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# *Tax treaty update: Several key pacts awaiting Senate approval*

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## *In brief*

In June 2011, the Senate Foreign Relations Committee recommended Senate approval of tax treaties or protocols with Hungary, Switzerland, and Luxembourg. However, one Senator has placed a “hold” on Senate floor consideration of the three pacts, and the fate and timing of these agreements, as well as others, remain uncertain. Separately, the US-Chile treaty was sent to the Senate for approval in May 2012, but was not considered last year by the Senate Foreign Relations Committee. As a result, no new US tax treaties or protocols entered into force during the 112th Congress.

The United States is expected to continue to strive in its treaties for effective protection against ‘treaty shopping.’ Other priorities include strong commitments for exchange of information, modernization of the treatment of cross-border retirement plans, and changes to the personal services articles of treaties (mainly, the policy of eliminating the independent personal services article as being redundant of 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.

This WNTS Insight will provide updates on important treaties and protocols between the United States and key countries in Europe, Asia, and South America.

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## *In detail*

### *Hungary treaty*

The US-Hungary treaty, which was signed on February 4, 2010, would replace the 1979 treaty currently in effect. The principal focus of the new treaty is addition of a limitation on benefits (LOB) article that is consistent with other recent US treaties. The US-Hungary treaty also would provide an exemption from tax withheld at source for royalties and interest (except contingent interest, which is subject to a 15-percent 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.

Hungary is a jurisdiction that had been identified by the US Treasury due to its lack of an anti-treaty-shopping article (the LOB article) and internal tax laws that provided residents of third countries an ability to access the benefits of a US income tax treaty.

### *Swiss protocol*

The Swiss protocol to the existing treaty, signed in 2009, is aimed primarily at updating

the exchange-of-information provision and 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. It has been widely reported that the United States and Switzerland have agreed to return to the negotiating table; however, it is not expected that formal negotiations will take place prior to the entry into force of the pending protocol, assuming ratification. Although the details of the agreement

have not been made public, it is expected that among the items to be discussed are possible elimination of tax withheld at source on certain parent/subsidiary dividends and a potential revision to the LOB article to be more in line with recent US tax treaties, which have tightened the requirements for eligibility.

#### ***Luxembourg protocol***

The Luxembourg protocol is aimed at updating the exchange-of-information provision in the existing US-Luxembourg treaty.

#### ***Chile treaty***

The US-Chile treaty was signed on February 4, 2010. The treaty was sent to the US Senate for approval on May 17, 2012, but was not considered last year by the Senate Foreign Relations Committee. The treaty would be only the second US income tax treaty with a South American country, following the income tax treaty with Venezuela that was signed in 1999. The new 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.

#### ***Spain protocol***

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

The new protocol provides for exclusive residence-state taxation of interest, royalties, certain parent/subsidiary dividends, and most capital gains. This is a significant revision compared to the existing

treaty, which did not provide for an exemption from source-state tax on interest or royalty income. The protocol also would add the treaty with Spain to the growing list of US treaties that permit exemption from source-state tax on parent/subsidiary dividends, provided certain requirements are met. Consistent with certain other recent US tax treaties, the new protocol contains a mandatory binding arbitration provision.

The new protocol includes an updated LOB article with some significant changes, and an updated exchange-of-information article. Among these changes is 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. By contrast, the new 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.

#### ***Poland treaty***

Treasury is actively pursuing renegotiation of the 1974 US-Poland treaty, the only remaining US tax treaty that both eliminates US tax on qualifying interest payments and lacks a robust LOB article. It was reported

in June 2012 that work on the treaty has been concluded and that the document is in the process of being translated so that the parties may sign the agreement.

#### ***Japan protocol***

On January 24, 2013, Treasury announced that a new protocol to the 2003 US-Japan Treaty has been signed. The new 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 tax on certain parent/subsidiary dividends; 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 twelve 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 elimination of source-country tax in certain circumstances. The protocol also 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.

#### ***Norway treaty***

It was reported in January 2013 that the United States and Norway have reached agreement on revisions to the US-Norway treaty, and that the text is being prepared for signature.

### **Other treaties**

It was reported in January 2013 that the United States and the United Kingdom have reached an agreement on revisions to the US-UK treaty, and that there are ongoing negotiations with Vietnam. In November 2012, a Treasury official reported that discussions are underway with Romania, one of the few remaining jurisdictions along with Poland with which the United States has a treaty that does not contain an LOB article. It has been reported that negotiations with Brazil and Colombia are underway. Discussions with Israel continue, although agreement does not appear imminent. There has been correspondence with South Korea, but negotiations are not anticipated in the near term. Discussions are underway with Venezuela and the Netherlands Antilles, and early discussions are underway with Malaysia. Treasury apparently has not yet concluded that it should pursue a treaty with Singapore or Hong Kong despite strong support from the business community for such treaties.

### **New US model treaty, other guidance**

Treasury has announced that it is planning to publish a new model treaty that would supersede the existing US model treaty published in 2006. Public comments by a Treasury official in January 2013 indicate that a revised discretionary grant of benefits provision within the LOB article, such as the one included in the recent protocol to the US-Spain Treaty (discussed above), may be included in the next US model treaty.

Separately, the 2012-2013 Treasury-IRS Priority Guidance Plan again includes a project to provide guidance on issues under income tax treaties, including beneficial ownership. In addition, the 2012-2013 Plan again includes a project to update Rev. Proc. 2006-54, which provides procedures

for requesting competent authority assistance under tax treaties.

### **Competent authority agreements**

Although no new treaties or treaty protocols entered into force during 2012, the United States reached competent authority agreements with Germany, the Netherlands, Norway, and Canada. A second competent authority agreement was signed with Norway in early 2013.

The agreement with Germany relates to dividends from investments made by certain US and German pension funds. The agreement with the Netherlands relates to the treatment of dividends and interest paid through a specific type of Dutch limited fund. The 2012 agreement with Norway addresses special sourcing rules for income received by individuals for performing government services and for social security payments. The 2013 agreement with Norway addresses the circumstances under which an item of income paid to an entity that is fiscally transparent under the tax laws of either jurisdiction will be seen as received by a resident of one of the two countries. The agreement with Canada relates to the interpretation of certain treaty provisions related to the attribution of profit to a permanent establishment.

### **FATCA implementation**

On January 17, 2013, the IRS issued comprehensive final regulations implementing the information reporting and withholding tax provisions commonly known as the Foreign Account Tax Compliance Act (FATCA). Enacted by Congress in 2010, these provisions target noncompliance by US taxpayers using foreign accounts. The issuance of the final regulations marks a key step in establishing a common intergovernmental approach to combating tax evasion. The Treasury news release accompanying the issuance of the regulations states that

the government will continue to work closely with business and foreign governments to implement FATCA effectively

Since regulations were first published in proposed form on February 15, 2012, Treasury has collaborated with foreign governments to develop two alternative model intergovernmental agreements that facilitate the implementation of FATCA.

These models serve as the basis for concluding bilateral agreements with interested jurisdictions and help implement the law in a manner that removes legal impediments to compliance, secures widespread participation by every non-exempt financial institution in the partner jurisdiction, fulfills FATCA's policy objectives, and further reduces burdens on foreign financial institutions located in partner jurisdictions.

The Treasury news release also announced that Norway has joined the United Kingdom, Mexico, Denmark, Ireland, Switzerland, and Spain as countries that have signed or initialed model agreements. Treasury is engaged with more than 50 countries and jurisdictions to curtail offshore tax evasion, and more signed agreements are expected during the course of this year.

### **The takeaway**

Some recent treaties have expanded the benefits offered by the treaties for qualified residents, such as exclusive residence-state taxation of interest, royalties, certain parent/subsidiary dividends, and certain capital gains. Along with the expansion of certain benefits, however, there has been a trend toward a tightening of the conditions that must be met to be eligible for treaty benefits, through more restrictive limitation on benefits conditions. Companies with operations or investments in any of

the countries mentioned above should continue to monitor these emerging treaty developments.

***Let's talk***

For a deeper discussion, please contact:

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