E/C.18/2016/CRP.16

Distr.: General
14 November 2016

Original: English

Committee of Experts on International Cooperation in Tax Matters
Thirteenth Session
New York, 5-8 December 2016
Agenda item 3 (a) (iii)
Base erosion and profit-shifting – possible changes to Articles and Commentaries, including a possible LOB clause;

Example of a Limitation on Benefits Article and Accompanying Commentary Drafting

Summary
The present note, prepared by Mr. Henry Louie of the Committee at the request of the Committee, puts forward for consideration in the context of a possible Limitation on Benefits Article for the *United Nations Model Double Taxation Convention between Developed and Developing Countries* an example of such a clause based in particular upon the United States of America experience in this area (Part I of this Paper). Part II addresses other possible related changes to treaties, while Part III gives an example of Commentary text on a Limitation on Benefits Article. Part IV gives an example of Commentary text on the definition of a "Special Tax Regime".

PART I – EXAMPLE OF A LIMITATION ON BENEFITS ARTICLE

Article 22

LIMITATION ON BENEFITS

1. Except as otherwise provided in this Article and in paragraph 6 of Article 10 (Dividends), paragraph 3 of Article 11 (Interest) and paragraph 3 of Article 12 (Royalties), a resident of a Contracting State shall not be entitled to the benefits of this Convention otherwise accorded to residents of a Contracting State (other than a benefit under paragraph 2 of Article 9 (Associated Enterprises) or Article 25 (Mutual Agreement Procedure) unless such resident is a "qualified person" as defined in paragraph 2 of this Article at the time when the benefit would be accorded.

2. A resident of a Contracting State shall be a qualified person at the time when a benefit otherwise would be accorded by this Convention if, at that time and, with respect to clause (i) of subparagraph (f) of this paragraph, on at least half of the days of any twelve-month period that includes the date when the benefit otherwise would be accorded, the resident is:

a) an individual;

b) a Contracting State, political subdivision or local authority thereof, or an agency or instrumentality of that Contracting State, political subdivision or local authority;

c) a company, if the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and either:

i) its principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or

ii) the company's primary place of management and control is in the Contracting State of which it is a resident;

d) a company, if:

i) at least 50 percent of the aggregate vote and value of the shares (and at least 50 percent of the aggregate vote and value of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subparagraph (c) of this paragraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under this Convention is being sought or is a qualifying intermediate owner; and

ii) with respect to benefits under this Convention other than under Article 10 (Dividends), less than 50 percent of the company's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions): (A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of this paragraph; (B) to persons that are connected persons with respect to the company described in this subparagraph and that benefit from a special tax regime with respect to the deductible payment; or (C) with respect to a payment of interest, to persons that are connected persons with respect to the company described in this subparagraph and that benefit from notional deductions described in subparagraph (e) of paragraph 2 of Article 11 (Interest);

e) a person described in paragraph 2 of Article 4 (Resident) of this Convention, provided that:

i) in the case of a person described in subclause (A) of clause (ii) of subparagraph (k) of paragraph 1 of Article 3 (General Definitions), more than 50 percent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; and

ii) in the case of a person described in subclause (B) of clause (ii) of subparagraph (k) of paragraph 1 of Article 3 (General Definitions), the earnings of such person benefit exclusively, or almost exclusively, pension funds that satisfy the requirements of clause (i) of this subparagraph; or

f) a person other than an individual, if:

i) persons that are residents of that Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of this paragraph own, directly or indirectly, shares or other beneficial interests representing at least 50 percent of the aggregate vote and value (and at least 50 percent of the aggregate vote and value of any disproportionate class of shares) of the shares or other beneficial interests of such person, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner; and

ii) less than 50 percent of the person's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions): (A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of this paragraph; (B) to persons that are connected persons with respect to the person described in this

subparagraph and that benefit from a special tax regime with respect to the deductible payment; or (C) with respect to a payment of interest, to persons that are connected persons with respect to the person described in this subparagraph and that benefit from notional deductions described in subparagraph (e) of paragraph 2 of Article 11 (Interest).

3. a) A resident of a Contracting State shall be entitled to benefits under this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a trade or business in the first-mentioned Contracting State, and the income derived from the other Contracting State emanates from, or is incidental to, that trade or business. For purposes of this Article, the term "active conduct of a trade or business" shall not include the following activities or any combination thereof:

i) operating as a holding company;

ii) providing overall supervision or administration of a group of companies;

iii) providing group financing (including cash pooling); or

iv) making or managing investments, unless these activities are carried on by a bank, insurance company or registered securities dealer in the ordinary course of its business as such.

b) If a resident of a Contracting State derives an item of income from a trade or business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from a connected person, the conditions described in subparagraph (a) of this paragraph shall be considered to be satisfied with respect to such item only if the trade or business activity conducted by the resident in the first-mentioned Contracting State to which the item is related is substantial in relation to the same or complementary trade or business activity carried on by the resident or such connected person in the other Contracting State. Whether a trade or business activity is substantial for the purposes of this paragraph shall be determined based on all the facts and circumstances.

c) For purposes of applying this paragraph, activities conducted by connected persons with respect to a resident of a Contracting State shall be deemed to be conducted by such resident.

4. A company that is a resident of a Contracting State shall be entitled to a benefit under this Convention, regardless of whether the resident is a qualified person if, at the time when the benefit would be accorded, and with respect to subparagraph (a) of this paragraph, on at least half of the days of any twelve-month period that includes the date when the benefit otherwise would be accorded:

a) at least 95 percent of the aggregate vote and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer

persons that are equivalent beneficiaries, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner; and

b) less than 50 percent of the company's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions): (i) to persons that are not equivalent beneficiaries; (ii) to persons that are equivalent beneficiaries only by reason of paragraph 5 of this Article or of a substantially similar provision in the relevant comprehensive convention for the avoidance of double taxation; (iii) to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from a special tax regime with respect to the deductible payment, provided that if the relevant comprehensive convention for the avoidance of double taxation does not contain a definition of a special tax regime analogous to the definition in subparagraph (l) of paragraph 1 of Article 3 (General Definitions), the principles of the definition provided in this Convention shall apply, but without regard to the requirement in clause (v) of that definition; or (iv) with respect to a payment of interest, to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from notional deductions of the type described in subparagraph (e) of paragraph 2 of Article 11 (Interest).

5. A company that is a resident of a Contracting State that functions as a headquarters company for a multinational corporate group consisting of such company and its direct and indirect subsidiaries shall be entitled to benefits under this Convention with respect to dividends and interest paid by members of its multinational corporate group, regardless of whether the resident is a qualified person. A company shall be considered a headquarters company for this purpose only if:

a) such company's primary place of management and control is in the Contracting State of which it is a resident;

b) the multinational corporate group consists of companies resident in, and engaged in the active conduct of a trade or business in, at least four countries, and the trades or businesses carried on in each of the four states (or four groupings of states) generate at least 10 percent of the gross income of the group;

c) the trades or businesses of the multinational corporate group that are carried on in any one state other than the Contracting State of residence of such company generate less than 50 percent of the gross income of the group;

d) no more than 25 percent of such company's gross income is derived from the other Contracting State;

e) such company is subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3 of this Article; and

f) less than 50 percent of such company's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property or payments in respect of financial obligations to a bank that is not a connected person with respect to such company, and in the case of a tested group, not including intra-group transactions): (i) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article; (ii) to persons that are connected persons with respect to such company and that benefit from a special tax regime with respect to the deductible payment; or (iii) with respect to a payment of interest, to persons that are connected persons with respect to such company and that benefit from notional deductions described in subparagraph (e) of paragraph 2 of Article 11 (Interest).

If the requirements of subparagraph (b), (c) or (d) of this paragraph are not fulfilled for the relevant taxable year, they shall be deemed to be fulfilled if the required ratios are met when averaging the gross income of the preceding four taxable years.

6. If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 of this Article, nor entitled to benefits under paragraph 3, 4 or 5 of this Article, the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income, taking into account the object and purpose of this Convention, but only if such resident demonstrates to the satisfaction of such competent authority a substantial nontax nexus to its Contracting State of residence and that neither its establishment, acquisition or maintenance, nor the conduct of its operations had as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the Contracting State to which a request has been made shall consult with the competent authority of the other Contracting State before either granting or denying the request made under this paragraph by a resident of that other Contracting State.

7. For the purposes of this Article:

a) the term "recognized stock exchange" means:

i) any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934;

ii) the _____ Stock Exchange; and

iii) any other stock exchange agreed upon by the competent authorities of the Contracting States;

b) the term "principal class of shares" means the ordinary or common shares of the company, provided that such class of shares represents the majority of the aggregate vote and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate vote and value of the company, the "principal class of shares" are

those classes that in the aggregate represent a majority of the aggregate vote and value of the company;

c) the term "disproportionate class of shares" means any class of shares of a company, or in the case of a trust, any class of beneficial interests in such trust, resident in one of the Contracting States that entitles the shareholder or interest holder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other Contracting State;

d) a company's "primary place of management and control" is in the Contracting State of which it is a resident only if:

i) the executive officers and senior management employees of the company exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company and its direct and indirect subsidiaries in that Contracting State, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that Contracting State, than in any other state; and

ii) such executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions, than the officers or employees of any other company;

e) the term "equivalent beneficiary" means:

i) a resident of any state, provided that:

A) the resident is entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that state and the Contracting State from which the benefits of this Convention are sought, under provisions substantially similar to subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under provisions substantially similar to paragraph 5 of this Article,] provided that, if such convention does not contain a comprehensive limitation on benefits article, the resident would be entitled to the benefits of this Convention by reason of subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article if such resident were a resident of one of the Contracting States under Article 4 (Resident) of this Convention. Notwithstanding the preceding sentence, an individual who is (1) liable to tax in his or her state of residence with respect to foreign source income or gains only on a remittance or similar basis, or (2) whose tax is determined in that state, in whole or in

part, on a fixed-fee, "forfait" or similar basis, shall not be considered an equivalent beneficiary; and

B) 1) with respect to income referred to in Article 10 (Dividends), 11 (Interest) or 12 (Royalties) of this Convention, if the resident had received such income directly, the resident would be entitled under such convention, a provision of domestic law or any other international agreement, to a rate of tax with respect to such income for which benefits are being sought under this Convention that is less than or equal to the rate applicable under this Convention. Regarding a company seeking benefits under paragraph 4 of this Article with respect to Article 10 (Dividends), for purposes of this subclause:

I) if the resident is an individual, and the company is engaged in the active conduct of a trade or business in its Contracting State of residence that is substantial in relation, and similar or complementary, to the trade or business that generated the earnings from which the income is paid, such individual shall be treated as if he or she were a company described in subparagraph (c) of paragraph 2 of this Article. Activities conducted by a person that is a connected person with respect to the company seeking benefits shall be deemed to be conducted by such company. Whether a trade or business activity is substantial shall be determined based on all the facts and circumstances; and

II) if the resident is a company (including an individual treated as a company), to determine whether the resident is entitled to a rate of tax that is less than or equal to the rate applicable under this Convention, the resident's indirect ownership of the shares of the company paying the dividends shall be treated as direct ownership; or

2) with respect to an item of income, profit or gain referred to in Article 7 (Business Profits), 13 (Gains) or 21 (Other Income) of this Convention, the resident is entitled to benefits under such convention that are at least as favorable as the benefits that are being sought under this Convention; and

C) notwithstanding that a resident may satisfy the requirements of subclauses (A) and (B) of this clause, where the item of income, profit or gain has been derived through an entity that is treated as wholly or partly fiscally transparent under the laws of the Contracting State of the company seeking benefits, if the item of income, profit or gain would not be treated as the income, profit or gain of the resident under a provision analogous to paragraph 6 of Article 1 (General Scope) of this Convention had the resident, and not the company seeking benefits under paragraph 4 of this Article, itself owned the entity through which

the income, profit or gain was derived by the company, such resident shall not be considered an equivalent beneficiary with respect to the item of income;

ii) a resident of the same Contracting State as the company seeking benefits under paragraph 4 of this Article that is entitled to all the benefits of this Convention by reason of subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under paragraph 5 of this Article, provided that, in the case of a resident described in paragraph 5 of this Article, if the resident had received such interest or dividends directly, the resident would be entitled to a rate of tax with respect to such income that is less than or equal to the rate applicable under this Convention to the company seeking benefits under paragraph 4 of this Article; or

iii) a resident of the Contracting State from which the benefits of this Convention are sought that is entitled to all the benefits of this Convention by reason of subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article, provided that all such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares) of the company seeking benefits under paragraph 4 of this Article does not exceed 25 percent of the total vote and value of the shares (and any disproportionate class of shares) of the company.

f) the term "qualifying intermediate owner" means an intermediate owner that is either:

i) a resident of a state that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation that includes provisions addressing special tax regimes and notional deductions analogous to subparagraph (l) of paragraph 1 of Article 3 (General Definitions) and subparagraph (e) of paragraph 2 of Article 11 (Interest), respectively; or

ii) a resident of the same Contracting State as the company applying the test under subparagraph (d) or (f) of paragraph 2 or paragraph 4 of this Article to determine whether it is eligible for benefits under the Convention;

g) the term "tested group" means the resident of a Contracting State that is applying the test under subparagraph (d) or (f) of paragraph 2 of this Article or paragraph 4 or 5 of this Article to determine whether it is eligible for benefits under the Convention (the "tested resident"), and any company or permanent establishment that:

i) participates as a member with the tested resident in a tax consolidation, fiscal unity or similar regime that requires members of the group to share profits or losses; or

ii) shares losses with the tested resident pursuant to a group relief or other loss sharing regime in the taxable year; and

h) the term "gross income" means gross receipts as determined in the person's Contracting State of residence for the taxable year that includes the time when the benefit would be accorded, except that where a person is engaged in a business that includes the manufacture, production or sale of goods, "gross income" means such gross receipts reduced by the cost of goods sold, and where a person is engaged in a business of providing non-financial services, "gross income" means such gross receipts reduced by the direct costs of generating such receipts, provided that:

i) except when relevant for determining benefits under Article 10 (Dividends) of this Convention, gross income shall not include the portion of any dividends that are effectively exempt from tax in the person's Contracting State of residence, whether through deductions or otherwise; and

ii) except with respect to the portion of any dividend that is taxable, a tested group's gross income shall not take into account transactions between companies within the tested group.

PART II – ADDITIONAL POSSIBLE CHANGES TO OTHER ARTICLES

DEFINITIONS FOR POTENTIAL INCLUSION IN ARTICLE 3 (GENERAL DEFINITIONS)

k) the term "pension fund" means any person established in a Contracting State that is:

i) generally exempt from income taxation in that Contracting State; and

ii) operated exclusively or almost exclusively:

A) to administer or provide retirement benefits and benefits that are incidental or ancillary to such retirement benefits; or

B) to earn income for the benefit of one or more persons established in the same Contracting State that are generally exempt from income taxation in that Contracting State and that are operated exclusively or almost exclusively to administer or provide pension or retirement benefits;

l) the term "special tax regime" means any statute, regulation or administrative practice in a Contracting State with respect to a tax described in Article 2 (Taxes Covered) that meets all of the following conditions:

i) results in one or more of the following:

A) a preferential rate of taxation for interest, royalties, guarantee fees or any combination thereof, as compared to income from sales of goods or services;

B) a permanent reduction in the tax base with respect to interest, royalties, guarantee fees or any combination thereof, without a comparable reduction for income from sales of goods or services, by allowing:

1) an exclusion from gross receipts;

2) a deduction without regard to any corresponding payment or obligation to make a payment;

3) a deduction for dividends paid or accrued; or

4) taxation that is inconsistent with the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises); or

C) a preferential rate of taxation or a permanent reduction in the tax base of the type described in part (1), (2), (3) or (4) of subclause (B) of this clause with respect to substantially all of a company's income or substantially all of a company's foreign source income, for companies that do not engage in the active conduct of a trade or business in that Contracting State;

ii) in the case of any preferential rate of taxation or permanent reduction in the tax base for royalties, does not condition such benefits on the extent of research and development activities that take place in the Contracting State;

iii) is generally expected to result in a rate of taxation[1] that is less than the lesser of either:

A) 15 percent; or

B) 60 percent of the general statutory rate of company tax applicable in the other Contracting State;

iv) does not apply principally to:

A) pension funds;

B) organizations that are established and maintained exclusively for religious, charitable, scientific, artistic, cultural or educational purposes;

C) persons the taxation of which achieves a single level of taxation either in the hands of the person or the person's shareholders (with at most one year of deferral), that hold a diversified portfolio of securities, that are subject to investor-protection regulation in the Contracting State and the interests in which are marketed primarily to retail investors; or

[1] For inclusion in an instrument reflecting an agreed interpretation: Except as provided below, the rate of taxation shall be determined based on the income tax principles of the Contracting State that has implemented the regime in question. Therefore, in the case of a regime that provides only for a preferential rate of taxation, the generally expected rate of taxation under the regime shall equal such preferential rate. In the case of a regime that provides only for a permanent reduction in the tax base, the rate of taxation shall equal the statutory rate of company tax generally applicable in the Contracting State to companies subject to the regime in question less the product of such rate and the percentage reduction in the tax base (with the baseline tax base determined under the principles of the Contracting State, but without regard to any permanent reductions in the tax base described in subparagraph (l)(i)(B)) that the regime is generally expected to provide. For example, a regime that generally provides for a 20 percent permanent reduction in a company's tax base would have a rate of taxation equal to the applicable statutory rate of company tax reduced by 20 percent of such statutory rate. In the case of a regime that provides for both a preferential rate of taxation and a permanent reduction in the tax base, the rate of taxation would be based on the preferential rate of taxation reduced by the product of such rate and the percentage reduction in the tax base.

D) persons the taxation of which achieves a single level of taxation either in the hands of the person or the person's shareholders (with at most one year of deferral) and that hold predominantly real estate assets; and

v) after consultation with the first-mentioned Contracting State, has been identified by the other Contracting State through diplomatic channels to the first-mentioned Contracting State as satisfying clauses (i) through (iv) of this subparagraph.

No statute, regulation or administrative practice shall be treated as a special tax regime until 30 days after the date when the other Contracting State issues a written public notification identifying the regime as satisfying clauses (i) through (v) of this subparagraph; and

m) two persons shall be "connected persons" if one owns, directly or indirectly, at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) or another person owns, directly or indirectly, at least 50 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

POTENTIAL NEW SENTENCE TO ARTICLE 4 (RESIDENT)

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that Contracting State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, and also includes that Contracting State and any political subdivision or local authority thereof. ***This term does not include any person whose tax is determined in that Contracting State, in whole or in part, on a fixed-fee, "forfait" or similar basis, or who is liable to tax in respect only of income from sources in that Contracting State or of profits attributable to a permanent establishment in that Contracting State.***

POTENTIAL NEW RULE FOR ARTICLE 10 (DIVIDENDS)

6. In the case of a company that otherwise satisfies the requirements of paragraph 2 of this Article, but fails to satisfy the requirements of paragraph 4 of Article 22 (Limitation on Benefits) regarding a dividend solely by reason of:

a) the requirement in subclause (B) of clause (i) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention; or

b) the requirement in clause (ii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) that a person entitled to benefits under paragraph 5 of Article 22

(Limitation on Benefits) would be entitled to a rate of tax with respect to the dividend that is less than or equal to the rate applicable under paragraph 2 of this Article;

such company may be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that Contracting State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention (notwithstanding the requirements referred to in subparagraphs (a) and (b) of this paragraph) would have been entitled if such persons had received the dividend directly. For purposes of this paragraph, (i) such persons' indirect ownership of the shares of the company paying the dividends shall be treated as direct ownership, and (ii) a person described in clause (iii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the dividends.

POTENTIAL NEW RULES FOR INCLUSION IN ARTICLE 11 (INTEREST)

c) interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payer of the interest may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits from a special tax regime with respect to the interest in its Contracting State of residence;

e) interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payer of the interest may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits, at any time during the taxable year in which the interest is paid, from notional deductions with respect to amounts that the Contracting State of which the beneficial owner is resident treats as equity;

f) interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is entitled to the benefits of this Article only by reason of paragraph 5 of Article 22 (Limitation on Benefits) may be taxed in the first-mentioned Contracting State, but the tax so charged shall not exceed 10 percent of the gross amount of the interest;

3. Notwithstanding the provisions of paragraph 1 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 22 (Limitation on Benefits) of this Convention regarding a payment of interest, if such company fails to satisfy the criteria of that paragraph solely by reason of:

a) the requirement in subclause (B) of clause (i) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention; or

b) the requirement in clause (ii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) that a person entitled to benefits under paragraph 5 of Article 22 (Limitation on Benefits) would be entitled to a rate of tax with respect to the interest that is less than or equal to the rate applicable under paragraph 2 of this Article;

such company may be taxed by the Contracting State in which the interest arises according to the laws of that Contracting State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention (notwithstanding the requirements referred to in subparagraphs (a) and (b) of this paragraph) would have been entitled if such persons had received the interest directly. For purposes of this paragraph, a person described in clause (iii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the interest.

POTENTIAL NEW RULES FOR INCLUSION IN ARTICLE 12 (ROYALTIES)

a) a royalty arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payer of the royalty may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits from a special tax regime with respect to the royalty in its Contracting State of residence; and

3. Notwithstanding paragraph 1 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 22 (Limitation on Benefits) of this Convention regarding a royalty, if such company fails to satisfy the criteria of that paragraph solely by reason of the requirement in subclause (B) of clause (i) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention, such company may be taxed in the Contracting State in which the royalty arises and according to the laws of that Contracting State, except that the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention (notwithstanding the requirement of subclause (B) of clause (i) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits)) would have been entitled if such persons had received the royalty directly. For purposes of this paragraph, a person described in clause (iii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the royalties.

POTENTIAL NEW RULES FOR INCLUSION IN ARTICLE 21 (OTHER INCOME)

2. Notwithstanding paragraph 1 of this Article:

a) a guarantee fee arising in a Contracting State and characterized as other income by that Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payer of the guarantee fee may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits from a special tax regime with respect to the guarantee fee in its Contracting State of residence;

PART III – EXAMPLE OF COMMENTARY ON A LIMITATION ON BENEFITS ARTICLE

Article 22 contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries. In general, the Article does not rely on a determination of purpose or intention but instead sets forth a series of objective tests. Except for purposes of the discretionary relief provision of paragraph 6, a resident of a Contracting State that meets the provisions of the objective tests under paragraph 2 through 5 will be entitled to the benefits provided for by those tests, regardless of its motivations in choosing its particular business structure.

The Article is comprised of seven paragraphs. Paragraph 1 states the general rule that residents are entitled to benefits otherwise accorded to residents only to the extent provided in the Article. Paragraph 2 provides a series of tests under which a resident of a Contracting State that satisfies any one of the tests will be entitled to the benefits of the Convention as a "qualified person." Paragraph 3 provides that, regardless of whether a person qualifies for benefits under paragraph 2, benefits may be granted to that person with regard to certain income earned in the conduct of an active trade or business. Paragraphs 4 and 5 provide a so-called "derivative benefits" and "headquarters company" test, respectively, under which a company that is not eligible for benefits under paragraph 2 may nevertheless qualify for benefits with respect to particular items of income. Paragraph 6 provides that if a resident of a Contracting State can neither satisfy the requirements of paragraph 2, nor is entitled to benefits with respect to particular items of income under paragraphs 3, 4 or 5, such resident may nevertheless be granted benefits (or benefits with respect to only a particular item income) if the competent authority of the State from which benefits are claimed determines in its sole discretion that it is appropriate to provide benefits in that case. Paragraph 7 defines certain terms used in the Article.

Paragraph 1

Paragraph 1 provides the general rule that a resident of a Contracting State will be entitled to the benefits otherwise accorded to a resident of a Contracting State under the Convention only if such resident is a "qualified person," as described in paragraph 2. Notwithstanding this general rule, benefits on particular items of income may nevertheless be granted if the resident is not a qualified person but meets one of the alternative provisions described in paragraph 3, 4, 5 or 6, or as otherwise provided in paragraph 6 of Article 10 (Dividends), paragraph 3 of Article 11 (Interest) and paragraph 3 of Article 12 (Royalties). The benefits otherwise accorded to residents under the Convention include all limitations on source based taxation under Articles 6 (Income from Real Property (Immovable Property)) through Article 21 (Other Income), the treaty-based relief from double taxation provided by Article 23 (Relief from Double Taxation), and the protection afforded to residents of a Contracting State under Article 24 (Non-Discrimination). The benefits provided under paragraph 2 of Article 9 (Associated Enterprises) or Article 25 (Mutual Agreement Procedure), however, do not require a resident to satisfy a limitation on benefits provision to be entitled to such benefits. Furthermore, some provisions of the Convention do not require that a person be a resident in order to enjoy the benefits of those provisions. For example, Article 27

(Members of Diplomatic Missions and Consular Posts) applies to diplomatic agents or consular officials regardless of residence. Article 22 accordingly does not limit the availability of treaty benefits under these provisions.

Article 22 and the anti-abuse provisions of domestic law complement each other, as Article 22 effectively determines whether a person has a sufficient nexus to a Contracting State to be treated as eligible for treaty benefits, while domestic anti-abuse provisions (*e.g.*, business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be respected, and if the form of the transaction is not respected, which resident, if any, must meet the limitations on benefits article in order to claim treaty benefits with respect to the item of income. For example, domestic law principles of the Contracting State where the income arises may be applied to identify the beneficial owner of an item of income, and Article 22 then will be applied to the beneficial owner to determine if that person is a qualified person that is entitled to the benefits of the Convention with respect to such income. Such determination is made at the time the benefit would be accorded.

Paragraph 2

Paragraph 2 has six subparagraphs, each of which describes a category of residents that will be considered to be qualified persons. Paragraph 2 requires that a resident of a Contracting State, in order to be a qualified person, satisfy the requirements of the paragraph at the time the desired benefit would be accorded. Additionally, with respect to a resident that seeks qualified person status under subparagraph 2(f), the resident must also meet certain ownership requirements for at least half the days of any twelve-month period that includes the date when the desired benefit would be accorded.

Individuals -- Subparagraph 2(a)

Subparagraph 2(a) provides that individual residents of a Contracting State as determined under Article 4 (Resident) are qualified persons. If such an individual receives income as a nominee on behalf of a third country resident, however, benefits will be denied under the applicable articles of the Convention because the beneficial owner of the income is not a resident of a Contracting State.

Governments -- Subparagraph 2(b)

Subparagraph 2(b) provides that the Contracting States and any political subdivision or local authority thereof are qualified persons. Any agency or instrumentality of any such Contracting State, political subdivision or local authority is also a qualified person. In the case of the United States, the reference to an agency or instrumentality of a Contracting State includes independent agencies within the U.S. Government such as the Federal Reserve Board, the Export-Import Bank and the Overseas Private Investment Corporation.

Publicly Traded Companies -- Subparagraph 2(c)

Subparagraph 2(c) provides that a company that is a resident of a Contracting State is a qualified person if the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges and the company satisfies at least one

of the following additional requirements: (i) the company's principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or, (ii) the company's primary place of management and control is in its State of residence.

The term "recognized stock exchange" is defined in subparagraph 7(a). It means (i) any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; (ii) the _____ Stock Exchange; and (iii) any other stock exchange agreed upon by the competent authorities of the Contracting States.

If a company has only one class of shares, it is only necessary to consider whether the shares of that class meet the relevant trading requirements. If the company has more than one class of shares, it is necessary as an initial matter to determine which class or classes constitute the "principal class of shares." The term "principal class of shares" is defined in subparagraph 7(b) to mean the ordinary or common shares of the company representing the majority of the aggregate vote and value of the company. If the company does not have a class of ordinary or common shares representing the majority of the aggregate vote and value of the company, then the "principal class of shares" shall be any combination of classes of shares that represent, in the aggregate, a majority of the vote and value of the company. Although in a particular case involving a company with several classes of shares, it is conceivable that more than one group of classes could be identified as accounting for more than 50 percent of the vote and value of the shares, it is only necessary for one such group to satisfy the requirements of subparagraph 7(b) in order for the company to be entitled to benefits. Benefits would not be denied to the company even if a second, non-qualifying group of shares with more than 50 percent of the company's vote and value could be identified.

A company whose principal class of shares is regularly traded on a recognized stock exchange will nevertheless not be a qualified person under subparagraph 2(c) if it has a disproportionate class of shares that is not regularly traded on a recognized stock exchange. The term "disproportionate class of shares" is defined in subparagraph 7(c). A company has a disproportionate class of shares if it has outstanding a class of shares that is subject to terms or other arrangements that entitle the holder to a larger portion of the company's earnings in the other Contracting State than that to which the holder would be entitled in the absence of such terms or arrangements. Thus, for example, a company resident in the other Contracting State has a disproportionate class of shares if it has outstanding a class of shares that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States. In the case of a trust, the reference to any "class of shares" means any class of beneficial interests in such trust.

Example 1. OCo is a corporation resident in the other Contracting State. OCo has two classes of shares: common and preferred. The common shares account for more than 50 percent of the value of the outstanding shares of OCo and 100 percent of the voting shares, and thus constitute the principal class of shares of OCo. The common shares are listed and regularly traded on a recognized stock exchange of the other Contracting State, but the preferred shares are not. The preferred shares only entitle the holder to receive dividends to the extent of interest payments that OCo receives from unrelated borrowers in the United States. The preferred shares are owned entirely by a single investor that is a resident of a country with which the United States does not have an income tax treaty. Because the owner of the preferred shares is entitled to receive payments corresponding to the U.S. source interest income paid to OCo, the preferred shares are a

disproportionate class of shares. Because the preferred shares are not regularly traded on a recognized stock exchange, OCo will not qualify for benefits under subparagraph 2(c).

The term "regularly traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will be defined by reference to the domestic tax laws of the State from which treaty benefits are sought, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(4)(i)(B), which defines the term for purposes of determining if a foreign corporation is publicly traded for purposes of the branch profits tax under the Code. Under these regulations, each class of shares relied on, if more than one class is relied upon to constitute the principal class of shares, is considered to be "regularly traded" if two requirements are met: (i) trades in each such class of shares are made in more than *de minimis* quantities on at least 60 days during the taxable year, and (ii) the aggregate number of shares in each such class traded during the year is at least 10 percent of the average number of shares outstanding during the year. Treas. Reg. sections 1.884-5(d)(4)(i)(A), (d)(4)(ii), and (d)(4)(iii) will not be taken into account in defining the term "regularly traded" for purposes of the Convention.

The regular trading requirement can be met by trading on any recognized stock exchange or exchanges located in either Contracting State. Trading on one or more recognized stock exchanges may be aggregated for purposes of this requirement. Thus, a company resident in the other Contracting State could satisfy the regularly traded requirement through being traded, in whole or in part, on a recognized stock exchange located in the United States. Authorized but unissued shares are not considered for purposes of this test.

The term "primarily traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will also have the meaning it has under the laws of the State concerning the taxes to which the Convention applies, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(3). Accordingly, each class of shares, if more than one class is relied upon to constitute the principal class of shares, must satisfy the "primarily traded" test, and the number of shares in each class that is traded during the taxable year on all recognized stock exchanges located in the Contracting State of which the company is a resident must exceed the number of shares in the company's principal class of shares that is traded during that year on established securities markets located in any other single country.

A company whose principal class of shares is regularly traded on a recognized stock exchange but is not primarily traded on a recognized stock exchange in its country of residence could nevertheless be a qualified person under subparagraph 2(c) if its "primary place of management and control," as defined in subparagraph 7(d), is in its country of residence. This test is distinct from the "place of effective management" test that is used in Article 4 (Resident) of the OECD Model and by many countries to establish corporate residence. For example, in some countries, the place of effective management test has been interpreted to mean the place where the board of directors meets. By contrast, the "primary place of management and control" test looks to where day-to-day responsibility for the management of the company and its direct and indirect subsidiaries is exercised. The company's primary place of management and control is located in the State in which the company is a resident only if the following two conditions are satisfied.

First, the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the

company and its direct and indirect subsidiaries in that State, and the staff that support such management in preparing for and making those decisions conduct more of their necessary day-to-day activities in that State, than in the other State or any third state. Thus, the test looks to the overall activities of the relevant persons to see where those activities are conducted. In most cases, it will be a necessary, but not a sufficient, condition that the chief executive officer and other top executives normally are in the Contracting State of which the company is a resident. Second, the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company and its direct and indirect subsidiaries, and the staff that support such management in making those decisions conduct more of their necessary day-to-day activities, than the officers or employees of any other company.

Subsidiaries of Publicly Traded Companies -- Subparagraph 2(d)

Subparagraph 2(d) sets forth rules to determine if a subsidiary of a publicly-traded company (a "tested subsidiary") will be a qualified person for purposes of the Convention. A tested subsidiary resident in a Contracting State is a qualified person under subparagraph 2(d) if it satisfies a two-pronged ownership and base erosion test, except that in the case of benefits under Article 10 (Dividends), the tested subsidiary would only need to satisfy the ownership prong. Clause (i) of subparagraph 2(d) sets forth the ownership test, and requires that at least 50 percent of the aggregate vote and value of the tested subsidiary's shares (and at least 50 percent of the aggregate vote and value of any disproportionate class of shares) be directly or indirectly owned by five or fewer publicly traded companies that satisfy the requirements of subparagraph 2(c). If the publicly traded companies are indirect owners, each of the intermediate companies must be a "qualifying intermediate owner," as defined in subparagraph 7(f) or a resident of the same Contracting State from which a benefit under this Convention is being sought. Under clause (i) of subparagraph 7(f), a qualifying intermediate owner is an entity resident of a third state that has in effect a comprehensive income tax convention with the Contracting State of source, and such convention includes provisions addressing special tax regimes and notional deductions that are analogous to the provisions in Article 3 (General Definitions) and Article 11 (Interest), respectively.

Under clause (ii) of subparagraph 7(f), a qualifying intermediate owner also includes a resident of the same Contracting State as the tested subsidiary claiming benefits under this subparagraph.

Thus, for example, a tested subsidiary resident in the other Contracting State would satisfy the requirements of clause (i) of subparagraph 2(d) if it is wholly owned by a company that is also a resident of the other Contracting State that satisfies the requirements of subparagraph 2(c). Furthermore, if a publicly traded parent company in the other Contracting State indirectly owns the tested subsidiary through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the Contracting State from which a benefit under this Convention is being sought or a qualifying intermediate owner in order for the tested subsidiary to meet the ownership test in clause (i) of subparagraph 2(d).

Clause (ii) of subparagraph 2(d) sets forth the base erosion test that a tested subsidiary that is seeking benefits, other than benefits under Article 10 (Dividends), must satisfy in order to be a qualified person. The base erosion test is satisfied if two requirements are met. First, less than 50 percent of the tested subsidiary's gross income (as defined in subparagraph 7(h)) is paid or accrued, directly or indirectly, in the form of payments that are deductible by the tested subsidiary for tax

purposes in the tested subsidiary's State of residence to ineligible persons. This technical explanation refers to the following as "ineligible persons": (i) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph 2(a), 2(b), 2(c) or 2(e); (ii) to persons that are residents of either Contracting State that are connected persons (as defined in subparagraph 1(m) of Article 3 (General Definitions)) with respect to the tested subsidiary and benefit from a special tax regime with respect to the deductible payment; or (iii) with respect to a payment of interest, to persons that are connected persons with respect to the tested subsidiary and that benefit from notional deductions described in Article 11 (Interest).

Second, if there is a tested group as defined in subparagraph 7(g), then less than 50 percent of the tested group's gross income is paid or accrued, directly or indirectly, in the form of payments that are deductible by any member of the tested group for tax purposes in the tested subsidiary's State of residence, to ineligible persons.

For the purpose of applying the base erosion test at either the tested subsidiary or tested group level, deductible payments do not include arm's-length amounts paid or accrued in the ordinary course of business for services or tangible property. To the extent they are deductible from the taxable base, trust distributions are deductible payments. Depreciation and amortization deductions, which do not represent payments or accruals to other persons, are disregarded for this purpose. Furthermore, in the case of a tested group, deductible payments do not include intra-group payments. Deductible payments that are not excluded are referred to as "base eroding payments". For purposes of applying the base erosion test, payments of interest are not arm's-length amounts paid or accrued in the ordinary course of business for services, and would be treated as base eroding payments if made to an ineligible person.

Subparagraph 7(h) defines the term "gross income" for purposes of applying the base erosion test clause (ii) of subparagraph 2(d). The starting point for calculating gross income is gross receipts as determined in the tested subsidiary's Contracting State of residence for the taxable period that includes the time when the benefit would be accorded. If the tested subsidiary is engaged in a business that includes the manufacture, production or sale of goods, "gross income" means gross receipts reduced by the cost of goods sold. If the tested subsidiary is engaged in a business of providing non-financial services, "gross income" means such gross receipts reduced by the direct costs of generating such receipts.

Clause (i) of subparagraph 7(h) further provides that except for determining benefits under Article 10 (Dividends), gross income shall not include the portion of any dividends that are effectively exempt from tax in the person's Contracting State of residence, whether through deductions or otherwise, regardless of source. Clause (ii) of subparagraph 7(h) provides that, except with respect to the portion of any dividend that is taxable, a tested group's gross income will not take into account any transactions between companies within the tested group.

Subparagraph 7(g) defines the term "tested group" for purposes of applying the tested group base erosion rule in clause (ii) of subparagraph 2(d). The tested group shall consist of the tested subsidiary and any company that either participates as a member with the tested resident in a tax consolidation regime, fiscal unity or similar regime that allows members of the group to share profits or losses, or any company that shares losses with the tested resident pursuant to a group relief or other loss sharing regime in the taxable year. If there is no tested group, then the base erosion test in clause (ii) of subparagraph 2(d) with respect to a tested group shall not apply.

Example 2. Assume that at all relevant times, R3 (the tested subsidiary) is wholly owned by another company, R2, which in turn is wholly owned by R1, a publicly traded company that satisfies the requirements of subparagraph 2(c). R3, R2 and R1 are all residents of the other Contracting State as determined under Article 4 (Resident) and are all members of the same tax consolidation group. The ownership prong in clause (i) of subparagraph 2(d) of the test is satisfied because R1, a company satisfying the requirements of subparagraph 2(c), indirectly owns at least 50 percent of the aggregate vote and value of R3 (and at least 50 percent of the aggregate vote and value of any disproportionate class of shares of R3), and R2, which is an intermediate owner, is a resident of the other Contracting State and is therefore a qualifying intermediate owner.

During the taxable year that includes the time when the benefit would otherwise be accorded, R3 derives: (i) $200 of dividends from a company resident in a third State that are excluded from gross income of R3 in the other Contracting State; and (ii) $100 of U.S. interest, for which R3 is seeking the benefits of Article 11 (Interest) of the Convention. R3 makes a base eroding payment of $49 to an ineligible person and pays a dividend of $51 to R2. In addition to the $51 dividend that it receives from R3, R2 receives additional gross receipts of $100 from persons outside the tested group. R2 makes a base eroding payment of $51 to an ineligible person.

In this example, the tested group consists of R3, R2 and R1, because the three companies participate in a tax consolidation regime. In order to be eligible for benefits with respect to the U.S source interest payment, R3 must meet the tested subsidiary base erosion test, and the tested group must meet the tested group base erosion test.

R3's gross income, as defined in subparagraph 7(h), is $100 (the U.S. source interest), since the $200 dividend paid to R3 from a third-country company is excluded. Thus, for the taxable year for which R3 seeks benefits, less than $50 of R3's gross income may be in the form of base eroding payments to ineligible persons. R3 has made only $49 in base eroding payments and would satisfy the first prong of the subsidiary base erosion test.

The tested group's gross income under the law of the other Contracting State excludes the $200 dividend paid to R3 from a third-country company and intragroup transactions (i.e., the $51 dividend from R3 to R2). The tested group's gross income is, therefore, $200 (the $100 U.S. source interest plus the $100 R2 received from persons outside the tested group). Thus, during the taxable year in question, the tested group may make less than $100 in base eroding payments to ineligible persons in order to satisfy the base erosion test of clause (ii) of subparagraph 2(d).

In this example, R3 does not satisfy the requirements of subparagraph 2(d). Although R3's $49 of base eroding payments to ineligible persons does not exceed the allowable limit of less than $50, the tested group's total base eroding payments to ineligible persons of $100 ($49 + $51), exceeds the tested group's allowable limit of base eroding payments to ineligible persons of less than $100.

Example 3. Assume the same facts as in Example 2, except that R3 derives $100 of U.S. source dividends rather than U.S. source interest, and has no other gross income in the taxable year. Because the only benefit that R3 is seeking is under Article 10 (Dividends), R3 is not required to apply the base erosion test under clause (ii) of subparagraph 2(d). Accordingly, R3 will be a qualified person with respect to the dividend under subparagraph 2(d) because it satisfies the ownership requirement of clause (i) of subparagraph 2(d).

Example 4. Assume the same facts as in Example 2, except that R3's only items of income are U.S. source royalties of $100, for which R3 seeks to claim benefits of Article 12 (Royalties) of the Convention. R3 makes a deductible royalty payment of $100 to R1. At all relevant times, R1 benefits from a special tax regime within the meaning of paragraph l of Article 3 (General Definitions) with respect to royalties.

The ownership prong of clause (i) of subparagraph 2(d) of the test is satisfied because R1, a company satisfying the requirements of subparagraph 2(c), indirectly owns at least 50 percent of the aggregate vote and value of R3 and R2 is a qualifying intermediate owner. However, even though R1 is a person that satisfies subparagraph 2(c), the deductible royalty payment made to R1 by R3 is a base eroding payment because R1 is an ineligible person. R1 is a connected person with respect to R3 and benefits from a special tax regime with respect to the royalty income. In this example, R3 does not satisfy the subsidiary base erosion test under clause (ii) of subparagraph 2(d) because R3 has made $100 of base eroding payments to a person who benefits from a special tax regime and the amount, $100, exceeds R3's allowable limit of base eroding payments to ineligible persons (less than $50 is the allowable limit).

Example 5. Assume that at all relevant times, P2 (the tested subsidiary) is a company that is wholly owned by P1, a publicly traded company that satisfies the requirements of subparagraph 2(c). P2 and P1 are residents of the other Contracting State.

During the taxable year in question, P2's only items of income are U.S. source interest of $100, for which P2 seeks to claim the benefits of Article 11 (Interest) of the Convention. P2 makes a deductible interest payment of $100 to P1, a person that satisfies subparagraph 2(c). P1 makes a deductible payment during the same taxable period of $100 to ThirdCo, a company resident in State Y. P2, through P1, has indirectly made a base eroding payment of $100 to an ineligible person. In this example, the base erosion test under clause (ii) of subparagraph 2(d) is not satisfied and P2 will not be a qualified person.

Pension Funds and Tax Exempt Organizations -- Subparagraph 2(e)

Subparagraph 2(e) provides rules under which the pension funds and other tax-exempt organizations described in paragraph 2 of Article 4 (Resident) will be qualified persons. A pension fund established in a Contracting State and described in subclause (A) of subparagraph 1(k)(ii) of Article 3 (General Definitions) is a qualified person if more than 50 percent of the beneficiaries, members or participants of the pension fund are individuals who are resident in either Contracting State. For purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the pension fund. A pension fund described in subclause (B) of subparagraph 1(k)(ii) of Article 3 (General Definitions) is a qualified person if the earnings of such person benefit exclusively, or almost exclusively, pension funds that satisfy the requirements of clause (i) of subparagraph 2(e).

On the other hand, an organization described in subparagraph 2(b) of Article 4 automatically qualifies for benefits, without regard to the residence of its beneficiaries, members, or participants. Organizations qualifying under this rule are established and maintained in that State exclusively for religious, charitable, scientific, artistic, cultural or educational purposes and are generally exempt from tax in their State of residence.

Ownership/Base Erosion -- Subparagraph 2(f)

Subparagraph 2(f) provides an additional method to become a qualified person for any form of legal person that is a resident of a Contracting State (a "tested person"). A tested person resident in a Contracting State is a qualified person under subparagraph 2(f) if it satisfies both the ownership test under clause (i) of subparagraph 2(f) and the base erosion test under clause (ii) of subparagraph 2(f).

The Ownership Test

The ownership prong of the test, under clause (i), provides that 50 percent or more of the aggregate vote and value of the outstanding shares or other beneficial interests (and at least 50 percent of the aggregate vote and value of any disproportionate class of shares) in the tested person must be owned, directly or indirectly, on at least half the days of any twelve-month period that includes the date when the benefit in question otherwise would be accorded by persons who are residents of the Contracting State of which the tested person is a resident and are themselves entitled to treaty benefits under subparagraph 2(a), 2(b), 2(c) or 2(e). In the case of indirect owners, each intermediate owner must be a qualifying intermediate owner as defined in subparagraph 7(f).

Trusts may be entitled to benefits under this provision if they are residents as determined under Article 4 (Residence) and they otherwise satisfy the requirements of this subparagraph. For purposes of this subparagraph, the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust. The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under subparagraph 2(a), 2(b), 2(c) or 2(e) if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of the beneficiaries in a trust, the ownership test under clause (i) of subparagraph 2(f) cannot be satisfied unless all possible beneficiaries are persons entitled to benefits under subparagraph 2(a), 2(b), 2(c) or 2(e).

Unlike the other tests described in paragraph 2, in order to be a qualified person, the tested person must satisfy the ownership test at the time when the benefit otherwise would be accorded, as well as on at least half of the days of any twelve-month period that includes the date when the benefit otherwise would be accorded.

The Base Erosion Test

Clause (ii) of subparagraph 2(f) sets forth a base erosion test that a tested person must satisfy in order to be a qualified person. This test is qualitatively the same as the base erosion test in clause (ii) of subparagraph 2(d), except that this base erosion test will also apply to a tested person that is seeking benefits under Article 10. The base erosion test under clause (ii) of subparagraph 2(f) is satisfied if two requirements are met.

First, less than 50 percent of the tested person's gross income may be paid or accrued, directly or indirectly, in the form of payments deductible by the tested person for tax purposes in the tested person's State of residence, to "ineligible persons", as that term is defined in the explanation to clause (ii) of subparagraph 2(d).

Second, if there is a tested group as defined in subparagraph 7(g), then less than 50 percent of the gross income of the tested group may be paid or accrued, directly or indirectly, in the form of payments that are deductible by any member of the tested group for tax purposes in the tested person's State of residence, to ineligible persons.

Similar to the base erosion test under clause (ii) of subparagraph 2(d), for the purpose of applying the base erosion test, deductible payments do not include arm's-length payments in the ordinary course of business for services or tangible property. To the extent they are deductible from the taxable base, trust distributions are deductible payments. Depreciation and amortization deductions, which do not represent payments or accruals to other persons, are disregarded for this purpose. Furthermore, in the case of a tested group, deductible payments do not include intra-group payments. For purposes of applying the base erosion test, payments of interest are not arm's-length amounts paid or accrued in the ordinary course of business for services and would be treated as base eroding payments if made to an ineligible person.

Subparagraph 7(h) defines the term "gross income" for purposes of applying the base erosion test.

Unlike subparagraph 2(d), if a tested person seeking to become a qualified person by satisfying subparagraph 2(f) wishes to obtain the benefits of Article 10 (Dividends), the tested person must satisfy the base erosion test in clause (ii) of subparagraph 2(f). Furthermore, because it is relevant for determining benefits under Article 10 of this Convention, a tested person shall include in its gross income any dividends received even if the dividends are effectively exempt from tax in the tested person's State of residence as provided in clause (i) of subparagraph 7(h).

Subparagraph 7(g) defines the term "tested group" for purposes of applying the tested group base erosion rule in clause (ii) of subparagraph 2(f), which is similar to the rule described in clause (ii) of subparagraph 2(d).

Example 6. Assume that at all relevant times, R2 (the tested person) is a wholly owned subsidiary of R1, which in turn is wholly owned by Z, an individual. R1, R2 and Z are all residents of the other Contracting State as determined under Article 4 (Resident). R2 and R1 are both members of the same tax consolidation group. The ownership prong of subparagraph 2(f) is satisfied because Z, a qualified person under subparagraph 2(a) owns indirectly at least 50 percent of the aggregate vote and value of R2, and R1 is a qualifying intermediate owner.

During the taxable year in question, R2 has $50 of exempt dividend income from non-U.S. sources and $50 of U.S. source interest. R2 makes a deductible interest payment of $24 to an ineligible person and pays a $51 dividend to R1. In addition to the $51 dividend that it receives from R2, R1 receives additional income of $100 from persons outside the tested group. R1 makes a deductible interest payment of $51 to an ineligible person. R2 is seeking to claim the benefits of Article 11 (Interest) of the Convention, but not Article 10 (Dividends).

For purposes of applying the tested group base erosion test, the tested group consists of R1 and R2. The tested group's gross income for this purpose is $150 ($50 of U.S. source interest plus $100 of additional income from persons outside of the tested group). R2 has made a base eroding payment of $24 and R1 has made a base eroding payment of $51 to ineligible persons. The base eroding payments of the tested group total $75 ($24 + $51), which is not less than 50 percent of the

tested group's gross income of $150. Therefore, the base erosion prong of the test is not satisfied and R2 is not a qualified person under subparagraph 2(f).

Example 7. Assume the same facts as Example 6 above, except that the U.S. source income with respect to which R2 seeks to be a qualified person is a $50 dividend. For this purpose, R2's gross income is $100 (the $50 dividend from the company in the third state plus the $50 U.S. source dividend). The gross income of the tested group is $200 (R2's gross income of $100 plus R1's income of $100 from persons outside the tested group). R2 has made a base eroding payment of $24 and R1 has made a base eroding payment of $51. The base eroding payments of R2 equal $24, which is less than 50 percent of R2's gross income of $100. In addition, the base eroding payments of the tested group total $75 ($24 + $51), which is less than 50 percent of the tested group's gross income of $200. Therefore, under this example, the base erosion prong of the test is satisfied and R2 shall be a qualified person under subparagraph 2(f) for purposes of obtaining a lower rate of taxation on the U.S. source dividend.

Paragraph 3

Paragraph 3 sets forth an alternative test under which a resident of a Contracting State that does not qualify for benefits under paragraph 2 may be able to qualify for benefits with respect to certain items of income that emanate from, or are incidental to, an active trade or business conducted in its State of residence.

Subparagraph (a) of paragraph 3 sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a trade or business in that State may obtain the benefits of the Convention with respect to an item of income derived from the other Contracting State if the income emanates from, or is incidental to, that trade or business.

The term "trade or business" is not defined in the Convention. Pursuant to paragraph 2 of Article 3 (General Definitions), when determining whether a resident of the other Contracting State is entitled to the benefits of the Convention under paragraph 3 of this Article with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the law of the United States, namely, the regulations issued under Code section 367(a)(3). In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitutes or could constitute an independent economic enterprise carried on for profit. The holding for one's own account of investments in stocks, securities, land or other property, including casual sales thereof, however, will not constitute a trade or business. Furthermore, a company generally will be considered to carry on the "active" conduct of a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

In addition, clauses (i) through (iv) of subparagraph 3(a) identify specific functions that, either on their own or in combination, will not, for purposes of this test, constitute the active conduct of a trade or business in a Contracting State, even when all such functions are conducted in the same Contracting State. These are: (i) operating as a holding company; (ii) providing overall supervision or administration of a group of companies; (iii) providing group financing (including cash pooling); and (iv) making or managing investments, unless these activities are carried on by a regulated bank, insurance company or registered securities dealer in the ordinary course of its business as such. This list of activities is intended to clarify that the administrative support functions of multinationals, as well as holding companies, are not active trades or

businesses and, therefore, income from the other Contracting State that emanates from, or is incidental to, such activities cannot benefit from a reduced treaty rate under paragraph 3.

Whether an item of income emanates from the company's active conduct of a trade or business in the State of residence must be determined based on facts and circumstances. In general, an item of income emanates from an active conduct of a trade or business in the residence country if there is a factual connection between the actively conducted trade or business and the item of income for which benefits are sought. For example, if a company conducts research and development in its State of residence and develops a patent for a new process, royalties from licensing the patent would be factually connected to the active trade or business in the residence State. In the case of dividends or interest paid to a parent company, the activities of the payor subsidiary will be relevant in determining whether the dividend or interest emanates from the parent's actively conducted trade or business in its State of residence.

The line of business in the State of source may be upstream or downstream to the activity conducted in the State of residence. Thus, the line of business in the State of source may provide inputs for a manufacturing process that occurs in the State of residence by a resident company, or the line of business in the State of source may sell the output of the manufacturing process conducted by a resident.

Example 8. USCo is a corporation resident in the United States. USCo is engaged in the United States in the active conduct of a manufacturing business that requires the use of Commodity X. USCo owns 100 percent of the shares of FCo, a corporation resident in the other Contracting State, which contains a large supply of Commodity X. FCo extracts Commodity X and sells it to USCO, which uses the commodity to manufacture goods that it sells in the open market. Since the business activity conducted by FCo provides upstream inputs to USCo for use in manufacturing of its goods, FCo's business is factually connected to USCo's manufacturing activities in the United States. Dividends paid by FCo to USCo will be treated as emanating from the USCo's trade or business.

Example 9. USCo operates a large research and development facility in the United States that develops intellectual property that it licenses to affiliates worldwide, including FCo. USCo owns 100 percent of the shares of FCo, a corporation resident in the other Contracting State. FCo manufactures and markets the USCo-designed products in the other Contracting State. Since the activities conducted by FCo are factually connected to USCo's actively conducted business in the United States, royalties paid by FCo to USCo for the use of its intellectual property will be treated as emanating from the USCo's trade or business.

Example 10. USCo is a corporation resident in the United States. USCo is engaged in the United States in the active conduct of a business that manufactures Product X. USCo owns 100 percent of the shares of FCo, a corporation resident in the other Contracting State. FCo acquires Product X from USCo and distributes it to customers in the other Contracting State. Since the distribution activity by FCo of Product X is factually connected to USCo's manufacturing of Product X, dividends paid by FCo to USCo will be treated as emanating from the USCo's trade or business.

An item of income derived from the State of source is "incidental to" the trade or business carried on in the State of residence if production of the item facilitates the conduct of the trade or business in the State of residence. An example of incidental income is the temporary investment of

working capital of a person in the State of residence in securities issued by persons in the State of source.

Subparagraph 3(b) states a further condition to the general rule in subparagraph 3(a) in cases where the trade or business generating the item of income in question is carried on either by the person deriving the income or by a connected person in the State of source. Subparagraph 3(b) states that the trade or business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. The determination of substantiality is based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each Contracting State, the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State.

The determination in subparagraph 3(b) is made separately for each item of income derived from the State of source, with reference to the trade or business in the State of residence from which the item of income in question emanates. It therefore is possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of income under paragraph 3, the resident is entitled to all benefits of the Convention insofar as they affect the taxation of that item of income in the State of source.

The substantiality requirement under subparagraph 3(b) will not apply, however, if the trade or business generating the item of income in question is not carried on in the State of source by the resident seeking benefits or by a connected person in the State of source. For example, if a small U.S. research firm develops a process that it licenses to a very large, pharmaceutical manufacturer in the other Contracting State that is not a connected person with respect to the U.S. research firm, the size of the business activity of the U.S. research firm would not have to be tested against the size of the business activity of the manufacturer. Similarly, a small U.S. bank that makes a loan to a very large company that is not a connected person with respect to the U.S. bank and that is operating a business in the other Contracting State would not have to pass a substantiality test to be eligible for treaty benefits under paragraph 3.

Subparagraph 3(c) provides attribution rules in the case of activities conducted by connected persons for purposes of applying the substantive rules of subparagraphs 3(a) and 3(b). Thus, these rules apply for purposes of determining whether a person meets the requirement in subparagraph 3(a) that it be engaged in the active conduct of a trade or business and that the item of income emanates from that active trade or business, and for making the comparison required by the "substantiality" requirement in subparagraph (b). The term "connected person" is defined in subparagraph 1(m) of Article 3 (General Definitions).

Example 11. Parent is a resident of a third state and is the common parent of OpCo1, HoldCo, and OpCo2. OpCo1 and HoldCo are residents of the other Contracting State. OpCo2 is a resident of the United States. OpCo1 and OpCo2 are engaged in the business of manufacturing the same product in their respective countries of residence. HoldCo manages the investments of the group and is not engaged in the active conduct of a trade or business. HoldCo receives U.S. source dividends from OpCo2. Under subparagraph 3(c), HoldCo is deemed to be engaged in the active conduct of a trade or business because it is deemed to conduct the activities of OpCo1, which is engaged in the active conduct of a trade or business. Therefore, HoldCo is treated as engaged in the active conduct of a trade or business in the other Contracting State. Nevertheless, the fact that

HoldCo's deemed trade or business is the same as the trade or business of OpCo2 is not sufficient to demonstrate that the dividends paid by OpCo2 are factually connected to HoldCo's actively conducted trade or business. Accordingly, such dividends will not enjoy the reduced rates of withholding of Article 10 (Dividends) of the Convention.

Example 12. Assume the same facts as Example 8, except that FCo is owned by HoldCo, a holding company resident in the United States, which also owns 100 percent of USCo. HoldCo is considered to be engaged in the active conduct of a trade or business because it is deemed under subparagraph 3(c) to conduct the activities of USCo. Since the business activity conducted by FCo provides upstream inputs for use in HoldCo's deemed active conduct of a trade or business, FCo's business is considered to form part of HoldCo's deemed manufacturing business, Dividends paid by FCo to HoldCo will therefore emanate from HoldCo's deemed active conduct of a trade or business.

Paragraph 4

Paragraph 4 sets forth an alternative test under which a resident of a Contracting State that is not a qualified person may receive treaty benefits with respect to certain items of income. In general, a derivative benefits test entitles a company that is a resident of a Contracting State (a "tested company") to the benefits if 95 percent of the vote and value of its shares are owned, directly or indirectly, by seven or fewer equivalent beneficiaries (as defined in subparagraph 7(e)) and the tested company satisfies the base erosion test in subparagraph 4(b). In the case of indirect ownership, each intermediate owner must be a qualifying intermediate owner as defined in subparagraph 7(f).

The Ownership Test

Subparagraph 4(a) sets forth the ownership test. Under this test, seven or fewer "equivalent beneficiaries" as defined in subparagraph 7(e) must own, directly or indirectly, shares representing at least 95 percent of the aggregate vote and value of the tested company and at least 50 percent of any disproportionate class of shares as defined in subparagraph 7(c) on at least half of the days of any twelve-month period that includes the date when benefits would otherwise be accorded. In the case of indirect ownership, each intermediate owner must be a "qualifying intermediate owner" as defined in subparagraph 7(f).

As described below, there are three categories of equivalent beneficiary.

Potential equivalent beneficiary status for residents of third States

The first category of equivalent beneficiary is limited to residents of third states that would be entitled to all of the benefits of a comprehensive income tax convention between that person's State of residence and the State from which benefits are sought (the "tested convention") under provisions that are substantially similar to the rules in subparagraph 2(a), 2(b), 2(c) or 2(e) of this Article. A company may also be an equivalent beneficiary if it is entitled to benefits under a treaty pursuant to a headquarters company test under the tested convention that is substantially similar to paragraph 5 of this Article, but only if the benefit being sought by the tested company is with respect to interest or dividends paid by a member of the equivalent beneficiary's multinational corporate group. If the tested convention does not

have a comprehensive limitation on benefits article, the requirement of subclause (A) of subparagraph 7(e)(i) is met only if the person would be entitled to benefits by reason of the tests in subparagraph 2(a), 2(b), 2(c) or 2(e) of this Article if the person were a resident of one of the Contracting States under Article 4 (Resident) of the Convention.

A third-country resident cannot be an equivalent beneficiary if the person only satisfies: (i) a test for subsidiaries of publicly traded companies substantially similar to subparagraph 2(d), (ii) a stock ownership base erosion test substantially similar to subparagraph 2(f), (iii) an active trade or business test substantially similar to paragraph 3, (iv) a derivative benefits test substantially similar to subparagraph 4, (v) a discretionary relief provision substantially similar to paragraph 6, or (vi) any other limitation on benefits provision of the tested convention that is not a test under this Convention, because such resident would not be a qualified person under provisions substantially similar to subparagraph 2(a), 2(b), 2(c) or 2(e) of this Article.

Example 13. HoldCo, a resident of the other Contracting State, is a wholly owned direct subsidiary of XCo, a resident of State X. XCo's principal class of shares is primarily and regularly traded on the Stock Exchange in State X. HoldCo is not entitled to benefits under paragraph 2, because it is a subsidiary of a company resident in and publicly traded in a third state. HoldCo is not engaged in the conduct of an active trade or business in the other Contracting State, and therefore it is not entitled to any benefits under paragraph 3. HoldCo derives and beneficially owns U.S. source interest that would be exempt from tax under this Convention. In order to determine if HoldCo is entitled to benefits under the derivative benefits test, it is necessary to determine whether XCo satisfies the definition of equivalent beneficiary in subparagraph 7(e). The income tax convention between the United States and State X (the U.S.-X convention) contains a comprehensive limitation on benefits provision, including a rule for companies whose principal class of shares is primarily and regularly traded on the Stock Exchange of State X that is substantially similar to subparagraph 2(c). Therefore, XCo satisfies the requirement of subclause (A) of subparagraph 7(e)(i). The U.S.-X convention would exempt the interest from tax if derived by XCo directly, so XCo satisfies the requirement of subclause (B) of subparagraph 7(e)(i). Accordingly, XCo is an equivalent beneficiary.

Subclause (A) of subparagraph 7(e)(i) also provides that if an individual would be entitled to the benefits of subparagraph 2(a) of a tested convention, the individual will nonetheless not be an equivalent beneficiary if he or she is liable to tax in whole or in part in that state on a remittance or similar basis, or in whole or in part on a fixed-fee, "forfait" or similar basis.

Except as otherwise provided in paragraph 6 of Article 10 (Dividends), paragraph 3 of Article 11 (Interest) and paragraph 3 of Article 12 (Royalties), subclause (B)(1) of subparagraph 7(e)(i) requires an equivalent beneficiary to be entitled to a rate of tax on the type of income derived by the tested company under either the tested convention, domestic law or any other international agreement that is less than or equal to the rate of tax applicable to the tested company under this Convention. Thus, the rates to be compared are: (i) the rate of tax that the source State could impose under the Convention on income paid to the tested company if it qualified for the benefits; and (ii) the rate of tax that the source State could have imposed if the potential equivalent beneficiary had derived the income directly from the source State (the "rate comparison test").

As described above, subclause (B)(1) of subparagraph 7(e)(i) provides that any reduced rates of taxation that are available under domestic law by virtue of a state's membership in an economic bloc will be taken into account. This rule recognizes that withholding taxes on many inter-company dividends, interest and royalties may be eliminated, for example, by reason of directives establishing economic blocs of countries, such as the Parent-Subsidiary Directive within the European Union, rather than by income tax convention.

Example 14. EUCo1, a company resident in EU1, wholly owns USCo, a resident of the United States. USCo wholly owns EUCo2, a resident of EU2 and derives interest from EUCo2. The US-EU2 convention contains a definition of equivalent beneficiary that is the same as the definition in this Convention. EUCo1 and EUCo2 are each a member of the European Union. Under the Parent-Subsidiary Directive, interest paid by EUCo2 to EUCo1 would be exempt from withholding by EUCo2. Therefore, EUCo1 would satisfy subclause (B)(1) of subparagraph 7(e)(i), even if the rate of withholding on interest under the EU1-EU2 convention were greater than zero.

Subclause (B)(1)(I) of subparagraph 7(e)(i) provides a rule in the case of dividends that allows an individual to be treated as a company for purposes of the rate comparison test described above. Because dividends beneficially owned by individuals are generally not entitled to a rate of tax that is less than 15 percent of the dividend paid under U.S. tax conventions, whereas a company may be entitled to a rate of 5 percent or lower if certain conditions are met, absent this provision, individual shareholders of a tested company generally would not qualify as equivalent beneficiaries in the case of dividends. By treating individuals as companies for purposes of the rate comparison test, this special rule allows tested companies to take into account the shares owned, directly or indirectly, by the individual as if such shares were owned by a company described in subparagraph 2(c) for purposes of determining whether the tested company is 95 percent owned by equivalent beneficiaries. This is relevant, for example, for purposes of qualifying for the 5 percent rate under subparagraph 2(a) of Article 10 (Dividends).

To be eligible to apply the rule in subclause (B)(1)(I) of subparagraph 7(e)(i), the tested company must be engaged in the active conduct of a trade or business in the state of residence. The rule treats an individual shareholder not otherwise disqualified under subclause (A) of subparagraph 7(e)(i) as if it were a company described in subparagraph 2(c) if the tested company is engaged in the active conduct of a trade or business in its Contracting State of residence that is both substantial in relation to, and similar or complementary, to the trade or business that generated the earnings from which the dividend is paid. The test in subclause (B)(1)(I) of subparagraph 7(e)(i) is similar to the active conduct of a trade or business test under paragraph 3 of this Article, but is not exactly the same because it does not require that the income from the source state "emanate" from the trade or business actively conducted by the tested company. The term "active conduct of a trade or business" has the same meaning as it does in subparagraph 3(a), and therefore does not include the activities described in clauses (i) through (iv) of that subparagraph. For purposes of determining if the tested company is engaged in an active conduct of a trade or business in a Contracting State, activities conducted by a person connected to the tested company shall be deemed to be conducted by such company. The term "substantial in relation to" has the same meaning as it does in subparagraph 3(c). However, that substantiality requirement must be applied regardless of whether the dividend is derived from a connected person. On the other hand, the dividend derived from the other Contracting State does not have to emanate from the active trade or business of the tested company, as is required under paragraph 3(a) in order to obtain benefits, because the active trade or business

conducted in the Contracting State of residence for purposes of subclause (B)(1)(I) of subparagraph 7(e)(i) need only be "similar or complementary" to the active trade or business conducted in the source State, and not the "same or complementary" to the active trade or business conducted in the source State.

Example 15. FCo is a company resident in the other Contracting State. FCo is engaged in the active conduct of a trade or business in the other Contracting State that is similar to the business of USCo. FCo has been a resident of the other Contracting State for 12 months and has owned 10 percent of the vote and value of USCo for 12 months. Individual Y is the sole shareholder of FCo and a resident of State Y. The terms of the U.S.-Y income tax treaty with respect to the terms of paragraph 2 of Article 10 (Dividends) are identical to those of this Convention. FCo, therefore, satisfies the requirements set forth in paragraph 2 of Article 10 (Dividends) for a 5 percent rate of tax on dividends from USCo. Absent subclause (B)(1)(I) of subparagraph 7(e)(i), however, FCo would not be entitled to a 5 percent rate of tax, because individual Y would only be entitled to a 15 percent rate on the dividends if it derived the dividends from USCo directly under subclause (B)(1) of subparagraph 7(e)(i). However, by virtue of subclause (B)(1)(I) of subparagraph 7(e)(i), which provides that for purposes of the rate comparison test, Y shall be treated as a company within the meaning of paragraph 2(c) of the U.S.-Y income tax treaty, and thus FCo satisfies the rate comparison requirement. Therefore, assuming all other requirements (such as the base erosion test and beneficial ownership) are satisfied, FCo will be entitled to a 5 percent rate on dividends paid by USCo.

Subclause (B)(1)(II) of subparagraph 7(e)(i) provides the rule for determining the percentage of the aggregate vote and value of the shares that a potential equivalent beneficiary will be deemed to own in the company paying a dividend for purposes of the rate comparison test, which will in turn affect the rate of tax that the equivalent beneficiary would be entitled to if it derived the dividend directly, either 5 or 15 percent under subparagraph(2)(a) or 2(b) of this Article 10 (Dividends). For these purposes, when applying the rate comparison test described in subclause (B)(II) of subparagraph 7(e)(i), the potential equivalent beneficiary's indirect ownership in the vote and value of the shares of the company paying the dividends shall be treated as direct ownership.

Example 16. XCo and YCo each own directly 50 percent of RCo, a company resident in the other Contracting State. For twelve months, RCo has both owned 10 percent of the vote and value of USCo and been a resident of the other Contracting State. The United States has tax treaties with Country X and Country Y that provide terms similar to this Convention. XCo is a resident of Country X and would meet qualified person status under subparagraph 2(c) of the U.S.-X income tax treaty. YCo is a resident of Country Y and would meet qualified person status under subparagraph 2(c) of the U.S.-Y income tax treaty. Both XCo and YCo, therefore, would satisfy subclause A of subparagraph 7(e)(i). However, for purposes of determining the rate of tax on dividend income that XCo and YCo would have been entitled under their respective tax treaties with the United States, XCo and YCo are each treated as owning directly 5 percent of the vote and value of shares of USCo (50 percent multiplied by 10 percent is equal to 5 percent, the amount of their indirect ownership in USCo that is treated as direct ownership). XCo and YCo, therefore, would not be entitled to a 5 percent rate and would not be considered equivalent beneficiaries because they failed to meet the rate comparison test under subclause (B)(1) of subparagraph 7(e)(i). However, even though the tested company may not meet the derivative benefits test under paragraph 4, it may nonetheless be entitled to treaty benefits with regard to dividends, interests, and royalties if it meets the requirements described in paragraph 6

of Article 10 (Dividends), paragraph 3 of Article 11 (Interest) and paragraph 3 of Article 12 (Royalties), respectively. See technical explanation to those Articles for a description of the test and reduced rates that would be allowed.

Subclause (B)(2) of subparagraph 7(e)(i) provides derivative benefit rules for items of business profits, or any other type of income under this Convention for which there are no fixed rates of tax to compare (business profits, capital gains and other income). The potential equivalent beneficiary must be entitled to a benefit under the tested convention that is at least as favorable as those that would apply under the Convention to such business profits, gains or other income. Thus, the benefits to be compared are: (i) the benefits that the source State would grant to the tested company if it qualified for benefits with respect to the item of income, profit or gain; and (ii) the benefits that the source State would grant the potential equivalent beneficiary if it derived the income directly.

Example 17. FCo is a company resident in State F, which is wholly owned by XCo, a publicly traded company resident in State X. FCo has a contract to construct a major office complex in the United States. Under the terms of the U.S.-F income tax treaty, an enterprise is deemed to have a permanent establishment with respect to a construction project if such project lasts for greater than 183 days. Under the terms of the U.S.-X income tax treaty, an enterprise is deemed to have a permanent establishment with respect to a construction project if such project lasts greater than 365 days. If the project extends beyond 183 days, XCo would not be an equivalent beneficiary because it would not be entitled to the same protection under the permanent establishment article of the U.S.-X treaty that FCo would be entitled to under the U.S-F income tax treaty.

Subclause (C) of subparagraph 7(e)(i) provides an additional limitation where the item of income, profit or gain has been derived through an entity that is treated as fiscally transparent under the laws of the Contracting State of the company claiming benefits. In such case, notwithstanding that the resident may satisfy the requirements of subclauses (A) or (B) of subparagraph 7(e)(i) based on a comparison of the terms of the tested convention with the terms of this Convention, the resident will not meet the requirements of this subclause if the relevant item of income, profit or gain would not be treated as the income, profit or gain of that resident under a provision analogous to paragraph 6 of Article 1 (General Scope) of this Convention had it, rather than the tested company, been paid the item of income for which the tested company is claiming benefits.

Example 18. FCo, a publicly traded company resident in the other Contracting State, owns shares of USCo, a U.S. company, through USLLC, a limited liability company organized in the United States. USLLC is fiscally transparent under U.S. law and is a company under the laws of the other Contracting State. Accordingly, under the provisions of paragraph 6 of Article 1 (General Scope), dividends paid by USCo through USLLC would not be considered derived by FCo, and thus would not be eligible for a reduction in tax under Article 10 (Dividends). FCo interposes XCo, a resident of Country X, between itself and USLLC. Under State X laws, USLLC is fiscally transparent, and therefore, XCo is considered to derive dividends paid by USCo to USLLC.

The U.S.-X income tax treaty contains a limitation on benefits rule identical to that of the Convention. In order to enjoy the dividend withholding tax reductions provided in the U.S.-X income tax treaty, XCo must satisfy the derivative benefits test. Although the dividend rates

under paragraph (2) of Article 10 (Dividends) of the Convention and the U.S.-X treaty are the same, and subclause (A) of subparagraph 7(e)(i) would be satisfied, dividends would not be considered derived by FCo if FCo, and not XCo, had owned USCo through USLLC, by virtue of subclause (C) of subparagraph 7(e)(i). Accordingly, FCo is not an equivalent beneficiary, and as such, XCo is not entitled to treaty benefits with respect to the dividend paid by USCo through USLLC.

Potential equivalent beneficiary status for residents of the same Contracting State as the tested company

The second category of equivalent beneficiary, which is described in clause (ii) of subparagraph 7(e), is for persons who are residents of the same Contracting State as the tested company. Such persons will be equivalent beneficiaries if they are eligible for benefits by reason of subparagraph 2(a), 2(b), 2(c) or 2(e), or under paragraph 5 as a headquarters company. Headquarters companies, however, will solely be equivalent beneficiaries of the tested company if the tested company is paid interest or dividends by a member of the headquarters company's multinational corporate group. A rate comparison test applies, however, for any resident satisfying the headquarters company test in paragraph 5 that derives interest from the other Contracting State. Accordingly, because a headquarters company is only entitled to a rate of tax of 10 percent on interest under subparagraph 2(f) of Article 11 (Interest), rather than zero percent in paragraph 1 of Article 11, it may only qualify as an equivalent beneficiary if the rate on interest applicable to the tested company is at least 10 percent.

Individuals who are residents of the same Contracting State as the tested company must be determined to be residents under Article 4 (Resident) in order to be considered an equivalent beneficiary. Accordingly, if such an individual's tax is determined in whole or in part on a fixed-fee, "forfait" or similar basis, such individual will not be considered an equivalent beneficiary for purposes of Article 4.

Potential equivalent beneficiary status for residents of the Contracting State of source

The third category of equivalent beneficiary, which is described in clause (iii) of subparagraph 7(e), applies to persons who are residents of the Contracting State of source. Such persons will be equivalent beneficiaries if they are eligible for benefits by reason of subparagraph 2(a), 2(b), 2(c) or 2(e), provided that such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares as defined in subparagraph 7(c)) of the tested company under paragraph 4 does not exceed 25 percent.

Under the ownership requirement in subparagraph 4(a), ownership may be direct or indirect, but in the case of indirect ownership, each intermediate owner must be a "qualifying intermediate owner" as defined in subparagraph 6(f).

Tested company claiming benefits based on a higher rate of tax applicable to a potential equivalent beneficiary of a third State.

A tested company that fails paragraph 4 solely because it fails to satisfy the requirement of subclause (B) of subparagraph 7(e)(i) or clause (ii) of subparagraph 7(e) may nonetheless be entitled to benefits provided under paragraph 6 of Article 10 (Dividends), paragraph 3 of Article

11 (Interest) and paragraph 3 of Article 12 (Royalties). See the explanation to those paragraphs for when benefits may be provided and for the applicable reduced rate.

Qualifying intermediate owner

Subparagraph 4(a) requires that in the case of indirect ownership, each intermediate owner must be a "qualifying intermediate owner" as defined in subparagraph 7(f). A qualifying intermediate owner is either (i) a resident of a state that has in effect with the Contracting State from which a benefit is being sought a comprehensive convention for the avoidance of double taxation that includes provisions addressing special tax regimes and notional interest deductions analogous to subparagraph 1(l) of Article 3 (General Definitions) and subparagraph 2(e) of Article 11 (Interest) respectively, or (ii) a resident of the same Contracting State as the company applying the test under subparagraph 2(d) or 2(f) or paragraph 4 to determine whether it is eligible for benefits under the Convention.

Example 19. Assume the same facts as in Example 13, except that ZCo, a company resident in State Z, has been interposed between XCo and HoldCo. As an intermediate owner, ZCo must satisfy the definition of "qualifying intermediate owner" of subparagraph 7(f) in order for HoldCo to be eligible for the exemption from U.S. tax on the payment of U.S. source interest. State Z does not have in effect a comprehensive convention for the avoidance of double taxation that includes provisions addressing special tax regimes and notional deductions analogous to subparagraph (1) of Article 3 (General Definitions) and subparagraph 2(e) of Article 11 (Interest), respectively. Accordingly, ZCo is not a qualifying intermediate owner under subparagraph 7(f) and the requirements of subparagraph 4(a) are not fully satisfied, and HoldCo will not be eligible for the benefits of the Convention.

The Base Erosion Test

Subparagraph 4(b) sets forth the base erosion test applicable for purposes of the derivative benefits test. This test is qualitatively the same as the base erosion test in clause (ii) of subparagraph 2(f), except that the test in subparagraph 4(b) treats as base eroding payments amounts paid or accrued to (i) persons who are not equivalent beneficiaries, and (ii) persons who are equivalent beneficiaries (A) solely by reason of being a headquarters company under this Convention or a tested convention, (B) that are connected persons (as defined in subparagraph 1(m) of Article 3 (General Definitions)) with respect to the tested company and benefit from a special tax regime in their state of residence with respect to the payment, or (C) that are connected persons with respect to the tested company and that benefit from notional deductions of the type described in subparagraph 2(e) of Article 11 (Interest) with respect to the payment. The tested company must satisfy the base erosion test in clause (i) of subparagraph 4(b) in order to obtain any treaty benefits.

Example 20. Company X, a resident of State X, owns Company Y, a resident of State Y. Company Y owns Company R, a resident of the other Contracting State and the tested company. Company X is an equivalent beneficiary under subparagraph 7(e), and Company Y is a qualifying intermediate owner under subparagraph 7(f). Accordingly, Company R would satisfy the ownership requirement of subparagraph 4(a) because (i) Company X, an equivalent beneficiary, indirectly owns shares representing at least 95 percent of the aggregate vote and value of the tested company and at least 50 percent of any disproportionate class of shares (within the meaning of subparagraph 7(c)), and (ii) each intermediate owner (i.e., Company Y) is a qualifying intermediate owner.

Company R's gross income for the taxable period in question consists of $100 of U.S. source interest and a $200 foreign source dividend which is exempt from tax under the law of the other Contracting State. Company R seeks treaty benefits with respect to the $100 of U.S. source interest income. Under the law of the other Contracting State, Company R, Company Y and Company X are not allowed to participate in a common tax consolidation or other regime that would allow the two companies to share profits or losses nor is there any loss sharing regime available. Accordingly, in this example there is no tested group. Company R's gross income is $100 (the U.S. source interest). Company R will fail the base erosion test of subparagraph 4(b) if Company R makes base eroding payments of at least $50 to ineligible persons.

Paragraph 5

Paragraph 5 sets forth an alternative test under which a resident of a Contracting State that is a headquarters company may receive treaty benefits with respect to dividends and interest paid by members of the company's multinational corporate group. A headquarters company's multinational corporate group means the company and its direct and indirect subsidiaries (and does not include upper-tier companies). A resident of a Contracting State that does not qualify for benefits under paragraph 2 may be able to qualify for benefits under paragraph 5.

A company seeking to qualify for benefits as a headquarters company must satisfy six conditions. First, the headquarter company's primary place of management and control must be in the Contracting State of which it is a resident. The term "primary place of management and control" is defined in subparagraph 7(d) and is the same test that is applied for publicly-traded companies. Clause (ii) of subparagraph 7(d) allows the possibility that, in certain limited cases, the management of a subgroup (such as a subgroup responsible for a regional area) may be exercised more by a company that is not the top-tier company for the entire group of connected companies, and in certain narrow cases a lower-tier company may satisfy the headquarters company test.

Second, the multinational corporate group must consist of companies resident in, and engaged in the active conduct of a trade or business (as defined in paragraph 3) in, at least four states (including either Contracting State), and the trades or businesses carried on in each of the four states (or four groupings of states) must generate at least 10 percent of the gross income of the group.

Example 21. Company X is resident in State X and is a member of a multinational corporate group consisting of itself and its direct and indirect subsidiaries resident in State X, State A, State B, State C, State D, State E and State F. The gross income generated by each of these companies for Year 1 and Year 2 is as follows:

State	**Year 1**	**Year 2**
X	$45	$60
A	$25	$12
B	$10	$20
C	$10	$12
D	$7	$10
E	$10	$9
F	$5	$7
Total	$112	$130

For Year 1, 10 percent of the gross income of this group is equal to $11.20. Only State X and State A satisfy this requirement for that year. The other countries may be aggregated into groupings to meet this requirement. Because State B and State C have a total gross income of $20, and State D, State E and State F have a total gross income of $22, these two groupings of countries may be treated as the third and fourth members of the group for purposes of subparagraph 5(b).

For Year 2, 10 percent of the gross income is $13. Only the companies in State X and State B satisfy this requirement. Because State A and State C have a total gross income of $24, and State D, State E and State F have a total gross income of $26, these two groupings of countries may be treated as the third and fourth members of the group for purposes of subparagraph 5(b). The fact that State A replaced State B in a group is not relevant for this purpose. The composition of the grouping may change annually.

Third, the trades or businesses of the multinational corporate group that are carried on in any one state other than the Contracting State of residence of such company must generate less than 50 percent of the gross income of the group. A company whose multinational corporate group generates 50 percent or more of the group's gross income in the Contracting State of source does not meet this condition. For the purposes of paragraph 5, the definition of "gross income" in subparagraph 7(h) applies.

Fourth, no more than 25 percent of the company's gross income can be derived from the other Contracting State. Unlike the third condition described immediately above, this condition looks only at the gross income earned by the company seeking status as a headquarters company, rather than the gross income earned by members of its multinational corporate group.

Fifth, such company must be subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3. Therefore, such company must be subject to the general corporate taxation rules for companies that are engaged in the active conduct of a trade or business in the Contracting State of residence, and not a regime for headquarters companies.

Sixth, such company must satisfy a base erosion test that is qualitatively the same as the base erosion prong of the stock ownership and base erosion test in clause (ii) of subparagraph 2(f), except that base eroding payments do not include payments in respect of financial obligations to a bank that is not a connected person with respect to the company. For example, unlike the base erosion test for stock ownership and base erosion companies, interest payments made by a company to a bank that is not a connected person to the company will not be treated as a base eroding payment for purposes of applying the base erosion test under paragraph 5.

These six conditions must be tested with respect to the taxable year in which the company received the dividends or interest for which it is seeking benefits under the Convention. A company that does not satisfy the second, third or fourth conditions described above for the relevant taxable year may still be treated as a headquarters company if it satisfies such conditions by averaging the required ratios for the preceding four taxable years (which does not include the taxable year that includes the payment for which a treaty benefit is being sought).

Paragraph 6

Paragraph 6 provides that a person who is a resident of one of the Contracting States but is not entitled to the benefits of the Convention under paragraphs 2 through 5 still may be granted benefits under the Convention at the discretion of the competent authority of the State from which benefits are sought, taking into account the object and purpose of this Convention, if the resident demonstrates to the satisfaction of such competent authority that neither its establishment, acquisition, or maintenance, nor the conduct of its operations, has or had as one of its principal purposes the obtaining of benefits under the Convention. Thus, persons that establish operations in one of the Contracting States with a principal purpose of obtaining the benefits of the Convention will not be granted benefits of the Convention under paragraph 6.

In order to be granted benefits under paragraph 6, a resident must establish to the satisfaction of the competent authority of the State from which benefits are being sought that (i) there were clear non-tax business reasons for its formation, acquisition, or maintenance in the other Contracting State, which demonstrate a substantial nexus or relationship to the other Contracting State, taking into account considerations in addition to those addressed through the objective tests in paragraphs 2 through 5, and (ii) the allowance of benefits would not otherwise be contrary to the purposes of the Convention. For example, in the case of a resident subsidiary company with a parent in a third state, the fact that the relevant withholding rate provided in the Convention is at least as low as the corresponding withholding rate in the income tax treaty between the State of source and the third state is not by itself evidence of a nexus or relationship to the other Contracting State. Similarly, a relationship or nexus to the treaty country cannot be established by a desire to take advantage of favorable domestic laws of the treaty country, including the existence of a network of tax treaties.

Discretionary benefits typically will not be granted if the benefit requested would result in no or minimal tax imposed on the item of income in both the country of residence of the applicant and the country of source, taking into account both domestic law and the treaty provision. For example, double non-taxation may occur through the use of a hybrid instrument that generates a deduction in the source State and the income from which is treated as exempt in the resident State.

The competent authority's discretion is quite broad. It may grant all of the benefits of the Convention to the taxpayer making the request, or it may grant only certain benefits. For instance, it may grant benefits only with respect to a particular item of income in a manner similar to paragraph 3. Further, the competent authority may establish conditions, such as setting time limits on the duration of any relief granted.

For purposes of implementing paragraph 6, a taxpayer must present its case to the relevant competent authority for a determination, based on all relevant facts and circumstances, before benefits may be claimed. If the competent authority determines that benefits are to be allowed, it is expected that benefits will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later, assuming that all relevant facts and circumstances justify granting the retroactive application of benefits.

Finally, there may be cases in which a resident of a Contracting State may apply for discretionary relief to the competent authority of its State of residence. This could arise if the benefit the taxpayer is seeking would be provided by the residence country and not by the source

country. For example, if a company that is a resident of the United States would like to claim the benefit of the re-sourcing rule of paragraph 3 of Article 23 (Relief from Double Taxation), but does not meet any of the objective tests of paragraphs 2 through 5, it may apply to the U.S. competent authority for discretionary relief.

The competent authority of the Contracting State to which a request has been made shall consult with the competent authority of the other Contracting State before either granting or rejecting a request made by a resident of that other Contracting State.

Paragraph 7

Paragraph 7 defines several key terms for purposes of Article 22. Each of the defined terms is discussed above in the context in which it is used.

PART IV – EXAMPLE OF COMMENTARY TEXT ADDRESSING THE DEFINITION OF A "SPECIAL TAX REGIME"

Special Tax Regimes

Subparagraph 1(l) defines the term "special tax regime." The term is used in operative paragraphs in Articles 11 (Interest), 12 (Royalties) and 21 (Other Income). Each of these paragraphs denies the treaty benefits provided under the relevant article if the beneficial owner of an item of income is a resident of the other Contracting State (the residence State), is a connected person with respect to the payor of such item of income, and benefits from a special tax regime in the residence State with respect to the particular item of income. The term "special tax regime" also is used in Article 22 (Limitation on Benefits) for purposes of the "base-erosion" tests in subparagraphs 2(d)(ii), 2(f)(ii), 4(b) and 5(f), as well as the definition of the term "qualifying intermediate owner" set forth in subparagraph 7(f) of that Article.

The application of the term "special tax regime" in Articles 11, 12 and 21 is consistent with the tax policy considerations that are relevant to the decision to enter into a tax treaty or amend an existing tax treaty, as articulated by the Commentary to the OECD Model, as amended by the Base Erosion and Profit Shifting initiative. In particular, paragraph 15.2 of the introduction of the OECD Model now provides:

> "Since a main objective of tax treaties is the avoidance of double taxation in order to reduce tax obstacles to cross-border services, trade and investment, the existence of risks of double taxation resulting from the interaction of the tax systems of the two States involved will be the primary tax policy concern. Such risks of double taxation will generally be more important where there is a significant level of existing or projected cross-border trade and investment between two States. Most of the provisions of tax treaties seek to alleviate double taxation by allocating taxing rights between two States and it is assumed that where a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State. Where a State levies no or low income taxes, other States should consider whether there are risks of double taxation that would justify, by themselves, a tax treaty. States should also consider whether there are elements of another State's tax system that could increase the risk of non-taxation, which may include tax advantages that are ring-fenced from the domestic economy."

The term "special tax regime" means any legislation, regulation or administrative practice (including a ruling practice) that exists before or comes into effect after the treaty is signed and that meets all of the following five conditions.

Under the first condition, described in clause (i) of subparagraph 1(l), a regime must result in one or more of the following: (1) a preferential rate of taxation for interest, royalties, guarantee fees or any combination thereof, as compared to income from sales of goods or services; (2) certain permanent reductions in the tax base with respect to interest, royalties, guarantee fees or any combination thereof, without a comparable reduction for sales or services income; or (3) a preferential rate of taxation or certain permanent reductions in the tax base with respect to substantially all income or

substantially all foreign source income for companies that do not engage in the active conduct of a trade or business in that Contracting State. That is, clause (i) is intended to identify regimes that, in general, tax mobile income more favorably than non-mobile income.

As provided in subclause (A), clause (i) shall be satisfied if a regime provides a preferential rate of taxation for interest, royalties or guarantee fees, as compared to sales or services income. For example, a regime that provides a preferential rate of taxation on royalty income earned by resident companies, but does not provide such preferential rate to income from sales or services, would meet this condition. Furthermore, a regime that provides a preferential rate of taxation for all classes of income, but such preferential rate is in effect available primarily for interest, royalties, guarantee fees or any combination thereof, would satisfy clause (i), despite the fact that the beneficial treatment is not explicitly limited to those classes of income. For example, a tax authority's administrative practice of issuing routine rulings that provide a preferential rate of taxation for companies that represent that they earn primarily interest income (such as group financing companies) would satisfy clause (i), even if such rulings as a technical matter provide the preferential rate to all forms of income.

Similarly, as provided in subclause (B), clause (i) shall be satisfied if a regime provides for a permanent reduction in the tax base with respect to interest, royalties or guarantee fees, as compared to sales or services, in one or more of the following ways: an exclusion from gross receipts (such as an automatic fixed reduction in the amount of royalties included in income, whereas such reduction is not also available for income from the sale of goods or services); a deduction without any corresponding payment or obligation to make a payment; a deduction for dividends paid or accrued; or taxation that is inconsistent with the principles of Articles 7 (Business Profits) or 9 (Associated Enterprises) of this Convention. An example of a tax regime that results in taxation that is inconsistent with the principles of Article 9 is that of a regime under which no interest income would be imputed on an interest-free note that is held by a company resident in a Contracting State and is issued by a debtor that is a resident of the other Contracting State and is an associated enterprise.

A permanent reduction in a country's tax base does not arise merely from timing differences. For example, the fact that a particular country does not tax interest until it is actually paid, rather than when it economically accrues, is not regarded as a regime that provides a permanent reduction in the tax base, because such rule represents an ordinary timing difference. However, a regime that results in excessive deferral over a period of many years shall be regarded as providing for a permanent reduction in the tax base, because such a rule in substance constitutes a permanent difference in the base of the taxing country.

Alternatively, as provided in subclause (C), clause (i) shall be satisfied if a regime provides a preferential rate of taxation or a permanent reduction in the tax base (of the type described above), with respect to substantially all income or substantially all foreign source income, for companies that do not engage in the active conduct of a trade or business in the Contracting State. For example, regimes that provide preferential rates of taxation only to income of group financing companies or holding companies would generally satisfy clause (i).

A regime that provides for beneficial tax treatment that is generally applicable to all income (in particular to income from sales and services) and across all industries should not satisfy clause (i). Examples of generally applicable provisions that would not meet clause (i) include regimes

permitting standard deductions, accelerated depreciation, corporate tax consolidation, dividends received deductions, loss carryovers and foreign tax credits. Another example of a generally applicable provision, in the case of the United States, are the entity classification rules set forth in Treas. Reg. §§ 301.7701-1 through 301.7701-3.

The second condition, described in clause (ii) of subparagraph 1(l), is with respect to royalties only and shall be satisfied if a regime does *not* condition benefits on the extent of research and development activities that take place in the Contracting State. Clause (ii) is intended to ensure that royalties benefiting from patent box or innovation box regimes are eligible for treaty benefits only if such regime contains a nexus requirement. Royalty regimes that are not determined to be "actually harmful" by the OECD's Forum on Harmful Tax Practices generally would not satisfy clause (ii) and therefore would not be treated as a special tax regime.

The third condition, described in clause (iii) of paragraph 1(l), requires that a regime be generally expected to result in a rate of taxation that is less than the lesser of either 15 percent or 60 percent of the general statutory rate of company tax applicable in the source State. The rate of taxation shall be determined based on the income tax principles of the residence State. As is set forth in paragraph [insert paragraph number] of the [insert reference to the relevant instrument], except as provided below, the rate of taxation shall be determined based on the income tax principles of the Contracting State that has implemented the regime in question. Therefore, in the case of a regime that provides only for a preferential rate of taxation, the generally expected rate of taxation under the regime will equal such preferential rate. In the case of a regime that provides only for a permanent reduction in the tax base, the rate of taxation will equal the statutory rate of company tax in the Contracting State that is generally applicable to companies subject to the regime in question less the product of such rate and the percentage reduction in the tax base (with the baseline tax base determined under the principles of the Contracting State, but without regard to any permanent reductions in the tax base described in subparagraph (l)(i)(B)) that the regime is generally expected to provide. For example, a regime that generally provides for a 20 percent permanent reduction in a company's tax base would have a rate of taxation equal to the applicable statutory rate of company tax reduced by 20 percent of such statutory rate. Therefore, if the applicable statutory rate of company tax in force in a Contracting State were 25 percent, the rate of taxation resulting from such a regime would be 20 percent (25 – (25*.20)). In the case of a regime that provides for both a preferential rate of taxation and a permanent reduction in the tax base, the rate of taxation would be based on the preferential rate of taxation reduced by the product of such rate and the percentage reduction in the tax base.

The fourth condition, described in clause (iv) of subparagraph 1(l), provides that a regime shall not be regarded as a special tax regime if it applies principally to pension funds or organizations that are established and maintained exclusively for religious, charitable, scientific, artistic, cultural or educational purposes (such as, in the case of the United States, organizations that are established under Code section 501(c)(3)). Under clause (iv), a regime shall also not be regarded as a special tax regime if it applies principally to persons the taxation of which achieves a single level of taxation, either in the hands of the person or its shareholders (with at most one year of deferral), that hold a diversified portfolio of securities, that are subject to investor-protection regulation in the residence State, and interests in which are marketed primarily to retail investors. For example, under clause (iv), the U.S. regime for regulated investment companies (RICs) shall not be treated as a special tax regime for the following reasons: RIC income is taxed at either the entity level (if the income is not distributed) or the shareholder level (including through withholding tax in the case of

nonresident shareholders); RICs are generally required to hold a diversified portfolio of securities; RICs are subject to U.S. regulation under the Investment Company Act of 1940; and RIC interests are marketed primarily to retail investors. In addition, under clause (iv), a special tax regime does not include a regime that applies principally to persons the taxation of which achieves a single level of taxation, either in the hands of the person or its shareholders (with at most one year of deferral), and such persons hold predominantly real estate assets. For example, the U.S. regime for real estate investment trusts shall not be treated as a special tax regime pursuant to clause (iv).

The fifth condition, described in clause (v) of subparagraph 1(l), provides that if after a bilateral consultation, the Contracting State of the payor of the item of income (the source State) identifies a potential special tax regime in the residence State, the source State must issue a notification to the residence State through diplomatic channels of its determination that the regime satisfies clauses (i) through (iv). Additionally, the flush language requires that the source State issue a written public notification stating that the regime satisfies clauses (i) through (v). It is anticipated that in the case of the United States, such written public notification would be issued through the Internal Revenue Bulletin. The treatment of such regime as a special tax regime for purposes of the Convention will be effective 30 days after the date of such written public notification.