KPMG report: Initial analysis of 2016 U.S. model treaty

The Treasury Department on February 17, 2016, released a newly revised "U.S. Model Income Tax Convention." The following discussion provides initial impressions and observations concerning the "2016 Model."

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Introduction

The U.S. model treaty, which was last updated in 2006, serves as a starting template for Treasury to use as it negotiates future tax treaties. The 2016 Model [PDF 251 KB] generally incorporates new provisions and substantial changes to existing provisions that were released in draft form on May 20, 2015, although the final version makes various modifications that take into consideration comments received on the "May 2015 draft." Treasury has not yet released a technical explanation to the 2016 Model.

Preamble to 2016 Model

According to the preamble [PDF 64 KB] to the 2016 Model, the updates to the U.S. model treaty reflect technical improvements developed in the context of bilateral tax treaty negotiations, with the new provisions intended to more clearly implement Treasury's longstanding policy of eliminating double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. The preamble highlights the following updates as examples of this policy:

- Rules to deny treaty benefits on deductible payments of highly mobile income to related persons that face low or no taxation of such income under a "preferential tax regime"
- New provisions designed to help the United States preserve the balance of benefits negotiated under the U.S. treaty network in the context of rapidly evolving tax laws of treaty partners
- Rules intended to deter inversion transactions by denying treaty benefits for inverted companies
- Technical improvements and policy changes to the Limitation on Benefits (LOB) provision;
- A revised version of the "triangular permanent establishment" rule that addresses income treated by a residence country as attributable to a permanent establishment (PE) and subject to little or no tax, as well as income excluded from the residence

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country's tax base and attributable to a PE located in a third country that does not have a tax treaty with the source country

- Provisions to encourage efficient and effective dispute resolution mechanisms between tax authorities through the use of mandatory binding arbitration.

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BEPS recommendations incorporated

The preamble emphasizes that U.S. tax treaty policy has for many years incorporated many of the key recommendations regarding bilateral tax treaties from the Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) initiative—such as LOB provisions and rules that determine when treaty benefits should be available for payments through fiscally transparent entities. The preamble notes, however, that the 2016 Model incorporates the following BEPS recommendations for the first time:

- A revised preamble for tax treaties that makes clear the intentions of the treaty partners that the purpose of a tax treaty is the elimination of double taxation with respect to taxes on income without creating opportunities for non-taxation through tax evasion or avoidance
- A rule to protect against contract-splitting abuses of the 12-month PE threshold for building sites or construction or installation projects
- A 12-month ownership requirement for the 5% withholding rate for direct dividends, with refinements that impose a 12-month residence requirement to prevent companies from circumventing the ownership period as well as to allow the payee company to take into account certain prior ownership

KPMG observation

Although the above changes are BEPS-related, the 2016 Model does not address several important issues considered by the OECD as part of the BEPS initiative. For example, the 2016 Model does not adopt the BEPS recommendations on the PE threshold (e.g., rules related to dependent / independent agents and the exemption for preparatory and auxiliary activities) due to concerns about the compliance burden on businesses and tax administrations and about consistent global understanding and administration of these provisions.

Denial of treaty benefits for income subject to "special tax regimes"

New rules target "special tax regimes" (STRs) designed to attract certain mobile forms of income. These rules preserve the source state's taxing rights when the recipient is subject to low or no taxation on the income in the residence state by denying treaty benefits for certain related-party deductible payments that benefit from an STR in the recipient's country of residence. Articles 11 (Interest), 12 (Royalties), and 21 (Other Income) are amended to provide that such income arising in one contracting state and paid to

a related-party resident in the other contracting state may be taxed in the source state in accordance with its domestic law if the recipient is subject to an STR with respect to that category of income in its country of residence at any time during the tax period in which the item of income is paid.

The 2016 Model STR provisions were significantly revised to reflect comments regarding the scope of the STR definition and comments requesting notification of particular STRs; revisions were designed to both limit and clarify application of these rules.

Narrower scope: The scope of the rule was narrowed so that STR provisions apply only when the resident benefits from an STR with respect to a particular related-party interest payment, royalty payment, or guarantee fee that is within the scope of Article 21.

Revised definition of "special tax regime": The May 2015 draft rules had defined "special tax regime" broadly to mean, with respect to an item of income or profits, any "…legislation, regulation, or administrative practice that provides a preferential effective rate of taxation to such income or profit, including through reductions in the tax rate or the tax base." The draft definition specifically excluded seven categories of tax regimes. However, the draft Technical Explanation released with the May 2015 draft did not specifically identify any foreign regimes that Treasury would consider to be an STR, and it was not completely clear which regimes the proposal was intended to target.

By contrast, the new "special tax regime" (STR) definition has been tightened up and now comprises an exclusive list of the circumstances in which a foreign tax regime will be treated as an STR. A regime is considered an STR if interest, royalties, or guarantee fees receive preferential treatment (i.e., a preferential rate, a permanent reduction in the tax base (as opposed to tax deferral)), or if there is a preferential rate or base reduction for companies that are not engaged in an active business in the residence state.

KPMG observation: The May 2015 draft Technical Explanation explicitly included ruling practices as a potential type of STR. The technical explanation associated with the 2016 Model will not be released until later in the spring. Although it is unclear to what degree the detail provided in the May 2015 draft Technical Explanation continues to apply in the context of the 2016 Model, presumably ruling practices will fall within the definition of an STR.

Exceptions to Definition of STR: The exceptions to STR treatment from the May 15 draft have been reformatted and clarified:

- **Royalties:** The May 2015 draft included an exception for preferential royalty regimes with a "substantial activity" requirement. The May 2015 draft Technical Explanation explained that the exception was intended to apply to regimes that are designed to incentivize, and actually require, substantial activities to be conducted in the residence state that are not of a mobile nature. The 2016 Model restates this exception in the affirmative, including in the definition of STR preferential regimes that "…do not condition such benefits on the extent of research and development activities that take place in the Contracting State." This exception presumably is focused on patent box regimes, but the exception is not limited on its face to patent royalties. It remains unclear what level of activity would be required to satisfy this exception, although the May 2015 draft Technical Explanation stated that Treasury anticipates that the substantial activity exception would be interpreted consistently with any standards

promulgated by the OECD Forum on Harmful Tax Practices.

- **Charities and pension funds:** The 2016 Model generally retained the exceptions for pension funds and for "… organizations that are established and maintained exclusively for religious, charitable, scientific, artistic, cultural or educational purposes." The definition of pension fund was elaborated upon to clarify that it includes entities that earn income for the benefit of pension funds, but that it applies only to tax-exempt entities.
- **Collective investment vehicles:** The provisions designed to exempt certain collective investment vehicles such as U.S. regulated investment companies and U.S. REITs were clarified in the 2016 Model so that they apply to: (1) "persons the taxation of which achieves a single level of taxation either in the hands of the person or the person's shareholders (with at most one year of deferral), that hold a diversified portfolio of securities, that are subject to investor-protection regulation in the Contracting State and the interests in which are marketed primarily to retail investors;" or (2) "persons the taxation of which achieves a single level of taxation wither in the hands of the person or the person's shareholders (with at most one year of deferral) and that hold predominantly real estate assets."

Minimum Rate of taxation: The 2016 Model provides additional guidance with respect to the exception for regimes that do not result in a low effective rate of taxation. The 2016 Model builds in some numeric benchmarks that previously had been included in the May 2015 draft Technical Explanation, stating that the definition of STR includes a regime that "is generally expected to result in a rate of taxation that is less than the lesser or 15 percent or 60 percent of the general statutory rate of company tax applicable in the other Contracting State."

"Connected person": To respond to comments requesting further guidance on when a payee is related to the payor (thereby potentially triggering STR provisions) the 2016 Model provides that a payee must be a "connected person." Two persons are connected persons where one person owns (directly or indirectly) at least 50% of the beneficial interest in the other or both persons are held by the same person (again, 50% or greater direct or indirect beneficial interest). Layered on to the 50% threshold is a facts and circumstances test for determining whether one person has control of the other or both are controlled by the same person or persons.

Removal of notional interest deductions: The May 2015 draft Technical Explanation stated that the provision of "notional interest deductions" (NIDs) with respect to equity always would be considered to disproportionately benefit interest (and, thus, would constitute an STR). The 2016 Model no longer treats regimes providing NIDs with respect to equity as STRs. Instead, Article 11 (Interest) is amended to include a new rule that allows a treaty partner to apply domestic rules to tax interest arising in that country when the interest is beneficially owned by a related person that benefits from a NID. According to the preamble, this shift to the more specific interest article reflects the understanding that such income often escapes taxation due to the time value of the deduction and—in the related-party context—the equity holder's potential participation exemption with respect to returns on that equity.

Notice: An STR provision may be invoked only after the country invoking the provision (1) consults with the country providing the STR; (2) notifies that country of its intention through a diplomatic note; and (3) issues a written public notification.

Denial of treaty benefits following change in law

The 2016 Model adds a new Article 28 (Subsequent Changes in Law) to address situations in which one of the treaty partners changes its general corporate tax system after entering into the treaty, so that it no longer imposes a significant tax on the cross border income of resident countries. Such a change would reduce the potential for double taxation and call into doubt the need for a treaty to mitigate the problem. Moreover, a reduction in the general rate could disrupt the original balance of negotiated benefits under the treaty.

KPMG observation: New Article 28 reflects an understanding that certain treaty partners that currently attract investment through the use of rulings or other STRs ultimately may adopt low rates across the board in response to BEPS.

Article 28 triggers a consultation between the two treaty partners to determine whether to amend the treaty when: (1) the general statutory rate of company tax of a treaty partner falls below the lesser of either 15% or 60% of the general statutory rate of company tax applicable in the other treaty partner; or (2) a treaty partner provides an exemption from taxation to resident companies for substantially all foreign source income (including interest and royalties).* If the consultation does not progress, the aggrieved treaty partner has the right to employ diplomatic channels to notify the treaty partner with the changed tax system that it will cease to apply the provisions of Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income); the cessation takes effect six months after diplomatic notice. The application of Article 28 would affect only the aforementioned articles; it would not terminate the treaty or affect any other provisions of the treaty (e.g., the PE and Business Profits Articles would continue to apply as intended).

*The May 2015 draft Technical Explanation to proposed Article 28 stated that the provision was targeted at regimes that exempt foreign source income from taxation solely by reason of its source being outside that contracting state. For example, this provision would apply to an exemption regime under which 95% of income from foreign sources is exempt from tax by reason of its foreign source, but 5% remains taxable as a proxy for the disallowance of allocable deductions. The provision would not apply, however, to taxation systems under which only foreign source dividends or business profits from foreign permanent establishments are exempt from tax by a contracting state. This limitation is consistent with the BEPS initiative's focus on base eroding payments like royalties and interest, as opposed to dividends, which represent an equity return on business operations that presumably were subject to tax in the source state.

For purposes of determining the general rate of company tax, the 2016 Model takes into account the allowance of generally available deductions based on a percentage of what otherwise would be taxable income, or other similar mechanisms to achieve a reduction in the overall rate of tax.*

*The May 2015 draft Technical Explanation to proposed Article 28 provided the following example: If the statutory company tax rate in a contracting state is 20% at the time the treaty is signed, and the contracting state subsequently allows resident companies to claim deductions equal to 50% of what otherwise would be their taxable income, the general rate of company tax would be 10%. A tax that applies to a company only upon a distribution by such company, or that applies to shareholders, would not be taken into account in determining the general rate of company tax.

The 2016 Model approach differs somewhat from the May 2015 draft provisions, which were triggered automatically with a drop below 15% in the general statutory rate, and did not involve a preliminary bilateral consultation. Treasury stated in the preamble that it did not intend for the use of a fixed rate to imply support for a floor on appropriate corporate tax rates, but rather only intended for the rate test to serve as a signal that the balance of negotiated benefits had shifted. In the context when both treaty partners make similar substantial reductions and the tax rate in both jurisdictions falls below 15%, the balance of benefits may remain intact.

The 2016 Model also narrows the scope of the May 2015 draft proposal to cover only changes in the tax rate that applies to companies; the May 2015 draft proposal had applied both to companies and individuals. The 2016 Model addresses concerns regarding changes to the taxation of individuals with discrete rules in other articles pertaining to the tax treaty benefits for individuals taxed on a remittance, fixed fee, “forfeit”, or similar basis.

Denial of treaty benefits for payments by expatriated entities

These provisions reflect a continuation of IRS and Treasury efforts to deter inversions by denying treaty benefits for base eroding payments made by expatriated entities following an inversion transaction. See for example Notice 2014-52, 2014-42 I.R.B. 712 (September 24, 2014). As was the case in the May 2015 draft, the 2016 Model amends Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 21 (Other Income) to provide that—notwithstanding other articles of the treaty—dividends, interest, royalties, and other income paid by a domestic corporation that is treated as an “expatriated entity” to a resident of a treaty partner may be taxed in accordance with the domestic law of the United States for a period of 10 years beginning on the date on which the acquisition of the “domestic entity” is completed. Thus, unless an exception applies under U.S. domestic law (e.g., the portfolio interest exception), the full 30% U.S. withholding tax is imposed on payments made by an expatriated entity during the 10-year period following an expatriation transaction.

The 2016 Model responds to comments on the May 2015 draft with several significant revisions:

- The rules apply only to a beneficial owner of the in-scope payments that is a “connected person” with respect to the expatriated entity
- Amendments to section 7874 that occur after the treaty is signed are not applicable (i.e., the definition of “expatriated entity” is fixed)
- Preexisting U.S. subsidiaries of the foreign acquirer are not considered expatriated entities for purposes of the treaty unless—subsequent to the acquisition date—they join in filing a U.S. consolidated return with either the domestic entity or another person that was a connected person with respect to the domestic entity immediately prior to the acquisition date

Revised LOB article

Like the May 2015 draft, the 2016 Model generally retains the framework of the LOB Article in the prior U.S. model treaty, but makes significant changes (both favorable and unfavorable to taxpayers). The 2016 Model also contains numerous revisions to the May 2015 draft proposal, to reflect comments received.

As described below, the 2016 Model includes a modified version of the derivative benefits test from the May 2015 draft; adds a new

"headquarters company" test; and makes changes to the ownership/base erosion test, the active trade or business test, and the subsidiary of a publicly traded corporation test. As is the case with other provisions that were originally advanced in a more consolidated fashion in the May 2015 draft, the LOB rules in the 2016 Model are now spread among several different articles in the treaty in addition to Article 22 (LOB): Article 19 (Dividends); Article 11 (Interest); and Article 12 (Royalties).

Derivative benefits test: The inclusion of a derivative benefits test in paragraph 2(f) of Article 22 of the 2016 Model generally is a "taxpayer favorable" change that increases the ability of foreign companies to qualify for treaty benefits. Although the prior U.S. model treaty did not contain a derivative benefits test, derivative benefits tests have been included in numerous U.S. tax treaties that were signed both before and after the prior U.S. Model.*

*See, e.g., Art. 28(3) of the 1989 U.S.-Germany Income Tax Treaty, as amended by the 2009 Protocol to the Treaty; Art. 23(3) of the 2001 U.S.-U.K Income Tax Treaty; Art. 23(3) of the 2013 U.S.-Poland Income Tax Treaty (signed but not yet approved by the Senate).

The derivative benefits test provides that a company that is a resident of a contracting state may qualify for treaty benefits, regardless whether the company is a qualified person, if at the time when the benefit would be accorded the company satisfies both an ownership test and a base erosion test.

The ownership prong of the derivative benefits test would require at least 95% of the aggregate voting power and value of the shares (and at least 50% of any disproportionate class of shares) of the company claiming treaty benefits to be owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner.

An equivalent beneficiary for this purpose generally means a resident of any state that has a comprehensive tax treaty with the United States under which the resident would be entitled to the same benefits as the benefits being claimed by the company under the first treaty. As was the case in the May 2015 draft, the rules in the 2016 Model eliminate the requirement in current U.S. tax treaties that an equivalent beneficiary be a resident of a member state of a particular economic zone such as the European Union (EU), European Economic Area (EEA), or a party to the North American Free Trade Agreement (NAFTA).

In addition, in response to comments received on the May 2015 draft, the 2016 Model allows certain categories of qualified persons in the state of source to be treated as equivalent beneficiaries, provided that such persons in the aggregate do not own more than 25% of the tested company.

The 2016 Model also removes the "cliff effect" in current tax treaties that results from the requirement that a third-country resident be entitled to a rate of tax less than or equal to the rate applicable under the tax treaty under which benefits are being claimed, by entitling a resident of the treaty partner to the highest rate of withholding to which its third-country resident owners would be entitled. In addition, the 2016 Model allows individual third-country resident shareholders to be treated as companies with respect to the rate comparison, so long as the company seeking to qualify under the derivative benefits test has sufficient substance in its residence country, thus allowing the company to qualify for the 5% rate of withholding on dividends even though the company's individual shareholders would not be entitled to the 5% rate.

Unlike the ownership prong of the derivative benefits provisions in current U.S. tax treaties, the 2016 Model would restrict intermediate ownership to qualifying intermediate owners. Thus, the ownership prong of the derivative benefits test in the 2016 Model is broader in some respects, but narrower in others, than in current tax treaties. However, in response to comments received, the 2016 Model expanded the definition of a qualified intermediate owner from the May 2015 draft to include any company that is a resident of a country that has in effect a comprehensive tax treaty that contains rules addressing STRs and NIDs that are analogous to the rules in the 2016 Model.

KPMG observation: The base erosion prong of the derivative benefits test in the 2016 Model is in all ways more restrictive than the base erosion prong of the derivative benefits tests in current U.S. tax treaties. The base erosion prong of the 2016 Model would require that less than 50% of the company's gross income, and less than 50% of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments (excluding arm's length payments in the ordinary course of business for services or tangible property) that are deductible for tax purposes in the residence state, either to persons that are not equivalent beneficiaries or to persons that are equivalent beneficiaries but are connected persons that benefit from an STR (or in the case of a payment of interest, that benefit from NIDs) in their state of residence with respect to the deductible payment.

The 2016 Model makes three material changes to tighten the base erosion prong of the derivative benefits test in current tax treaties.

- First, consistent with the STR rules, the 2016 Model treats a deductible payment to an equivalent beneficiary as a base eroding payment if the recipient is a connected person that benefits from an STR (or in the case of a payment of interest, that benefits from NIDs) with respect to the payment in the recipient's state of residence.
- Second, the 2016 Model applies the base erosion test to **both** the company claiming treaty benefits and the "tested group." The "tested group" means the resident of the contracting state that is claiming treaty benefits (the "tested resident") and any company that is a member with the tested resident of a tax consolidation regime or similar group regime that allows members of the group to share profits or losses.
- Lastly, the 2016 Model generally narrows the definition of gross income—and thus lowers the threshold for flunking the base erosion test—by excluding from gross income dividends that are "effectively exempt" from tax in the recipient's state of residence, whether through deductions or otherwise. [This restriction would not apply if the company is claiming benefits for dividends under Article 10.] The 2016 Model does not provide any guidance, however, for determining whether income is "effectively exempt" for this purpose. The 2016 Model also would exclude from a tested group's gross income any income received or accrued from any person within the same tested group.

KPMG observation: The 2016 Model's derivative benefits test is more restrictive than the OECD's recommended derivative benefits proposal in several key respects: (1) the OECD proposal requires only 75% ownership by equivalent beneficiaries (versus 95% in the Treasury provision) and does not limit the number of equivalent beneficiary owners (the Treasury provision requires seven or fewer); (2) the OECD proposal does not require intermediate owners to be tested; (3) the OECD proposal does not contain a base erosion prong. The OECD continues to consider its recommendations

regarding treaty abuse, and it is unclear whether the OECD's recommended derivative benefits provision will be modified to be more consistent with the 2016 Model's derivative benefits test.

"Headquarters company" test: In response to comments to the May 2015 draft, the 2016 Model includes a "headquarters company" rule that is based on analogous tests found in some current U.S. tax treaties. To qualify for benefits as a headquarters company, the company's multinational corporate group must consist of companies resident in, and engaged in the active conduct of a trade or business in, at least four countries, and the trades or businesses carried on in each of the four countries (or four groupings of countries) must generate at least 10% of the gross income of the group. In addition, the trades or businesses of the multinational corporate group that are carried on in any one state other than the company's state of residence must generate less than 50% of the gross income of the group, and the company must derive 25% or less of its gross income from the other contracting state.

Unlike current tax treaties, the 2016 Model requires a headquarters company to exercise **primary** management and control functions (and not just supervision and administration) in its residence country with respect to itself and its subsidiaries. The 2016 Model "headquarter company" test also includes a base erosion test. Furthermore, a headquarters company is only entitled to benefits with respect to dividends and interest paid by members of its multinational corporate group, and the lowest withholding rate on interest is 10%.

Ownership / base erosion test: The 2016 Model retains the ownership prong of the ownership/base erosion test under the prior U.S. Model, but tightens the base erosion prong of the test. Consistent with the base erosion prong of the new derivative benefits test, the 2016 Model modifies the base erosion prong of the test under the prior U.S. model treaty by: (1) applying the base erosion test to both the person claiming treaty benefits as well as the tested group; (2) treating a deductible payment that benefits from an STR as a base eroding payment, even if made to an otherwise qualified person; and (3) including the revised version of gross income applicable to the derivate benefits test, as discussed above.

Subsidiary of publicly traded corporation test: The prior U.S. model treaty treated certain subsidiaries of publicly traded corporations as qualified persons eligible for treaty benefits when at least 50% of the subsidiary corporation's stock was owned directly or indirectly by five or fewer corporations that would qualify for treaty benefits under the publicly traded corporation test. The 2016 Model adds a base erosion prong to the subsidiary of a publicly traded corporation test that applies if the subsidiary corporation is claiming treaty benefits for income other than dividends. The base erosion prong is substantially similar to the base erosion prongs of the derivative benefits and ownership/base erosion tests discussed above.

Active trade or business test: The "active trade or business test" in the prior U.S. model treaty generally allowed a resident of one contracting state to receive treaty benefits with respect to an item of income derived from the other contracting state if the resident engaged in the active conduct of a trade or business in the residence state and the income derived from the source state was derived in connection with, or incidental to, that trade or business. The prior U.S. model treaty generally also treated a person as conducting the activities conducted by certain related persons. The 2016 Model retains the basic framework of the active trade or

business test, but only permits the attribution of activities between related persons that are engaged in the same or a complementary line of business.

Denial of treaty benefits for income attributable to triangular or exempt permanent establishment

The 2016 Model adds a “triangular” or “exempt” PE provision that is almost identical to the proposal in the May 2015 draft. This new provision would deny treaty benefits for income attributable to a PE located in either the source state or a third jurisdiction if the income is subject to no or little tax in any jurisdiction. Although the prior U.S. model treaty did not contain an analogous triangular PE provision, such provisions have been included in numerous U.S. tax treaties that were signed both before and after the release of the prior U.S. Model.*

*See, e.g., Art. 21(6) of the 2006 U.S.- Belgium Income Tax Treaty; Art. 30(4) of the 1994 U.S.-France Income Tax Treaty, as amended by the 2004 and 2009 Protocols to the Treaty; Art. 28(5) of the 1989 U.S.-Germany Income Tax Treaty, as amended by the 2009 Protocol to the Treaty; Art. 24(5) of the 2010 U.S.-Chile Income Tax Treaty (signed but not approved by the Senate).

New Article 1, Paragraph 8 would turn off treaty benefits for income derived from one contracting state (the source state) by an enterprise of the other contracting state (the residence state), if the residence state treats the income as attributable to a PE situated outside that state and **either**:

- The profits of the PE are subject to a combined aggregate effective tax rate in the residence state and the state in which the PE is situated of the lesser of (1) 15% or (2) 60% of the general company tax rate applicable in the residence state; or
- The PE is situated in a third state that does not have a comprehensive income tax treaty with the source state and the residence state does not include the income attributable to the permanent establishment in its tax base.

The above test modifies the version in the May 2015 draft by tweaking the threshold for the combined aggregate effective tax rate to make it the lesser of 15% or 60% of the general company tax rate; the May 2015 draft included only the 60% threshold. Income not eligible for treaty benefits under this provision is taxed in accordance with the domestic law of the source state. However the competent authority of the source state may grant treaty benefits with respect to a specific item of income if such grant of benefits is justified in light of the reasons such resident did not satisfy the requirements of the provision. The 2016 Model augments the May 2015 draft proposal by adding a requirement that the source country competent authority may not either grant or deny such a request without first consulting the competent authority of the residence state.

KPMG observation: This provision would subject all U.S. source dividends, interest, royalties, and other income to full statutory withholding if the provision applies. The triangular provisions in current U.S. tax treaties on the other hand, generally allow for a reduced rate of withholding on at least certain types of income. For example, under the U.S. tax treaties with France, Germany, and Ireland, interest, royalties, and dividends subject to the triangular provisions in those treaties are subject to a maximum tax rate of 15%.*

*See Art. 30(4) of the 1994 U.S.-France Income Tax Treaty, as amended by the 2004

and 2009 Protocols to the Treaty; Art. 28(5) of the 1989 U.S.-Germany Income Tax Treaty, as amended by the 2009 Protocol to the Treaty; Art. 23(7) of the 1997 U.S.-Ireland Income Tax Treaty, as amended by the 1999 Protocol to the Treaty.

Mandatory binding arbitration

The 2016 Model adds new rules to Article 25 (Mutual Agreement Procedures) to require mandatory binding arbitration for certain disputes between tax authorities. When the competent authorities are unable to reach agreement and certain conditions have been satisfied,* a case will be submitted to arbitration under the "last-best offer" approach contained in a number of newer U.S. tax treaties and treaties awaiting Senate approval. The new procedures will take effect upon a treaty's entry into force and any cases that are under consideration at the time of entry into force will be subject to the new terms of Article 25.

*The provision lists the following conditions: tax returns have been filed with at least one of the treaty partners with respect to the tax years at issue in the case; at least two years have passed since the commencement date of such case, unless the competent authorities of the contracting states have agreed to a different date and notified the presenter of the case of such agreement; the presenter of the case has submitted a written request to the competent authority to which the case was presented for a resolution of the case through arbitration; and all concerned persons and their authorized representatives or agents have submitted to the competent authorities of both contracting states written agreements not to disclose to any other person any information received during the course of the arbitration proceeding from either contracting state or the arbitration panel, other than the determination of the panel.

Miscellaneous changes not contained in the May 2015 proposal and consistent with OECD BEPS recommendations

Article 5: Permanent Establishment: The 2016 Model made two changes to the 2006 Model with regard to when a building site, construction or installation project triggers a permanent establishment.

- First, the term "exploitation of natural resources" now explicitly includes the exploitation of sea beds and subsoil.
- Second, the 2016 Model adopts the OECD BEPS recommendation regarding anti-fragmentation rules that prevent contract-splitting to meet the 12-month permanent establishment threshold. The rule provides that when connected persons carry on activities that are connected to a building site or construction or installation project in intervals of more than 30 days, those time periods are added to the periods of time in which the primary enterprise has carried on activities at that construction or installation project.

Article 10: Dividends: The 2016 Model makes significant changes to the dividends article contained in the 2006 Model in addition to the revised LOB provision and restrictions on benefits to expatriated entities discussed above:

- The 2016 Model maintains two preferential tax rates for dividends —5% and 15%. However, the 2016 Model adopts requirements from the OECD BEPS initiative that impose additional ownership and residency requirements in order to obtain the 5% rate. The beneficial owner claiming the 5% rate must for a 12-month period ending on the date on which it is entitled to the dividends: (1) be resident in the other contracting state or a qualifying third state; and, (2) own at least 10% of the vote and value of the shares of

the payor or a qualifying predecessor owner. For the purposes of this requirement, the qualifying third state must be a state with a comprehensive income tax treaty with the contracting state when the company paying the dividend is resident and the rate must provide for a preferential 5% rate with similar terms. A qualifying predecessor owner is any connected person who the beneficial owner of the dividends acquired the shares from and such connected person was a connected person at the time of acquisition. For the purposes of this test, a resident of a contracting state is considered to directly own shares held by a fiscally transparent entity that is not resident of the other contracting state in proportion to the company's ownership interest in that entity.

- The term "dividends" now explicitly excludes distributions that are treated as gains under the law of the contracting state where the company is making the distribution.

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