Reservations Leave Lasting Questions for Treaty Policy

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Practitioners are curious about the interaction of potential treaty override provisions and foreign tax credit limits on relief from double taxation after the Senate included reservations in the Chile-U.S. tax treaty.

The Chile-U.S. treaty was signed in 2010, but spent more than a decade in the Senate because Sen. Rand Paul, R-Ky., blocked it over taxpayer privacy concerns, claiming the standard for information sharing is too lax and easily allows for potential oversharing. In June the Senate approved on a 95-2 vote a resolution for ratification and sent the treaty to President Biden's desk. While the Senate doesn't ratify treaties, it takes up a resolution of ratification — which requires a two-thirds vote of approval — to allow the president to proceed with ratification.

Because the Senate Foreign Relations Committee inserted two reservations in May 2022, the treaty will have to be sent back to the Chilean Congress for approval before it can enter into force.

The first reservation affirms the right of the United States to impose tax under section 59A on a U.S. resident company or the profits of a Chilean resident company that are attributable to a permanent establishment in the United States. Under section 59A, the base erosion and antiabuse tax operates as a minimum tax — 5 percent for 2018, 10 percent for 2019-2025, and 12.5 percent thereafter — on related-party payments. The BEAT is calculated on the excess of modified taxable income over a taxpayer's regular tax liability, reduced by some types of credits.

The second reservation amends language on the relief from double taxation to say that U.S. citizens or residents who pay Chilean income tax may credit that tax against U.S. tax on income. It also says that a U.S. company owning at least 10 percent of the value of the shares of a company that is a resident of Chile and from which the U.S. company receives dividends may deduct the dividends when computing the taxable income of the U.S. company.

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Ignacio Gepp of Puente Sur told *Tax N*

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should not be an obstacle to its approval." He noted that "Chile has been pushing a tailor-made exception for U.S. investors capping their overall tax burden on Chilean-source capital income to 35 percent, the same as if the treaty was in effect."

The BEAT Reservation

The same reservations were included in the Croatia-U.S. tax treaty, which was signed on December 7, 2022. However, they were not included as stand-alone provisions but were integrated into the treaty language. The treaty has not been passed along for Senate consideration yet. When it does progress, it will include Treasury's technical explanation, which will provide insight into the policy considerations surrounding the integration of the reservations and what portions may become common treaty practice in the future.

The reservations placed in the Chile tax treaty and their integration in the Croatia treaty represent some of the first deviations to the 2016 U.S. model treaty after the changes made to the IRC by the 2017 Tax Cuts and Jobs Act. The language of the BEAT reservation in the Chile tax treaty corresponds closely to the language in the Croatia-U.S. treaty, John Harrington of Dentons noted. He said that the reservations likely reflect the current U.S. treaty policy and predicted that they will also be part of Treasury's future negotiations.

The inclusion of the reservations may finally bring the end to an ongoing debate on whether the BEAT represents a treaty violation, a treaty override, or an overhyped conflict that never got a chance to come to fruition.

Dave Noren of McDermott Will & Emery told *Tax Notes* that while "the intent was that the BEAT should apply in a tax treaty context, there was enough concern about the issue to specifically address the point in the reservation for Chile and in the treaty with Croatia."

That clarification raises more questions about how the BEAT should interact with other, often older, treaties and whether an argument could be made "that under them, there is a treaty-based exemption under the nondiscrimination or FTC article for BEAT," Noren said.

While "I would be a little surprised if there were controversies with prior treaties . . . it shows how untidy the coordination with BEAT and treaties has been," Noren said.

Relief From D

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The relief from double taxation reservation highlights the need for treaty language to reflect the changes made by the TCJA, which removed the ability to claim indirect FTCs under section 902, Noren said.

The final Senate Foreign Relations Committee report on the Chile-U.S. treaty highlighted the changes and included a disclaimer that “the terms of the reservation and this report are not intended to create any inferences regarding the interpretation of existing tax treaties.” It also included a declaration that "further work is required to fully evaluate the policy of 'Relief From Double Taxation' articles in future tax conventions and their relationship to U.S. domestic tax laws in light of the substantial changes made" by the TCJA.

The declaration is “likely acknowledging the position that existing U.S. tax treaties continue to provide indirect tax credits after the TCJA, an issue that has additional significance after the new limitations on creditability imposed in the 2022 final foreign tax credit regulations,” said Amanda Varma of Steptoe & Johnson LLP.

The 2022 FTC regs (T.D. 9959) covered the first tranche of tax rules. They redefined foreign income taxes, updated the definition of a tax in lieu of an income tax, and created an attribution requirement for deeming a tax creditable for U.S. tax purposes. Practitioners have criticized the regs, noting that the sourcing rules for royalties will allow an FTC only if a country has sourcing rules that are similar to the U.S. tax rules. Some practitioners also said the U.S. treaty network could provide relief.

The changes in acquiring indirect FTCs present a slew of questions because the final regs added new restrictions on the creditability of foreign taxes. That in turn raises new issues when trying to claim an indirect FTC under existing code sections like subpart F, global intangible low-taxed income, and section 960, Noren said.

The proposed FTC regs (REG-112096-22) would alleviate some of the concerns through a single-country license rule that deems royalty payments in reference to a written license agreement that limits use to a single foreign country imposing the tested foreign tax as qualifying as a deemed creditable tax even where the sourcing rules may not follow the IRC.

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The Croatia treaty slightly altered a small provision in article 23 (relief from double taxation), changing the parenthetical that clarified the limitation of the article to read “as it may be amended from time to time.” In the 2016 U.S. model treaty and the Chile treaty, that provision reads, “As it may be amended from time to time without changing the general principle hereof.”

Noren said the change in language may indicate that it's possible to apply a limitation that didn't exist when the treaty was negotiated, as long as it's “in the ballpark of the concept of double taxation relief under general treaty principles.” He added that “in edge cases, this could be important” but that overall, it likely won’t be critical for taxpayers requesting FTCs through the treaty provision or with the treaty country.

Because there is no longer direct statutory support under section 902 for receiving an FTC, the reservation is useful for situations when “you might encounter an issue under the FTC regs where it might be nice to rely on a treaty to receive an indirect FTC,” Noren said.

Harrington said he expects to see more explanations for the reservation when the Senate releases the technical explanation accompanying the Croatia treaty. The explanation behind the FTC language changes will be interesting because it is unclear how the double tax provisions operate regarding indirect FTCs, he added.

Future of Treaty Negotiations

The last time contentious reservations were used and finalized in U.S. treaty negotiations was in 1999. The Senate altered the information exchange provisions of the Italy-U.S. tax treaty and included a reservation that changed the main purpose test for withholding provisions. President Clinton signed the ratification instrument in December 1999, but the treaty did not enter into force until December 16, 2009.

The Italian treaty reservations covered potential policy choices and concerned “the policy of whether we adopted a limitation on benefits or a principal purpose type of test to protect the treaty from treaty shopping,” while the Chile reservations “relate to direct changes and provisions of U.S. tax law,” said Quyen Huynh of KPMG. The reservations bring the treaty in line with U.S. tax law, and “I would think that Chile would appreciate the change and how long this treaty has b

quickly, but it's hard to predict what C

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The ratification process — even with the reservations — is good news because it demonstrates to treaty partners that the work they put into negotiations is worthwhile, said Arlene Fitzpatrick of EY.

While the Chile treaty ultimately required Senate floor time to pass, which isn't always ideal, its passage shows that "with enough of a push from the business community and careful thought towards legislative strategy and timing, the Senate can still clear tax treaties without the ability to use unanimous consent procedures," Noren said.

"This gives us some reason to believe that some of the tax treaty instruments currently pending might actually get finished and could put the wind in the sails with ongoing tax treaty negotiations and will show treaty partners that, notwithstanding dysfunction, we are able to continue to do business in the tax treaty area," Noren added.

Others were less optimistic. Varma said that "the Senate's approval of the U.S.-Chile treaty is a welcome recognition of the role of U.S. tax treaties in promoting cross-border investment. However, it appears that the recent impediments to timely Senate consideration remain, which suggests that we are likely to see more of the same: Treasury will continue to negotiate tax treaties and the Senate's consideration of them will be protracted."

The United States is negotiating with Israel, and officials have indicated that the talks will likely result in a new treaty. The 1975 Israel-U.S. treaty has been amended by protocols twice (1980 protocol; 1993 protocol).

Several other pending treaties, such as the ones with Poland and Vietnam, will need updates taking the TCJA changes into account before they can be passed to the Senate for consideration. In September 2022 Jose Murillo, then-Treasury deputy assistant secretary for international tax affairs, said that negotiations on new treaties with Romania and Norway were complete, but neither treaty has been signed because they predate the TCJA and targeted reservations must be drafted.

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