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U.S. Treasury Issues Guidance on Applying Tax Treaties After USMCA Supersedes NAFTA

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The U.S. Department of the Treasury and the IRS released Announcement 2020-6, which indicates that references to the North American Free Trade Agreement (NAFTA) in U.S. tax treaties will be interpreted as references to the Agreement between the United States of America, the United Mexican States, and Canada (USMCA) when USMCA supersedes NAFTA later this year.

Background

NAFTA, the first multilateral free trade agreement between the United States, Mexico and Canada, became effective on January 1, 1994. The three countries began renegotiating NAFTA in 2017, and the resulting treaty, USMCA, will become effective on July 1, 2020. Although the treaties' names are different, much of both treaties is similar, and USMCA is sometimes even referred to as NAFTA 2.0.

Most U.S. tax treaties include a "limitation on benefits" provision (or LOB), which determines which taxpayers are eligible for benefits under the tax treaty. In many U.S. tax treaties, the LOB refers to NAFTA explicitly. For example, the LOB of the U.S.-Germany tax treaty includes a "derivative benefits" test, under which a company can qualify for treaty benefits if more than a threshold amount of the company's shares are held by seven or fewer "equivalent beneficiaries" and certain other tests are met. For this purpose, an equivalent beneficiary generally includes a resident of a NAFTA country (and certain other countries).

As another example, the LOB of the U.S.-France tax treaty includes a provision under which a U.S. company can generally qualify for treaty benefits if its shares are regularly traded on a recognized stock exchange located in the United States or another NAFTA country.

References to NAFTA Treated as References to USMCA

Announcement 2020-6 clarifies that the U.S. Treasury Department and the IRS will interpret these LOB provisions of U.S. tax treaties as if the references to NAFTA were references to USMCA, and will reach out to relevant treaty partners to confirm that they agree with this interpretation.

No Position Expressed on Brexit

A similar issue has resulted from the United Kingdom's withdrawal from the European Union, commonly known as Brexit. It is unclear whether tax treaty provisions that apply to member states of the European Union should still be available for companies with British owners, now that the United Kingdom is no longer part of the European Union. Unfortunately, official guidance on the effect of Brexit on European tax treaties is not yet available. European companies with British owners may need to review their tax structures if they depend on the derivative benefits test to qualify for tax treaty benefits.

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