2009 TREATY DEVELOPMENTS

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This column discusses recent developments with respect to U.S. tax treaties. This year, the U.S. has signed a protocol amending its treaty with France, and its 1999 treaty with Italy has at long last been ratified by the Italian parliament. Both agreements make extensive revisions to the previously-existing-source taxation, mutual agreement, and limitation-on-benefits provisions. In addition, the United States has recently initialed a new treaty with Hungary including a comprehensive limitations on benefits provision. Finally, the United States has recently stepped up its efforts to prevent offshore tax evasion, as evidenced by the modified exchange-of-information provisions in its treaties with Luxembourg and Switzerland and a new tax exchange information agreement with Gibraltar.

Rather than providing a comprehensive review of the changes made by these new agreements, this column explores aspects that are primarily of interest to corporate rather than individual taxpayers.

Protocol to the U.S. treaty with France

On 1/13/09, the United States signed a protocol to its 1994 income tax treaty with France (the 1994 Treaty).[1] The protocol was ratified by the French Senate on July 20 but has yet to be ratified by the U.S. Senate. The protocol will have effect with respect to taxes withheld at source on the first day of January of the year the protocol enters into force and with respect to all other taxes on the first day of January of the following year.[2]

Definition of resident. The protocol revises Article 4 of the 1994 Treaty, which defines residents of each country. The most significant change is to the provision addressing fiscally transparent entities. As revised by the protocol, the treaty for the most part no longer assigns residency to fiscally transparent entities themselves; instead, it tests whether income derived through such entities is derived by a resident of one of the countries.

When an item of income is derived through an entity that is fiscally transparent under the laws of either country, it is considered to be derived by a resident of a country to the extent the country treats the income as income of a resident for purposes of its tax law—so long as the fiscally transparent entity is formed in one of the countries or a country that has entered into a satisfactory exchange of information agreement with the source country.[3] With respect to "French qualified partnerships," income paid from the United States must be *currently* included in the income of a partner who is a resident of France under the treaty in order to be derived by a resident of France.[4] Regardless of these provisions, however, France may still tax an entity that has its place of effective management and is subject to tax in France, even if the United States views it as fiscally transparent.[5]

Taxation at source. The protocol eliminates source taxation for dividends paid from subsidiaries to shareholders meeting an 80% control test—applied differently depending on whether the shareholder is a U.S. or French company—but only if the controlling shareholder qualifies for treaty benefits under specific provisions of the limitation on benefits article. Corporate shareholders qualifying for treaty benefits under the same provisions of the limitation on benefits article are exempt from the application of the U.S. branch profits tax and the equivalent French taxing regime. Limitations on the reduction of source taxation similar to those applicable to dividends from U.S. real estate investment trusts (REITs) are also extended to dividends from certain French entities: the "société d'investissement immobilier cotée" (SIIC) and the "société de placement à prépondérance immobilière à capital variable" (SPPICAV).[6]

In addition, the protocol eliminates entirely source taxation on royalties.[7]

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Arbitration. The protocol amends Article 26, which sets forth mutual agreement procedures, to include a new mandatory arbitration provision.[8] Unless the competent authorities of both countries agree that the case is not suitable for determination by arbitration, cases will be submitted to arbitration if a resolution cannot be reached within two years, or earlier if agreed to by the treaty partners. The resolution is binding on both countries.

A memorandum of understanding sets out the arbitration procedures in greater detail, which are based on "baseball arbitration." Each treaty partner selects one member of the arbitration board, and a third member is selected by the other two members. Each country submits a proposed resolution of the dispute to the arbitration panel and may submit a reply submission to the proposed resolution of the other party. Additional information may be submitted to the panel only at its request. The panel selects one party's proposed resolutions as its determination. The panel does not state a rationale for its determination, and the determination will have no binding precedential value. The person or persons whose tax liability is affected by the panel's determination may reject the determination of the panel, but the case may not be subject to a second arbitration proceeding.

Exchange of information. The protocol provides an entirely new Article 27, which governs the exchange of information. The principal substantive changes are provisions barring each country from declining to supply information solely because it has no domestic interest in such information or because such information is held by a bank, other financial institution, nominee or person acting in an agency or fiduciary capacity, or because it relates to ownership interests in a person.[9]

Limitation on benefits. The protocol substantially revises Article 30, the limitation-on-benefits article of the treaty, which restricts the rights of residents otherwise qualifying for benefits to claim benefits under the treaty.[10] The changes generally conform the limitations-on-benefits provision more closely to the 2006 U.S. Model Treaty.[11]

Similar to the 2006 U.S. Model Treaty, the protocol contains a "publicly traded" provision, permitting a publicly traded company to claim treaty benefits if it is traded on an exchange located in an EU country (in the case of a company resident in France) or a NAFTA country (in the case of a company resident in the United States) or if its primary place of management and control is in the country of which it is a resident. Subsidiaries, at least half of whose shares are owned by five or fewer such publicly traded companies or by a government entity qualifying for benefits, may also claim benefits, provided each intermediate owner is a resident of one of the treaty partners. For purposes of this test, a company is publicly traded if its "principal class of shares" and any "disproportionate class of shares" are traded on a recognized stock exchange.[12] The protocol eliminates a provision of the 1994 Treaty, not found in the 2006 U.S. Model Treaty, allowing a company not meeting the predecessor of either of the aforementioned tests to claim benefits if it meets certain thresholds for ownership by publicly traded companies and government entities of both the treaty countries and other EU countries.

The protocol also revises the so-called "ownership/base erosion" test to bring it into line with the 2006 U.S. Model provision. Residents, other than individuals, may qualify for benefits if they meet both the "ownership" and "base erosion" prongs of the test. The ownership prong requires that on at least half the days of the tax year at least 50% of the aggregate voting power and value of the resident's shares (including any disproportionate class of shares) or other beneficial interests are owned by residents of a treaty partner entitled to claim benefits under specific clauses of the limitation on benefits article. In the case of indirect ownership, each intermediate owner must be a resident of a treaty partner. The base erosion prong requires that less than 50% of the person's gross income be paid or accrued to persons not entitled to treaty benefits under specific clauses of the limitation-on-benefits article in the form of payments deductible in the person's state of residence. Such payments do not include arm's-length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to unrelated banks.

The protocol includes a second "ownership/base erosion test" that does not appear in the 2006 U.S. Model Treaty. A company that is a resident of either of the treaty parties can claim treaty benefits if at least 95% of the aggregate voting power and value of its shares (and at least 50% of any disproportionate class of shares) is owned, directly or directly, by seven or fewer "equivalent beneficiaries" and it meets the base erosion test described above. For this purpose, equivalent beneficiaries include residents of one of the treaty partners qualifying for benefits under certain of the limitation-on-benefits provisions, and certain residents of member countries of the EU or NAFTA with comprehensive income tax treaties with the country from which benefits are claimed.

Residents not otherwise entitled to treaty benefits may nonetheless claim them with respect to particular items of income derived from the other treaty partner if they meet an "active business test" similar to that in the 2006 U.S. Model. The resident must be engaged in the active conduct of a business in its state of residence, the income must be connected with that

business, and the business conducted in the state of residence must be substantial in relation to the activity in the other treaty partner generating the income. The protocol eliminates an arithmetic safe harbor provided by the 1994 Treaty for measuring substantiality in this context, but adds a provision attributing the activities of related persons to the resident for testing whether the resident is engaged in the active conduct of a trade or business.

The protocol revises the so-called "triangular branch rule" of the 1994 Treaty that generally limits benefits where a resident of France derives profits from the United States through a permanent establishment in a low-tax third jurisdiction and the profits are exempt from French tax due to its territorial system of taxation. This rule applies when the total tax imposed by France and the third jurisdiction is less than 60% of the tax that would be imposed if the income were not attributable to a permanent establishment. The protocol adds a provision that this rule will not apply in the case of royalties received as compensation for the use of intangible property produced or developed by the permanent establishment itself. The protocol also eliminates a provision limiting the applicability of the test if profits are derived by a resident of France and are taxed in France under certain provisions of its domestic law or in the United States under the subpart F provisions.

Finally, the protocol eliminates entirely a provision granting benefits to a resident of either treaty partner that functions as a headquarters company for a multinational group.

The "new" U.S.-Italy treaty

On 3/3/09, the Italian Parliament approved a new U.S.-Italy income tax treaty and protocol,[13] which had been signed on 8/25/99. The reasons for the ten-year delay remain unclear, but the result is that the treaty reflects U.S. treaty policy as it existed ten years ago and fails to include provisions that have become commonplace in more recently negotiated treaties. The treaty will enter into force on the exchange of ratification instruments by the countries.

Taxation at source. The new treaty provides for a reduction of source taxation of dividends, interest, and royalties. The rate of source taxation on dividends is generally reduced to 15%, and to 5% if a corporate beneficial owner owns 25% or more of the voting stock of the company paying dividends. To qualify for the 5% rate, the owner must own the stock of the company paying the dividends for a 12-month period ending on the date the dividend is declared.[14] Dividends paid to a governmental entity that holds less than 25% of the voting stock of the company paying dividends are exempted from source-country tax.[15] The new treaty eliminates a provision prohibiting companies deriving more than 25% of their income from interest or dividends from qualifying for the 5% rate, but has included a new provision denying the 5% rate to RICs and REITs. REITS are also barred from qualifying for any reduction of tax under the treaty unless the beneficial owner's interest in the REIT falls below certain thresholds.[16] Finally, the previous exemption from branch-profits tax is eliminated.[17]

The rate of taxation on interest is reduced in the new treaty from 15% to 10%, and new exemptions are established for interest paid or accrued with respect to sales on credit of goods, merchandise, or services provided by one enterprise to another enterprise, and for interest paid or accrued in connection with sales on credit of industrial, commercial, or scientific equipment.[18] A protocol provides an anti-abuse exception to these reductions of source-country taxation for interest that is an excess inclusion with respect to a real estate mortgage investment conduit (REMIC).[19]

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[1] Protocol Amending the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Signed at Paris on August 31, 1994, as Amended by the protocol Signed on December 8, 2004 (hereinafter, the French protocol).

[2] Article XVI of the French protocol. The protocol will enter into force when the parties notify each other when their respective constitutional and statutory requirements for entry into force have been satisfied.

[3] Article I(4) of the French protocol.

[4] Article I(3) of the French protocol. A "French qualified partnership" is defined as a partnership with its place of effective management in France that has not elected to be taxed in France as a corporation, the tax base of which is computed at the partnership level for French tax purposes, and all of the shareholders, associates, or other members of which are liable to taxation by France in respect of their share of partnership profits.

[5] Article XIII(1) of the French protocol.

[6] Article II of the French protocol.

[7] Article III of the French protocol.

[8] Article X of the French protocol.

[9] Article XI of the French protocol.

[10] Article XIV of the French protocol.

[11] United States Model Income Tax Convention of 11/15/06.

[12] A "disproportionate class of shares" is defined as any class of shares that entitles the shareholder to a disproportionately higher participation, through dividends, redemption payments, or otherwise, in the earnings generated in the other country by particular assets or activities of the entity.

[13] Convention Between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion Done at Washington on August 25, 1999 (hereinafter, the "Italian treaty").

[14] Article 10(2) of the Italian treaty.

[15] Article 10(8) of the Italian treaty.

[16] Article 10(9) of the Italian treaty.

[17] Article 10(6) of the Italian treaty.

[18] Article 11(2) of the Italian treaty.

[19] Article 1(11) of the protocol to the Italian treaty.

The new treaty also reduces the rate on royalties, eliminating the tax for the use of any literary, artistic, or scientific copyright, and reducing the rate to 5% for the use of computer software or industrial, commercial, or scientific equipment, and to 8% for all other royalty payments.[20]

Fiscally transparent entities. Unlike the new French protocol, the new U.S.-Italy treaty continues to assign residency to fiscally transparent entities themselves based on the residency of the entities' partners or beneficiaries.[21] This type of provision can give rise to confusion, particularly when some partners and beneficiaries are residents of a treaty partner and some are not. Perhaps recognizing the drawbacks of this type of provision, the U.S. technical explanation to the treaty states that results under the new treaty with Italy are intended to be the same as under the 1996 U.S. Model, which contains a residence article similar to that contained in the new French protocol.[22] Instead of assigning residence to the fiscally transparent entity itself, the Model examines items of income earned through fiscally transparent entities and determines whether they are derived by a resident. U.S. courts assign little weight to technical explanations, however, leaving the treatment of fiscally transparent entities under the new treaty somewhat unclear.

Limitation on benefits. The new treaty greatly expands the limitation on benefits provisions, adopting the rules of the 1996 U.S. Model Treaty.[23] The provision allows the full benefits of the treaty to individuals, qualified governmental entities, charities, and pension plans at least 50% of whose beneficiaries, members, or participants are individuals resident in either country.[24] The new limitation on benefits provision also extends treaty benefits to residents meeting "publicly traded" or "ownership/base erosion" tests.[25] Residents not otherwise qualifying for benefits may claim benefits for particular items of income meeting an "active business" test.[26]

The "publicly traded" and "ownership/base erosion" tests are similar to those in the French protocol, though there are some differences. Unlike the "publicly traded" test in the French protocol, the test contained in the new U.S.-Italy treaty cannot be met by a company with its place of management and control in the country of residence if it is not primarily traded in that country. Further, shares must be traded on an exchange in the United States or Italy; shares traded on exchanges in other NAFTA or EU countries do not qualify. The "ownership" prong of the "ownership/base erosion" test does not extend the 50% ownership requirement to disproportionate classes of shares. Under the "base erosion" prong, deductible payments to persons who are not residents of either contracting state cannot exceed 50% of the person's gross income; only payments attributable to permanent establishments situated in either state are excluded from this requirement. The treaty does not contain a second "ownership/base erosion" test extending treaty benefits to entities owned by residents of other NAFTA and EU countries. For purposes of both the "publicly traded" and "ownership/base erosion" tests, indirect ownership must be through a person entitled to benefits under the limitation-on-benefits provisions, rather than through a resident.

The "active business" test also closely resembles the test in the new French protocol. However, the test in the new U.S.-Italy treaty includes an arithmetic safe harbor for determining the substantiality of a trade or business, and there is no provision attributing the activities of related persons to the resident for testing whether the resident is engaged in the active conduct of a trade or business.

Arbitration. The new treaty revises the mutual agreement procedure to add a provision for arbitration.[27] The arbitration provision will not take effect on the treaty's entry into force, however. At the time the treaty was negotiated, the U.S. treaty policy had yet to embrace arbitration fully, and the United States insisted on a provision requiring further consultation between the treaty partners up to three years beyond the treaty's entry into force to determine whether implementation of arbitration procedures would be appropriate.[28]

In addition, the arbitration provision is far less robust than that included in the new French protocol. Once arbitration procedures are implemented, they will not be mandatory, but instead will require mutual consent of the competent authorities and the affected taxpayers. A memorandum of understanding broadly sketches the arbitration procedures to be used but leaves many procedures to be determined by the competent authorities and the arbitration panel itself.

IRAP. The new treaty contains a somewhat unusual provision allowing a partial foreign tax credit for the Italian Regional Tax on Productive Activities

[20] Article 12(2) of the treaty.

[21] Article 4(1)(b) of the Italian treaty.

[22] Department of the Treasury Technical Explanation of the Convention Between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, article 4(1).

[23] United States Model Income Tax Convention of 9/20/96.

[24] Articles 2(2)(a), (b), (d), and (e) of the protocol to the Italian treaty.

[25] Articles 2(2)(c) and (e) of the protocol to the Italian treaty.

[26] Article 2(3) of the protocol to the Italian treaty.

[27] Article 25(5) of the Italian treaty.

[28] Senate Foreign Relations Committee Report (S. Exec. Rep't. 106-8), 11/3/99, at p. 14.

(l'Imposta Regionale sulle Attivita Produttive, or IRAP).[29] Effective 1/1/98, IRAP replaced a previously existing local income tax, l'Imposta Locale sui Redditi (ILOR). Unlike ILOR, which was a tax on net income, IRAP does not allow a deduction for labor costs or, for certain taxpayers, interest expense. Thus, the IRS had taken the position that it was not a creditable tax because the U.S. permits a credit for taxes to reach only net income.[30]

The treaty permits a foreign tax credit for IRAP subject to adjustments in its computation. The amount of tax paid is reduced by the ratio of labor and interest expense not allowed as deductions to the total IRAP tax base in order to approximate the amount of tax that would be creditable under U.S. domestic law.

Hungarian treaty

In June, the Treasury Department announced that it had concluded negotiations of a new income tax treaty with Hungary. Although the treaty text has yet to be released, Treasury has particularly emphasized that the new treaty adds a comprehensive limitation on benefits provision.[31]

Exchange of information

As part of its recent effort to erode offshore tax evasion, the United States signed a protocol on 5/20/09, updating its treaty with Luxembourg to include an exchange of information provision to conform to the Organisation for Economic Co-operation and Development (OECD) standard.[32] On June 19, it announced that it had initialed a similar protocol with Switzerland.[33]

The Luxembourg protocol includes provisions substantially similar to those in the 2008 OECD Model Treaty. It requires the competent authorities to exchange information "foreseeably relevant" for carrying out the provisions of the treaty and the domestic tax laws of each state. The articles of the treaty governing its general scope and the taxes covered do not restrict this obligation. A country receiving information under the exchange-of-information provision is required to treat the information with the same standards of confidentiality as if the information had been obtained under the country's domestic law. Countries are not obliged to provide information if it would require them to carry out administrative measures at variance with their laws and administrative practice, to supply information not obtainable under their laws or in the normal course of their administration, or to disclose trade secrets or information the disclosure of which would be contrary to public policy. Nevertheless, the parties cannot refuse to supply information solely because it does not need such information for its own tax purposes or because it is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity, or because it relates to ownership interests in a person.

On 3/31/09, the United States also signed a tax information exchange agreement with Gibraltar, with which it does not have an income tax treaty.[34] The agreement imposes obligations similar to those contained in exchange of information articles typically found in income tax treaties but is somewhat more extensive. The permissible and impermissible grounds on which requests for information can be denied are similar to those contained in the exchange-of-information provision of the new Luxembourg protocol, for example, but the procedures for requesting information from the other treaty partner are laid out in considerably more detail. Significantly, while there is no obligation to carry out administrative measures in violation of the laws and administrative practices of the requested country, the agreement effectively requires the parties to amend their internal laws and policies where necessary to ensure that they have the authority to obtain and provide information held by financial institutions and fiduciaries and certain information regarding the beneficial ownership of business entities and information on trusts.

Conclusion

The changes made by these treaties generally accord with the United States' current focus on reducing source taxation, combating treaty abuse, and preventing offshore tax evasion through more transparent information exchange procedures. The new treaties also reflect a trend towards expediting competent authority procedures through arbitration. ■

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[29] Article 23(2)(c).

[30] Mutual Agreement Between United States and Italy on Partial Creditability of Italian Regional Tax, IR-INT-98-6 (3/31/98).

[31] Announcement of Negotiation of Bilateral Income Tax Treaty, as reprinted in 2009 WTD 105-24 (6/3/09).

[32] Protocol Amending the Convention Between the Government of the United States of America and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital signed at Luxembourg 4/3/96.

[33] United States, Switzerland Agree to Increased Tax Information Exchange, as reprinted in 2009 WTD 117-32 (6/19/09). The text of the Swiss protocol has not yet been made available, but its provisions are likely similar to those set forth in the new Luxembourg Protocol.

[34] Agreement Between the Government of the United States of America and the Government of Gibraltar for the Exchange of Information Relating to Taxes Done at London on 3/31/09.