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WHAT IMPACT WILL BREXIT HAVE ON DERIVATIVE BENEFITS TEST UNDER U.S. DOUBLE TAX TREATIES?

To Our Clients and Friends:

The United Kingdom's withdrawal from the European Union could have a significant effect on international and U.K. domestic taxation. It will likely impact aspects of the United Kingdom's value added tax and withholding tax regimes, customs and excise taxes, State Aid determinations, and double tax treaties. This alert concerns one discrete issue that has not yet been decided by the U.S. Treasury, but that could have dramatic consequences for entities currently claiming the benefit of U.S. tax treaties: whether the United Kingdom's withdrawal from the European Union means that U.K. shareholders will no longer be considered "equivalent beneficiaries" for purposes of the derivative benefits test in the limitation on benefits provision in U.S. tax treaties.

As explained in more detail below, strong arguments support U.S. Treasury extending treaty benefits to deal with unintended collateral consequences of the larger Brexit discussions; however, U.S. Treasury will need to tread carefully to avoid creating issues with either its treaty partners or the Senate.

We encourage clients to address these structural issues in advance of the United Kingdom's formal exit from the European Union.

The Limitation on Benefits Article and Derivative Benefits Test

The limitation on benefits (LOB) article in U.S. tax treaties is intended to prevent "treaty shopping," whereby residents from third countries not party to the treaty manipulate treaty residence rules or corporate shareholdings in order to obtain treaty benefits. Given the LOB's mechanical and objective nature (as opposed to more subjective tests like the "principal purpose" test), even entities structured with no treaty shopping purpose whatsoever can run afoul of its requirements.

The LOB includes, depending on the treaty, up to five distinct safe harbors: the publicly traded companies/subsidiary test, the tax exempt organization and pension funds test, the stock ownership and base erosion test, the active trade or business test, and the derivative benefits test.[1] The derivative benefits test is intended to grant treaty benefits to a treaty state resident if its nonresident owners would be granted the same benefits if the income flowed directly to them. Essentially, the test extends treaty benefits to a resident entity that nonetheless fails the other LOB tests on the basis that its ownership structure is not abusive if its shareholders could have received the same treaty benefits without locating the entity in the treaty state. These nonresident owners are considered "equivalent beneficiaries" for purposes of the test.

Currently, sixteen U.S. tax treaties include derivative benefits tests in their LOB provisions.[2] Most of these clauses limit the grant of equivalent beneficiary status to some combination of residents of EU and European Economic Area (EEA) member states and parties to NAFTA. Taxpayers with U.K. shareholders hoping to rely on the derivative benefits test when applying for benefits under any of these treaties that restrict equivalent beneficiary status to EU, EEA, and NAFTA membership need to be aware that they might fail the test post-Brexit, in which case they would be denied treaty benefits entirely.

Arguments Supporting Extending Equivalent Beneficiary Status

One argument for extending equivalent beneficiary status to U.K. residents post-Brexit is that disallowing such status would frustrate the purpose of the derivative benefits test, which is to disapply the LOB in cases where its application is counterintuitive—for example, a situation where a resident of the United Kingdom would not be entitled to treaty benefits if investing or earning income in the United States via an entity resident in Ireland, in a situation where the United States grants the very same benefits under the Irish treaty as the treaty between the United Kingdom and the United States. Revoking U.K. residents' status as equivalent beneficiaries would result in precisely such an outcome.

Another argument in favor of extending equivalent beneficiary status to U.K. residents is that the 2016 U.S. Model Income Tax Convention adopted a derivative benefits test that avoids this issue by removing the test's geographic limitations. In the 2016 Model, the derivative benefits rule defines equivalent beneficiaries as residents of *any* state, provided that they would be entitled to the same benefits under their residence state's comprehensive double tax treaty with the contracting state from which they seek to obtain benefits.[3] If the model treaty's version of the derivative benefits test applied to all U.S. tax treaties, then treaty residents would obtain the benefits they sought regardless of the United Kingdom's status as member of the European Union or European Economic Area, due to the benefits granted in the United States-United Kingdom treaty.

Finally, it is possible that revoking U.K. residents' equivalent beneficiary status would cause harmful economic distortions. Brexit is predicted to have significant deleterious effects on states that have deep trade ties with the United Kingdom—many of whom are members of the European Union. A significant number of entities that would no longer be able to claim treaty benefits after Brexit may be forced to incur the expense of relocating or restructuring, expenses that would not be necessary but for the failure of U.S. treaties to reflect what the U.S. government itself considers to be model treaty provisions.

Arguments Against Extending Equivalent Beneficiary Status

The primary argument against the extension of equivalent beneficiary status to U.K. residents is that a plain text reading of the definitions of equivalent beneficiaries in the treaties at issue clearly shows that they include current EU and/or EEA member states but do not include former EU and/or EEA member states. In customary international law, a plain text reading of a treaty's terms is the primary means of treaty interpretation. In most nations, the Vienna Convention on the Law of Treaties (VCLT) serves as the principle authority when it comes to treaty interpretation.

The United States is a signatory to the VCLT but has not ratified it and is not a party to it. Thus, U.S. courts are not bound by its terms. In practicing its own form of treaty interpretation completely separate

from the VCLT, the Supreme Court has not been entirely consistent on its guiding principles. In a 2014 case *BG Grp. Plc v. Republic of Arg.*, the Court focused on the intent of the parties, stating that "[a] treaty is a contract between nations, and its interpretation normally is a matter of determining the parties' intent."[4] In order to determine that intent when interpreting treaties, the Court will "'begin with the text of the treaty and the context in which the written words are used.'"[5]

If Treasury decides to extend equivalent beneficiary status to U.K. residents after Brexit, it must contend with the fact that it will be doing so in direct contravention of the plain meaning of the relevant treaties' terms.

Treasury's Options[6]

When it comes to addressing the issue, Treasury's most unilateral option is to issue a notice stating that for purposes of the U.S. double tax treaties that define equivalent beneficiary status by reference to the European Union and/or European Economic Area, U.K. residents will be treated as equivalent beneficiaries after Brexit. This method is easy and simple for both Treasury and the companies applying for treaty benefits. No change needs to be made to Form W-8BEN-E, the form that taxpayers use in applying for benefits under a tax treaty. The status quo will be preserved. However, it is not clear that Treasury has this authority, and it is possible that U.S. lawmakers and treaty partners may bristle at such an action.

In a subtler move, Treasury and the IRS might choose not to enforce the failure of U.S. withholding agents to withhold at a rate above the treaty rate when treaty benefits are denied by virtue of U.K. residents' post-Brexit loss of equivalent beneficiary status. This would be an approach similar to the "don't ask, don't tell" approach taken by the Internal Revenue Service with respect to domestic taxation of employee frequent-flier miles.[7] This approach is attractive by virtue of its quietness, as opposed to a Treasury notice's announcement to the world that the U.S. intends to ignore or purposefully misread tax treaty provisions; however, large enterprises that need to account for tax costs years in advance will find little assurance in an unannounced policy on which they cannot explicitly rely.

Competent authority relief is likely Treasury's most effective option, since it is clearly within its authority and springs from the treaties themselves. A Competent Authority Arrangement is a bilateral agreement between the U.S. and its treaty partners to clarify or interpret treaty provisions. Treasury could enter into Competent Authority Arrangements with its treaty partners that grant equivalent beneficiary status to U.K. residents in a way that does not veer so far from reasonable treaty interpretation as to constitute treaty renegotiation. If that boundary is crossed, however, there is a possibility that certain U.S. lawmakers might consider such arrangements to usurp the Senate's power to approve treaties and treaty protocols. There is also the possibility that Treasury faces pushback from treaty partners.

Potential Challenges

If Treasury uses one of the methods listed above in granting U.K. residents equivalent beneficiary status, it is conceivable that the contracting state may be displeased—by the granting of benefits itself, the method by which Treasury grants the benefits, or both. The contracting state may raise the issue with the United States by reference to a mutual agreement procedure contained in the treaty. Or, the contracting

state could deny benefits to the resident company by assessing the tax it believes should have been withheld in the United States.[8]

If Treasury enters into agreements with treaty partner states agreeing to grant U.K. residents equivalent beneficiary status post-Brexit, the Senate may argue that such an agreement constitutes treaty renegotiation that infringes upon the Senate's treaty power granted in the U.S. Constitution. In 2015, Senator Rand Paul challenged a different type of international tax agreement on similar grounds. He and several individual plaintiffs sued Treasury to strike down the Foreign Account Tax Compliance Act (FATCA) and certain intergovernmental agreements (IGAs). The Sixth Circuit ruled that Senator Paul did not have standing to challenge the IGAs.[9] The court distinguished the facts from those of *Coleman v. Miller*,[10] in which the Supreme Court found that a group of twenty-one Senators had standing to challenge a resolution that twenty of them had voted against, suggesting that a large enough bloc of Senators might have standing to challenge a Competent Authority Arrangement. On the other hand, legislators likely do not have standing to challenge a policy of discretionary non-enforcement, because the Service has enforcement authority with respect to tax assessment and collection, and enforcement authority includes the authority to prioritize certain enforcement goals over others.

Moving Forward

Businesses with U.K. shareholders that currently use the derivative benefits test in a U.S. treaty are encouraged to remain engaged with this issue. Those who have not begun contingency planning should consider it, in consultation with counsel, financial, and tax advisors. Members of the Gibson Dunn Tax team are available to discuss strategy, options, and considerations as these developments unfold.

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[1] *See* IRS Tax Treaty Table 4, *available at* https://www.irs.gov/pub/irs-utl/Tax_Treaty_Table_4.pdf.

[2] Belgium, Canada, Denmark, Finland, France, Germany, Iceland, Ireland, Jamaica, Luxembourg, Malta, Mexico, Netherlands, Sweden, Switzerland, United Kingdom.

[3] *See* 2016 United States Model Income Tax Convention Art. 22(7)(e), *available at* *https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf*

[4] *BG Grp. plc v. Republic of Arg.*, 572 U.S. 25, 26 (2014) (quoting *Air France v. Saks*, 470 U.S. 392, 399 (1985)).

[5] *Water Splash, Inc. v. Menon*, 137 S. Ct. 1504, 1508-09 (2017) (quoting *Volkswagenwerk Aktiengesellschaft v. Schlunk*, 486 U.S. 694, 699 (1988)).

[6] In assessing its options, U.S. Treasury might look to two potentially analogous historical events where changes in the intergovernmental landscape created similar hazards with respect to tax treaty interpretation and applicability: the collapse of the Soviet Union in 1991 and the United Kingdom's handover of control over Hong Kong to China in 1997. However, the principal issues in those cases

revolved around state succession and treaty succession (i.e., whether the U.S.-U.S.S.R. and U.S.-China treaties would remain in effect with respect to the former Soviet republics and China-controlled Hong Kong, respectively), which are fundamentally different than those raised by the interaction between Brexit and the derivative benefits test. *See* IRS Notice 97-40, 1997-2 C.B. 287 (announcing that the U.S.-China tax treaty would not apply to Hong Kong); Treasury News NB-1763 (announcing that the U.S.-U.S.S.R. tax treaty would remain in effect for the members of the Commonwealth of Independent States).

[7] *See* Lawrence Zelenak, *Custom and the Rule of Law in the Administration of the Income Tax*, 62 Duke L.J. 829, 830-31 (2012).

[8] If a contracting state were to do this, then the competent authority relief provision in most U.S. tax treaties would require the contracting state to consult with the U.S. competent authority before such denial.

[9] *Crawford v. United States Dep't of the Treasury*, 868 F.3d 438 (6th Cir. 2017).

[10] 307 U.S. 433.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Tax practice group, or the authors:

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