Latest treaty developments further US government’s commitment to fostering cross-border investment

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Since the start of the year, there have been three major developments on the US tax treaty front: a new protocol with Spain signed on January 14, a new protocol with Japan signed on January 24 and a revised treaty with Poland signed on February 13.

While these agreements are not yet in force, they tell us a great deal about the aims of this US Administration around cross-border investment.

**Reduced withholding tax rates**

Under the new Spain protocol, dividends paid to parent companies meeting certain requirements are exempt from withholding tax; otherwise, the rate is 5 percent if the beneficial owner directly owns at least 10 percent of the subsidiary’s voting stock or 15 percent in all other cases.

The new Japan protocol and revised Poland treaty both maintain a 5-percent dividend withholding tax rate for parent companies that own at least 10 percent of the subsidiary’s voting stock. For companies that own less than 10 percent of such stock, the rate is favorably reduced from 15 to 10 percent. The new Japan protocol further broadens a full exemption from withholding tax for parent companies that (i) own “at least” 50 percent of the subsidiary’s voting stock and (ii) hold such stock for six months. The revised Poland treaty exempts dividends paid to pension funds.

Interest and royalties are exempt from withholding tax under the Spain and Japan protocols. The rate increases to 5 percent under the revised Poland treaty, but there are a few carved-out exemptions (e.g., contracting states, political subdivisions, local authorities, pension funds, banks, insurance companies, lenders/financiers). The new Japan protocol has an exception from exemption for excessive interest (5 percent tax on the excess), and both new protocols have exceptions for certain contingent interest (10 percent tax).

Among others, these changes may be helpful to multinational corporations looking to enter into global cash management arrangements.

**Taxpayers may invoke “baseball arbitration”**

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Both new protocols allow taxpayers to invoke mandatory binding arbitration for MAP cases that the competent authorities are unable to resolve after two years. Currently, four other US treaties (Belgium, Canada, Germany and France) and two pending protocols (Spain 2006 and Switzerland) have similar provisions.

The essence of mandatory binding arbitration is that the panel may not compromise or arrive at its own conclusion. Instead, each competent authority submits a proposed resolution along with an optional position paper and/or reply to the other authority’s position paper. The panel’s ultimate determination is then binding on the competent authorities (but not on the taxpayer).

This system is commonly known as “baseball arbitration” due to its prominent use during Major League Baseball salary disputes. Use of baseball arbitration should encourage both sides to avoid extreme and unrealistic positions.

Comprehensive LOB provisions

The 1974 treaty with Poland is infamous because it is one of the few remaining US treaties that doesn’t have a limitation on benefits (LOB) article. If the revised treaty with Poland enters into force, however, that will no longer be the case because this treaty and the new Spain protocol both contain comprehensive LOB provisions that align with contemporary US tax treaty policy.

Under both LOB articles, only “qualified persons” satisfying one or more tests based on their identity are entitled to treaty benefits. These tests include (1) the publicly traded test, (2) the ownership/base erosion test, (3) the derivative benefits test, (4) the active trade or business test and (5) the headquarters company test. Both articles also contain the now familiar triangular branch rule, which generally denies treaty benefits to residents whose income is attributable to a permanent establishment (PE) in a third jurisdiction and whose combined effective tax rate is less than 60 percent of the resident’s statutory rate.

However, the LOB article in the new Spain protocol is much more strict than the one in the revised Poland treaty. For example, the new Spain protocol’s derivative benefits test requires that each intermediate owner be a resident of either the EU or NAFTA. In addition, the protocol requires that the competent authority evaluate the extent to which the resident comes close to satisfying the above-mentioned tests before granting discretionary benefits.

Adoption of AOA

Article 7 of the revised Poland treaty explicitly adopts the authorized OECD approach (AOA) for attributing profits to a PE. The AOA generally attributes profits to a PE as if the PE were “a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.”

Tax administration – new provisions

All three agreements add new provisions designed to facilitate the administration of each jurisdiction’s tax laws. Specifically, the competent authorities must exchange certain information and help each other collect various taxes.

A more open attitude toward global trading partners

Subject to exceptions some of which are mentioned above, the following table summarizes the major changes from these recent treaty developments:
Together with the 2011 signing of a treaty with Chile and other recent tax treaty developments, these agreements exemplify the US government’s more open attitude toward developing its relationships with global trading partners.

For more information about tax treaty developments or global cash management arrangements, please contact Chris Kotarba.

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