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Global Tax Alert

US Treasury and IRS announce that references to NAFTA in US income tax treaties should be interpreted as references to USMCA

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Executive summary

On 19 May 2020, in Announcement 2020-6 (Announcement), the United States (US) Treasury Department (Treasury) and the Internal Revenue Service (IRS) announced that, once the *Protocol Replacing the North American Free Trade Agreement with the Agreement between the United States of America, the United Mexican States, and Canada* (USMCA) enters into force, they will interpret references in US income tax treaties to the North American Free Trade Agreement (NAFTA) as references to the USMCA.

Detailed discussion

On 30 November 2018, the Governments of the United States, Mexico, and Canada signed the USMCA. The USMCA, upon entry into force, will supersede the NAFTA. The NAFTA has governed trade relations between the United States, Mexico, and Canada since 1 January 1994, and many US tax treaties in force today contain explicit references to the NAFTA (e.g., the derivative benefits test within the Limitation on Benefits (LOB) article), but do not mention agreements that might supersede it. As a result, questions have arisen regarding the application of treaty provisions referencing the NAFTA once the USMCA enters into force.

For instance, Article 17(3) of the US-Spain Income Tax Treaty provides that a company that is a resident of a treaty country shall be entitled to claim benefits if, among other things, at least 95% of the aggregate voting power and value of its shares (and at least 50% of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are "equivalent beneficiaries." The term "equivalent beneficiary" is defined in Article 17(8)(g) as a resident of a member state of the European Union (EU) or of a party to the NAFTA that meets certain other requirements. Article 17(3) provides that in cases of indirect ownership, each intermediate owner must be a resident of a Member State of the EU or any party to the NAFTA. Notably, the treaty does not refer to any agreements that might succeed or supersede the NAFTA.

The Announcement clarifies that, once the USMCA enters into force, the Treasury and the IRS (including the US Competent Authority) will interpret references to the NAFTA in US tax treaties as references to the USMCA because the USMCA modernizes and replaces the NAFTA, is entered into by the same parties, and governs the terms of trade among those parties.

Article 34(5) of the USMCA provides that each party to the USMCA shall notify the other parties, in writing, once it has completed the internal procedures required for the USMCA to enter into force. It is expected that the USMCA will then enter into force on the first day of the third month following the last notification.

Implications

The Announcement provides helpful guidance for interpreting the US tax treaties that explicitly refer to the NAFTA. Once the USMCA enters into force and replaces the NAFTA, companies may continue to claim US tax treaty benefits by applying provisions that refer to the NAFTA (such as the derivative benefits test) provided they meet all other requirements specified in the treaty for claiming such benefits.

The IRS and Treasury noted that they will reach out to countries that have an applicable tax treaty containing references to the NAFTA to confirm that those countries will similarly interpret references to the NAFTA as references to the USMCA. While this outreach is ongoing, taxpayers claiming US treaty benefits can generally rely on the Announcement as to how Treasury and the IRS believe the reference should be applied. Although these taxpayers are less likely to be affected by a contrary interpretation by a treaty partner country, they should continue to monitor further developments.

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