Reduced Withholding Taxes Among Benefits of U.S. Tax Treaty Changes Taking Effect

Income tax treaties with two key U.S. trading partners received long-awaited updates that went into effect as early as August 30, the Treasury Department announced last week. The two protocols, amending U.S. treaties with Japan and Spain, were negotiated during the Obama administration but had been held up for years in the Senate over taxpayer privacy concerns raised by Sen. Rand Paul (R-KY). The Senate finally approved the protocols, along with those affecting treaties with Switzerland and Luxembourg, earlier this summer.

U.S. companies with affiliates in Spain and Japan should consult their tax advisors to determine any potential opportunities the new rules may create on structuring cross-border payment flows or resolving competent authority matters.

Japan

The protocol makes several taxpayer-favorable changes to the withholding tax rules that apply to cross-border payments, broadening the availability of exemptions on both dividends and interest. Generally speaking, all interest payments flowing between the contacting states will now be exempt from source-country withholding taxes, subject to anti-abuse rules that apply in the case of contingent payments and payments on interests in real estate mortgage investment conduits, or "REMICs." In addition, for purposes of qualifying for zero-rate withholding on dividend payments, the protocol reduces the ownership requirement from "more than 50 percent" to "at least 50 percent," and drops the requisite ownership period from twelve months to six.

The new protocol also adds a mandatory arbitration provision to the U.S.-Japan treaty, thus creating a venue for gridlocked competent authority disputes, which will kick in as early as two years after a case has been initiated.

The changes to withholding taxes will go into effect on November 1, 2019, and the mandatory arbitration provisions became effective on August 30.

Spain

The protocol substantially updates the withholding tax provisions of the U.S.-Spain treaty, bringing its rules in line with tax agreements between the U.S. and most other E.U. countries. The treaty will now provide an exemption from dividend withholding tax where an eighty percent ownership test is met for twelve months, and a 5 percent dividend withholding rate in cases of 10 percent ownership. All other dividends will be subject to a 15 percent withholding tax. (Previously 10 percent was the best rate one could achieve on dividends between the two countries.)

Interest and royalty payments between payors in the two countries will also now be largely exempt from withholding tax, subject to the same restrictions on contingent interest and REMIC payments in the U.S.-Japan agreement noted above.

Notably, the protocol also updates the treaty's limitation-on-benefits rules to bring them more in line with recent U.S. model treaties; taxpayers should consult their outside tax advisors to ensure they will qualify for the newly reduced rates of withholding taxes.

The Spain instrument provides for mandatory arbitration on competent authority matters and lowers the bar – from "necessary" to "foreseeably relevant" – to the sharing of taxpayer information between the two nations.

The changes to the U.S.-Spain tax treaty will go into effect on November 27, 2019.

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