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Competent authority arrangements on derivative benefits under United States-United Kingdom income tax treaty

The competent authorities of the United Kingdom and the United States entered into two arrangements regarding the continued inclusion of the United Kingdom, Mexico, and Canada as “equivalent beneficiary” jurisdictions for purposes of applying the so-called “derivative benefits test” in paragraph 3 of Article 23 (Limitation on Benefits) of the United States-United Kingdom income tax treaty.¹

Read text on the IRS website (posted July 28, 2021) of:

- The [competent authority arrangement](#) [PDF 105 KB] concerning the United Kingdom and “Brexit”
- The [competent authority arrangement](#) [PDF 104 KB] regarding the USMCA

Texts of these competent authority arrangements are also provided by the IRS in Announcement 2021-13 and Announcement 2021-14 (published in the [Internal Revenue Bulletin 2021-33](#) [PDF 774 KB] dated August 16, 2021).

United States-United Kingdom income tax treaty defines an “equivalent beneficiary” as “a resident of a Member State of the European Community or of a European Economic Area state or of a party to the North American Free Trade Agreement” that meets certain additional requirements.

¹ The Convention between the United States of America and the United Kingdom of Great Britain and Northern Ireland for the avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains signed at London on July 24, 2001, as amended by the Protocol signed on July 19, 2002 (the “United States-United Kingdom income tax treaty”).

The two competent authority arrangements provide favorable guidance to certain United Kingdom, Canada, and Mexico-owned groups whose access to United States-United Kingdom income tax treaty benefits became uncertain following the United Kingdom's departure from the European Union ("Brexit") and the replacement of the North America Free Trade Agreement ("NAFTA"), respectively.

The Brexit competent authority arrangement

One of the U.S. and U.K. competent authority arrangements notes the shared understanding of the competent authorities that residents of either Contracting State should be eligible to qualify as equivalent beneficiaries for purposes of applying the derivative benefits test in Article 23(3) of the United States-United Kingdom income tax treaty, and states that the U.S. and U.K. competent authorities agree that for purposes of Article 23(7)(d), a "resident of a Member State of the European Community" continues to include a U.K. resident.

KPMG observation

- The Brexit competent authority arrangement is particularly relevant to the availability of relief from U.S. tax for amounts paid to: (1) U.K. holding companies owned in part by U.K. individual shareholders; and (2) U.K. resident subsidiaries owned indirectly through a U.K. publicly traded parent company, when a non-U.K. resident subsidiary is interposed in the ownership chain between the U.K.-resident parent and the U.K.-resident subsidiary company.
- By virtue of its nature as an agreement between the U.S. and U.K. governments, the Brexit competent authority arrangement only provides relief to U.S. and U.K. residents seeking benefits under the United States-United Kingdom income tax treaty, and does not address whether the United Kingdom would be an equivalent beneficiary jurisdiction for purposes of applying the derivative benefits test under any other U.S. bilateral income tax treaties.
- The IRS's decision to provide relief by way of a bilateral competent authority arrangement—rather than through general interpretive guidance—raises doubts as to whether the United Kingdom would be considered a Member of the European Community in the context of any other U.S. bilateral income tax treaty, absent formal relief. This doubt is exacerbated by the fact that the stated basis for the conclusion is that residents of the Contracting States were intended to be eligible to qualify as equivalent beneficiaries, which does not appear to apply under other U.S. tax treaties.

The USMCA competent authority arrangement

The second companion U.S. and U.K. competent authority arrangement provides that the competent authorities agree that, upon entry into force of the United States-Mexico-Canada Agreement (the "USMCA")², references to NAFTA shall be understood as references to the USMCA, because the USMCA modernizes NAFTA, is entered into by the same parties, and governs the standards for trade and investment among the parties going forward.

KPMG observation

² Protocol Replacing the North American Free Trade Agreement with the Agreement between the United States of America, the United Mexican States, and Canada, done at Buenos Aires on November 30, 2018 (the "Agreement"), as amended by the Protocol of Amendment to that Agreement, done at Mexico City on December 10, 2019 (the "Protocol of Amendment" and collectively with the Agreement, the "USMCA").

- The primary fact pattern to which this relief applies is one in which a publicly traded parent company resident in Mexico or Canada has a U.K.-resident subsidiary that derives U.S.-source income.
- While this arrangement is limited in scope to the application of the United States-United Kingdom income tax treaty, this arrangement is consistent with the policy expressed by the IRS in Announcement 2020-6 (announcing that the U.S. tax authorities will interpret any reference to NAFTA in U.S. bilateral income tax treaties as a reference to USMCA once the USMCA goes into effect). Read [TaxNewsFlash](#)
- In Announcement 2020-6, the U.S. tax authorities stated they will reach out to countries that have an applicable tax treaty containing references to NAFTA to confirm they agree with this interpretation. The United Kingdom is the first treaty partner to formally agree that references to NAFTA include USMCA for this purpose.

For more information, contact a tax professional in KPMG's Washington National Tax practice:

Danielle Rolfes | +1 202 533 3378 | drolfes@kpmg.com

Seth Green | +1 202 533 3022 | sethgreen@kpmg.com

Jonathan Galin | +1 202 533 3178 | jgalin@kpmg.com

Jason Connery | +1 202 533 6370 | jconnery@kpmg.com

Jesse Eggert | +1 202 533 5512 | jeggert@kpmg.com

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