US Senate approves four treaty protocols

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In brief

The US Senate this week approved by more than a 2/3 majority vote four pending protocols to the US tax treaties with Spain, Switzerland, Japan, and Luxembourg, without any reservations.

This approval advances the protocols toward eventual entry into force, with the next US steps being signature by the President of the relevant instruments of ratification; for the protocols with Switzerland and Japan, exchanging those instruments with the other Contracting State; and, for the protocols with Spain and Luxembourg, notification through diplomatic channels that the internal procedures for entry into force have been complied with, and then entry into force. The step completed this week brings resolution to a lengthy delay in the process of entry into force for these four protocols, which were agreed upon in 2009 and 2013.

In detail

Background

The four protocols were agreed to in 2009 (Switzerland and Luxembourg) and 2013 (Spain and Japan), and were signed at that time by the authorized US representative. All were reported out favorably by the Senate Foreign Relations Committee (SFRC) on at least one occasion, but required another SFRC hearing when they did not advance in the Senate and the relevant session of Congress adjourned. A SFRC hearing was held on June 25, 2019, and the four protocols were reported out favorably to the Senate.

Treaties typically are addressed in the Senate under a unanimous consent procedure, but in recent years, Senator Rand Paul (R-KY) had placed a hold on consideration based on his concerns about certain exchange of information provisions. To advance past this delay, Senate leadership filed cloture on July 11, 2019, to enable the consideration of the four protocols on the Senate floor.

On July 16, the Spain protocol received more than 2/3 support on the Senate floor, followed by a similar vote the next day with respect to the Swiss, Luxembourg, and Japan protocols. All four protocols now will advance toward entry into force.

Key provisions of each of these protocols are summarized below.

Spain protocol

On January 14, 2013, Treasury announced the signing of a new protocol and memorandum of understanding related to the 1990 US-Spain Treaty. The protocol is intended to modernize the existing treaty and bring it into closer conformity with the two countries' current tax treaty policies.

The protocol provides for exclusive residence-state taxation of interest, royalties, certain parent/subsidiary

dividends, and most capital gains. ***Observation:*** This is a significant revision compared to the 1990 treaty, which does not provide an exemption from source-state tax on interest or royalty income. The protocol also adds the treaty with Spain to the growing list of US treaties that permit exemption from source-country tax on parent/subsidiary dividends, provided certain requirements are met. Consistent with certain other more recent US tax treaties, the protocol contains a mandatory binding arbitration provision.

The protocol includes an updated limitation on benefits (LOB) article with some significant changes, and an updated exchange of information article. These changes include a new discretionary grant of benefits provision within the LOB article that departs from the standard that has been applied in previous treaties. The standard commonly applied is that the competent authority of the source country may provide a discretionary grant of treaty benefits if the taxpayer demonstrates that the establishment, acquisition, or maintenance of the taxpayer and the conduct of its operations did not have as one of its principal purposes the obtaining of treaty benefits. However, the protocol imposes a significantly more restrictive standard that requires an evaluation of the extent to which the resident satisfies the requirements of the qualified person tests (which include the publicly traded company, subsidiary of a publicly traded company, and ownership-base erosion tests), the derivative benefits test, the active trade or business test, and the headquarters company test.

Another restrictive standard in the protocol is the requirement in the derivative benefits test that to satisfy the test's ownership requirement, any intermediate owner between the tested company and the qualifying owner must be a resident of a European Union (EU) member state or party to the North American Free Trade Agreement (NAFTA), as those terms are defined in the treaty. ***Observation:*** This protocol includes the first US derivative benefits LOB provision to impose a residence requirement with respect to intermediate owners.

The protocol will enter into force three months from the date that the Contracting States have completed notification that they have complied with their required internal procedures. The protocol will be effective with respect to the withholding provisions on the date of entry into force. With respect to taxes determined with reference to a tax period, it will be effective for tax periods beginning on or after the protocol enters into force. All other provisions of the protocol will be effective on the date the protocol enters into force.

Swiss protocol

On September 23, 2009, the United States and Switzerland signed a protocol that modifies the tax information exchange provisions of the existing US-Switzerland income tax treaty. In particular, the Swiss protocol is aimed primarily at updating the exchange of information provision to generally conform to OECD information exchange standards. Pursuant to the updated provisions, generally, the information to be exchanged is that which may be relevant for carrying out the provisions of the treaty or the domestic laws of the Contracting States concerning taxes covered by the treaty, provided the taxation thereunder is not contrary to the provisions of the treaty. The Swiss protocol also includes a requirement for binding arbitration for double tax disputes that are not resolved by agreement between the competent authorities of the two countries.

In addition, the protocol expands the scope of beneficial owners entitled to the zero rate of withholding tax to include individual retirement savings plans that are set up in, and owned by a resident of, the other Contracting State. Dividends received from a controlled payor remain ineligible for the elimination of withholding tax. In addition, in order to be eligible for the zero rate of withholding for these plans, the competent authorities of the Contracting States must agree that the pension or other retirement arrangement, or individual retirement savings plan, generally would be recognized as such for tax purposes in the other Contracting State.

The Swiss protocol enters into force upon the exchange of instruments of ratification.

The amended dividends provision has effect for amounts paid or credited on or after January 1 of the year following entry into force (e.g., if it enters into force in 2019, the amended dividends provision has effect for amounts paid or credited on or after January 1, 2020). The provisions related to information exchange apply for requests made on or after the date of entry into force of the protocol. Information described in paragraph 5 of revised Article 26 (pertaining to bank secrecy) shall be exchanged upon request if it relates to any date beginning on or after September 23, 2009, the date the protocol was signed. In all other cases, information shall be exchanged pursuant to the amended information exchange provisions if the information relates to taxable periods beginning on or after January 1, 2010.

In addition, there are specific effective dates for the binding arbitration provisions, depending upon whether

the case is under consideration by the competent authorities as of the date of entry into force of the protocol, or whether the case comes under consideration after the date of entry into force.

Japan protocol

On January 24, 2013, Treasury announced that a protocol to the 2003 US-Japan Treaty was signed. The protocol is intended to bring the treaty into closer conformity with the current tax treaty policies of the two countries.

The existing treaty provides for the elimination of source-country taxation of certain parent/subsidiary dividends, and the protocol expands the category of direct dividends eligible for exclusive residence-country taxation by slightly amending the ownership threshold (from ‘more than 50 percent’ to ‘at least 50 percent’) and shortening the holding period from 12 to six months. Except in certain circumstances (e.g., debt held by governmental entities or by certain financial institutions), the lowest rate of tax on interest in the existing treaty is 10 percent. The protocol provides for the elimination of source-country tax in certain circumstances.

The protocol amends the treatment of capital gains in a way that more closely aligns with the US domestic law provisions related to the taxation of foreign investment in US real property. In addition, the protocol provides for mandatory binding arbitration, provisions to enable the competent authorities to assist each other in the collection of taxes, and full exchange of information between competent authorities.

The protocol will enter into force on the date that the United States and Japan exchange the instruments of ratification.

The protocol will be effective with respect to the withholding provisions on the first day of the third month following its entry into force. With respect to other taxes, it will be effective for tax years beginning on or after January 1 following the date the protocol enters into force. Other provisions relating to the exchange of information, assistance in the collection of taxes, and mutual agreement procedure have varying dates of effect.

Luxembourg protocol

On May 20, 2009, the United States and Luxembourg signed a protocol that expands the information exchange provisions between the two countries and incorporates the Organisation for Economic Co-operation and Development (OECD) tax treaty standard on exchange of information for tax purposes. Negotiations for the protocol were initiated by Luxembourg in response to its inclusion on an OECD list of countries that had agreed to, but had not yet substantially implemented, OECD information exchange standards.

The Luxembourg protocol enters into effect for information requests made by either government on or after the date of entry into force of the protocol.

Pending treaties

There currently are three bilateral tax agreements awaiting Senate approval, namely, proposed income tax treaties with Chile, Hungary, and Poland. A fourth agreement, with Vietnam, has been signed and also awaits Senate approval, but in contrast to the other three which on at least one occasion have been reported out favorably by the SFRC, it has never been transmitted to the Senate.

Despite recent approval of the four treaty protocols (discussed above), the outstanding tax agreements with Chile, Hungary, Poland, and Vietnam remain held from Senate floor consideration. It has been reported that the latter three agreements were not considered at the June 2019 hearing of the SFRC because of reservations requested by Treasury regarding the base erosion and anti-abuse tax (BEAT) rules that were enacted as part of the 2017 tax reform legislation (115 P.L. 97). At this time, the timing for Senate consideration of these agreements is unclear.

Chile treaty

The US-Chile Treaty was signed on February 4, 2010 and was approved by the SFRC on April 1, 2014. The treaty represents only the second US income tax treaty with a South American country. (A US income tax treaty with Venezuela was signed in 1999.)

The pending US-Chile Treaty is based broadly on the 2006 US Model Income Tax Treaty, except that it has a more restrictive LOB article and higher rates of taxation on dividends, interest, and royalties. The US-Chile Treaty does not provide an exemption from tax for parent/subsidiary dividends.

The treaty will enter into force on the date that Chile and the United States both have notified each other that they have complied with their applicable internal procedures.

For withholding provisions, the treaty will be effective for amounts paid or credited on or after the first day of the second month following the date the treaty enters into force. For all other taxes, the treaty will be effective for tax periods beginning on or after January 1 of the calendar year immediately following the date on which the treaty enters into force. The information exchange provisions are effective from the date of entry into force, without regard to the taxable period to which the matter relates.

Hungary treaty

The US-Hungary Treaty, which was signed on February 4, 2010 and was approved by the SFRC on April 1, 2014, would replace the 1979 treaty currently in effect. The principal focus of the new treaty is addition of a LOB article that is consistent with other more recent US treaties. The US-Hungary Treaty also provides an exemption from tax withheld at source for royalties and interest (except contingent interest, which is subject to a 15% tax rate). Unlike newer treaties with other EU countries, the US-Hungary Treaty does not contain an exemption from tax for certain parent/subsidiary dividends.

The treaty generally will enter into force on January 1 of the year following the exchange of instruments of ratification. For taxes withheld at source, the provisions will be effective for amounts paid on or after the first day of the second month following the exchange of instruments of ratification.

Poland treaty

The new treaty with Poland was signed on February 4, 2010 and was approved by the SFRC on June 19, 2014. It would replace the 1974 income tax treaty and, significantly, includes a modern LOB article. The treaty does not eliminate source-state taxation on intercompany dividends, certain types of interest, or royalties.

The treaty will enter into force on the date that Poland and the United States both have notified each other that they have complied with their applicable internal procedures.

For withholding provisions, the treaty will be effective the first day of the second month following the date on which the treaty enters into force. For all other taxes, the treaty will be effective for tax periods beginning on or after the first day of January of the next tax year following the date on which the treaty enters into force.

Vietnam treaty

The US-Vietnam Treaty was signed on July 7, 2015. It has not been transmitted to the Senate. The treaty represents the first US income tax treaty with Vietnam.

Unlike some other recent treaties, the pending treaty does not eliminate source-country taxation on intercompany dividends, certain types of interest, or royalties. Importantly, the Vietnam treaty provides that a building site or construction project can give rise to a permanent establishment (PE) after only six months. The treaty similarly provides that a services PE can exist for consultancy services continuing for six months within any 12-month period. ***Observation:*** New language appearing in the PE article may signal a shift in US tax treaty policy regarding an enterprise's exclusive relationship with an independent agent.

Finally, the treaty does not contain a derivative benefits provision, nor does it contain the restrictions found in the 2013 protocol to the US-Spain treaty with respect to the grant of discretionary benefits.

The treaty will enter into force on the date that both the United States and Vietnam have notified each other that they have complied with their applicable internal procedures.

For withholding provisions, the treaty will be effective the first day of January of the year immediately following the year in which the treaty enters into force. For all other taxes, the treaty will be effective for tax years (in Vietnam) or tax periods (in the United States) beginning on or after the first day of January of the year immediately following the year in which the treaty enters into force.

The takeaway

Having been in pending status for several years since completion of negotiations regarding the four treaty protocols, their approval by the US Senate advances them toward entry into force. The next US steps to permit the protocols to enter in force are (1) for the President to sign the relevant instruments of ratification; (2) for Spain and Luxembourg to notify the other Contracting State through diplomatic channels that the internal procedures for entry into force have been complied with; and (3) for Japan and Switzerland, to exchange the instruments of ratification with the other Contracting State.

See also:

The United States and Vietnam sign first income tax treaty and protocol

New US-Poland treaty sent to the Senate

US-Japan protocol exempts interest from source State taxation and reduces ownership for exemption from tax on certain dividends to 50%

New protocol to US-Spain treaty signals possible changes in US policy on limitation on benefits

New US - Hungary treaty; Luxembourg treaty developments

New US - Switzerland protocol; New Zealand protocol sent to US Senate for ratification

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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