

TAX TREATIES AND THE LIMITATION ON BENEFITS CLAUSE

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Overview

- ▶ Evolution of Limitation On Benefits (“LOB”)
- ▶ Currently Applicable Rules
- ▶ Examples
- ▶ 2016 Model Treaty - Proposed Amendments

Evolution of LOB

- ▶ Tax on US citizens vs. nonresidents
- ▶ Taxpayers could take advantage of lower tax rates by setting up entities in low-tax jurisdictions
- ▶ LOB put in place to restrict benefits to the intended parties

Current Rules: Limitation on Benefits

- ▶ To obtain treaty benefits, a taxpayer must
 1. Satisfy all requirements specific to the particular benefit
 2. Be a “treaty resident” and
 3. Meet at least one of the **LOB tests**

Purpose of the LOB Provision

- ▶ Taxpayer seeking to benefit under the treaty must have some further connection to that “Contracting State”
- ▶ Thus, third country residents are prevented from “treaty shopping”

Common LOB Tests

- ▶ Public company test (or subsidiary)
- ▶ Ownership and base erosion test
- ▶ Active trade or business test
- ▶ Derivative benefits test (if all else fails - available in some cases)

- ▶ Or by competent authority

Ownership/Base Erosion Test

- ▶ Entity resident in one of the Contracting States qualifies if:
 1. A specified percentage of beneficial interests in such entity is owned by certain residents of the Contracting State, and
 2. It erodes no more than a specified percentage of its income through certain deductible payments

Examples

▶ US-Bermuda:

1. LOB - Article 22:

1. 50% beneficial ownership, EXCEPT
2. If income derived from one Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the other Contracting State

1. No “derivative benefits” option

Proposed Revisions to Model Treaty

- ▶ First update since 2006.
- ▶ Denial of treaty benefits for income attributable to low-tax PE
- ▶ Does not reduce withholding taxes on payments of “highly mobile income” (royalties/interest)
- ▶ Preventing post-expatriation earnings-stripping transactions - 10 years.
- ▶ Modifying the LOB - “derivative benefits” clause