

Newsalert

International Tax Services – U.S. Tax Treaty Developments

January 20, 2009

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New U.S. Protocol with France Signed

The New Protocol Provides for Tax Exemption for Certain Cross-Border Dividends and Royalties with Retroactive Application

Background

The United States and France signed a protocol on January 13, 2009, that, on ratification, will update the current U.S.-France income tax treaty (the "Protocol"). The Protocol makes several significant changes to the existing treaty, including elimination of source-country taxation of certain parent-subsidiary dividends, elimination of source-country taxation of cross-border royalty payments, and strengthening the limitation on benefits ("LOB") provision. Further, the Protocol provides for mandatory arbitration of certain cases that cannot be resolved by the competent authorities within a specified period of time, and it updates the rules for exchange of taxpayer information between the tax authorities of each country.

The current U.S.-France income tax treaty, which was signed on August 31, 1994, and amended by an earlier protocol of December 8, 2004, provides a maximum 15% tax rate on dividends received by a resident of a Contracting State and a 5% maximum rate for dividends received by a company that owns at least 10% of the dividend-paying company. These 5% and 15% tax rates on dividends are maintained in the new Protocol. However, the new Protocol provides an exemption from taxation for dividends that are distributed to a beneficial owner that is a resident of one of the treaty countries and has owned (directly or indirectly), through one or more residents of either Contracting State, shares representing 80% or more of the voting power in the company paying the dividends, provided certain other conditions are met.

The modernizing of the U.S.-France income tax treaty through the Protocol brings the treaty into closer conformity with current U.S. tax treaty policy. The Protocol is the fourth agreement signed by the United States in the past two years to contain a mandatory arbitration provision, following pacts with Belgium, Germany, and Canada. The Protocol was accompanied by a memorandum of understanding setting out procedures for the arbitration.

Residency and Rules for Fiscally Transparent Entities

The Protocol expands the list of French investment vehicles that are automatically defined as residents. In addition to SICAVs (*sociétés*

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d'investissement à capital variable) that are included in the current treaty, SIICs (*sociétés d'investissement immobilier cotée*) and SPPICAVs (*sociétés de placement à prépondérance immobilière à capital variable*) are expressly included as residents, thereby entitling these entities to treaty benefits if they are eligible under the LOB article.

Observation: For one of the above investment vehicles to qualify under the LOB article, more than half the interests in the entity must be owned (directly or indirectly) by residents of one of the Contracting States that are individuals, governments (or governmental entities), companies meeting the publicly-traded test of the LOB article, or qualifying pension funds or charitable organizations. In the case of a U.S. investment vehicle, U.S. citizens also are qualifying owners. In the case of indirect ownership, each intermediate entity must be resident in the Contracting State in which the investment vehicle is resident.

The Protocol also adds/modifies the rule, now commonly found in U.S. tax treaties, for determining who is considered to be the beneficial owner of income derived through an entity that is fiscally transparent under the laws of either Contracting State. However, the rule applies only to entities formed under the laws of either Contracting States or under the laws of a third state if that state has an exchange of information agreement in place with the source country.

Observation: The Protocol revises the Miscellaneous Provisions article of the treaty to provide that the above rule regarding income derived through a fiscally transparent entity does not apply with respect to entities that have their place of effective management in France.

The revisions to the Residency Article also include a specific fiscal transparency rule for U.S. source income derived through certain "qualified" French partnerships.

Elimination of Tax on Parent-Subsidiary Dividends

The Protocol limits the tax on dividends as follows:

- The maximum source country tax on dividends for a beneficial owner that is a company that controls the distributing corporation was 5%, but source country taxation has been eliminated entirely if the beneficial recipient of the dividend is a company that has, for at least the last 12 months, owned, directly or indirectly,

through one or more residents of either Contracting State, at least 80% of the voting power in the company paying the dividend and the recipient meets one of the following LOB criteria:

- the publicly-traded test,
 - the subsidiary of a publicly-traded company,
 - the ownership/base erosion test and the trade or business test, or
 - the discretionary grant of benefits.
- Dividends paid by either a U.S. Regulated Investment Company (RIC) or a SICAV are subject to the 15% rate of tax on dividend distributions;
 - Dividends paid by either a U.S. Real Estate Investment Trust (REIT), a SIIC, or a SPPICAV are subject to a 15% tax rate on dividend distributions if:
 - (i) the beneficial owner is an individual, pension fund or other retirement vehicle owning less than 10% of the REIT, SIIC or SPPICAV,
 - (ii) the dividends are paid with respect to a class of shares that are publicly traded and the recipient holds less than 5% of any class of shares, or
 - (iii) the beneficial owner of the dividend owns less than 10% of the REIT, SIIC, or SPPICAV;
 - Dividends paid by either a REIT, SIIC, or SPPICAV that do not fall into one of the categories above are subject to taxation by the source country without limitation.

Observation: The Protocol retains the rule in the current treaty that a U.S. corporation claiming the limitation of the tax on dividends to 5% must directly own 10% or more of the shares of the French distributing company. In the case of dividends received by a French company, the 5% limitation will apply based on either direct or indirect ownership of the U.S. distributing company.

Tax Exemption for Royalties

The Protocol eliminates source country taxation of royalties beneficially owned by a resident of the other contracting state.

Updated Limitation on Benefits Provision

The updated LOB article modernizes the LOB provision between the United States and France and brings it into conformity with current U.S. income tax treaty policy. This revised LOB provision is significantly more restrictive than

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the prior LOB provision.

In order for a company that is a resident of either country to claim the benefits of the treaty, the company must meet one of the following criteria:

- *Publicly Traded Test* — The company's principal class of shares is regularly traded on a recognized exchange *and* either:
 - (i) the shares are primarily traded on a treaty-recognized exchange in the country of residence or, for French companies, any EU exchange identified in the treaty, and, for U.S. companies, any exchange in North America identified by the treaty; or
 - (ii) the company's primary place of management and control is located in the company's country of residence.
- *Subsidiary of a Publicly Traded Company Test* — At least 50% of the vote and value of the shares (and at least 50% of any disproportionate class of shares) in the company are owned directly by five or fewer companies qualifying for the above publicly traded test, provided, in the case of indirect ownership, each intermediary owner is a resident of one of the Contracting States.
- *Ownership/Base Erosion Test* — At least 50% of each class of shares is owned (directly or indirectly) by residents of the country of residence of the company that are individuals, governmental units, or publicly traded companies (provided all intermediate owners are resident in the country of residence of the tested company) (Ownership Prong) and less than 50% of the gross income of the tested company (as determined under the tax laws of the residence country) is paid or accrued (directly or indirectly) to persons that do not meet the above criteria for the Ownership Prong, in the form of payments that are deductible in the residence country (other than arm's-length payments in the ordinary course of business for services or tangible property or certain payments of interest to financial institutions) (Base Erosion Prong).
- *Derivative Benefits* — At least 95% of the vote and value of the shares of the tested company are owned, directly or indirectly, by seven or fewer equivalent beneficiaries – defined as a resident of a member state of the European Union or of a party to the North American Free Trade Agreement – so long as that resident is entitled to the benefits of a comprehensive income tax treaty between the resident country of the owner and the source country and meets further

limiting criteria (Ownership Prong) *and* less than 50% of the gross income of the tested company (as determined under the tax laws of the residence country) is paid or accrued, directly or indirectly, to persons who are equivalent beneficiaries in the form of payments that are deductible in the residence country, other than arm's-length payments in the ordinary course of business for services or tangible property or certain payments of interest to financial institutions (Base Erosion Prong).

- *Trade or Business* — The company is actively engaged in trade or business in its country of residence (either directly or through affiliates), and, if the income for which treaty benefits are claimed is from a related party, the business conducted in the residence country must be substantial in relation to the business conducted in the source country. Only income connected with the trade or business can qualify under this test.
- *Discretionary Grant* — A company not eligible for benefits under the above tests can obtain a grant of treaty benefits from the competent authority of the source country by establishing that the establishment, acquisition, or maintenance of the company and the conduct of its operations did not have a principal purpose of obtaining the benefits of the treaty.

The LOB article also contains the so-called triangular provision, which limits treaty benefits where, by virtue of the income being attributable to a permanent establishment located in a third country, the combined tax of the residence country and the PE jurisdiction is less than 60% of the tax that would have applied had the income not been attributable to PE.

Observation: This strengthened LOB article should be reviewed closely, as some entities that currently benefit from the treaty may no longer qualify for treaty benefits under the Protocol. Any elimination of benefits will be immediately applicable, as there is no grace period within the effective dates set out by the Protocol.

Binding Arbitration

The Protocol adds a binding arbitration provision between France and the United States.

- Binding Arbitration: In general, the treaty provides for arbitration in cases where the competent authorities have been unable to reach agreement under a mutual agreement procedure, if:

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- tax returns have been filed with at least one of the Contracting States with respect to the taxable years at issue in the case;
 - the case is not a particular case that both competent authorities agree, before the date on which arbitration proceedings otherwise would have begun, is not suitable for determination by arbitration; and
 - all concerned persons agree on nondisclosure provisions.
- **Scope of Binding Arbitration:** Pursuant to the memorandum of understanding accompanying the Protocol, the determination reached by the panel will be limited to the amount of income, expense, or tax reportable to the Contracting States. Unless a "concerned person" refuses to accept the determination of the arbitration panel, the panel's determination is binding.

The binding arbitration provisions of the Protocol will become effective as of the date of entry into force of the Protocol.

Observation: No transition rule is included that would allow companies currently eligible for treaty benefits to continue to apply the existing treaty for an additional 12-month period.

Ratification Likely to Occur in 2009

The Protocol must go through the ratification process both in France and the United States before its entry into force. However, it is expected that the ratification process will occur in both France and the United States during 2009. Provided the Protocol enters into force in 2009, the new tax exemptions for dividends and royalties would be applicable to payments made as early as January 1, 2009, while the provisions of the Protocol affecting other taxes would not apply until January 1, 2010.

Effective Dates and Transitional Rule

The Protocol will enter into force on the date of the exchange of instruments of ratification. It will be effective with respect to withholding taxes for amounts paid or accrued on or after the first day of January of the year in which the Protocol enters into force, likely 2009.

For other taxes, the Protocol will be effective for taxable years beginning on or after the 1st of January of the year following the entry into force.

For more detailed information, please do not hesitate to contact your international tax services representative or any of the following members of the Treaty Developments Group:

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