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**INTRODUCTION**

For more than 30 years, the United States has included in all of its newly negotiated income tax treaties a limitation-on-benefits (LOB) article intended to prevent (or at least limit) treaty shopping by residents of third countries. In fact, over the past two decades, one of the priorities of the US tax treaty program has been to renegotiate existing treaties in order to add a LOB provision. From the US perspective, treaty shopping that allows “residents of countries other than the countries that are parties to the treaty to derive treaty benefits (such as rate reductions on passive income) by channeling investments through entities organized in or resident in a treaty jurisdiction)” violates the principle that tax treaties represent a deal negotiated between two sovereign states.¹

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¹ Testimony of John E. Chapoton, Assistant Secretary (Tax Policy), United States Department of the Treasury, before the House Committee on Government Operations, Subcommittee on Commerce, Consumer and Monetary Affairs, April 13, 1983: “We believe that an income tax treaty is a contract between two countries designed to benefit directly the residents of the two countries and not indirectly residents of third countries.”
Although treaty shopping has been described as constituting tax avoidance,\(^2\) the Treasury Department now views treaty shopping more pragmatically. As long as residents of third countries can enjoy the benefits of reduced withholding rates by engaging in treaty shopping, they will not lobby their governments to enter into treaties that provide reciprocal benefits to US taxpayers.\(^3\) Proof that LOB provisions are working can be seen in the fact that countries such as Japan and Canada have, after many years, agreed to much-desired reductions in withholding rates. The price of those reductions was time-consuming and difficult negotiations.

As of the time of writing, it appears likely that the Organisation for Economic Co-operation and Development (OECD) will be adding a US-style LOB provision to the OECD model convention\(^4\) as part of its base erosion and profit shifting (BEPS) project.\(^5\) As a result, more countries may begin negotiating LOB provisions in the future.\(^6\) Accordingly, it seems to be a suitable time to review the development of the US LOB provision and determine whether it provides useful lessons for the international community.

**TRANSACTION-SPECIFIC ANTI-TREATY-SHOPPING RULES**

It is important to keep in mind that the LOB provision is not the only tool used by the United States to attack the inappropriate use of tax treaties. Other useful doctrines include substance over form, economic substance, step transaction, and beneficial ownership. Although these doctrines are more commonly used in domestic circumstances, in 1999 the Senate Foreign Relations Committee confirmed their application in the treaty context.\(^7\) A pending treaty-shopping case against Ingersoll Rand suggests that the Internal Revenue Service believes that a particular structure may implicate a number of these doctrines at the same time. In general, the doctrines are used to attack particular transactions, while the LOB provision is used to attack entities. For example, for the anti-conduit regulations to apply, there must have been a reduction in withholding rates, which means that some entity must have satisfied the requirements of the applicable LOB provision.

\(^2\) Ibid.

\(^3\) Statement of Leslie B. Samuels, Assistant Secretary (tax policy), Department of the Treasury, Before the Committee on Foreign Relations, United States Senate, October 27, 1993.


\(^6\) Of course, the negotiation process could be considerably shortened if the OECD is successful in developing a multilateral process for modifying existing tax treaties. In that case, most countries would face a steep learning curve in connection with the implementation of such provisions but not the negotiation of them.

The US Treasury Department has even flirted with a UK-style “main purpose” test, including it in treaties with Italy and Slovenia that were signed in 1999. When the treaties were presented to the Senate for advice and consent to ratification, the Senate Foreign Relations Committee was harshly critical of the main purpose test. The committee stated that the “new main purpose tests in the proposed treaty are subjective, vague and add uncertainty to the treaty.” It noted that the main purpose test was similar to subjective tests that had formed the basis of some earlier anti-treaty-shopping provisions. Quoting the Treasury Department’s technical explanation to the proposed treaty, the committee said that the “fundamental problem presented by this approach” was that “it is based on the taxpayer’s motives in establishing an entity in a particular country, which a tax administrator is normally ill-equipped to identify.” As a result, “[t]hese subjective tests have been replaced in recent treaties (including the proposed treaty) with limitation on benefits provisions that apply clear, bright-line objective tests.” The Senate entered a reservation to each of the two treaties requiring the main purpose provisions to be struck before the treaty could enter into force. The committee also made it clear that although it would consider “appropriate ways to address tax avoidance in the treaty context,” the Treasury Department would face an uphill battle should it propose any such main purpose test in future treaties. As a result, even the US treaty with the United Kingdom, which was signed in 2001, did not include the test; instead, the treaty introduced more targeted rules addressing conduit arrangements. The United States continues to resist the adoption of a main purpose test in connection with the BEPS project.

THE DEVELOPMENT OF OBJECTIVE TESTS

The OECD received hundreds of pages of comments on its discussion draft on treaty abuse. Many of the comments suggested that a US-style LOB provision is too complicated and called for a simpler provision. Of course, the original provisions used by the United States to combat treaty shopping were relatively simple. They were also almost completely ineffective.

The relatively simple one-sentence provisions that were introduced in the early 1960s did not become today’s multi-page LOB extravaganzas overnight. The current version of the LOB provision consists of a series of objective tests. Residents of a contracting state that satisfy one of the tests essentially are presumed to have a good

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8 Ibid., at 5. The committee elaborates on its theme by continuing, “It is unclear how the provisions are to be applied. In addition, the provisions lack conformity with other U.S. tax treaties. This uncertainty could create difficulties for legitimate business transactions, and can hinder a taxpayer’s ability to rely on the treaty.”

9 Ibid., at 5-6.

10 Slovenia promptly accepted the Senate reservation, allowing that treaty to enter into force in 2001. Italy was much slower to accept the reservation, and the US-Italy treaty entered into force only in 2009.

business reason for structuring their activities through that contracting state. Each new definition or rule has been a response to a particular issue or need of the parties. Once a provision is introduced in one agreement, it is likely to be replicated—or expanded—in another agreement. This evolutionary process is interrupted every decade or so when it becomes clear that the provision has evolved in such a way that it no longer serves its purpose of preventing treaty shopping.

Several US tax treaties entered into after the Second World War included provisions in the dividend article that denied the benefits of the “direct dividend” rate to corporations that were established with the purpose of qualifying for that rate. Those provisions, relying as they did on the subjective intention of the taxpayer in establishing the entity, were not particularly effective in preventing the use of treaties by residents of third countries.

These provisions were succeeded by a provision directed at “investment or holding companies,” which first appeared in the 1962 US-Luxembourg treaty and was soon followed by a similar provision in the US-Netherlands treaty as it applied to the Netherlands Antilles. These more objective provisions initially disqualified entities that were entitled to specified beneficial tax regimes in their state of residence or that enjoyed a lower level of taxation as a result of “special measures.” Eventually, even the reference to special measures was dropped, so that the provisions could apply whenever the tax imposed on the treaty-benefited income was substantially less than the tax that would be imposed on corporate profits generally. The ownership test included in such provisions was an additional, not an alternative, requirement and thus was seldom an issue. The provisions could easily be avoided by ensuring that the company was subject to the same corporate tax regime as any other company resident in the jurisdiction (even if that regime included a participation exemption, allowed extreme thin capitalization, or provided a deduction for dividends).

US faith in the investment or holding companies provision evaporated in early 1981, with the release of the Gordon report on tax havens. The report highlighted abusive structures that did not rely on the existence of “special measures” (which it equated with a “special rate of tax”). The report’s discussion of holding company structures demonstrated that the same result could be achieved through reducing the corporate tax base by allowing high levels of deductible payments. Accordingly, focusing on ownership and special measures is not enough—base erosion must also be prevented.

The effect of the Gordon report can be seen in the rapid renegotiation of the US-Jamaica treaty. The treaty that had been signed on May 21, 1980 included the then standard investment or holding companies provision. The treaty was transmitted to the Senate on August 4, 1980; before the Senate could consider it, the treaty was amended by a protocol signed on July 17, 1981, which included a new “limitation on

12 Richard A. Gordon, “Tax Havens and Their Use by the United States Taxpayers: An Overview: A Report to the Commissioner of Internal Revenue, the Assistant Attorney General (Tax Division), Secretary of the Treasury (Tax Policy).”
benefits” provision. This provision included the seeds of what became the “standard” US LOB provision. The main test was an ownership/base erosion test: an entity could be denied benefits, even if it was owned by residents of a contracting state, if its income was eroded (and therefore not taxed in its state of residence) through deductible payments to residents of third states. Thus, the rule responded directly to the concerns raised in the Gordon report. However, now that every entity had to satisfy both prongs of the test, proof of ownership became crucial. Because of the difficulties of proving ownership of a publicly traded company, the US-Jamaica provision presumed that a company in whose stock there was substantial trading in a contracting state was owned by residents of the contracting state of which the company was a resident.

Because the ownership/base erosion test included in the US-Jamaica protocol was significantly more effective than the “special measures” provision in earlier treaties, entities owned by residents of third countries generally did not qualify for treaty benefits. In many cases, however, there were legitimate business reasons for establishing the entity in the treaty country. This point was recognized through the introduction of other avenues by which entities that have legitimate business reasons for being resident in a jurisdiction may qualify for treaty benefits.

Two important concepts thus make an appearance in the US-Jamaica provision in the form of guidelines to be followed in applying the catchall second paragraph, under which an entity qualifies for benefits if it is determined that the entity was not treaty shopping. If a Jamaican entity is owned by residents of third countries, it nevertheless qualifies for benefits if the treaty-benefited income is derived in connection with business operations conducted in Jamaica. If the Jamaican entity is owned by individual residents of third countries who would have been entitled to substantially similar benefits under US tax conventions, the entity also qualifies for benefits.

Thus, in less than two years, the main components of the modern LOB provisions—ownership/base erosion, publicly traded companies, active conduct of a trade or business, and even derivative benefits—evolved from the old investment or holding companies provision. From 1982 to 1992, there was little change in the US approach to the LOB provisions. There generally was an ownership/base erosion test and an active trade or business test. The ownership presumption regarding publicly traded companies soon became a stand-alone rule pursuant to which such companies simply qualified for benefits without regard to ownership. By 1989, it had become clear that the determination of an entity’s qualification under the residual rule was within the discretion of the competent authority of the contracting state providing the benefits. Over time, rules were added to make it clear that individuals did not have to meet any of the other tests and to address specific issues relating to governments and government-owned entities and to tax-exempt entities such as charities and pension funds. The language of these provisions was tightened over the years, adding much to their length and complexity. However, since each of those changes was made in response to taxpayer behaviour, it is hard to imagine reverting to simpler drafting.
Unlike the other tests in the US-Jamaica protocol, the derivative benefits test fell out of favour and did not appear again until 1992 in the US-Mexico treaty and, of course, in the US-Netherlands treaty. In essence, the derivative benefits test is simply an ownership/base erosion test with a much broader universe of “good” owners and recipients of base-eroding payments. The ownership/base erosion test is limited to certain persons resident in the same contracting state as the entity that claims benefits. Under the derivative benefits test, the entity may qualify even if it is owned by residents of specified third states and makes payments to residents of specified third states, as long as those third-country residents would have qualified for the same benefits had they received the income directly from the source state.

The theory behind the derivative benefits test is that third-country residents are not treaty shopping if they would have been entitled to the same treaty benefits. Nevertheless, it is clear that allowing benefits under a derivative benefits test allows for regime shopping. That is, the treaty-benefited income need not be paid on to the “equivalent beneficiaries” in the third countries. In many cases, the entity located in the treaty country that is claiming benefits under the derivative benefits provision also qualifies for a beneficial regime, so that the treaty-benefited income might not suffer significant taxation. For example, one of the primary benefits to Canadian multinationals of the elimination of the withholding tax on interest in the 2007 protocol to the US-Canada treaty is not that interest can be paid straight from US subsidiaries to Canadian parent companies, but rather that the Canadian multinationals can once again utilize finance subsidiaries in the Netherlands or Ireland because the subsidiaries will now qualify for benefits under the derivative benefits provisions of treaties with those countries.

NEXUS AND THE PUBLICLY TRADED COMPANY TEST

For multinational companies, the “publicly traded company” test is by far the best way to qualify for treaty benefits. If a company meets the requirements of the test, then all of its income, and the income of its subsidiaries resident in the same country, qualifies for treaty benefits. Conceptually, the test is harder to understand, since even the earliest LOB provisions allowed trading in either contracting state to qualify a company under the test. In fact, unlike the other tests in the LOB provision, the publicly traded company test did not require the taxpayer to establish a nexus with its country of residence. Rather, there seemed to be an assumption that establishing nexus was not necessary in the case of publicly traded companies because publicly traded companies do not engage in treaty shopping. More pragmatically, the test

13 In earlier treaties, the owners and recipients of such payments could be in either of the two contracting states. This policy changed with the 2004 protocol to the US-Barbados tax treaty, negotiated in response to a number of high-profile corporate inversions out of the United States.

ensures that multinational corporations can easily qualify for treaty benefits. Without such a test, the LOB provision would be much harder to sell politically.

The importance of the publicly traded company test can be seen in the number and types of comments received by the OECD with respect to the version of the LOB provision that was included in the public discussion draft. A number of comments focused on one aspect of the test—the requirement that an entity that is not primarily traded in its country of residence (or, in many cases, within a regional grouping that includes its country of residence) must have its primary place of management and control in its country of residence. A common misperception seems to be that the “primary place of management and control” test was intended to deal with corporate inversion transactions. Although the test was adopted in conjunction with anti-inversion provisions, its purpose was different. Accordingly, if governments acceded to the suggestions in the comments, they would in fact facilitate a particularly expensive form of treaty shopping.

The Publicly Traded Company Test Goes Global

Although many Europeans describe the 1992 US-Netherlands treaty as the first US tax treaty to have a LOB provision, it is really only the first that anyone had to worry about. The treaty was important because it was the first of a series of renegotiated tax treaties with countries where treaty shopping was widely acknowledged to be a problem but which also were significant US trading partners and fellow members of the OECD. It would have been difficult to terminate any of those agreements. By the end of the 1980s, however, the threat of treaty overrides by Congress had become sufficiently credible that those countries began to come (reluctantly) to the negotiating table.

The LOB provision in the US-Netherlands treaty has been described as “the most complicated set of tax treaty provisions ever devised,” but in most respects it did not substantially change the practical effect of the standard provisions in earlier treaties. However, a more generous publicly traded company test loosened the test’s already tenuous nexus requirement. The US-Netherlands treaty, like some earlier treaties, anticipated that the term “recognized stock exchange” would include third-country exchanges. More importantly, by the time the treaty entered into force, it had been agreed that the term “recognized stock exchange” would include the principal stock exchanges of Frankfurt, London, Paris, Brussels, Hamburg, Madrid, Milan, Sydney, Tokyo, and Toronto. New treaties with Austria, Ireland, Luxembourg, and Switzerland, all considered by the Senate in 1997, similarly include expansive lists of third-country exchanges.

In its 2007 study addressing inappropriate use of tax treaties and proposed responses, the Treasury Department provided the following assessment of the development of the publicly traded company test:

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15 Testimony of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, before the Committee on Foreign Relations, United States Senate, October 27, 1993.
In its original form, the publicly traded test focused on corporations that were regularly traded on the stock markets in their home country and reflected the view that such corporations likely would not be used by residents of third countries for treaty shopping purposes. The parameters of the test evolved with changes in the global financial markets. With the growth of regional markets, corporations that are listed on a stock exchange in their home country nevertheless may have a substantial portion of their trading volume occur on another exchange in their region. Moreover, the international prominence of the U.S. stock exchanges means that many foreign corporations are listed and substantially traded on U.S. exchanges. The publicly traded test has been structured to take into account both home-country trading and also U.S. and regional third-country trading to reflect the realities of modern global financial markets. However, it has become clear that, in some circumstances, additional nexus between the corporation and its country of residence is necessary to effect the underlying objective of the LOB provision.16

This well-reasoned explanation of the evolution of the publicly traded company test unfortunately has relatively little to do with the facts. Presumably, the reference to “the growth of regional markets” was intended to explain trading tests that included third-country exchanges. The list of third-country exchanges in the US-Slovenia treaty, for example, consisted of Frankfurt, London, Paris, and Vienna. One can imagine that a capital-hungry Slovenian company might go to any of those exchanges to raise capital. However, if the rise of regional financial markets was a significant factor, one would have expected that more of the treaties entered into in the 1990s—particularly treaties with countries in Eastern Europe and other emerging markets—would have included such provisions. They do not. By contrast, as noted above, the treaties with the Netherlands, Luxembourg, Ireland, and Switzerland included as recognized stock exchanges the stock exchanges of Sydney, Tokyo, and Toronto, which clearly cannot be explained by reference to regional trading. Accordingly, the inclusion of an expansive list of third-country exchanges serves mostly as a diagnostic tool for treaty havens.17

16 United States, Department of the Treasury, Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties (Washington, DC: Department of the Treasury, November 2007), at 80 (herein referred to as “the treaty report”), which was mandated by sections 424 and 806 of Pub. L. no. 108-357, the American Jobs Creation Act of 2004.

17 The US treaties with Denmark and the United Kingdom also included relatively expansive lists of third-country exchanges. Although these two countries do not fall into the same category as the Netherlands, Ireland, Switzerland, and Luxembourg, there were signs in the 1990s that Denmark might be trying to compete for that business. See, for example, “Using Denmark as a Holding Company Jurisdiction” (taxand.com/news/newsletters/Using_Denmark_as_a_Holding_Company_Jurisdiction?utm_source=Taxands_Take_September_2010&utm_medium=email &utm_campaign=Using_Denmark_as_a_Holding_Company_Jurisdiction). The United Kingdom was never an attractive location for a conduit company because the advance corporation tax, imposed on a company at the time that it paid a dividend, could not be offset by foreign tax credits. When the advance corporation tax was eliminated with respect to
The expansion of the publicly traded company test to third-country markets would not have been problematic if publicly traded companies were not used for treaty shopping. By 2001, however, it had become clear that such an assumption was simply incorrect. That realization led to the last major change to the LOB provision, a drastic revision of the publicly traded company test.

**Adding Insult to Injury: Treaty Shopping by Inverted Companies**

The corporate inversion transactions that became a political issue in the United States in the early 2000s were not about tax treaties, but the transactions’ success depended on them. Their purpose was to reduce the overall corporate tax on business operations by removing foreign subsidiaries of US companies from the US tax net. They also offered the prospect of substantially reducing US corporate tax on any remaining US operations by stripping income out of the United States. In order to achieve those two goals, however, an inverting company would have to find a new home that imposed little or no tax and had a favourable tax treaty with the United States. Thus, if the injury was leaving the United States for tax reasons, the insult was using US tax treaties to strip income out of the United States while incurring minimal withholding taxes.

Inverted companies could satisfy the publicly traded company test under standard LOB provisions because such provisions generally did not distinguish between trading in the two contracting states—trading in the United States was treated as a nexus to the other contracting state to the same extent as trading in that other state. This problem was corrected in the 2004 protocol to the US-Barbados tax treaty, which included a complete rewriting of the LOB provision. In particular, the publicly traded company test was modified so that a company can qualify for benefits only if its principal class of shares is primarily traded on a recognized stock exchange in its country of residence (or, in the case of Barbados, on the other stock exchanges that made up its regional stock exchange).

**The Need for a New Nexus: Primary Place of Management and Control**

The Treasury Department soon ran into problems when it tried to replicate this simple solution in other treaties. Other countries wanted to ensure that their resident companies would not be prevented from, or penalized for, raising capital in the US financial markets. A new test for establishing nexus was necessary: accordingly,
a “public corporation that does not have sufficient nexus to its residence country through trading on the stock exchanges in that country must establish nexus through primary management and control in its residence country.”20 The treaty report made it clear that this revised publicly traded test, developed in the context of the 2004 protocol to the US-Netherlands treaty, was about stopping third-country treaty shoppers.21

Who were these third-country treaty shoppers that had managed to claim benefits despite “the most complicated set of tax treaty provisions ever drafted”? At the time, relatively few Dutch companies were traded primarily in the United States or on one of the third-country exchanges listed in the US-Netherlands treaty. Among the few companies in that category, however, some were clearly treaty shopping.

James Hardie Industries has publicly expressed its treaty-shopping goals. In 2001, the company, which had been in business as a resident of Australia for over a century, announced that it would be moving to the Netherlands in order to qualify for the 5 percent withholding rate applicable to dividends paid by its substantial US subsidiaries to the parent corporation rather than the 15 percent rate that then was applicable to all dividends under the US-Australia tax treaty. In 2010, the company moved its corporate domicile to Ireland because it could be more certain of receiving US tax treaty benefits there.22

As the Treasury Department described, the point of the primary place of management and control test was to establish nexus with respect to a particular type of company—namely, a company that the treaty partner already considered to be a resident. However, it was a company that, although publicly traded, was not primarily traded in its home markets. It also would not meet the ownership/base erosion test, usually because it was owned by residents of a third country. It might not meet the “active conduct of a trade or business” test. What test would prove that the company had non-tax reasons for being resident in the jurisdiction?

The answer—in the form of the primary place of management and control test—is that the company (or the group of which the company is the parent) actually must be run from that country. That is, the country of which the company is claiming to be a resident must be

the country where the corporation’s executive officers and senior management employees exercise the most day-to-day responsibility for the strategic, financial, and operational decision making of the corporation, and where the most day-to-day activities necessary for preparing and making those decisions take place.23

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20 Ibid.
21 “Given developments in trading patterns, the new publicly traded test better serves the intended purpose of limiting treaty shopping by third-country residents” (ibid.).
23 Treaty report, supra note 16, at 82.
The US model technical explanation explicitly stated that the primary place of management and control test is “to be distinguished from the ‘place of effective management’ test which is used in the OECD Model and by many other countries to establish residence.”24 In part, this statement was prompted by the fact that at the time the test was developed, a discussion paper had been issued under the auspices of the OECD that suggested that the “place of effective management” test might be interpreted to mean the place where meetings of a company’s board of directors are held.25 In May 2003, while the 2004 protocol with the Netherlands was being negotiated, the Technical Advisory Group (TAG) released a formal proposal that would have incorporated a modified version of this approach in the OECD commentary.26 By 2008, the Committee on Fiscal Affairs provided an alternative view: “Many countries . . . considered that the TAG’s proposed interpretation gave undue priority to the place where the board of directors of a company would meet over the place where the senior executives of that company would make key management decisions.”27

Even though the OECD’s final conclusions might have been consistent with the concept behind the primary place of management and control test, there is still a virtue in adopting a test that is relevant only for the purposes of determining whether a company is treaty shopping. As noted above, many countries use the place of effective management as a test for determining corporate residence. Because the purpose of the test is to establish the residence of a company that is incorporated in another country (and therefore to establish taxing authority over that company), the tax authorities have an incentive to interpret the language aggressively and make the test easy to meet. As described above, that intention is the exact opposite of the intention behind the primary place of management and control test in US LOB provisions.

**CONCLUSION**

A US-style LOB test prevents most common forms of treaty shopping, at least when it is combined with anti-abuse rules aimed at specific transactions. However, it is not at all clear that the United States has significantly increased the amount of withholding taxes that it collects. Instead, it measures the success of the expanded LOB rules

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by the extent to which it achieves its goal of reducing withholding rates in treaties with important trading partners (such as Japan and Canada) or widens its treaty network to other countries that may be important sources of investment capital (such as Israel). The achievement of these goals has required substantial resources: having even one treaty without a LOB provision is almost as bad as having no LOB provisions in any treaty. Accordingly, a country should be very clear about its goals, and realistic about the difficulty of negotiating LOB provisions, before embarking on an anti-treaty-shopping strategy based primarily on the introduction of a LOB provision into its tax treaties.