U.S. INCOME TAX TREATY UPDATE

Authors
Nina Krauthamer
Wooyoung Lee

Tags
894A
Chile
Croatia
Hungary
Income Tax Treaty
Israel
Norway
Poland
Romania
Taiwan
Vietnam

INTRODUCTION

A robust and extensive income tax treaty network has worked to the advantage of U.S. corporations and individuals. But for years, the tax treaty approval process of the U.S. Senate has been stymied by Senator Rand Paul. His opposition arises because of privacy concerns stemming from the Foreign Account Tax Compliance Act, also known as F.A.T.C.A., which was passed in 2010 and his concern that these treaties will lead to unchecked intergovernmental information sharing and snooping.

Historically, income tax treaties were ratified by unanimous consent. Senator Paul's decision not to permit ratification by unanimous consent was essentially a threat to filibuster income tax treaties brought to the floor of the Senate for a vote.

In the summer of 2019, Senate Majority Leader Mitch McConnell successfully brought treaties with Spain, Switzerland, Japan, and Luxembourg to the floor, just as the Senate was about to leave Washington for scheduled recess. Affirmative votes from two-thirds of the senators present are required for a treaty resolution to be approved.

This article addresses recent developments related to the income tax treaty network of the U.S.

TAIWAN

Early this year, Senate Foreign Relations Committee Chair Senator Robert Menendez and Senator Jim Risch proposed a bill that embodies the Taiwan Tax Agreement Act of 2023, the equivalent of a U.S.-Taiwan tax treaty. Given Taiwan's unique status with China, the United States and Taiwan cannot enter into a treaty, but this bill was designed to contain the key features of an income tax treaty. The bill would facilitate investment between the United States and Taiwan in key strategic industries such as semiconductors. On June 1, Senator Paul held up consideration of legislation by offering a reservation clause as an amendment. This was rejected by most of the other members of the Committee. The Senate Foreign Relations Committee finally approved the bill on July 13.[1]

In the meantime, on July 12, the leaders of the Senate Finance Committee and House Ways and Means Committee unveiled a bipartisan discussion draft of legislation aimed at reducing double taxation for employees and businesses involved in U.S. and Taiwan cross-border investment.[2] Again, the legislative proposal was intended to achieve the same goals as an income tax treaty. This legislation would

[1] See here.

[2] See here.

 © Ruchelman P.L.L.C., 2023. All rights reserved.

have bypassed the Senate Foreign Relations Committee to bring the legislation directly to the floor of the Senate. Senator Paul is a member of the Foreign Relations Committee, but not the Finance Committee.

The bill aims to significantly reduce withholding taxes on dividends, interest and royalties paid on cross-border investments, lower barriers for smaller businesses to make such investments, reduce complexity for dual residents, and unlock deeper economic cooperation with Taiwan. Nonetheless, the reduced rates of withholding tax would be significantly greater in several instances than rates on comparable categories of income that are in effect in recent income tax treaties of the U.S.

The legislation would add new Code §894A, having provisions fall into four primary categories.

Reduction of Withholding Taxes

A reduced rate of withholding tax would apply to certain income from U.S. sources – interest, dividends, royalties, and certain other comparable payments, such as dividend equivalent amounts – received by qualified residents of Taiwan. Instead of the 30% withholding tax generally imposed on U.S. source fixed and determinable, annual and periodic income received by nonresident, noncitizen individuals and foreign corporations, lower rates would apply. Interest and royalties would be subject to a 10% withholding tax. Dividends generally would be subject to a 15% withholding tax, which would be reduced to 10% for direct investment dividends where a corporation resident in one country owns at least 10% of the shares of stock in a corporation resident in the other country. The lower withholding tax rates on dividends would not apply in certain circumstances to dividends from a R.E.I.T., certain dividends from a R.E.M.I.C., amounts subject to F.I.R.P.T.A., and payments to or from inverted companies.[3]

Application of Permanent Establishment Rules

The threshold for imposing tax on the effectively connected income of a Taiwanese resident corporation will not be determined in accordance with Code §§864 and 882. Rather, the threshold will be raised to the permanent establishment standard in income tax treaties.

Income From Employment

No tax will be imposed on qualified wages paid to a qualified resident of Taiwan who either (i) is not a U.S. resident or (ii) is employed as a member of the regular component of a ship or aircraft operated in international traffic. Qualified wages are those wages, salaries, or similar remunerations with respect to employment involving the performance of personal services within the United States when the wages (a) are paid by, or on behalf of, any person other than a U.S. person and (b) are not borne by a U.S. permanent establishment of any person other than a U.S. person.

Several categories of qualified wages are not given favorable tax treatment. These include (i) directors' fees, (ii) income derived by entertainers or athletes from their performance of services as such in the U.S., (iii) income derived as a student or

---

[3] Joint Committee on Taxation, *Description of the Chairman's Mark of the "United States-Taiwan Expedited Double-Tax Relief Act,"* Sept 12, 2023, JCX-37-23.

© Ruchelman P.L.L.C., 2023. All rights reserved.

trainee, (iv) pensions, or (v) amounts paid with respect to employment with the U.S., any State, or any U.S. possession.

Qualified Residents of Taiwan, Including Rules for Dual Residents

A qualified resident of Taiwan generally is any person who is liable for tax to Taiwan because of such person's domicile, residence, place of management, place of incorporation, or any similar criterion, and is not a U.S. person. For corporations, a qualified resident of Taiwan must also meet the limitation on benefits requirements to be a beneficiary of the provision.

The provision contains rules to determine whether certain dual resident individuals who are subject to residence based tax by both Taiwan and the U.S. are to be treated as qualified residents of Taiwan. The tie-breaker rules look to factors such as where a permanent home exists, where personal and economic relations are closer, and other factors.

All the above changes would become effective if and when Taiwan grants reciprocal benefits to U.S. persons, as determined by the Treasury Secretary, in consultation with the American Institute in Taiwan and the Taipei Economic and Cultural Representative Office in the United States.

The Senate Finance Committee approved the bill on September 14, 2023. The bill appears to have administration support.[4] The legislation builds on a trade bill with Taiwan that was enacted in August this year.[5]

The outlook for passage is complicated by the competing legislative bills in the Senate, reflecting a "turf war" between committees having jurisdiction over tax matters and other committees having jurisdiction over treaties. The leaders of the Senate Finance Committee and House Ways and Means Committee have asserted jurisdiction as their proposal constitutes tax legislation. However, it has been reported that the draft has rankled some members of the Senate Foreign Relations Committee, because the tax agreement is the equivalent an income tax treaty, which would be within the purview of their committee.[6]

CHILE

At the beginning of June, the Senate Foreign Relations Committee favorably reported out the Chile-U.S. Income Tax Treaty by a vote of 20 to 1. This was the fourth time the committee has approved the treaty over the last nine years. On June 22, 2023, the full Senate approved a resolution to advance the Chile-U.S. treaty by a vote of 95 to 2. This is only the third treaty with a Latin American country, Venezuela and Mexico being the other two countries. In addition, an income tax treaty exists with Barbados which is located off the coast of Venezuela.

Under the Constitution's supremacy clause (Article VI, section 2), a U.S. treaty enjoys equivalent legal standing to U.S. domestic law.[7] Code Section 894(a) provides

---

4 See here.

5 See here.

6 See here.

7 *Foster v. Neilson*, 27 US (2 Pet.) 253, 314 (1829).

© Ruchelman P.L.L.C., 2023. All rights reserved.

that the tax code shall be applied with “due regard” to the nation’s treaty obligations. Code Section 7852(d)(1) assigns equal weight to these two sources of law, so that neither is presumed to control the other.

A later-in-time rule is applied to resolve any conflicts. The U.S. Supreme Court has ruled that in such cases, in general, effect should be given to the legislative enactment if it conflicts with an earlier treaty obligation, but to a treaty obligation if the treaty was ratified subsequent to the conflicting legislation, because “the last expression of sovereign will must control.”[8] Treaty provisions can override previously enacted legislation, and the U.S. Congress can override treaty provisions by subsequent legislation. However, a number of courts have held that for legislation to override a treaty obligation, a clear expression of Congressional intent must be present.[9]

“There is some thought by tax professionals (not universally shared) that the new treaty might have the effect of overriding recent tax legislation.”

There is some thought by tax professionals (not universally shared) that the new treaty might have the effect of overriding recent tax legislation. The Senate Foreign Relations Committee report on the Chile-U.S. treaty, however, contains two reservations, designed to implement the substantial changes made to the international provisions of the Internal Revenue Code by the Tax Cuts and Jobs Act in 2017 (the “2017 Legislation”).

The first reservation clarifies that nothing in the agreement prevents the imposition of the Base Erosion and Anti-Abuse Tax (“B.E.A.T.”) under Code Section 59A.

The second reservation changes Article 23 (Relief from Double Taxation) with a modified provision in order to account for the repeal of the indirect foreign tax credit rules of Code §902 and the implementation of the current dividends received deduction under Code §245A in its place. When addressing the effect of the repeal of the indirect foreign tax credit on provisions of existing income tax treaties, the Foreign Relations Committee Report declined to take a position, stating as follows:

> The terms of the reservation and this report are not intended to create any inferences regarding the interpretation of existing tax treaties to which the United States is a party.[10]

Chile approved the treaty as signed several years ago. It must now approve and ratify the reservations adopted by the U.S. Senate.

POLAND, VIETNAM, AND CROATIA

An income tax treaty with Croatia was signed on December 7, 2022 but has not been sent to the Senate for consideration. The same reservations described above in the case of the treaty with Chile were integrated into the language of the Croatia treaty.

Treasury Officials have stated that in the case of new treaties with Poland and Vietnam, targeted reservations must be drafted due to the passage of the 2017 Legislation after the proposed treaty was signed.[11]

---

[8] *Chae Chan Ping v. United States (The Chinese Exclusion Case),* 130 US 581 (1889).

[9] *Cook v. United States*, 288 US 102, 120 (1933).

[10] See here.

[11] See here.

© Ruchelman P.L.L.C., 2023. All rights reserved.

HUNGARY

On July 8, 2022, the United States notified Hungary of its termination of the Hungary-U.S. Income Tax Treaty, which was in force since 1979. Termination is effective as of January 8, 2023, six months from date of notification. The effect of the termination is as follows:

- Reduced withholding tax benefits will cease to have effect on January 1, 2024.
- In respect of other taxes, the Convention will cease to have effect with respect to taxable periods beginning on or after January 1, 2024.

It is widely thought that termination of the treaty resulted from Hungary's policy of attracting investment through a low-tax economic policy:

- Hungary opposed the E.U.'s adoption of the O.E.C.D. Pillar 2 global minimum tax rules and delayed its adoption by E.U. Member States.
- Hungarian domestic law does not contain provisions for the imposition of withholding tax on payments to nonresident corporate entities.
- The nominal rate of corporate tax in Hungary is below 10%.

A replacement treaty between the U.S. and Hungary was signed in 2010. Its fate is uncertain. Commentators have noted that in most cases, the termination of the treaty would not result in a significantly higher tax burden for US companies with investments in Hungary, although there would be exceptions.

FUTURE DEVELOPMENTS

Treasury officials have indicated that the U.S. is negotiating a new income tax treaty with Israel. Although negotiated in 1975, reflecting the peace accords between Egypt and Israel, the treaty did not come into effect until 1995, after protocols were signed in 1980 and 1993.

Negotiations on new income tax treaties with Romania and with Norway are complete, but await acceptable reservations as to the B.E.A.T. provisions and to the language of the avoidance of double taxation article.[12]

---

[12] See here.

© Ruchelman P.L.L.C., 2023. All rights reserved.