TAX AUTHORITIES PROVIDE CLARIFICATION OF US-UK TAX TREATY AFTER BREXIT AND USMCA

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INTRODUCTION

On July 26, 2021, the competent authorities of the United States and the United Kingdom entered into an arrangement (Brexit Arrangement)[1] interpreting the US-UK income tax treaty.[2] The Brexit Arrangement provides that notwithstanding the UK's exit from the European Union (commonly known as Brexit), the UK will continue to be treated as an EU member state for purposes of the US-UK Treaty's "Limitation on Benefits" clause. The Brexit Arrangement is sensible, and avoids a perverse result wherein, following Brexit, it could in certain circumstances be easier for a UK company owned 100 percent by non-UK EU shareholders to qualify for US-UK Treaty benefits than it would be for a UK company owned by a mix of UK and EU shareholders.

In addition to the Brexit Arrangement, the US and UK competent authorities entered into another arrangement on July 24, 2021—the USMCA Arrangement,[3] which has replaced and superseded NAFTA. While taxpayers arguably could have interpreted the US-UK Treaty's reference to NAFTA to include the USMCA even without guidance from the tax authorities, the USMCA Arrangement removes any doubt.

This article will first examine anti-abuse provisions of tax treaties, highlighting the rules regarding hybrid entities and the anticonduit rules. It will then focus on the US-UK Treaty's Limitation on Benefits clause. Finally, it will illustrate the operation of the Brexit Arrangement and the USMCA Arrangement, and how they affect the Limitation on Benefits clause.

TREATY ANTI-ABUSE PROVISIONS

In General

Many or most countries tax non-residents on income derived from such country. To avoid double-taxation and generally facilitate international trade, many countries enter into bilateral income tax treaties (also referred to as "double taxation treaties"), eliminating or mitigating such double taxation, and otherwise containing several specialized tax provisions that override domestic law to taxpayers' benefit. The US-UK Treaty is one such double taxation treaty and is thus of great importance for trade between the US and UK.

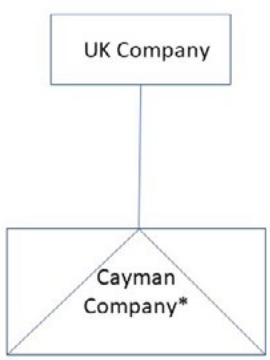
A hallmark of double taxation treaties is that taxpayers should be subject to taxation on income precisely once; they should not be subject to double taxation on the same income, but they also should not be able to escape taxation altogether. The US-UK Treaty addresses two specific fact patterns that may be used to claim inappropriate treaty benefits: the hybrid entity rules, and the anticonduit rules.

Hybrid entities

The US-UK Treaty provides that only residents of the US or UK can rely on the benefits of the treaty. For this purpose, a "resident" of the US or UK is defined as "any person who, under the laws of [the US or UK], is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature."[4] In other words, a UK tax resident company, which in theory will be subject to UK taxation on its income, can claim the benefits of the US-UK Treaty to avoid US taxation on certain US-source income.[5]

The existence of "hybrid" entities that are fiscally transparent for one country's tax purposes (meaning that such country does not tax the entity, but instead taxes its owners) complicates the notion of "tax residence." For example, imagine a UK tax resident company that owns a limited company organized in the Cayman Islands that has elected to be classified as a "disregarded entity" for US tax purposes, but is treated as a separate corporation for UK tax purposes.

Figure 1



*Hybrid entity: Corporation for UK tax purposes; fiscally transparent for US tax purposes

If the Cayman subsidiary earns US-source income that would be taxable but for the US-UK Treaty, the US would treat the income as earned not by the disregarded Cayman subsidiary but by the UK owner, and would therefore exempt the income from taxation under the US-UK Treaty. But since for UK tax purposes, the income is earned by the Cayman company, it would not generally be subject to UK taxation, absent an antideferral rule. In other words, the income would be subject to no immediate US or UK taxation, running counter to the intent of the US-UK Treaty, which is generally to ensure that income from the US or the UK is taxed precisely once. To solve this, the US-UK Treaty provides that income derived through an entity that is fiscally transparent under the law of *either* the US or the UK is considered to be derived by a US or UK resident only to the extent that the income is treated under such state's tax law as being derived by a resident.[6] In the example above, because the UK taxing authority doesn't treat the UK company as earning the income of its Cayman subsidiary, the UK company would not be eligible to claim benefits under the US-UK Treaty in respect of the income.[7]

Anticonduit

In addition to the rules on hybrid entities, the US-UK Treaty has a special limitation on "conduit arrangements." A conduit arrangement is generally defined as a transaction in which a US or UK resident otherwise eligible for benefits under the treaty receives an item of income from the other state and pays all or substantially all of that income to another party who would not be eligible for the same treaty benefits (or substantially equal benefits under a comparable treaty), if a main purpose of the transaction structure was to claim benefits under the treaty.[8] For example, imagine a US company pays $100 US-source interest to a UK tax resident company, which immediately pays the same amount as interest to a Cayman company.

Figure 2

In general, the interest payment would be subject to a 30 percent US withholding tax unless a treaty applied.[9] If the UK tax resident company genuinely received the $100 interest payment, then it generally could claim an exemption from US withholding tax under the US-UK Treaty.[10] However, under the anticonduit provisions of the US-UK Treaty, the UK company likely would be treated as a conduit, in which case it could not claim treaty benefits in respect of the interest payment.[11]

The US-UK Treaty is somewhat distinctive in that it has explicit anticonduit provisions. Most other US tax treaties do not make any reference to anticonduit principles. Instead, US authorities rely on longstanding caselaw, regulations, and other guidance to prevent persons residing in a treaty partner country from invoking the treaty when they are acting as a conduit. This US legal framework essentially accomplishes the same thing as the US-UK Treaty's anticonduit provisions. As such, the anticonduit provisions of the US-UK Treaty may be more relevant for purposes of preventing a *US* tax resident from claiming treaty benefits in respect to *UK* source income when the US party is acting as a conduit, rather than the reverse.

Limitation on Benefits

The foregoing anti-abuse provisions that limit the use of hybrid entities and conduits to claim treaty benefits are somewhat effective in preventing abuse, but there remains a concern that companies will be established in the US or UK solely to claim treaty benefits, with the "true" taxpayer being a tax resident in a non-treaty jurisdiction. Therefore, like many modern treaties, the US-UK Treaty contains a "Limitation on Benefits" clause designed to combat "treaty shopping" by residents of third countries attempting to obtain inappropriate treaty benefits.

The US-UK Treaty's Limitation on Benefits provision is in Article 23. It generally provides that an otherwise eligible US or UK tax resident will be unable to qualify for benefits under the US-UK Treaty if it cannot satisfy the Limitation on Benefits requirements.

A US or UK tax resident who otherwise satisfies the benefits of the US-UK Treaty can satisfy the Limitation on Benefits requirements if such resident is:

- An individual;[12]
- A "qualified governmental entity" (generally, a state authority or state-owned company that does not carry on business);[13]
- Publicly traded on one of several specified exchange, and meets certain specified trading requirements, or is a subsidiary of such a publicly traded company;[14]
- A specified pension or benefit entity with more than 50 percent of its beneficiaries, members, or participants residing in the US or UK;[15] or
- A specified charitable entity.[16]

A US or UK tax resident can also satisfy the Limitation on Benefits requirements with respect to an item of income if it is engaged in the active conduct of a trade or business in the US or the UK (other than the business of making or managing investments for its own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company, or registered securities dealer), so long as: (i) the income is derived in connection with, or is incidental to, that trade or business and any other specified requirements are satisfied; and (ii) the trade or business engaged in the tax resident's country is "substantial" in relation to its activities in the other country.[17] For example, a UK company that is engaged in a "substantial" trade or business in the UK can claim benefits under the US-UK Treaty with respect to income earned in the US, so long as such income is "derived in connection with," or is "incidental to," its UK business.

As a last resort, a US or UK tax resident entity that cannot satisfy any of the Limitation on Benefits tests above (or the ownership and earnings stripping tests described below) can apply for a determination of competent authority that it was not established, acquired or maintained, and did not conduct its operations with a principal purpose to obtain benefits under the US-UK Treaty.[18]

Ownership and earnings stripping tests

All of the Limitation on Benefits tests described above relate to the status of the tax resident itself or its activities. A US or UK tax resident entity that cannot meet any of the requirements above may still satisfy the Limitation on Benefits requirements based on a combination ownership and "earnings stripping" test. Specifically, a company can qualify if it satisfies both an earnings stripping test, and *either*:

- Fifty percent or more of the company (by vote and value) is owned by US or UK tax residents who otherwise would satisfy specified Limitation on Benefits tests (the "50 percent ownership test");[19] or
- Ninety-five percent or more (by vote and value) of the company is owned by seven or fewer

"equivalent beneficiaries" (the "95 percent ownership test").[20]

Similarly, a US or UK tax resident trust can qualify if it satisfies the "earnings stripping test" *and* at least 50 percent of the beneficial interest in the trust is held by certain other qualified residents or "equivalent beneficiaries."[21]

An equivalent beneficiary generally is defined as a tax resident of the European Union or European Economic Area, or NAFTA, who otherwise satisfies the Limitation on Benefits article of the treaty between such resident's jurisdiction and the US or UK, as applicable (or if there is no such Limitation on Benefits article, a tax resident who would satisfy specified prongs of the Limitation on Benefits article of the US-UK Treaty).[22]

To simplify, under the ownership test, a UK company can satisfy the Limitation on Benefits requirements of the US-UK Treaty if it satisfies the earnings stripping test and it is owned either 50 percent or more by any number of qualified UK or US tax residents, or 95 percent or more by seven or fewer qualified EU/EEA/NAFTA tax residents.

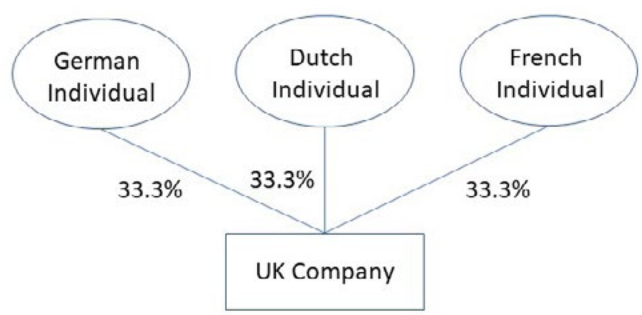
The earnings stripping test generally requires that less than 50 percent of the US or UK tax resident's gross income is paid or accrued, directly or indirectly, to persons who are not residents of either the US or the UK (or in the case of the 95 percent ownership test, to "equivalent beneficiaries") in the form of deductible payments, excluding certain arm's length payments in the ordinary course of business and certain payments in respect of financial obligations to a bank. The purpose of the earnings stripping test, which is somewhat similar to the purpose of the anticonduit rules, is to ensure that income is not "stripped" out of the taxing jurisdiction. For example, imagine a UK company that is wholly owned by a UK individual, and earns US-source income, but then enters into a separate agreement with a Cayman company, whereby the UK company makes deductible payments to the Cayman company, thus reducing its overall UK tax. If the deductible payment is 50 percent or more of the UK company's gross income, it will fail the earnings stripping test, and would need to satisfy an alternate Limitation of Benefits test in order to qualify for benefits under the US-UK Treaty. In contrast, if the UK company made dividend distributions to its non-UK/non-equivalent beneficiary shareholders, this would not be an example of earnings stripping, assuming the dividend is not deductible for UK tax purposes.

BREXIT ARRANGEMENT

Following Brexit, the UK is no longer a member state of the EU or EEA. Accordingly, applying the US-UK Treaty's definitions strictly, a UK tax resident would no longer be an "equivalent beneficiary." This generally would have no effect on a company that is owned 50 percent or more by qualified UK tax residents and therefore satisfies the 50 percent ownership test. However, it *could* matter for a company with mixed UK/EU ownership.

To illustrate, imagine a UK company that satisfies the earnings stripping test and is owned equally by three individual tax residents of, respectively, France, Germany, and the Netherlands.

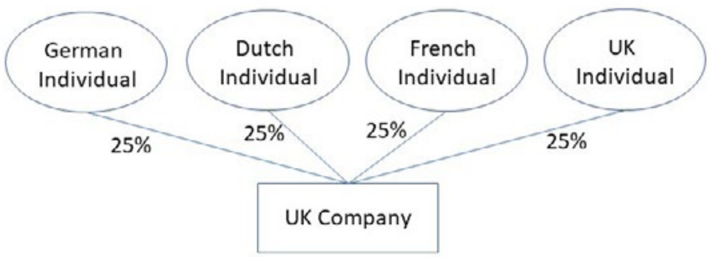
Figure 3



Each of the three owners would be an "equivalent beneficiary," and therefore the UK company generally could claim benefits under the US-UK Treaty pursuant to the 95 percent ownership test. Now imagine that a UK individual tax resident were admitted to the company ownership, with the four owners continuing to share ownership equally.

If the UK tax resident were not an "equivalent beneficiary," only 75 percent of the company would be owned by equivalent beneficiaries, so it would fail the 95 percent ownership test. Furthermore, because

Figure 4



only 25 percent of the company would be owned by UK tax residents, it would also fail the 50 percent ownership test. But this result is perverse since it would treat foreign-owned UK companies more favorably than domestically owned UK companies.

Accordingly, the Brexit Arrangement provides that UK tax residents will continue to be treated as "equivalent beneficiaries" under the US-UK Treaty.

The Brexit Arrangement was issued jointly by US and UK competent authority and is in effect for both US and UK purposes. Furthermore, the Brexit Arrangement is an interpretation of, rather than an amendment to, the US-UK Treaty, so taxpayers can rely on the Brexit Arrangement with respect to prior tax periods.

USMCA ARRANGEMENT

The US-UK Treaty also includes tax residents of NAFTA parties as equivalent beneficiaries. The signatories to NAFTA were the US, Mexico, and Canada. Because NAFTA has been replaced and superseded by the USMCA, there technically are no current member states of NAFTA. However, it is clear that the US treats the USMCA as the successor to NAFTA for tax treaty purposes, as the IRS has previously announced for purposes of all US tax treaties that refer to NAFTA.[23] As a result, for purposes of US taxation, the USMCA Arrangement does not have any effect, since the US tax authorities would already have interpreted the treaty as if it referred to the USMCA. For example, a UK company owned by a Canadian tax resident likely could have claimed an exemption from US taxes under the US-UK Treaty pursuant to the IRS announcement. Rather, the USMCA Arrangement is relevant for UK tax purposes, and confirms that UK tax authorities will continue to treat US, Canadian, and Mexican tax residents as equivalent beneficiaries under the US-UK Treaty.

The USMCA Arrangement was issued jointly by US and UK competent authorities and is in effect for both US and UK purposes. Furthermore, the USMCA Arrangement is an interpretation rather than an amendment to the US-UK Treaty, so taxpayers can rely on the USMCA Arrangement with respect to prior tax periods.

CONCLUSION

Prior to the Brexit Arrangement and the USMCA Arrangement, taxpayers could perhaps have taken the position that "equivalent beneficiaries" continued to include UK, US, Mexican, and Canadian tax residents. There would certainly be a strong case that the reference to NAFTA continues to refer to the USMCA, under the general principle of successor legislation (as well as the prior IRS announcement). The Brexit issue would be harder from the standpoint of pure textual analysis, but one can imagine a taxpayer adopting a purposive reading that "equivalent beneficiaries" were clearly intended to include UK tax residents, and excluding them would create an absurd result. That said, there would still be some uncertainty. The Brexit Arrangement and the USMCA Arrangement remove that uncertainty. While there are still multiple difficult questions that may arise in interpreting the US-UK Treaty's Limitation on Benefits article, the US and UK competent authorities have removed one small but important roadblock to application of the treaty.

Notes

1 The Brexit Arrangement is available at https://www.irs.gov/pub/irs-utl/competent-authority-arrangement-regarding-united-kingdom-withdrawal-from-the-eu-july-26-2021.pdf.

2 Officially, the treaty is the "Convention between the United States of America and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains" signed at London

on July 24, 2001, as amended by the Protocol signed on July 19, 2002. It is available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/uktreaty.pdf. The Protocol is available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/ukprotoc.pdf.

3 The USMCA Arrangement interprets the US-UK Treaty's Limitation on Benefits clause to direct that references to the North American Free Trade Agreement (NAFTA) will refer to the Protocol Replacing the North American Free Trade Agreement with the Agreement between the United States of America, the United Mexican States, and Canada, done at Buenos Aires on November 30, 2018, as amended by the Protocol of Amendment to that agreement, done at Mexico City on December 10, 2019 (together, the USMCA). It is available at https://www.irs.gov/pub/irs-utl/competent-authority-arrangement-regarding-usmca-July-26-2021.pdf.

4 US-UK Treaty, Art. 4, Par. 1. Complex "tiebreaker" rules apply to a taxpayer that is a dual resident of both the US and the UK. See also id. at Par. 4-5.

5 Of course, there may be multiple ways in which a UK or US tax resident can reduce or eliminate its UK or US income tax. But the theoretical framework of the US-UK Treaty designates each country as the primary taxing authority for its own tax residents.

6 US-UK Treaty, Art. 1, Par. 8.

7 See also I.R.C. § 894(c) and the Treasury Regulations thereunder, which override treaties in certain cases involving hybrid entities.

8 US-UK Treaty, Art. 3, Par. 1(n).

9 I.R.C. §§ 881(a)(1), 1442(a). Many interest payments are exempt from US withholding tax even without a treaty under the "portfolio interest exemption." See IRC §§ 881(c), 1442(a). However, there are multiple examples of US-source interest payments that are ineligible for the portfolio interest exemption, and that would therefore require a treaty to avoid US withholding tax.

10 US-UK Treaty, Art. 11, Par. 1.

11 See id. at Par. 7.

12 US-UK Treaty, Art. 23, Par. 2(a).

13 Id. at Par. 2(b).

14 Id. at Par. 2(c)-(d).

15 Id. at Par. 2(e).

16 Id.

17 Id.at Par. 4. Additional rules apply to activities conducted by partnerships and affiliated enterprises.

18 Id. at Par. 6.

19 Id. at Par. 2(f).

20 Id. at Par. 3.

21 Id. at Par. 2(g).

22 Id. at Par. 7(d).

23 See IRS Announcement 2020-6, available at https://www.irs.gov/pub/irs-drop/a-20-06.pdf.