Global View

Brexit Impacts Treaty Benefits Analysis

*By Robert J. Misey, Jr.**

Many U.S. tax professionals have ignored Brexit, believing Brexit is a problem between only the United Kingdom and the European Union. However, Brexit can be a problem for U.S. subsidiaries of foreign corporations that have U.K. shareholders. Many of the foreign corporations in these structures no longer qualify for treaty benefits.

U.S. payers of dividends, interest, and royalties to foreign persons must withhold 30% for the IRS.[1] If the payee is a resident of a treaty country, there should be a reduced rate of withholding tax. However, the limitation of benefit articles in U.S. tax treaties requires foreign corporations to have more substance before receiving treaty benefits, such as reduced withholding on U.S. payments of dividends, interest, and royalties.

All U.S. tax treaties with our European trading partners provide for satisfaction of limitation of benefits under one of the following alternatives:[2] public ownership, stock ownership/base erosion (at least 50% of the shares are owned by a resident of the treaty country and no more than 50% of deductible payments are made to non-treaty residents), or an active trade or business. Most recently negotiated tax treaties with our European trading partners contain an additional alternative to obtain treaty benefits—the derivative benefits provision. A foreign corporation generally satisfies the derivative benefits provision if, *inter alia,* 95% of the shares of the foreign corporation are owned by equivalent beneficiaries. Brexit causes problems because equivalent beneficiaries, as defined in the various treaties to include U.K. residents, may no longer own 95% of the foreign corporation.

Consider this example. A U.K. individual and a German individual decide to form a joint venture to sell widgets in the United States. Seeking to avoid direct ownership of shares of a U.S. corporation so that the business is not an asset of a U.S. estate, the U.K. individual and the German individual form GerCo, a German company that will hold the shares of the U.S. corporation. As the brains behind the operation, the U.K. individual receives a guaranteed management fee, which will exceed 50% of the income of GerCo. The U.S. corporation pays a dividend to GerCo (*see* Figure 1).

GerCo is not entitled to reduced withholding when evaluating the first three alternatives to satisfy limitation of benefits in the German-U.S. tax treaty. First, GerCo is not publicly held. Second, more than 50% of GerCo's deductible payments are made to the U.K. individual so the base erosion test of the stock ownership/base erosion provision fails. Third, GerCo is not conducting an active

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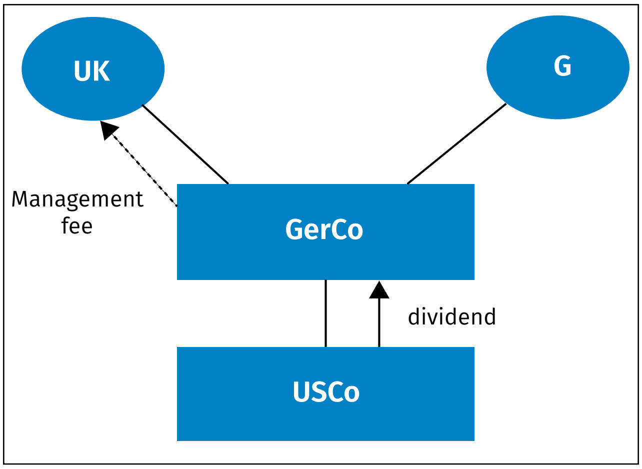
FIGURE 1.



trade or business. The only alternative is for GerCo to satisfy the derivative benefits provision, which requires an inquiry into equivalent beneficiaries.

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The German-U.S. tax treaty, which is similar to many other U.S. tax treaties with European countries, defines an equivalent beneficiary as a resident of a member of either the European Union or the European Economic Area.[3] In the past, both the U.K. individual and the German individual would be equivalent beneficiaries because both the United Kingdom and Germany were part of the European Union. As a result, more than 95% of GerCo's shareholders were equivalent beneficiaries and treaty benefits may have been derived.

As a result of Brexit, GerCo no longer satisfies the equivalent beneficiaries' definition. With the United Kingdom leaving the European Union (and appearing not to seek entrance to the European Economic Area), only 50% (the German individual's shareholder percentage) represents shares owned by an equivalent beneficiary, which falls below the 95% threshold. Accordingly, GerCo does not satisfy the derivative benefits provision and the U.S. subsidiary should withhold 30% of the dividend (the non-tax treaty withholding rate) for the IRS.

This scenario is not unique to joint ventures involving German corporations that own U.S. subsidiaries. Similar equivalent beneficiary definitions are in the derivative benefits provisions in U.S. tax treaties with Denmark, Finland, France, Germany, Iceland, Ireland, Luxembourg, the Netherlands, Sweden, and the United Kingdom. Similar equivalent beneficiary definitions are in proposed, but not yet enacted, derivative benefits provisions of U.S. tax treaties with Belgium, Hungary, Poland, and Spain.

Tax advisors often ignore limitation on benefits articles when advising U.S. payers of items of income to foreign corporations. However, with Brexit, it is time to examine the applicability of any payments to a European corporation with U.K. shareholders.

ENDNOTES

* Robert Misey is the author of the treatises *U.S. Taxation of International Transactions* and *Federal Taxation: Practice and Procedure.*

1 Code Secs. 1441 and 1442.

2 *See*, for example, Article 28 of the German-U.S. Tax Treaty.

3 Article 28(8)(e)(aa)(A) of the German-U.S. Tax Treaty.