September 15, 2015

Mark Mazur
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
1500 Pennsylvania Ave., N.W.
Washington, DC 20220

Re: Proposed Changes to U.S. Model Income Tax Convention

Dear Mr. Mazur:

On behalf of the Organization for International Investment (OFII), I write to provide our comments on several of the proposed changes to the U.S. Model Income Tax Convention released on May 21, 2015.

OFII is a business association representing the U.S. subsidiaries of many of the world's leading global companies. The U.S. subsidiaries of companies based abroad directly employ 5.8 million Americans and support an annual U.S. payroll of over $400 billion. OFII works to ensure the United States remains the top location for global investment. As such, OFII advocates for fair, non-discriminatory treatment of foreign-based companies and promotes policies that will encourage them to establish U.S. operations, increase American employment, and boost U.S. economic growth.

OFII believes that the United States should ensure U.S. international tax policy aligns with U.S. economic interests to promote job creation and economic growth. Historically, U.S. tax treaties have played a critical role in fostering bilateral trade and investment by preventing double taxation of cross-border income. As a strong proponent of U.S. bilateral tax treaties, including those awaiting Senate ratification, OFII believes that changes to U.S. tax treaty policy should not undercut the historical purpose of treaties in providing a reliable tax environment for companies operating across borders. Any concerns regarding double non-taxation and treaty shopping must be tailored to address the abusive behavior while avoiding adverse impacts on cross-border investment. Further, changes should be developed with a clear recognition and understanding of how multinational companies (MNCs) operate to prevent companies legitimately operating in treaty countries from being denied treaty benefits.

OFII believes the proposed changes to the U.S. Model Convention do not achieve the right policy balance and will have an adverse effect on the ability of the United States to attract global investment and may also undercut the Administration's international trade efforts to open markets to U.S. goods and services.

Moreover, the proposed new anti-abuse rules attempt to dictate, set, and monitor U.S. domestic tax policy, which is not the role of tax treaties. Certain provisions in the proposed U.S. Model Convention, such as the special tax regimes provisions, could act as a restraint on Congress's ability to reform or implement tax policy without creating additional tax burdens on businesses. The resulting uncertainty of whether treaty benefits would apply will have negative economic consequences for the United States. Given the domestic policy focus of many of the proposed

changes, OFII believes an international treaty with bilateral commitments is not the appropriate mechanism to address these perceived concerns. Many of the issues the proposed changes attempt to address can be more appropriately addressed through U.S. tax reform.

The following sections outline how the new and proposed U.S. model treaty anti-abuse provisions and the proposed changes to the limitation on benefits (LOB) article could negatively and unnecessarily impact global companies investing in the United States. If these proposed changes were to be included in a U.S. tax treaty, many MNCs would be prevented from claiming benefits under the severely tightened LOB article. Even if an MNC could access the treaty under the LOB article, its benefits could still be denied under the proposed non-LOB restrictions in many common fact patterns, some of which we highlight below. These changes would severely and inappropriately prevent access to treaties in many situations where there is no abuse. We strongly recommend reconsideration of this approach.

Special Tax Regimes

The proposed special tax regimes provisions would deny treaty benefits for interest, royalties, or other income that benefits from a special tax regime in the recipient's country of residence. The proposal describes a special tax regime as any legislation, regulation, or administrative practice that provides a preferential effective rate of tax to the tested income, with some exceptions. The definition is so broadly defined that instead of providing specificity and clarity, it actually creates additional uncertainty. This broad definition could apply to so many rules that the United States may wish to enact that the decision of whether to grant treaty benefits is essentially left to the discretion of tax administrators in treaty partner nations.

For example, while the proposed provision provides a substantial activities exception with regard to royalties, it is unclear what type of regime would actually qualify for this exception. Another example is the exception from the definition of special tax regimes for any legislation, regulation, or administrative practice that implements the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises). It would appear that unilateral advance pricing agreements are intended to fit into this exception, provided they comply with the arm's length standard. Again, however, it is left to the treaty partner's tax administrators to decide whether an APA complies with the arm's length standard, effectively ceding to treaty partners a veto right over U.S. APAs.[1]

As these examples demonstrate, the ambiguous and broad definition of special tax regimes will lead to uncertainty for taxpayers and may inappropriately prevent Congress and treaty partner legislative bodies from undertaking appropriate or necessary domestic tax reform. OFII recommends that, instead of including such an ambiguous provision that selectively denies treaty benefits to certain persons, the United States should maintain the current and more appropriate approach of assessing the tax system of other countries before deciding whether to enter into a bilateral tax treaty. Subsequent changes in law should be put through the traditional process of substantive discussions between the treaty partners, rather than giving one of the treaty partners the sole right to judge whether the actions of the other treaty partner merit denial of treaty benefits.

[1] While the Treasury Department's Technical Explanation states that the United States currently does not have any special tax regimes, a treaty partner tax administrator would not be required to take the same view.

Partial Termination of Treaties

The proposed U.S. Model Convention calls for the right of a treaty partner to partially terminate the treaty if, after the treaty is signed, the treaty partner reduces its income tax rate below 15 percent for substantially all income of a corporate resident, or exempts substantially all offshore income from tax. Treasury has indicated that it may consider revisions to this approach, such as a threshold based on a percentage reduction in the income tax rate that exists at the time the treaty is signed.

The United States has in the past terminated treaties only in unusual cases where the treaty partner does not have a meaningful income tax regime. A proposal to make such a unilateral and automatic partial treaty termination easier does not give due regard to the seriousness of such an action. Any right granted to a treaty partner (including the United States) to terminate a treaty relationship, partial or complete, based on an arbitrary tax rate trigger would represent a fundamental shift in policy that requires Congressional input. OFII believes that income tax treaties are not the appropriate vehicle for pressuring legislatures, including the U.S. Congress, to keep income tax rates above a certain level.

Moreover, the ability of one country to partially terminate the treaty would impact residents of both treaty countries. For example, if the United States partially terminated a treaty because the treaty partner substantially reduced its domestic tax rate, U.S. companies that generated income from the other country would lose treaty benefits. This outcome would result even when the United States tax rate was not reduced, and even if the treaty partner did not reduce its withholding tax rate imposed on foreign persons. Similarly, treaty partners could terminate treaties if the United States moved to a territorial tax system for non-U.S. income.

As a result, both inbound and outbound U.S. investors would be faced with a lack of certainty as to whether treaty benefits would be available whenever the United States or a treaty partner undertakes a domestic tax reform. The provision would undermine the stability, administrability, and certainty surrounding U.S. tax treaties and could have adverse impacts on cross-border investment and economic growth.

Expatriated Entities

The proposed provision would, for a period of ten years, deny treaty benefits to payments made by U.S. entities that had engaged in a transaction where substantially all the assets of the U.S. entity were acquired (directly or indirectly) by a foreign corporation and where there was between 60 and 80 percent shareholder continuity. The suggested provision appears overbroad in that it would apply to all payments made by an expatriated entity, not just payments made to related persons. For example, the provision would deny treaty benefits to a third party bank in a treaty country that extended a loan to the expatriated entity, imposing U.S. tax on an unrelated bank that had no involvement in the expatriation transaction.

Limitation on Benefits Article

A treaty's LOB article should operate in such a way as to prevent treaty shopping, but should not be so arbitrarily restrictive that many legitimate business structures, where no treaty shopping exists, are denied treaty benefits. The advantage of an LOB article over subjective tests is that it provides certainty to taxpayers. However, excessively complicated LOB provisions can result in just as much uncertainty as the subjective tests they purport to replace.

As evidenced below, OFII believes the proposed additional restrictions will make the LOB article too complicated to administer and will increase double taxation of legitimate businesses engaging in cross-border trade and investment, undermining the purpose of tax treaties and ultimately leading to less investment in the United States. Further, many of the additional layers of restrictions appear to fail to address a clear policy objective and, therefore, are not only harmful to our economic objectives but unnecessarily so.

Publicly Traded Companies

The publicly traded company test provides that a company that is a resident of a treaty country and the stock of which is regularly traded on one or more recognized stock exchanges is eligible for the benefits of the treaty. The proposed LOB article retains the 2006 U.S. Model Convention's substantial presence test for publicly traded companies, requiring a company to be either primarily traded on exchanges in its country of residence or requiring the company's group to be primarily managed and controlled in its country of residence. The primarily traded requirement unfairly penalizes companies with multiple listings, which may be particularly prevalent in countries with stock exchanges that do not attract as many investors as the exchanges of other countries. Moreover, the primarily managed and controlled test is ambiguous and unnecessarily restrictive, as many existing public groups that have decentralized management (for example, along regional lines) may fail this test, even where no treaty shopping is present or where the group does not include an expatriated entity.

Companies need access to capital markets to fund their business operations and investments in order to generate economic growth. Larger markets, including key stock exchanges, provide size and liquidity to taxpayers so that they have access to equity capital. Taxpayers resident in smaller countries with limited capital markets will trade on multiple exchanges to meet their equity needs. Thus, we believe that the "primarily traded" test is too restrictive for such companies listed on more than one exchange. Given the importance of accessing multiple exchanges, we strongly suggest amending the proposed language to allow a number of specific stock exchanges to qualify under the publicly traded company test, *i.e.*, to aggregate all regularly traded principal class of shares on all recognized stock exchanges on which a company's shares are listed. This more flexible proposal would also be consistent with most existing U.S. tax treaties, such as the U.S.-U.K. treaty.

OFII recommends that the substantial presence test be eliminated from the U.S. Model Convention, because it unfairly prevents public companies from qualifying for treaty benefits where they have legitimate non-tax reasons for their global trading and decentralized management structures. This additional test only adds complexity and is unnecessarily restrictive.

Derivative Benefits Test

OFII welcomes the addition of a derivative benefits test to the U.S. Model Convention and the expansion of the definition of equivalent beneficiary beyond that which is currently included in certain U.S. treaties, which permit only European and North American persons to be equivalent beneficiaries. OFII believes that a derivative benefits test reflects sound treaty policy. However, we are concerned that Treasury has added other restrictions to the test that will prevent most companies from being able to benefit from the test.

Specifically, Treasury has added a restrictive intermediate ownership test and has tightened the base erosion test in ways that are not targeted at treaty shopping and which ignore common MNC

structures. The derivative benefits test is often used by subsidiaries that have publicly traded parent companies resident in a different jurisdiction than the subsidiary. These MNCs often have intermediate entities resident in other jurisdictions in the chain of ownership between the parent and the company seeking treaty benefits, with the company seeking benefits making ordinary course deductible payments. The proposed new restrictions could present significant problems to businesses in these common circumstances that are unrelated to treaty shopping.

Our overall concerns regarding the restrictive intermediate ownership and base erosion tests apply equally to other LOB provisions that contain similar restrictive tests (as discussed more generally below). However, there is one particularly unnecessary restriction with respect to the derivative benefits test that should be removed. The proposed Model would require that any intermediate owners between the company seeking treaty benefits and its ultimate beneficial owners must be resident in countries that have a treaty with the source State, *and* that treaty must contain a special tax regimes article. Application of this restriction would mean that if a country were to agree to such a derivative benefits test in a treaty with the United States, then no treaty partner resident company that has intermediate owners in its structure would be able to use the derivative benefits test, unless and until the United States negotiated a special tax regimes provision with every single country in which such intermediate entities are resident.

It is unclear what legitimate policy concern this intermediary ownership requirement serves, particularly because the requirement appears unrelated to whether any intermediate entity actually benefits from a special tax regime. It only requires the treaty between the United States and the country of the intermediate entity's residence to contain the provision. It is not realistic to expect treaty partners to negotiate derivative benefits tests that will not apply until other treaties with other countries have been negotiated or revised.

For example, assume the United States and Country X add the restrictive derivative benefits test to their income tax treaty. A company resident in Country X that receives income from the United States is directly owned by a Country Y entity, which is directly owned by a publicly traded Country Z company. The company in Country X could not qualify under the derivative benefits test unless the United States and Country Y renegotiated their treaty to include a special tax regimes provision.

Even if we were to assume Treasury will be able to quickly renegotiate its treaties with these provisions, it should be noted that the restriction would apply equally to U.S. companies seeking to benefit from the derivative benefits test. In effect, U.S. companies would be denied treaty benefits unless the treaty partner renegotiated its treaties with other jurisdictions to include special tax regimes provisions. This intermediary restriction will cause the derivative benefits test to not be available to many MNCs, given the substantial period of time it would take for the United States and treaty partners to renegotiate all relevant treaties to include special tax regimes provisions, assuming the treaty partners were even inclined to do so.

Restrictive Intermediate Ownership Tests

The proposed Model Convention would include restrictive intermediate ownership tests as part of the subsidiary of publicly traded company test, the ownership/base erosion test, and the derivative benefits test. These tests would limit intermediate owners to residents of certain countries and in some cases may require them to satisfy additional requirements. Including restrictive intermediate ownership tests for subsidiaries of publicly traded companies and in the ownership/base erosion and derivative benefits tests ignores the business reasons for how MNCs operate.

For example, an MNC that has a publicly traded parent in a treaty country may have acquired an existing corporate group in a different country with a finance subsidiary in the same country as the MNC's parent. The reason that the intermediate entity between the publicly traded company and the finance subsidiary is resident in another jurisdiction has nothing to do with treaty shopping, yet the proposed LOB article would deny treaty benefits for this structure. Such restrictive tests will prevent many companies from qualifying for treaty benefits where no treaty shopping exists and, thus, should not be adopted.

Restrictive Base Erosion Tests

Current treaty base erosion tests deny treaty benefits when a company pays a substantial portion of its income to other persons that would not have qualified for similar treaty benefits and where the payments reduce the taxable income of the payor. There are exceptions for the types of payments that are unlikely to raise treaty shopping concerns, such as payments in the ordinary course of business.

Both the 2006 U.S. Model Convention and the proposed new Model Convention include several restrictions in the various base erosion tests that are unnecessary and should not be adopted. Crucially, the proposed Model retains a rule in the 2006 Model which identifies "good" recipients of base eroding payments as only individuals, publicly traded companies, governments, pension funds, and tax exempts. However, persons that themselves would qualify for treaty benefits with respect to a payment received from the source State under an ownership/base erosion test, subsidiary of a publicly traded company test, or (where applicable) derivative benefits test are treated as nonqualified recipients.

Requiring base eroding payments to be made directly to a publicly traded parent rather than its subsidiaries is particularly unrealistic, as most publicly traded parent companies are holding companies. If a subsidiary of such a publicly traded parent had received a payment directly, it would have qualified for treaty benefits, so there should be no concern about base erosion with respect to the payment made to the subsidiary. Treating such payments as bad payments fails to take into account how MNCs operate and would be needlessly complicated.

In addition, access to external financing is crucial for MNCs and any base erosion test should contain robust exceptions for financial payments. If an exception for financial payments is not included, the result would be that every external interest payment to a bank would be treated as a bad base-eroding payment unless made directly to the publicly traded parent entity of a bank. This is an extremely unlikely scenario, as the parent entity will often be a holding company that may not even hold a banking license. To the extent that there is any legitimate concern that payments to banks could present a base erosion concern, existing U.S. anti-conduit rules adequately police this concern.

Active Trade or Business Test

The active trade or business test provides that when a company or group of companies conducts an active trade or business in country X, income received from another country that is generated by the same (or similar) business conducted in country X is eligible for treaty benefits. The proposed U.S. Model Convention would permit the attribution of activities conducted by other group entities to an entity seeking treaty benefits only if such entity is itself an operating company. The policy behind the existing test recognizes that the presence of a substantial active business in a country indicates that a

group of entities is in the country for business reasons, not treaty shopping purposes. If the affiliated group has a substantial active business, whether it structures its activities in the other country through a holding company should not matter.

Not allowing holding or finance companies to take advantage of the active trade or business test ignores the business reasons for how MNCs operate, needlessly complicating cross-border investment while failing to advance any clear policy objective. MNCs generally separate their holding and group financing functions into separate legal entities for non-tax reasons having nothing to do with treaty shopping.

The proposed U.S. Model Convention indicates that it is Treasury's policy that holding and finance companies should look to the derivative benefits test to qualify for treaties, rather than the active trade or business test. Even if the proposed derivative benefits test were not so restrictive as to make it difficult for anyone to use it, the fact remains that such a policy would result in only publicly traded groups being able to qualify for treaty benefits. Privately held companies, which are more likely to need the active trade or business test to be eligible for treaty benefits, would generally be entirely shut out.

Restricting the active trade or business test to operating companies would again prevent companies that are not treaty shopping from being able to qualify for treaty benefits. This negative outcome undermines the purpose of tax treaties and accomplishes no clear policy outcome other than arbitrarily forcing companies to restructure their operations. OFII therefore recommends that the current rules permitting attribution be retained.

Discretionary Grant of Treaty Benefits

Currently, U.S. income tax treaties permit the competent authorities of one of the States to grant a resident of the other State treaty benefits if the resident was not established, acquired, or maintained, and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the relevant treaty. The proposed U.S. Model Convention would provide an additional requirement that the person seeking the discretionary grant of treaty benefits must also demonstrate a substantial nontax nexus to its State of residence.

This additional requirement is unnecessarily broad and overly vague. It is unclear what would be considered a substantial nontax nexus, and why the current standard must be expanded beyond preventing treaty shopping. For example, it is not clear whether the substantial non-tax nexus requirement would require a taxpayer to show that it was located in that treaty jurisdiction for reasons specific only to that jurisdiction and no other jurisdiction, a level of proof that would be very difficult to establish.

Because the proposed U.S. Model Convention's LOB article contains so many additional restrictions that would prevent companies from qualifying under the formerly objective tests, the discretionary grant of treaty benefits would likely take on a heightened importance for companies operating in treaty countries. In addition, given the inherent uncertainty in taxpayers' ability to obtain discretionary relief and the resulting adverse impact on ordinary course business transactions, OFII recommends that the proposed changes to the discretionary grant – which are not focused on treaty shopping – not be included in the U.S. Model Convention.

It is particularly troubling that the IRS has decided to implement this new standard in its existing process for discretionary grants of treaty benefits in Revenue Procedure 2015-40. This is not the standard which the United States has specifically agreed to apply in its existing income tax treaties – a standard which treaty partners expected the United States to apply when agreeing to sign the relevant treaties and a standard that was approved by the U.S. Senate when it ratified these treaties. Accordingly, we believe that the provisions should be withdrawn, as it goes against existing treaty policy and practice and raises questions on the certainty of U.S. treaty policy, with the result of negatively affecting U.S. trade and investment.

Conclusion

Overall, we believe that the proposals will lead to many cases where MNCs not engaged in treaty shopping will be prevented from claiming treaty benefits. Implementing these proposals in U.S. income tax treaties will reduce foreign direct investment by making the United States a less attractive destination for inbound investment. We accordingly recommend that the special tax regimes and partial termination provisions not be adopted in the U.S. Model Convention. Further, we recommend that the LOB article in the new Model eliminate the substantial presence test from the publicly traded company test, not adopt restrictive and complex intermediate ownership and base erosion tests, retain the rule permitting attribution of activities to holding and finance companies for purposes of the active trade or business test, and eliminate the requirement to demonstrate a substantial nontax nexus as a necessary condition for a discretionary grant of treaty benefits.

OFII would welcome consideration of these comments in any future U.S. Model Convention, and we recommend consultation with the Congress before the Treasury publishes a new U.S. Model Convention.

Thank you in advance for your consideration.

Sincerely,

Nancy McLernon
President & CEO
Organization for International Investment

CC:

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