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# What Has Changed in the Limitation on Benefits Clause of the 2016 US Model?: Technical Modifications, Policy Considerations and Comparisons with Base Erosion and Profit Shifting Action 6

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*The Limitation on Benefits (LOB) clause of the US Model Income Tax Convention (US Model) has undergone significant changes in the latest version of the US Model published in February 2016. The aim of this article is to analyse the changes to the LOB clause in the 2016 US Model as compared to its predecessor in the previous 2006 US Model and the LOB clause recommended by the Action 6 Final Report of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project. The article first focuses on changes which simultaneously affect multiple tests, namely the changes to the ownership requirements and the changes to the base erosion requirements, which are found throughout the LOB. Second, the article examines two tests which made their way into the US Model for the first time, namely the derivative benefits test and the headquarters company test. It assesses what balance has been struck between the desire to open up and modernize the LOB clause, while maintaining its effectiveness in counteracting treaty shopping. Throughout its detailed study of these changes, it offers lessons that could be taken into account by the Organisation for Economic Co-operation and Development (OECD) in the finalization of its proposed LOB clause under Action 6 and by those states that choose to adopt a detailed LOB provision in their tax treaties in order to meet the minimum standard under Action 6.*

## 1 Introduction

On 17 February 2016, the United States released its 2016 Model Income Tax Convention (2016 US Model)[1] with new and strengthened provisions against treaty abuse.[2] Preceding this, on 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released the final report on Action 6 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project (OECD Action 6 Final Report)[3] recommending fundamental changes to the OECD Model Tax Convention on Income and on Capital (OECD Model) aimed at preventing the inappropriate use of tax treaties, including by means of a Limitation on Benefits (LOB) clause. Two of the most influential models for tax conventions are undergoing major changes and both are influencing each other in significant ways. This influence can be seen in the OECD Action 6 Final Report where it expressly states its plan to fully consider the 2016 US Model before finalizing some of its proposals.[4] The LOB clause is a prime example of this feedback loop. At its origins, it is a product of US tax treaty policy[5] that is now making its way into international tax policy via the OECD/G20 BEPS recommendations.

The LOB clause is a specific anti-avoidance rule, designed to prevent treaty shopping.[6] To do so, it limits treaty

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1 US Treasury Department, *United States Model Income Tax Convention* (17 Feb. 2016), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US Model-2016.pdf (accessed 15 Aug. 2016) [hereinafter *2016 US Model*].

2 US Treasury Department, *Preamble to 2016 U.S. Model Income Tax Convention* (17 Feb. 2016), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US Model-2016.pdf (accessed 15 Aug. 2016) [hereinafter *Preamble to the 2016 US Model*].

3 OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, *Action 6 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project OECD Publishing, Paris (2015), http://dx.doi.org/10.1787/9789264241695-en (accessed 15 Aug. 2016) [hereinafter *OECD Action 6 Final Report*].

4 *OECD Action 6 Final Report*, *supra* n. 3, at 11.

5 For more on the development of the LOB by the United States, *see* e.g. A. Rust, in *Klaus Vogel on Double Taxation Conventions* (Reimer & Rust eds, Wolters Kluwer, 4th ed. 2015), Art. 1, at m.no. 64. Although the United States is the main proponent of LOB clauses, Japan and India have also included LOB clauses in some of their tax treaties.

6 Treaty shopping has been defined by the Technical Explanation of the 1996 US Model as 'the use, by residents of third states, of legal entities established in a Contracting State with a principal purpose to obtain the benefits of a tax treaty between the United States and the other Contracting State'. *See* US Treasury Department, *United States Model Income Tax Convention – Technical Explanation* (20 Sept. 1996), https://www.irs.gov/pub/irs-trty/usmtech.pdf (accessed 15 Aug. 2016) at Art. 22 [hereinafter *Technical Explanation to the 1996 US Model*].

benefits, as its name implies, to only those persons that have a sufficient nexus – or connection – to their Contracting State of residence. Obtaining 'residence' alone can be easily achieved by the mere formality of incorporation (see Article 4(1) US Model) and, therefore, easily manipulated. By testing whether a sufficiently strong nexus exists, the LOB seeks to ensure that these persons genuinely reside – for tax purposes – in the Contracting State in question and are not merely there for the purpose of obtaining treaty benefits. Because a tax treaty is generally negotiated to provide benefits to the residents of the two Contracting States, in a reciprocal bilateral way, this clause tries to exclude residents of third countries who attempt to interpose an entity in one of the two Contracting States in order to 'shop into' treaties, the benefits of which they would not otherwise be entitled to. To accomplish this, the LOB is structured as a series of objective tests.[7] To begin, certain persons are automatically deemed to have a sufficient nexus to a Contracting State, namely residents that are individuals (i.e. natural persons) and the Contracting State itself or its subdivisions and agencies.[8] Other types of persons must fulfil additional requirements. For some entities, such as certain publicly-traded entities or certain non-profit organizations and pension funds, it is sufficient to meet less rigorous conditions.[9] These 'qualified persons' are presumed to present a low risk of treaty shopping. By contrast, other entities, notably privately-owned companies, are more carefully scrutinized. They must fulfil additional tests, which, simply put, investigate who their owners are (ownership-leg of the test) and to whom their income is paid (base erosion-leg of the test).[10] Under these tests, when these entities are majority-owned by third-country residents or pay out the majority of their gross income in deductible payments to third-country residents, the LOB presumes that treaty shopping is occurring and therefore denies treaty benefits. As these qualified persons tests[11] are quite restrictive, they are followed by other 'safeguard' provisions that offer additional opportunities to obtain partial treaty benefits if e.g. the person carries on active business in the Contracting State of which it is resident ('active trade or business test')[12] or is not driven by any tax avoidance motive in its transaction or arrangement, which is to be assessed by the tax administration in its discretionary power ('discretionary relief provision').[13]

The LOB clause, already notorious for its length and complexity, has been further expanded in the 2016 US Model. The aim of this article is to analyse the changes to the LOB clause in the 2016 US Model (also referred to as the 'new LOB' clause) as compared to its predecessor in the previous 2006 US Model[14] and the LOB clause recommended by the OECD Action 6 Final Report. As far as the structure is concerned, rather than wading through a separate analysis of each individual test of the LOB clause, the article pulls out the common parts of the different tests and analyses them side-by-side. First, the changes to the ownership requirements of the different tests (hereinafter commonly referred to as 'ownership tests'), and specifically the introduction of the new key concept of a 'qualifying intermediate owner', are discussed (section 2). This new definition could have significant consequences on the way multinational enterprises (MNEs) are structured for the purpose of achieving the most tax efficient set-up. Next, the changes aimed at preventing tax base erosion in the state of residence of the recipient of the income (hereinafter commonly referred to as 'base erosion tests') are explained (section 3). Not only has a base erosion test been tacked onto nearly all of the LOB provisions, but it has also been tightened, through the addition of new categories of 'tainted payees' and restrictions in the case of a 'special tax regime'. Finally, this article also examines the new tests which made their way into the new LOB clause, namely the derivative benefits test and the headquarters company test (section 4). Under these tests, further categories of persons may qualify for treaty benefits, which, although welcome from the perspective of MNEs, further increases the complexity of the LOB

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7 US Treasury Department, *United States Model Income Tax Convention – Technical Explanation* (15 Nov. 2006), https://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf (accessed 30 Sept. 2016) at Art. 22, at 63: 'In general, the 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.' [hereinafter *Technical Explanation to the 2006 US Model*].

8 *2016 US Model*, *supra* n. 1, at Art. 22(2)(a) and (b); *see also OECD Action 6 Final Report*, *supra* n. 3, at Art. X(2)(a) and (b), at 21, 25.

9 *2016 US Model*, *supra* n. 1, at Art. 22(2)(c), (d) and (e); *see also OECD Action 6 Final Report*, *supra* n. 3, at Art. X(2)(c) and (d), at 21, 26. In essence, these provisions grant treaty benefits to non-profit organizations and pension funds under certain conditions, to companies whose shares are regularly traded on stock exchanges under certain conditions (a 'publicly-traded company' test), and to companies that are majority-owned by these qualified publicly-traded companies (a 'subsidiary of publicly-traded companies' test).

10 *2016 US Model*, *supra* n. 1, at Art. 22(2)(f); *see also OECD Action 6 Final Report*, *supra* n. 3, at Art. X(2)(e), at 21, 30. In essence, these provisions grant treaty benefits to other entities if they are majority-owned by certain residents and if less than half of their gross income is paid to non-residents (an 'ownership and base erosion' test).

11 *2016 US Model*, *supra* n. 1, at Art. 22(2). For more on the qualified persons tests, *see* R. Szudoczky & P. Koch, *Limitation on Benefits: 'Qualified Person' – Article X(1) and (2) of the OECD Model*, in *Base Erosion and Profit Shifting (BEPS): The Proposals to Revise the OECD Model Convention,* at 219–245 (Lang et al. eds, 2016).

12 *2016 US Model*, *supra* n. 1, at Art. 22(3); *see also OECD Action 6 Final Report*, *supra* n. 3, at Art. X(3), at 21, 36.

13 *2016 US Model*, *supra* n. 1, at Art. 22(6); *see also OECD Action 6 Final Report*, *supra* n. 3, at Art. X(5), at 21, 43.

14 US Treasury Department, *United States Model Income Tax Convention* (15 Nov. 2006), https://www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf (accessed 15 Aug. 2016) [hereinafter *2006 US Model*].

provision. In addition to providing a detailed explanation of these new tests, the article also addresses the potential policy reasons for adding them to the LOB clause. In this context, it will be explored what balance has been struck between the desire to open up and modernize the LOB clause, while maintaining its effectiveness in counteracting treaty shopping.

It is timely to critically examine these latest adjustments to the LOB provision, as the finalization of the OECD version of the provision is still to be expected[15] and the Multilateral Instrument,[16] adopted in November 2016 after negotiations among over 100 jurisdictions, contains options for including LOB clauses into bilateral tax treaties. Therefore, the LOB clause is bound to play an increasingly prevalent role in the international network of tax treaties.

## 2 Changes to the ownership tests

### 2.1 *Overview of the Ownership Tests*

The ownership tests capture the essential idea of the LOB, according to which a person who is majority-owned by third-country residents may be presumed to be treaty shopping. Accordingly, these tests require that companies claiming treaty benefits be majority-owned by (1) residents, more specifically, certain types of residents (i.e. individuals, Contracting States or their subdivisions, certain publicly-traded companies, non-profit organizations or pension funds) or (2) third-country residents that are considered to be 'equivalent beneficiaries' and as such cannot be driven by treaty shopping purposes. An ownership test appears in (1) the ownership and base erosion test (Article 22(2)(f)(i) US Model 2016), (2) the subsidiary of a publicly-traded company test (Article 22(2)(d)(i) US Model 2016), and (3) the derivative benefits test (Article 22(4)(a) US Model 2016) of the LOB clause. All of the tests look at both the threshold of the ownership – e.g. 50% or more – and who the owners are – i.e. depending on the test, the owners must qualify as specific types of persons. For example, the taxpayer can qualify for treaty benefits as a subsidiary of a publicly-traded company if 50% or more of the aggregate vote and value of its shares are held by five or fewer publicly-traded companies, which themselves in turn are subject to a number of conditions.[17] In the 2016 US Model, the tests for the owners themselves remain largely the same; however, with regard to intermediate owners, the new LOB clause brought about important changes.[18] As will be explained in the next section, this could have beneficial practical implications for MNEs by offering more flexibility in how they can configure their corporate ownership structure.

### 2.2 *Qualifying Intermediate Owners*

The ownership tests all refer to 'direct' and 'indirect' ownership. For this reason, each of the ownership tests contains rules for indirect ownership, i.e. for intermediate owners. As MNEs have increasingly diverse and complex structures, often with more than one layer of corporate ownership,[19] intermediate owners can be an important part of the ownership structure with genuine roles and functions and, therefore, their qualification under the LOB clause is highly relevant.

The 2016 US Model has developed the new concept of 'qualifying intermediate owners'. Previous requirements for intermediate owners have been strict. In the 2006 US Model, any intermediate owners had to be a resident of one of the Contracting States[20] or a resident of the same Contracting State as the person claiming the benefits.[21] The OECD proposal also includes the same provisions, while, however, acknowledging that they were rather restrictive.[22] These versions had a very limited geographical scope and, consequently, the choice for the location of intermediate owners was confined to one or maximum two states, i.e. either the residence state or the two Contacting States in question. This is in line with the bilateral reciprocal nature of tax treaties, but less in line with the globalized reality of international business and investment.

The new term 'qualifying intermediate owner' in the 2016 US Model seems to have been designed in response to this, in order to develop a more workable standard for intermediate owners of MNEs that have operations in

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15 The OECD originally planned to finalize the LOB 'in the first part of 2016'. *See OECD Action 6 Final Report*, *supra* n. 3, at 11.

16 OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (adopted 24-25 Nov. 2016), available at http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm (accessed 13 Dec. 2016) at Art. 7 Prevention of Treaty Abuse, para. 15, 12-13 [hereinafter Multilateral Instrument].

17 *2016 US Model*, *supra* n. 1, at Art. 22(2)(d)(i). To be regarded a qualified person, a publicly traded company has to have its principal class of shares traded regularly on one or more recognized stock exchanges, and either (1) its principal class of shares be primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident, or (2) the company's primary place of management and control be located in the Contracting State of which it is a resident.

18 As regards changes to the requirements for intermediate owners under the derivative benefits test, these will be discussed in detail in section 4.2.4.1.

19 United Nations Conference on Trade and Development, *UNCTAD World Investment Report 2016* (United Nations 2016), http://unctad.org/en/PublicationsLibrary/wir2016_en.pdf (accessed 23 Sept. 2016), at 129 et seq..

20 *2006 US Model*, *supra* n. 14, at Art. 22(2)(c)(ii), i.e. the ownership-leg of the subsidiary of a publicly-traded company test.

21 *2006 US Model*, *supra* n. 14, at Art. 22(2)(e)(i), i.e. the ownership-leg of the ownership and base erosion test.

22 *See OECD Action 6 Final Report*, *supra* n. 3, at 28, para. 19; for a detailed version of the OECD proposal, *see OECD Action 6 Final Report*, *supra* n. 3, at 26, 30; *See also* Szudoczky & Koch, *supra* n. 11, at 234.

multiple jurisdictions. To be considered a qualifying intermediate owner, there are now two possibilities:

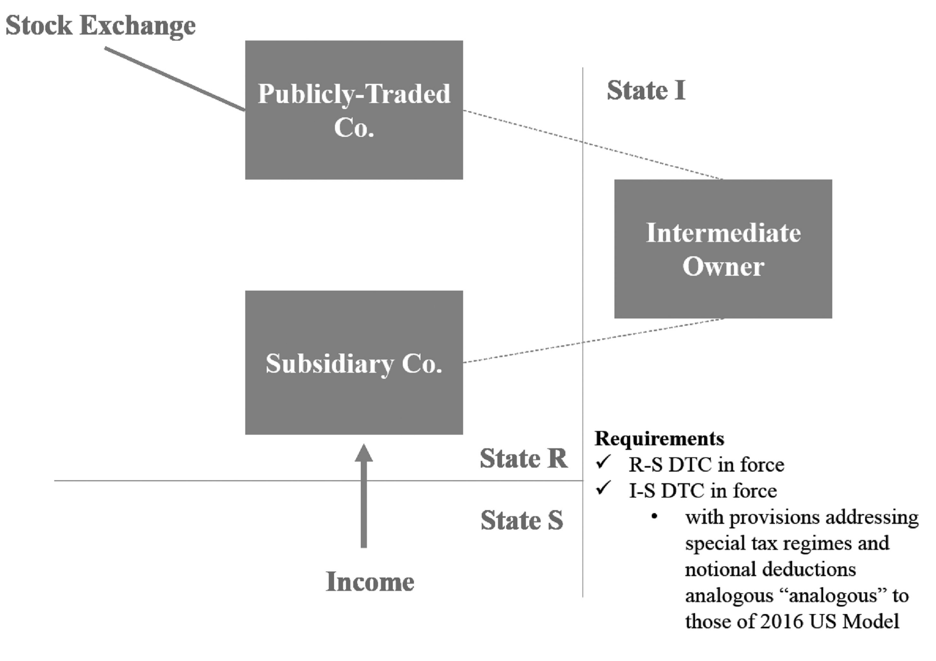
> f) the term 'qualifying intermediate owner' means an intermediate owner that is either:
>
> i) a resident of a state that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation that includes provisions addressing special tax regimes and notional deductions analogous to subparagraph (l) of paragraph 1 of Article 3 (General Definitions) and subparagraph (e) of paragraph 2 of Article 11 (Interest), respectively; or
>
> ii) a resident of the same Contracting State as the company applying the test under subparagraph (d) [the subsidiary of a publicly-traded company test] or (f) of paragraph 2 [the ownership and base erosion test] or paragraph 4 [the new derivative benefits test] of this Article to determine whether it is eligible for benefits under the Convention;[23] (brackets added)

Under alternative (i), a qualifying intermediate owner can now be a resident of *any* state. This, in principle, drastically broadens the territorial scope, by comparison with its predecessor versions which were strictly bilateral. However, this comes with strict conditions. The residence state of the intermediate owner must have a tax treaty in force with the source state. Furthermore, this tax treaty must include provisions which address special tax regimes and notional deductions, 'analogous' to the ones which have now been newly added to the 2016 US Model.

To illustrate, Figure 1 (below) depicts one scenario under which a subsidiary of a publicly-traded company (Subsidiary Co.) with an intermediate owner in a third state would now qualify under alternative (i).

Despite the broadening of the territorial scope, it can be assumed that it will be very unlikely to qualify as a qualifying intermediate owner under these conditions due to the fact that it may be some time before there are any tax treaties in force which would contain these new special tax regime and notional deduction provisions. Until the United States starts concluding tax treaties based on this new model, there will hardly be any person which qualifies under these requirements. If provisions on special tax regimes were to be included in the OECD Model as well, this could give this new type of 'qualifying intermediate owner' rule greater effect, more quickly. In this regard, it should be noted that the OECD has included proposals for special tax regime provisions in its Final Report on Action 6 (see section 3.2.1).[24] However, the OECD Multilateral Instrument does not contain any such provisions. Therefore, it remains to be seen if and when more tax treaties would meet the condition under alternative (i) of the 'qualifying intermediate owner' rule.

*Figure 1*

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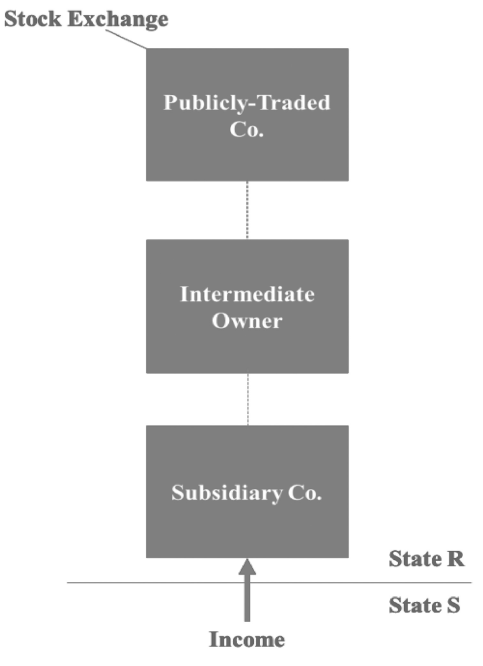
[23] *2016 US Model*, *supra* n. 1, at Art. 22(7)(f).

[24] *OECD Action 6 Final Report*, *supra* n. 3, at 96–98, paras. 79–81.

To be regarded a qualifying intermediate owner under alternative (ii), the intermediate owner has to be a resident of the same Contracting State as the company applying the test, i.e. the residence state.[25] In other words, it reverts back to a restrictive territorial scope.

To illustrate, Figure 2 depicts the scenario under which a subsidiary of a publicly-traded company (Subsidiary Co.) with an intermediate owner in the residence state qualifies under alternative (ii).

*Figure 2*

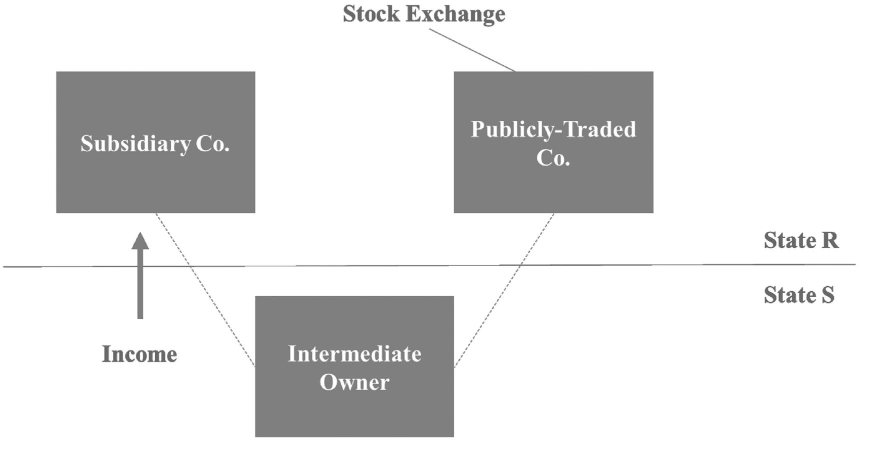



At first glance, based on the definition of a qualifying intermediate owner, the two scenarios above appear to be the only ownership structures that qualify (i.e. ownership structures with an intermediate owner in a third state or in the residence state). However, reading this definition in conjunction with each of the tests to which it relates – namely, the subsidiary of a publicly-traded company test, the ownership and base erosion test and the derivative benefits test – reveals that subsidiaries of publicly-traded companies are treated more generously under the LOB. In particular, the ownership and base erosion test and the derivative benefits test only state that 'each intermediate owner is a qualifying intermediate owner' (in Article 22(2)(f) and Article 22(4), respectively), whereas uniquely under the test for subsidiaries of publicly-traded companies (in Article 22(2)(d)), the requirements for indirect ownership are also fulfilled if an intermediate owner is 'a resident of the Contracting State from which a benefit under this Convention is being sought',[26] i.e. the source state.

To illustrate, Figure 3 depicts one scenario under which a subsidiary of a publicly-traded company (Subsidiary Co.) with an intermediate owner in the source state qualifies under the additional condition available for this type of claimant of treaty benefits.

Under the derivative benefits test and under the ownership and base erosion test, it is not possible for the intermediate owner to be located in the source state. This raises the question as to the underlying policy rationale for this difference. Apparently, subsidiaries of publicly-traded companies are deemed to present less risk of treaty shopping than privately-owned companies and are, therefore, allowed more flexibility in their corporate structures. However, even for subsidiaries of

*Figure 3*

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[25] The provision specifies that it is a company claiming treaty benefits under the subsidiary of a publicly-traded company test, the ownership and base erosion test or the derivative benefits test, although mentioning these tests is not particularly necessary, as qualifying intermediate owners can only be included in structures that rely precisely on these tests.

[26] *2016 US Model*, *supra* n. 1, at Art. 22(2)(d).

publicly-traded companies, can there be real business reasons for setting up a zigzag structure as above where, in order for the income to reach the ultimate company in the chain of shareholdings, it has to be first paid from the source state to the residence state then back to the source state and finally to the residence state again? It is quite plausible that such a structure is, in fact, aimed at avoiding some tax liabilities which would be incurred on a pure domestic flow of income either in the source state (i.e. if the income were paid directly to the Intermediate Owner) or the residence state (if the income were paid from Subsidiary Co. directly to Publicly-Traded Co.) by making use of the tax treaty between State R and State S. Is it excluded that such a structure is tax driven just because the ultimate owner is a publicly-traded company? It seems more likely that it is a loophole in the LOB clause left open for subsidiaries of publicly-traded companies.

In sum, compared to the 2006 US Model and the OECD proposal, the scope for intermediate ownership has been expanded by taking into account residents of any state; however, the necessity of having a tax treaty in force that addresses special tax regimes and notional deductions makes it quite difficult for intermediate owners to qualify under this new provision. As mentioned above, the Multilateral Instrument could have served as a unique opportunity to adjust a number of bilateral treaties quickly to address these regimes, but it did not ultimately do so. Therefore, in the meantime, most companies will still have to maintain structures in which the intermediate owners are either in the residence state of the company claiming treaty benefits or, uniquely for subsidiaries of publicly-traded companies, in the source state of the income.

## 3 Changes to the base erosion tests

### 3.1 *Overview of the Base Erosion Tests*

In the 2006 US Model, the base erosion test appeared only in one provision of the LOB clause, namely the ownership and base erosion test. The ownership and base erosion test enables a privately-owned company that cannot be considered a qualified person under any of the other tests to have access to treaty benefits. As explained above, the ownership-leg of the test is intended to ensure that the majority of the company's owners/shareholders are residents in the state of the company seeking treaty benefits and that they fall within specific categories of qualified persons. The base erosion-leg of the test is a vital complement to the ownership-leg. It ensures that treaty shoppers do not undermine the ownership test, which focuses on the legal ownership, by simply arranging for most of the gross income of the entity receiving treaty benefits to be passed on through deductible base-eroding payments to third-country residents, making the latter in a sense the economic owners of the income (and making the immediate recipient a mere pass-through entity). It has long been recognized that a relevant tax nexus for a company to a certain state not only depends on whether its ultimate owners are residents of the same state but also on the question whether that state can actually tax the company's income, or is instead prevented from doing so due to the income being siphoned out of its tax jurisdiction.[27] The base erosion test is designed to take this into account.

However, under the previous US Model, the principle underlying the base erosion test was not implemented consistently, as the test did not apply to all the cases where a company claiming treaty benefits could erode the tax base of its residence state.[28] Now this deficiency has been remedied, as the 2016 US Model added a base erosion-leg to the subsidiary of a publicly-traded company test (Article 22(2)(d)(ii)). In addition, a base erosion examination is also part of the new tests of the LOB clause, i.e. the derivative benefits test and the headquarters company test (Article 22(4)(b) and Article 22(5)(f)).[29]

Apart from the more frequent appearance of the base erosion test in the new US Model, its content has also changed compared to the 2006 version as well as the version of the OECD Action 6 Final Report. The main modification concerns the expansion of the scope of 'tainted payees', i.e. those persons the payments to whom causes a company to fail the base erosion test and thereby fall out of treaty benefits.

### 3.2 *Variations of the Base Erosion Test Under the New LOB Clause*

#### 3.2.1 *Subsidiary of a Publicly-Traded Company Test, the Ownership and Base Erosion Test, and the Headquarters Company Test*

Under three of the provisions where the base erosion test appears – namely the subsidiary of a publicly-traded company test, the ownership and base erosion test and the headquarters company test – it requires that less than

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[27] D.H. Rosenbloom, *Limiting Treaty Benefits: Base Erosion, Intermediate Owners and Equivalent Beneficiaries*, Tax Notes International, at 650 (24 May 2010); J. Bates et al., *Limitation on Benefits Articles in Income Tax Treaties: The Current State of Play*, 41(6/7) Intertax, at 395 (2013).

[28] Rosenbloom, *supra* n. 27, at 650; Szudoczky & Koch, *supra* n. 11, at 233.

[29] A base erosion test has always been part of the various versions of the derivative benefits test included in bilateral tax treaties while that is not the case with the headquarters company test, which in its various formulations in bilateral tax treaties had not encompassed a base erosion-leg.

50% of the person's gross income be paid, directly or indirectly, to certain 'tainted payees'. The following categories of persons are considered tainted payees:

(1) persons that are *not* residents of either Contracting State;

(2) persons that are indeed residents of one of the Contracting States but do not fall within specified categories of qualified persons – such excluded 'tainted' residents are subsidiaries of publicly-traded companies and companies which qualify for treaty benefits only under the ownership and base erosion test;

(3) persons that are deemed 'connected' persons with respect to the company claiming treaty benefits and that benefit from a special tax regime with respect to the payment; or

(4) with regard to a payment of interest, persons that are deemed 'connected' persons with respect to the company claiming treaty benefits and that benefit from notional deductions mentioned in Article 11 of the US Model.

In other words, under the base erosion test, the company claiming treaty benefits can pay the majority of its gross income in the form of deductible payments only to other residents of its state provided that they are:

(1) individuals;

(2) the Contracting State or its subdivisions;

(3) a publicly-traded company;

(4) a pension fund or non-profit organization;

however, even some of these residents may be deemed tainted if these persons are considered to be connected to the company and benefit from a special tax regime or rules which allow notional interest deductions.

These restrictions appear to entail that interest payments on a loan taken out from a foreign bank would also be tainted payments and, therefore, could exclude the borrower from treaty benefits; this would be a severe limit on the ability of the borrower to choose a credit facility with the most favourable conditions. In this respect, it has to be pointed out that there is a carve-out under the base erosion test. This carve-out allows arm's length payments in the ordinary course of business for services or tangible property without limitation. In other words, these arm's length payments do not count when calculating the portion of the gross income paid to tainted payees. Payments of interest to an unrelated bank could, in principle, fall under this carve-out if they can be considered arm's length payments for services in the ordinary course of business. However, the fact that payments to an unrelated bank are expressly and specifically mentioned in the carve-out under the headquarters company test[30]suggests that the narrower carve-outs under the two other tests (i.e. subsidiary of a publicly-traded company test and ownership and base erosion test), *a contrario*, do not cover interest payments to unrelated banks and, therefore, these interest payments qualify as tainted payments which can disqualify their payers for treaty benefits. This would lead to an inexplicable difference in treatment.

In the above lists of tainted payees, two new concepts appear that the 2016 US Model added to the previous version of the base erosion test. First, provisions regarding persons benefitting from special tax regimes or from notional interest deductions were inserted into the test (discussed below). Second, the test is stricter now because it takes into account both the deductible payments made by the person claiming treaty benefits and also deductible payments made by persons in the same fiscal group ('tested group'). A tested group refers to companies that are participating in a group taxation regime together with the company that claims treaty benefits, under which they either share their profits and losses or only their losses.[31] In other words, the new base erosion test scrutinizes more persons (payers and payees) and, in turn, more types of payments.

As regards the term 'special tax regimes', one of the main novelties of the 2016 US Model in general, with relevance beyond just the LOB, is the introduction of this notion. The provisions on 'special tax regimes' are intended to target cases of double non-taxation whereby a taxpayer makes use of benefits provided by a tax treaty, combined with the exploitation of special tax regimes in its country of residence, to pay no or very low tax in either Contracting State. According to the US Treasury, it is inappropriate to reduce US statutory withholding tax rates on deductible US source payments when the corresponding income is not subject to tax or is subject to very low tax in the treaty partner state. As the Preamble to the

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30 The wording of the carve-out under the headquarters company test of Art. 22(5)(f) is: 'but not including arm's length payments in the ordinary course of business for services or tangible property *or payments in respect of financial obligations to a bank that is not a connected person with respect to such company*' (emphasis added). By comparison, see the wording of the carve-outs under the subsidiary of a publicly-traded company test and the ownership and base erosion test of Art. 22(2)(d)(ii) and (f)(ii) respectively: 'but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions'.

31 *2016 US Model*, *supra* n. 1, at Art. 22(7)(g).

2016 US Model explains, this could also give an advantage to companies with foreign parent companies over companies with US parents, which cannot engage in such base eroding transactions.[32] As a response to these tactics, the new provisions on special tax regimes deny certain treaty benefits to companies benefitting from preferential tax regimes in their state of residence. In particular, such companies cannot avail themselves of the withholding tax reduction under the treaty for deductible related-party payments of interest and royalties (and certain guarantee fees, which fall under Article 21 of the Model). These consequences are set out in Article 11 and Article 12 of the US Model, whilst the definition of special tax regimes can be found in Article 3(1)(l) amongst the General Definitions.

The definition in Article 3(1)(l) considers a special tax regime any laws, regulations or administrative practice which result in a lower rate of taxation or a permanent reduction in the tax base with respect to interest, royalties or guarantee fees as compared to the taxation of income from sales of goods and services or which provide such benefits with respect to substantially all of the income of offshore companies (i.e. companies that do not carry out active trade or business in the Contracting State of which they are resident). There is one exception in the case of royalties: preferential regimes for royalties fall under the definition only in the case where the preferential treatment of such income is not conditional upon the extent of research and development activities carried out in the state offering the preferential regime. This provision is intended to carve out from the definition those intellectual property (IP) box regimes which conform to the 'modified nexus approach' agreed under BEPS Action 5.[33] In order to be considered a special tax regime, the preferential treatment of the above-mentioned income should result in a tax rate which is less than the lesser of either 15% or 60% of the general statutory tax rate for corporate income tax applicable in the state concerned. This numerical approach is in line with the US preference for specific anti-abuse rules, which seek to create an objective measurable standard for detecting these special tax regimes. Lastly, there is a carve-out: preferential regimes which principally apply to pension funds, charitable organizations, collective investment vehicles or real estate investment trusts do not fall under the definition of special tax regimes.[34]

By comparison, the special tax regime provisions in the OECD Action 6 Final Report are defined in a more general way. Similar to the US version, the OECD definition takes into account 'any legislation, regulation or administrative practice' and takes into account reductions in the tax rate and/or in the tax base.[35] Thus, it contains the same general idea as the US version, but it uses a very different formulation. To begin, it does not provide a check list of characteristics as to what precisely constitutes a special tax regime. Instead, the OECD definition adopts a negative formulation, specifying what is *excluded* from the special tax regime provision.[36] In this way, in principle, the OECD definition covers all kinds of preferential regimes irrespective of the type of income, while the US definition is limited to preferential regimes on interest, royalty and guarantee fees that fulfil specified characteristics. However, in effect, the OECD definition also seems to be limited to these same types of income due to its exclusion of regimes 'the application of which does not disproportionately benefit interest, royalties or other income, or any combination thereof'. Other exclusions are also rather similar under the two definitions (e.g. preferential regimes for pension funds, collective investment funds, charities) but it is true that the OECD exclusions are broader. Another difference is that the OECD definition specifically mentions notional interest deduction regimes as being a special tax regime, which is not the case under the US definition. The main substantive difference, however, seems to be the lack of a tax rate indication in the OECD provision (as to which precise level taxation is deemed preferential). Finally, there is also an important procedural

Notes

32 *Preamble to the 2016 US Model*, *supra* n. 2, at 2.

33 OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (2015), http://dx.doi.org/10.1787/9789264241190-en (accessed 15 Aug. 2016).

34 As regards the procedure of identifying a regime of the other Contracting State as a special tax regime, first, a consultation is required with that state, after which the first Contracting State has to notify the other state through diplomatic channels that the regime satisfies all the conditions mentioned above and issue a written public notification.

35 *OECD Action 6 Final Report*, *supra* n. 3, at 96, para. 81.

36 *OECD Action 6 Final Report*, *supra* n. 3, at 96, para. 81: 'However, the term shall not include any legislation, regulation or administrative practice: *i*) the application of which does not disproportionately benefit interest, royalties or other income, or any combination thereof; *ii*) except with regard to financing income, that satisfies a substantial activity requirement; *iii*) that is designed to prevent double taxation; *iv*) that implements the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises); *v*) that applies to persons which exclusively promote religious, charitable, scientific, artistic, cultural or educational activities; *vi*) that applies to persons substantially all of the activity of which is to provide or administer pension or retirement benefits; *vii*) that facilitates investment in widely-held entities that hold real property (immovable property), a diversified portfolio of securities, or any combination thereof, and that are subject to investor-protection regulation in the Contracting State in which the investment entity is established; or *viii*) that the Contracting States have agreed shall not constitute a special tax regime because it does not result in a low effective rate of taxation;'.

difference, since the US definition also dictates the procedure for a state to apply this special tax regime provision.[37] For these reasons, the US provision is better for legal certainty. It is worth mentioning, though, that the OECD emphasized in its Action 6 Final Report that this special tax regime definition is a provisional formulation, which the OECD intended to review in view of the final version in the US Model. Thus, it is possible that the OECD definition will further align itself with that of the United States and will ultimately be considered 'analogous' for the purposes of the 'qualifying intermediate owner' definition (see section 2.2).

Having elaborated on the general role and definition of 'special tax regimes' in the 2016 US Model, the analysis now turns to its implications for the LOB. In addition to its relevance for the 'qualifying intermediate owner' definition, the provisions on special tax regimes have implications for the base erosion tests. In particular, deductible payments made to persons benefitting from special tax regimes are taken into account in the calculation of the proportion of the gross income paid to tainted payees. The same applies to payments of interest made to beneficiaries that are entitled to notional interest deductions. Although regimes providing for notional interest deductions have been removed from the definition of special tax regimes in the final version of the 2016 US Model,[38] they have consequences that are similar to those of special tax regimes in the context of the LOB clause in that persons benefitting from notional interest deductions are regarded as tainted payees. The only difference is that payments to such tainted payees will disqualify the payer for treaty benefits only with respect to interest income.

These special tax regime provisions under the LOB clause can be explained by the same tax policy considerations as the denial of the withholding tax reduction on related-party interest and royalty payments, i.e. preventing double non-taxation. If the company claiming treaty benefits were allowed to shift its income through deductible payments to persons that are not taxed or taxed at very low rates on the income, the income could escape taxation in all the states concerned. The source state would allow a deduction on the payment of the income and would grant a withholding tax reduction or other treaty benefit for it, while the residence state would not tax the recipient, since the recipient would make a deductible payment and pass the income on to a payee that is *also* not taxed due to a special tax regime.

Despite being a significant legal innovation in the 2016 US Model and despite its prevalence throughout the LOB clause, appearing in all of the base erosion tests, it seems that the addition of the 'special tax regime' rules will not ultimately have serious practical consequences, at least under the three tests of the LOB clause discussed here. Indeed, when analysing which types of payees would be affected by the 'special tax regime' rules under the base erosions tests of (1) subsidiaries of publicly-traded companies, (2) companies qualifying under the ownership and base erosion test or (3) headquarters companies, the practical impact seems very limited. First, payments to non-residents are generally not allowed under the base erosion tests (as was also the case under the old version of the test). Thus, a payment to a person benefitting from a special tax regime must necessarily be a payment to another resident. Moreover, the resident can only be an individual, a Contracting State or its subdivision, a pension fund or non-profit organization or a publicly-traded company, as other residents, namely a subsidiary of a publicly-traded company and a company which qualifies under the ownership and base erosion test, are already tainted payees (under both the new and the old version of the test). An individual or the government will hardly be able to benefit from a special tax regime of the kind that is at issue here. Pension funds and other tax exempt entities are carved out from the scope of persons who can benefit from special tax regimes. This leaves only publicly-traded companies. Thus, it seems that the only scenario in which the claimant would be disqualified due to the special tax regime provisions is: the very specific scenario of deductible payments, which represent 50% or more of the claimant's gross income, made to a publicly-traded company that is connected to the company claiming the treaty benefits, and that is resident in the same state as the claimant but that benefits from a special tax regime in the very same state. How often such scenarios will arise in practice is uncertain.

In addition to the similarities between these three base erosion tests discussed so far, there are also a few differences between the base erosion tests applicable to subsidiaries of publicly-traded companies, companies under the ownership and base erosion test and headquarters companiments that, though deductible, are not taken into account as base eroding payments in the application of the test. As mentioned above, in the

Notes

[37] *2016 US Model*, *supra* n. 1, at Art. 3(1)(l)(v): 'after consultation with the first-mentioned Contracting State, has been identified by the other Contracting State through diplomatic channels to the first-mentioned Contracting State as satisfying clauses (i) through (iv) of this subparagraph. No statute, regulation or administrative practice shall be treated as a special tax regime until 30 days after the date when the other Contracting State issues a written public notification identifying the regime as satisfying clauses (i) through (v) of this subparagraph;'.

[38] *See Preamble to the 2016 US Model*, *supra* n. 2, at 3. It was originally planned that notional interest deductions would be included in the definition of special tax regimes in Art. 3, but they were removed from Art. 3 in the final version of the US Model. Instead, notional interest deductions are mentioned alongside special tax regimes each time it appears in the LOB provisions.

base erosion test for headquarters companies, not only are arm's length payments in the ordinary course of business for services or tangible property carved out from the test but also payments in respect of financial obligations to a bank that is not a connected person with respect to the company claiming treaty benefits.[39] The fact that deductible payments to an unrelated bank are not taken into account as base eroding payments is an acknowledgment of the functions of a headquarters company, which frequently requires taking out loans from a bank in order to finance acquisitions. This ensures that a headquarters company can obtain financing either at home or abroad, wherever the best loan conditions are offered. However, as discussed above, it is rather inexplicable why this specific carve-out applies only to headquarters companies and *not* to subsidiaries of publicly-traded companies and to companies under the ownership and base erosion test.[40] Payments to unrelated banks, provided they are at arm's length, should not exclude companies from treaty benefits, especially taking into account that base erosion through interest payments can be fought by way of other anti-abuse rules that are present in many domestic laws, such as thin capitalization or general interest deduction limitation rules.

Compared to the 2006 version of the base erosion test, a new element regarding the scope of carved out payments is that, in the case of a tested group, intra-group transactions are also not taken into account as base eroding payments. In this way, the addition of the tested group provisions to the base erosion test simultaneously narrows the test and broadens it. On the one hand, payments made within the tested group are not counted as base eroding payments, thereby narrowing the test and making it more flexible. On the other hand, as mentioned above, the test now scrutinizes not only the payments made by the company claiming benefits but also the payments made by its fellow group members, thereby broadening the test and making it stricter.

A more conspicuous difference between the various base erosion tests discussed above is that specifically, and only, in the case of a subsidiary of a publicly-traded company, benefits under Article 10 of the Model are *not* subject to the base erosion test. In other words, if such subsidiary claims treaty benefits with regard to dividends received, it does not have to prove that it passes the base erosion test, i.e. it does not have to prove that it pays less than 50% of its gross income to tainted payees. The base erosion test applies to all other treaty benefits. The question arises as to what could be the reason for carving out Article 10. It could be related to two different factors: the tax treatment of dividends in connection with the obligations of a publicly-traded company to pay out dividends to its ultimate shareholders. First, with respect to the dividends, there is less of a concern of base erosion in the source state as they are generally paid out of after-taxed profits and are not deductible. Also, once the dividends arrive in the residence state, in most cases this income will benefit from a participation exemption[41] and thus will not be taxed in the residence state. Therefore, in the case of dividends, the goal of the base erosion test, which is to ensure that the income which benefitted from a treaty-based reduction of tax in the source state is taxed in the residence state, cannot generally be achieved. Second, in any case, the risk of base erosion is perhaps decreased by the fact that the publicly-traded owner is more likely to require that most of the income is in fact passed on in the form of dividends, as it has its obligations to distribute income to its ultimate shareholders.

### 3.2.2 *The Base Erosion-Leg of the Derivative Benefits Test*

Compared to the base erosion tests applied for the purposes of the previous provisions, the base erosion test under the derivative benefits clause takes a rather different form. Basically, under this test, not all payments made to third-country residents are *per se* restricted. Payments to third-country residents that are equivalent beneficiaries are allowed, i.e. such payments will not be regarded as tainted (the definition of equivalent beneficiary will be discussed in detail in section 4.2.4). As explained by other commentators, the derivative benefits test is not concerned with whether or not the person claiming treaty benefits is taxed in the other Contracting State, since base erosion that could wipe out all the taxable income in that state is tolerated (as long as the income ends up in the hands of an equivalent beneficiary).[42] Instead the test is solely concerned with whether more treaty benefits are being

*Notes*

[39] The term 'connected persons' is defined under the General Definitions in Art. 3 (1)(m). It refers to a situation when one person owns, directly or indirectly, at least 50% of the aggregate vote and value of the shares in the other, or another person owns, directly or indirectly, such a stake in each person. However, the definition adds that, in any case, such a relationship exists if, based on all the relevant facts and circumstances, one person has control of the other or both are under the control of the same person.

[40] To see the different wording of the carve-outs under these three base erosion tests, *supra* n. 30.

[41] In the United States, this would be referred to as a 'dividend received deduction', according to 26 U.S. Code § 243.

[42] Rosenbloom, *supra* n. 27, at 652.

requested from the source state than would be the case if the investment had been made directly by the equivalent beneficiary.

As the derivative benefits test was not included in the previous US Model, it is worth comparing the base erosion-leg of this new test in the 2016 US Model with the OECD Action 6 proposal. Under the provision proposed by OECD Action 6, only payments to non-equivalent beneficiaries are restricted. In other words, there is no limit on the amount paid to equivalent beneficiaries, meaning that technically the residence state's tax base could be eroded to zero as long as it is in favour of equivalent beneficiaries.[43] The 2016 US Model tightens the nozzle on some of this outflow with much more detailed rules regarding tainted payees. There are now four categories of persons to whom tax-deductible payments may be deemed problematic. In addition to non-equivalent beneficiaries, now, even certain persons who are indeed equivalent beneficiaries are excluded, seemingly because they present too great a risk of unacceptable base erosion. These new tainted payees include:

(1) persons that are equivalent beneficiaries but only by reason of fulfilling the headquarters company requirements,

(2) equivalent beneficiaries that are deemed connected to the company claiming benefits and that benefit from a special tax regime and,

(3) in the specific case of interest payments, equivalent beneficiaries deemed connected to the company claiming benefits and that benefit from certain notional deductions.

As can be seen, there is some symmetry with other base erosion tests with regard to adding the beneficiaries of special tax regimes as tainted payees. However, it has to be emphasized that, in contrast to the other base erosion tests, in the derivative benefits test these special tax regime provisions are likely to have greater practical relevance. As equivalent beneficiaries can be, and in most cases are, residents of third states, it is more plausible that they benefit from a special tax regime in that third state than companies that are residents of the *same* state as the company claiming treaty benefits. To recall, the other base erosion tests (i.e. under the subsidiary of a publicly-traded company test, the ownership and base erosion test and the headquarters company test) assume a scenario wherein the recipient of the payment benefits from a special tax regime while being a resident of the *same* state as the company claiming treaty benefits where, at the same time, the company claiming treaty benefits is not entitled itself to such a special tax regime. This is rather unlikely to occur in practice, as opposed to the case where an equivalent beneficiary that is resident in a third state benefits from a special tax regime in its state of residence. On the other hand, under the base erosion-leg of the derivative benefits test too, the scope of equivalent beneficiaries that can be recipients of the sort of deductible payments covered by the test is limited to the same type of persons as mentioned above, i.e. individuals, a Contracting State or its subdivisions, non-profit organizations or pension funds, or publicly-traded companies, which again leaves publicly-traded companies as the most likely equivalent beneficiaries that could be disqualified because of the provisions on special tax regimes.

### 3.3 *Direct and Indirect Base Eroding Payments*

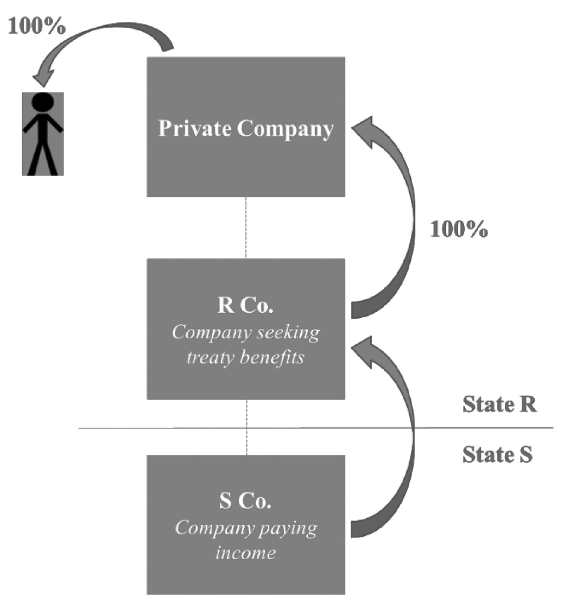
As regards all the variations of the base erosion test, a common interpretation difficulty may arise and has not been resolved in the 2016 US Model. The test takes into account amounts paid both 'directly or indirectly' to tainted payees. How exactly to trace such indirect payments is unclear.[44] In addition, the literal interpretation of this wording of the base erosion test leads to an ambiguous result when deductible payments are made directly to a tainted payee (to an extent which would disqualify the company claiming treaty benefits) and then paid onward, indirectly, to other persons who are non-tainted payees (which would not justify such disqualification). Figure 4 below demonstrates such a situation. Technically, the claimant in this situation could either qualify for or be denied treaty benefits depending on whether the 'direct' or the 'indirect' payment is taken into account when applying the base erosion test. In this case, 100% of the income of the company seeking treaty benefits is paid out directly to another resident company that is a tainted payee, as it is not within the specific categories of qualified persons (i.e. individuals, a Contracting State or its subdivisions, non-profit organizations or pension funds, or publicly-traded companies) to whom payments are allowed. However, the entire payment is passed on and thus received indirectly by an individual resident in the state of the company seeking treaty benefits who is a non-tainted payee. In this case, a teleological interpretation of the provision should lead to the result of granting treaty benefits to this legitimate arrangement where the ultimate beneficiary of the payment is a qualified person under the LOB clause.

**Notes**

[43] *See*, e.g. Rosenbloom, *supra* n. 27, at 650, analysing the US-Hungary DTC.

[44] *See* Szudoczky & Koch, *supra* n. 11, at 238. *See also* Rosenbloom, *supra* n. 27, at 650.

*Figure 4*




## 4 Two new tests

### 4.1 Headquarters Company Test

#### 4.1.1 Overview of the Headquarters Company Test

Companies that are solely dedicated to performing the headquarters functions for an MNE usually cannot qualify under the LOB clause because they do not meet the conditions under the ownership and base erosion test, nor under the active trade or business test. In a multinational corporate structure, they may very well be owned by ultimate shareholders residing elsewhere which disqualifies them under the ownership test. Their typical functions, i.e. management, supervision, coordination and provision of group-wide corporate services, do not allow them to qualify in their own right under the active trade or business test.[45] It is true that they might still qualify under the latter test if they have a subsidiary in the same country which is able to pass the active trade or business test.[46] Some protocols of US treaties include an example which shows that a headquarters company can qualify under the LOB clause in this way.[47] However, countries which are home to many headquarters companies may instead prefer a separate headquarters company test, so that headquarters companies can qualify regardless of whether they have a subsidiary in the country as well.[48] Also, from the perspective of MNEs, the use of headquarters companies is a legitimate way of structuring their international operations. These companies perform important management, administrative and coordination functions and, therefore, should not be automatically regarded as a means to engage in treaty shopping. The necessity of having a subsidiary in the same country which qualifies under the active trade or business test could prove to be rather restrictive, especially in a region with quite small countries, as Europe. In order to avoid situations where a legitimate structure with a headquarters company fails to qualify under the LOB clause, a separate test for these companies should, therefore, be included. The difficult question is, of course, how to design such a provision so that it grants benefits to genuine headquarters operations without becoming vulnerable to abuse.

While the 2006 US Model did not include a headquarters company test, some treaties concluded by the United States since the 1990s, mainly with European countries, contain a separate test for such companies.[49] Now the headquarters company test has made its way into the 2016 US Model.[50] There are some differences, however, between the test in the new US Model and the tests which can be found in bilateral tax treaties. Compared to the already existing provisions, the most important differences include: the fact that the scope of the test is limited to only dividends and interest; the meaning of the term ‘primary place of management and control’; the impact of the new ‘qualifying intermediate owner’ test (as discussed in section 2.2); and the inclusion of a base erosion test in the headquarters company test (as mentioned above in section 3.2.1).

As regards the drafting technique, the 2016 US Model version of the headquarters company test has learned from and improved upon previous attempts to formulate these tests in bilateral tax treaties. In older treaties, such as the ones with Austria and Switzerland, the relevant provision

Notes

45 *2016 US Model*, *supra* n. 1, at Art. 22(3)(a): ‘The term “active conduct of a trade or business” shall not include the following activities or any combination thereof: 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, insurance company or registered securities dealer in the ordinary course of its business as such.’ *See also Technical Explanation to the 2006 US Model*, *supra* n. 7, at Art. 22, 69: ‘Because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business for purposes of paragraph 3.’ For a further analysis on the headquarters test in the US-Austria DTC, *see* J. Schuch & G. Toifl, *Der ‘headquarters’ Test als Voraussetzung für die Abkommensberechtigung*, in *Das neue Doppelbesteuerungsabkommen Österreich-USA*, at 135 et seq. (Gassner, Lang & Lechner eds, Vienna: Linde 1997).

46 *See 2016 US Model*, *supra* n. 1, at Art. 22(3)(c).

47 *See* Example III in the Memorandum of Understanding to the US-Austria DTC (1996). The same example can also be found in the US-Finland DTC (1989).

48 *See* Bates et al., *supra* n. 27, at 396.

49 EU treaties: US-Netherlands DTC (1992), US-Austria DTC (1996), US-Belgium DTC (2006), US-Hungary DTC (2010, not in force), US-Poland DTC (2013, ratified – not applicable); non EU-treaty: US-Switzerland DTC (1996).

50 *2016 US Model*, *supra* n. 1, at Art. 22(5).

of the LOB clause simply states that 'a recognized headquarters company for a multinational corporate group' can be a qualified person under the LOB clause,[51] whilst the conditions under which a company can be regarded as such are included in the Memorandum of Understanding of each treaty and not in the provision itself.[52] Other treaties include extensive conditions already in the provision itself which have to be met in order to qualify under the headquarters company test.[53] The 2016 US Model has opted for the latter approach. The conditions for the headquarters test can be found in the treaty itself, which is a clearer and therefore more transparent way of structuring the requirements.

### 4.1.2 *The Conditions for the Application of the Headquarters Company Test*

In order to fall under the headquarters company test, a company has to fulfil several requirements. First, the company must have its primary place of management and control in the residence state. Second, the multinational corporate group that the company heads must consist of companies which are actively doing trade and business in at least four countries[54] and, in each country, generate at least 10% of the gross income of the group. This 10% requirement is motivated by the need to prevent the circumvention of this test by simply setting up non-operating subsidiaries, which can often be done quickly and inexpensively, in different countries. While this makes sense, problems can arise due to relative and absolute differences in the sizes of the economies in question. For example, it could be difficult for a Danish headquarters company to have 10% of its gross income coming from each of the countries where it operates if those countries include both big and small countries, e.g. Germany, Austria, Czech Republic and Switzerland.[55] Third, less than 50% of the group's income should be generated in any one country outside the country of residence of the headquarters company. Indeed, if the business carried on in one of the other countries reaches a level of generating 50% or more of the gross income, such substantial operations are likely to require management activities and decisions to be taken in that country, which could indicate that the headquarters functions are not, in fact, exercised in the country which is claimed to be the headquarters jurisdiction. Fourth, no more than 25% of the gross income is generated in the other Contracting State. From the perspective of the United States as the 'other Contracting State', i.e. the source state from which treaty benefits are claimed, this provision seems to be motivated by the need to ensure that the United States is far from being the main market, which could be an indication that, in reality, it is historically a US company. This could prevent the temptation to simply switch, or invert, the location of the headquarters company to a lower-tax jurisdiction, even though in reality it is historically an American company with most of its business and operations there. Furthermore, the headquarters company must be subject to the same income taxation rules as companies which carry out active trade and business in its country of residence. This would exclude companies which already benefit from favourable income taxation. Inserting this requirement prevents the granting of a probable 'double' benefit – i.e. special income taxation and treaty access. For these first four requirements, the US Model has largely based itself on existing treaties. However, what is new in the 2016 US Model is that, in addition to all these requirements, the headquarters company has to fulfil a base erosion test. Even if a headquarters company meets all these requirements, treaty benefits are only granted with respect to dividends and interest income derived by the headquarters company (as will be discussed in the next section). Moreover, it has to fulfil a 'primary place of management and control' test (as will be discussed in section 4.1.2.2).

To sum up, in order to meet this test, a headquarters company as well as the multinational corporate group has to fulfil certain requirements regarding the geographical spread of the group, the proportion of income generated in the different countries where it operates, and the types of activities which generate that income.

#### 4.1.2.1 Treaty Benefits Restricted to Dividends and Interest

In the former versions of the headquarters company tests found in various treaties with European countries, treaty

**Notes**

[51] *See* US-Austria DTC (1996), Art. 16(1)(h) and US-Switzerland DTC (1996), Art. 22(1)(d).

[52] The Memorandum of Understanding is part of the treaty and has, therefore, the same legal status. *See* Lang, *Die Besonderheiten der Auslegung des DBA Österreich-USA*, in *Das neue Doppelbesteuerungsabkommen Österreich-USA,* at 35 et seq. (Gassner, Lang & Lechner eds, Vienna: Linde 1997).

[53] *See* US-Netherlands DTC (1992), Art. 26(5); US-Hungary DTC (2010, not in force), Art. 22(5); US-Belgium DTC (2006), Art. 21(5); US-Poland DTC (2013, ratified – not applicable), Art. 22(5).

[54] In former versions active trade or business was required in five countries. *See* e.g. US-Netherlands DTC (1992), Art. 26(5); US-Hungary DTC (2010, not in force), Art. 22(5); US-Belgium DTC (2006), Art. 21(5); US-Poland DTC (2013, ratified – not applicable), Art. 22(5).

[55] E.g. imagine that the Danish multinational group sells t-shirts. In each jurisdiction, it can sell 1 t-shirt per 10,000 of population. Therefore, it has the same market penetration in each jurisdiction. In Germany, therefore, it can sell approximately 8,000 t-shirts (approximately 75%). In Austria, it could sell only approximately 850 (approximately 8%). In the Czech Republic, it could sell only approximately 1,000 (approximately 9.4%). In Switzerland, it could sell only approximately 830 (approximately 7.7%). This example demonstrates how an MNE with the correct amount of geographic dispersion could fail this 10% gross income requirement, despite having an active business and an equivalent market penetration in all the countries concerned. (In addition, it also fails the requirement according to which none of the operating subsidiary jurisdictions should generate 50% or more of the gross income of the group.)

entitlement was not limited to specific items of income.[56] The new version in the 2016 US Model, however, limits the treaty benefits to dividends and interest provided that the headquarters company fulfils all other requirements.[57] This does not seem to be particularly problematic, because one main duty of a headquarters company often is to administer different shareholdings and intra-group financing. Thus, dividends and interest will likely be the most important part of the company's income. However, managing shareholdings and investments also means that this company has to buy and/or sell shareholdings on a regular basis. Therefore, it could be problematic that capital gains (Article 13 OECD Model and US Model) realized by a headquarters company would not be eligible for treaty benefits.

Furthermore, the new test can only be applied if the dividends and interest are paid by members of the multinational group of the headquarters company. If for any reason the headquarters company also received interest or dividends from companies outside of its multinational group, this income would not benefit under the test. These limitations, however, can be justified by the fact that the headquarters company test is designed to allow these companies to benefit from a tax treaty only for that part of the income which they receive for their role as a headquarters company. For other benefits, the headquarters company would likely have to rely on the active trade or business test.[58]

The benefits of this provision are further curtailed by allowing the source state to apply a minimum withholding tax on interest paid to headquarters companies. This can be found in Article 11(2)(f), which stipulates that the source state may tax such interest up to 10%. Generally, under the US Model, there is no withholding tax on interest in the source state. However, if a company qualifies under the headquarters company test, then a maximum of 10% withholding tax can be levied on the interest paid to that company (provided, of course, that the domestic law of the source state imposes a tax on such interest). According to the preamble to the 2016 US Model, this aligns the treatment of such interest with that of the OECD Model.[59] However, this raises the further question as to why this alignment with the OECD Model is relevant and why it only comes into play in the case of interest received by a headquarters company.

#### 4.1.2.2 Primary Place of Management and Control

One condition under the headquarters company test is that the company claiming benefits under this test must have its 'primary place of management and control [ … ] in the Contracting State of which it is a resident'.[60] The term 'primary place of management and control' is not new within the LOB clause. What is new is expanding it to the headquarters company test and expanding the scope of its definition. Previously, the term could be found in Article 22(2)(c) of the 2006 US Model under a different LOB test, namely the publicly-traded company test.[61] In the context of the publicly-traded company test, the Technical Explanations to the 2006 US Model gave the following interpretation of the term:

> The company's primary place of management and control will be located in the State in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries) in that State than in the other State or any third state, and the staff that support the management in making those decisions are also based in that State. Thus, the test looks to the overall activities of the relevant persons to see where those activities are conducted.[62]

The term primary place of management and control has a different meaning than that of 'effective place of management' used in the OECD Model. As emphasized by the Technical Explanations to the 2006 US Model, the latter is often understood as referring to the place where the highest level management body makes its decisions, whilst primary place of management and control refers to the place of day-to-day management activities.[63]

In the 2016 version of the US Model an additional requirement has been added to the definition of 'primary place of management and control'. The 2006 explanation emphasized the question of where, or in which state, the management

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[56] *See* e.g. US-Netherlands DTC (1992), Art. 26(5): 'A person that is a resident of a State shall also be entitled to *all* the benefits of this Convention otherwise accorded to residents of a State if that person functions as a headquarters company for a multinational corporate group and that resident satisfies any other specified conditions for the obtaining of such benefits' (emphasis added).

[57] In some treaties, the entire LOB is restricted to these types of income. *See* Bates et al., *supra* n. 27, at 396. However, such restriction has the opposite effect: if the *entire* LOB is restricted to certain articles of the treaty, this actually gives more treaty entitlement to taxpayers, because the LOB is only scrutinizing those types of income, whereas if only one test of the LOB, which is intended to grant treaty benefits, is restricted in such a way, it actually limits the benefits to only those types of income.

[58] This is the view of the US Treasury Department. *See Preamble to the 2016 US Model*, *supra* n. 2, at 7.

[59] *See Preamble to the 2016 US Model*, *supra* n. 2, at 7.

[60] *2006 US Model*, *supra* n. 14, at Art. 22(5)(a).

[61] *2006 US Model*, *supra* n. 14, at Art. 22(2)(c)(i)(B).

[62] *Technical Explanation to the 2006 US Model*, *supra* n. 7, at 66.

[63] *Technical Explanation to the 2006 US Model*, *supra* n. 7, at 66 et seq.: '[the primary place of management and control] should be distinguished from the "place of effective management" test which is used in the OECD Model and by many other countries to establish residence. In some cases, the place of effective management test has been interpreted to mean the place where the board of directors meets. By contrast, the primary place of management and control test looks to where day-to-day responsibility for

functions were performed. The new definition examines not only in which state the relevant management functions are performed, but also which company's staff in fact does the main part of those functions in relation to other companies' staff members.[64] In other words, in order to fulfil both requirements, it has to be the case that, first, the relevant functions are performed more in the headquarters state than in any other state and, second, the relevant functions are performed more by the employees of the headquarters company than by the employees of any other company in the group.

Adding this second component reinforces the need for substance at the level of the headquarters company. This is also not entirely new. The origin of this 'workload comparison' requirement can be found in existing treaties that include a headquarters test. In older treaties, the headquarters company test did not use the term primary place of management and control, but rather sought to determine the place where the 'substantial portion of the overall supervision and administration of the group'[65] was exercised. This substantial portion had to be performed more by the headquarters company in relation to other companies.[66] The new version of the headquarters test, therefore, still requires a substantial portion of the relevant decisions to be made by the headquarters company, but this 'workload comparison' between companies has simply been incorporated into a new version of the definition of 'primary place of management and control'. In sum, the 2016 US Model concept of 'primary place of management and control' seems to combine together relevant requirements from the 2006 US Model publicly-traded companies test[67] and from existing tax treaties' headquarters company tests into a unified and strengthened concept that can now be applied more consistently throughout the LOB, both to the publicly-traded companies test and to the headquarters company test alike.

In addition, this combination has resulted in an expansion of the scope of the management functions. In comparison, former versions of the headquarters company tests in older treaties only required supervision and administration functions to be exercised. Under this new definition, due to its fusion with the requirements for publicly-traded companies, now the day-to-day responsibility regarding strategic, financial and operational policy decision-making has to be exercised by the employees of the headquarters company. Therefore, the new test requires the headquarters company to have a more extensive management function than before.[68] Changing this requirement is in line with the general objective of the LOB clause, namely to fight against treaty shopping. As headquarters companies could easily be incorporated as letter-box companies without any significant functions, this change enables the provision to better detect whether there is sufficient substance.

In sum, the 2016 US Model offers this new opportunity for headquarters companies to qualify under the LOB clause; however, it comes with a number of significant limitations. An explanation could be that the US Treasury Department still believes that the active trade or business test is a more appropriate way for headquarters companies to qualify under the LOB clause.[69] The OECD seems to hold a similar view, as the OECD Action 6 proposal does not currently include a headquarters company test.

## 4.2 *Derivative Benefits Test*

### 4.2.1 *Overview of the Derivative Benefits Test*

The derivative benefits test acts as a safeguard against the strict qualified persons tests, in particular the ownership and base erosion test. As explained above, this latter test, in essence, leads to a presumption of treaty shopping if a company is majority-owned by third-country residents. The derivative benefits test, on the other hand, recognizes that third-country residents may have legitimate 'bona fide' business reasons for investing in a Contracting State and should not automatically be presumed to be treaty shopping. Therefore, under the derivative benefits test, a company that is majority-owned by third-country residents may nevertheless be entitled to 'derivative' treaty benefits for an item of income if its owners and payees would be entitled to equivalent benefits had they received the income in question directly, rather than through the interposed company. The purpose is to sift out those third-country residents who are 'equivalent beneficiaries' by virtue of being entitled to equal (or better) benefits, thereby ruling out treaty shopping as their motive.

The addition of a derivative benefits test is one of the most visible changes to the 2016 US Model LOB article, as this test is a lengthy, complex, multi-step objective provision. It now constitutes the new paragraph 4 of Article 22 of the 2016 US Model (in conjunction with its accompanying definitions in

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the management of the company (and its subsidiaries) is exercised.' It should be noted that the OECD proposes to replace the place of effective management as a tie-breaker rule with a mutual agreement procedure. *See OECD Action 6 Final Report*, *supra* n. 3, at 72.

64 *2016 US Model*, *supra* n. 1, at Art. 22(7)(d).

65 *See* e.g. US-Netherlands DTC (1992), Art. 26(5)(a).

66 For further details regarding the comparison element, *see* Schuch & Toifl, *supra* n. 45, at 140 et seq.

67 *2006 US Model*, *supra* n. 14, at Art. 22(5)(d), and *Technical Explanation to the 2006 US Model*, *supra* n. 7, at 66 et seq.

68 *Preamble to the 2016 US Model*, *supra* n. 2, at 7: '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 geographically diverse subsidiaries'.

69 *See Preamble to the 2016 US Model*, *supra* n. 2, at 7.

paragraph 7). This represents a notable evolution in US tax treaty policy. Although a derivative benefits test has appeared in tax treaties in practice, it has hitherto not been fully endorsed as US tax treaty policy and thus has never been officially incorporated in the US Model.[70] Rather, it has been seen as a compromise that the United States makes vis-à-vis its treaty partner, most often with European Union Member States who regard the inclusion of a derivative benefits test as a prerequisite for the compliance of the LOB article with the European Union (EU) fundamental freedoms.[71] The influence of this test is now apparent, as the OECD also included a tentative derivative benefits provision in its proposed LOB article.[72] Yet, throughout the evolution of Action 6 (from the 2014 Deliverable to the 2015 Final Report), this provision has remained in brackets. This is an indication that the inclusion of derivative benefits remained provisional. This may, possibly, no longer be the case now that the 2016 US Model has incorporated this test and a derivative benefits test is included in the Multilateral Instrument;[73] it may now have a fixed place in all future LOB clauses.

The version that is now incorporated in the 2016 US Model contains new unique features as compared to any other (current or previously existing version of the) derivative benefits test. For comparison purposes, reference will be made to the 'detailed' derivative benefits test of the LOB of the OECD Action 6 Final Report, especially because the detailed OECD version embodies the rules and structure of most existing tax treaties' provisions (with some modifications). Also, to better understand the derivative benefits test, it is worth briefly discussing its inherent trade-offs. This will shed light on the reasons it has not to date been recognized as official US tax treaty policy and the reasons it has been kept in brackets in the OECD's proposals. Also, these trade-offs underpin a number of the changes found in the new version of the test in the 2016 US Model. To begin, in a sense, this test undermines the principle of reciprocity of the tax treaty.[74] Indeed, it is clear that a derivative benefits test expands the granting of treaty benefits, intended for the residents of the two Contracting States, to residents of third states. On the other hand, it attempts to do so in a narrowly framed manner that only grants the benefits if the presumption that the third-country residents are treaty shopping can be ruled out, thus keeping in line with the overall objective of the LOB clause to prevent treaty shopping.

One concern is that derivative benefits provisions give rise to 'unacceptable' base erosion risks.[75] For instance, it is possible that interest payments, which are deductible in the source state, thereby reducing the tax base there, are made to the residence state, only to be passed onward through the residence state and to equivalent beneficiaries in foreign countries under the derivative benefits test. The new 'special tax regimes' provisions, which focus on certain deductible payments, will alleviate some of these objections. Concerns of base erosion can also be allayed by other means, such as interest deduction limitation rules under domestic law.

The derivative benefits test is also criticized for opening the door for third-country residents to benefit from more favourable domestic law regimes, e.g. lower corporate income tax rates, beneficial IP box regimes for royalties, among others.[76] In this regard, it has to be noted that the LOB clause targets treaty-benefit-shopping and therefore is not designed to counteract all forms of domestic-benefit-shopping.

Overall, beyond maintaining reciprocity and strict bilateralism, tax treaties are concluded for the primary purpose of facilitating international trade. This latter objective could be undermined if legitimate multinational structures are denied benefits by virtue of third-country ownership. A strictly bilateral view is too narrow given the global economic reality of taxpayers with businesses spanning many countries. The US Treasury Department expressly recognized this as a reason for including the derivative benefits test, as well as the headquarters company test, for the first time.[77] The derivative benefits test is probably the clearest example of an attempt to strike a balance between the competing objectives of tax treaties.

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70 For further information on the evolution of the US approach to derivative benefits provisions, *see* M.C. Bennett et al., *A Commentary to the United States-Netherlands Tax Convention*, 21(4/5) Intertax, at 203–204 (1993).

71 *See*, e.g. New York City Bar, Committee on Taxation of Business Entities, *New York City Bar Report Offering Proposals Regarding the 'Derivative Benefits' Provisions Found in the Limitation on Benefits Articles in Certain U.S. Income Tax Treaties*, at 17–18 (21 May 2008) [hereinafter New York City Bar Report]; M.C. Bennett et al., *supra* n. 70, at 195; M. J. Miller et al., *The Evolution of Limitation On Benefits, Beneficial Ownership, and Similar Rules: Recent Trends and Future Possibilities*, 37(12) Tax Mgt. Intl. J., at 5 (2008).

72 This marks a change from the OECD Commentary, whose version of the LOB article that was added during the 2003 update to the OECD Commentary on Art. 1, at paras. 20 et seq., does not include a derivative benefits test. It also marks a change from the first OECD/G20 Action 6 Art. X (LOB article) found in the earliest Action 6 Discussion Draft, released in Mar. 2014. Originally, no derivative benefits test was planned for Art. X. *See* OECD, *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Public Discussion Draft, 14 March 2014 – 9 April 2014*, OECD/G20 Base Erosion and Profit Shifting Project, at 5–7 (2014), http://www.oecd.org/tax/treaties/treaty-abuse-discussion-draft-march-2014.pdf (accessed 14 May 2016).

73 The OECD Multilateral Instrument includes a Simplified LOB clause with a simplified version of the derivative benefits test. *See* Multilateral Instrument, *supra* n. 16, at Art. 7 Prevention of Treaty Abuse, para. 11, at 11. It also offers the option for states to adopt a combination of a detailed LOB clause 'and either rules to address conduit financing structures or a principal purpose test (…)'. *See* Multilateral Instrument, *supra* n. 16, at Art. 7 Prevention of Treaty Abuse, para. 15, at 12-13.

74 For more, in general, on the US rationale of reciprocity underlying bilateral tax treaties, *see* J. Clifton Fleming, *Searching for the Uncertain Rationale Underlying the US Treasury's Anti-treaty Shopping Policy*, 40(4) Intertax, at 245–253 (2012).

75 *See* OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2014 Deliverable*, at 54, para. 61 (OECD Publishing 2014), http://dx.doi.org/10.1787/9789264219120-en (accessed 15 Aug. 2016).

76 J. L. Rubinger, *Qualifying for Treaty Benefits Under the 'Derivative Benefits' Article*, 88(8) Florida Bar J., at 45 et seq. (Sept./Oct. 2014).

77 *Preamble to the 2016 US Model*, *supra* n. 2, at 4.

### 4.2.2 *Differences Between the Derivative Benefits Tests of the 2016 US Model and OECD Action 6*

The 2016 US Model derivative benefits test opens with the following wording:

> 'A company that is a resident of a Contracting State shall be entitled to a benefit under this Convention, regardless of whether the resident is a qualified person if, at the time when the benefit would be accorded, and on at least half of the days of a twelve-month period commencing or ending on the date when the benefit otherwise would be accorded:' [ … ] the company fulfils certain conditions.

Already in the first sentence of the derivative benefits test, one substantive change that can be found is a new time requirement. In the OECD version, the relevant question is whether the conditions of the derivative benefits test are met *at the moment* the benefit would be accorded.[78] In the US version, the conditions of the derivative benefits test must have been fulfilled (or will be) for at least half a year. In this way, the US version is stricter than the OECD version. It aligns the derivative benefits test with some of the qualified persons' ownership tests, which also require a half-year duration. This is an additional anti-abuse consideration, designed to prevent situations where, e.g. third-country residents increase their ownership in an intermediary company immediately before the date of an income flow solely for purposes of obtaining derivative benefits via the intermediary company.

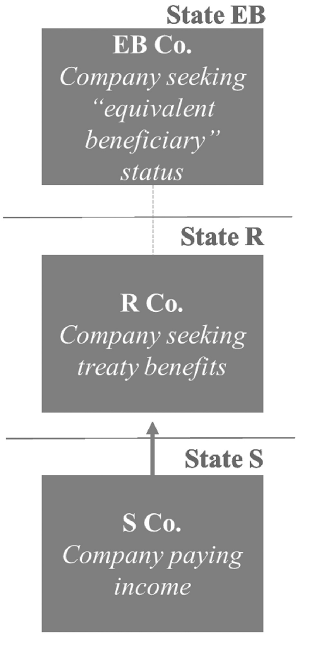
As for the conditions that the company must respect during this time period, there are a number of changes. Similar to other LOB tests (discussed above in section 2 and section 3), the derivative benefits test has been updated with new conditions for intermediate owners, changes to the base erosion test, and the special tax regime provision. In addition, other consequential modifications of the derivative benefits test in the 2016 US Model include: the new conditions for equivalent beneficiaries, a solution for the often-cited 'cliff effect', and new rules to calculate the ownership percentage deemed to be held by the equivalent beneficiary in the case of dividends.

### 4.2.3 *Conditions of the New Derivative Benefits Test*

#### 4.2.3.1 Assessment of R Co.: The Company Seeking Benefits

To begin, the scenarios to which the derivative benefits test applies will contain at least the following basic elements, as depicted in Figure 5.

*Figure 5*




A company resident in State R, R Co., earns income from S Co., a company resident in State S. R Co. is claiming treaty benefits, e.g. a reduced withholding tax rate, for this income under the S-R DTC. However, because R Co. is wholly owned by EB Co.,[79] a company resident of a third state, R Co. fails the qualified persons ownership test. For this reason, R Co. relies on the derivative benefits test to gain access to treaty benefits.

The derivative benefits test will assess the characteristics of both the company claiming benefits, R Co., as well as the owners (and payees) of this company, EB Co. At the level of the company, R Co., it applies its own tailored form of an ownership and base erosion test followed by, at the level of the owner(s), EB Co., a number of conditions to ascertain whether the owners truly are 'equivalent beneficiaries' entitled to equivalent benefits.

Under the ownership-leg of the test, R Co. must be owned at least 95% by (seven or fewer) equivalent beneficiaries. To fully carry out its purpose, the derivative benefits test would require 100% ownership by equivalent beneficiaries; however, a threshold of 95% is often stipulated to offer some leeway, to avoid disqualifying companies by reason of some small parts of ownership being held by non-equivalent beneficiaries. This ownership percentage takes into account the aggregate vote and value of the shares and it takes into account both

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[78] *OECD Action 6 Final Report*, *supra* n. 3, at 42. In the OECD Action 6 Final Report, the detailed version of the derivative benefits test, which resembles the wording of most EU-US tax conventions, begins with the following wording: '[4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if, *at the time when that benefit would be accorded*:' (emphasis added).

[79] For the purposes of this example, EB is a company, but it does not have to be. It could be an individual or any other type of person.

direct and indirect ownership. In the case of indirect ownership, each intermediate owner must be a 'qualifying intermediate owner' (see above section 2.2). The OECD, by contrast, stipulated that 'each intermediate owner is itself an equivalent beneficiary', a much stricter standard. This was highly contested in the debates on Action 6 and the United States has crafted a compromise, the significance of which will be revisited below (in section 4.2.4) as this debate is best understood in conjunction with the definition of 'equivalent beneficiaries'.

Under the base erosion-leg of test, the company, R Co., cannot pay out the majority (or even half) of its gross income as deductible payments to non-equivalent beneficiaries. As discussed above, the 2016 US Model has expanded the list of tainted payees (see section 3.2.2) in order to strengthen the base erosion test.

#### 4.2.3.2 Assessment of EB Co.: The Equivalent Beneficiary

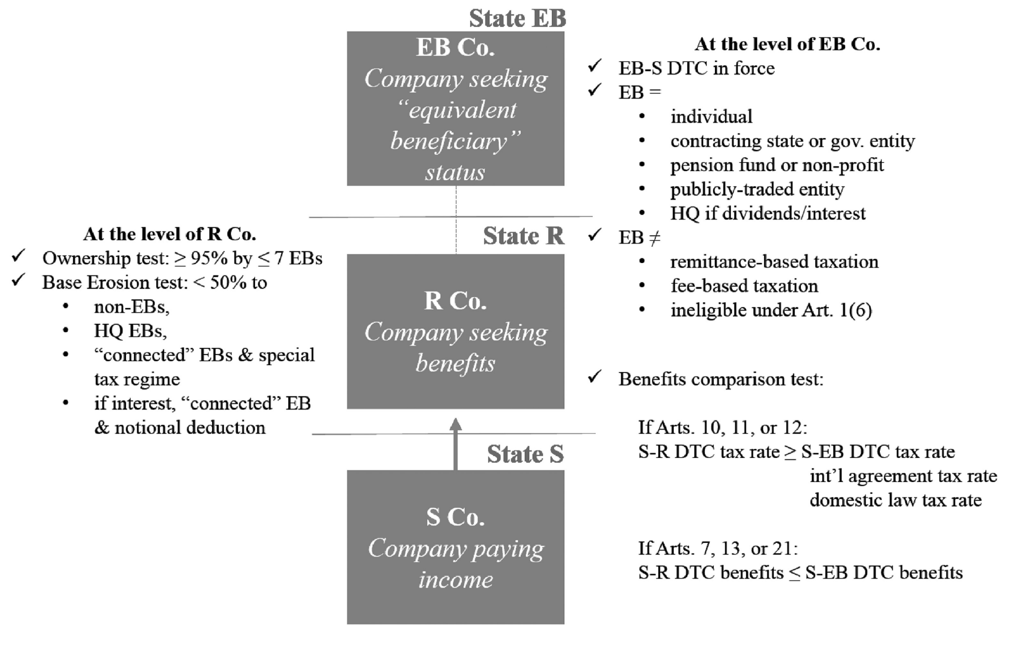
For R Co. to fulfil these ownership and base erosion tests, it is also necessary to test whether the owners (and payees) of the company, EB Co., qualify as 'equivalent beneficiaries'. The new definition of the term 'equivalent beneficiary', found in Article 22(7)(e), is more than double the size of the derivative benefits test itself and contains a number of changes as compared to the OECD Action 6 proposal. In the 2016 US Model, there are now three alterative tests for equivalent beneficiaries, expanding upon the two under the OECD proposal.

### 4.2.4 *Equivalent Beneficiary Definition*

#### 4.2.4.1 Alternative One: Location and Nature of the Equivalent Beneficiary

Under alternative (i), the main test, there are two cumulative conditions. First, the owner EB Co. (or payee) can be a resident of 'any State'[80] – thereby stipulating a worldwide territorial scope – as long as there is a 'comprehensive' tax treaty in force between that state, State EB, and the source state, State S. This worldwide territorial scope marks a change from most US tax treaties with derivative benefits tests, wherein the definition of equivalent beneficiaries is geographically restricted to those who are resident of the EU, European Economic Area (EEA) or a party to the North American Free Trade Agreement (NAFTA).[81] The shift to a worldwide territorial scope seems to be in line with the underlying logic of the derivative benefits test: what matters is whether the third-country resident is entitled to equivalent benefits, not necessarily where it is located.[82] The OECD

*Figure 6 Overview of Derivative Benefits Test in 2016 US Model*

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[80] *OECD Action 6 Final Report*, *supra* n. 3, at 51. The OECD Action 6 proposal uses the wording 'a resident of any *other* State' (emphasis added).

[81] Exceptions can be found in some non-EU tax treaties, such as the US-Canada DTC (2007) and the US-Jamaica DTC (1980).

[82] In this regard, *see* New York City Bar Report, *supra* n. 71, at 17 et seq.

Action 6 proposal also has a worldwide territorial scope. In fact, the Working Group expressly resisted the idea to draft alternatives that would be restricted to EU/EEA States 'in order to avoid giving preferential treatment to EU/EEA residents compared to residents of other States'.[83] Whether this would amount to some sort of unfair advantage for EU Member States could be debated,[84] but in any case the worldwide territorial scope now seems to be the new norm.

Second, EB Co. must be entitled to treaty benefits as an individual, a Contracting State or extension thereof,[85] a qualifying non-profit organization, a qualifying pension fund, or a publicly-traded entity. To this list, the 2016 US Model adds qualifying headquarters companies in the case of interest and dividends. In other words, EB Co. must qualify under one of these specific enumerated tests of a LOB article: it must qualify either under a LOB article in the S-EB DTC or, if there is not one, under the LOB article of the S-R DTC, assuming EB Co. were a resident under Article 4 of the S-R DTC. Moreover, the 2016 US Model provides for two new exceptions: an individual that benefits from a remittance-based taxation regime or from a fixed-fee, 'forfait'-based taxation regime cannot be an equivalent beneficiary. This is clearly a very restricted list of persons who qualify as 'equivalent beneficiaries'.

As such strict conditions apply to the equivalent beneficiary owner (EB Co.) of the company claiming benefits (R Co.), this makes the conditions for the intermediate owners, or indirect ownership, all the more important. Indeed, it is not uncommon that MNEs will be multi-layered structures with more than one level of company ownership. Thus, returning to the contentious question of intermediate owners, the OECD proposal that 'each intermediate owner is itself an equivalent beneficiary'[86] was seen by a number of businesses as far too restrictive: it is unfeasible that MNEs will have individuals or pension funds, etc. as intermediate owners, thereby rendering the derivative benefits test – intended to act as a safeguard – de facto useless for MNEs.[87] Under most (nearly all) tax treaties between the United States and EU Member States, there is no specification as to the intermediate owners.[88] This seems to be far too permissive. Thus, the 2016 US Model seems to seek a compromise between these two extremes: it does not require all indirect owners to fulfil the strict standards of 'equivalent beneficiaries' but invents a new standard of 'qualifying intermediate owners'. However, as discussed in section 2.2, the US definition of 'qualifying intermediate owners', although more generous than the OECD proposal, is still subject to strict conditions.

Finally, EB Co. must also be entitled to equivalent benefits and, therefore, the test continues with a comparison of benefits.

#### 4.2.4.2 Alternative One: Benefits Comparison

To ascertain whether EB Co. would be entitled to equally beneficial, or more beneficial,[89] treaty provisions had it earned the income directly, both the OECD proposal and the 2016 US Model require a comparison of tax rates in the case of dividends, interest and royalties. The 2016 US Model expanded the scope of this comparison. Usually, including under the OECD proposal, the tax rates to be compared are those under the S-EB DTC and those under the S-R DTC.[90] In other words, it is limited to the tax treaties in question. Under the 2016 US Model, the comparison is broader: it takes into account the tax treaties, provisions of domestic law or any other international agreement. This is a significant improvement from the standpoint of designing the derivative benefits test to more effectively achieve its purpose. To illustrate, if the withholding tax rate on dividends under the S-EB DTC is 15% and under the S-R DTC is 10%, EB Co. would not have been entitled to equivalent benefits under the tax treaties. However, if State EB and State S are both EU Member States, EB Co. would have been entitled to zero withholding tax on dividends under the EU Parent-Subsidiary Directive

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83 OECD, *BEPS Action 6: Prevent Treaty Abuse, Revised Discussion Draft, 22 May 2015 – 17 June 2015*, OECD/G20 Base Erosion and Profit Shifting Project, at 13, para. 35 (2015), https://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-6-prevent-treaty-abuse.pdf (accessed 15 Aug. 2016).

84 On the one hand, EU Member States could argue that situations that take place within the EU are not legally comparable to situations that occur outside of the EU, as the EU is more integrated in matters of administrative cooperation and exchange of information in tax matters. This is especially the case now given the recent developments to counteract BEPS concerns in the EU, as prominently illustrated by the EU Commission's investigations into prominent tax State Aid cases and the Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (also known as the EU Anti-Tax Avoidance Directive). On the other hand, it can be argued that, in any case, 'there does not appear to be anything in the [EU] Treaty that would prohibit non-Europeans from qualifying as equivalent beneficiaries'. For the latter point, *see* New York City Bar Report, *supra* n. 71, at 18–19.

85 *OECD Action 6 Final Report*, *supra* n. 3, at 25: 'b) a Contracting State, or a political subdivision or local authority thereof, or a person that is wholly-owned by such State, political subdivision or local authority'.

86 *OECD Action 6 Final Report*, *supra* n. 3, at 42.

87 *See* e.g. comments submitted by the American Chamber of Commerce in the Netherlands, in OECD, *Public Comments Received on Public Discussion Draft, Follow-Up Work on BEPS Action 6: Prevent Treaty Abuse*, at 22–25 (OECD Publishing 12 Jan. 2015).

88 One exception can be found in the Protocol amending the US-Spain DTC (1990), still pending ratification by the United States, where it is stated that, in the case of indirect ownership, each intermediate owner is a resident of a Member State of the European Union or any party to NAFTA. *See* U.S. Department of State, *Treaties Pending in the Senate (updated as of September 22, 2016)*, http://www.state.gov/s/l/treaty/pending/ (accessed 23 Sept. 2016). This is better than no conditions whatsoever. There should be some sort of stipulation for intermediate owners. Otherwise, presumably, a 'treaty partner company owned by a Cayman company that is, in turn, owned by an equivalent beneficiary is just fine'. Rosenbloom, *supra* n. 27, at 651. The key is to strike the right balance. The 2016 US Model attempts to do this.

89 The 2016 US Model replaced the wording 'at least as low as', which appears in most treaties as well as in the OECD Action 6 proposal, with the new wording 'less than or equal to', which is simply easier to understand.

90 *OECD Action 6 Final Report*, *supra* n. 3, at 52, para. 82: '(1) the rate of tax that the source State would have imposed if a resident of the other Contracting State who is a qualified person were the beneficial owner of the income; and (2) the rate of tax that the source State would have imposed if the third State resident received the income directly from the source State.'

(assuming the requirements of the Directive are fulfilled). Nevertheless, under the previous version of the benefits comparison test, EB Co. would fail, despite the fact that it could obtain a more beneficial tax rate under another international agreement had it invested directly in State S. The US version avoids this result and ensures that EB Co. qualifies as an equivalent beneficiary in such a case.

The US version improves the benefits comparison test further. In order to properly carry out this tax rate comparison in the case of dividends, it must be possible to calculate the percentage of shareholding that EB Co. would be deemed to own in S Co. had it invested directly, instead of through R. Co. Unlike in the case of interest payments on loans or royalty payments on licenses where a shareholding is not required, the receipt of dividends is contingent upon owning a shareholding in a subsidiary and the tax rate in treaties often differs depending on the precise amount of that shareholding. Thus, the 2016 US Model clarifies that, in order to determine whether EB Co. would be 'entitled to a rate of tax that is less than or equal to the rate applicable' under the S-R DTC, EB Co.'s indirect ownership in the shares of S Co. will be treated as direct ownership. For example, if EB Co. holds 95% of the aggregate vote and value of the shares in R Co. and if R Co. holds 25% in S Co., then EB Co. is deemed to own 23.75% (95% x 25%) in S Co.

Furthermore, it provides a special rule for the case where a natural person (e.g. Madame EB instead of EB Co.) holds shares in R Co. which in turn holds shares in S Co. The reason for this rule is that, in nearly all cases, individuals will be subject to a higher tax rate than companies. This, of course, is because both the US and OECD model conventions apply lower, more favourable tax rates, e.g. 5%, exclusively to companies with substantial shareholdings and never to individuals, who are often subject to 15%. This can give rise to two possible consequences, depending on how the withholding tax rates are compared. One consequence could be that equivalent beneficiaries who are 'qualified persons' by virtue of being an 'individual' will always fail at this stage of the tax rate comparison, because they would always be subject to a higher tax rate had they invested directly in State S instead of through a company in State R. This would defeat the purpose of allowing individuals to qualify as equivalent beneficiaries in the first place.

Alternatively, the tax rate comparison could be interpreted differently. The comparison could instead examine:

- the rate of tax that Madame EB would be entitled to if she directly held those shares in S Co. – in other words, the tax rate that applies to individuals under the S-EB DTC – and
- 'the rate of tax to which the same persons, *if they would be residents of the {c}ontracting {s}tate of which the recipient is a resident*, would be entitled if they directly held their proportionate share of the shares that gave rise to the dividends' – in other words, the tax rate that would apply to Madame EB as an individual resident in State R under the S-R DTC.[91]

In other words, R Co. could obtain a 5% withholding tax rate as long as the withholding tax rate for individuals is 15% under both the S-EB DTC and the S-R DTC.[92] This would create a perverse incentive for individuals to set up companies in states with tax treaties that offer low withholding tax rates. Ultimately, the answer was not clear in cases of individuals as equivalent beneficiaries. Therefore, the 2016 US Model drafted a specific rule. This natural person will 'be treated as if he or she were a company' for the purposes of calculating the ownership percentage (and, in turn, for determining the applicable withholding tax rate) on the condition that R Co. is carrying on an active trade or business to which the dividends are related. Essentially, it is similar to an 'active trade or business' test which can be found in Article 22(3) as a separate test.[93] By requiring R Co. to carry on active business activities, it reduces the possibility for an individual to set up R Co. solely for the purpose of obtaining a lower withholding tax rate.

The US Model expanded the benefits comparison test beyond dividends, interest and royalties. In addition, it is also necessary to compare the benefits in the case of other types of income, namely, business profits, capital gains and other income.[94] This update makes sense considering that, by virtue of comparing benefits only under Article 10, Article 11 and Article 12, the test ignored the fact that other articles can also be the object of treaty shopping. Other existing versions of the derivative benefits test in tax treaties, as well as the derivative benefits test proposed in OECD Action 6, would not detect those cases where a person was seeking more

**Notes**

[91] Rubinger, *supra* n. 76, at 45 et seq., citing the Exchange of Notes to the US-Luxembourg DTC. According to Rubinger, this interpretation can be found in the US-Luxembourg DTC and the US-Ireland DTC, and it is unclear whether this view of the tax rate comparison test can be expanded to other DTCs.

[92] Rubinger, *supra* n. 76, at 45 et seq.

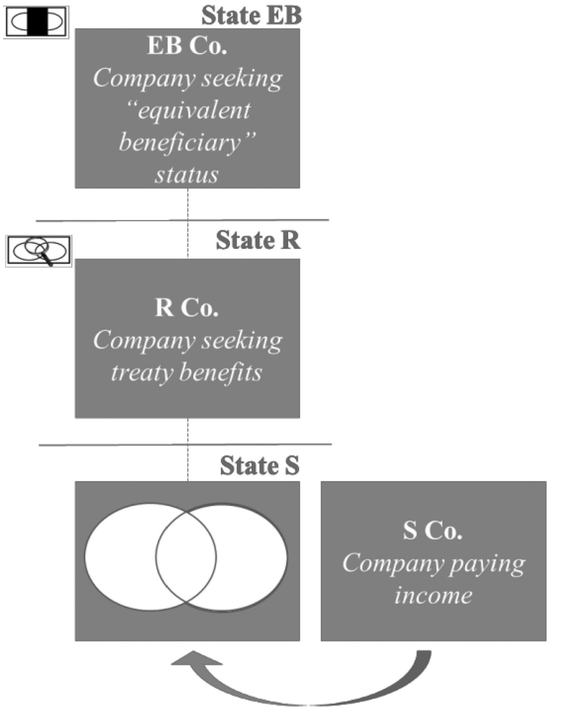
[93] *2016 US Model*, *supra* n. 1, at Art. 22(7)(e)(i)(B)(1): 'Regarding a company seeking benefits under paragraph 4 of this Article with respect to dividends, for purposes of this subclause: I) if the resident is an individual, and the company is engaged in the active conduct of a trade or business in its Contracting State of residence that is substantial in relation, and similar or complementary, to the trade or business that generated the earnings from which the dividend is paid, such individual shall be treated as if he or she were a company. Activities conducted by a person that is a connected person with respect to the company seeking benefits shall be deemed to be conducted by such company. Whether a trade or business activity is substantial shall be determined based on all the facts and circumstances;'.

[94] Art. 6, Art. 8, and Arts. 15–20 are excluded. While most of the excluded articles apply to income earned by individuals (e.g. employment income, pensions, directors fees) and therefore cannot be derived by an interposed entity, i.e. R Co., the reason for the exclusion of other articles is not entirely clear.

favourable taxation of capital gains, for example. Thus, in respect of Article 7, Article 13 and Article 21, EB Co. must be entitled to benefits under the S-EB DTC that are 'at least as favorable' as those under the S-R DTC. This is a vaguer standard. It is, naturally, not as clear-cut as comparing tax rates. In order to determine whether benefits are 'at least as favorable', in a first step, one must determine what benefit is being sought from the source state, State S. It seems, under Article 7, Article 13, and Article 21, this is likely a case where R Co. is claiming that there is no (or low) taxation in State S of the business profits, the capital gain or other income. Then, in a second step, one must examine the provisions of Article 7 or Article 13 or Article 21 under the S-EB DTC and the S-R DTC. In the case of business profits, for example, suppose that Article 7 of the S-EB DTC allows for taxation under a 'force of attraction' principle, thereby increasing the amount of business profits taxable in State S, whereas Article 7 of the S-R DTC does not permit this. Could EB Co. have set up R Co. in order to do business in State S without the risk of this 'force of attraction' principle? In the case of capital gains, for example, perhaps Article 13 of the S-EB DTC contains a real estate holding company provision modelled after Article 13(4) OECD Model, whereas Article 13 of the S-R DTC does not. Could EB Co. have set up R. Co. in order to invest in and sell immovable property in State S while avoiding source state taxation? These comparisons require a case-by-case assessment, identifying the benefits being sought from State S and weighing up what would be more 'favourable' from the perspective of the equivalent beneficiary. Based on the wording, this test looks *only* at the tax treaties in question (not domestic law or other international agreements). In practice, this is an isolated view, since whether or not a given structure is ultimately more 'favourable' for a taxpayer often depends on a combination of the tax treaties and domestic law.

Finally, under alternative (i), the US Model includes yet another test. This test is dedicated to fiscally transparent entities. In particular, it imposes an extra condition for qualifying as an equivalent beneficiary in cases where the income/profit/gain is 'derived through' an entity that is fiscally transparent under the laws of State R (i.e. 'the Contracting State of the company seeking benefits'). There are no conditions as to where this fiscally transparent entity is located. It first asks whether State R treats the entity as fiscally transparent. If so, then this test asks what would happen if EB Co. itself owned the entity through which the income is derived. It uses a negative formulation for the response, stating that 'if the item of income, profit or gain would ***not*** be treated as the income, profit or gain of the resident under a provision analogous to paragraph 6 of Article 1 (General Scope) of this Convention' (emphasis added) had EB Co., instead of R Co., directly owned the entity, then EB Co. is ***not*** an equivalent beneficiary. For example, this would be the case if State EB would treat the entity as opaque, in Figure 7 below. In this structure, income is derived through an entity that is treated as fiscally transparent under the tax laws of State R (condition 1). From the perspective of State R, the income flows through this transparent entity and is attributable directly to its owner, R Co. Thus, the income is treated as the income of a resident of State R. By contrast, if EB Co. directly owned the transparent entity, instead of indirectly through R Co., then none of the income would be attributable to a resident of State EB (condition 2). This results from the fact that State EB treats the entity as a separately taxable entity that earns the income and, therefore, would not attribute any of the income to EB Co. Therefore, treaty benefits would not apply.

*Figure 7*




In sum, under alternative (i), to be an equivalent beneficiary requires the existence of a comprehensive tax treaty between State EB and State S, and involves a qualifying persons test, a benefits comparison test and an additional test in the case of fiscally transparent entities.

### 4.2.4.3 Alternatives Two and Three

In the 2016 US Model, there are two other alternative tests for equivalent beneficiaries. Similar to the OECD version,[95]

**Notes**

[95] *OECD Action 6 Final Report*, *supra* n. 3, at 52: 'the term "equivalent beneficiary" means a resident of any other State, but only if that resident: [ … ] ii) is a resident of a Contracting State that is entitled to the benefits of this Convention by reason of subparagraph a), b) or d), or subdivision i) of subparagraph c), of paragraph 2 of this Article.]'.

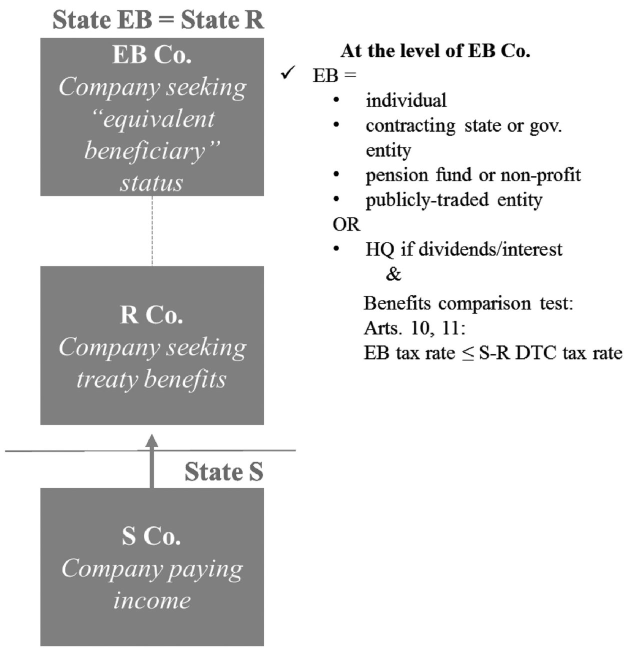
these alternatives provide that an equivalent beneficiary can be resident in either of the Contracting States (State S or State R) as long as it is an individual, a Contracting State or extension thereof, a qualifying non-profit organization, a qualifying pension fund, or a publicly-traded entity under the LOB article. As the derivative benefits test is drafted with third-country residents in mind, these alternatives clarify that certain persons that are resident in either Contracting State also qualify as equivalent beneficiaries. Also, importantly, in this case, there is no need for a benefits comparison to ascertain whether these resident equivalent beneficiaries would be entitled to the same (or better) benefits had they received the income directly.[96] Thus, for example, if 90% of R Co. is owned by five companies resident in State EB that qualify as equivalent beneficiaries and 10% of R Co. is owned by an individual resident in State R, then R Co. can still satisfy the requirements of the derivative benefits ownership test.[97]

The 2016 US Model has made a few changes to this alternative test. To begin, the 2016 US Model breaks up the OECD alternative into two new distinct parts. Under the 2016 US Model, the scenario under which EB Co. is a resident of State R (the same state as the company seeking benefits) and the scenario under which EB Co. is a resident of State S (the state from which benefits are sought) come with different conditions.[98]

Under alternative (ii), in Figure 8 below, if EB Co. is a resident of State R, then in addition to the above qualified persons, the 2016 US Model adds that: EB Co. may also qualify if it fulfils the headquarters company test. This, of course, only applies in the case of dividends and interest payments made by a member of EB Co.'s multinational group (see section 4.1.2.1). In this case, it is still necessary to carry out a benefits comparison to be sure that EB Co. would be entitled to the same tax rate on the interest or dividends had it earned the income directly instead of via R Co.

Under alternative (iii), EB Co. may qualify as an equivalent beneficiary if it is a resident of State S. It covers the scenario depicted in Figure 9.

*Figure 8 Alternative (ii)*



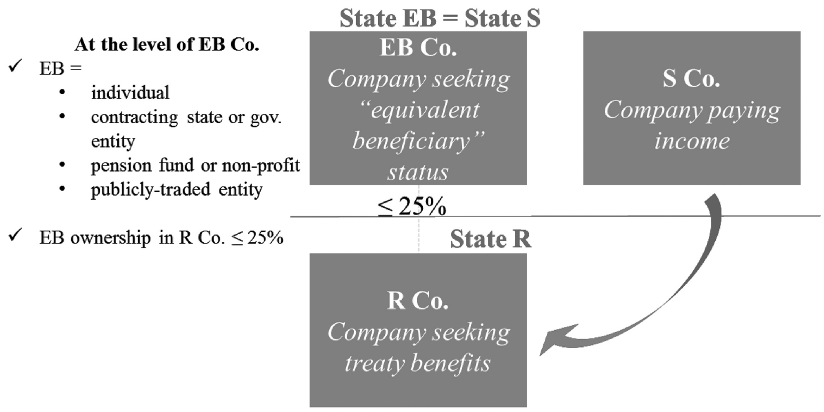

**Notes**

96 *OECD Action 6 Final Report*, *supra* n. 3, at 53, para. 84.

97 *OECD Action 6 Final Report*, *supra* n. 3, at 53, para. 84.

98 *2016 US Model*, *supra* n. 1, at Art. 22(7)(e): 'the term "equivalent beneficiary" means: [ … ]
ii) a resident of the same Contracting State as the company seeking benefits under paragraph 4 of this Article that is entitled to all the benefits of this Convention by reason of subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under paragraph 5 of this Article, provided that, in the case of a resident described in paragraph 5 of this Article, if the resident had received such interest or dividends directly, the resident would be entitled to a rate of tax with respect to such income that is less than or equal to the rate applicable under this Convention to the company seeking benefits under paragraph 4 of this Article; or
iii) a resident of the Contracting State from which the benefits of this Convention are sought that is entitled to all the benefits of this Convention by reason of subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article, provided that all such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares) of the company seeking benefits under paragraph 4 of this Article does not exceed 25 percent of the total vote and value of the shares (and any disproportionate class of shares) of the company.'

*Figure 9 Alternative (iii)*




Again, it requires that EB Co. be an individual, government entity, publicly-traded company, pension fund or non-profit organization. Additionally, EB Co.'s shareholding must be 25% or less of the aggregate vote and value of the shares in R Co. This provision seems to prevent the scenario in which the tax treaty is being used to obtain more favourable tax treatment than that available under the domestic tax law of the source state. Such treaty shopping will only be assumed in cases where EB Co. has a shareholding substantial enough to indicate some level of influence and control over the interposed company. Otherwise, it is possible that the structure is coincidental and not intentional. The 25% ownership threshold thus offers a safe harbour in cases of smaller, less consequential shareholdings in R Co. Only if the holding exceeds 25%, R Co. cannot receive derivative benefits in this particular structure.

However, alternative (iii) seems to be contradicted by the subsidiary of a publicly-traded company test. Under the latter test, the same configuration is possible: it is also possible for R Co. to qualify for treaty benefits as a subsidiary of a publicly-traded company in cases where its owners – both its intermediate owners[99] and possibly its publicly-traded owners[100] – are resident in State S. In this case, however, R Co. *must* be owned 50% or more by its publicly-traded owner. Thus, the 25% ownership limit under alternative (iii) is circumvented in cases where EB Co. is a publicly-traded equivalent beneficiary, by qualifying R Co. instead under the subsidiary of a publicly-traded company test. Not only will the ownership that EB Co. holds in R Co. exceed 25%, but in fact it *must* – in this case, it must reach 50% or more. This casts shadows on the reason for this 25% limit and the relationship between these two provisions of the LOB clause of the 2016 US Model.

### 4.2.5 *Legal Consequences of the Derivative Benefits Test*

The final question to address is the legal consequences of the derivative benefits test. If R Co. and its owners, EB Co., (and payees) fulfil all of the conditions of the derivative benefits test, then R Co. is entitled to the benefits of the S-R DTC for the specific item of income in question. By contrast with certain 'qualified persons' tests, it does not result in entitlement to all benefits of the tax treaty.[101]

If R Co. and its owners, EB Co., (and payees) fail any of the conditions of the derivative benefits test, then R Co. is not eligible for tax treaty benefits. Consequently, R Co. is subject to domestic tax law unrestricted by the tax treaty. For example, in the case of dividends, R Co. is now subject to the full domestic rate of withholding tax on the income in State S – which, in the United States, could be 30%[102] – rather than the tax rate that the third country owner, EB Co., would have been entitled to had it received the income directly from State S – which usually would not exceed 15%.

**Notes**

99 As discussed above in section 2.2, in the case of subsidiaries of publicly-traded companies, intermediate owners can be located in the source state.

100 *See 2016 US Model*, *supra* n. 1, at Art. 22(2)(c), the publicly-traded company test, in conjunction with Art. 22(2)(d), the subsidiary of a publicly-traded company test. A joint reading reveals that nothing excludes the publicly-traded owner from being resident in either Contracting State.

101 In other words, the scope of the benefits is limited to one benefit at a time; thus, in the case where there is more than one item of income, e.g. dividends and royalties, the test needs to be applied separately for each item of income in question. It is technically possible to obtain derivative benefits for one item of income and to fail for another. The test *has* to be this way (item-per-item) since, by its nature, it is based on a comparison of benefits and, in any given tax treaty, the benefits vary among the different types of income.

102 26 U.S. Code § 1441 – Withholding of tax on non-resident aliens.

This is sometimes referred to as the 'cliff effect' and has been criticized as being disproportionate: rather than simply 'undoing' the undue unintended treaty benefits, it has a punitive effect, which goes beyond what is necessary to counteract the treaty shopping behaviour.[103] For this reason, it has been argued that, instead, the higher of the two withholding tax rates available under the DTCs should apply. The 2016 US Model opted for the latter solution, finally giving a long sought-after resolution to this question. This results in clearer, more proportionate legal consequences, and it is also an improvement from the perspective of EU law (which subjects restrictive measures to a proportionality test).

Regarding how the US solution works more precisely, the solution is not found in Article 22 where the LOB provisions are set forth. Rather, the 2016 US Model achieves this solution by adding a provision to the dividends, interest and royalties articles, namely Article 10(6), Article 11(3), and Article 12(3) respectively. Indeed these provisions should be located in the distributive articles which provide the substantive rules, such as the applicable tax rates, rather than in the LOB which serves only as a gateway to treaty benefits.[104] It is formulated as a new exception to the general rule for the allocation of taxation rights under the dividends, interest and royalties articles. When applicable, these new provisions take precedence over the general rule by specifying a new cap, or limitation, on the taxation right of the source state. They state that, if a company fails the derivative benefits test 'solely by reason of' the withholding tax rate comparison, then the source state tax 'shall not exceed the highest rate among the rates of tax to which' the equivalent beneficiaries 'would have been entitled if such persons had received the [income] directly'.

Similar to the definition of equivalent beneficiaries (see section 4.2.4.2), Article 10(6) also provides instructions for how to correctly calculate the percentage of ownership. For the purposes of Article 10 (i.e. for determining the cap on the source state's taxation right), the equivalent beneficiaries' indirect ownership is treated as direct ownership.[105] In this way, the application of the two provisions (Article 22(7)(e)(i)(B)(II) and Article 10 (6)) is aligned. As a result of these changes, the 2016 US Model brings more legal certainty as to the precise application of the derivative benefits test. However, along with more legal certainty comes an increasingly complex provision.

## 5 Conclusion

This article undertakes a thorough analysis of some key changes to the LOB clause in the 2016 US Model. Overall the changes, in addition to some technical improvements, indicate a recalibration of US tax treaty policy on treaty shopping, intended to simultaneously make the LOB clause more flexible by allowing new persons to qualify for treaty benefits, while keeping it secure and closing off loopholes. Changes which indicate an opening up of the LOB include, for example, the new concept of 'qualifying intermediate owners' as well as the addition of the derivative benefits test and the headquarters company test. Changes which indicate a simultaneous effort to keep the LOB clause watertight against treaty shopping include the addition of base erosion tests to more provisions throughout the LOB with new stricter requirements. For example, it has expanded the scope of tainted payments and has included provisions protecting against double or multiple non-taxation by excluding taxpayers that benefit from special tax regimes.

A detailed study of these changes offers some lessons that could be taken into account by the OECD in the finalization of its proposed LOB clause under BEPS Action 6 and in the next update to the OECD Model, as well as by those countries taking part in the Multilateral Instrument that opt for a detailed version of the LOB clause. As regards the overall tax policy considerations underlying the LOB clause, the OECD should strive to strike a similar balance as the 2016 US Model, i.e. a balance between preventing third-country residents from inappropriately benefitting from tax treaties while recognizing that business is conducted in highly integrated MNEs with subsidiaries all over the world and that, in the case of legitimate corporate structures, treaty benefits should not be denied merely for the reason that the owners/shareholders of the person claiming treaty benefits are third-country residents. With this in mind, the OECD would be well-advised to adopt some of the changes that were made to the 2016 US LOB. To begin, it makes sense to adopt the 'qualifying intermediate owner' provision of the LOB clause of the 2016 US Model. This provision offers greater flexibility to multi-layered corporate structures with more geographically-dispersed intermediate owners, by allowing intermediate owners in third states to qualify for treaty benefits. By comparison with the

**Notes**

103 *See* R. Mason, *When Tax Treaty Derivative Benefits Provisions Don't Apply*, 43 Tax Notes Intl. 7 (2006).

104 M.J. Miller, *What's New in the New US Model Treaty?*, 64(2) Can. Tax J., at 542 (2016).

105 In fact, Art. 10 provides very specific rules for determining what precisely is the 'higher of' tax rate that needs to apply. It was also necessary to include a specific rule for alternative (iii): in the case where the EB Co. is resident in the source state, as described in alternative (iii) of the equivalent beneficiary definition, then EB Co. will be 'treated as entitled to the limitation of tax to which [EB Co.] would be entitled if [EB Co.] were a resident of [State R] the same Contracting State as the company receiving the dividends'.

current version of the OECD's LOB proposal, which confines the location options for intermediate owners to one, or both, of the Contracting States, this would be more realistic for many MNEs. Admittedly, the practical effect of the provisions on qualifying intermediate owners is currently rather limited because it requires tax treaties to be in place with special tax regime provisions. However, as the OECD is also considering the introduction of special tax regime provisions in the OECD Model, it is probable that more and more tax treaties will gradually fulfil this condition in the future. To assist the spread of special tax regime provisions in bilateral tax treaties and thereby also give effect to the provisions on 'qualifying intermediate owners', the OECD should consider the inclusion of special tax regime provisions in the next update to the OECD Model.

Regarding the headquarters company test, the OECD does not currently include such a provision in its proposed LOB clause. The choice whether or not to include this test essentially revolves around the following question: should it be possible for companies that exist solely for the purpose of performing headquarters-type functions to independently qualify under the LOB or should such companies always be subject to some sort of active trade or business test? In order to avoid the denial of benefits in cases of legitimate headquarters companies, it is worthwhile for the OECD to consider the adoption of a headquarters company provision similar to that of the new US LOB clause. The new US LOB provision seems to have struck the right balance between granting benefits to genuine headquarters companies and barring those with insufficient substance and a weak connection to their residence state.

Regarding the derivative benefits provision, it reflects a compromise between the bilateral reciprocal nature of tax treaties and the desire to grant benefits in cases where third-country residents are genuinely investing through or operating in one of the Contracting States. In the new derivative benefits test of the 2016 US LOB clause, a number of technical improvements have been made as compared to the derivative benefits provision of the LOB clause proposed by the OECD. These technical improvements address a number of the concerns that were also expressed in public comments sent to the OECD on Action 6 as well as in academic literature. In particular, to the benefit of taxpayers, under the new US LOB the legal consequences of failing the derivative benefits test are proportionate, now that it incorporates the 'higher of' approach instead of fully denying treaty benefits. Moreover, for the first time, it offers detailed rules on precisely how to apply the 'higher of' approach. To the benefit of revenue authorities, it reduces the scope of unacceptable base erosion and other abuse by, *inter alia*, expanding the scope of the tainted payees, including the special tax regime provisions, closing a gap with respect to fiscally transparent entities, and expanding the scope of the comparison test in order to scrutinize both the possibility of seeking lower withholding tax rates (under the dividends, interest and royalties articles) and the possibility of seeking more favourable treatment (under the business profits, capital gains and other income articles). To the benefit of all, it increases legal certainty by clarifying the way to calculate the percentage of ownership that an equivalent beneficiary is deemed to hold, which is a key component in facilitating a consistent application of the test. Considering the improvements brought about by these changes, the OECD should adopt similar ones in the detailed derivative benefits provision of its proposed LOB. However, the OECD should also take caution to address and remedy some of the interpretation ambiguities in the derivative benefits provision of the new US LOB clause. For example, it is difficult to reconcile the application of 'alternative (iii)' of the equivalent beneficiary definition with the application of the subsidiary of a publicly-traded company test. The *first* denies benefits if the equivalent beneficiary that is resident in the source state holds 25% or more of the ownership in the company seeking treaty benefits, while the *latter* would entitle the very same structure to treaty benefits only if the owner holds 50% or more in the company seeking treaty benefits.

As regards the changes to the US LOB clause that intend to strengthen the provision in order to more effectively prevent treaty shopping, the OECD ought to consider adding a base erosion test to the subsidiary of a publicly-traded company test. In addition, similar to the new US LOB, it should expand the scope of tainted payees under the different base erosion tests. At the same time, the OECD should improve the application of the base erosion tests under its proposed LOB clause, as compared to the new US LOB provision, by reformulating or clarifying the wording 'paid directly or indirectly', which causes interpretation difficulties. Also, under the base erosion tests of the new US LOB clause, there is a discrepancy between the payments that are carved-out under the headquarters company test and those carved-out under other base erosion tests (i.e. the subsidiary of a publicly-traded company test, ownership and base erosion test, and derivative benefits test). The OECD should avoid this. Rather the OECD should ensure that, under its own LOB clause, arm's length interest payments to unrelated banks are carved-out from tainted payments under each of the base erosion tests.

Having said that, one overarching observation that cannot be ignored is the clear trade-off between the improvements needed and the resulting complexity. In order for the LOB to capture all of the possible scenarios of treaty shopping in a time of increasing diversity and sophistication of global business, only time will tell whether this 2016 version with all of its new technical improvements has managed to once-and-for-all prevent treaty shopping as intended. If not, the LOB seems set down a path of continuous tweaks and detailed technical adjustments, risking ever-increasing complexity. This is a trade-off that all countries participating in the Multilateral Instrument, or otherwise intending to make their tax treaties more resistant to treaty shopping, will have to weigh when choosing how to implement the minimum standard against treaty abuse under BEPS Action 6.[106]

Notes

[106] For more on the minimum standard, *see OECD Action 6 Final Report*, *supra* n. 3, at 9–10.