

Article 22 (Limitation on Benefits) 2016 U.S. Model Treaty—An Overview

Limitation on Benefits (Background)

- 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.
- A resident of a Contracting State that meets the provisions of an objective test will be entitled to the benefits provided for by such test, regardless of its motivations in choosing its particular business structure.

Qualified Persons

- 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”
- There are 6 categories of residents that are considered “qualified persons”

Categories of Qualified Persons

- Individuals
- Governments (Contracting States and any political subdivision or local authority thereof)
- Publicly Traded Companies
- Subsidiaries of Publicly Traded Companies
- Pension Funds and Tax Exempt Organizations
- Legal persons meeting the ownership/base erosion test

Other Objective LOB tests

- Even if a resident is not a qualified person, the resident may nevertheless qualify for benefits on particular items of income if it meets one of the alternative provisions described in paragraph 3 (active trade or business), 4 (derivative benefits), 5 (headquarters company) , or as otherwise provided in paragraph 6 of Article 10 (Dividends), paragraph 3 of Article 11 (Interest) and paragraph 3 of Article 12 (Royalties)(cliff effect exceptions).

Discretion

- Even if a resident of a Contracting is neither a qualified person nor able to satisfy one of the other objective tests described in the prior slide, such resident may be granted benefits (or benefits with respect to only a particular item of 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.

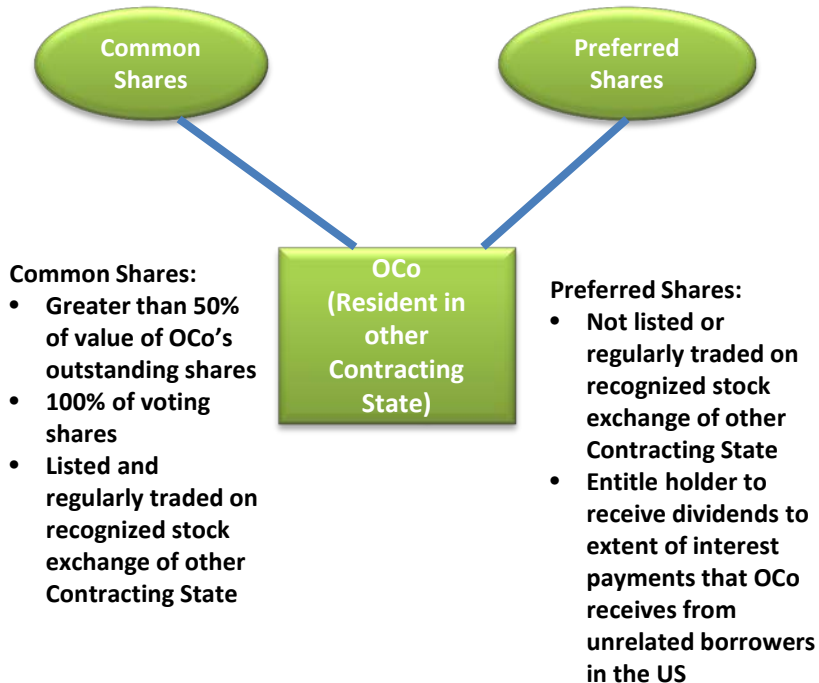
Publicly Traded Company Test

- Basic Rule: The principal class of the company's 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:
 - 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,
 - the company's primary place of management and control is in its State of residence.

Publicly Traded Company Test Continued

- Principal class of shares: the ordinary or common shares of the company representing the majority of the aggregate vote and value of the company
- Disproportionate class of shares: 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 (e.g. a class of shares that pays dividends based upon a formula that approximates the company's return on its assets employed in the Source State)

Example 1: Publicly Traded Company Test



Analysis:

- Because the owner of the preferred shares is entitled to receive payments corresponding to the US 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 under the public company test

Subsidiary of Publicly Traded Company

- Basic Rules
- Ownership: At least 50% of the vote and value of the company's shares (and at least 50% of the vote and value of any disproportionate class of shares) in the company is owned (directly or indirectly) by 5 or fewer companies satisfying the publicly traded company test. If the publicly traded companies are indirect owners, each intermediate owner must be a resident of the other contracting state or a "qualifying intermediate owner" (QIO)
 - QIO means either an entity resident in a third state that has in effect a comprehensive income treaty with the source state addressing special tax regimes and notional deductions, or
 - A resident of the same Contracting State as the company seeking benefits.
- Base Erosion: Except with respect to benefits under Article 10 (Dividends) the company and (where applicable) its tested group must also satisfy a base erosion test.

Subsidiary of Publicly Traded Company

- Base Erosion Test has 2 requirements:
 - less than 50 percent of the tested subsidiary’s “gross income” 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, and
 - if there is a “tested group”, 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.

Subsidiary of Publicly Traded Company

- There are 3 types of “ineligible persons”
 - persons that are not residents of either Contracting State entitled to benefits as individuals, governments, publicly traded companies, pensions, or tax-exempt entities;
 - persons that are residents of either Contracting State that are connected persons with respect to the tested subsidiary and benefit from a special tax regime with respect to the deductible payment; or
 - 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.

Subsidiary of Publicly Traded Company (Connected Persons)

- Two persons are "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 is 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.

Subsidiary of Publicly Traded Company (Tested Group)

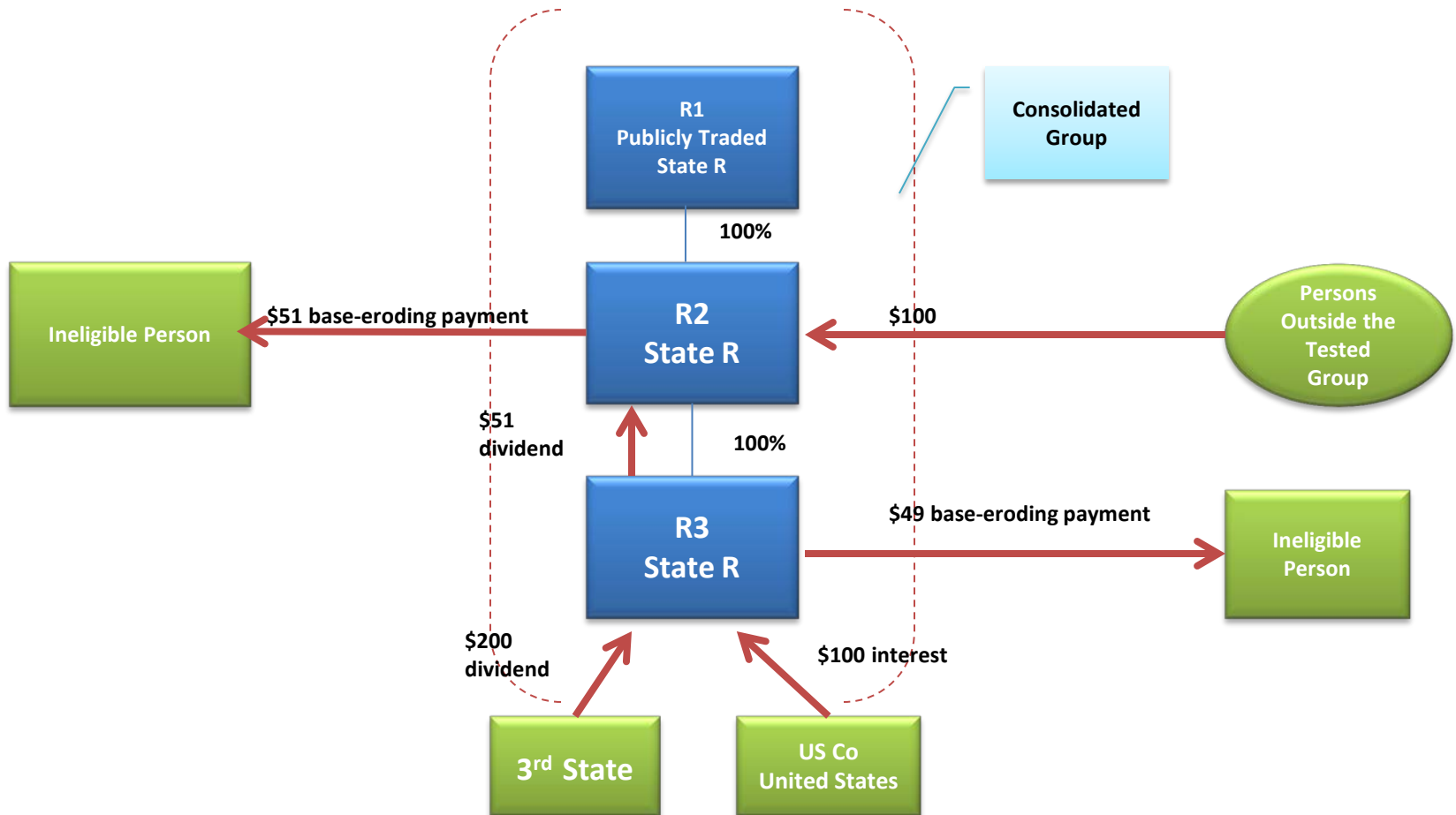
- Definition of “tested group”: The tested subsidiary and any company that either participates as a member with the tested resident in a tax consolidation regime, fiscal unity or similar regime that allows members of the group to share profits or losses, or any company that shares losses with the tested 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 with respect to a tested group does not apply.

Subsidiary of Publicly Traded Company (Definition of Gross Income)

- 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. Except for determining benefits for dividends, gross income does not include the portion of any dividends effectively exempt from tax in the person’s Contracting State of residence.
- 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 test group.

Example 2: Subsidiary of a Publicly Traded Company

Issue: Is R3 eligible for Treaty benefits with respect to the \$100 interest payment from the US to R3?

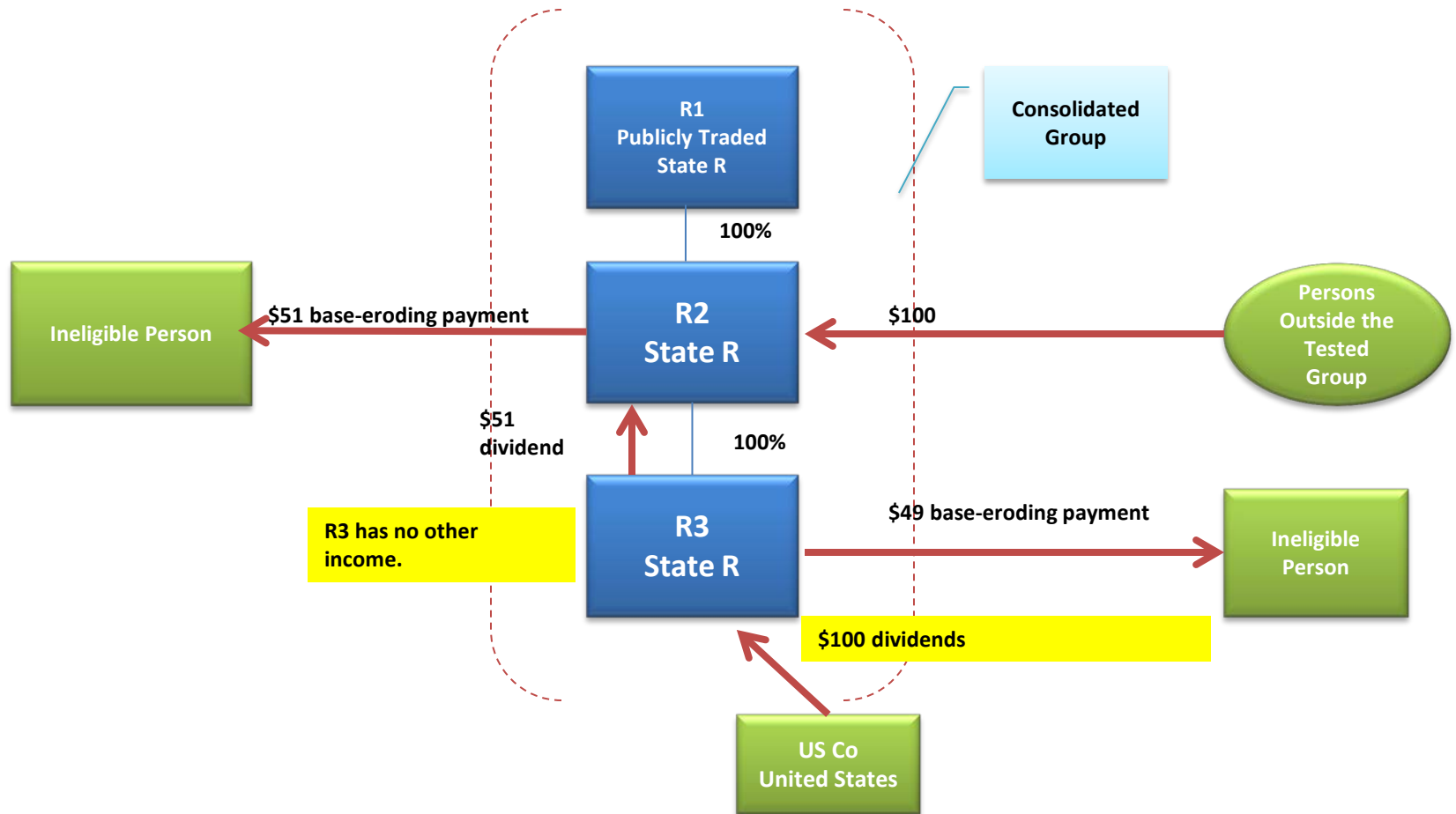


Example 2: Subsidiary of a Publicly Traded Company (Analysis)

- Issue: Is R3 eligible for Treaty benefits with respect to \$100 interest payment from the U.S. to R3?
- Ownership Prong Met. R1 is a publicly traded company indirectly owning at least 50% of R3. R2 (intermediate owner of R3) is a resident of State R and therefore a QIO
- Base Erosion (Tested Subsidiary) Met: R3's Gross income is \$100 (the \$200 dividend is excluded since it is not taxable in State R). Base eroding payments must be less than 50% of Gross Income, \$50 (50% x \$100). R3 has made only \$49 of base eroding payments to ineligible persons, satisfying base erosion test (\$49 is less than 50% of R3's Gross Income)
- Base Erosion (Tested Group) Not Met: Benefits not available for payment: Tested Group applies because R3 is part of a consolidated group. Tested Group Gross Income is \$200 (\$100 U.S. source interest plus the \$100 R2 received from outside the group). Tested group limited to base eroding payments of less than \$100 to ineligible persons. R3 does not satisfy this requirement because the tested groups total base eroding payments to ineligible persons of \$100 (\$49 + \$51) exceeds the tested group's limit of base eroding payments of less than \$100

Example 3: Subsidiary of a Publicly Traded Company

Issue: R1, R2 and R3 are members of Consolidated Group. Will R3 be a qualified person with respect to dividend?



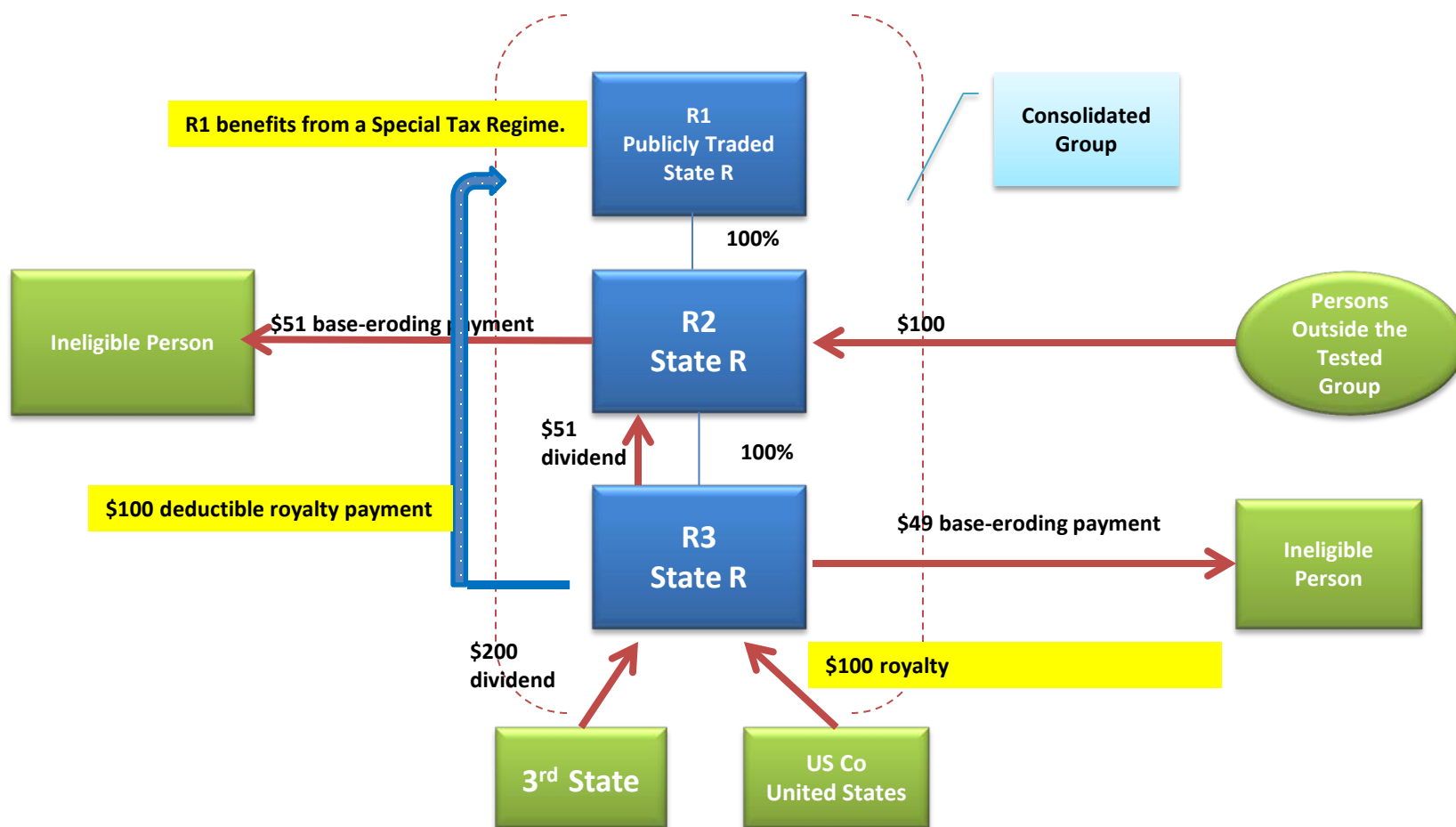
Facts same as Example 2, except that R3 derives \$100 of US source dividends rather than US source interest.

Analysis Example 3 (Subsidiary of Publicly Traded Company)

- Because the only benefit that R3 seeks is Article 10 Dividends, R is not required to apply the base erosion test
- As noted in Example 2, R3 satisfies the ownership requirement of the subsidiary of public company test
- Accordingly, R3 will be qualified person with respect to dividends

Example 4: Subsidiary of a Publicly Traded Company

Issue: R1, R2 and R3 are members of Consolidated Group. Will R3 be a qualified person eligible for benefits with respect to the royalty payment?



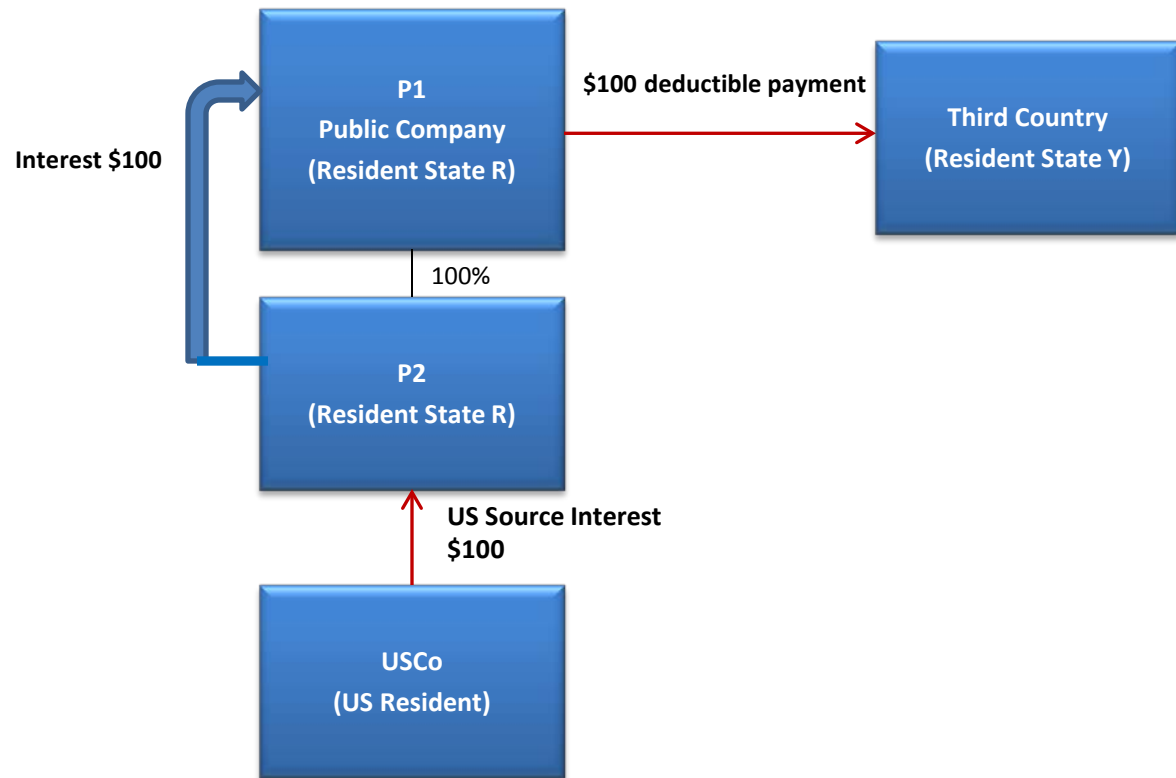
Facts same as Example 2, except that R3's only items of income are US source royalties of \$100.

Analysis Example 4 (Subsidiary of Publicly Traded Company)

- Ownership prong is satisfied because R1 is a publicly traded company that indirectly owns at least 50 percent of R2 and R2 is a QIO.
- Base Erosion (Tested Subsidiary) Not Met. R3's Gross Income is \$100 (the royalty payment). R3's base eroding payments must be less than \$50 (50% x \$100). R3 made a deductible payment of \$100 to an ineligible person, R1. R1 is an ineligible person because R1 and R3 are "connected persons" (R1 indirectly owns at least 50% of the vote and value of R3) and R1 benefits from a special tax regime. Because the base eroding payment (\$100) exceeds R3's allowable limit of base eroding payments (less than \$50), R3 does not meet subsidiary of publicly trade test.

Example 5: Subsidiary of a Public Company – Indirect Base Erosion

Issue: Will P2 be a Qualified Person?



Ownership Test: Met. 100% owned by P1, a publicly traded company resident in State R.

Base Erosion Tested Subsidiary: Not Met. While P1 meets the publicly traded company test, P2 (through P1) has indirectly made a base eroding payment of \$100 to Third Country (an ineligible person because it is a resident of State Y). Because this base eroding payment is not less than \$50 (the maximum base eroding payment that P2 can make ($\$100 \times 50\%$)) the base erosion test is not met.

Ownership/Base Erosion

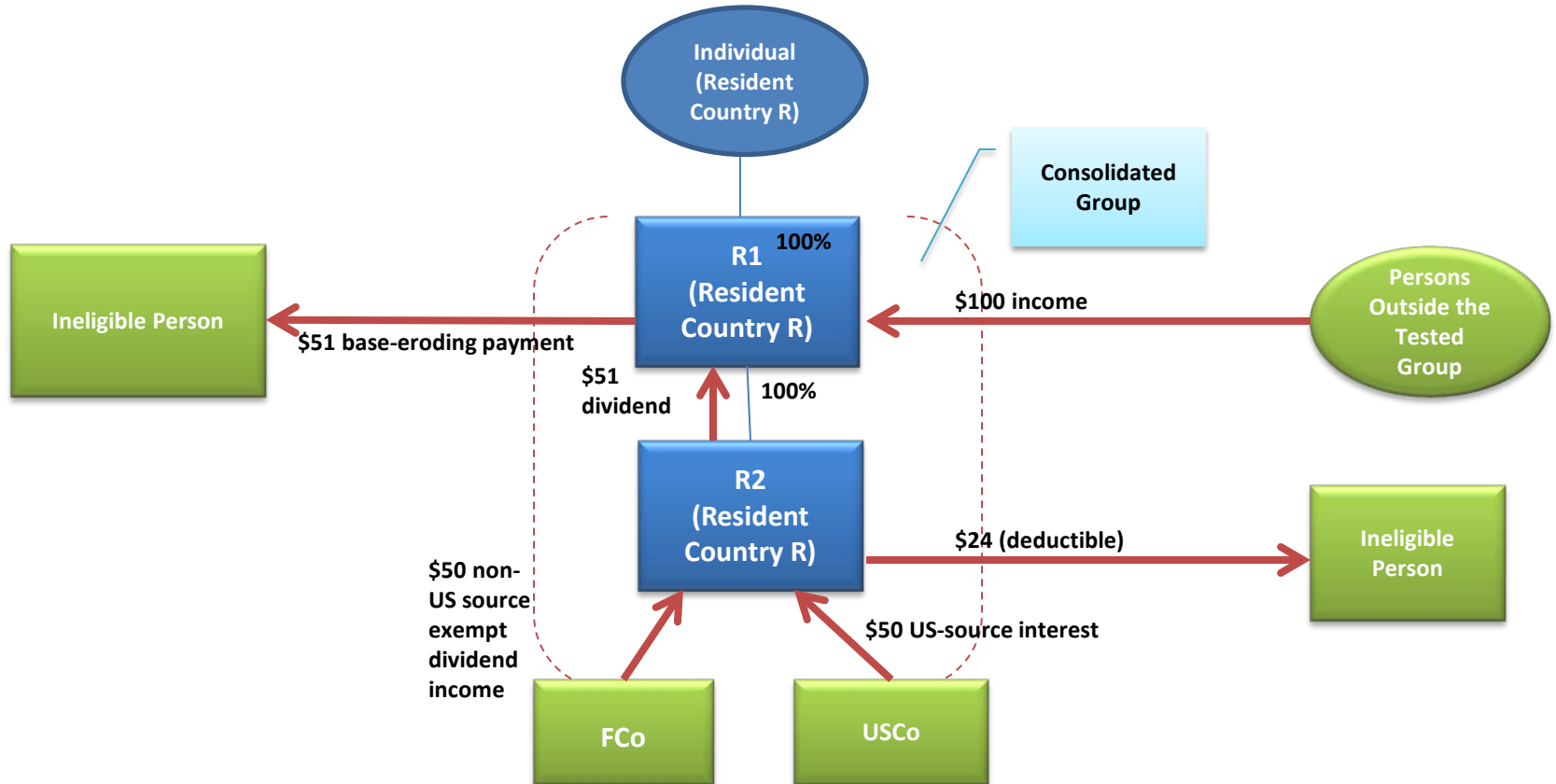
- Basic Rule: The ownership base erosion test provides an additional method to become a qualified person for any form of legal person that is a resident of a Contracting State (a “tested person”) if it satisfies both an ownership test and the base erosion test.

Ownership/Base Erosion Continued

- Ownership Test: 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 as an individual, government, publicly traded company (but not subsidiary of a publicly traded company) or a pension fund or charitable organization. In the case of indirect owners, each intermediate owner must be a QIO.

Example 6: Ownership/Base Erosion

Issue: Can R2 claim the benefits of Article 11 (Interest)?



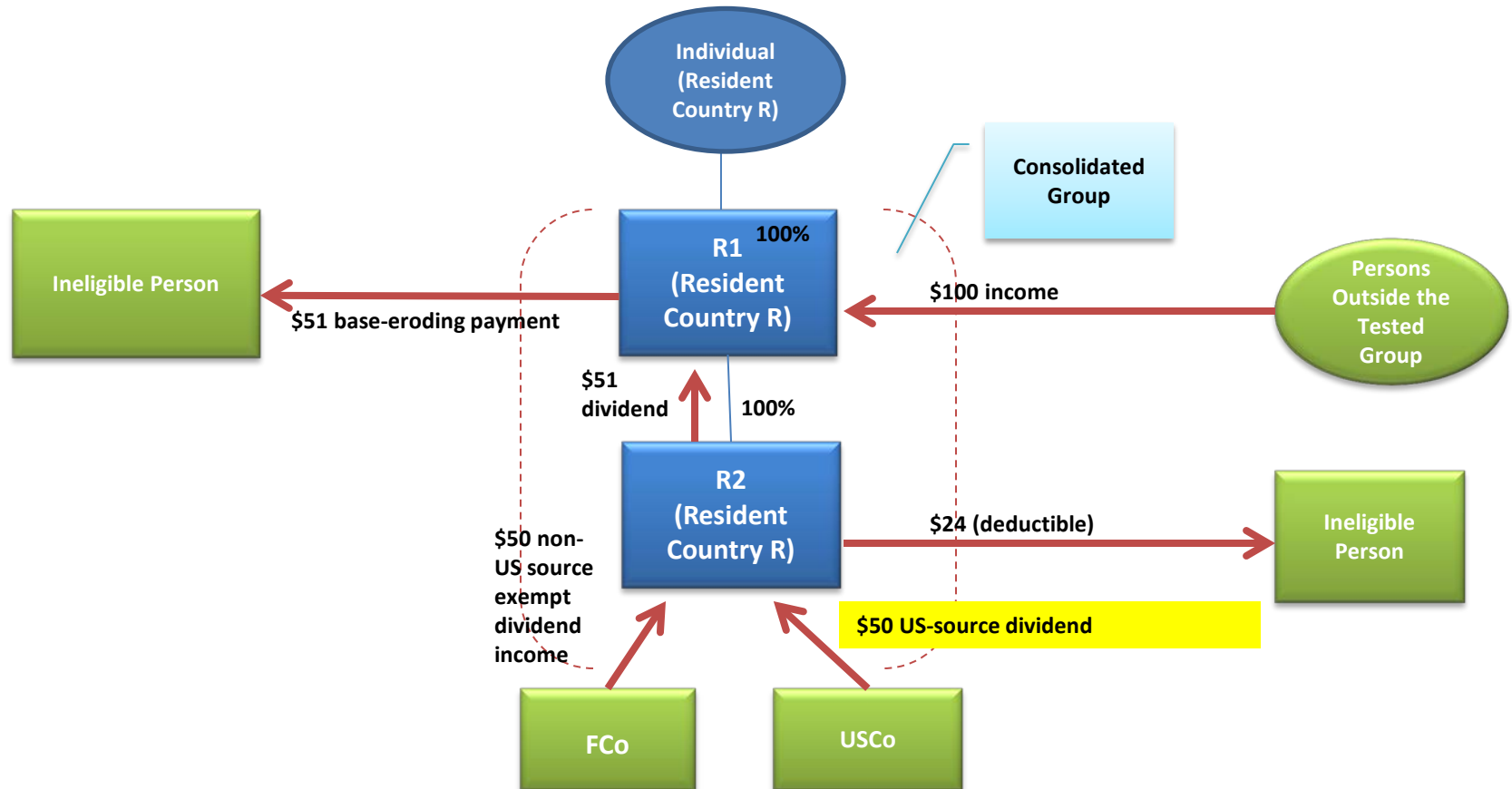
Ownership Prong: Met. Both R1 and R2 are residents of State R and have been residents of R2 for at least 12 months. R1 has owned 50% or more of R2 for 12 months. .

Base Erosion Prong: Tested Group Base Erosion Prong: R1 and R2 are members of the same Consolidated Group. Therefore, R1 and R2 are the tested group (Group Gross Income \$150). Maximum base eroding payments less than \$75 ($\$150 \times 50\%$). Base eroding payments total \$75 ($\$51 + \24). Base eroding payments are not less than \$75. Base erosion test not met and interest does not qualify for treaty benefits.

Example 7: Ownership/Base Erosion

Issue: Can R2 claim the benefits of Article 10 (Dividends)?

Facts same as Example 6 except that US source income with respect to which R2 seeks to be a qualified person is also a \$50 dividend.



Ownership Prong: Met. Both R1 and R2 are residents of State R and have been residents of R2 for at least 12 months. R1 has owned 50% or more of R2 for 12 months.

Base Erosion Prong: Tested Group Base Erosion Prong: R1 and R2 are the tested group. Tested Group's Gross income is \$200 (\$50 + \$50 + \$100). Maximum Base Eroding Payment is less than \$100 ($\$200 \times 50\%$). Actual base eroding payments ($\$51 + \$24 = \$75$) are less than \$100. Base erosion satisfied.

Active Trade or Business

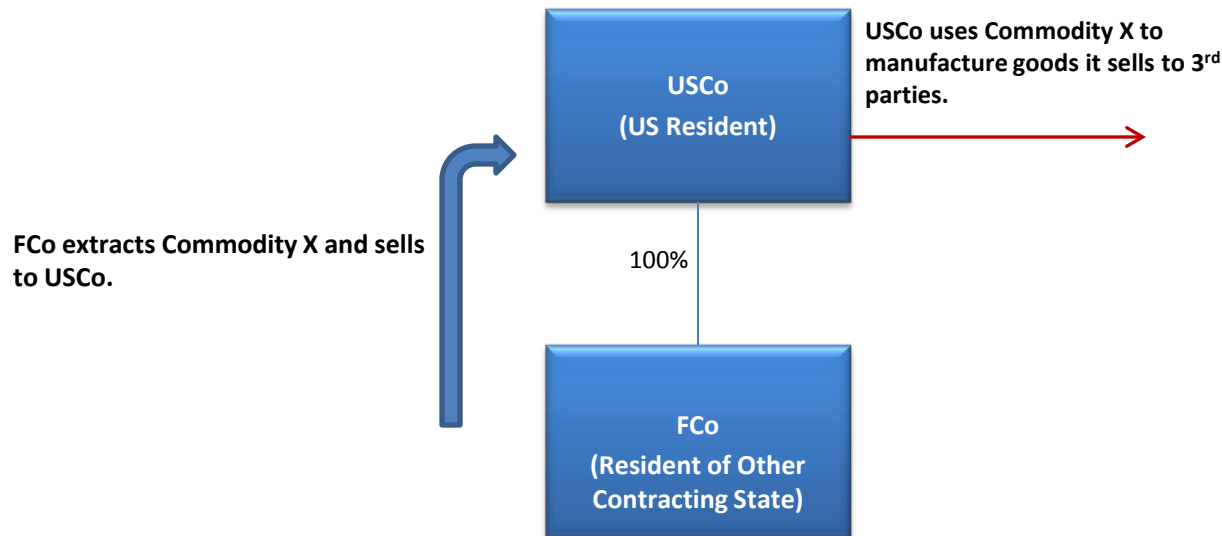
- A resident of a Contracting State engaged in the active conduct of a trade or business in that State may obtain treaty benefits with respect to an item of income derived from the other Contracting State if the income emanates from, or is incidental to, that trade or business.
- Active trade or business for these purposes does not include: holding companies, group financing, group supervision and administration, and making or managing investments.
- Activities conducted by connected persons with respect to a resident of a Contracting State can be attributed to the tested company. These attribution rules apply for purposes of determining whether a company is engaged in the active conduct of a trade or business and that the item of income emanates from the active trade or business, and for making the comparison required by the substantiality requirement.

Active Trade or Business

- Definition of “emanates”: Generally, 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: Active Trade or Business (Emanates)

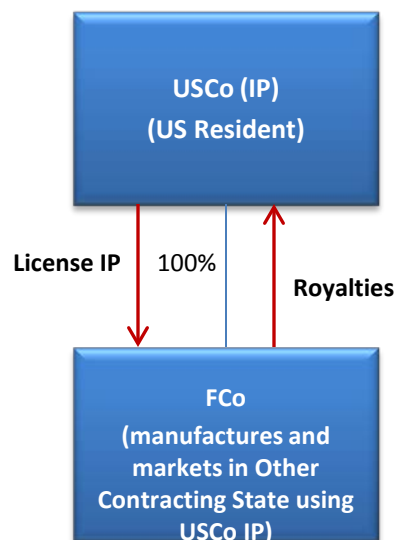
Issue: Are FCo's activities factually connected to USCo's actively conducted US business?



Analysis: Yes. 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. Dividends paid by FCo to USCo will be treated as emanating from USCo's trade or business.

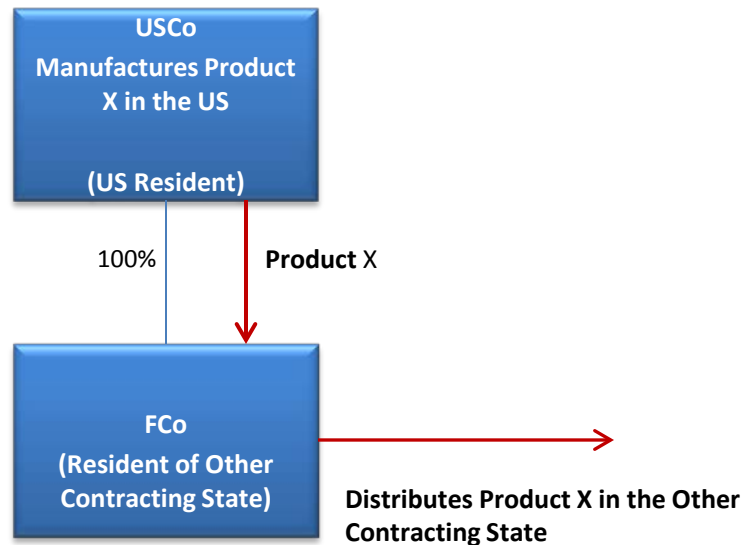
Example 9: Active Trade or Business

Issue: Will dividend qualify for treaty benefits under active trade or business test?



Analysis: Yes. Because activities conducted by FCo are factually connected to USCo's actively conducted US business royalties paid by FCo to USCo for use of IP will be treated as emanating from USCo trade or business.

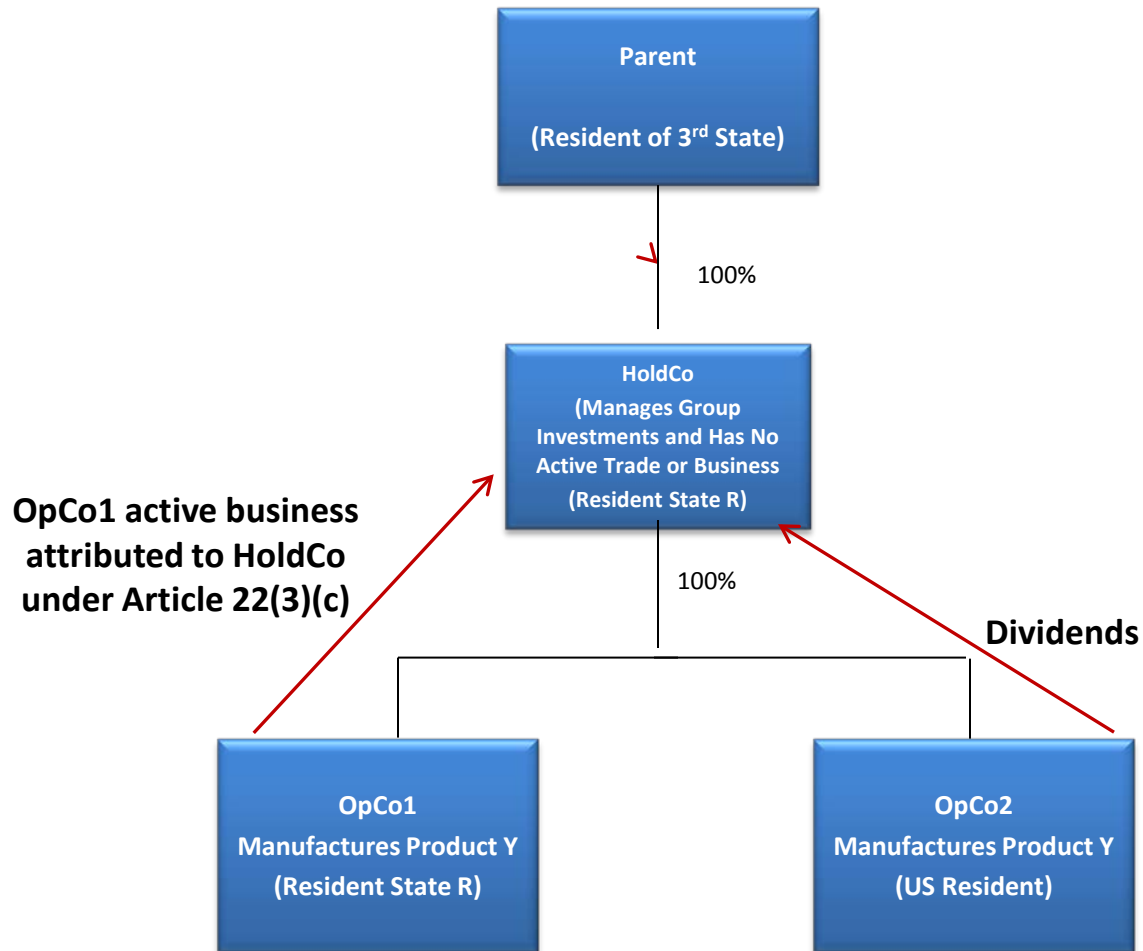
Example 10: Active Trade or Business (Emanates)



Because 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.

Example 11: Active Trade or Business (Attribution of Activities)

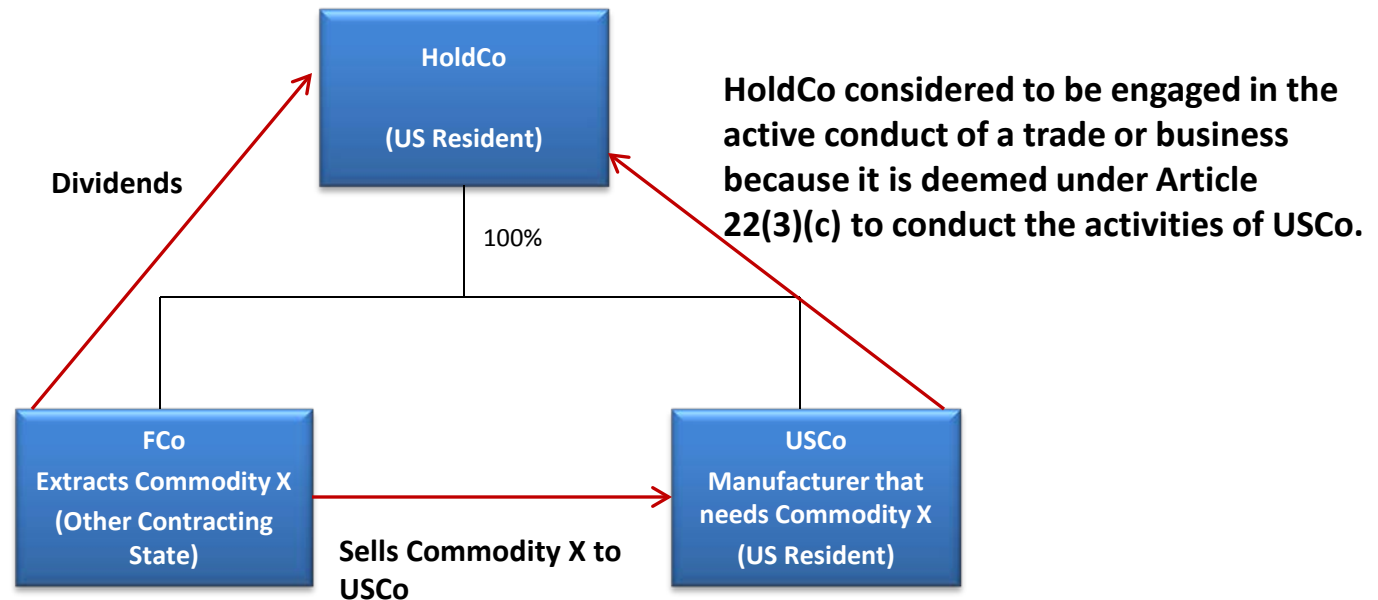
Issue: Will US source dividends be eligible for reduced withholding under the Active Trade or Business Test?



Analysis: No. 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 dividends paid by OpCo2 are factually connected to HoldCo's actively conducted trade or business. Dividends will not enjoy reduced withholding rates under Article 10.

Example 12: Active Trade or Business (Attribution)

Issue: Will dividends from FCo to HoldCo be eligible for reduced withholding under the Active Trade or Business Test?



Analysis: Yes. HoldCo and USCo are Connected Persons. Thus HoldCo is considered engaged in an active trade or business from the attribution of USCO's activities. FCo's business activity provides upstream inputs (commodity X for use in HoldCo's deemed active trade or business), FCo's business is considered to form part of HoldCo's manufacturing business. Dividends paid by FCo to HoldCo will emanate from HoldCo's deemed active trade or business.

Derivative Benefits

- General Rule: A resident of a Contracting State that is not a qualified person may receive treaty benefits with respect to certain items of income if it meets the derivative benefits test. 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 (and at least 50% of any disproportionate class of shares) are owned, directly or indirectly, by seven or fewer “equivalent beneficiaries” on at least half of the days of any twelve-month period that includes the date when benefits would otherwise be accorded, and
 - the tested company satisfies a 50% base erosion test.
- In the case of indirect ownership, each intermediate owner must be a QIO

Derivative Benefits

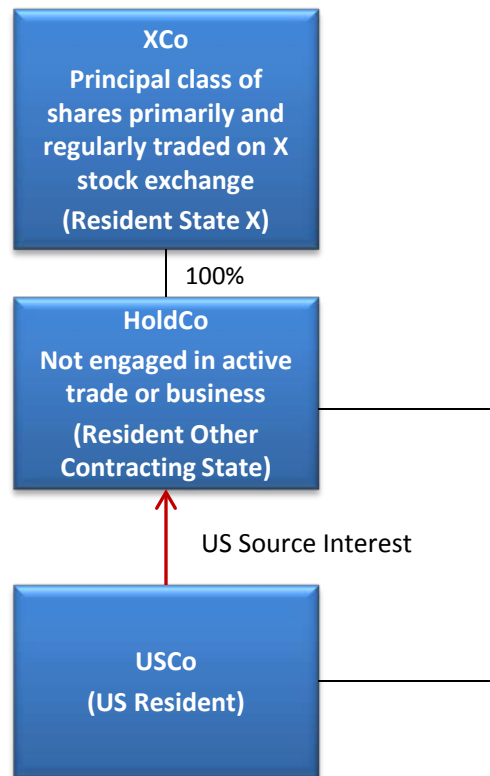
- There are 3 categories of equivalent beneficiaries (“EBs”) depending on whether the owner is a resident of a third State, a resident of the source State, or a resident of the same State as the tested company

Derivative Benefits (Equivalent Beneficiaries—Residents of 3rd State)

- Must satisfy LOB test for an individual, government, publicly traded company, pension or tax-exempt entity or with respect to dividends or interest received from a subsidiary in the resident's multinational corporate group a headquarters company, and
- must satisfy a rate equivalence test.

Example 13: Derivative Benefits

Issue: Is X Co an equivalent beneficiary in which case interest payments from USCo to HoldCo would be exempt from withholding, assuming the base erosion test is met?



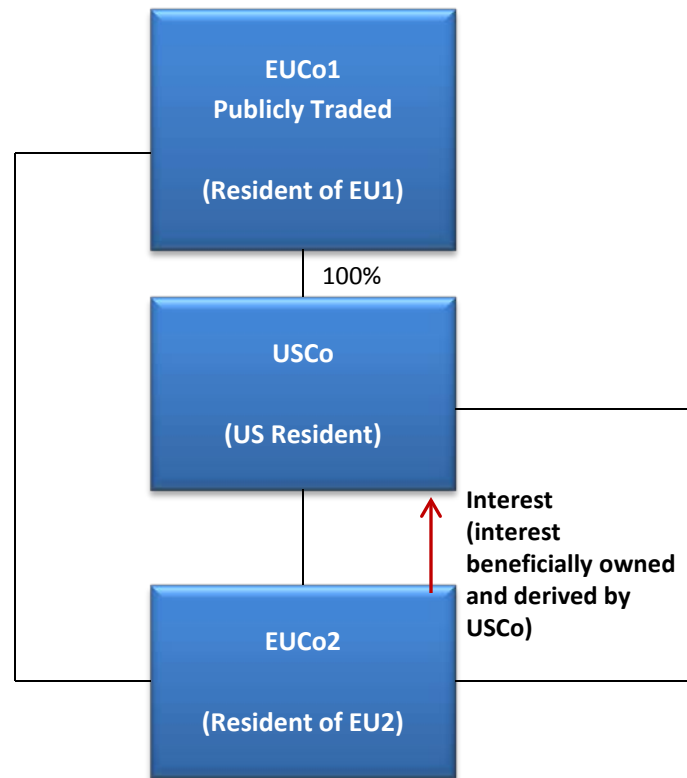
HoldCo derives and beneficially owns the US source interest. Under the US State X Convention, which contains a comprehensive limitation on benefits article, US source interest is exempt from tax. Similarly, State X has a treaty with the US providing for a comprehensive LOB provision and a zero rate of withholding on interest payments. Accordingly, XCo is an equivalent beneficiary.

Example 14: Derivative Benefits (Rate Comparison Satisfied via the EU Parent Subsidiary Directive)

Under EU1-EU2 treaty, the rate of withholding on interest is greater than zero.

EU1 and EU2 are members of the European Union.

Under the Parent Subsidiary Directive, interest paid by EU2 to EU1 would be exempt from withholding.



Under US-EU2 treaty, interest is exempt from withholding and contains a definition of equivalent beneficiary that is the same as 2016 Model Treaty.

Analysis: EUCo1 meets the rate comparison requirement of the equivalent beneficiary test because under the EU Parent Subsidiary Directive, the withholding rate between EUCo1 and EUCo2 is zero, a rate at least as low as the rate between EUCo2 and the US, notwithstanding that the rate of withholding on interest under the EU1-EU2 Convention is greater than zero.

Derivative Benefits: Rule Allowing Individual to be Treated Like a Company for Purposes of Derivative Benefits Rate Comparison Test

- 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 because they would not pass rate comparison (15 percent is not less than or equal to 5 percent)
- Article 22(7)(e)(i)(B)(1)(I) of the 2016 Model provides a rule allowing individual to be treated like a company for purposes of derivative benefits rate comparison test

Derivative Benefits: Rule Allowing Individual to be Treated Like a Company for Purposes of Derivative Benefits Rate Comparison Test (Continued)

- The Tested Company must (1) be engaged in the active conduct of a trade or business in its state of residence and (2) the business must be both substantial in relation to, and similar or complementary, to the trade or business that generated the earnings from which the dividend is paid.
- This active trade or business test is similar to but not identical to the active trade or business test under Article 22(3) as it does not require that the income from the source state emanate from the trade or business actively conducted by the tested company

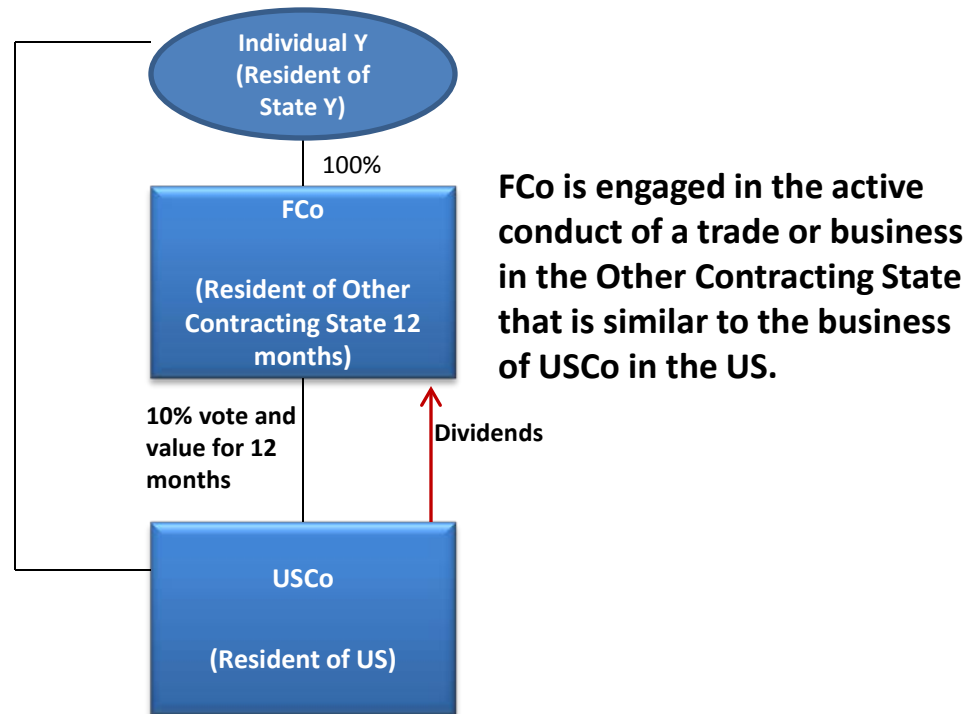
Derivative Benefits: Rule Allowing Individual to be Treated Like a Company for Purposes of Derivative Benefits Rate Comparison Test

- 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 connected person to the tested company are deemed to be conducted by such company.
- For purposes of this special rule, when applying the rate comparison test, the potential equivalent beneficiary's indirect ownership in the vote and value of the shares of the company paying the dividends will be treated as direct ownership

Example 15: Derivative Benefits (Rate Comparison)

Issue: Is FCo entitled to the 5% withholding rate on dividends under the FCo-USCo income tax treaty by virtue of the Derivative Benefits Test?

The terms of the US-Y income tax treaty with respect to Article 10(2) are identical to the 2016 US Model.

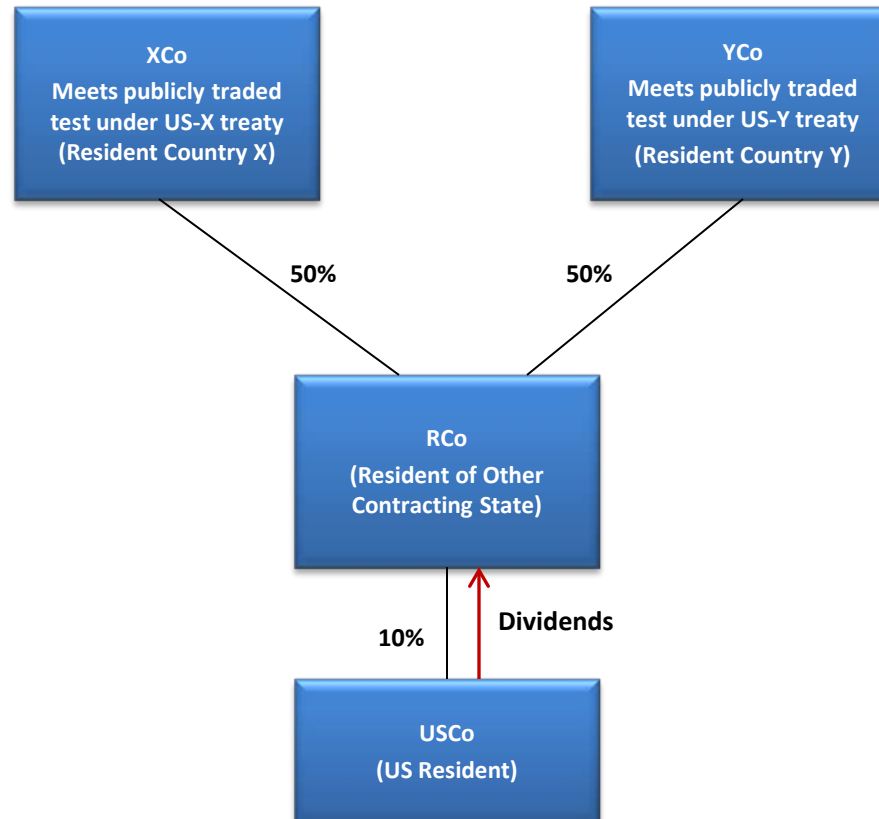


FCo is engaged in the active conduct of a trade or business in the Other Contracting State that is similar to the business of USCo in the US.

Analysis: Because (1) FCo is engaged in an active business similar to USCo's business and (2) Individual Y is treated as a publicly traded company for purposes of Rate Comparison, Individual Y will be treated as an Equivalent Beneficiary, assuming all other requirements (e.g., base erosion test and beneficial ownership) are satisfied. Therefore, FCo will be entitled to a 5% rate on dividends (rather than a 15% rate) paid by USCo.

Example 16: Derivative Benefits (Rate Comparison Not Met)

Issue: Are XCo and YCo equivalent beneficiaries under the derivative benefits test (which would entitle RCo to 5% withholding on dividends paid by USCo to RCo)?



Facts: The US has tax treaties with Country X and Country Y that provide terms similar to the 2016 US Model.

Analysis: XCo and YCo are not equivalent beneficiaries. Under the US-Country R treaty, RCo would be entitled to 5% withholding. However, for purposes of determining the dividend rate, XCo and YCo would be entitled to under their treaties with the US, they are considered to own 5% of USCo (50% x 10%) and thus would be entitled only to a 15% withholding rate, failing rate comparison.



Derivative Benefits: Business Profits, Capital Gains and Other Income

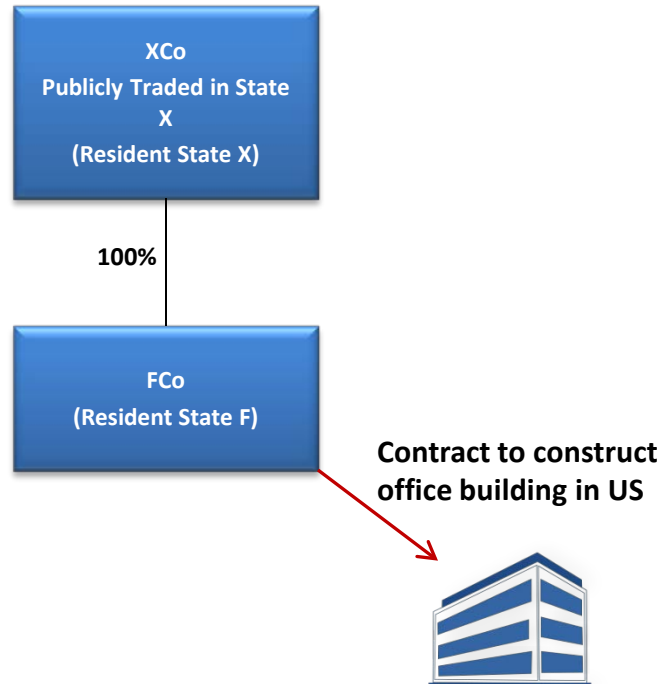
- The 2016 Model provides derivative benefits rules for items of income for which there are no fixed rates of tax to compare (business profits, capital gains, other income). The potential equivalent beneficiary must be entitled to a benefit under the tested convention that is at least as favorable as those that would apply under the baseline convention to such business profits, gains or other income.

Derivative Benefits: Business Profits, Capital Gains and Other Income

- Thus the benefits to be compared are:
 - 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
 - The benefits that the source State would grant the potential equivalent beneficiary if it derived the income directly

Example 17: Derivative Benefits (Business Profits, Capital Gains and Other Income)

Issue: If the construction project extends beyond 183 days, will XCo be an equivalent beneficiary with respect to business profits?



Facts: Under the US-F income tax treaty, an enterprise has a PE with respect to a construction project if it lasts more than 183 days. Under the terms of the US-X treaty, the PE standard for a construction project is 365 days.

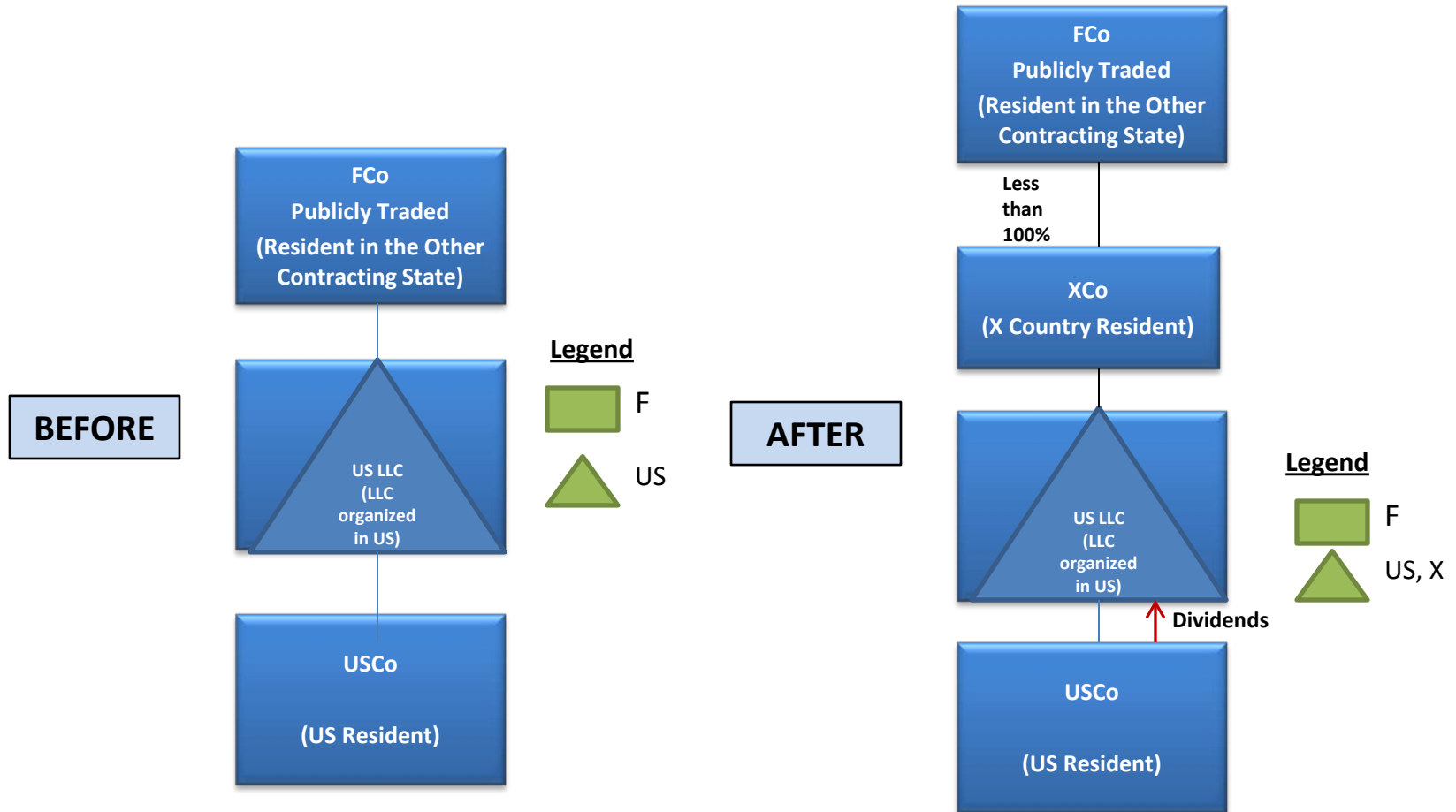
Analysis: No, because after 183 days, XCo would not be entitled to the same protection under the PE article of the US-X treaty that FCo would be entitled to under the US-F treaty (the 183 day standard of the US-F treaty is not as favorable as the 365 day standard of the US-X treaty).

Derivative Benefits Fiscally Transparent Entities

- An additional limitation on the definition of equivalent beneficiary applies where the item of income, profit or gain has been derived through a fiscally transparent entity under the laws of the Contracting State of the Company claiming the benefits
- In those cases, even though the resident may otherwise meet the requirements for equivalent beneficiary status, the resident will not meet the definition of equivalent beneficiary 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 Article 1(6) of the U.S. Model Treaty had it, rather than the tested company, been paid the item of income for which the company is claiming benefits

Example 18: Derivative Benefits (Fiscally Transparent Entities)

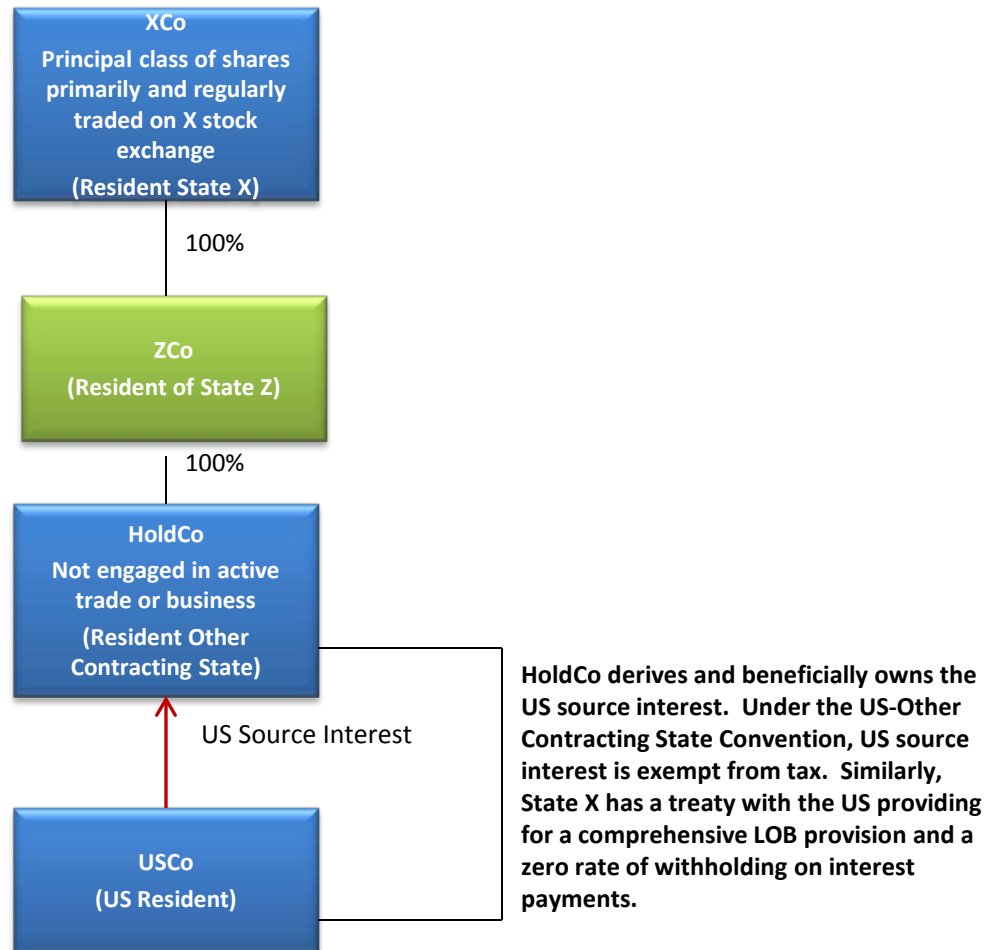
Issue: Would dividends paid by USCo through USLLC be considered derived by FCo and thus eligible for a rate reduction under Article 10 dividends?



Analysis: No. USLLC is fiscally transparent under US law and a company under the laws of the Other Contracting State. Accordingly, under Article 1(6), dividends paid by USCo through USLLC would not be considered derived by FCo and would not be eligible for a rate reduction under Article 10. If XCo, is interposed between FCo, and Country X views USLLC as fiscally transparent, then XCo is considered to derive dividends paid by USCo to USLLC and would be eligible for a reduced withholding rate.

Example 19: Derivative Benefits: QIO

Issue: Is X Co an equivalent beneficiary in which case interest payments from USCo to HoldCo would be exempt from withholding, assuming the base erosion test is met?



Facts same as Example 13 except ZCo is interposed between XCo and Holdco.

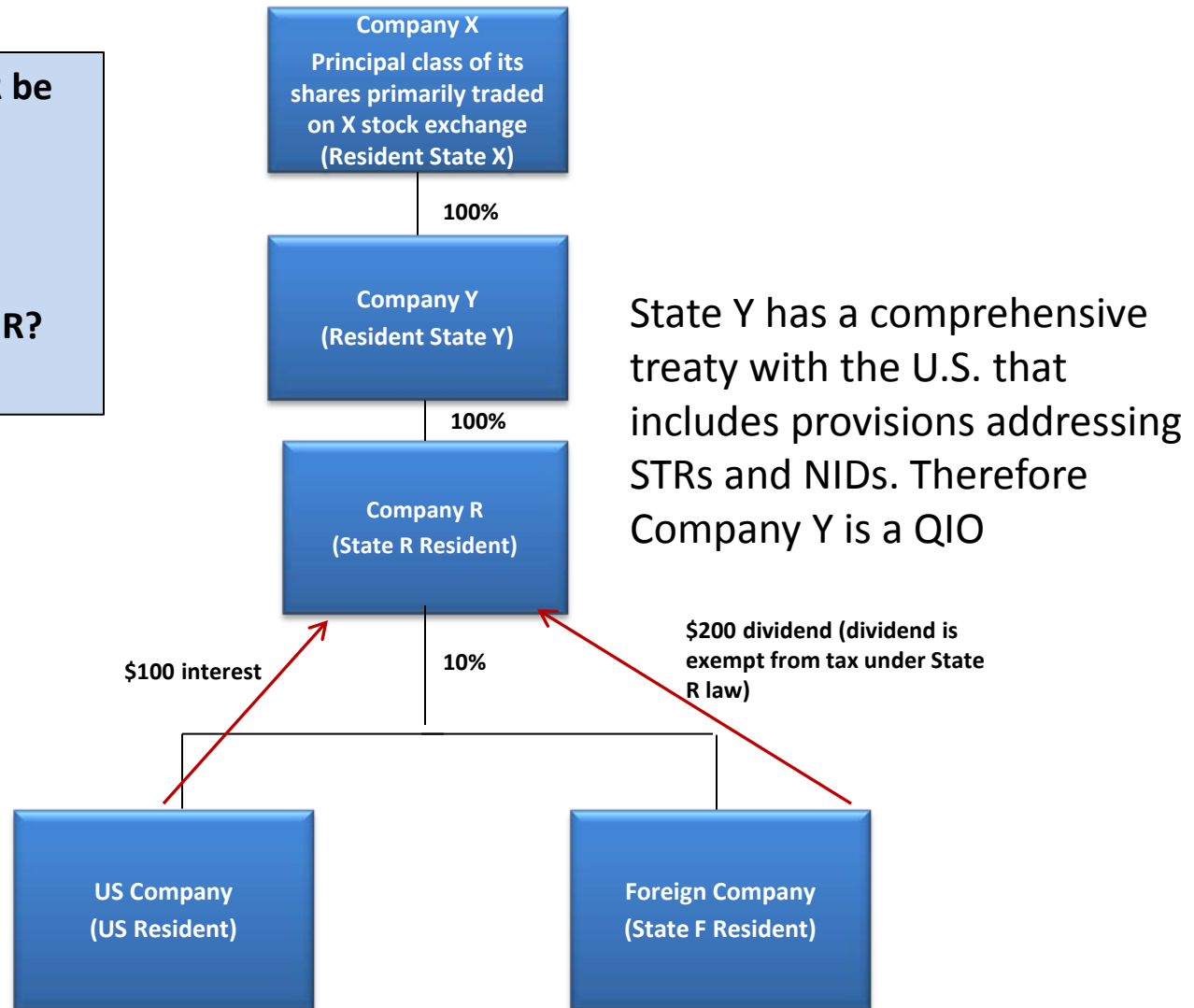
Analysis: State Z does not have in effect a comprehensive treaty with the US that includes provisions addressing STRs and notional interest deductions. Therefore, State Z is not a QIO. The requirements of derivative benefit are not satisfied.

Derivative Benefits—Base Erosion Test

- The Derivative Benefits test for base erosion is the same as the Base Erosion test for Ownership Base Erosion discussed above, except that the test treats payments as base eroding payments amounts paid or accrued to:
 - Persons who are not equivalent beneficiaries
 - Persons who are equivalent beneficiaries
 - Solely by reason of being a headquarters company,
 - That are connected persons with respect to the tested company and benefit from an STR in their state of residence with respect to the payment, or
 - That are connected persons with respect to the tested company and that benefit from notional interest deductions with respect to the payment

Example 20: Derivative Benefits (Base Erosion)

Issue: Will Company R be entitled to the 0% withholding rate with respect to the \$100 of interest paid from US Company to Company R?



Analysis: Because (1) Company X, an equivalent beneficiary, indirectly owns shares representing at least 95% of the aggregate vote and value of Company R and (2) each intermediate owner (Company Y) is a QIO, then Company R will satisfy the ownership requirement of derivative benefits. Under State R law, Companies X, Y and R cannot participate in a consolidation or loss sharing regime. Therefore there is no tested group. Accordingly for base erosion testing Company R's gross income is \$100. Company R will fail base erosion if it makes base eroding payments to ineligible persons of \$50 or more.

Cliff Effect

Generally, in order to qualify as an equivalent beneficiary with respect to dividend income, a third-country resident must be entitled, either under a comprehensive convention for the avoidance of double taxation between its country of residence and the source country or otherwise, to a rate of tax with respect to the particular category of income that is less than or equal to the rate applicable under the tax treaty pursuant to which benefits are being claimed. Companies that fail to satisfy this rate comparison test are not entitled to treaty benefits under the derivative benefits test), and therefore are generally subject to 30-percent gross basis withholding tax on U.S. source payments of dividends, interest, and royalties (the “cliff effect”).

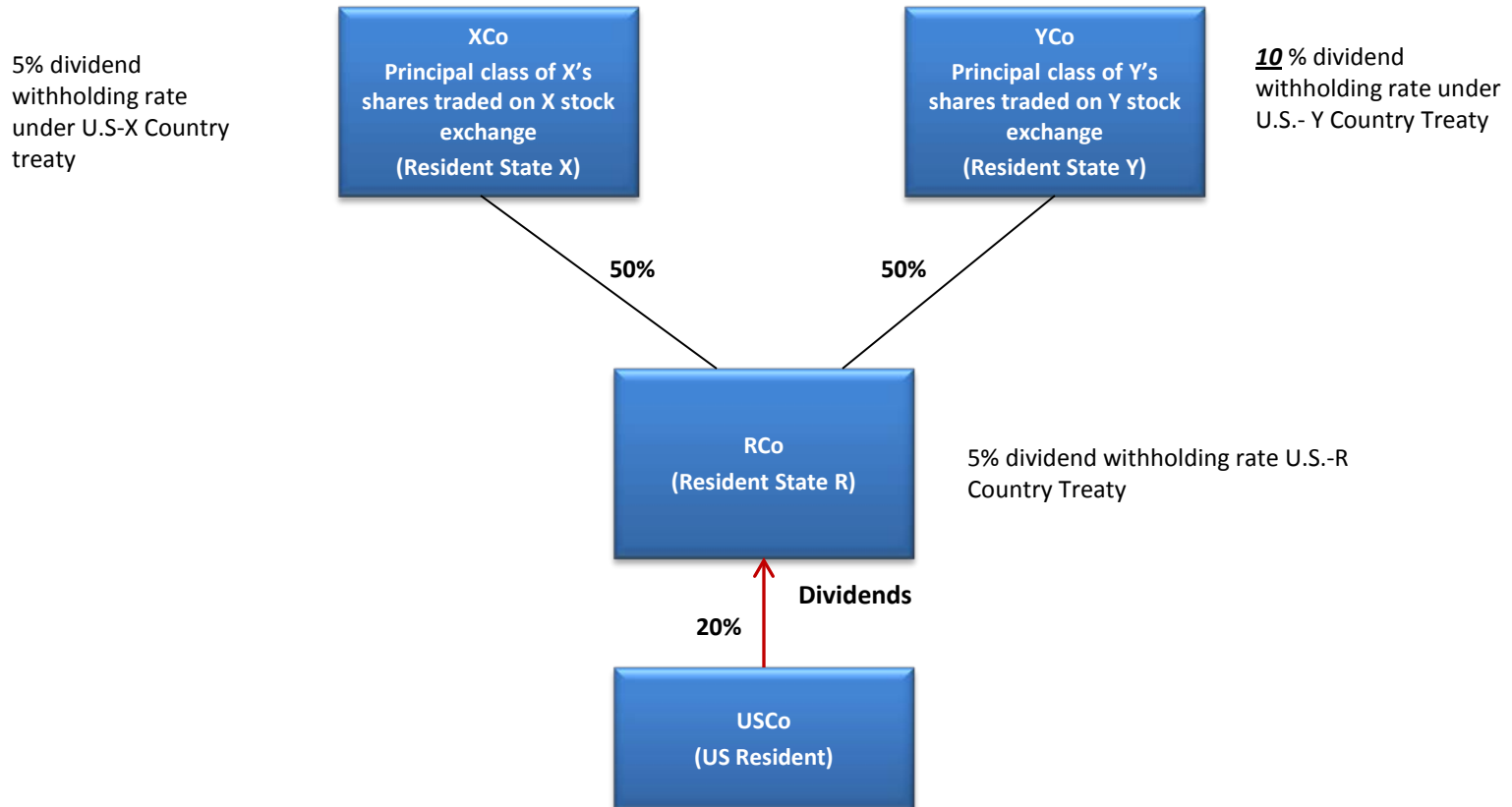


Amelioration of Cliff Effect

- The 2016 Model potentially ameliorates this “cliff effect” with respect to dividends, interest, and royalties where a company fails Derivative Benefits solely because it fails the rate comparison requirement of derivative benefits. Note this exception will not apply with respect to royalties where a benefit is claimed by a headquarters company under Article 22(5).
- Where the Cliff Exception applies, the rate of tax charged is limited to the highest rate of tax to which a potential equivalent beneficiary would have been entitled if such person had received the item of income directly. For purposes of this rule, a potential equivalent beneficiary’s indirect ownership in the vote and value of the shares of the company paying the income will be treated as direct ownership.

Example 20A: Cliff Effect Amelioration

Issues: Is RCo entitled to reduced withholding under the derivative benefits provision of the US-R Country treaty? If not, is RCo entitled to reduced withholding (and at what rate) under the Cliff Amelioration Effect rule of Article 10(6) of the 2016 US Model?



Analysis: RCo is not entitled to reduced withholding on derivative benefits as an equivalent beneficiary since only 50% of its shares is owned by an equivalent beneficiary. (XCo). YCo is not an EB because it fails rate comparison. However, RCo is entitled to 10% rate of withholding under the Cliff Effect Amelioration rule because it failed Derivative Benefits only because of rate comparison (YCo was only entitled to a 10% withholding rate under the treaty, not 5%).



Headquarters Company

- A resident of a Contracting State that does not qualify for benefits as a qualified person may be able to qualify for benefits with respect to dividends (5% withholding if 10% vote and value) and interest (10% withholding) paid by members of the company's multinational corporate group if it meets the headquarters company test
- Multinational corporate group ("MCG") means the company and its direct and indirect subsidiaries (and does not include upper-tier companies)

Headquarters Company: 6 Conditions

- Headquarters Company's primary place of management and control in Company's residence state
- MNG consists of companies resident in, and engaged in the active conduct of a trade or business in at least 4 countries and the trades or business carried on in each of the 4 states (or 4 groupings of states) generates at least 10% of MNG's gross income (the "4 State Gross Income Test")
- The trades or businesses of the MNG carried on in any one state other than the Contracting State of residence of such company generate less than 50% of the MNG's gross income

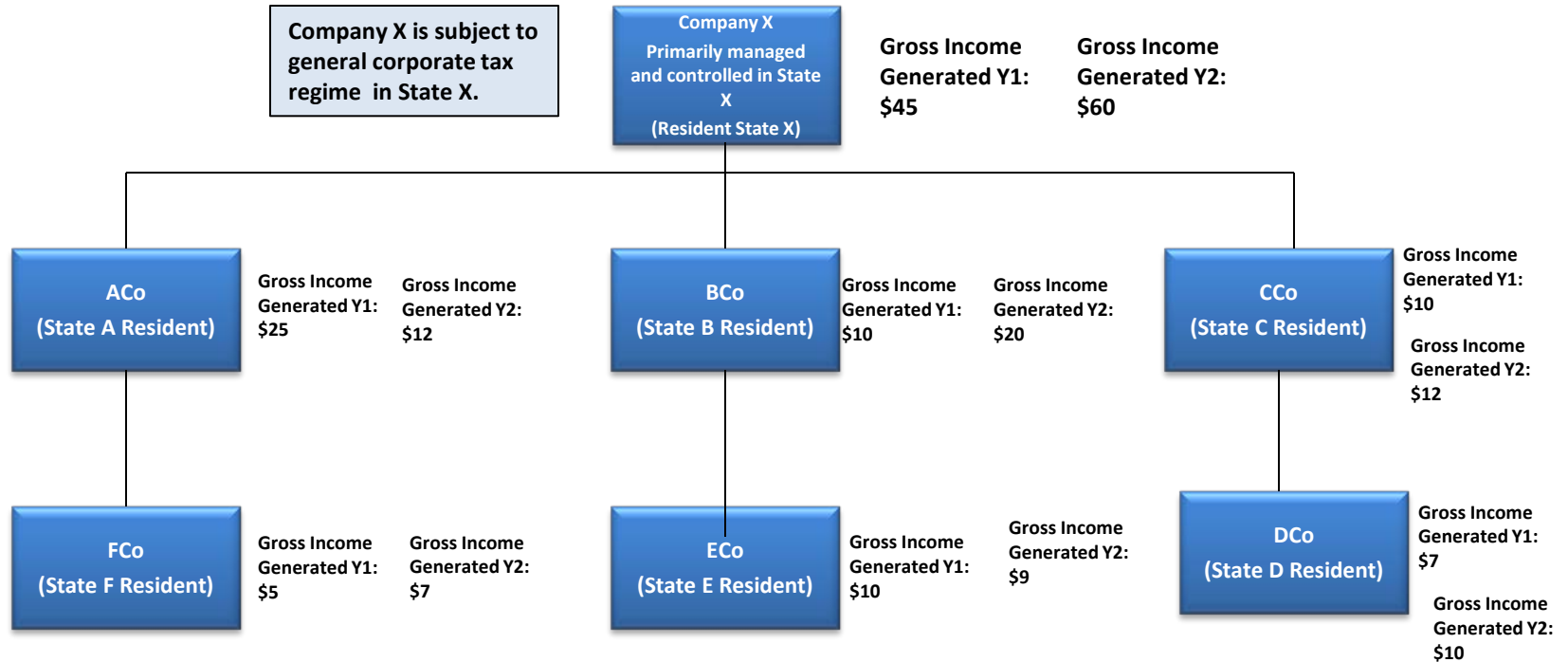
Headquarters Company: 6 Conditions

Continued

- No more than 25% of the Headquarters Company's gross income is derived from the other Contracting State. Unlike the third condition described above, this condition only looks at the gross income earned by the company seeking status as a headquarters company, rather than the gross income of the MNG
- The Headquarters Company is subject the general corporate taxation rules for company's engaged in the active conduct of a trade or business in its Contracting State of residence, and not a regime for headquarters companies
- Meets a base erosion test that is like the base erosion prong of the ownership base erosion test except that the 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 Headquarters Company

Example 21: Headquarters Company

Issue: Are there four states or groupings of states that each meet the 10% gross income requirement?



Companies A, B, C, D, E and F are engaged in active trades or businesses in their respective resident states.

Total Gross Income All Companies Year 1: \$112
Total Gross Income All Companies Year 2: \$130

Analysis: Yes, because companies resident in and engaged in the active conduct of a trade or business in at least 4 states, and the trades or businesses carried on in each of the 4 states (or groupings on states) generate at least 10% of the Gross Income of the Group. In Year 1 10% of Group Gross Income is \$11.20. State X (\$45) and State A (\$25) meet requirement. Additionally, States B and C have total gross income of \$20 and States D, E, and F have gross income totaling \$26. In Year 2 10% of Group Gross Income is \$13. State X (\$60) and State B (\$20) satisfy requirement. Additionally States A and C have Gross Income totaling \$24 and States D, E, and F have Gross Income totaling \$26. Note composition of groupings may change from year to year.

Analysis Example 21 Headquarters Company

Year 1-- 4 State Gross Income Test Met

- Total gross income of MNG in Year 1 is \$112 (\$45+\$25+\$10+\$10+\$7+\$10+\$5)
- 10% of the MNG's gross income for Year 1 is \$11.20 (112 x 10%)
- State X (\$45) and State A (\$25) meet this requirement for year 1
- Because State B and C have total gross income of \$20 (\$10+\$10) from active trades or businesses carried on in their respective states and States D, E, and F have a total gross income of \$22 (\$7+\$10+\$5), from active trades or businesses carried on in their respective states these two groups of countries may be treated as the third and fourth members of the group



Analysis Example 21 Headquarters Company

Year 2--4 State Gross Income Test Met

- Total gross income of MNG in Year 1 is \$130 (\$45+\$25+\$10+\$10+\$7+\$10+\$5)
- 10% of the MNG's gross income for Year 2 is \$ 13 (130 x 10%)
- State X (\$60) and State B (\$20) meet this requirement for year 1
- Because States A and C have total gross income of \$24 (\$12+\$12) from active trades or businesses carried on in their respective states and States D, E, and F have a total gross income of \$22 (\$7+\$10+\$5) with respect to active trades or businesses carried on in their respective states, these two groups of countries may be treated as the third and fourth members of the group
- Thus the 4 State Gross Income Test is met for year 1.

Analysis Example 21 Headquarters Company

- Since X Company is managed and controlled in State X its residence State, the 4 State Gross Income Test is met in both Years 1 and 2, X Company is subject to the general corporate tax provisions of State X, the trades or businesses in any one of these states (other than X) generate less than 50% of the MNG's gross income, and assuming no more than 25% percent of X Company's gross income is generated from the Other Contracting State and that the base erosion test is met, then X Company will be entitled to the 5% withholding rate on Dividends it receives from the Other Contracting State.

Discretionary Benefits

- If a resident cannot satisfy any of the objective tests, paragraph 6 allows the competent authority of the source State to grant benefits at its discretion, and after considering:
 - object and purpose of the Convention;
 - existence of a substantial non-tax nexus of resident to residence State; and
 - if establishment, acquisition, maintenance or conduct of resident's business has as one of its principal purposes the obtaining benefits of the Convention.
- Consultation with competent authority of residence State required (however such consultation is not a MAP).