Discretionary Treaty Benefits

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Panelists

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Agenda

• Background: The purpose of a discretionary benefits rule under objective Limitation on Benefits (“LoB”) tests
• Procedures for requesting discretionary benefits
• Interpreting discretionary benefits rules
  • Threshold issues presented by a test that preserves treaty access only if treaty access was not a “principal purpose”
  • Relevant factors in evaluating purpose
  • Potential analytical approaches
Background

Objective LoB Tests and the Purpose of a Discretionary Benefits Rule
Policy Behind LoB Tests

• Preamble to 2016 Model
  • “A fundamental pillar of U.S. tax treaty policy for over two decades has been to include objective LOB rules to prevent a practice known as ‘treaty shopping,’ in which an investor from a third country routes investment into the United States through a company resident in a treaty partner that does not have sufficient nexus to that country with respect to the treaty-benefitted income.” (emphasis added)

• TE to 2006 Model
  • “In general, the [LoB] provision does not rely on a determination of purpose or intention but instead sets forth a series of objective tests. A resident of a Contracting State that satisfies one of the tests will receive benefits regardless of its motivations in choosing its particular business structure.” (emphasis added)
LoB Provisions: General Operation

• Article 22 of the 2016 U.S. Model Treaty provides five objective tests that may apply to corporations:

1. **Ownership Test** – A company that is at least 50 percent owned by treaty-qualified residents (subject to a base erosion test).

2. **Publicly Traded Test** – A company that is publicly traded on a recognized exchange if either (i) the exchange on which the principal class of shares is primarily traded is in the Contracting State of residence, or (ii) the company’s primary place of management and control is in the Contracting State of residence.
   • Related test for public company subsidiaries

3. **Derivative Benefits Test** – At least 95% of the vote and value is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries (subject to a base erosion test).
   • For indirect ownership 2016 Model includes “qualified intermediate owner” tests
LoB Provisions: General Operation (Cont’d)

4. **Active Trade or Business Test** – A resident of one Contracting State is engaged in an active trade or business (“ATB”) in that Contracting State and derives income that “emanates from, or is incidental to” that ATB. An ATB does not include:
   - Operating as a holding company
   - Providing supervision or administration of a group of companies
   - Providing group financing (including cash pooling), or
   - Making or managing investments (subject to certain exceptions)

5. **Headquarters Company** – A company for a multinational corporate group consisting of the company and its direct and indirect subsidiaries with respect to dividends and interest paid by members of that group. The group must carry on an active trade or business in at least four countries and derive less than 50% of its income in any one country other than the Contracting State, among other requirements.
Why Discretionary Benefits?

- TreatyCo is a resident of Country Y, and wholly owns US Sub, which is a U.S. resident.
- ParentCo is a resident of Country X.
  - May or may not be a treaty country
- Assume TreatyCo is not a “qualified person” under any of the “objective” tests of the LoB Article.
- But TreatyCo may not in fact be treaty shopping, despite its failure to meet the treaty’s objective LoB tests.
  - For example, assume ParentCo has equivalent treaty benefits, and TreatyCo bears full Country Y tax
  - Discretionary benefits rules provide flexibility to address deserving cases otherwise excluded by objective tests
Discretionary Benefits: Treaty Language

• 2016 Model: “If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 of this Article, nor entitled to benefits under paragraph 3, 4 or 5 of this Article, the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income, taking into account the object and purpose of this Convention, but only if such resident demonstrates to the satisfaction of such competent authority a substantial nontax nexus to its Contracting State of residence and that neither its establishment, acquisition or maintenance, nor the conduct of its operations had as one of its principal purposes the obtaining of benefits under this Convention.”

• 2006 Model: If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 nor entitled to benefits with respect to an item of income under paragraph 3 of this Article the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income, if it determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention.”

• TE to 2006 Model
  • “In making determinations under [discretionary benefits provision],…competent authority will take into account as its guideline whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person’s operations, has or had as one of its principal purposes the obtaining of benefits under the Convention.”
  • “The competent authority’s discretion is quite broad.”

• TE to 1996 Model
  • “This discretionary provision is included in recognition of the fact that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country residents in an enterprise of a Contracting State is warranted by sound business practice or long-standing business structures and does not necessarily indicate a motive of attempting to derive unintended Convention benefits.”
Procedures for Requesting Discretionary Benefits
Prior Rules - Revenue Procedure 2006-54

• In addition to general procedures for competent authority requests, applicants were required to provide the information specified in IRM Ex. 4.60.3-3, including:
  • Applicant organization/structure and financial information;
  • Identification of benefits requested;
  • Statement regarding why objective LoB tests are not satisfied;
  • Description of business activities in treaty country;
  • Statement as to whether ownership chain includes a “conduit company” or companies failing treaty base erosion test;
  • Local tax information; and
  • A statement discussing each factor that is relevant to a decision to grant treaty benefits, either under the treaty, an accompanying memorandum of understanding, or other relevant positions.

• Unless addressed by a treaty/TE, there was no clear written statement of the standard applied by the U.S. competent authority (“USCA”).
Current rules - Revenue Procedure 2015-40

• Provides greater insight into the factors considered by USCA in deciding whether to grant relief
  • Note similarity to 2016 US Model
• Modifies procedures for obtaining discretionary relief
Revenue Procedure 2015-40: USCA Position on Review

• “The U.S. competent authority *in its sole discretion* may grant benefits under the discretionary provision of an LOB article in an applicable U.S. tax treaty. A decision by the U.S. competent authority not to grant discretionary benefits is *final and not subject to administrative review*. An applicant that does not qualify for the requested benefits under the relevant LOB provisions of the applicable U.S. tax treaty may not claim those treaty benefits, either at source or through a refund claim, unless it has received a favorable determination from the U.S. competent authority exercising its discretion to grant benefits.” (emphasis added)

• IRS argued in Starr International that its exercise of discretion was not subject to judicial review either
Revenue Procedure 2015-40: Substantive Requirements (§ 3.06(2))

• “All facts and circumstances” may be considered in evaluating whether relief should be granted.

• Applicant must demonstrate to the satisfaction of the USCA that:
  • It does not qualify for the requested benefits under the relevant LOB provisions of the applicable U.S. tax treaty;
  • The applicant has a substantial nontax nexus to the treaty country; and
  • If benefits are granted, neither the applicant nor its direct or indirect owners will use the treaty in a manner inconsistent with its purposes.
Revenue Procedure 2015-40: Substantive Requirements (§ 3.06(2))

• Listed examples of situations in which the USCA typically will not exercise its discretion to grant benefits:
  • The applicant or any of its affiliates is subject to a special tax regime in its country of residence with respect to the class of income for which benefits are sought (e.g., notional interest deduction);
  • No or minimal tax would be imposed on income in both the source and residence countries;
  • The applicant bases its request solely on the fact that it is a direct or indirect subsidiary of a publicly traded company resident in a third country and the relevant withholding rate provided in the tax treaty between the United States and the country of residence of the applicant is not lower than the corresponding withholding rate in the tax treaty between the United States and the country of residence of the parent company or any intermediate owner.
Revenue Procedure 2015-40: Process

• Specific information required for request is listed in an appendix, including:
  • Applicant organization/structure and financial information;
  • Identification of type of benefits requested;
  • Statement regarding why objective LOB tests are not satisfied;
  • Applicant organizational information;
  • Consistent with the factors relevant to the competent authority’s determination:
    • Explanation of the non-tax business reasons why the applicant was formed or maintained in
      the treaty country;
    • Detailed description of the facts that demonstrate a sufficient relationship or nexus to the treaty
      country;
    • Analysis of any relevant factor for determining whether to grant a discretionary request, such
      as in treaty or TE;
    • Statement of the applicant’s effective global tax rate;
    • Statement of the extent to which deductible payments are made outside the ordinary course of
      business;
    • Detailed description of tax treatment in other contracting state if discretion is granted.
Revenue Procedure 2015-40: Process

• A discretionary grant of benefits is initially effective for three years unless a material change occurs.

• New “triennial statements” to keep favorable determination in force.
Interpreting “Principal Purpose” Discretionary Benefits Rules

Threshold Issues
Threshold Issues

• Interpretive issues regarding the taxpayer’s “principal” purpose
• Logical issues regarding evaluation of the taxpayer’s principal purposes when taxes and treaties are always relevant to a cross-border entity’s choices of entity and jurisdiction
• Relevance of derivative benefits
“Principal Purpose” Domestic Interpretations

• The phrase “principal purpose” appears throughout U.S. tax law
  • **Dittler Bros. Inc. v. Commissioner**, 72 T.C. 896 (1979), aff’d 642 F.2d 1211 (5th Cir. 1981)
    • “[T]he term ‘principal purpose’ should be construed in accordance with its ordinary meaning . . . .
      Webster’s New Collegiate Dictionary defines ‘principal’ as ‘first in rank, authority, importance, or
degree.’ Thus, the proper inquiry hereunder is whether the exchange of manufacturing know-how was in
pursuance of a plan having as one of its ‘first-in-importance’ purposes the avoidance of Federal income
taxes.” (emphasis added)
  • **Bobsee Corp. v. United States**, 411 F.2d 231 (1969)
    • “As we view the operation of the statute, there are only two relevant classes of purposes: tax-avoidance
      and non-tax-avoidance; the statute applies only if the former class exceeds the latter.”
  • **Santa Fe Pac. Corp. v. Cent. States, Se. & Sw. Areas Pension Fund**, 22 F.3d 725 (7th Cir. 1994)
    • “It needn’t be the only purpose; it need only have been one of the factors that weighed heavily in the
      seller’s thinking. We can find no decisions discussing situations in which there is more than one principal
      (major, weighty, salient, important) purpose, but we would be doing violence to the language and the
      purpose of the statute if we read ‘a principal’ as ‘the principal.’” (emphasis added)
It Is a Truth Universally Acknowledged that Death and Taxes Are Best Deferred or Avoided

• Of course, the taxpayer is only requesting discretionary benefits from the Competent Authority because the treaty provides material tax benefits.

• But that cannot be *per se* evidence that the taxpayer’s principal purpose was obtaining those treaty benefits, since that view would render the rule a nullity.

• Thus, the taxpayer’s awareness of (and desire for) tax benefits must be accepted and then somehow weighed against the taxpayer’s other motivations in evaluating “principal purpose.”

• On the other hand, tax considerations will never be the singularly most important factor to a taxpayer, even if the most important factors are taken as a “given” in the taxpayer’s thinking.
  • No rational company would organize in a jurisdiction mired in civil war, regardless of tax.
  • But this cannot mean that “not at war” is always the principal purpose, and tax is always secondary.
  • Competent Authority must somehow weigh the tax purpose against other *relevant* business considerations.
Relevance of Derivative Benefits?

• If Country X is a treaty country with a 15% rate on dividends, using TreatyCo does not improve ParentCo’s treaty position.
  • So by definition ParentCo is not treaty shopping.
  • But using TreatyCo may have local tax benefits.
• Many treaties would take such “derivative benefits” into account in preserving benefits for TreatyCo, but often limited to EU/NAFTA members.
• 2016 Model eliminates EU/NAFTA-type requirement.
• How relevant to the application of discretionary benefits rules?
Interpreting “Principal Purpose”
Discretionary Benefits Rules

Relevant Factors
Potential Factors in Analysis for Article 22(6)

1) Taxpayer’s Purpose
   • Does taxpayer have substantial, non-tax purposes or purpose for how it is organized and operates?
   • Are those purposes or purpose substantial in relation to tax objectives?
   • TE to 1996 Model: “While an analysis under [the discretionary benefits provision] may well differ from that under [the objective tests], its objective is the same: to identify investors whose residence in the other State can be justified by factors other than a purpose to derive treaty benefits.” (emphasis added)

2) “Substantial Nontax Nexus”
   • How significant is the taxpayer’s relationship to the relevant Contracting State?
   • Extent of nexus informs “purpose” analysis.
Nontax Nexus

• The objective LoB tests generally involve different measures of nontax nexus:
  • **Ownership**: Nexus though beneficial owners.
  • **Publicly Traded**: Full regulatory and legal oversight in Contracting State.
  • **ATB**: Direct measure of business activity.
  • **Headquarters**: Bona fide management in the contracting state.

• Presence is so significant that non-tax purposes are necessarily subsidiary.
Interpreting “Principal Purpose” Discretionary Benefits Rules

Potential Analytical Approaches
Analytical Approaches

• Potential analytical approaches to “Principal Purpose” tests
  • A foot-fault rule?
    • Allow discretionary benefits where resident is a “near miss,” in terms of satisfying objective tests.
  • A substance test?
    • Allow discretionary benefits where resident would not be subject to anti-conduit regulations, economic substance doctrine, and/or other domestic tax law that focuses on the “substance” of a legal structure.
  • A purely subjective facts and circumstances test?
    • Allow discretionary benefits where facts and circumstances support that treatment. (But what factors are relevant?)
Foot-Fault Approach

• The U.S.-Spain protocol (2013) states that the competent authority may grant benefits “if such grant of benefits is justified based on an evaluation of the extent to which such resident satisfies the requirements of paragraphs 2, 3, 4 or 5 of this Article and after considering the opinion, if any, of the competent authority of the first-mentioned Contracting State as to whether under the circumstances it would be appropriate to grant such benefits.” (Emphasis supplied.)

• This approach has been considered a “foot fault” or “near miss” standard.

• The concept is that treaty benefits should not be denied when:
  • (i) The taxpayer comes close to meeting the formal requirements of the LoB provision; and
  • (ii) There is no discernable policy offended.
Foot Fault Example

- TreatyCo is receiving a dividend from US Sub; that dividend would be eligible for a reduced rate of withholding (15%) if TreatyCo received discretionary benefits.
- ParentCo is eligible for U.S.-Country X tax treaty.
- Individual Z is Country Z resident; there is no U.S.-Country Z tax treaty.

**Foot Fault**: A clear “near miss” for Derivative Benefits Test? Do other circumstances matter (e.g., Individual Z unexpectedly received the interest in TreatyCo as a bequest from an individual Country X resident)
Substance Test

• The Competent Authority will look to established legal standards related to the “substance” of a legal structure to determine whether to grant discretionary benefits.

• Test administered based on the economic substance doctrine and/or anti-conduit rules, etc.
  • Economic substance doctrine, as codified in section 7701(o)
    • Transaction changes taxpayer’s position in a material, non-tax way
    • Taxpayer has a substantial non-tax purpose for entering into the transaction
  • Anti-Conduit regulations
    • Looks to back-to-back financing arrangements
Substance Test (Cont’d)

TE to 2006 Model

• “[The LoB provision] and the anti-abuse provisions of domestic law complement each other, as [the LoB provision] effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (e.g., business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source Contracting State may be applied to identify the beneficial owner of an item of income, and [the LoB Provision] then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.”
TreatyCo is receiving interest on a loan to US Sub.
That interest would be eligible for a reduced rate of withholding if TreatyCo received discretionary benefits.
ParentCo has also made a loan to TreatyCo.
There is no U.S.-Country X tax treaty.
TreatyCo has business activities in the U.S., but they are insufficient to bring TreatyCo within LoB provision.
Good reason for TreatyCo to be in Country Y (continental headquarters)
Significant spread between two loans, so not covered by anti-conduit regulations.

But is substance test duplicative of nexus analysis, and existing U.S. law and judicial doctrines?
Facts and Circumstances

• Finally, the principal purpose test could be applied on a facts and circumstances basis: the Competent Authority will know it when they see it.

• This ambiguous standard allows for significant flexibility, but would also purport to grant standard-free discretion to an agency that courts periodically find to have abused its discretion.

• Consistent with Rev. Proc. 2015-40:
  • “The U.S. competent authority in its sole discretion may grant benefits under the discretionary provision of an LOB article in an applicable U.S. tax treaty. A decision by the U.S. competent authority not to grant discretionary benefits is final and not subject to administrative review.” (emphasis added)
Facts and Circumstances: Possible Factors

- **Jurisdiction**: U.S. has a good relationship with other Contracting State?
- **History**: Is entity new or existing?
- **Business Operations**: Substantiality and relationship to Contracting States.
- **Derivative Benefits**: Equivalent treaty benefits available to owners.
- Other factors used for “Qualified Resident Ruling” under Treas. Reg. section 1.884-5(f), including
  - “continuity of the historical business”
  - “The extent to which the [U.S. business] is dependent on capital, assets, or personnel of the [foreign business]”
  - “The extent to which the foreign corporation receives special tax benefits in its country of residence”
- *But analysis must ultimately be informed by policy against treaty shopping*
Example: No Change in Treaty Position

- TreatyCo is receiving a dividend from US Sub; that dividend would be eligible for a reduced rate of withholding (15%) if TreatyCo received discretionary benefits.
- The U.S.-Country X tax treaty provides the same reduced rate of withholding on dividends.
- **Foot Fault:** Depends on characteristics of ParentCo; how much of a “near miss” is qualification for Country Y/Country X treaties?
- **Substance:** Depends on economic substance of ParentCo and TreatyCo, along with intercompany financing arrangements.
- **Facts and Circumstances:** ?
Example: Improved Treaty Position

- In the absence of a U.S.-Country X tax treaty, TreatyCo’s access to a reduced rate of withholding (15%) if it received discretionary benefits would improve ParentCo’s treaty position.

- Foot Fault: How much of a “near miss” is qualification for Country Y treaty?

- Substance: Depends on economic substance of TreatyCo, along with intercompany financing arrangements.

- Facts and Circumstances: ?
Example: Business Restructuring that Changes Treaty Position (Before)

- ParentCo operates hotels in the U.S. through US Sub.
- There is no U.S.-Country X tax treaty.
- ParentCo is considering a new investment in a casino, but gambling is illegal in Country X. Gambling profits distributed to Country X may violate Country X AML laws.
- ParentCo decides to reincorporate as TreatyCo in Country Y.
- Country Y has favorable gambling laws, and the U.S.-Country Y tax treaty provides for 10% withholding on dividends.
Business Restructuring that Changes Treaty Position (After)

- Post-restructuring, should TreatyCo receive discretionary benefits?
- What if there is a third country with a more favorable gambling regime relative to Country Y, but that third country’s tax treaty only provides for a 15% rate on dividends?
- Is the answer affected if the regulatory difference between Country X and Country Y is less stark (e.g., gambling is legal in both countries, but regulation was more onerous in Country X?)
- Foot Fault: Restructuring is less relevant, relative to whether TreatyCo is otherwise a “near miss?”
- Substance: Regulatory considerations show substance?
- Facts and Circumstances: ?
Thank you.