and mechanical in nature and thus are self-explanatory.”

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1 All “Article” and “Art.” references are to the Draft Model Treaty, unless otherwise indicated.
3 Art. 22(3)(a).
4 Art. 22(3)(c).
5 Id. Footnote omitted.
We believe the new restriction will unduly restrict treaty access for persons that choose, for reasons having nothing to do with treaty avoidance, to conduct their ATBs in the treaty country through entities that are separate from those that earn the U.S. income for which treaty benefits are sought. We understand that Treasury may be concerned about the potential for a non-treaty country resident to engage in improper treaty shopping by acquiring an ATB (possibly a relatively small ATB) in a treaty country in order to claim treaty benefits for any U.S. income that qualifies as having been “derived in connection with” the ATB. In this regard, we note that, under existing treaties that follow the 2006 Model Treaty, the standard for satisfying the derived-in-connection-with requirement may give rise to this concern.

The Technical Explanation to the 2006 Model Treaty states: “An item of income is derived in connection with a trade or business if the income-producing activity in the State of source is a line of business that ‘forms a part of’ or is ‘complementary’ to the trade or business conducted in the State of residence by the income recipient.” The Technical Explanation further provides that, in order to satisfy the latter test, “the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other.”

The Technical Explanation provides a number of examples, including one in which a U.S. corporation operates an international airline and its foreign subsidiary operates a chain of hotels in the other Contracting State that are located near airports. The U.S. corporation frequently sells tour packages that include air travel to the other Contracting State and lodging at the foreign subsidiary’s hotels. The example states that the two businesses are distinct, and therefore the hotel business of the foreign subsidiary does not form a part of the air travel business conducted by the U.S. parent. However, the example concludes that the business of the foreign subsidiary is complementary to the business of the U.S. parent, “because they are part of the same overall industry (travel) and the links between their operations tend to make them interdependent.” Accordingly, we understand that the linkage required to satisfy the “complementary test” is relatively modest (but arguably appropriately so), and that this may concern Treasury. We also recognize that the ability to use a complementary ATB for treaty planning purposes is enhanced by the relatively modest threshold of substantiability, including the fact, as stated in the Technical Explanation to the 2006 Model Treaty, that “due regard will be given to the relative sizes of the economies in the two Contracting States.”

Given these issues, it is not surprising that Treasury may wish to limit the ability of taxpayers to gain treaty access in what it might consider to be inappropriate circumstances through the ATB test. However, we do not believe the proposed attribution restriction is a desirable solution to any such perceived problem. First, it accomplishes too little, in that it does absolutely nothing to restrict such abuses in the scenario where the treaty resident that wishes to

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7 Id.
8 Id.
9 Id.
gain treaty access conducts the ATB directly. Second, it accomplishes too much, in that it precludes treaty access in circumstances where the ATB conducted by the connected entity is very closely connected with the activity producing the U.S. income and reaches a high threshold of substantiality.

Treasury has stated in footnote 2 of the Draft Model Treaty that “the ‘derivative benefits’ test set forth in paragraph 4 of this Article sets forth the appropriate standard for determining whether a holding company or financing entity qualifies for benefits.” However, in our view the derivative benefits test is not relevant. The purpose of the ATB test is to serve as an independent basis for allowing treaty benefits without regard to ownership, on the ground that the conduct of an ATB in the other Contracting State evidences meaningful business activity and not treaty shopping. If, as we submit, the new restriction on attribution is arbitrary and serves no discernible treaty policy, it is no answer to say that the company seeking treaty benefits may coincidentally satisfy the derivative benefits test in Article 22(4). Indeed, it would be as logical to say that the company seeking treaty benefits may potentially satisfy the public company subsidiary test in Article 22(2)(d) or the ownership and base erosion test in Article 22(2)(f).

We therefore recommend that the proposed restriction on attribution under Article 22(3)(c) be withdrawn. Instead, we would suggest that, if Treasury considers the complementary test to be too lenient, or the substantiality threshold to be too low, it may be appropriate to add more definition to these tests to address such concerns. Nonetheless, we recognize that the nature of the tests, and the desire to create tests applicable across activities of every kind, make it difficult to fine-tune the two tests in a manner that raises the bar to exactly the appropriate level.

B. Derivative Benefits Test

1. Background

A number of U.S. income tax treaties that have entered into force since the early 1990s, including in particular a number of treaties with countries within the European Union, include within their LOB articles a “derivative benefits” provision designed to allow treaty access, even if none of the other LOB tests is satisfied, where it seems clear that the entity was not used for impermissible treaty-shopping purposes. ¹⁰

Under the U.S.-Germany Tax Treaty, for example, a corporation satisfies the derivative benefits test if 95% or more of its stock is owned, directly or indirectly, by seven or fewer equivalent beneficiaries. ¹¹ In order to qualify as an equivalent beneficiary, a person generally must be a resident of a member state of the European Union (“EU”) or the European Economic Area (“EEA”) or a party to the North American Free Trade Agreement (“NAFTA”) and must qualify for the benefits of a comprehensive income tax treaty between such state and the Contracting State from which benefits are claimed (the “Home Country Treaty”) under certain

¹⁰ See, e.g., the treaties with Germany, Luxembourg, Belgium and the Netherlands.

specified provisions of the LOB article of the Home Country Treaty.\textsuperscript{12} In the case of dividends, interest and royalties, the person must also satisfy an “at least as low as” requirement. In order to satisfy this latter requirement, such person must be entitled, under the Home Country Treaty, to a rate of withholding tax that is “at least as low as the rate applicable” under the U.S.-Germany Tax Treaty.\textsuperscript{13}

Typically, in treaties and protocols entered into since 2003, the definition of equivalent beneficiary also includes an alternative test. Under the alternative test, a person may qualify as an equivalent beneficiary by being a resident of either Contracting State and qualifying for treaty benefits under certain specified provisions of the LOB article of the applicable treaty.\textsuperscript{14}

With few exceptions, the U.S. income tax treaties containing derivative benefits provisions to date have been with European nations. Accordingly, such a provision has not been part of the “standard issue” LOB article and was not included in the 2006 Model Treaty or its predecessors. However, the Draft LOB Article includes a derivative benefits provision, signaling that such provision may now become “standard issue” within the LOB article. The inclusion of this provision advances Treasury’s policy of allowing treaty access in circumstances that do not involve treaty shopping, and we support this change.

2. Comments

a. Replacing “at least as low as” requirement with a “higher of” test

The “at least as low as” requirement appears to be “all or nothing,” meaning that, if it is not met, treaty benefits for the item of income at issue are denied entirely. Consider the following example:

\textbf{Example 1.} X, a U.K. resident corporation, is wholly owned by Y, a Maltese public corporation that qualifies for all benefits under the public company test of the U.S.-Malta Tax Treaty.\textsuperscript{15} X earns U.S.-source interest that does not qualify for the portfolio interest exemption and wishes to claim an exemption under the U.S.-U.K. Tax Treaty.\textsuperscript{16} X will qualify for such treaty benefits only if it satisfies the derivative benefits test.

\textsuperscript{12} U.S.-Germany Tax Treaty, Art. 28(6)(e)(aa)(A).

\textsuperscript{13} U.S.-Germany Tax Treaty, Art. 28(6)(e)(aa)(B).

\textsuperscript{14} \textit{E.g.}, U.S.-Germany Tax Treaty, Art. 28(6)(e)(bb).

\textsuperscript{15} Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Aug. 8, 2008, U.S.-Malta, Art. 22(c), Tax Treaties (CCH) ¶ 5801 (hereinafter, the “U.S.-Malta Tax Treaty”).

Under the U.S.-Malta Tax Treaty, Y would not be entitled to a complete exemption from U.S. withholding tax on interest, as the tax rate for interest under that treaty is 10%. Consequently, the “at least as low as” requirement is not met. The result is that Y is not an equivalent beneficiary with respect to the interest income, and X therefore fails to satisfy the derivative benefits test. Accordingly, X is subject to U.S. withholding tax at a 30% rate.

There is a policy question as to whether the complete denial of treaty benefits in this scenario is necessary to prevent treaty shopping or whether it would be appropriate to allow treaty benefits in Example 1 to the extent of reducing the U.S. withholding rate to 10%. In our view, the latter approach seems more appropriate. It is certainly sufficient to prevent treaty shopping, as Y could not achieve a lower withholding rate by earning its U.S.-source interest income through X, rather than directly.

Accordingly, we propose replacing the “at least as low as” requirement with a “higher of” test. Under the “higher of” test, the withholding rate would be reduced to the higher of (1) the withholding rate that would have applied under the applicable treaty if the corporate treaty resident seeking treaty benefits (the “Claimant”) satisfied the LOB test, and (2) the lowest rate for which the “at least as low as” requirement would have been satisfied if such rate had been the rate applicable to the Claimant. Applying this test in Example 1, above, treaty benefits would be allowed at the higher of (1) the 0% rate to which X would have been entitled under Article 11(1) of the U.S.-U.K. Tax Treaty, if X satisfied the LOB test, and (2) the 10% rate for which the “at least as low as” requirement would have been satisfied, if 10% had been the rate applicable to X. Accordingly, under our proposed “higher of” test, X would be eligible for a reduced withholding rate of 10% on its U.S.-source interest income.

Since the “higher of” test would do more than simply allow or disallow treaty benefits, by changing in appropriate circumstances the rate to be permitted under the applicable treaty, conforming changes would need to be made to the dividend, interest, royalty, and other income articles. In our view, however, the changes would not be difficult. Thus, we believe the “higher of” test would achieve greater fairness, with no increased complexity and without rewarding treaty shopping.

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17 U.S.-Malta Tax Treaty, Art. 11(2).
b. Treating source country residents as equivalent beneficiaries

The Draft LOB Article makes a number of changes to the definition of equivalent beneficiary. For example, the geographic restriction under the general rule requiring equivalent beneficiaries to be residents of specific treaty countries (such as member states of the EU or EEA, or of parties to NAFTA) has been removed, so that residents of any treaty country may potentially qualify.\(^\text{18}\) The removal of the geographic restriction advances Treasury’s purpose of allowing treaty access to treaty residents in circumstances that do not involve treaty shopping, and we strongly support this change.

However, the Draft LOB Article would also limit the alternative test so that only “a resident of the same Contracting State as the company claiming benefits” under the derivative benefits test may qualify.\(^\text{19}\) Under this more restrictive alternative test, a U.S. resident would never qualify as an equivalent beneficiary with respect to a foreign corporation seeking reduced U.S. tax under a U.S. income tax treaty, as it would be a resident of the source Contracting State rather than of the same Contracting State as the foreign corporation. Thus, for example, assuming a 95% “good” ownership test, a foreign corporation that is 90%-owned by an equivalent beneficiary (such as a foreign corporation that meets the publicly traded test, the “at least as low as” requirement, and other applicable requirements) and 10%-owned by a U.S. resident could never qualify for derivative benefits.

This approach would represent a substantial departure from Treasury’s policy with respect to derivative benefits provisions to date. We note, for example, that an alternative test applicable to residents of both Contracting States is included in the existing treaties with Belgium, Bulgaria, Denmark, Finland, France, Germany, Malta, Netherlands, Sweden and the United Kingdom, as well as pending treaties or protocols with Hungary, Poland, and Spain. Thus, under derivative benefits provisions included in treaties and protocols signed over at least the last twelve years, U.S. residents may qualify as equivalent beneficiaries of foreign corporations seeking U.S. treaty benefits.

Notably, the U.S.-Switzerland Tax Treaty does not expressly include an alternative test under its (unusual) derivative benefits test,\(^\text{20}\) but the Competent Authorities of the United States  

\(^\text{18}\) Art. 22(6)(e)(i).

\(^\text{19}\) Art. 22(6)(e)(ii).

\(^\text{20}\) Convention for the Avoidance of Double Taxation with respect to Taxes on Income, Oct. 22, 1996, U.S.-Switzerland, Art. 22(3), Tax Treaties (CCH) ¶ 9101 (hereinafter, the “U.S.-Switzerland Tax Treaty”). Under Article 22(3)(a) of the U.S.-Switzerland Tax Treaty, a company that is a resident of a Contracting State may receive derivative benefits with respect to dividends, royalties and interest if, among other requirements, more than 70% of the aggregate vote and value of the company’s shares is ultimately owned by persons that are either (1) certain residents of the same Contracting State or (2) residents of member states of the EU or EEA or parties to NAFTA that are described in Article 22(3)(b). Pursuant to Article 22(3)(b), shares ultimately owned by a person that is a resident of a member state of the EU or of the EEA or a party to NAFTA are taken into account only if, among other requirements, such person “is a resident of a country with which the other Contracting State has a comprehensive income tax convention and that person is entitled to all of the benefits provided by the other Contracting State under that convention[.]”
and Switzerland reached an agreement that nevertheless allows stock owned by certain U.S. resident shareholders of a Swiss corporation to be taken into account towards the applicable ownership requirement. 21 It can be inferred, both from the fact of the agreement and the approach taken in treaties and protocols signed after the date of the agreement, that the Competent Authorities felt that the result was justified on policy grounds and that the language of the equivalent beneficiary definition, which did not expressly refer to residents of either Contracting State, 22 was unintentionally overly restrictive.

We recognize that the proposed change would conform the derivative benefits provision to the 50% ownership/base erosion provision in the 2006 Model Treaty in this respect. We have serious reservations as to whether 2006 Model Treaty’s failure to treat U.S. residents as “good” owners of foreign corporations under the 50% ownership/base erosion test is appropriate (for example, not all U.S. treaties entered into are consistent with that approach, and U.S. residents and citizens would seem categorically more benign owners than residents of non-treaty countries). Regardless, we believe that the derivative benefits test in the Draft Model Treaty and the 50% ownership/base erosion test in the 2006 Model Treaty are distinguishable in that the latter inherently allows for substantially more “bad” ownership than the the former. Accordingly, significant U.S. ownership does not necessarily prevent qualification under the 50% ownership/base erosion test in the 2006 Model Treaty.

In sum, we respectfully disagree with the proposed change that would restrict the alternative test for equivalent beneficiary status to residents of the same country as the company seeking derivative benefits. We note, for example, that under this restrictive approach, any ownership in excess of 5% (in the context of a 95% “good” ownership requirement) by a source country resident would prevent qualification of a corporation resident in the other Contracting State under the derivative benefits test even if the remaining shares are owned by a public company resident in an appropriate foreign treaty country. We do not believe the U.S. policy against treaty shopping compels or justifies this result. Accordingly, we propose that, consistent with U.S. treaty policy to date, the alternative test be modified to apply to residents of both Contracting States.


22 Article 22(3)(b) of the U.S.-Switzerland Tax Treaty, as the corresponding provision in certain other treaties of the era, contained convoluted language that, read literally, defined an “equivalent beneficiary” in a convoluted way that, likely unintended by the drafters, would exclude a source country resident from the definition of an equivalent beneficiary because, in effect, a country cannot have an income tax treaty with itself.
c. Attribution issues

i. Full vs. proportionate attribution

Consider the following example:

Example 2. X, a Country F resident corporation, is 50% owned by A and B, two publicly traded Dutch corporations that each qualify, under the public company test (including the regular trading and substantial presence requirements), for all benefits under the U.S.-Netherlands Tax Treaty. X owns 10% of Z, a U.S. corporation, and claims a reduced rate of withholding tax, of 5%, under Article 10(2)(a) of the U.S.-Country F Tax Treaty (the “Country F Treaty”), X will qualify for such treaty benefits only if it satisfies the derivative benefits test. Assume that the dividend article of the Country F Treaty is identical to Article 10 of the 2006 Model Treaty, and that the LOB article of the Country F Treaty is identical to the Draft LOB Article.

In order to determine whether the “at least as low as” requirement is satisfied, and whether A and B are therefore equivalent beneficiaries with respect to the 5% rate on dividends, it is first necessary to determine how much Z stock A and B should each be considered to own. If proportionate attribution is applied, each should be considered to own only 5% of the stock of Z, which would not qualify. If full attribution is applied, so that A and B are each considered to own all of the Z stock owned by X, then they would qualify.

We are aware that a number of treaties prescribe full attribution for purposes of determining whether a person is an equivalent beneficiary with respect to zero withholding on dividends. For example, the U.S.-U.K. Tax Treaty provides as follows:

For the purposes of applying paragraph 3 of Article 10 (Dividends) in order to determine whether a person, owning shares, directly or indirectly, in the company claiming the benefits of this Convention, is an equivalent beneficiary, such person shall be deemed to hold the same voting power in the company paying the dividend as the company claiming the benefits holds in such company.24

We believe that this full attribution approach is equally sensible in the context of determining qualification for the 5% rate. Clearly, A and B could have organized a Dutch company to hold their stock in Z, and the Dutch company would have qualified for the 5% rate. By choosing instead to use a Country F holding company, they have not improved their treaty position, so full attribution seems appropriate, as in the case of zero withholding. We recommend that Treasury clarify whether proportionate or full attribution is intended in determining equivalent beneficiary status with respect to the 5% rate.

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24 U.S.-U.K. Tax Treaty, Art. 23(d) (flush language). Similar provisions can be found in the treaties with Denmark, Finland, France, Germany, the Netherlands, and Sweden.
Consider the following example:

**Example 3.** Same as Example 2, except that A and B are residents of Spain, instead of the Netherlands. A and B are not equivalent beneficiaries as to the 5% rate, because the lowest rate of withholding on dividends under Article 10(2) of the U.S.-Spain Tax Treaty is 10%. X claims a 15% rate of withholding tax on dividends from Z, under Article 10(2)(b) of the Country F Treaty, because the 10% rate to which A and B are entitled under the U.S.-Spain Tax treaty is at least as low as the 15% rate claimed by X under the Country F Treaty.

Since A and B would qualify for a rate that is at least as low as the 15% rate claimed by X, it appears that the “at least as low as” requirement is satisfied. Moreover, it seems quite clear that A and B are not engaging in any form of treaty shopping, since they are not achieving a better treaty result than if they each received a portion of the dividend directly. However, we understand that the Service may not agree with this result and may take the view that the “rate applicable” under the Country F Treaty can only be 5%, as that is the lowest rate for which X would qualify under Article 10 of that treaty, if the LOB test were met. Under this view, once it is determined what dividend withholding rate would apply to the Claimant under Article 10, the “at least as low as” requirement may be satisfied, if at all, only as to this rate (with no retesting at any higher rate that may otherwise be available under Article 10). Accordingly, we understand that the Service may disallow all treaty benefits in circumstances such as Example 3, above.

We respectfully submit that nothing in the “at least as low as” requirement (as set forth in either the Draft LOB Article or existing derivative benefits provisions) requires this interpretation, and this result would be demonstrably at odds with the purpose of the derivative benefits provision. Moreover, applying the “at least as low as” requirement to different rates within the dividend article (e.g., so as to allow the 15% rate in Example 3) is strongly implied by the guidance that has previously been issued under certain of the existing derivative benefits provisions. Consider the following example from the Technical Explanation to the U.S.-U.K. Tax Treaty:

A U.K. resident company, Y, owns all of the shares in a U.S. resident company, Z. Y is wholly owned by X, a German resident company that would not qualify for all of the benefits of the U.S.-Germany income tax treaty but may qualify for benefits with respect to certain items of income under the “active trade or business” test of the U.S.-Germany treaty. X, in turn, is wholly owned by W, a French resident company that is substantially and regularly traded on the Paris Stock Exchange. Z pays a dividend to Y. Y qualifies for benefits under paragraph 3 of Article 23, assuming that the requirements of subparagraph 3(b) of Article 23 are met. Y is directly owned by X, which is not an equivalent beneficiary within the meaning of subparagraph 7(d)(i) of Article 23 (X does not qualify for all of the benefits of the U.S.-Germany tax treaty). However, Y is also indirectly

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owned by W and W may be an equivalent beneficiary. Y would not be entitled to the zero rate of withholding tax on dividends available under the Convention because W is not an equivalent beneficiary with respect to the zero rate of withholding tax since W is not eligible for such rate under the U.S.-France income tax treaty. W qualifies as an equivalent beneficiary with respect to the 5 percent maximum rate of withholding tax because (a) it is a French resident company whose shares are substantially and regularly traded on a recognized stock exchange, within the meaning of the Limitation on Benefits Article of the U.S.-France income tax treaty and (b) the dividend withholding rate in the treaty between the United States and France is 5 percent. Accordingly, U.S. withholding tax on the dividend from Z to Y will be imposed at a rate of 5 percent in accordance with subparagraph 2(a) of Article 10.\(^2\)

The example concludes that W, the French company, qualifies as an equivalent beneficiary with respect to the 5% rate of withholding tax, and Y therefore qualifies for the 5% withholding rate on dividends from Z, even though W is not an equivalent beneficiary as to zero withholding on dividends (“ZWD”).

The example does not expressly state, one way or the other, whether Y would qualify for ZWD if it did not need W to be an equivalent beneficiary as to ZWD, e.g., if Y met the LOB requirement under the ownership and base erosion test. However, we note that Y would meet the requirements for ZWD under Article 10(3) of the U.S.-U.K. Tax Treaty if it had owned, directly or indirectly, its 100% interest in Z (or at least stock possessing 80% of the total voting power) since October 1, 1998, which seems entirely plausible.\(^2\) Accordingly, the example cannot reasonably be limited to those scenarios where Y fails to qualify for ZWD under Article 10(3). Consequently, the strong implication is that, where a Claimant fails to qualify for a lower withholding rate under Article 10, solely due to the lack of a suitable equivalent beneficiary with respect to such lower rate, it may nevertheless qualify for a higher withholding rate under some other portion of Article 10, if there is an equivalent beneficiary (owning stock meeting the 95% threshold) as to such higher rate.\(^2\) As a technical matter, it appears that, for purposes of

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\(^{2}\) Emphasis added.


\(^{2}\) There is also another example in the Technical Explanation to the U.S.-U.K. Tax Treaty that supports this implication:

USCo is a wholly owned subsidiary of UKCo, a company resident in the United Kingdom. UKCo is wholly owned by FCo, a corporation resident in France. Assuming UKCo satisfies the requirements of paragraph 3(a) of Article 10 (Dividends), UKCo would be eligible for a zero rate of withholding tax. The dividend withholding rate in the treaty between the United States and France is 5 percent. Thus, if FCo received the dividend directly from USCo, FCo would have been subject to a 5 percent rate of withholding tax on the dividend. Because FCo would not be entitled to a rate of withholding tax that is at least as low as the rate that would apply under the Convention to such income (i.e., zero), FCo is not an equivalent beneficiary within the meaning of paragraph 7(d)(i) of Article 23 with respect to zero rate of withholding tax on dividends. [Emphasis added.]

As would be expected, the example makes it clear that UKCo cannot qualify for ZWD under the derivative benefits provision of the LOB article, because the would-be equivalent beneficiary, FCo, would have been subject to withholding at a 5% rate, which is not as low as 0%.

Interestingly, the example concludes that the French company “is not an equivalent beneficiary ...
applying the “at least as low as” requirement, the “rate applicable” under the Claimant’s income tax treaty is any rate that the Claimant may choose to claim under the dividend article of such treaty. The fact that the Claimant may meet the requirements for a lower withholding rate under such dividend article should not be relevant.

A similar example appears in the Memorandum of Understanding (the "Dutch MOU") agreed to by the United States and the Netherlands in connection with the 2004 protocol to the Dutch Treaty:

A Netherlands resident company, Y, owns all of the shares in a U.S. resident company, Z. Y is wholly owned by X, a U.K. resident company that would not qualify for all of the benefits of the U.S.-U.K. income tax treaty but may qualify for benefits with respect to certain items of income under the "active trade or business" test of the U.S.-U.K. treaty. X, in turn, is wholly owned by W, a French resident-company that is substantially and regularly traded on the Paris Stock Exchange. Z pays a dividend to Y. For purposes of this example, assume that Y does not qualify for benefits under paragraph 2 of Article 26 (Limitation on Benefits). Y does qualify for benefits under paragraph 3 of Article 26, however, assuming that the requirements of subparagraph 3 b) of Article 26 are met. Y is directly owned by X, which is not an equivalent beneficiary within the meaning of subparagraph 8 f) of Article 26 (X does not qualify for all of the benefits of the U.S.-U.K. tax treaty). However, Y is also indirectly owned by W, which is an equivalent beneficiary for purposes of the benefits provided by paragraph 2 a) of Article 10 within the meaning of subparagraph 8 f) of Article 26 (because W is a French resident company whose shares are substantially and regularly traded on a recognized stock exchange, within the meaning of the Limitation on Benefits Article of the U.S.-France income tax treaty). Accordingly, U.S. withholding tax on the dividend from Z to Y will be imposed at a rate of 5% in accordance with subparagraph 2 a) of Article 10.29

Much like the prior example from the Technical Explanation to the U.S.-U.K. Tax Treaty, this example from the Dutch MOU concludes that W is an equivalent beneficiary with respect to the 5% rate, and that treaty benefits at the 5% rate are therefore allowed.30 The example in the Dutch MOU does not state one way or the other whether Y satisfies the requirements for ZWD under Article 10(3) of the U.S.-Netherlands Tax Treaty, and once again it seems entirely plausible that such requirements were satisfied. In particular, we note Y would meet the requirements for ZWD under Article 10 if it had owned, directly or indirectly, its 100% interest in Z (or at least stock possessing 80% of the total voting power) since October 1, 1998,
which seems entirely plausible. Accordingly, we do not think this example may reasonably be limited to scenarios where Y does not meet the requirements for ZWD.

The examples above support the proposition that equivalent beneficiary status may be retested, and treaty benefits may be available, at any rate within the dividend article. Nevertheless, significant uncertainty remains as this proposition is not expressly stated in such examples. Moreover, a number of U.S. income tax treaties with comparable derivative benefits provisions do not include similarly favorable examples. Accordingly, we recommend that this point be clarified by confirming that the “rate applicable” under the income tax treaty from which derivative benefits are sought is any rate provided for under any paragraph, subparagraph or other provision of the dividend article of such treaty. This could be done by revising the “at least as low as” requirement to refer specifically to “the rate claimed under this Convention” or by including an appropriate example in the Technical Explanation. Of course, if our proposed “higher of” approach were adopted, the applicable rate issue would not arise, and the clarification requested in this Part II.B.2.c.ii would not be needed.

iii. **Application to individual owners**

Consider the following example:

**Example 4.** X, a Country F resident corporation, is wholly owned by Mr. Y, a Dutch individual resident who qualifies for all benefits under the U.S.-Netherlands Tax Treaty. X receives dividends from its wholly owned U.S. subsidiary, Z, and claims a reduced rate of withholding tax of 5% under Article 10(2)(a) of the Country F Treaty. X will qualify for such treaty benefits only if it satisfies the derivative benefits test. Assume that the dividend article of the Country F Treaty is identical to Article 10 of the 2006 Model Treaty.

Under a straightforward application of the “at least as low as” requirement, Mr. Y cannot be an equivalent beneficiary with respect to the desired 5% withholding rate on the dividend, because he would not have qualified for a 5% tax rate if he had received the dividend directly. Thus, it appears that X should not qualify for a reduced withholding tax rate of 5%. However, we do not believe that denying the 5% rate under these circumstances would advance the policy objectives behind the derivative benefits provision. Presumably, as a resident of the Netherlands, it would seem entirely reasonable for Mr. Y to hold Z through a Dutch corporation; and, if he had done so, the Dutch corporation would have qualified for a rate of U.S. withholding tax that is at least as low as the 5% rate sought by X. Consequently, while granting treaty benefits to X allows Mr. Y to achieve a better result than if he held the stock in Z directly, it does not allow him to achieve a better result than if he held the stock in Z through a Dutch corporation and thus does not seem to reflect an impermissible treaty shopping motive. Accordingly, we believe it would better advance Treasury’s treaty policy to treat Mr. Y as an equivalent beneficiary, by comparing the rate for which a Dutch corporation would have qualified under the U.S.-

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32 Similarly, if Mr. Y had been a resident of Country F, X would likewise have qualified for the 5% rate.
Netherlands Tax Treaty with the rate sought by X, under the Country F Treaty, in the example above.

We also note that this would be consistent with the result that applies under the derivative benefits provision of the U.S.-Luxembourg Tax Treaty.\(^{33}\) The Memorandum of Understanding accompanying the U.S.-Luxembourg Tax Treaty (the “Luxembourg MOU”), provides as follows:

For purposes of determining under subparagraph 4(c) if a comprehensive income tax Convention between one of the Contracting States and a third State provides with respect to dividends a rate of tax that is equal to or less than the rate of tax provided under the Convention, it is understood that the following two tax rates must be compared:

a) the rate of tax to which each of the persons described in subparagraph 4(a) would be entitled if they directly held their proportionate share of the shares that gave rise to the dividends; and

b) the rate of tax to which the same persons, if they would be residents of the Contracting State of which the recipient is a resident, would be entitled if they directly held their proportionate share of the shares that gave rise to the dividends.\(^{34}\)

The Technical Explanation restates the rate comparison rule set forth in the Luxembourg MOU and provides the following helpful example:

Assume that a U.S. company pays a dividend to LuxCo, a company resident in Luxembourg. LuxCo has two equal shareholders, a corporation resident in the United Kingdom and an individual resident in the United Kingdom. Both are residents of a member State of the European Union within the meaning of subparagraph 4(d)(i). Each person's proportionate share of the dividend payment is 50 percent of the dividend. If the U.K. corporation had received this portion of the dividend directly, it would be subject to a withholding tax of 5 percent under the income tax treaty between the United States and the United Kingdom. If the individual had received his portion of the dividend directly, it would be subject to a withholding tax of 15 percent under the U.S.-U.K. treaty. These rates are the same rates that would apply if they were residents of Luxembourg. Therefore, the test under subparagraph 4(c) is satisfied with respect to this dividend payment.

According to the example, the Luxembourg holding company qualifies for a 5% withholding rate because the withholding rate for individuals is the same under the income tax treaties with Luxembourg and the United Kingdom.


\(^{34}\) Memorandum of Understanding regarding the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital, April 3, 1996, U.S.-Lux Tax Treaties (CCH) ¶5735.
We do not agree with this approach of comparing individual rates, but we think Treasury adopted this approach under the U.S.-Luxembourg Tax Treaty because it recognized that comparing the individual rate with the corporate rate is also inappropriate. As indicated above, we think it most appropriate to compare the rate sought by the corporation seeking to claim derivative benefits with the rate that would have been available to a corporation resident in the same country as the country of residence of the individual shareholder. Accordingly, we would recommend that the Technical Explanation clarify that, in the case of an individual shareholder, the “at least as low as” requirement is applied by comparing the applicable corporate rates.

We note that, if this recommendation is not accepted, the same “applicable rate” question addressed in Example 3 above arises here as well. Thus, for example, if X in Example 4 were found not to be entitled to the 5% rate, on the ground that Mr. Y is not an equivalent beneficiary as to such rate, the question will remain as to whether X may claim a 15% rate. Consequently, if our recommendation to issue guidance comparing the applicable corporate rates in such circumstances is not accepted we would recommend that the Treasury Explanation include an example confirming that Mr. Y is an equivalent beneficiary as to the 15% rate and that X therefore qualifies for the 15% rate.

d. **Elimination of the “seven or fewer” limitation**

As indicated above, a corporation will meet the derivative benefits test only if 95% or more of its stock is owned by seven or fewer equivalent beneficiaries. The seven or fewer limitation seems unnecessary, other than to the extent it may provide a modicum of administrative simplicity. We do not think this small benefit to the Government justifies the denial of treaty benefits in circumstances where the requisite 95% interest is ultimately owned by eight or more equivalent beneficiaries. Accordingly, we would propose that the “seven or fewer” limitation be eliminated.

C. **Intermediate Owner Residence Requirements**

In connection with three of the LOB ownership tests set forth in the Draft LOB Article, there is a requirement as to the residence of each intermediate owner. First, the ownership prong of the test for public company subsidiaries set forth in Article 22(2)(d)(i) requires that, in addition to at least 50% direct or indirect ownership by five or fewer public companies qualifying for treaty benefits under Article 22(2)(c), “in the case of indirect ownership, each intermediate owner is a resident of either Contracting State[.]” Second, the ownership prong of the ownership and base erosion test set forth in Article 22(2)(f)(i) requires that, in addition to the requirement that at least 50% direct or indirect ownership by certain residents of the same Contracting State, “in the case of indirect ownership, each intermediate owner is a resident of that Contracting State[.]”

Third, under the derivative benefits test set forth in Article 22(4), each intermediate owner must be a “qualifying intermediate owner.” Pursuant to Article 22(6)(f), a qualifying intermediate owner is an intermediate owner that (1) is a resident of a state that is party to a comprehensive income tax treaty with the Contracting State from which treaty

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35 Note that, in this case, residence must be in the same Contracting State will suffice, in contrast with the requirement in Article 22(d)(i) of residence in either Contracting State.
benefits are claimed, provided that such comprehensive income tax treaty includes provisions addressing special tax regimes; (2) satisfies the “at least as low as” requirement, in the case of dividends, interest, and royalties, and (3) provides treaty benefits that are at least as favorable as those otherwise available to the taxpayer seeing treaty benefits, in the case of business profits, gains, and other income.

We recognize that these are not new requirements, and the first two appeared, for example, in the 2006 Model Treaty. Nevertheless, we would like to take this opportunity to comment.

It is not clear to us what the rationale is for these intermediate owner requirements. With respect to the public company subsidiary test and the ownership and base erosion tests, the Technical Explanation to the 2006 Model Treaty reiterates the applicable requirements, but does not explain Treasury’s concern. We believe that Treasury may be concerned about the possibility that profits of the treaty country resident may somehow be “parked” in a tax-haven jurisdiction in a manner that improperly avoids taxation in the Contracting State(s) where the qualifying owner(s) reside(s). In our view, however, this concern does not justify the intermediate owner requirement.

Preliminarily, we wish to emphasize that any such parking would only occur after the treaty country resident has been fully taxed by its Contracting State of residence. Accordingly, the only impact of the parking arrangement would be to potentially defer or avoid the imposition of a second (or further) level of tax on such profits – and any further income that such profits may generate -- by the Contracting State or other treaty country where the ultimate owner(s) reside. We do not believe that attempting to defer or avoid multiple levels of taxation through such parking arrangements is an abuse that merits the denial of treaty benefits. We also note that such parking concerns have no apparent connection with treaty shopping, which we had understood to be the focus of the LOB article.

Further, it seems that, of the various ways to migrate funds from the treaty country resident and into a tax-haven affiliate, intermediate ownership is relevant only where such migration is accomplished via dividends. Interest, royalties, and service fees, for example, may easily be paid to a sibling or any other affiliated entity outside the ownership chain between the treaty resident and the ultimate owner(s). Moreover, parking can also be accomplished through contributions to a tax-haven subsidiary of the treaty country resident earning the income.

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36 2006 Model Treaty, Art. 22(2)(c)(ii) and (e)(i). Moreover, an intermediate owner requirement appears in the derivative benefits provision of the U.S.-Spain Pending Protocol which has not yet been ratified. Protocol Amending the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Jan. 14, 2014, U.S.-Spain, Tax Treaties (CCH) ¶ 8403A (hereinafter, the “U.S.-Spain Tax Pending Protocol”).


38 And, of course, the applicable base erosion requirements (which are arguably stricter under the Draft LOB Article than previously) would prevent excessive erosion of the tax base in such Contracting State.

39 Such payments are, of course, subject to base erosion limitations.
Alternatively, the treaty country resident can pay dividends up the chain to one more intermediate treaty country owners and one of those treaty country owners can contribute funds to a tax-haven subsidiary.

Accordingly, even if parking is deemed to be abusive, we do not think a rule that prevents taxpayers from paying dividends up the ownership chain and parking them in a tax-haven intermediate owner, while still allowing every other form of parking, including parking in a tax-haven subsidiary of the taxpayer or one of its intermediate treaty owners, is effective at accomplishing its objective.

Consider the following example:

Example 5. FP is a publicly traded corporation that is resident in Country F, which has a comprehensive income tax treaty with the United States and a LOB Article identical to the Draft LOB Article. FP qualifies for treaty benefits under the public company test. FP has a wholly owned subsidiary, FS, that is also a resident of Country F and that satisfies the public company subsidiary test. FP believes it would be beneficial to park the after-tax profits of FS in a BVI corporation, BVICo.

In light of the intermediate owner requirement of Article 22(2)(d)(i), FP cannot interpose BVICo between itself and FS so as to enable parking through the payment of dividends by FS to BVICo. However, BVICo could easily be organized as a subsidiary of FS, and FS could easily contribute funds to BVICo. Alternatively, a treaty country holding company could potentially be interposed between FP and FS, and BVICo could be a subsidiary of such treaty country holding company.

In summary, we do not believe parking to be abusive, and, in any event, we think the intermediate ownership requirements do very little to prevent it. Accordingly, we propose that the intermediate ownership requirements be eliminated. We understand that Treasury may be particularly concerned about parking in the context of treaty country residents that benefit from favorable patent box regimes and would therefore pay relatively low taxes in the Contracting State of residence (without running afoul of the new rules for special tax regimes). However, we think that, if this is a concern, the focus should be on when the new rules for special tax regimes should or should not apply, rather than on intermediate ownership.

If our proposal to eliminate the intermediate ownership requirements is not accepted, we would suggest that such requirements apply solely in circumstances where the parking concern is exacerbated by the presence of low-taxed income arising from the application of a favorable patent box or other similar regime. Furthermore, we would suggest that Treasury consider exceptions in situations where the other Contracting State (or, in the case of the derivative benefits provision, the treaty country in which the applicable indirect owner resides) has controlled foreign corporation rules that are adequate to prevent deferral though the types of parking arrangements that Treasury considers abusive. In addition, we would suggest that Treasury issue guidance as to what constitutes an intermediate owner. We assume that the term is intended to include corporations and not partnerships, but confirmation would be helpful. Finally, if that is correct, we would suggest that Treasury provide clarification as to which country’s or countries’ tax laws should be applied for purposes of making this determination.
Consider the following example:

Example 6. FCo is a corporation that is resident in Country F, which has a comprehensive income tax treaty with the United States. FCo is wholly owned by a BVI corporation (BVICo) that is not a resident of any treaty country. BVICo is wholly owned by Ms. X, an individual resident of Country F. BVICo is not fiscally transparent under the tax laws of Country F, but elects to be treated as a disregarded entity for U.S. federal tax purposes. FCo receives U.S.-source dividend income and U.S.-source interest income that does not qualify for the portfolio interest exemption.

It is well established that undefined terms are ascribed the meaning that applies under the laws of the Contracting State from which treaty benefits are claimed, unless the context requires otherwise or the competent authorities agree to another meaning. Accordingly, unless it is determined that the context requires otherwise (or the competent authorities reach an agreement to the contrary), BVICo in Example 6 above should not be considered an intermediate owner because it is disregarded as separate from its owner under U.S. federal tax law. Given the lack of clarity as to the policy driving the intermediate ownership requirements, it will be difficult for tax advisors (and the Service) to determine whether any departure from the general rule, requiring application of U.S. tax principles, is warranted in circumstances such as Example 6 above.

Finally, if the intermediate ownership requirements are retained in any form, we would suggest that Treasury include within the Technical Explanation an explanation of what abuse they are intended to address.

III. Comments on the Low-Taxed PE Provision

Pursuant to Article 1(7)(a) of the Draft Model Treaty (the “Low-taxed PE Provision”), treaty benefits would be denied in cases where (1) an enterprise of a Contracting State derives income from the other Contracting State, (2) the first-mentioned Contracting State treats the income as attributable to a permanent establishment (“PE”) outside such Contracting State, and (3) the profits of such PE are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and the state in which the PE is located (the “PE State”) that is less than 60% of the general rate of company tax applicable in the first-mentioned Contracting State (the “60% threshold”). In contrast with certain existing “triangular PE” provisions, the Low-taxed PE Provision would apply even if the PE is located in the other Contracting State and does not contain an active trade or business exception.

In light of Treasury’s objective of limiting the use of U.S. income tax treaties to promote double non-taxation, we support the new Low-taxed PE Provision. However, we do not believe this objective is advanced in circumstances where equivalent treaty benefits would have been allowed if the PE had been separately incorporated. In such circumstances, the Low-taxed PE Provision would appear to discriminate unnecessarily between a PE and a separately incorporated subsidiary.

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40 See, e.g., 2006 Model Treaty, Art. 3(2).
Accordingly, we propose that an exception apply with respect to an item of income where (1) such item of income is taxed in the PE State under rules that are no more favorable than those that would have applied if the PE had been a separately incorporated resident of the PE State, (2) a comprehensive income tax treaty is in force between the PE State and the other Contracting State, and (3) such separately incorporated resident of the PE State would have been entitled to benefits under such treaty with the Other Contracting State (e.g., by reason of meeting any test of the LOB article of such treaty) with respect to such item of income that are no less favorable than those sought under the treaty between the Contracting States.

IV. Special Tax Regime Provisions

A. Overview

The Draft Model Treaty includes new provisions in Articles 11 (Interest), 12 (Royalties), and 21 (Other Income) that would deny treaty benefits if the taxpayer is subject to a “special tax regime” with respect to interest, royalties, or other income, as the case may be. A detailed and complex definition of what constitutes a special tax regime is set forth in proposed Article 3(1)(l).

Subject to certain exceptions, proposed Article 3(1)(l) generally defines a special tax regime, with respect to an item of income or profit, as “any legislation, regulation or administrative practice that provides a preferential effective rate of taxation with respect to such income or profit, including through reductions in the tax rate or tax base.” However, a number of exceptions are provided, including for any legislation, regulation or administrative practice that: (i) does not disproportionately benefit interest, royalties, or other income; (ii) with regard to royalties, satisfies a substantial activity requirement; (iii) implements the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises); (iv) applies principally to persons that exclusively promote religious, charitable, scientific, artistic, cultural or educational activities; (v) applies principally to persons substantially all of the activities of which are to provide or administer pension or retirement benefits; (vi) facilitates investments in certain entities that are marketed primarily to retail investors and satisfy certain additional requirements; or (vii) the two Contracting States agree to exclude, on the basis that such regime “does not result in a low effective rate of taxation.”

Paragraph 2 of the proposed model protocol that would accompany the Draft Model Treaty (the “Draft Model Protocol”) would provide further guidance by listing certain tax rules that the Contracting States have agreed are special tax regimes, and Paragraph 3 of the Draft Model Protocol would similarly set forth certain tax rules that the Contracting States have agreed are not special tax regimes.

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41 Proposed Art. 3(1)(l) further provides that, as to interest, a special tax regime includes notional deductions that are allowed with respect to equity.
B. Comments

The list of special tax regimes in Paragraph 2 of the Draft Model Protocol does not appear to be exclusive. Accordingly, taxpayers will need to evaluate the local tax rules in the treaty countries in which they reside to determine whether a special tax regime is present. Given the breadth of the definition and the unclear scope of the exceptions, we are concerned that this will inject a substantial level of uncertainty, which will undercut the effectiveness of our income tax treaties in facilitating cross-border investments between the United States and our treaty partners. Accordingly, we have considered what reasonably can be done to provide taxpayers with greater certainty without imposing undue and unrealistic burdens on the Government. In particular, we have considered whether or to what extent the list of special tax regimes, as set forth in Paragraph 2 of the Draft Model Protocol, should be exclusive.

To the extent that any legislation, regulation or administrative practice is in existence on the date a U.S. income tax treaty is signed, we think Treasury should bear the burden of determining special tax regime status and informing taxpayers. That approach seems reasonable since we presume Treasury will have the opportunity to consult with the tax authorities of the applicable treaty partner as needed in connection with the negotiations that precede the conclusion of the applicable protocol. Accordingly, we would propose that the list of special tax regimes set forth in Paragraph 2 of the Draft Model Protocol be exclusive as of such date, subject to the ability of Treasury or the IRS to advise taxpayers, solely on a prospective basis following the date of the announcement, of any additional tax rules that it considers a special tax regime.

In the case of regimes adopted following the signing of a given protocol, however, adopting the same approach would seem to unreasonably burden Treasury with the obligation to monitor the continually evolving tax regimes of every country within the U.S. treaty network. As between taxpayers and the tax authorities, we think the taxpayer that resides (or forms an entity) in a given treaty country, and that wishes to take advantage of some new and favorable tax regime while claiming U.S. treaty benefits, should properly bear the burden of ascertaining whether that tax regime falls within the definition in Article 3(1)(l), provided that the definitional standards are sufficiently clear. Accordingly, we suggest that Treasury and the IRS should be free to assert that any legislation, regulation or administrative practice enacted or adopted subsequent to the signing of the applicable protocol constitutes a special tax regime, even if no prior announcement has been made.

Nevertheless, since some taxpayers will be relatively unsophisticated and relatively uninformed as to international tax matters, we propose that Treasury provide periodic updates to taxpayers of new foreign tax rules that may potentially constitute special tax regimes as it becomes aware of them, along with the conclusion, if any, that Treasury has reached. The issuance of such an update would not be a prerequisite for Treasury or the IRS to assert that a post-protocol development constitutes a special tax regime, but would simply be an aid to some taxpayers who might otherwise miss the issue. In our view, this approach fairly balances taxpayers’ legitimate desire for certainty in determining treaty access with the need to avoid imposing disproportionate burdens on the Government.
V. Expatriated Entity Provisions

The Draft Model Treaty includes new provisions in Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 21 (Other Income) that would deny treaty benefits for dividends, interest, royalties, and other income, as the case may be, received from an expatriated entity (as defined in Internal Revenue Code section 7874(a)(2)(A)) at any time during a specified ten-year period. Nothing in these provisions, or in the accompanying draft Technical Explanation, expressly requires any relationship between the recipient of the payment and the expatriated entity.

In the case of interest, royalties, and other income, it is unclear what treaty policy would be served by denying treaty benefits to an unrelated and otherwise qualifying treaty country resident merely because the counterparty to a loan, license, or other business transaction, is “tainted” as an expatriated entity.\(^{42}\) The treaty disallowance may well impose additional costs on expatriated entities by forcing them to “gross up” the counterparties to their business transactions for the loss of treaty benefits, but we are uncertain as to the propriety of such an objective from a treaty policy perspective, and we do not believe this result was intended.

Accordingly, we propose that the new provisions for payments from expatriated entities be clarified to confirm that, in the case of interest, royalties, and other income, they apply only in the case of a person related to the expatriated entity.\(^{43}\) However, in order to deter abuse, we also recommend that the Technical Explanation state that the conduit rules of Treasury Regulation section 1.881-3 will apply, in conjunction with the new expatriated entity rules, to disallow treaty benefits in the case of back-to-back loans and similar conduit financing arrangements.

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\(^{42}\) We recognize that, in the case of dividend payments, a corporation-shareholder relationship is necessarily present. Accordingly, our proposal does not apply to dividends.

\(^{43}\) We understand Treasury may already be considering such a clarification.