

Income Tax Treaties / Conventions

Select Tax Issues

23 October 2024

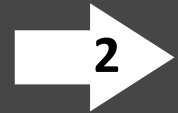
LEA Global Conference in Vienna Austria

International Tax Seminar

Agenda



Introduction



Tax Treaty Approach & Utilization / Benefits



Limitations on Treaty Benefits (LOB Article)



U.S. withholding tax rules, anti-conduit, and double taxation vs. double benefits***



Introduction and Overview

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Adnan Islam *(mostly in Southern California)*
Partner – [International] Tax & Business Services
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Adnan Islam is tax partner who specializes in U.S. international tax consulting, structuring, and global tax optimization with a focus on tech, services, blockchain, cryptocurrency transactions, and alternative investments. He has nearly 20 years of public accounting experience as a tax attorney and a CPA.

Adnan specializes in cross-border strategies, comprehensive inbound tax services, global information reporting, and outbound U.S. tax planning, structuring, and tax optimization. He has advised U.S. based and inbound companies within the technology, telecom, pharmaceutical/life sciences, PE/alternative investments, manufacturing and distribution, and professional services sectors.

Professional & Civic Affiliations

- American Institute of Certified Public Accountants (AICPA)
- Blockchain Technologies certification, MIT
- Economics of Blockchain and Digital Assets certification, Wharton
- Certified Public Accountant (licensed CPA in NY and CA)
- Certified Taxation Law Specialist (State Bar of California)
- Licensed attorney admitted to practice law in New Jersey, Washington, D.C., California, and the United States Tax Court
- Enrolled Agent, authorized to practice by IRS (through exam)
- ProVisors, EC Member of DTLA5 (Global Group)



PRACTICE FOCUS

- Tax Structures, Compliance, and Planning
- International Tax Analyses
- Cross-border Reorganizations
- Guidance to Inbound Companies
- Research and Analysis of Technical International Tax Positions

INDUSTRY FOCUS

- Blockchain & Digital Assets; Technology
- Alternative Investments; Funds
- Consumer & industrial products; services

EDUCATION

- Juris Doctor, Rutgers University
- Master of Business Administration, Rutgers University
- Master of Laws, Taxation, New York University School of Law
- Master of Laws, International Tax Certificate, Georgetown University Law Center

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Tax Treaty Approach & Utilization

What is a Tax Treaty?

- A tax treaty is a bilateral agreement made by two countries to resolve issues involving double taxation of passive and active income of each of their respective residents
- Aim is to prevent double [income] taxation***
- An income tax treaty is also called a Double Tax Agreement (DTA) or Convention
- The United States has entered income tax treaties with several foreign countries
- Some treaties allow for residents of foreign countries to be taxed at a reduced rate, or are entirely exempt from taxation on U.S. sourced income
- Importantly, these reduced rates and exemptions vary among countries and specific items of income
- Strict eligibility criteria applies, and the entity must meet compliance and reporting requirements to benefit
- Generally, and without an applicable tax treaty, the **U.S. statutory withholding tax rate is 30%** on the gross amount of certain outbound, U.S. source (“FDAP”) payments to foreign persons

Approach to Applying & Utilizing Tax Treaties

1. Identify a relevant tax treaty In Force or In Effect.
2. Confirm Parties to the applicable Treaty.
3. Confirm relevant parties are **residents** that are qualified for tax treaty benefit purposes.
4. Check Resident Article and **LOB Article before** applying any substantive Treaty Article.
5. Identify Substantive Tax Treaty Article (e.g., Dividends, Interest, Royalties).
6. Confirm applicable tax treaty rate and/or benefit (e.g., no PE, IA/IC vs. DA).
7. Prepare and collect relevant tax treaty documentation such as withholding tax certificates, if and as applicable (e.g., U.S. W-8BEN, -E; IRS 6166; Indian PAN card and 10-F, etc.)

Example of Income Tax Treaty

- ❑ U.S. entity 100% owned by UK entity
- ❑ Capital structure – 50% Debt/Equity
- ❑ U.S. entity to repatriate interest and dividends to UK parent entity

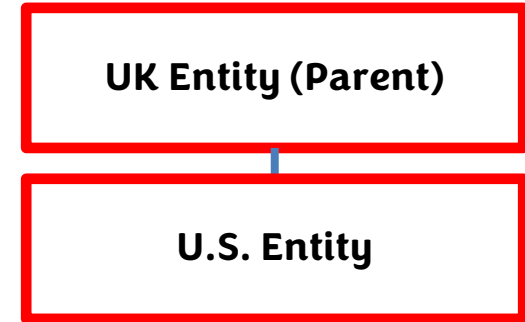
Per treaty, income tax if eligible and applicable,

Maximum Tax on Dividends, per Treaty, *if* applicable, *after* LOB:

a) 5 per cent, of the gross amount of the dividends if the beneficial owner is a company that owns shares representing directly or indirectly at least 10 per cent, of the voting power of the company paying the dividends;

or

b) 15 per cent, of the gross amount of the dividends



Considerations when structuring globally

Capital structuring implications, consider interest versus dividend payments with tax treaty country

Current U.S. political, legislative, and regulatory environment impacting investments when structuring in and outside the U.S.

Common US inbounds responses to the changing global and US environment and potential structuring issues inbounds should consider

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LOB Clause and Anti-Treaty Shopping
Rules and Regimes to Consider

QUALIFIED PERSONS

A specific anti-abuse rule, the **limitation-on-benefits (LOB) rule**, that limits the availability of treaty benefits to entities that meet certain conditions. These conditions are based on the legal nature, ownership and general activities of the entity. They seek to ensure that there is a sufficient link between the entity and its State of residence



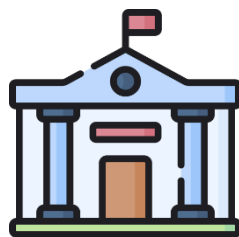
Condition for Availing Treaty Benefit

Resident of a Contracting State shall not be entitled to the benefits of the Convention unless it constitutes a **“Qualified Person”**

“Qualified Persons” includes:



Resident



Contracting state or
Local authority



Listed Entities



Resident NPO &
Pension Funds



Person Satisfying
Ownership & Base Erosion
test

Active Conduct Test (ACTB test)

A person is entitled to the benefits of the Convention with respect to an item of income even if **it does not** constitute a “qualified person” as long as that item of income is derived in connection with the **active conduct** of a trade or business in that person’s State of residence.

Conditions for Availing of Benefit



1. Entity is engaged in the active conduct of a business in its State of residence
2. The payment for which benefits are sought is related to the business

Derivative Benefits Rule

“Derivative benefits” rule allows certain entities owned by residents of third States to obtain treaty benefits provided that these residents would have been entitled to equivalent benefits if they had invested directly.



Condition for Availing of Benefit

1. Ownership Test **AND**
2. Base Erosion Test

Ownership Test

95%

Voting Power & Value

Held Directly/Indirectly by
<=7 equivalent beneficiaries

Base Erosion Test

< 50%

Company's Gross Income

paid/accrued, directly/ indirectly, to
persons who are not equivalent
beneficiaries in form of deductible
payments

INDIA – USA LOB CLAUSE

PARAGRAPH 1- Ownership & Base erosion test

A person (other than an individual) which is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if:

(a) More than 50 percent of the beneficial interest in such person or company is owned by individual residents of one of the Contracting States, or other individuals subject to tax in either Contracting State on their worldwide incomes, or citizens of the United States; and

(b) The income of such person is not used in substantial part to meet liabilities of persons who are not resident of one of the Contracting States or citizens of the United States.

INDIA – USA LOB Clauses

PARAGRAPH 2 – ACTIVE CONDUCT TEST

The provisions of paragraph 1 **shall not apply** if the income derived from the other Contracting State is derived in connection with, or is incidental to, **the active conduct by such person** of a trade or business in the first-mentioned State.

PARAGRAPH 3 – STOCK EXCHANGE TEST

The provisions of paragraph 1 shall not apply if the person deriving the income is a company which is a resident of a Contracting State **in whose principal class of shares there is substantial and regular trading on a recognized stock exchange.**

INDIA – USA LOB Clauses

PARAGRAPH 4 – POWER WITH COMPETENT AUTHORITY

A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs of this Article may, nevertheless, **be granted the benefits of the Convention if the competent authority** of the State in which the income in question arises **so determines.**

COURT CASE ON TREATY ISSUES

MORGAN STANLEY – INDIAN SUPREME COURT (SC)

Facts of the Case:

- MS & Co. is incorporated in the United States and is in the business of providing financial advisory services, corporate lending, and securities underwriting services
- MSAS is an Indian private limited company set up by the Morgan Stanley Group to support the group members' front office
- MS & Co. outsourced some activities to MSAS by way of a service agreement.
- MS & Co. proposed sending some personnel to India to undertake stewardship activities to enforce quality control standards. Also, some personnel would be assigned to MSAS and would work under the supervision and control of MSAS

Tax Issues

Whether MS & Co. have a PE in India under the India-U.S. income tax treaty by virtue of MSAS being regarded as its fixed place of business, through “dependent agents” working India, or through a service PE on account of personnel sent for stewardship or assignment of its personnel to MSAS.

MORGAN STANLEY – INDIAN SUPREME COURT (SC)

SC observations

- **Fixed place of business:** MSAS in India would be engaged in supporting the front office functions of MS & Co. Hence, Article 5(1) of the Treaty **is not applicable and there is no fixed place of business.**
- **Agency PE:** **There shall be no agency PE, as MSAS in India had no authority to enter into or conclude contracts on behalf of MS & Co.**
- **Service PE:** For services rendered by personnel of MS & Co. on assignment to MSAS, this assignment would constitute a PE within the terms of article 5(2)(l) of the treaty. The assigned employee remains an employee of MS & Co. and is providing services to and for MSAS, constituting service PE in India.
- **Stewardship services:** Personnel of MS & Co. engaged in stewardship activities for MSAS would not constitute a service PE because the object of the employees of MS & Co. sent as stewards was primarily to protect the interest of MS & Co., it could not be said that MS & Co. had been rendering the services to MSAS

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U.S. Withholding Tax

Taxable Presence – Taxation of Non-US persons

- Taxation differs depending on type of income earned
 - Non-business (passive > “**FDAP**”) income
 - 30 percent tax on gross amount of certain US-source income
 - Collected through withholding at source
 - US trade/business (USTB-**ECI**) income
 - Net basis tax on ECI (at graduated rates)
 - Application of US branch taxes, where applicable
 - Tax return filing requirements
 - Tax treaties may alter treatment of both types of income

Overview of FDAP (*think passive, non-business*)

- FDAP Income – FDAP income is defined broadly and *generally* includes all US-source income that is not ECI (has a catch-all for FDAP withholding within the regulations)
 - Interest
 - **With some exceptions**
 - Portfolio interest (PIE)
 - Bank deposit interest
 - Short-term obligations
 - Dividends
 - Rents
 - Royalties
 - Additional miscellaneous items – alimony; covenants not to compete; income upon surrender of insurance policy
 - **Generally, not (regular) capital gains. Section 865.**

Taxation of FDAP Income – Portfolio Interest Exception

- FDAP income excludes “portfolio interest” and interest on deposits in US banks.
 - Requirements for qualification as portfolio interest
 - Debt in registered form
 - 10% shareholder or less
 - Voting power test for corporate borrowers
 - recent proposals to extend test to value
 - Interest in capital or profits for partnership borrowers
 - Look-through rule for partnership lenders
 - not contingent on revenues or profits of borrower
 - bank not lender
 - not a related CFC

Taxation of FDAP Income – Withholding Tax

- Nonresident individuals and foreign corporations are taxed at a 30% flat (or lower treaty upon qualification and with documentation) rate on the gross amount of FDAP income that is NOT effectively connected with USTB.
- Tax is paid through withholding at the source by the payor (“withholding agent”) who remits the withheld tax to the IRS.

Taxation of FDAP Income – Withholding

- **Rationale behind withholding**

- Person making payment has the information to determine the tax position of the recipient
- Has custody of proceeds
- If recipient is outside the jurisdiction of taxing authority, payor is last best chance to collect revenue

FDAP – why is documentation important?

- Establishes the foreign status of payee for income & FATCA purposes
- Presumption rules:
 - Backup withholding under Section 3406
- Characterizes the payee (e.g., individual or entity, beneficial owner or intermediary)
- Required for the recipient to claim a treaty or statutory based reduction or exemption from US withholding
- Very specific documentation required for certain statutory exemptions (e.g., PIE in Sections 871(h)(2) and 881(c)(2))

FDAP – why is documentation important? (cont'd)

- A withholding agent that cannot reliably associate a payment with documentation on the date of payment and does not withhold or withholds less than 30% under Sections 1441 and 1442 is liable under Section 1461 for the tax due without the benefit of a reduced rate (Treas. Reg. § 1.1441-1(b)(7)(i)).
- Exceptions:
 - Appropriately relied-on presumptions to treat payee as a US person or to treat the payment as ECI
 - Evidence to satisfaction of district director or assistant commissioner (International) that proper amount of tax, if any, was in fact paid to IRS
 - No documentation required for reduced rate of withholding under Section 1441
 - Compliance with Treas. Reg. § 1.1441-6(c) or (g)

Withholding Tax documentation

- IRS Form W-9 (US persons), Request for Taxpayer Identification Number and Certification:
 - Beneficial owner is a US person.
 - Form is mandatory; otherwise backup withholding may apply (Sections 6109(a)(2), 3406(a)(1)(A)).
- Form W-8BEN-E (foreign entities), Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding:
 - Payee as foreign non-individual
 - Payee as beneficial owner of the income
 - Claiming a reduced rate of withholding under a tax treaty – US or foreign TIN required
 - Establish statutory exemption from withholding
 - Affidavit for curing prior years

Withholding documentation (cont'd)

- Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals):
 - Only to be used for non-US > foreign individuals
 - Form W-8BEN-E is for non-US > foreign entities
- Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting
 - Generally used for pass-through or other entities who are intermediaries between the payor and the beneficial owner
 - Accompanied by underlying beneficial owner statements and “withholding statement” (apportioning income among various beneficial owners)
- Foregoing forms also generally used for FATCA compliance

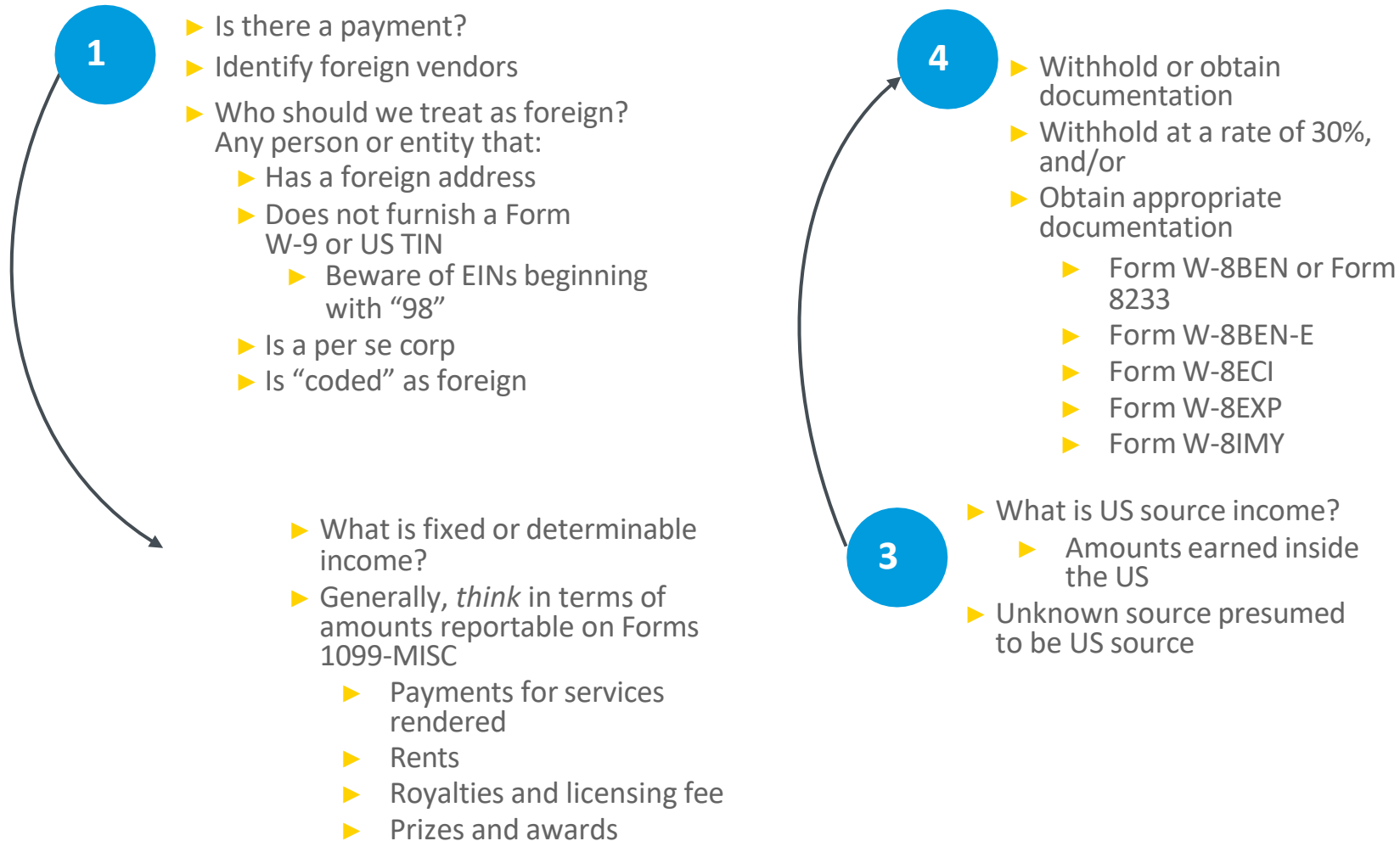
Withholding Forms – Common Issues/Problems

- Withholding forms may have substantive or technical issues
 - Software used by administrators or compliance functions may automatically kick back forms that seem/are incorrect
- Expired forms –
 - W-8 Forms expire every 3 years
 - IRS issuing a new form causes previous form to be invalid 6 months after updated form is issued
- Treaty benefits –
 - Failure to complete treaty eligibility section (not a technical failure, but could result in over-withholding)
 - Investors claim a treaty that does not exist
- Legal form of entity inconsistent with default entity classification
 - “LP” for local law purposes – indicated as “corporation” on W-8BEN-E
 - Requirement to provide filed IRS Form 8832 (CTB election) where filer is reverse hybrid?
- W-8IMY without underlying W-8/W-9 forms and withholding statement
- Lack of proper signing authority statement

Compliance for U.S. Source* Payments

- Withholding Agents are required to file the following forms:
 - Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, must be filed by the withholding agent by March 15th following the calendar year in which the income subject to reporting was paid, unless an extension of time to file is obtained.
 - Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, must be filed by the withholding agent for every foreign payee with respect to which it paid FDAP income. Each Form 1042-S must indicate the amount of each category of income paid to the foreign payee (e.g., dividends, interest, etc.) and the amount of tax withheld.
 - 1042-S filing requirements for W-8BEN-E and W-8IMY recipients different
 - Penalties for failing to file/report IRS Forms 1042/1042-S:
 - Up to \$290 per form/recipient up to maximum of \$3,532,500 (caps for both 1042 and 1042-S)
 - Penalties increased for intentional disregard (no maximum)

Chapter 3 withholding tax >>> four-step process



U.S. “Inbound” tax compliance / informational reporting

	Purpose	Filing dates
Form W-8BEN/ Form W-8BEN-E	Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding	Due when requested by a withholding agent
Form W-8ECI	Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States	Due when requested by a withholding agent
Form W-8IMY	Certificate of Foreign Intermediary, Foreign Flow-Through Entity or Certain US Branches for US Tax Withholding	Due when requested by a withholding agent
FinCEN Form 114	Report of Foreign Bank and Financial Accounts	Filed electronically with the Department of Treasury, annually and due on or before 15 April following the year reported (automatic 6 month extension to file)
Form 1042	Annual Withholding Tax Return for US Source Income of Foreign Persons	Filed by 15 March following year of payment and mailed to the address for instructions
Forms 1042S and 1042T	Foreign Person's US Source Income Subject to Withholding	Filed by 15 March following year of payment and mailed to address per instructions
Form 1120-F	US Income Tax Return of a Foreign Corporation	Generally by 15th day of the 4th month following year-end
Form 8288 and 8288-A	U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests (N.B., also applies to Dispositions covered by 864(c)(8))	Generally within 20 days following the transfer triggering tax

Taxation of US Source Capital Gains*

- US Domestic Law under Section 865:
 - US source capital gain of a non-resident that is not effectively connected with a trade or business (“USTB-ECI”) in the US is generally exempt from taxation in the US, **unless** it is related to the disposition of a US real property interest (USRPI), or a nonresident alien (NRA) individual has spent a sufficient amount of time in the US and certain other requirements are met.
 - Capital Gain is subject to US net basis income tax if it is effectively connected with taxpayer’s US trade or business (US T/B).
 - Gain is considered effectively connected only if the asset is used in or held for use in the conduct of a US T/B or the activities of a US trade were a material factor in the realization of the gain.
 - See also **Section 864(c)(8) providing a special source rule for the sale or disposition of *operating* U.S. partnership interests by a foreign partner (person)**

Taxation of US Source Capital Gains (cont'd)

- US Income Tax Treaties
 - US Treaties generally allocate taxing rights on capital gains to the **source state** if the gains are attributable to the sale of: (i) real property; (ii) moveable property that is part of a PE; (iii) ships or aircraft used in international traffic; and, (iv) containers unless they are used solely for transport between places in the state of residency.
 - Otherwise, taxing jurisdiction is ceded to the state of residency (**regular rule, e.g., sale of tech company's stock/shares by a non-US person generally not subject to further US taxation**).

RECAP / MAIN TAKEWAYS

- Treaties generally help to **mitigate** double income taxation on the same item of income.
- Local/internal law may have nuances that supersede or clarify Treaty provisions or articles, such as for the sale of real estate
- After the residency article, the LOB Article is generally the gateway (technical qualifier) to receiving most tax treaty benefits
- Documentation and technical analysis on documentation may be required to obtain treaty benefits (especially in US, India, and Canada to name a few jurisdictions)
- For certain countries and cases, the substance, **as well as the form**, matter (e.g., Cyprus corporate tax residency certificate)