18 July 2019

Global Tax Alert

US Senate approves four protocols updating the existing bilateral tax treaties with Luxembourg, Switzerland, Japan and Spain

Executive summary

On 16 and 17 July 2019, following the recommendation of the United States (US) Senate Foreign Relations Committee, the US Senate gave its advice and consent to approve the following four protocols:

- Luxembourg – 2009 Protocol to amend 1996 Treaty (Luxembourg Protocol)
- Switzerland – 2009 Protocol to amend 1996 Treaty (Swiss Protocol)
- Japan – 2013 Protocol to amend 2003 Treaty (Japanese Protocol)
- Spain – 2013 Protocol to amend 1990 Treaty (Spanish Protocol)

Efforts to have those agreements approved by the Senate had been stalled for several years. In particular, Senator Rand Paul had expressed concerns about privacy issues associated with the exchange of information provisions in the agreements.

Senator Rand Paul offered amendments to the Spanish Protocol that would have created a higher standard for information sharing and modified the effective date of its provisions; both amendments were defeated.

Before these agreements are considered to have entered into force, a few additional steps must be taken in the US, including drafting the instruments of ratification, which must be signed by the President. It is expected that there would be an announcement to indicate when the agreements have officially

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entered into force. The date of entry into force for the provisions in each agreement may vary as discussed in more detail later.

Generally, all four protocols modernize provisions in the respective tax treaties, conforming them to more recent US bilateral tax treaties as well as US law and international standards (the protocols generally conform to provisions in the 2006 US Model Treaty, which was the US's most recent model treaty at the time these protocols were under negotiation).

Detailed discussion

Luxembourg

Exchange of information

On 20 May 2009, the US and Luxembourg signed a protocol, updating the 1996 *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* (US-Luxembourg Treaty). The Luxembourg Protocol replaces Article 28 (Exchange of Information) of the US-Luxembourg Treaty, allowing for more robust tax information exchange between the two countries.

The Luxembourg Protocol introduces a new information exchange article, incorporating the exchange of information standard reflected in both the 2008 OECD[1] Model Treaty and the 2006 US Model Treaty, and generally provides for full exchange of information upon request for all types of federal taxes in both civil and criminal matters, without regard to a domestic tax interest requirement or domestic bank secrecy rules, and provides for safeguards of the confidentiality of the information exchanged.

Specifically, Article 28 was revised to provide that the competent authorities of the treaty countries must exchange such information as is foreseeably relevant for enforcing the treaty or the laws of the treaty countries. Also, information can **now** be requested concerning taxes of any type imposed by either treaty country, such as US estate and gift taxes, excise taxes, and Luxembourg value-added taxes. Unlike the original Article 28, the new provision explicitly provides that, if information is requested by one treaty country, the other treaty country must try to gather the requested information, even though it would not need such information for its own tax purposes. Thus, the protocol limits the ability of either country to refuse to provide information based on the lack of its own need for such information or the expiration of the limitations period in the requested country. It also specifically prohibits a treaty country from refusing to provide information solely because the information is held by a bank or other financial institution. Furthermore, the new provision would not permit a country to decline to provide information solely because it has no domestic interest in such information.

However, the protocol retains the original provision stating that treaty countries are not obligated to carry out administrative measures at variance with the laws and administrative practice of either treaty country. Moreover, the treaty does not require exchange of information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information whose disclosure would be contrary to public policy. Finally, the new Article 28 also retains the requirement imposed on the treaty countries to generally retain the confidentiality of the information received.

Entry into force and effective dates

The Luxembourg Protocol will enter into force once both the US and Luxembourg have notified each other (in writing) that their respective applicable procedures for ratification have been satisfied. Luxembourg has already taken the necessary steps to approve the Luxembourg Protocol according to its own domestic law, and an announcement is expected indicating when the notification process has occurred and all applicable procedures have taken place in the US and Luxembourg. The Luxembourg Protocol provides that, once in force, it shall have effect for requests for information made, on or after the entry into force, for tax years beginning on or after 1 January 2009.

Switzerland

On 23 September 2009, the US and Switzerland signed the proposed protocol amending the 1996 *Convention between The United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income* (US-Switzerland Treaty). The Swiss Protocol, corrected on 16 November 2010, amends the US-Switzerland Treaty signed 2 October 1996. The Swiss Protocol updates the provision relating to exchange of information, addresses the taxation of dividends received by pensions and similar funds, and includes mandatory arbitration procedures for certain cases that the competent authorities of the countries have been unable to resolve after a reasonable period.

Exchange of information

Like the Luxembourg Protocol, the Swiss Protocol replaced the provision regarding the Exchange of Information. In particular, the Swiss Protocol introduces changes that require the competent authorities of both countries to collect and exchange information that may be relevant for carrying out the provisions of the US-Switzerland Treaty and respective domestic laws, on all taxes imposed by each country, provided such taxation is not contrary to the US-Switzerland Treaty. The Swiss Protocol also contains rules on the protection of the confidential information and against violation of domestic laws. Finally, the Swiss Protocol now provides that the requesting state should be able to obtain authenticated copies of unedited original documents.

Taxation of dividends beneficially owned by pension funds

The Swiss Protocol also amends Article 10 and provides that dividends that are beneficially owned by a pension or other retirement arrangement are not subject to tax in the source state. To qualify, the competent authorities must agree that the pension or retirement arrangement, or individual retirement savings plan, generally corresponds to a pension or similar arrangement recognized for tax purposes in the other country. A special limitation provides that this dividend exemption does not apply if the pension or similar arrangement controls the company paying the dividends.

Mandatory arbitration

The Swiss Protocol also provides for mandatory arbitration of certain cases that the competent authorities of each country have been unable to resolve after a reasonable period. The arbitration provisions in the Swiss Protocol are similar to other mandatory arbitration provisions that have been included in other US bilateral tax treaties that are currently in force.

The arbitration procedures may be initiated only if (i) tax returns have been filed with at least one of the countries for the tax year at issue, (ii) the case is not one that the competent authorities believe is unsuitable for arbitration, and (iii) the taxpayer affected by the decision and its representatives agree not to disclose any information received during the course of the arbitration. If these procedural requirements are met, then the arbitration proceeding may begin no earlier than two years after all information for consideration of a mutual agreement is made available to the competent authorities. A 2009 Diplomatic Note accompanies the Swiss Protocol and includes details on establishing the procedure to be followed by the parties during the arbitration proceedings.

Entry into force and effective dates

The Swiss Protocol will enter into force upon the exchange of instruments of ratification. Switzerland had previously taken steps to approve the Swiss Protocol, and an announcement is expected indicating when the exchange of instruments of ratification has taken place.

The effective dates of the various provisions within the protocol differ. Specifically, the protocol becomes effective with respect to withholding taxes, for amounts paid or credited on or after the first of January of the year following the entry into force of the Swiss Protocol (for example, 1 January 2020, assuming that the Swiss Protocol enters into force in 2019). For information exchange, the Swiss Protocol will have effect for requests made on or after the date of entry into force for information that is held by a bank or other financial institution and relates to any date beginning on or after the date of signature of the Swiss Protocol (i.e., 23 September 2009). For all other cases of information exchange, the Swiss Protocol will have effect for information requests that relate to tax periods beginning on or after the first day of January of the year following the date of signature (i.e., 1 January 2010). The mandatory arbitration provision will have effect for both cases that are under consideration by the competent authorities as of the date on which the protocol enters into force, and for cases that come under consideration after that date.

Japan

On 24 January 2013, the US and Japan signed a new protocol amending the 2003 *Convention between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (US-Japan Treaty). In general, the Japanese Protocol modernizes provisions of the US-Japan Treaty. Key items of the Japanese Protocol include:

- Revised dividend withholding tax exemption
- General exemption on cross-border interest payments
- New definition of indirect interest in real property
- Mandatory binding arbitration procedures
- Revised exchange of information provisions
- Expanded and strengthened provisions regarding assistance in the collection of taxes

Dividend withholding tax exemption

The Japanese Protocol, like the US-Japan Treaty, provides for a 0% rate on certain intercompany dividends. However, the Japanese Protocol lowers key threshold requirements for the dividend exemption from withholding tax. Whereas Article 10(3)(a) of the US-Japan Treaty required an ownership interest of **more than** 50%, the Japanese Protocol calls for **at least** 50%. In addition, the holding period in subsidiary stock has been reduced from 12 months to 6 months.

General exemption on cross-border interest payments

In most cases, the US-Japan Treaty taxed interest at a rate of 10%. The Japanese Protocol has revised this and, like the 2006 US Model Treaty, generally eliminates source country taxation on most interest. The Japanese Protocol would still tax contingent interest at a rate of 10%, providing similar treatment as under the 2006 US Model Treaty. Specifically, the Japanese Protocol provides that the source country will continue to retain taxing jurisdiction, at a maximum rate of 10%, on interest paid by the debtor or a related person that is determined by reference to: (i) receipts, sales, income, profits or other cash flow; (ii) any change in the value of any property; (iii) any dividend or partnership distribution or similar payment; or (iv) any other similar interest.

New definition of indirect interest in real property

Another important change in the Japanese Protocol is the alignment of the definition of an indirect interest in real property with the definition of a US real property interest (USRPI) under US law. The importance of this change is that it permits the US to fully apply the *Foreign Investment in Real Property Tax Act* (FIRPTA) by incorporating the definition of a USRPI into the treaty language. Essentially, FIRPTA allows for the taxation of capital gains on the sale of a USRPI by a foreign person. A USRPI includes not only a directly held real property interest as defined by general law, but also holdings in domestic corporations that are US real property holding corporations (USRPHC) at any point during the five years prior to the sale. The alignment of the Japanese Protocol's definition of a USRPI with the FIRPTA rules allows for the full application of the FIRPTA rules in the treaty context, including the five-year look back rule.

Elimination of special provision for teachers and researchers

The Japanese Protocol eliminated Article 20 of the US-Japan Treaty, which previously provided a two-year exemption for income derived by temporary visitors in teaching and research positions. This income now falls within the Article 14 provisions governing personal services. However, teachers and researchers who are entitled to Article 20 benefits at the time the Japanese Protocol enters into force, continue to be entitled to such benefits for the remainder of their two-year exemption period.

Mandatory arbitration

The Japanese Protocol introduces three new paragraphs to the existing text of Article 25 (Mutual Agreement Procedure) requiring mandatory binding arbitration when competent authorities are unable to reach agreement under the Mutual Agreement Procedure. This provision is expected to facilitate more efficient settlement of disputes between the competent authorities of the two countries.

Exchange of information

The Japanese Protocol updates Article 26, Exchange of Information, by providing that a treaty country may not decline to provide information solely because such information is held by a bank, other financial institution, or fiduciary, or because it relates to ownership interests in a person. The Japanese Protocol also adds a paragraph to protect attorney-client privilege.

Assistance in the collection of taxes

The Japanese Protocol replaces Article 27 of the US-Japan Treaty. Unlike the US-Japan Treaty provision, the Japanese Protocol provides for assistance in the collection of taxes above and beyond basic treaty-shopping cases. It is similar to the Spanish Protocol and the 2006 US Model Treaty, and makes clear that each treaty country will lend assistance to the other in the collection of taxes. It applies to all of the taxes listed in Article 2 as well as other taxes that are not covered by the US-Japan Treaty, including estate and gift taxes, consumption taxes, excise taxes and employment taxes.

Treaty countries are not required to assist each other, however, if the request is contrary to the US-Japan Treaty or any other agreement to which the treaty countries are parties. Further, claims are limited to: (i) claims that are not eligible to be resolved by mutual agreement under Article 25; (ii) claims that have been mutually agreed upon under Article 25 or, (iii) claims in which the company has terminated the mutual agreement procedure. Certain individual claims also fall within the scope of the agreement.

Entry into force and effective dates

The Japanese Protocol will enter into force on the date of the exchange of instruments of ratification. Japan has already taken the necessary steps to approve the Japanese Protocol.

An announcement is expected indicating when the exchange of instruments of ratification has taken place. The Japanese Protocol will have effect for withholding taxes for amounts paid or credited on or after the first day of the third month following the date on which the protocol enters into force. For all other taxes, the Japanese Protocol will apply to tax years beginning on or after of the first day of January following the date on which the protocol enters into force. The provisions regarding mandatory arbitration will have effect for cases that are under consideration by the Competent Authorities as of the date that the protocol enters into effect, as well as cases that come under consideration after the date the protocol comes into force. Finally, the provisions of the new Exchange of Information Article will have effect as of the date that the protocol comes into force.

Spain

On 14 January 2013, the US and Spain signed a new protocol amending the 1990 *Convention between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (US-Spain Treaty). The Spanish Protocol contains the most significant changes compared to the other three protocols and it generally modernizes several provisions of the US-Spain Treaty. Some of the key provisions of the Spanish Protocol include:

- Revised dividend withholding tax exemption
- New fiscally transparent entity rules
- General exemption from source-country tax on cross-border interest, royalties and capital gains
- A new comprehensive limitation on benefits (LOB) provision
- Mandatory binding arbitration procedures
- Revised exchange of information provisions

Dividend withholding tax exemption

The Spanish Protocol contains changes with regard to dividend taxation. First, the Spanish Protocol provides for a full exemption from tax on certain intercompany dividends, and dividends paid to certain pension funds. The full exemption applies only to a resident company that is a beneficial owner of the dividend and that has "owned directly or indirectly through one or more residents of either treaty country, shares representing 80% or more of the voting stock in the company paying the dividends for a 12-month period ending on the date on which entitlement to the dividend is determined."

Particular LOB requirements must be satisfied to qualify for the complete elimination of withholding tax on an intercompany dividend. Specifically, Article 10 provides the benefits of the zero rate only if the beneficial owner of the dividend: (1) satisfies the publicly traded company (or subsidiary of a publicly traded company) test; (2) satisfies the ownership-base erosion test, but only if it also satisfies the conditions of the active trade or business test with respect to the dividend; (3) satisfies the derivative benefits test; or (4) receives a competent authority determination.

Second, the Spanish Protocol provides for a 5% tax rate (reduced from 10%) for dividends paid to a company that directly owns at least 10% of the shares of the payor, and preserves the 15% tax in all other cases.

The Spanish Protocol provides a withholding tax exemption for a dividend paid to a pension fund that is a resident of either treaty country and is generally exempt from tax or subject to a zero rate of tax, provided that the dividend is not derived from the conduct of a trade or business by the pension fund or through an associated enterprise.

Finally, the Spanish Protocol retains the provision authorizing the branch profits tax but it specifically subjects such tax to the rate imposed on dividends. Even if the Spanish Protocol did not expressly subject the branch profits to the same rate as imposed on dividends, Internal Revenue Code Section 884(e)(2) requires the rate of that tax to be limited to the rate of US withholding tax provided by the treaty for dividends from a wholly-owned US subsidiary.

General exemption on cross-border interest, royalty, and capital gains

Consistent with the 2006 US Model Treaty, the Spanish Protocol generally eliminates source-country withholding tax on interest and royalty payments. In most cases, it also eliminates capital gains tax for dispositions by a resident of a treaty country of stock in a company resident in the other treaty country, although the sale of a direct or indirect interest in real property is still subject to tax, consistent with FIRPTA.

Fiscally transparent entity rules

The Spanish Protocol adds a new paragraph to Article 1 addressing fiscally transparent entities. Under the new provision, an item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either the United States or Spain, and that is formed or organized (a) in either the United States or Spain or (b) in a country

that has an agreement in force containing a provision for the exchange of information on tax matters with the treaty country from which the income is derived, will be considered to be derived by a resident of the United States or Spain (as the case may be) to the extent that the item is treated for purposes of the taxation law of United States or Spain (as the case may be) as the income of a resident.

The scope of the rules for income derived through fiscally transparent entities is narrower than the scope of those rules in the 2006 US Model Treaty. As described previously, the rules of the Spanish Protocol apply only if the fiscally transparent entity in question is formed or organized in one of the two treaty countries or in a country that has in force with the source country an agreement that includes a provision for the exchange of information on tax matters. Under the US Model Treaty, the residence of the fiscally transparent entity was not relevant to the treaty analysis.

New LOB provision

The Spanish Protocol also contains a comprehensive LOB provision that is similar to those of other US treaties and protocols, as well as with the 2006 US Model Treaty. Generally, the LOB article provides that a treaty-resident company will be eligible for benefits under the US-Spain Treaty only if it satisfies one of the following tests:

- The publicly traded company (or subsidiary of a publicly traded company) test
- The ownership-base erosion test
- The active trade or business test
- The derivative benefits test
- The headquarters company test
- A competent authority determination

The Spanish Protocol, however, has some unique modifications. For example, the derivative benefits provision contains a limitation not found in other bilateral treaties requiring, in case of indirect ownership, each intermediate owner between the income recipient and the treaty resident to be a resident of a member state of the European Union (EU) or NAFTA.[2] Also, in a departure from the 2006 US Model Treaty, the Spanish Protocol includes a headquarters company as a category of a qualified person. Additionally, the Spanish Protocol includes a "triangular" provision that may deny or limit benefits for amounts earned through a permanent establishment in a third jurisdiction.

Mandatory arbitration

The Spanish Protocol provides for mandatory and binding arbitration and incorporates provisions on procedural aspects of the arbitration process.

Exchange of information

The Spanish Protocol has also updated the exchange of information provisions to conform to the 2006 US Model Treaty and to OECD standards. Like the other three protocols, the Spanish Protocol requires the competent authorities of both countries to collect and exchange information that may be foreseeably relevant for carrying out the provisions of the US-Spain Treaty and respective domestic laws, for all taxes imposed by each country, and irrespective of the fact that the requested country may not need such information for its own tax purposes or that bank secrecy rules limit disclosure of such information. The Spanish Protocol also contains confidentiality provisions and provisions protecting each country from violating its own laws.

Entry into force and effective dates

The Spanish Protocol will enter into force three months after Spain and the US satisfy their respective internal ratification procedures and provide notification to each other, through diplomatic channels. Spain has already taken the necessary steps to approve the Spanish Protocol, and an announcement is expected indicating when the notification process has occurred and all applicable procedures have taken place in the US and Spain. For withholding taxes, the Spanish Protocol generally will apply to income derived on or after the date on which the protocol enters into force; for taxes determined by reference to a tax period, the protocol will apply for tax years beginning on or after the date that the protocol enters into force; in all other cases, the protocol will apply on or after the date that it enters into force.

Implications

Generally, all four protocols conform their respective provisions to the 2006 US Model Treaty. The Japanese and Spanish Protocols introduce additional changes that benefit cross-border investments between the countries. The exemption from withholding tax on interest in the protocols with Japan and Spain will be welcomed by taxpayers. Because the withholding tax rates under the Spanish Protocol now align with those in several other

US treaties with EU countries, it may now be possible for subsidiaries of Spanish-parented groups that are resident in those countries to qualify for the derivative benefits test under their treaties with the US. In addition, changes to the dividend article in the Spanish Protocol will make distributions more tax efficient. Also, the mandatory arbitration provisions included in the Swiss, Japanese and Spanish Protocols are anticipated to facilitate more efficient settlement of disputes. The updated exchange of information provisions are expected to provide the IRS with the data it needs to more effectively audit US taxpayers.

Taxpayers should carefully review the protocols, and the entry-into-force provisions, to determine whether and to what extent they are affected by these new developments, as well as the effective dates of the new provisions.

The approval of these protocols may signal more firm resolve to advance ratification of the other outstanding agreements (i.e., treaties with Hungary, Poland and Chile) in the near term, even if those agreements may require reservation language to account for the 2017 enactment of the base erosion anti-abuse tax in the *Tax Cuts and Jobs Act*.

Endnotes

1. Organisation for Economic Co-operation and Development.
2. North American Free Trade Agreement.

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EYG no. 003421-19Gbl

1508-1600216 NY
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