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IRS says USMCA = NAFTA for tax treaty purposes

Author(s): Paul Seraganian, Jennifer Lee, Kevin Colan, Kaleigh Hawkins-Schulz, Andrew M. Granek

On May 19, 2020, the U.S. Internal Revenue Service (IRS) released long-awaited guidance providing comfort to taxpayers that the imminent replacement of the North American Free Trade Agreement (NAFTA) by the Agreement between the United States of America, the United Mexican States and Canada (USMCA) would generally not jeopardize a taxpayer’s ability to rely on U.S. income tax treaty benefits. For many Canadian multinationals with U.S. operations or subsidiaries, including those with cross-border financing arrangements using European financing subsidiaries, this provides much-needed and anticipated confirmation that payments made by their U.S. subsidiaries will continue to qualify for a reduction of or exemption from U.S. withholding taxes under the applicable treaties to the extent that they so qualified prior to the adoption of the USMCA.

Many U.S. income tax treaties include a limitation on benefits (LOB) article, which sets forth provisions designed to prevent companies resident in a non-treaty (or less favourable treaty) jurisdiction from inappropriately accessing tax treaty benefits through entities set up in a treaty (or more favourable treaty) jurisdiction. One important avenue for qualifying for treaty benefits under the LOB article of many U.S. income tax treaties is through the “derivative benefits” clause, which may grant access to certain treaty benefits to companies even though the ultimate ownership rests in a third country. Among other requirements, a derivative benefits clause generally will grant treaty benefits to a treaty-resident recipient of a U.S. source payment if, had such payment instead been made directly to the recipient’s owner who is resident in a third country, such payment would have been eligible for benefits under a U.S. income tax treaty with such third country that are equivalent or better than the benefit being sought. The eligible third country residence for the ultimate owners for purposes of the derivative benefit clause in many U.S. income tax treaties is defined by reference to parties to NAFTA or members of the European Union.

Given the imminent adoption of the USMCA, uncertainty arose as to whether taxpayers relying on the NAFTA reference in the derivative benefits clauses in U.S. income tax treaties may continue to qualify for treaty benefits once NAFTA is replaced by the USMCA. In Announcement 2020-6, the IRS announced that it believes that any reference to NAFTA in a tax treaty should be interpreted as a reference to the USMCA given that the USMCA modernizes and replaces NAFTA, is entered into by the same parties, and governs the terms of trade among those parties. The IRS further expressed that it will reach out to countries that have an applicable tax treaty containing references to NAFTA to confirm that they agree...
with this interpretation. This is the sensible interpretation of the U.S. income tax treaties and a very welcome confirmation by the IRS. Taxpayers generally may rely on the legal position taken by the IRS in an unrevoked and unmodified announcement such as Announcement 2020-6; so while there may not be bilateral confirmation of this legal position yet by the applicable treaty partners, taxpayers should nevertheless be able to rely on the IRS following the approach described in Announcement 2020-6 in evaluating their structures as a result of the adoption of the USMCA.
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