
US Tax Treaty Newsalert

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US tax treaty update

Last year ended without final Senate action on US tax treaty protocols with Switzerland and Luxembourg, and also without a new treaty with Hungary; all three agreements were approved by the Senate Foreign Relations Committee. As we begin 2012, these three pacts, as well as a new income tax treaty with Chile, await final ratification. In addition, there are considerable US tax treaty policy developments and trends to monitor. At the end of 2011, the IRS and Treasury issued final anti-conduit regulations that address the treatment of disregarded entities. They have indicated that they continue to study hybrid instruments in the context of financing transactions.

New tax treaties and protocols

No new US treaties or protocols entered into force in 2011.

The United States signed new income tax treaties with Hungary and Chile during 2010. The Senate Foreign Relations Committee held a treaty hearing on June 7, 2011, where the treaty with Hungary and the protocols to the treaties with Switzerland and Luxembourg were considered. The Committee reported out the three pacts to the full Senate with the recommendation that they be approved. However, late in 2011, Senator Rand Paul (R-KY) placed a “hold” on Senate floor consideration of the three pacts – based on his objection to the enhanced exchange of information provisions in the Swiss and Luxembourg agreements – leaving their fate and timing uncertain.

The treaty with Chile was not considered at the June 7, 2011 hearing. The State Department held it up with no indication of when it will move forward.



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- **Hungary Treaty.** The US-Hungary Treaty was signed on February 4, 2010. It would replace the 1979 treaty currently in effect. The principal focus of the new treaty is the addition of a limitation on benefits ("LOB") article that is consistent with other recent US treaties. The US-Hungary Treaty also provides an exemption from source country taxation of royalties and interest (except contingent interest, which is subject to a 15% tax rate). Unlike newer treaties with other European Union ("EU") countries, the US-Hungary Treaty does not contain an exemption from tax for certain parent/subsidiary dividends.

Hungary is one of three jurisdictions singled out by the US Treasury whose lack of an anti-treaty shopping article (the LOB article) and internal tax laws enabled third country residents to access the benefits of a US income tax treaty. The other jurisdictions were Iceland and Poland. A new treaty with Iceland entered into effect in 2008, adding an LOB article. Negotiations with Poland for a new treaty are discussed below.

- **Chile Treaty.** The pending US-Chile Treaty represents only the second US income tax treaty with a South American country (the treaty with Venezuela was signed in 1999). The new US-Chile Treaty is broadly based on the 2006 US Model Income Tax Treaty, except that it has a more restrictive LOB article and higher tax rates for dividends, interest, and royalties than those in US Model. Similar to the US-Hungary Treaty, this treaty does not provide a tax exemption for parent/subsidiary dividends. While the treaty benefits are limited, its (potential) entry into effect could stimulate other South American countries, and, in particular, Brazil, to enter into tax treaties with the United States.
- **Swiss Protocol.** The Swiss protocol primarily updates the exchange of information provision and also includes a binding arbitration requirement for double tax disputes that are not resolved by agreement between the competent authorities of the two countries. It has been widely reported that the United States and Switzerland have agreed to return to the negotiating table two years after the signing of the protocol, which occurred in 2009. However, the formal negotiations likely will not occur prior to the pending protocol's entry into effect. Although the agreement's details have not been made public, the discussion topics likely include the possible elimination of source-country taxation of certain parent/subsidiary dividends and a potential revision to the LOB article to align it with recent US tax treaties that have tightened the eligibility requirements.
- **Luxembourg Protocol.** The Luxembourg protocol updates the exchange of information provision in the existing US-Luxembourg Treaty.

Agreements in negotiation

- **Poland Treaty.** Treasury is actively pursuing renegotiation of the 1974 US-Poland Treaty, the only remaining US tax treaty with a jurisdiction often used as an intermediary jurisdiction for holding and finance companies that lacks a robust LOB article. Reportedly, work on the treaty has concluded and it awaits signature.
- **Other Treaties.** The United States has completed a third round of treaty negotiations with Spain. In addition, the United States has held two rounds of negotiations with both Vietnam and the United Kingdom, the latter pursuant to an agreement whereby the two countries periodically meet to discuss treaty matters. Moreover, the United States has been negotiating with Japan to revise

the current treaty and bring it into conformity with current US and Japanese tax treaty policies.

New US model treaty, other guidance

The US Treasury has announced that its plans to publish a new model income tax treaty, which would supersede the existing US model that was published in 2006.

The 2011-2012 Treasury-IRS Priority Guidance Plan includes a project to provide guidance on income tax treaty issues, including beneficial ownership. Currently, the only guidance on treaty interpretation comparable to regulations is the Treasury Technical Explanation that accompanies a treaty or protocol submission to the US Senate during the ratification process. There is no procedure for modifying a treaty explanation to correct errors or reflect the most recent thinking of the IRS or Treasury. Furthermore, Treasury Technical Explanations are accorded limited weight by the courts, although they are accorded more weight in the exceptional cases where the treaty partner has indicated its acceptance of the US interpretations (such as in the case of the Fifth Protocol to the US-Canada Treaty). In addition, the 2011-2012 Priority Guidance Plan includes guidance updating Rev. Proc. 2006-54, which provides procedures for requesting Competent Authority assistance under tax treaties.

Both the model treaty and the pending regulation project offer opportunities for businesses to provide input to the government on ways to improve treaty guidance as well as to affect the future direction of US tax treaty policy. Areas in which comments could be offered include concepts of beneficial ownership, application of fiscal transparency rules beyond the treatment of dividends, interest, and royalties (including the impact of hybrid entity structures on accessing treaty benefits for business profits and reductions in the branch profits tax), and improvements to the LOB article.

Trends in US tax treaty policy

The United States is expected to continue to strive for effective anti-treaty shopping protection in its treaties. Such policies include LOB articles and monitoring the use of US tax treaties by inverted companies. Other priorities include strong exchange of information commitments, modernization of the treatment of cross-border retirement plans, and the personal services articles of treaties (mainly, the policy of eliminating the independent personal services article as being redundant with the business profits article). In addition, Treasury likely will continue its recent policy of including binding arbitration as a means of deciding Competent Authority cases that otherwise are unresolved.

On the tax administration side, the IRS is focusing greater attention on permanent establishments, inbound financing, and withholding taxes.

New finalized anti-conduit financing regulations

On December 8, 2011, the IRS and Treasury Department issued final regulations relating to multiple-party financing arrangements that are effected through disregarded entities. These regulations, which finalize regulations issued in proposed form on December 22, 2008, treat an entity disregarded as separate from its owner as a separate person for purposes of determining whether a conduit financing arrangement exists. Structures that have utilized the classification of entities as disregarded in the context of the anti-conduit rules should be revisited in light of the final regulations.

The final regulations do not address the treatment of "hybrid instruments," defined by the IRS and Treasury as "instruments treated as debt for foreign law purposes and equity for US purposes," in the context of conduit financing arrangements. The IRS and Treasury could issue future guidance on the treatment of such instruments in the context of financing transactions.

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