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Qualifying for Treaty Benefits Under the "Derivative Benefits" Article

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Background on Derivative Benefits Provisions

Derivative Benefits - Equivalent Beneficiary

- Many income treaties concluded with the United States that have LOB provisions contain a “derivative benefits” clause in such provision.
  - Discussion not focused on treaties that don't have LOB provisions, including those with Hungary, Poland, Greece, Egypt, Pakistan, Norway, etc.
- A company that does not satisfy any of the other LOB tests may qualify for treaty benefits if a specified percentage (typically 95 percent) of its shares is owned, directly or indirectly, by seven or fewer "equivalent beneficiaries" and a base erosion test is satisfied.

Equivalent Beneficiary

An "equivalent beneficiary" generally means any person that:

- In connection with certain European country treaties, is a resident of a member state of the EU, any state of the European Economic Area, a party to NAFTA, or, in some cases, Switzerland, or Australia (i.e., Malta-U.S. Treaty) (each, a "Qualifying Country");
- Is entitled to the benefits of a comprehensive income tax treaty between such Qualifying Country and the Contracting State from which treaty benefits are claimed and satisfies certain LOB requirements (even if that treaty has no LOB article); and
- In the case of dividends, interest, royalties, and possibly certain other items (e.g., insurance premiums), would be entitled, under the treaty between the Qualifying Country and the Contracting State in which the income arises, to a rate of tax with respect to the particular class of income for which benefits are claimed that is "at least as low as" the rate provided for under the treaty between the Contracting States.

Current List of Treaties in Effect with Derivative Benefits Provisions

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Belgium – applies to EU, EEA, NAFTA, and Switzerland
Canada – applies to <u>any</u> jurisdiction that has treaty with the U.S.
Denmark - applies to EU and EEA, and parties to NAFTA
Finland - applies to EU and EEA, and parties to NAFTA
France - applies to EU and parties to NAFTA
Germany - applies to EU and EEA, and parties to NAFTA
Iceland - applies to UE and EEA, and parties to NAFTA
Ireland - applies to EU and parties to NAFTA
Jamaica – applies to <u>any</u> jurisdiction that has treaty with the U.S.
Luxembourg – applies to EU and parties to NAFTA
Malta - applies to EU and EEU, parties to NAFTA and Australia
Mexico – applies to parties to NAFTA
Netherlands - applies to EU and EEA, and parties to NAFTA
Sweden - applies to EU, EEA, parties to NAFTA, and Switzerland
Switzerland - applies to EU and EEA, and parties to NAFTA
United Kingdom - applies to EU and EEA, and parties to NAFTA

Planning Opportunities – Local Law Shopping

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- One foreign jurisdiction may have more favorable local tax benefits than other jurisdiction, including:
  - Lower corporate income tax rate
  - Exemption on income from intellectual property
  - Participation exemption on dividends and capital gains
  - No withholding on interest, dividends, or royalties
  - No thin capitalization rules
  - No CFC rules
  - No stamp or capital duties
  - Better treaty network
  - No transfer pricing rules
  - Tax consolidation or group relief

Planning Opportunities – Local Law Shopping (cont.)

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Example:

- Residents of France wish to lend money to the United States to finance the acquisition of U.S. real property that will be owned by related parties.
- Instead of investing through French corporation, which has a 33.3 percent corporate income tax rate, French taxpayers invest through Swiss corporation, which has an 8.5 percent effective corporate income tax rate, no withholding taxes on interest and royalties, and very favorable participation exemption for dividends and capital gains.
- Both U.S.-France and U.S.-Swiss treaties provide for 0 percent withholding on interest paid from U.S. sources.
- French residents would qualify as "equivalent beneficiaries" under U.S.-Swiss treaty, and therefore, have the ability to shop for more favorable local tax benefits.

Different Types of Equivalent Beneficiaries

Different Types of Equivalent Beneficiaries - Most Common

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- Only includes (i) individuals, (ii) governmental entities, (iii) publicly traded entities, and (iv) pension funds (or tax-exempt entity) that are residents in a contracting state.
  - Switzerland also includes recognized company headquarters for multinationals and family foundations
- Therefore, third country residents cannot qualify under (i) ownership/base erosion test; or (ii) active trade or business test.
- Treaties with such definition include treaties with: (i) Belgium; (ii) Denmark; (iii) Finland; (iv) France; (v) Germany; (vi) Iceland; (vii) Malta; (viii) Mexico; (ix) Netherlands; (x) Sweden; and (xi) Switzerland.
- New treaty with Hungary (not yet in effect) has same limitations.
- New protocol with Spain (not yet in effect) has same limitations and also requires each intermediate entity to be EU resident or party to NAFTA.

Different Types of Equivalent Beneficiaries - Less Common

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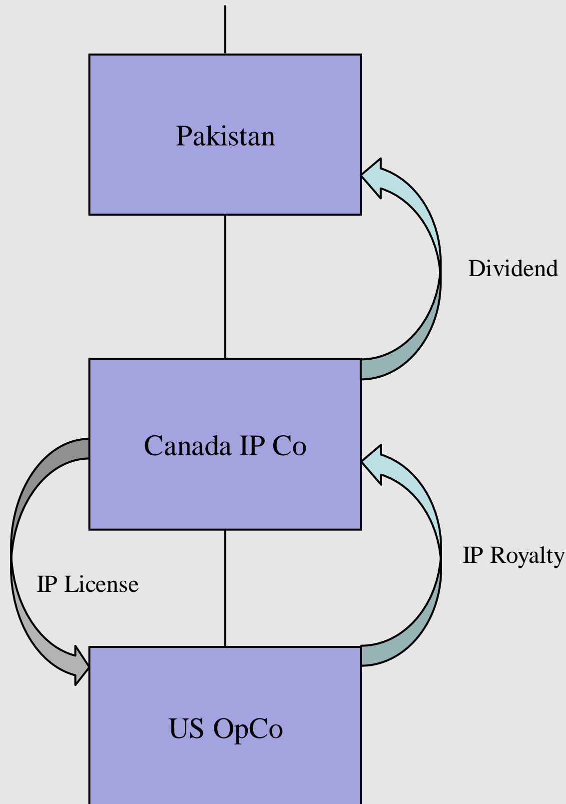
- Third country resident can be located in any jurisdiction that has an income tax treaty with the United States.
  - Can also qualify if third country owner's treaty has no LOB provision.
- Treaties that contain such provision includes: (i) Canada; and (ii) Jamaica.

Licensing of IP into U.S. through Canada



- Treaty qualification
  - Royalties paid by U.S. OpCo to Canada IP Co:
    - Exempt from U.S. withholding tax under U.S.-Canada
    - Derivative benefits provision satisfied because U.S. has income tax treaties with Canada and Pakistan, withholding rates on royalties zero under both treaties.
    - Pakistan treaty has no LOB provision, so can be owned by 3rd country taxpayers regardless of their residence.

Different Types of Equivalent Beneficiaries - Even Less Common

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- Treaties allow third country residents to also qualify under (i) ownership/base erosion test or (ii) active trade or business test (as well as all prior tests discussed on previous slide, *i.e.*, individual residents, publicly-traded companies, etc.).
- Third country resident need to be located in jurisdictions that are part of EU, EEA, or be party to NAFTA.
- Treaties that contain such provision includes: (i) Luxembourg; and (ii) Ireland.
- If relying on active trade or business test, treaty with Luxembourg requires U.S.-source income to be derived in connection with that trade or business.
  - If relying on active trade or business test, Ireland treaty has no such requirement.

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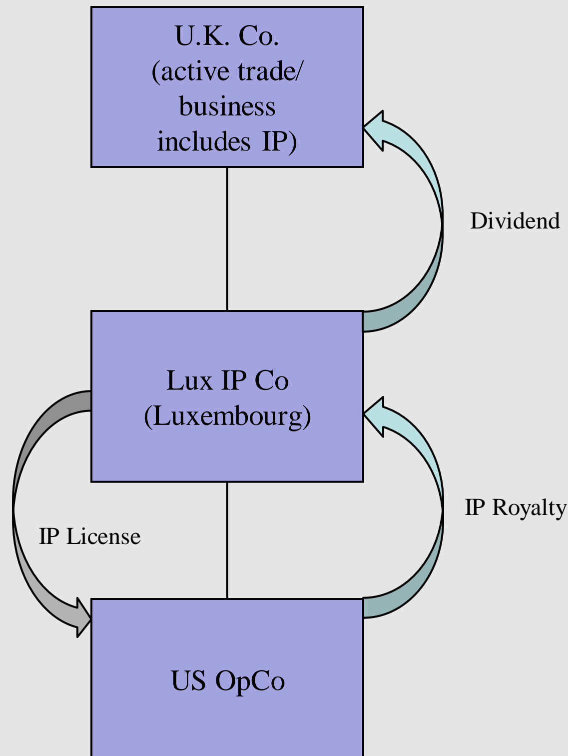
Licensing of IP into U.S. through Luxembourg



- Tax treatment
  - Royalties paid by US OpCo to Lux IP Co:
    - Exempt from U.S. withholding tax under U.S.-Luxembourg Treaty
    - Subject to an effective tax rate of 5.84% in Luxembourg
    - Qualify for treaty benefits under derivative benefits article because Lux Co. owned by EU resident that has active trade or business, and royalties paid to Lux Co. would be derived by U.K. business if paid to U.K.
    - Rates of withholding on royalties are zero under both U.S.-U.K., and U.S.-Luxembourg treaties.

Licensing Through Luxembourg with Royalty-Free License From Ireland

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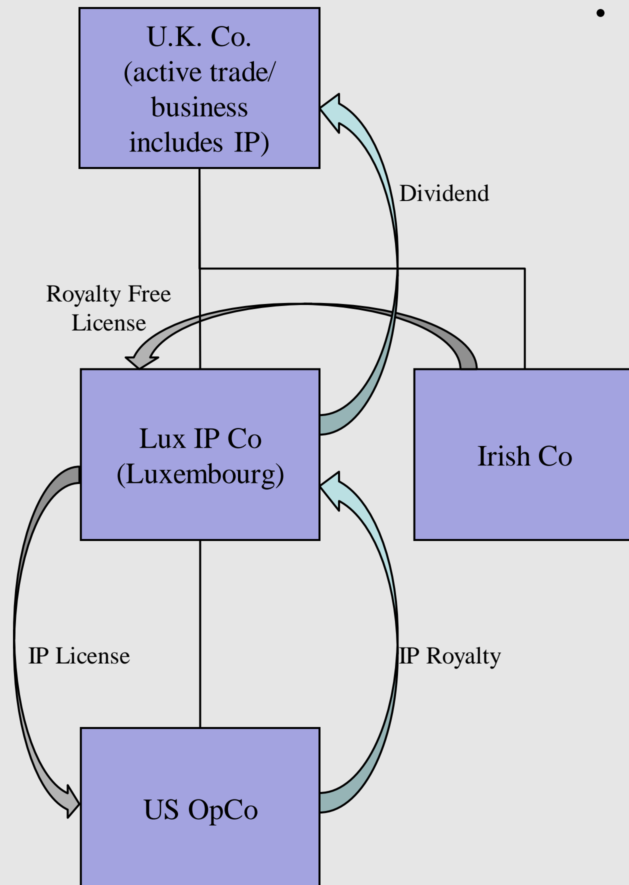

- Tax treatment
  - Royalty payments
    - No transfer pricing rules on passive income in Ireland so no taxable income because no actual royalty payment
    - Royalty payment from US OpCo to Lux IP Co exempt from U.S. withholding tax under U.S.-Luxembourg Treaty
    - Qualify for treaty benefits under derivative benefits article because owned by EU resident with active trade or business which includes IP, and royalty rates same under both treaties.
    - No conduit financing issues because royalties could have been paid directly to Ireland.
    - Minimal tax in Luxembourg due to deemed royalty deduction
      - Leaving a spread of approximately 5% of income
      - Spread taxed at regular corporate income tax rate of 28.8% in Luxembourg

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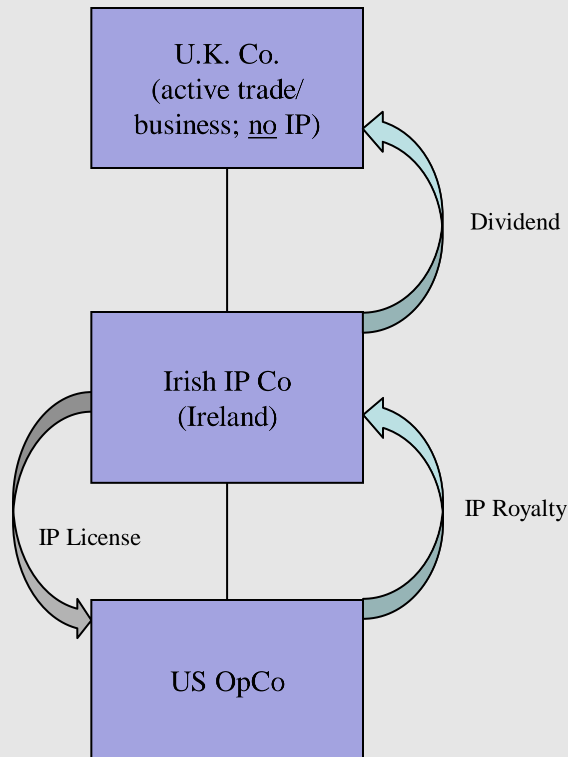
Licensing of IP into U.S. through Ireland



- Tax treatment
  - Royalties paid by US OpCo to Ireland IP Co:
    - Exempt from U.S. withholding tax under U.S.-Ireland Treaty
    - Possibly to an effective tax rate less than 12.5% in Ireland if trading activity.
    - Qualify for treaty benefits under derivative benefits article because Irish Co. owned by EU resident that has active trade or business; royalties paid to Irish Co. do not need to be derived by U.K. business if paid to U.K.
    - Rates of withholding on royalties are zero under both U.S.-U.K., and U.S.-Ireland treaties.

Unanswered Questions

What if Fail "As Least as Low" Test?

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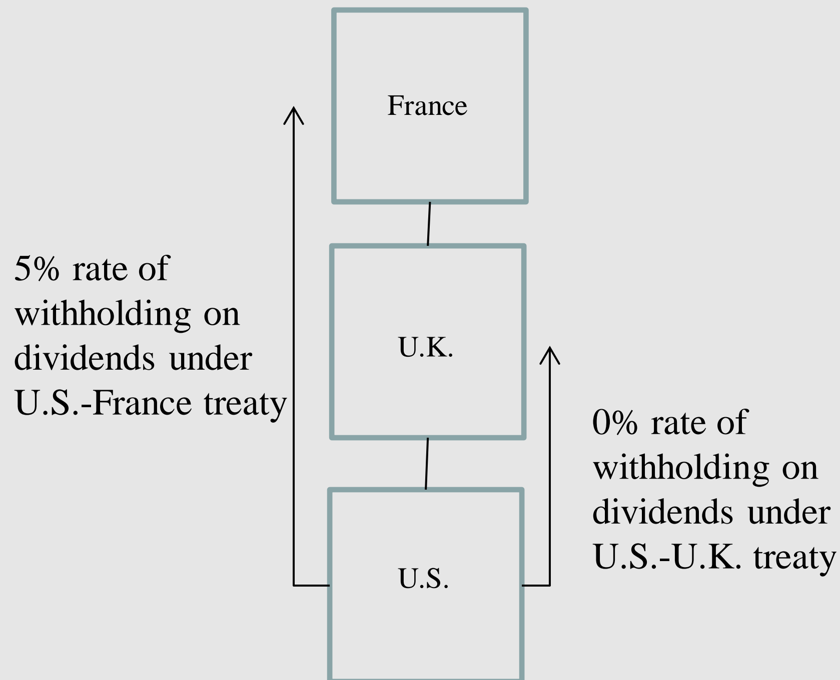

French shareholder is not equivalent beneficiary under U.S.-U.K. treaty because rate of withholding on dividends under U.S.-France treaty (5%) is not as least as low as rate of withholding under U.S.-U.K. treaty (0%).

Is dividend paid by U.S. to U.K. subject to 30 percent withholding or 5 percent withholding?

What if Fail "As Least as Low" Test? (cont.)

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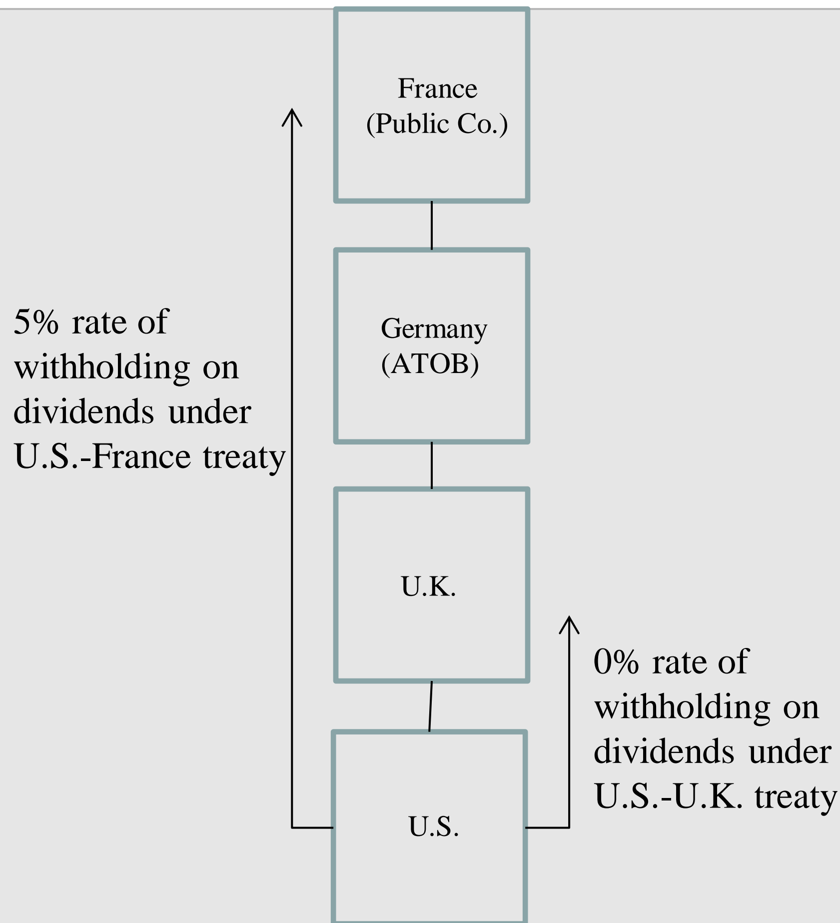

Technical Explanation to U.S.-U.K. treaty concludes that French company qualifies as equivalent beneficiary with respect to 5% withholding, even though it would not be entitled to 0% withholding under U.S.-U.K. treaty (0%).

Similar language appears in Memorandum of Understanding agreed to by the U.S. and Netherlands in connection with the 2004 protocol to U.S.-Dutch treaty.

Should this position be followed in other treaties?

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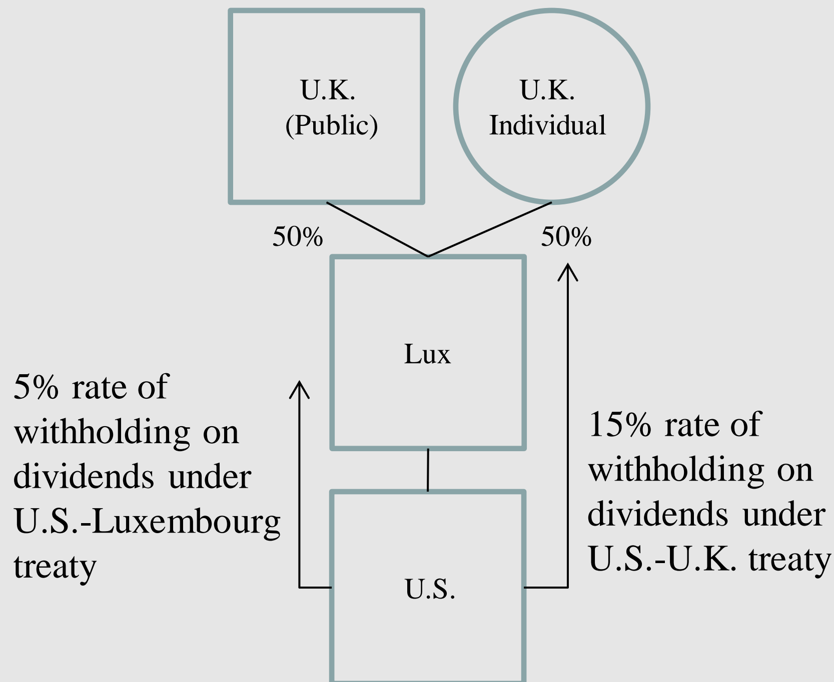
Individual as Equivalent Beneficiary



Dividend from U.S. to Luxembourg will be eligible for 5% withholding tax rate, so long as both U.K. Public Co. and U.K. individual are both equivalent beneficiaries with respect to 5% rate.

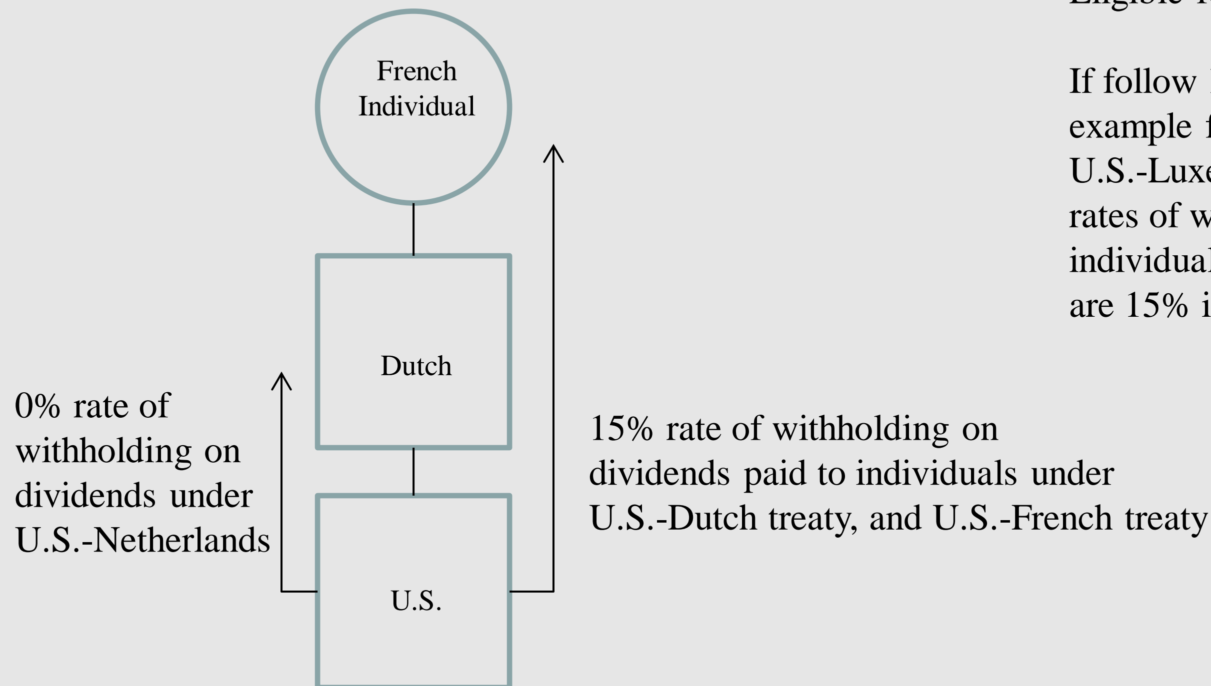
According to example in the Technical Explanation (and to language in the Exchange of Notes) to the U.S.-Luxembourg treaty, the dividend paid from U.S. to Luxembourg qualifies for 5% withholding tax rate because the rate of withholding for <u>individuals is the same under both the U.S.-Luxembourg treaty, and the U.S.-U.K. treaty</u> (i.e., 15%).

This appears to be contrary to intent of the "at least as low" requirement, which is to prevent residents of a third state from using an entity that is a resident of one of the Contracting States to obtain a more favorable rate of withholding tax that would otherwise be available to them.

Individual as Equivalent Beneficiary (cont.)

Is dividend paid from U.S. to Netherlands Eligible for 0% withholding?

If follow language from Exchange of Notes and example from Technical Explanation in U.S.-Luxembourg treaty it would be because rates of withholding on dividends paid to individuals of France and the Netherlands are 15% in both situations.



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