a report on key federal tax controversy developments

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INTERNATIONAL TAX ALERT

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655 15th Street, N.W.
Suite 900
Washington, DC 20005-5701

For more information, please contact:

Leonard Bickwit, Jr.
lbickwit@milchev.com
202-626-6030

Rocco V. Femia
rfemia@milchev.com
202-626-5823

Marc J. Gerson
mgerson@milchev.com
202-626-1475

John Gilliland
jgilliland@milchev.com
202-626-1466

or visit our Web site:
www.milchev.com

House Passes Provision to Curtail Tax Treaty Benefits

On July 27, the House passed over Republican objection H.R. 2419, *The Farm, Nutrition, and Bioenergy Act of 2007*. To partially offset the cost of the bill, the legislation includes a controversial provision that would override current U.S. tax treaties and result in a significant tax increase on many foreign multinational corporations with significant U.S. operations. The provision faces an uncertain future in the Senate, which will not take up its own farm reauthorization legislation until after the impending August recess, and has triggered a veto threat by the Administration.

Provision Denies or Reduces Tax Treaty Benefits on Deductible Payments

The provision, based on a bill introduced by Rep. Lloyd Doggett (D-Tex.) in the 109th Congress, would limit tax treaty benefits on deductible payments made by a U.S. subsidiary of a foreign multinational company to a foreign affiliate other than the foreign parent corporation. Specifically, the legislation would provide that the applicable U.S. withholding tax on such payments be no less than the withholding tax that would be applicable to a similar payment made directly to the foreign parent corporation. Thus, the legislation would deny the benefit of any reduced withholding tax rate applicable to the payment if it is made to a foreign affiliate in a treaty country. The legislation would apply to any deductible payment, including interest, royalties, guarantee fees, and management and other service fees, on which a withholding tax could be applied under U.S. domestic law.

The legislation would apply to any deductible payment made by a U.S. subsidiary to a foreign affiliate that is part of the same foreign controlled group of entities as the U.S. subsidiary. For this purpose, corporations are considered to be members of the same ultimate foreign controlled group if 50 percent or more of their stock is held by other corporations within the group. The 50 percent ownership rule also applies to non-corporate entities where 50 percent of their beneficial interests are held by other members of the same group.

Provision Would Affect Many Types of Arrangements

The proposal would impact directly those foreign multinational corporations that are headquartered in countries with either no tax treaty with the United States or in countries with treaties that have less favorable withholding tax rates. Thus, companies headquartered in Latin America, Canada, most of Asia, and parts of Europe will be subject to increased withholding taxes on interest, royalties, service fees and other deductible payments made by their U.S. subsidiaries to other foreign affiliates.

For example, under current law, interest paid by a U.S. subsidiary of a Japanese or Canadian-based group to a financing affiliate in the United Kingdom or the Netherlands typically would be exempt from withholding tax under the applicable U.S. tax treaty. Under the proposal, however, such interest would be subject to withholding tax equal to the rate specified in the U.S. treaty with the country in which the parent company is resident. That would be the case even if the U.K. or Dutch financing affiliate were financed through third-party debt rather than by the ultimate parent company. Furthermore, if the parent company were resident in a jurisdiction that had no tax treaty with the United States, such as Brazil, Taiwan, Hong Kong, or Singapore, then any deductible payments to foreign affiliates would be subject to a 30% withholding tax. Thus, for example, if a U.S. subsidiary of a Brazilian-based group made a service payment to a group service center in the United Kingdom, such a payment could be subject to 30% withholding tax notwithstanding the U.S.-U.K. tax treaty. The provision would be particularly problematic for closely-held multinationals as their parent companies are less likely to qualify for tax treaty benefits under existing limitation on benefits rules.

Outlook for Provision is Uncertain

The White House and Treasury Department, as well as leading trade associations, have expressed opposition to the proposal. The provision faces an uncertain future in the Senate, which is not expected to consider its own farm reauthorization legislation until later this fall, giving time for opposition to the proposal to strengthen. In light of the need for revenue offsets under the Congressional "pay-go" rules, however, foreign-based companies with substantial U.S. operations should consider voicing their objection to the provision.

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