# Traps for the Unwary in Treaties

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This note highlights a few traps for the unwary for companies in common Limitation on Benefits provisions in a U.S. bilateral income tax treaty. This note also briefly describes situations in which discretionary competent authority relief might be available.

## I. General Background

As background, the United States, like other countries, maintains an extensive network of bilateral income tax treaties. The U.S. network includes comprehensive income tax treaties covering dozens of countries, including the vast majority of key U.S. trading partners. Income tax treaties remove barriers to cross-border investment and trade by allocating taxing jurisdiction between countries with residence- and source-based claims to tax the income from this investment and trade. Income tax treaties also provide a framework for the exchange of information between taxing authorities in an effort to prevent tax avoidance and evasion. Income tax treaties operate by modifying the operation of internal law (*e.g.*, reducing a statutory 30 percent withholding tax rate to 5 percent in a particular case). Treaties generally cannot *increase* a taxpayer's tax liability relative to the liability under internal law. At the same time, under the "saving clause" found in all U.S. treaties, treaties generally cannot be used by a taxpayer to reduce tax liability in the taxpayer's *own residence country*, subject to several important exceptions (*e.g.*, for foreign tax credits and correlative transfer pricing adjustments). Under the saving clause, each country's right to tax its own residents is generally reserved under its own internal law.

The U.S. model income tax treaty typically provides the substantive framework used by the U.S. Treasury Department in negotiations for U.S. bilateral income tax treaties (compared to the Organisation for Economic Co-operation and Development (OECD) model treaty used by OECD countries). The U.S. model income tax treaty is intended to facilitate negotiations and not to provide a text that the United States would propose that the treaty partner accept without variation.[1] Each bilateral relationship has its own special issues. The U.S. model income tax treaty (referred to as the "1996 U.S. Model") was updated in 2006 (referred to as the "2006 U.S. Model") and 2016.

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## II. Background on the Limitation on Benefits Article

All recent income tax treaties to which the U.S. is a treaty party (a "U.S. treaty" or a "non-U.S. treaty" for those income tax treaties to which the U.S. is *not* a treaty party) contain comprehensive Limitation on Benefits ("LoB") provisions. The LoB article, typically Article 22 or thereabouts, contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries.[2] In general, unlike the LoB provisions in many non-U.S. treaties, the LoB provision in U.S. treaties does not rely on a determination of purpose or intention but instead sets forth a series of objective tests.[3] 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.[4] Non-U.S. treaties generally do not include the elaborate anti-treaty shopping provisions found in U.S. treaties.

Under LoB articles, it is not sufficient for a taxpayer to establish that it is resident in a treaty country. Rather, having established resident status of the treaty country, the taxpayer must be a "qualified" person by satisfying the terms of at least one prong of the LoB article. Qualified persons under a typical LoB article include an individual, a governmental entity, a company that satisfies the public company test (or subsidiary of public company test), tax-exempt organization (charity or pension), or entity satisfying the "ownership and base erosion" test. Treaty benefits could also be available with respect to particular items of income under a typical LoB article under the active trade or business test, derivative benefits test, and competent authority discretion.

This note discusses a few traps for the unwary in LoB provisions common for companies. This note also provides some background on the competent authority relief provision present in many LoB articles.

### A. Qualifying Public Company Test

Under paragraph 2(c)(i) of the LoB article of the 1996 U.S. Model, in order for a company to satisfy the public trading test, all the shares in the class or classes of shares representing more than 50 percent of the voting power and value of the company must be "regularly traded" on a "recognized stock exchange."[5] A recognized stock exchange of a U.S. treaty typically includes the New York Stock Exchange, the NASDAQ system, and stock exchanges of the country or zone of residence.

If a company has only one class of shares, it is only necessary to consider whether the shares of that class are regularly traded on a recognized stock exchange.[6] If the company has more than one class of shares, it is necessary as an initial matter to determine whether one of the classes accounts for more than half of the voting power and value of the company.[7] If so, then only those shares are considered for purposes of the regular trading requirement.[8] If no single class of shares accounts for more than half of the company's voting power and value, it is necessary to identify a group of two or more classes of the company's shares that account for more than half of the company's voting power and value, and then to determine whether each class of shares in this group satisfies the regular trading requirement.[9] Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that account for more than 50 percent of the shares, it is only necessary for one such group to satisfy the requirements of this subparagraph in order for the company to be entitled to benefits.[10] Benefits would not be denied to the company even if a second, non-qualifying group of shares with more than half of the company's voting power and value could be identified.[11]

The term "regularly traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will be defined by reference to the domestic tax laws of the country from which treaty benefits are sought (*i.e.*, the source country).[12] In the case of the United States, this term is understood to have the meaning it has under Reg. §1.884-5(d)(4)(i)(B), relating to the branch tax provisions of the Code.[13] Under these regulations, a class of shares is considered to be "regularly traded" if two requirements are met: trades in the class of shares are made in more than *de minimis* quantities on at least 60 days during the taxable year, and the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year.[14] Reg. §§1.884-5(d)(4)(i)(A), (ii), and (iii) will not be taken into account for purposes of defining the term "regularly traded" under the treaty.[15]

A trap for the unwary exists for those who assume that, by reason of a treaty-resident company being publicly traded, that company qualifies for treaty benefits. As described above, it is not sufficient for a taxpayer to establish that it has shares that are traded on a recognized stock exchange. Rather, the principal class or classes of shares must be regularly traded on a recognized stock exchange. For example, ownership of a class of high-vote shares that are not publicly traded could prevent satisfaction of the public trading test. This could arise for example where a

class of high-vote shares are held by original founders or family members. European public companies often have multiple classes of shares with varying voting rights.

### B. Subsidiary of Public Company Test

Under the 1996 U.S. Model, to satisfy the subsidiary of public company test, at least 50 percent of each class of shares in the company seeking treaty benefits must be owned directly or indirectly by the qualifying public company described above, provided that in the case of indirect ownership, each intermediate owner must be a person entitled to comprehensive treaty benefits (as compared to treaty benefits on an item-by-item basis, such as under the active trade or business test or derivative benefits test).

A trap for the unwary exists for those who assume that, by reason of being an indirect subsidiary of a qualifying public company, the subsidiary of the public company test would be met. As described above, each intermediate owner must be a person entitled to comprehensive treaty benefits. Thus, if the relevant treaty has such a requirement and the intermediate entity is not a same-country resident (or is a same-country resident but qualifies for treaty benefits solely under the active trade or business test or the derivative benefits test), the subsidiary of the public company would not be met. Similarly, if a non-resident owns more than 50 percent of a class of shares (even if the class of shares itself does not have significant vote or value), the subsidiary of the public company test might not be met under such circumstances. Tracing through the chain of ownership could be necessary, for example, if the company seeking treaty benefits is an indirect subsidiary of a qualifying public company or part of a joint venture with a mix of owners.[16]

## III. Miscellaneous Traps

### A. Active Trade or Business Test

Under paragraph 3 of the LoB article of the 1996 U.S. Model, to satisfy the active trade or business test, three requirements must be met: (1) the resident must be engaged in the active conduct of a trade or business in the resident's country, (2) the income must be connected with or incidental to the trade or business, and (3) the trade or business must be substantial in relation to the activity in the other country generating the income. Under article 3(2), undefined terms have the meaning under the law of the source state, unless the context requires otherwise or the competent authorities agree to a common meaning. The Technical Explanation to the 1996 U.S. Model states: "Accordingly, the United States competent authority will refer to the regulations issued under Code Sec. 367(a) for the definition of the term "trade or business." Reg. §1.367(a)-2(d)(2) states that the "group of [trade of business] activities must *ordinarily* include the collection of income and the payment of expenses." Interestingly, the spin-off rules contain nearly identical language that a trade or business must ordinarily include the collection of income,[17] and this requirement has been relaxed recently for purposes of Code Sec. 355[18] but potentially not in the context of Code Sec. 367(a) and thus potentially not for purposes of satisfying the active trade or business test of an LoB article.

### B. Fiscally Transparent Entities

Different treaties reflect different approaches to entities that are fiscally transparent under U.S. or foreign law, and some treaties do not explicitly address fiscally transparent entities. The application of treaties to fiscally transparent entities presents many complex, treaty-specific issues. The particular language of the relevant treaty with respect to fiscally transparent entities should be parsed with care.

### C. State Taxation

Bilateral income tax treaties generally do not apply to states but a state could voluntarily follow treaty provisions. Thus, a taxpayer should take into account state income tax considerations in analyzing a structure, even if a treaty applies to exempt U.S. federal income tax.

## IV. Competent Authority Relief

Where a taxpayer does not objectively satisfy an LoB article, a taxpayer may wonder whether treaty benefits could be available *via* competent authority relief. U.S. treaties generally provide that a resident of a treaty country not otherwise entitled to benefits may be granted benefits of the treaty if the competent authority of the source country so determines. Thus, with respect to taxes on U.S. source income, such as U.S. withholding tax, a resident of a treaty country not otherwise entitled to benefits under an LoB may be granted benefits if the U.S. competent authority so determines.

As a practical matter, the U.S. competent authority provides discretionary relief in only very limited circumstances and the time required to go through the competent authority process may be prohibitive in many



  

circumstances. The U.S. competent authority will not issue a determination regarding whether an applicant satisfies an objective LOB test.[19] In determining whether to provide discretionary benefits, the U.S. competent authority requires that the applicant represent that, and explain why, it does not qualify for the requested benefits under the relevant LoB provisions.[20] The U.S. competent authority in its sole discretion may grant benefits under the discretionary provision of an LoB article in an applicable U.S. tax treaty.[21] A decision by the U.S. competent authority not to grant discretionary benefits is final and not subject to administrative review.[22]

To qualify for discretionary competent authority relief, the applicant must demonstrate that it has substantial nontax nexus to the treaty country, and that, if benefits are granted, neither the applicant nor its direct or indirect owners will use the treaty in a manner inconsistent with its purposes. Treasury guidance contains a nonexclusive list of situations which the U.S. competent authority typically will not exercise its discretion to grant benefits, for example, where:

(i) the applicant or any of its affiliates is subject to a special tax regime in its country of residence with respect to the class of income for which benefits are sought (*e.g.*, notional interest deduction with respect to equity in the residence country);

(ii) no or minimal tax would be imposed on the item of income in both the country of residence of the applicant and the country of source, taking into account both domestic law and the treaty provision ("double non-taxation"). For example, double non-taxation would occur if a payment under a hybrid instrument was exempt from withholding and generated a deduction in the country of source, while being treated as income exempt from tax in the country of residence of the applicant; or

(iii) the applicant bases its request solely on the fact that it is a direct or indirect subsidiary of a publicly traded company resident in a third country and the relevant withholding rate provided in the tax treaty between the United States and the country of residence of the applicant is not lower than the corresponding withholding rate in the tax treaty between the United States and the country of residence of the parent company or any intermediate owner.

Thus, as discussed above, discretionary treaty benefits are available in only limited circumstances. Thus, satisfying an objective LoB provision is generally the preferred approach, if possible.

## V. Conclusion

Taxpayers should be careful in parsing the relevant treaty language to determine whether it satisfies the relevant LoB requirements. If the relevant LoB requirements are not met, discretionary treaty benefits could be available in limited circumstances.



### ENDNOTES

1 *See also* United States Model Income Tax Convention of September 20, 1996 Technical Explanation ("Technical Explanation to the 1996 U.S. Model"), at page 2.

2 United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006 (the "Technical Explanation to the 2006 U.S. Model"), at page 63. *See also* Technical Explanation to the 1996 U.S. Model.

3 *See id*.

4 *See id*.

5 The test has been tightened in recent treaties to require greater nexus to the residence country. For example, some recent treaties require primary trading in the country or zone of residence (as opposed to trading in the source country), or management and control in the residence country. *See e.g.,* U.S.–France treaty.

6 Technical Explanation to the 1996 U.S. Model, at page 65.

7 *Id*.

8 *Id*.

9 *Id*.

10 *Id*. at page 66.

11 *Id*.

12 *Id*.

13 *Id*.

14 *Id*.

15 *Id*.

16 Another potentially available path to treaty benefits is the ownership and base erosion test. In the 1996 U.S. Model, the ownership prong of this test similarly requires that if the person seeking treaty benefits is *indirectly* owned by "good" qualifying owners, each owner in the chain of ownership must be entitled to comprehensive treaty benefits.

17 Reg. §1.355-3(b)(2)(ii) ("A corporation shall be treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of [trade or business] activities *ordinarily must include the collection of income* and the payment of expenses.").Emphasis added. *See also* Rev. Rul. 82-219, 1982-2 CB 82.

18 *See e.g.,* LTR 202009002 (Sep. 4, 2019). In the LTR, Distributing conducts research and development (R&D) to identify and create new products. The Office of Associate Chief Counsel (Corporate) ruled: "The absence of income collection does not prevent Distributing's Business 2 from constituting a "trade or business" within the meaning of Reg. §1.355-3(b)(2)(ii) for purposes of determining whether the Distribution satisfies the active trade or business requirement of Code Sec. 355."

19 Rev. Proc. 2015-40, IRB 2015-35, 236. Procedures for requesting and obtaining assistance from the U.S. competent authority under U.S. tax treaties is on the Treasury Department's priority guidance plan, available at *www.irs.gov/pub/irs-utl/2021-2022-pgp-3rd-quarter-update.pdf*. The guidance plan lists projects that will be the focus of the Treasury Department's efforts in the near term. Based on informal communications with Treasury personnel, it seems the updates are part of a periodic update of the revenue procedure.

20 *Id*.

21 *Id*.

22 *Id*.