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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*

ii) with respect to benefits under this Convention other than under Article 10 (Dividends), less than 50 percent of the companyôs gross income, and less than 50 percent of the tested groupôs 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 companyôs Contracting State of residence (but not including armôs 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)

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 ñactive conduct of a trade or businessò 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 con1 3-sr.((9.0509 Tc[(i))] TJETBT1 0 i)6(i)-4())] TJE

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 companyôs gross income, and less than 50 percent of the tested groupôs 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 companyôs Contracting State of residence (but not including armôs 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 subs

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f) less than 50 percent of such companyôs gross income, and less than 50 percent of the tested groupôs 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 companyôs Contracting State of residence (but not including armôs 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 ñrecognized stock exchangeò 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 ñprincipal class of sharesò 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 ñprincipal class of sharesò are

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

c) the term ñdisproportionate class of sharesò 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 companyôs ñprimary place of management and controlò 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 ñequivalent beneficiaryò 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

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 residentôs 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 residentsô 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 ñqualifying intermediate ownerò 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

h) the term ñgross incomeò means gross receipts as determined in the personôs 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, ñgross incomeò 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, ñgross incomeò 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 personôs 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 groupôs gross income shall not take into account transactions between companies within the tested group.

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 companyôs income or substantially all of a companyôs 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 statutor

D) persons the taxation of which achieves a single level of taxation either in the hands of the person or the personôs 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 ñconnected personsò 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 companyôs 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 companyôs 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 ñresident of a Contracting Stateò 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.

(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

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 th

(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

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 offthe

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.

R3ôs 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 R3ôs 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

Example 4. Assume the same facts as in Example 2, except that R3ôs only items of income are U.S. source royalties of $100, for which R3 seeks to claim benefits of Article 12

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 ñtested personò). 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 p] TETBT1 0 0 1 442[(ow)4(e)-33(

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 personôs 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 armôs-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 armôs-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 ñgross incomeò 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 (ipur TJFpC(cl)-es5(i)9(at)5(i),y be pa/F2 ardes 313.963.9630

tested groupôs 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, R2ôs 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 (R2ôs gross income of $100 plus R1ôs 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 groupôs 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

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

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 stateôs 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

conducted in the Contracting State of residence for purposes of subclause (B)(1)(I) of subparagraph 7(e)(i) need only be ñsimilar or complementaryò to the active trade or business conducted in the source State, and not the ñsame or complementaryò 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

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 companyôs 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 individualôs tax is determined in whole or in part on a fixed-fee, ñforfaitò 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 residentsô 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 ñqualifying intermediate ownerò 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 ñqualifying intermediate ownerò 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 ñqualifying intermediate ownerò 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)) i610(D)5(ef)22(r)7(e) tsehats ub62( )-32(s)9(at)5(i)2(r)7(e) ce.70 g0 GC( )-2279b62

Company Rôs 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 Rôs 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 companyôs multinational corporate group. A headquarters companyôs 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 companyôs primary place of management and control must be in the Contracting State of which it is a resident. The term ñprimary place of management and controlò 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

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 Regimes

Subparagraph 1(l) defines the term ñspecial tax regime.ò 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 ñspecial tax regimeò also is used in Article 22 (Limitation on Benefits) for purposes of the ñbase-erosionò tests in subparagraphs 2(d)(ii), 2(f)(ii), 4(b) and 5(f), as well as the definition of the term ñqualifying intermediate ownerò set forth in subparagraph 7(f) of that Article.

The application of the term ñspecial tax regimeò 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:

> ñSince 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 Stateôs tax system that could increase the risk of non-taxation, which may include tax advantages that are ring-fenced from the domestic economy.ò

The term ñspecial tax regimeò 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 1r/MCID 17>BDC BT1.141.14 Tm[80.37 Tm[(nne15(se121.1 2277(o)11(f)-3(227

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 authorityôs 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 countryôs 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 al(es)- no intt-184(r5(i)-4(n(ng)22(6r)5(ent)5(i)-4(an8( )-97(b1 0 0.)-64( )-

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 ñactually harmfulò by the OECDôs 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 companyôs 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 ï (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

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.