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U.S. Treasury Proposes Significant Changes to the Model Tax Treaty and Requests Comments

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On May 20, 2015, the U.S. Treasury Department released proposed changes to the U.S. model tax treaty, which has not been updated since 2006.

The Treasury Department has departed from its usual process for revising the U.S. model tax treaty by publishing drafts of certain of the more meaningful proposed revisions and inviting comments from practitioners. In addition, another unusual aspect of the Treasury Department's handling of these revisions is that previous revisions to the U.S. model tax treaty have generally reflected developments originating in existing tax treaty negotiations; in this case, however, the Treasury Department is designing new provisions on a prospective basis. These departures from the Treasury Department's historical process reflect a fast-moving policy debate currently spearheaded by the OECD, which has been developing a series of reports and proposals under its base erosion and profit shifting (BEPS) initiative involving the United States and other OECD and G20 nations. Treasury officials have stated that the proposed changes to the U.S. model tax treaty are intended to influence the debate concerning BEPS at the OECD.

The new provisions include the following:

- Denying treaty benefits in certain "triangular" permanent establishment situations. This would occur when a resident of State A seeks to claim treaty benefits under the State A–State B tax treaty in respect of income earned from State B through a permanent establishment in State C, and either: (i) that income is subject to a low combined rate of tax in State A and State C; or (ii) State C does not have a tax treaty with State B and the income is not includible in the tax base of State A.

- Imposing the full U.S. withholding tax rate of 30% on dividends, interest, royalties and other amounts paid by entities that have expatriated from the United States in an inversion transaction.

- Denying treaty benefits with respect to the payment of interest, royalties and other income to a related party that benefits from a "special tax regime". Special tax regimes are tax rules that provide a preferential effective rate of taxation with respect to a specified category of income. Certain specified types of tax rules are exempt from the definition of special tax regime, such as tax rules that do not disproportionately benefit interest, royalty or other income; that satisfy a "substantial activity requirement" with regard to royalties; that apply to charitable organizations, pension plans and retirement plans; or that apply to tax-favored investment entities similar to REITs and RICs.

- Revising the article on the limitation on benefits to include the derivative benefits rule adopted in certain recent U.S. tax treaties.

- Allowing either country to "turn off" treaty benefits if the other country changes its law to either reduce the rate of tax on individuals or companies to less than 15% or change its system for taxing companies to a territorial-based system.

The Treasury Department expects to release the final updated model tax treaty before the end of 2015.

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