TAX TREATIES
AND THE
LIMITATION ON BENEFITS
CLAUSE

RUBY BANIPAL
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

1. **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