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Development of limitation of benefits concept in USA¹

The United States has a network of 58 income tax treaties that encompasses 66 countries. Through this network the United States seeks to minimize tax-related impediments to inbound foreign investment by reducing, and in many cases waiving, its statutory taxing rights on U.S.-source income earned by residents of its treaty partners. An underlying principle of U.S. tax-treaty policy is that the benefits accorded in these bilateral agreements must be safeguarded from abuse. In particular, adequate rules must protect against unintended and inappropriate application of the benefits provided in tax treaties.

In addition, the United States has been a longstanding world leader in the development of limitation on benefits rules to prevent the inappropriate use of a bilateral tax treaty by residents of third countries, known as "treaty shopping." Analysis of data from U.S. corporate tax returns indicates that a small subset of U.S. tax treaties that have deficient anti-treaty-shopping protections is being exploited by third-country residents.

Residents of non-treaty countries may seek ways of lowering the tax cost of their investments in the United States. This result could be achieved by routing the investment through an entity that has been established in a country that has an income tax treaty with the United States. By establishing such a structure, the third-country resident can obtain the benefits of the bilateral treaty. This abuse of a bilateral agreement by third-country residents is commonly referred to as "treaty shopping."

As a policy matter, tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source Country taxes in a particular treaty means that U.S. persons pay less tax to the other country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country.

However in some cases, third-country residents may establish entities in the treaty partner for legitimate business reasons. An effective anti-treaty shopping rule should separate those cases from the abusive situations in which the primary reason for establishing the entity is to obtain treaty benefits. It is difficult to prove that a particular structure or transaction was motivated by tax-avoidance reasons, thus making anti-abuse rules based on subjective determinations of the taxpayer's

motives difficult to administer.

Recognizing the shortcomings of subjective anti-abuse rules, the United States has developed a series of objective tests, known as Limitation on Benefits ("LOB") provisions, which are intended to determine whether a person is sufficiently connected economically to the treaty partner to warrant receiving treaty benefits. Further, under § 7701(l), the Treasury Department is afforded broad authority to prescribe regulations to recharacterize any multiple-party financing transaction, as a transaction directly among any two or more parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax. These regulations provide that, for withholding tax purposes, the IRS may disregard the participation of certain intermediate entities in "treaty shopping."

Several objective tests were evolved over a period of time to determine a person's level of economic nexus to its country of residence. Collectively, the ownership/base-erosion, active-conduct, and publicly traded tests form the core of today's LOB provisions.

(1) Ownership/base-erosion test - The ownership/base-erosion test denies treaty benefits to corporations that are majority owned by third-country residents or that disburse more than half of their gross income in the form of certain deductible payments to third-country residents.

(2) Active-conduct test - Under the active-conduct test, a corporation will be eligible for treaty benefits if it satisfies two conditions: (i) it is engaged in the active conduct of a trade or business in its country of residence; and (ii) the payment for which benefits are sought is related to the trade or business. In certain cases, an additional requirement that the trade or business be substantial in size relative to the activity in the source country generating the income must be met.

(3) Publicly traded test - With the growth of regional markets, corporations that are listed on a stock exchange in their home country nevertheless may have a substantial portion of their trading volume occur on another exchange in their region. Moreover, the international prominence of the U.S. stock exchanges means that many foreign corporations are listed and substantially traded on U.S. exchanges.

The publicly traded test requires either that the corporation's principal class of shares be primarily traded on a stock exchange in its country of residence, or that the corporation's primary place of management and control be in its country of residence. However, in some circumstances, additional nexus between the corporation and its country of residence is necessary to effect the underlying objective of the LOB provision.

For example, a Netherlands corporation that has more trading of its shares on U.S. stock exchanges than on exchanges in the Netherlands and its economic region or whose shares otherwise are overwhelmingly traded on exchanges outside the Netherlands will qualify for U.S. treaty benefits under this new test if the corporation's center of management and control is in the Netherlands.

The term "primary place of management and control" is defined as the country where the corporation's executive officers and senior management employees exercise the most day-to-day responsibility for the strategic, financial, and operational decision making of the corporation, and

where the most day-to-day activities necessary for preparing and making those decisions take place.

The Treasury Department seeks to achieve the appropriate balance of preventing inappropriate reductions of withholding taxes while at the same time allowing cross-border economic activity to reach its full potential. At the same time it ensures that the treaty provisions will not be exploited by persons who were not intended to enjoy the benefit.

The Treasury Department has also taken steps to revise those U.S. tax treaties that are most vulnerable to treaty shopping. The Treasury Department reviews, on a continuing basis, the current U.S. tax-treaty network to identify deficiencies in existing agreements and areas where more beneficial terms for U.S. taxpayers could be negotiated. As part of this process, anti-treaty-shopping provisions are given special scrutiny to ensure that they are functioning appropriately. Those treaties with LOB provisions that are out of date or need strengthening are given higher priority in the Treasury Department's plan for negotiations.

Source: Department of Treasury, KNAV Desk

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