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United States Tax Alert

Senate approves protocols to tax treaties with Japan, Luxembourg, Spain, and Switzerland

The U.S. Senate on July 16 and 17 approved resolutions of ratification of protocols signed during the administration of President Obama that would amend the U.S. income tax treaties currently in force with Japan, Luxembourg, Spain, and Switzerland. Doing so gives President Trump the authority to ratify each of them.
In the case of each protocol, ratification by the President, and completion by the other country of its own ratification procedures, will permit the protocol to enter into force when (or shortly after) each country notifies the other, in accordance with the formality prescribed in the protocol, that ratification has occurred.

All the protocols other than the Luxembourg protocol would add mandatory binding arbitration provisions (often applicable in transfer pricing matters) to their respective treaties. The Luxembourg and Switzerland protocols would conform their treaties' exchange of information provisions more closely to those in other U.S. treaties. The Japan protocol would, like the U.S. model treaties ("U.S. Models") and U.S. treaties with other developed countries, reduce to zero the general rate of source-country tax on interest owned by a treaty-country resident. It would also institute collection assistance provisions similar to those found in a select few recent U.S. treaties. Finally, the Spain protocol would broadly update the provisions of the current treaty to more closely track those of U.S. treaties with other European Union (EU) member countries. Among other things, these updates would in some cases result in reducing permitted source-country tax rates, or eliminating source-country taxes altogether, as compared to the current treaty with Spain. The updates would also give the treaty with Spain a more "modern" limitation on benefits (LOB) article.

This alert summarizes some of the provisions of the protocols, including the effective dates of the amendments they will make to the existing treaties. The entry into force of the protocols is thought to be a priority of the U.S. government.

Spain

The 1990 U.S.-Spain income tax treaty now in force would be amended by a protocol signed in 2013 (the "Spain protocol").

Source-country taxation of dividends, interest, and royalties

Dividends

The Spain protocol generally would lower the permitted rates of source-country tax on certain dividends, interest, and royalties paid by residents of one treaty country and owned by residents of the other treaty country.

Like 12 other U.S. income tax treaties, the Spain protocol would eliminate source-country taxation of certain parent-subsidiary dividends (and eliminate the branch profits tax), where certain LOB and holding-period tests are met. (U.S. income tax treaties with the following countries include zero-rate parent-subsidiary dividend provisions: Australia, Mexico, and United Kingdom (zero-rate provisions ratified in 2003); Japan and the Netherlands (2004); Sweden (2006); Belgium, Denmark, Finland, and Germany (2007); France (2009); and New Zealand (2010)). Dividends paid by a company that is a resident of one treaty country and beneficially owned by a company that is a resident of the other treaty country generally may not be taxed by the country of residence of the dividend-paying company when the company receiving the dividends (1) has owned at least 80% of the voting stock of the dividend-paying company for the 12-month period ending on the date on which entitlement to the dividend is determined and (2) satisfies one of a limited subset of the LOB tests. The Spain protocol also generally eliminates source-country taxation of dividends paid by a resident of one treaty country and beneficially owned by a tax-exempt pension fund that is a resident of the other treaty country if the fund does not derive the dividends in carrying on a trade or business.

For dividends beneficially owned by a company that directly owns at least 10% of the voting stock of the dividend-paying company, the Spain protocol generally reduces source-country tax to 5% of the gross amount of the dividends (from the current treaty's permitted rates of either 10% (for dividends to 25%-or-greater owners) or 15%). The U.S. tax rates permitted on dividends paid by regulated investment companies and real estate investment trusts to residents of Spain (and the Spanish tax rates with respect to similar Spanish entities) are adjusted in accordance with other recent U.S. treaties.

Interest

Like the U.S. Models and other U.S. treaties with EU countries, the Spain protocol generally would eliminate the 10% source-country tax permitted by the current treaty on interest beneficially owned by a resident of the other treaty country. The protocol would permit a 10% U.S. tax to be imposed on contingent interest, and a full 30% U.S. tax on an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (REMIC).

Royalties

Also like other U.S. treaties with EU countries, the Spain protocol would eliminate the 5%, 8%, and 10% source-country tax generally permitted by the current treaty on royalties beneficially owned by a resident of the other treaty country.

Limitation on benefits

The Spain protocol would replace the short LOB article in the current treaty with a much longer LOB article similar to those in the most recently revised U.S. income tax treaties with EU member states. The revised version would add a "derivative benefits" provision, a "triangular" rule, and a "headquarters company" test. What follows is an overview of certain important features of the LOB article.

Publicly traded companies

The Spain protocol generally would allow all treaty benefits to a public company that is a resident of the United States or Spain and that satisfies certain other requirements related to the trading of its stock or the primary place of its management and control. A U.S.- or Spanish-resident public company generally is eligible for all treaty benefits as a "qualified person" if its principal class of shares is regularly traded on one or more recognized stock exchanges and either (1) its principal class of shares is primarily traded on one or more recognized stock exchanges located in its country of residence or, for a Spanish resident company, in another EU member state, or, for a U.S. resident company, in another NAFTA member country; or (2) its primary place of management and control is in the treaty country of which it is a resident. In contrast with the existing treaty, the Spain protocol defines "recognized stock exchange" to include not only U.S. and Spanish exchanges, but also the principal stock exchanges of a number of cities in other North American, South American, and European countries.

The Spain protocol also includes a more detailed rule than the existing treaty allowing benefits to subsidiaries of public companies. Under the protocol, a U.S.- or Spanish-resident company is generally eligible for all treaty benefits as a "qualified person" if at least 50% of the vote and value of its shares is owned directly or indirectly by five or fewer companies entitled to treaty benefits under the public-trading test just described, so long as, in the case of indirect ownership, each intermediate owner is a resident of either Spain or the United States.

Ownership and base erosion test

The Spain protocol also includes an ownership and base erosion test for a legal entity's qualification for treaty benefits that conforms with provisions of the LOB articles of the most recent U.S. income tax treaties and the 2006 U.S. model treaty. The Spain protocol ownership and base erosion test generally defines a "qualified person" to include a treaty country resident other than an individual if (1) the stock of the resident is owned at least 50% by vote and value for at least half the days of the taxable year by residents of the same treaty country that are themselves qualified persons by reason of being individuals, government entities, public companies, or tax-exempt institutions, and (2) less than 50% the resident's gross income for the taxable year is paid or accrued directly or indirectly in deductible payments (other than payments in the ordinary course of business for services, tangible property, or financial obligations to unrelated banks) to persons that are not residents of the United

States or Spain entitled to benefits as qualified persons in a category described in (1) above. Like the test for subsidiaries of publicly traded corporations, the ownership prong of the new ownership and base erosion test includes a requirement that in the case of indirect ownership, each intermediate entity must be a resident of the country of residence of the person whose eligibility for benefits is being tested.

Active trade or business test

The Spain protocol includes an active trade or business test for treaty benefits that is similar to the active trade or business rules of other recent U.S. treaties and the 2006 U.S. model treaty. Under the rules of the Spain protocol, if certain requirements are satisfied, then a resident of one of the two treaty countries that is not a qualified person is entitled to treaty benefits in respect of an item of income derived from the other treaty country in connection with the active conduct of a trade or business in the residence country. One such requirement is that the trade or business activities carried on by the taxpayer in its country of residence must be substantial in relation to the trade or business activities carried on by the taxpayer in the other treaty country.

Other rules

The LOB article of the Spain protocol also can be met under certain circumstances by (1) a headquarters company for a multinational corporate group and (2) a company at least 95% owned (directly or indirectly) by seven or fewer "equivalent beneficiaries." Among other anti-abuse rules, the Spain protocol denies or reduces treaty benefits in certain "triangular" cases in which the income of a treaty-country resident from the other treaty country is attributable to a third-country permanent establishment and as a result bears a relatively low effective tax rate. These provisions are largely similar to comparable provisions of other recent U.S. income tax treaties.

Mandatory binding arbitration

The Spain protocol would amend the mutual agreement procedure (MAP) of the existing treaty by generally requiring arbitration of cases (often transfer pricing disputes) that the competent authorities of the two treaty countries are unable to resolve. The decision in a mandatory arbitration is binding on the two countries, but not on a taxpayer. The arbitration provisions of the Spain protocol are similar but not identical to mandatory binding arbitration provisions of the 2016 U.S. model and of U.S. income tax treaties with Belgium, Canada, France, and Germany.

As amended by the Spain protocol, the treaty would require that, before any arbitration proceedings are initiated, the competent authorities must agree in writing that certain procedures and timetables outlined in the protocol will be applicable to all arbitration proceedings. Once the competent authorities have agreed on and formalized these rules of procedure, a taxpayer may generally initiate an arbitration proceeding when (1) the competent authorities have tried but are unable to reach an agreement to resolve the taxpayer's mutual agreement proceeding within two years of its commencement date; (2) the taxpayer submits a written request for resolution through arbitration; and (3) all concerned persons (and their authorized representatives or agents) provide written statements not to disclose information received during the proceeding to persons not involved in the proceedings. Arbitration will not be available, however, where (1) a decision about the issue has already been rendered by a U.S. or Spanish court or administrative tribunal; (2) the competent authorities agree that the case is not suitable for arbitration; or (3) the issue is already the subject of consultation between the competent authorities for the elimination of double taxation in cases not provided for in the treaty. Unless the presenter chooses not to accept the arbitration panel's determination (in which event the case is ineligible for further consideration by the competent authorities), the panel's determination is binding on both countries.

The arbitration rules of the Spain protocol are largely similar to the arbitration rules of the U.S. treaty with France and differ in a few respects from the mandatory arbitration provisions of the treaties with Belgium, Canada, and Germany. First, the Spain protocol allows the presenting taxpayer to submit its views on the case for consideration by the arbitration panel. Second, the Spain protocol prohibits a competent authority from appointing an employee from its own tax administration. Finally, the arbitration rules do not provide relative weights of legal authorities to be considered by the arbitration panel, and instead rely on international rules of treaty interpretation.

Exchange of information

Consistent with the U.S. Models, the Spain protocol provides for the exchange of information that is foreseeably relevant to carrying out the provisions of the treaty or of the domestic laws of either treaty country. The "foreseeably relevant" standard is based on the exchange of information standard in the OECD Model Tax Convention on Income and Capital and is understood to conform to the U.S. domestic law standard prescribed in Code section 7602 for information gathering and examination of records.

Pension funds

The Spain protocol provides that when an individual resident of one of the treaty countries participates in a pension fund that is a resident of the other treaty country, income of the fund may be taxed as income of the individual only when the income is paid from the fund to or for the benefit of the individual. Under this provision, for example, if a U.S. citizen contributes to a U.S. qualified plan when the individual is employed in the United States and the individual then becomes a resident of Spain, Spain may not tax the plan's earnings with respect to that individual; the country in which the individual is resident when distributions are made from the fund may tax the individual on the distributions. This provision follows the U.S. Model rule for taxation of income in respect of pension funds.

Commitment related to Puerto Rico – Spain cross-border investment

A memorandum of understanding accompanying the Spain protocol provides that Spain and the United States commit to initiating, within six months following the date that the Spain protocol enters into force, discussions related to concluding an agreement to avoid double taxation on investments between Puerto Rico and Spain.

Clarification of "first notification" for purposes of mutual agreement procedures

The Spain protocol provides that under the MAP the term "first notification" generally means: (1) in the case of the United States, the notice of proposed adjustment; and (2) in the case of Spain, the notification of the administrative act of assessment.

Effective date

The Spain protocol will enter into force three months following the date the U.S. and Spain notify each other that their respective ratification procedures have been satisfied.

- For taxes withheld at source, the Spain protocol will be effective for amounts paid or credited on or after the date on which the protocol enters into force.
- With respect to other taxes determined with reference to a taxable period, the Spain protocol will be effective for taxable periods beginning on or after the date on which the protocol enters into force.
- The arbitration provisions of the protocol will *not* apply with respect to MAP cases that are under consideration by the competent authorities at the time the protocol enters into force. For MAP cases that come under such consideration after the time the protocol enters into force, the arbitration provisions of the protocol will apply on the date on which the U.S. and Spanish competent authorities agree in writing on time periods and procedures for certain actions required to be taken in an arbitration. If a MAP case comes under consideration after the date when the protocol enters into force but before the arbitration provisions of the protocol take effect, the general two-year countdown from commencement of the MAP case to the date on which arbitration must begin starts not on the actual date of commencement of the MAP case, but rather on the date on which the competent authorities have reached the written agreement just described.

Japan

The 2003 U.S.-Japan income tax treaty now in force would be amended by a protocol signed in 2013 (the "Japan protocol").

Mandatory binding arbitration

The Japan protocol would add a mandatory binding arbitration provision broadly similar to the one in the Spain protocol.

Collection assistance

The protocol would require the Japanese and U.S. revenue authorities to give limited assistance to one another in the collection of taxes. Five U.S. income tax treaties (with Canada, Denmark, France, Netherlands, and Sweden) include collection assistance provisions.

The collection assistance provisions of the protocol apply to taxes covered by the U.S.-Japan treaty – for example, the U.S. federal individual and corporate income taxes – and to the following non-covered taxes: the Japanese consumption tax, inheritance tax, and gift tax and the U.S. federal estate and gift tax, federal insurance excise tax, federal private foundation excise taxes, and federal employment and self-employment taxes.

The collection assistance provisions include several limitations. For example, one treaty country may assist the other treaty country in the collection of a revenue claim that the second treaty country has against a national of the first treaty country only if the national has filed a fraudulent tax return or a fraudulent claim for refund, has willfully failed to file a tax return in an attempt to evade tax, or has transferred assets into the first treaty country to avoid collection of the claim. For a revenue claim against a company that is a resident of a treaty country, the protocol limits collection assistance to circumstances in which the revenue authority seeking assistance has exhausted all remedies under the mutual agreement procedure of the treaty.

Source-country taxation of gains from the alienation of real property

The Japan protocol would change the definition of "real property," gains from the alienation of which may be taxed by the country in which the real property is situated. Under the existing treaty real property includes (1) a direct interest in real property and (2) shares of a company that is a resident of a treaty country and that derives at least 50% of its value from real property situated in that country. The Japan protocol would eliminate the 50% rule and, when the source country is the United States, provides that real property includes a United States real property interest as defined in Code section 897(c). This amendment would eliminate the current treaty's effect of barring the United States from taxing certain stock gains of a Japanese resident that the Code would otherwise tax by reason of section 897 (also known as "FIRPTA").

Source-country taxation of dividends and interest

Interest

Most U.S. tax treaties with developed countries (as well as the U.S. Models) have a general rule exempting interest from source-country tax, subject to various exceptions (e.g., for contingent interest or excess inclusions on residual interests in REMICs) that permit tax at positive (in some cases, full internal-law) rates. The current U.S.-Japan treaty, by contrast, has a *general* rule permitting a source-country tax of 10% of the gross amount of the interest, with some exceptions prohibiting source-country tax (e.g., for interest owned by a government, bank, insurance company, or registered securities dealer, and interest on a government-insured debt), and other exceptions allowing full internal-law tax. Consistent with the U.S. Models and other recent U.S. income tax treaties, the Japan protocol would eliminate the general rule permitting 10% source-country tax. It also would cap the rate at which contingent interest can be taxed at 10% (like the Spain protocol, but in contrast to some other U.S. treaties that permit such interest to be taxed by the source country at a 15% rate).

Subsidiary dividends

The Japan protocol broadens the exemption from source-country taxation of so-called "parent-subsidiary dividends." The exemption in the current treaty with Japan is already broader than similar exemptions included in other U.S. treaties since 2002. Under the existing treaty, when a company that is a resident of one of the treaty countries pays a dividend that is beneficially owned by a company that is a resident of the other treaty country, the country of residence of the dividend-paying company may not tax the dividend if, among other requirements, the beneficial owner of the dividends has owned more than 50% of the voting stock of the payor company for the 12-month period ending on the date on which entitlement to the dividends is determined. (Other U.S. treaties that offer dividend tax exemption typically require 80% ownership.) The Japan protocol would reduce the voting-stock ownership percentage threshold for exemption from more-than-50% to 50% or more and would reduce the holding period threshold to the six-month period (rather than the 12-month period) ending on the date on which entitlement to the dividends is determined.

Effective date

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

- For taxes withheld at source, the Japan protocol will be effective for amounts paid or credited on or after the first day of the third month following the date on which the protocol enters into force.
- With respect to other taxes, the protocol is effective for taxable years beginning on or after the first day of January following the date on which the protocol enters into force.
- The arbitration provisions of the protocol apply with respect to MAP cases that are under consideration by the competent authorities at the time the protocol enters into force, or that come under such consideration after that time. If a MAP case is already under consideration on the date of entry into force, the general two-year countdown from commencement of the MAP case to the date on which arbitration must begin starts not on the actual date of commencement of the MAP case, but rather on the protocol's entry-into-force date.

Switzerland

The 1996 U.S.-Switzerland income tax treaty now in force would be amended by a protocol signed in 2009 (the "Switzerland protocol").

Exchange of information

The Switzerland protocol would amend the exchange of information article in the treaty to provide that the two countries would exchange information as may be relevant in carrying out the provisions of the treaty or the provisions of domestic law of either treaty country concerning taxes that are subject to the treaty. (Compare Code section 7602, authorizing the Secretary to examine materials, or summon persons to produce materials or give testimony, "which may be relevant or material" to "ascertaining the correctness of any return" and "determining liability for any internal revenue tax," among other inquiries.) The protocol prohibits either country from declining to supply information solely because the information is held by a bank or other financial institution or by a nominee or a person acting in an agency or fiduciary capacity or because the information relates to ownership interests in a person. It gives the tax authorities of the requested state the power to enforce such disclosure notwithstanding contrary domestic laws.

Although the Switzerland protocol's rules governing information exchange are broadly consistent with the rules of the U.S. Models and other U.S. tax treaties, certain details of the protocol reflect particular aspects of Swiss internal law and the U.S.-Switzerland treaty relationship.

Mandatory binding arbitration

The Switzerland protocol would add a mandatory binding arbitration provision broadly similar to those in the Spain and Japan protocols.

Dividends owned by IRAs

The Switzerland protocol broadens the existing treaty's exemption from source-country taxation for cross-border dividends paid to a pension plan or other retirement arrangement (not including individual retirement arrangements, or IRAs). Under the Switzerland protocol this exemption is extended to dividends paid by a resident of one treaty country to an individual retirement savings plan set up and owned by a resident of the other treaty country. The exemption from source-country taxation is not available if the pension plan or other retirement arrangement or the individual retirement savings plan controls the company paying the dividend.

Effective date

The Switzerland protocol will enter into force upon the exchange of instruments of ratification by the U.S. and Swiss governments.

- For taxes withheld at source, the protocol is effective for amounts paid or credited on or after the first January of the year following the date on which the protocol enters into force.
- The amendments to the treaty's exchange of information article are effective for requests made on or after the date the protocol enters into force, with the following limitations. For requests made on or after the entry-into-force date, the amendments generally apply to information that relates to taxable periods beginning on or after January 1, 2010. By contrast, if the information is held by a bank or other financial institution or by a nominee or a person acting in an agency or fiduciary capacity, or relates to ownership interests in a person, the amendments apply to information that relates to any date beginning on or after September 23, 2009 (the date the protocol was signed).
- The arbitration provisions of the protocol apply with respect to MAP cases that are under consideration by the competent authorities at the time the protocol enters into force, or that come under such consideration after that time. If a MAP case is already under consideration on the date of entry into force, the general two-year countdown from commencement of the MAP case to the date on which arbitration must begin starts not on the actual date of commencement of the MAP case, but rather on the protocol's entry-into-force date.

Luxembourg

The 1996 U.S.-Luxembourg income tax treaty now in force would be amended by a protocol signed in 2009 (the "Luxembourg protocol"). The Luxembourg protocol replaces the exchange of information provisions of the existing treaty with new exchange of information rules that more closely conform to the exchange of information article of the U.S. Models and recent U.S. treaties and that permit broader exchange than the information exchange practices of the existing treaty.

In general, under the Luxembourg protocol the United States and Luxembourg would agree to exchange information that is "foreseeably relevant" to carrying out the provisions of the treaty or the provisions of domestic law of either treaty country concerning taxes of every kind imposed by a treaty country. As in the case of the Switzerland protocol, the Luxembourg protocol also prohibits a treaty country from declining to supply information solely because the information is held by a bank or other financial institution or by a nominee or a person acting in an agency or fiduciary capacity or because the information relates to ownership interests in a person.

Effective date

The Luxembourg protocol will enter into force on the date the United States and Luxembourg notify each other in writing that their respective ratification procedures have been satisfied. The provisions of the Luxembourg protocol will have effect for exchange of information requests made on or after the date the protocol enters into force with regard to tax years beginning on or after January 1, 2009.

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