Executive summary

On 17 February 2016, the US Treasury Department (Treasury) released a revised US Model Income Tax Convention (the 2016 Model Treaty), which is the baseline text Treasury uses when it negotiates tax treaties. The US Model Treaty was last updated in 2006 (the 2006 Model Treaty).

The 2016 Model Treaty was not accompanied by a technical explanation. In the preamble accompanying the release of the 2016 Model Treaty (the Preamble to 2016 Model Treaty), Treasury stated that it plans to release the technical explanation to the 2016 Model Treaty in the spring of 2016.

The 2016 Model Treaty incorporates, with significant modifications, the new model treaty provisions that were released in proposed form on 20 May 2015 (the May 2015 draft), as well as making other amendments and revisions to the 2006 Model Treaty.

Significant provisions include:

- Tightening the “triangular provision” and denying treaty benefits when certain income is attributable to a permanent establishment (PE) outside the beneficial owner’s country of residence (and so would take into account operations in the US, for example)
- Denying treaty benefits to certain income items benefiting from a “special tax regime” (an STR) in the beneficial owner’s country of residence
Denying treaty benefits for interest if the interest is beneficially owned by a related person that benefits from a notional interest deduction for equity

Denying treaty benefits for certain dividends and deductible payments made by a domestic corporation treated as an expatriated entity under Section 7874 during the 10 years following the completion of an inversion transaction

Modifying the limitation-on-benefits (LOB) article, including adding a “derivative benefits test,” a base erosion prong to the “subsidiary of a publicly traded company” test and a “headquarters company test” that would allow treaty benefits for certain interest and dividends paid by members of a multinational corporation

Enabling the US or its treaty partner to terminate some benefits if changes in domestic tax law affecting tax rates are made after a treaty is signed

Modifying the Mutual Agreement Procedure of Article 25 to require mandatory binding arbitration to resolve certain disputes between tax authorities

Detailed discussion

The discussion that follows first addresses the new provisions that were initially included in the May 2015 draft and then discusses certain of the other modifications that were made to the 2006 Model Treaty that have not been proposed previously.

I. Provisions included in the May 2015 draft

1. Triangular provision

The “triangular provision” is a common feature of recent US income tax treaties. In general, this provision is intended to limit treaty benefits for income attributable to a third-country PE if little or no tax is paid to the PE jurisdiction or to the residence state unless an active business was conducted in the PE jurisdiction. This provision was generally found within the LOB article.

The 2016 Model Treaty includes an updated triangular provision in paragraph 8 of Article 1 (General Scope). Under this provision, treaty benefits would be denied when a resident of a Contracting State earns income from the other Contracting State through a PE situated outside of the Contracting State of residence, and the resident is subject to a significantly lower tax rate on income attributable to the PE. Thus, the new provision addresses income treated by the residence state as attributable to a PE and subject to little or no tax.

Specifically, the tax benefits that otherwise would be available under other provisions of the treaty will not apply to income attributable to the PE if either of the following occurs: (i) the profits of the PE are subject to a combined aggregate effective rate of tax in the residence state and the state in which the PE is situated that is less than the lesser of (a) 15%, or (b) 60% of the generally applicable tax rate in the residence state; or (ii) the third state in which the PE is situated does not have a comprehensive income tax treaty in force with the Contracting State from which the benefits of the Convention are being claimed (i.e., source state), unless the residence state includes the income attributable to the PE in its tax base. Unlike provisions included in current US treaties, no exception is provided for when an active business in conducted in the PE jurisdiction.

The triangular provision in the 2016 Model Treaty is a modified version of a similar provision proposed in the May 2015 draft. That provision did not, however, contain an exception to the triangular provision for income attributable to a PE that is subject to a combined aggregate effective rate of tax of 15% or more.

The triangular provision in the 2016 Model Treaty also provides that, if a resident of a treaty country is denied benefits under this provision, the competent authority of the other treaty country may nevertheless grant benefits with respect to an item of income, if granting the benefits is justified in light of the reasons the resident did not satisfy the requirements of new paragraph 8, such as having losses that reduced the resident’s effective tax rate. Further, the 2016 Model Treaty requires the competent authorities to consult before either granting or denying a request for relief in these circumstances.

2. Special tax regimes

The 2016 Model Treaty revises Article 3 (General Definitions) to include a definition of “special tax regime” (STR) which, in conjunction with changes made to Articles 11 (Interest), 12 (Royalties) and 21 (Other Income) operates to deny benefits under the treaty for certain items of income 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 (Other Income). In response to comments received, Treasury
significantly modified the STR provisions, which were originally introduced in the May 2015 draft, to limit and clarify when a relevant item of income will be ineligible for benefits under the treaty because the income is subject to an STR.

To constitute an STR, certain conditions must be met and the regime must provide preferential treatment to interest, royalties or guarantee fees as compared to income from sales of goods or services. Such preferential treatment must be in the form of either a preferential rate, a permanent reduction in the tax base with respect to such income, or a preferential regime for companies that do not engage in an active business in the residence state. According to Article 3, an STR would generally be expected to result in a rate of taxation that is less than the lesser of either: (i) 15%; or (ii) 60% of the general statutory rate of company tax applicable in the other Contracting State. The 2016 Model Treaty provides some language that could be included in an agreed interpretation, explaining how the rate of taxation should be determined. An STR may include a preferential rate of taxation or permanent reduction in the tax base for royalties but only if the regime does not condition benefits on the extent of research and development activities that take place in the Contracting State.

Importantly, no statute, regulation or administrative practice will be treated as an STR until the country invoking the STR provisions, after consultation with the other country, notifies the other country of its intention through a diplomatic note and issues a written public notification.

In a departure from the approach taken in May 2015 draft, regimes that provide “notional interest deductions” (NIDs) for equity are not treated as STRs under the 2016 Model Treaty. Instead, Article 11 (Interest) includes a new rule allowing a treaty partner to tax interest arising in that country in accordance with domestic law if the interest is beneficially owned by a connected person that benefits from a NID.

3. Certain payments made by expatriated entities

The 2016 Model Treaty denies treaty benefits for US withholding taxes on certain US-source dividends, interest, royalties and certain guarantee fees paid by US companies that are “expatriated entities” (the expatriated provision). Expatriated entity is defined in the Internal Revenue Code in Section 7874(a)(2)(A) and is generally a domestic entity with respect to which a foreign corporation is a surrogate foreign corporation. According to the expatriated provision, the definition of “expatriated entity” shall be fixed as of the date on which the treaty is signed, notwithstanding changes to US law that occur after that date.

Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income) contain similar provisions denying benefits under the treaty for the relevant items of income, for 10 years beginning on the date on which the acquisition of the domestic entity is completed, if the beneficial owner of the item of income is a “connected person” with respect to the expatriated entity. Article 3(1)(m) provides that two persons are “connected persons” if one owns, directly or indirectly, at least 50% of the beneficial interest in the other (or, in the case of a company, at least 50% of the aggregate vote and value of the company’s shares) or another person owns, directly or indirectly, at least 50% of the beneficial interest in each person (or, in the case of a company, at least 50% of the aggregate vote and value of the company’s shares). In any case, a person is connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

The 2016 Model Treaty provides that, under certain circumstances, preexisting US subsidiaries of the foreign acquirer (i.e., was a US subsidiary prior to the date of the acquisition) would not be considered expatriated entities for purposes of the treaty unless, subsequent to the date on which the acquisition of the domestic entity is completed, such entities join in filing a US consolidated return with the domestic entity or another entity connected to the domestic entity.

4. Modifications to the LOB article

To qualify for treaty benefits, a resident of a Contracting State generally must be a qualified person as determined under paragraph 2 of the LOB article, or meet one of the other objective tests in that article. The 2016 Model Treaty introduces new provisions and changes into the LOB article that would tighten preexisting LOB tests. The Alert only discusses the major modifications from recent income tax treaties or the 2006 Model Treaty.

In general, Article 22(2) of the 2016 Model Treaty requires that, in order to be entitled to treaty benefits, the resident must be a “qualified person,” within the meaning of that paragraph, at the relevant time that treaty benefits are sought with respect to an item of income. In the case of applying the so-called ownership base erosion test under
Article 22(2)(f), the definition of “qualified person” requires that the resident must satisfy the ownership and base erosion thresholds on half of the days of any 12-month period that includes the date when the treaty benefit otherwise would be accorded. In addition, there is also a requirement to meet the provisions of the derivative benefits test during a particular period.

**Derivative benefits**

Article 22(4) of the 2016 Model Treaty incorporates a derivative benefits test in the US Model Treaty. Under the new derivative benefits test, a company that is a resident of a Contracting State is entitled to treaty benefits, regardless of whether the resident is a qualified person under Article 22(2) if, at the time when the benefit would be accorded, and on at least half of the days of a 12-month period commencing or ending on the date when the benefit otherwise would be accorded, the ownership and base erosion prongs are both met.

The ownership prong requires that shares representing at least 95% of the aggregate voting power and value of the shares of the company (and at least 50% of any disproportionate class of shares) 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.”

To satisfy the base erosion prong, 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 (subject to certain exceptions) that are deductible for purposes of the taxes covered by the treaty in the company’s state of residence to:

i. Persons that are not equivalent beneficiaries (as defined under Article 22(7)(e))

ii. Persons who are equivalent beneficiaries solely by reason of the “headquarters test” (defined below) or a substantially similar provision in the relevant income tax treaty

iii. Persons that are equivalent beneficiaries that are connected persons with respect to the company seeking benefits under the treaty and that benefit from an STR with respect to the deductible payment or

iv. Persons, with respect to a payment of interest, that are equivalent beneficiaries and connected persons with respect to the company seeking benefits under the treaty and that benefit from a NID.

Unlike existing derivative benefits tests found in US treaties, the derivative benefits test in the 2016 Model Treaty does not limit the geographic location of the “equivalent beneficiary” to states such as members of the EU and NAFTA. The 2016 Model Treaty allows certain categories of qualified persons resident 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.

Additionally, each intermediate entity must be considered a “qualifying intermediate owner,” which is defined in Article 22(7)(f). Qualifying intermediate owner means: (1) an intermediate owner that is either resident in a country that has a comprehensive income tax treaty in force with the source country containing rules addressing STRs and NIDs that are analogous to the rules in the 2016 Model Treaty; or (2) a resident of the same state as the company seeking treaty benefits.

The base erosion prong of the new derivative benefits test requires that both the “tested group” and the individual tested resident meet the test. A “tested group” is defined in Article 22(7)(g) as the tested resident and any intermediate owner of the tested resident that is both a resident of the same Contracting State as the tested resident, and 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.

The 2016 Model Treaty removes the so-called cliff effect that applies to income referred to in Article 10 (Dividends), 11 (Interest), or 12 (Royalties) under the derivative benefits test in existing US tax treaties. Under the 2016 Model Treaty, Articles 10, 11, and 12 have been amended to provide that, if a third-country resident is not entitled, either under a treaty between its country of residence and the source country or otherwise, to a rate of tax with respect to the particular category of income that is less than or equal to the rate applicable to the tax treaty under which benefits are being claimed, the treaty resident entity may still claim a reduced withholding tax rate equal to the highest rate of withholding to which its third-country resident owners would be entitled. In contrast, under the derivative benefits provisions in existing US tax treaties, companies that fail the rate comparison test would not be entitled to treaty benefits.

Similarly, under existing US treaties that include a derivative benefits test, subsidiaries of private companies with individual owners, may not be able to qualify for benefits with respect to dividends under the derivative benefits
test because individual shareholders are only entitled to a 15% rate on dividends, and therefore the cliff effect described earlier would preclude any reduction in dividend withholding. The 2016 Model Treaty solves this problem by allowing certain companies relying on derivative benefits to qualify for the 5% rate of withholding on dividends even if the company’s shareholders are individuals who would not be entitled to the 5% rate. To achieve this, the definition of equivalent beneficiary in the 2016 Model Treaty in Article 22(7)(e)(X)(B) has been modified to allow individual shareholders to be treated as companies for purposes of the rate comparison test with respect to dividends, provided that the company seeking to qualify under derivative benefits has sufficient substance through the conduct of an active trade or business in its residence country to indicate that the individual shareholders are not simply routing income through a corporate entity in order to benefit from the lower company rate.

Subsidiary of a publicly traded company

The 2016 Model Treaty modifies the subsidiary of a publicly traded test of Article 22(2)(d) in two ways. First, the ownership prong of the subsidiary of a publicly traded test can now be met if, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under the treaty is being sought or is a qualifying intermediate owner (as defined earlier). The 2006 Model Treaty did not allow for intermediate ownership in any country other than one of the Contracting States. Second, this test includes a base erosion test, similar to the base erosion test found in the new derivative benefits test.

Active trade or business

The 2016 Model Treaty modifies the active trade or business test of Article 22(3), replacing the standard in the 2006 US Model Treaty that provided for benefits under the active trade or business test if the income was “derived in connection with” an active trade or business in the residence country. The active trade or business test of the 2016 Model Treaty requires a factual connection between an active trade or business in the residence country and the item of income for which benefits are sought. Specifically, the 2016 Model Treaty requires that the treaty-benefitted income “emanates from, or is incidental to, a trade or business that is actively conducted by the resident in the residence state. Unlike the May 2015 draft, a resident seeking to qualify under the active trade or business test can be attributed activities from connected persons.

According to the Preamble to 2016 Model Treaty, the technical explanation of the 2016 Model, which Treasury plans to release this spring, will provide guidance on when an item of income, in particular an intra-group dividend or interest payment, is considered to emanate from the active conduct of a trade or business of a resident. Two examples that may be included in the Technical Explanation are: (i) dividends and interest paid by a commodity-supplying subsidiary that was acquired by a company whose business in the residence state depends on a reliable source for the commodity supplied by the subsidiary; and (ii) dividends and interest paid by a subsidiary that distributes products that were manufactured by the parent company in its state of residence. It is noted, however, that the mere fact that two companies are in similar lines of businesses would not be sufficient to establish that dividends or interest paid between them are related to the active conduct of a trade or business. The Preamble specifically invites comments with additional examples illustrating when dividend or interest income would be treated as emanating from an active trade or business.

In the 2016 Model Treaty, certain activities are specifically excluded from the active trade or business test, such as: (i) operating as a holding company; (ii) providing overall supervision or administration of a group of companies; (iii) providing group financing (including cash pooling); or (iv) making or managing investments, unless these activities are carried on by a bank, an insurance company or registered securities dealer in the ordinary course of its business.

Headquarters companies

The 2016 Model Treaty adds to the LOB article a provision that would permits companies that serve as the active headquarters company of a multinational corporate group (“headquarters companies”) to receive treaty benefits. The headquarters companies test (Article 22(5)) in the 2016 Model Treaty is based on analogous tests found in some existing US tax treaties, but with some important modifications. Most significantly, the 2016 Model Treaty 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 geographically diverse subsidiaries. Additionally, unlike the headquarters companies test in existing treaties, the 2016 Model Treaty headquarters companies 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
Subsequent changes in law

The 2016 Model Treaty includes a new article entitled Subsequent Changes in Law (Article 28), which enables either the US or its treaty partner to cease granting treaty benefits in certain circumstances when changes to domestic tax law are enacted after the treaty has been signed. Under Article 28(1), if changes in domestic tax law result in (i) the tax rate falling below the lesser of (a) 15%, or, (b) 60% of the general statutory rate for companies in the other Contracting State, or, (ii) the creation of a regime which exempts resident companies from taxation on substantially all foreign source income, including interest and royalties, then either Contracting State may initiate diplomatic processes to amend the treaty. In the event that the efforts to amend the treaty fail, a treaty partner may issue a diplomatic note stating that it will cease to apply the provisions of Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income).

The scope of Article 28 in the 2016 Model Treaty is narrower than the scope of the article originally proposed in the May 2015 draft. Under the 2016 Model Treaty, Article 28 addresses only changes in the laws governing the taxation of companies, not individuals. The Preamble to 2016 Model Treaty states that the “2016 Model [Treaty] contains discrete rules in other articles that address the availability of tax treaty benefits for individuals who are taxed on a remittance, fixed fee, “forfeit,” or similar basis that are sufficient to address concerns regarding individuals.”

When implicated, Article 28 of the 2016 Model Treaty requires the treaty partners to consult to determine if amendments to the treaty are necessary to restore an appropriate allocation of taxing rights between the two countries that are consistent with the purpose of the treaty to eliminate double taxation without creating opportunities for non-taxation. The 2016 Model Treaty explicitly provides that it is only after such consultations fail to progress that a treaty party can cease granting the relative benefits under the treaty. In contrast, the May 2015 draft appeared to allow each treaty partner to unilaterally suspend portions of treaty after having provided notice to the other Contracting State.

The May 2015 draft provided that Article 28 would be triggered if the general rate of company tax fell below 15%. The 60% test that looks to the general statutory rate for companies in the other Contracting State was not in the May 2015 draft. According the Preamble to 2016 Model Treaty, Treasury did not intend for the use of a fixed rate to imply support for a floor on appropriate corporate tax rates, which, arguably, could be inferred by the bright line 15% rate test of the May 2015 draft, but rather only intended for the rate test to serve as a signal for when the original balance of negotiated benefits between the two countries had been significantly altered. The Preamble to 2016 Model Treaty notes that, if both the United States and its treaty partner substantially reduce their general rates of company tax, the...
fact that one country’s general rate falls below 15% may not be indicative of a shifting of the balance of benefits under the treaty. In order to better effectuate the policy underlying Article 28, the 2016 Model Treaty was modified to provide that Article 28 is triggered if a treaty partner’s general rate of company tax falls below the lesser of either 15% or 60% of the other country’s general statutory rate of company tax.

II. Modifications to specific articles

Dividends, interest and royalties

As discussed in detail earlier, each of Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income) adopts language that limits and clarifies when a relevant item of income will be ineligible for benefits under the treaty because the income is subject to an STR. Similarly, these articles contain provisions that deny treaty benefits for US withholding taxes on dividends, interest, royalties and certain guarantee fees paid by US companies that are “expatriated entities.” In addition, Articles 10, 11 and 12 contain nearly identical language removing the so-called cliff effect that applies to income referred to in each respective article under all derivative benefits provisions in existing US tax treaties.

In addition to these changes, these articles have been modified as follows:

**Article 10 — Dividends**

To qualify for the 5% rate of withholding tax, Article 10(2) has been revised to require that:

i. The beneficial owner of the dividend has been a company that was a resident of the other Contracting State or of a “qualifying third state” for the 12-month period ending on the date on which the entitlement to the dividends is determined;

ii. At least 10% of the shares (vote and value) of the payor of the dividends was owned directly by the beneficial owner or a “qualifying predecessor owner.”

For treaty residents that are ineligible for the 5% withholding tax rate, the maximum withholding tax rate on dividends is 15%, which is unchanged from the 2006 Model Treaty.

A “qualifying third state” means a state that has in effect a comprehensive income tax treaty with the source state that would have entitled the beneficial owner of the dividend to a tax rate of 5% or lower. The term “qualifying predecessor owner” means a company from which the beneficial owner acquired the shares of the payor of the dividend but only if that company was, at the time the shares were acquired, a connected person with respect to the beneficial owner of the dividend and resident in a state that has in effect a comprehensive income tax treaty with source state that would have entitled the beneficial owner of the dividend to a tax rate of 5% or lower.

Article 10(10) generally allows for the imposition of a branch profits tax, but limits the rate of that tax to 5% or to the rate of tax that would be imposed on the beneficial owner of the company on dividends under the derivative benefits test, but only if, for the 12-month period ending on the date on which the entitlement to the dividend equivalent amount is determined, the company has been a resident of the other Contracting State or of a “qualifying third state” (defined earlier).

**Article 11 — Interest**

Article 11(2)(f) provides that interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that only meets the headquarters companies test of the LOB provision (Article 22(5)) may be taxed in the source at a rate not exceeding 10%.

**Article 12 — Royalties**

In addition to the changes noted earlier, Article 12 has been amended to provide that royalty payments are deemed to arise in the Contracting State when they are in consideration for the use of, or the right to use, property, information or experience in that Contracting State in which the property subject to the royalty payment may be exploited.

Modification to other articles

**Preamble to 2016 Model Treaty**

The preamble to the US Model Treaty includes a notable change that incorporates recommendations from the work on Action 6 of the OECD BEPS project. In particular, the change incorporates explicit language to clarify that, in entering into a tax treaty, the treaty partners intend to eliminate double taxation with respect to taxes on income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.

**Article 1 — General Scope**

Article 1(5) provides for exceptions to the general savings clause in Article 1(4). The provision is expanded to include new cross-references to Article 7(3) (Business Profits) (elimination of double taxation due to transfer pricing adjustments); Article 13(7) (Associated Enterprises) (allows for an elective basis step-up in situations involving exit taxes
when taxpayers cease to be residents of a jurisdiction); and subparagraph (b) of paragraph 1 of Article 17 (tax-exempt receipts under pension plans). Other cross-references have been modified to reflect the re-numbering throughout portions of the treaty.

The 2016 Model Treaty modifies Article 1(6), which relates to fiscally transparent entities. Whereas in the prior version of the treaty, reference was made to income “derived through an entity that is fiscally transparent,” the new provision applies to income “derived by or through an entity that is treated as wholly or partially fiscally transparent.” Additionally, Article 22(7)(e)(X)(C) now provides that differences in the treatment of an entity as fiscally transparent is taken into account in determining whether a resident is an “equivalent beneficiary,” for purposes of the LOB provisions.

Article 1(7) is a new provision that would limit the applicability of the treaty with respect to residents of a treaty state that are taxed on a remittance basis in their country of residence. In that case, treaty benefits would apply only to so much of the amount of income that is actually taxed in the residence state.

Article 1(8) contains the new “triangular provision” that denies treaty benefits when certain income is attributable to a permanent establishment (PE) outside the beneficial owner’s country of residence. The triangular provision is discussed in greater detail earlier.

Article 4 – Resident

Article 4(1) is modified to provide that a person whose tax is determined on a fixed-fee or “forfait” basis would not be included in the definition of “resident.” Similarly, such persons would not be considered equivalent beneficiaries for purposes of the LOB article.

Consistent with some of the recent US tax treaties, Article 4(4) is modified to provide that a company is a resident of both Contracting States, (e.g., a dual-resident company), will not be treated as a resident of either Contracting State, and therefore would not be eligible to claim the benefits provided by the treaty.

Article 5 – Permanent establishment

The Preamble to 2016 Model Treaty explains that the 2016 Model Treaty does not adopt the recommendations made under Action 5 of the BEPS project relating to defining a PE except for Article 5(3). Article 5(3) is modified to include a rule intended to protect against splitting up contracts in order to come within the 12-month exception relating to building, construction or installation projects. The Preamble to 2016 Model Treaty notes that Treasury is working with the OECD and G20 member countries to create a common global understanding regarding profit attribution that will address the concerns raised by these BEPS permanent establishment recommendations.

Article 17 – Pension, social security, annuities, alimony, and child support

Article 17 is amended to provide that, where a resident of a Contracting State is a participant in a pension fund in the other Contracting State, the residence state will not tax income derived by the pension fund until the income is paid to the beneficiary of the pension fund. The provision also allows the resident to roll over its beneficial interest in a pension fund to another pension fund established in the other Contracting State if such transfer qualifies as a tax-deferred transfer under the laws of that other Contracting State. There is a similar provision with respect to citizens of the United States who are resident in the other Contracting State.

It should be noted that the definition of “pension fund” in Article 3(1)(k) was also modified.

Article 21 – Other Income

Certain guarantee fees arising in Contracting State that are received by a connected person in the other Contracting State may be subject to source-based taxation under one of the provisions of the 2016 Model Treaty that are discussed earlier with respect to the significant changes made to the 2016 Model Treaty.

Technical improvements to the 2016 Model Treaty and changes that are generally consistent with recently negotiated treaties

Article 7 – Business Profits

The business profits article is amended to include a new provision that reduces the potential for double taxation when one Contracting State adjusts the profits attributable to a PE in the other Contracting State. In this event, the other Contracting State also must adjust the taxable income of the PE to the extent that it agrees with the adjustment. To the extent that the other Contracting State does not agree with the adjustment, the two Contracting States must resolve the issue through mutual agreement. This amendment is similar to recently negotiated US income tax treaties, such as the Polish Treaty.
**Article 13 — Gains**

A new paragraph 7 has been added to Article 13 to provide that, when an individual is subject to an exit tax as a result of ceasing to be a resident of a Contracting State, that individual may elect to be treated as if he or she had disposed and reacquired such property for its fair market value immediately before ceasing to be a resident. A similar provision is included in the Polish Treaty and the Canadian Treaty, as well as in other recent US income tax treaties.

**Article 15 — Directors’ Fees**

The definition of the income subject to the article has been modified to include “similar payments.”

**Article 16 — Entertainers and Sportsmen**

The gross receipts threshold for such activities to be subject to source-based taxation is raised from $20,000 to $30,000 for the tax year in question.

**Article 20 — Students and Trainees**

The threshold for personal services that are exempt from tax in the state of temporary residence is raised from $9,000 to $10,000.

**Article 25 — Mutual Agreement Procedure**

Consistent with US tax treaty policy, Article 25 (Mutual Agreement Procedure) of the 2016 Model Treaty now contains rules requiring certain disputes between tax authorities to be resolved through mandatory binding arbitration. The “last-best offer” arbitration approach in the 2016 Model Treaty is substantively the same as the arbitration provision that is found in four US tax treaties in force and three additional US tax treaties that are awaiting ratification in the US Senate.

**Article 26 — Exchange of Information and Administrative Assistance**

Article 26(1) allows the competent authorities of the Contracting States to exchange information as is “foreseeably” relevant for purposes of carrying out the purposes of the treaty or domestic law of one of the Contracting States. The modification is consistent with the OECD recommendations for exchange of information provisions.

Additionally, Article 26(2) provides that the competent authority of the Contracting State receiving information under this Article may, with the written consent of the other Contracting State, make that information available to be used for other purposes allowed under the provisions of an existing mutual legal assistance treaty between the Contracting States that allows for the exchange of tax information.

**Implications**

The Preamble to 2016 Model Treaty reiterates the policy of the US that tax treaties should eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. The changes introduced in the 2016 Model Treaty reflect this policy by introducing several new provisions as well as tightening many of the preexisting rules in an effort to prevent treaty abuse. While the 2016 Model Treaty maintains a long-standing policy of providing objective criteria in the LOB test so that residents may determine whether they are eligible for treaty benefits, rather than applying, for example, a principal purpose test (one of the recommendations of BEPS Action 6), it would undoubtedly be more difficult to qualify for treaty benefits if the changes were to become part of a tax treaty.

Although only model provisions and not part of a treaty that has entered into force, the 2016 Model Treaty would seem to reflect current US treaty policy. Certain provisions added to the 2016 Model Treaty, such as the denial of certain treaty benefits to residents of a jurisdiction that allow for a NID, already are grounds for denying access to the discretionary relief provision in US treaties currently in force, as provided in Revenue Procedure 2015-40, 2015-35 I.R.B. 236.

Additionally, with respect to the expatriated provision in the 2016 Model Treaty, if such a provision were adopted in any future treaty, companies that restructured that are subject to the provisions of section 7874 could be denied treaty benefits if certain conditions are met, notwithstanding that the transactions that implicate section 7874 were completed before the relevant treaty was signed.
It is notable that the 2016 Model Treaty only adopts certain limited OECD BEPS recommendations with respect to Article 5 (PE), reflecting US Treasury stated position that it will be important to ensure that the implications from any modifications to the PE provisions are commonly understood and consistently administered by treaty partners.

There are a number of treaties (Hungary, Chile and Poland) and treaty protocols (Switzerland, Luxembourg, Spain and Japan) that are currently awaiting ratification in the US Senate. A Treasury official was quoted as saying that Treasury does not plan to renegotiate such treaties and treaty protocols even though the 2016 Model Treaty has been released in the interim.

With respect to the LOB, as described earlier, the 2016 Model Treaty introduces a new concept with respect to the active trade or business test requiring the treaty-benefitted income “emanates from, or is incidental to,” a trade or business that is actively conducted by the resident in the residence state. Treasury is asking for taxpayer comments with examples for potential inclusion in the technical explanation that would illustrate dividend or interest income that should be considered to emanate from an active trade or business in the residence state. Taxpayers should consider taking the opportunity to comment on the new provision. The deadline for public comments is 18 April 2016.
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