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RE: Proposed New U.S. Model Tax Convention
July 14, 2015
New York City, New York

TOPIC 1: EXEMPT PERMANENT ESTABLISHMENTS (PE) 5 MINUTES

I BACKGROUND

Income derived by a resident of a state from a permanent establishment in another state generally enjoys an exemption or otherwise favorable tax treatment in the resident state under most tax treaties, including the existing U.S. Model Convention of 2006. This favorable treatment extends to business profits, dividends, and interest. This benefit is sometimes called the foreign branch exemption. The benefit comprehends that the state in which the PE is situated will appropriately tax the income derived by the resident state. But this is not always the case. PEs located in jurisdictions with low or zero tax can result in income escaping taxation in both the resident and the PE state.

II PROPOSED NEW ARTICLE 1, PARAGRAPH 7

The general scope paragraph, excludes from treaty benefits the income received in a state attributable to a PE in a foreign source state if:

a. The net profits attributable to the PE are subject to a combined aggregate effective rate of tax in the resident and PE states of less than 60% of the general rate of company tax in the resident state., or

b. The PE is in a third state that does not have a treaty with the state from which the treaty benefits are being claimed-a/k/a “triangulation”

III 3rd STATE PE EXAMPLE

U.S. resident enterprise has no tax treaty with Isle of Man. Isle of Man corporate tax rate is zero. Estonia has a tax treaty with Isle of Man. Estonia resident enterprise has PE in Isle of Man. Estonia resident enterprise loans money to the U.S. resident enterprise through its Isle of Man PE. The Isle of Man PE is integral to the Estonia enterprise. Interest therefore received by the Estonia resident enterprise with respect to loans issued by its Isle of Man PE are presently entitled to treaty benefits, reducing U.S. withholding tax on interest from 30% to 10%, and simultaneously taxed at 0% by the Isle of Man under its law, and exempt in Estonia under its treaty with the Isle of Man!. The proposed paragraph 7 of Article 1 would deny U.S. treaty benefits to Estonia. The interest would thus be subject to full statutory 30% withholding in the U.S.

IV COMMENTARY

The proposed change to paragraph 7 of article 1, if adopted and successfully negotiated in existing treaties going forward, will eventually greatly reduce the utility of certain foreign entity structures involving intermediary entities. While this may have some value where artificial PE's have been established with less than transparent, arms-length transfer-pricing, it otherwise has the detrimental effect of erecting obstacles to international trade where legitimate structures and appropriate transfer-pricing has resulted in reasonable allocations of income attributable to bona fide PEs

TOPIC 2: SPECIAL TAX REGIMES 5 MINUTES

I BACKGROUND

Generally interest, royalties and elements of other income arising (paid) in a contracting state and paid to a resident of the other (resident/recipient) contracting state is taxable in the resident/recipient state. For this reason, treaty benefits exempting from or subjecting payments to reduced withholding are available in state where the income arises (paying state). The basis of these treaty benefits is the avoidance of double taxation in cases where it is assumed that the resident/recipient state is already appropriately taxing the income arising in the other state. But, this is not always the case, particularly where there exists a special tax regime favoring the income in the resident/recipient state.

II PROPOSED NEW SUB-PARAGRAPHS DENYING TREATY BENEFITS TO SPECIAL TAX REGIMES IF RESIDENT/RECIPIENT IS RELATED TO THE PAYOR IN STATE WHERE THE INCOME ARISES

a. 1(l) ADDED TO ARTICLE 3 DEFINITIONS
b. 2(c) ADDED TO ARTICLE 11 (INTEREST)
c. 5(a) ADDED TO ARTICLE 12 (ROYALTIES)
d. 3(a) ADDED TO ARTICLE 21 (OTHER INCOME)

III DEFINITION OF SPECIAL TAX REGIME

a. Not clearly defined. Proposed 1(l) of Article 3 defines a "Special Tax Regime" as any legislation, regulation, or administrative practice that provides preferential effective rate of tax to an item of income or profit either through reductions of the tax rate or the tax base.
b. Paragraph 2 of the New Model Protocol will provide a list that the contracting states agree are special tax regimes
c. 7 Specific exceptions sub-paragraph 1(l) of Article 3;
    a. Clause i:Not a disproportionate benefit to interest, royalties, or other income
    b. Clause ii: With regard to royalties, substantial activities required in resident state in exchange for benefit.
        i. Similar to special economic zones or research or production activities required in resident state in exchange for benefits.

c. Clause iii: If there is a unilateral Advanced Pricing Agreement for arms-length transactions under Article 7 (Business Profits) or Article 9 (Associated Enterprises)
d. Clause iv: Application to otherwise exempt organizations and activities
e. Clause v: Application to Pension and Retirement benefits
f. Clause vi: Application to collective investments (Regulated Investment Companies and REITS)
g. Clause vii: States agree that something is not a special tax regime because it does not result in a low or no effective tax rate.

IV EXAMPLE OF SPECIAL TAX REGIME

U.S. resident enterprise pays interest to related enterprise resident outside of the U.S. with whom the U.S. has a tax treaty. The domestic law of the non-U.S. resident/recipient state obtains a ruling reducing its rate of tax on its U.S. source interest compared to the rate applied to foreign source interest received by other residents of the non-U.S. state. The proposed new sub-paragraph 2(c) of Article 11 would deem this a special tax regime. As a result, the U.S. would be free to tax the interest paid to the non-U.S. resident at under U.S. domestic law and subject it to 30% statutory withholding.