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In this issue

Treaty news

US Senate approves long-delayed tax protocols with Luxembourg, Switzerland, Japan and Spain

The US Senate on 16 and 17 July 2019 gave its advice and consent to approve the following four tax 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)

The protocols had been stalled in the Senate for nearly a decade. Senator Rand Paul (R-KY) had expressed concerns about privacy issues associated with the exchange of information provisions in the agreements.

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 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).

The Senate Foreign Relations Committee has not yet considered the new US tax treaties with Chile, Hungary and Poland, which may require reservations to account for enactment of the Base Erosion and Anti-abuse Tax (BEAT) in the 2017 *Tax Cuts and Jobs Act*. The four protocols approved by the Senate are narrower in scope and therefore were unaffected by the BEAT, so no reservations were required for them.

Luxembourg

The Luxembourg Protocol introduces a new information exchange article, incorporating the exchange of information standard reflected in both the 2008 OECD Model Treaty and the 2006 US Model Treaty. It 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 includes safeguards of the confidentiality of the information exchanged.

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

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.

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.

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 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

The Japanese Protocol generally 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

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.

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

The Spanish Protocol contains the most significant changes compared to the other three protocols and 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

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.

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.

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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., US tax 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 BEAT.

Altera requests Ninth Circuit rehearing in cost sharing case

On 22 July 2019, Altera Corp. filed a petition for a rehearing *en banc* with the Ninth Circuit. The petition requests that the Ninth Circuit rehear its challenge of the 2003 cost-sharing regulations and reverse the Ninth Circuit's opinion of 7 June 2019. The Ninth Circuit has 45 days to respond.

Digital taxation

US responds to France's new DST

The US Government upped the ante on France's new digital tax legislation in July when President Trump instructed US Trade Representative (USTR) Robert Lighthizer to initiate an investigation, under Section 301 of the *Trade Act of 1974*, of France's new Digital Services Tax (DST). The Office of the USTR announced it will hold a public hearing on the French DST on 19 August 2019. An adverse finding by the USTR could lay the groundwork for the US taking retaliatory action against France.

The tax was approved by the French Senate on 11 July, a week after it was passed by the lower house, the National Assembly. French President Emmanuel Macron signed the bill on 24 July 2019.

The French DST consists of a 3% levy applied to revenue derived from specific digital activities by companies with revenue of more than €750 million worldwide and €25 million in France. President Trump responded with a tweet on 26 July: "France just put a digital tax on our great American technology companies. If anybody taxes them, it should be their home Country, the USA. We will announce a substantial reciprocal action on Macron's foolishness shortly."

The press later quoted President Trump as saying the Administration was working on a new potential tax on French wine.

The US Government's position is that the French DST, as well as other similar unilateral measures under consideration, are disproportionately aimed at US multinational companies.

US government officials have repeatedly indicated the US prefers a multilateral solution to address the cross-border tax issues associated with the digitalization of the economy.

Bipartisan members of Congress have also expressed serious concern to Treasury over proposed unilateral digital tax measures.

In a 11 July letter to Senate Finance Committee Chairman Chuck Grassley (R-IA) and Ranking Member Ron Wyden (D-OR), Treasury indicated that "without action by the U.S. government, other countries will adopt taxes similar to the French DST." The letter went on to say that the Administration is "evaluating a range of potential U.S. responses to the adoption of a French DST."

Treasury and IRS news

IRS proposed regulations address passive foreign investment companies, clarify longstanding PFIC issues

On 10 July 2019, Treasury and the IRS issued proposed regulations (REG-105474-18) under the passive foreign investment company (PFIC) rules, providing guidance under Code Sections 1291, 1297 and 1298,

The Proposed Regulations:

- Clarify which exclusions from passive income under the Subpart F rules are relevant for PFIC purposes
- Specify that various look-through rules under the Subpart F definition of passive income are irrelevant for PFIC testing purposes, and that the look-through rules under the PFIC provisions are the only ones to be used for PFIC testing purposes
- Discuss in more detail the operation of the PFIC look-through rules for 25% subsidiaries, including 25% domestic subsidiaries, and payments from related parties
- Provide that an interest of less than 25% in a partnership is a passive asset and produces passive income for PFIC testing purposes
- Clarify application of attribution rules for purposes of determining whether a partner in a partnership is subject to the PFIC rules when the partnership owns PFIC stock through a non-PFIC foreign corporation
- Reduce the likelihood that a foreign real estate corporation will be a PFIC

The Proposed Regulations also offer guidance concerning the Section 1297(b)(2)(B) exception for insurance companies. (See a related article in this issue of the *Washington Dispatch*.)

The Proposed Regulations would apply to tax years of US persons that are shareholders in certain foreign corporations prospectively, beginning on or after the date of publication of the final regulations in the Federal Register. Until the regulations are finalized, taxpayers may generally rely on the Proposed Regulations for all open tax years as if they were final regulations, provided the regulations are consistently applied.

IRS releases final regulations addressing partnership allocations of creditable foreign tax expenditures

On 24 July 2019, the IRS published final regulations (T.D. 9871) under Section 704(b) relating to the allocation of creditable foreign tax expenditures (CFTEs) by a partnership (the 2019 final regulations). The 2019 final regulations adopt, with minor changes, the temporary (T.D. 9748) and proposed (REG-100861-15) regulations addressing CFTEs published on 4 February 2016 (the 2016 temporary and proposed regulations).

As background, CFTEs are generally foreign income taxes paid or accrued by a partnership that are eligible for a credit under Section 901(a) or a US income tax treaty. The IRS and Treasury determined that a partnership's allocation of CFTEs cannot have substantial economic effect within the meaning of Section 704(b) and the regulations. Thus, CFTEs must be allocated in accordance with the partners' interest in the partnership to be respected.

The existing regulations under Section 704(b) provide a safe harbor rule for a partnership to allocate CFTEs in a manner deemed to be in accordance with the partners' interest in the partnership. To apply the safe harbor, a partnership must: (i) determine the partnership's CFTE categories, (ii) determine the partnership's net income in each CFTE category, and (iii) allocate the partnership's CFTEs to each category. To satisfy the safe harbor, a partnership's allocations of CFTEs in a category must be in proportion to the allocations of the partnership's net income in the CFTE category.

US proposed regulations on PFICs have implications for insurance companies

The new IRS proposed regulations under the passive foreign investment company (PFIC) rules (Proposed Regulations) that were issued on 10 July 2019 are relevant for the insurance industry, particularly those concerning the Section 1297(b)(2)(B) exception for insurance companies (PFIC Insurance Exception). The PFIC Insurance Exception rules provide guidance regarding, *inter alia*, whether income of a foreign corporation is excluded from passive income because the income is derived in the active conduct of an insurance business by a qualified insurance corporation (QIC). The Proposed Regulations provide guidance on definitional and computational matters, including:

- Whether a foreign corporation is a QIC
- The definition of an insurance business
- Whether a QIC is engaged in the active conduct of an insurance business (the active conduct test)
- The determination of a QIC annual amount that is derived from the active conduct of an insurance business and excluded from passive income and passive assets, including a bright-line test for measuring the QIC's active conduct based on expenses (the active conduct percentage)
- The treatment of income and assets of certain look-through subsidiaries and look-through partnerships held by the QIC
- The treatment of income and assets of certain domestic insurance corporations owned by a tested foreign corporation as active for purposes of Section 1297(a), except for purposes of the attribution rule and determining whether a tested foreign corporation is a PFIC
- The prohibition of double counting of any item for purposes of applying the PFIC Insurance Exception rules

Comments to the Proposed Regulations are due on 9 September 2019. The IRS specifically requests comments on several topics included in the PFIC Insurance Exception rules.

The 2019 final regulations, like the 2016 temporary and proposed regulations, address: (i) the effect of a transferee partner's Section 743(b) adjustment on a partnership's net income in a CTFE category, (ii) the effect of certain allocations and guaranteed payments in computing a partnership's net income in a CFTE category, and (iii) certain disregarded payments within a partnership. The 2019 final regulations are effective 24 July 2019.

OECD news

G7 Finance Ministers support OECD two-pillar project to develop new rules for taxing multinational businesses

On 18 July 2019, at the conclusion of the two-day meeting in Chantilly of the G7 Finance Minister and Central Bank Governors group, France issued a Chair's Summary of the discussion at the meeting.

The Chair's Summary includes a section on international taxation, which focuses on the OECD/G20 Inclusive Framework project to address the tax challenges of the digitalization of the economy through revisions to existing profit allocation and nexus rules (Pillar 1) and development of new global minimum tax rules (Pillar 2).

The Chair's Summary indicates that the G7 Finance Ministers agreed that addressing these challenges is urgent and supported a two-pillar solution to be developed through the OECD workplan. The Chair's Summary notes that the new rules to be developed should be administrable and simple and that mandatory arbitration must be a component of this global solution.

IRS releases Section 965 transition tax information

The IRS on 16 July 2019 announced (IR-2019-128) the release of additional information to assist taxpayers in meeting filing and payment obligations for the Section 965 transition tax on untaxed foreign earnings. The IRS provided answers to questions on Section 965 to address questions that do not specifically relate to the 2017 and 2018 tax returns, including how to make subsequent installment payments when the transition tax is paid over eight years.

UN updates tax treaty negotiation manual

The 2019 United Nations (UN) tax treaty negotiation manual was updated to reflect changes in the 2017 UN Model Treaty to include changes that resulted from the OECD's Base Erosion and Profit-Shifting Project. The *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* which covers entitlement to treaty benefits was finalized and adopted during the 18th session of the UN Committee of Experts on International Cooperation in Tax Matters in New York, on 23-26 April 2019.

With respect to the Pillar 1 work on revising profit allocation and nexus rules, the Chair's Summary reflects the G7 group's discussion aimed at bridging the gap between the US "marketing intangibles" proposal and the "user participation" proposal favored by many European nations, including, in particular, the UK and France.

This potential unification of these alternative proposals is reflected in the G7 group's agreement that the OECD should work on an approach under which the new taxing rights under Pillar 1 would be determined "by reference to criteria reflecting the level of businesses' active participation in a customers' or users' jurisdiction, such as valuable intangibles or employment of a highly digitalized model." The concept of highly digitalized business models is referenced twice in the Chair's Summary, underscoring the importance of this aspect of the project to some European countries.

The Chair's Summary also states that the new rules for profit allocation and nexus should be administrable and simple, further noting that the G7 group agreed that, "in order to avoid double taxation and ensure the stability of the international tax system, robust and effective tax dispute resolution through mandatory arbitration must be a component of this global solution."

With respect to the Pillar 2 work on new global minimum tax rules, the Chair's Summary states that the G7 group agreed that a minimum level of effective taxation – "such as for example the U.S. Global Intangible Low-taxed Income (GILTI) regime" -- would contribute to ensuring that companies pay their fair share of tax. The Chair's Summary further notes that "the tax level to be set would depend on concrete design features of the rules."

OECD releases update on peer review of preferential tax regimes and no-or-only-nominal tax jurisdictions

On 23 July 2019, the OECD released an update on the results of the peer reviews of jurisdictions' domestic laws under Action 5 (harmful tax practices) of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project. The results were approved on 19 July 2019 during a meeting of the Inclusive Framework on BEPS.

The updated results cover 56 regimes, bringing the number of regimes that have been reviewed, or are under review, to 287. The assessments were undertaken by the OECD Forum on Harmful Tax Practices (FHTP). The update is an indication of the extent of the ongoing work aimed at ending harmful tax practices, through the requirement that all preferential regimes require adequate levels of substance. The peer review results will continue to be updated from time to time, as approved by the Inclusive Framework on BEPS.

Additionally, the OECD released the results of the review of the substantial activities factor for no or only nominal tax jurisdictions in connection with the domestic laws of the 12 jurisdictions that have been identified by the FHTP as being a no-or-only-nominal-tax jurisdiction.

The updated results of the review of the preferential tax regimes underscore the swift and geographically comprehensive progress being made on the implementation of BEPS Action 5 on harmful tax practices. They further affirm the actions of Inclusive Framework on BEPS members in making significant commitments to change their tax rules. The release of the updated results also provides information to taxpayers on the status of preferential regimes in jurisdictions in which they may operate.

Puerto Rico's new Incentives Code includes various tax incentives for investments in opportunity zones

On 1 July 2019, the Governor of Puerto Rico signed into law *Act 60*, also known as the Puerto Rico Tax Incentives Code (Incentives Code), which consolidated dozens of tax decrees, incentives, subsidies and tax benefits in a single statute, including *Act No. 21* of 14 May 2019, also known as the "*Development of Opportunity Zones of Economic Development Act of Puerto Rico of 2019*" (the Act). Through the enactment of the Incentives Code, the Act was repealed. However, most of the provisions of the Act establishing various tax incentives in Puerto Rico for investments in qualified opportunity zones were codified in the Incentives Code.

Approximately 95% of the territory of Puerto Rico is considered a qualified opportunity zone under the parameters established by the US Federal Government. The opportunity zone provisions under the Incentives Code are intended to align local tax statutes with the benefits afforded under the US *Tax Cuts and Jobs Act of 2017*. In addition to the preferential income tax treatment, the local statute provides for reductions in other local taxes and a transferable tax credit of up to 25% of cash contributed. These provisions, among other benefits such as the expedited permitting process, are intended to make Puerto Rico's market more appealing for investors looking to take advantage of opportunity zones.

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