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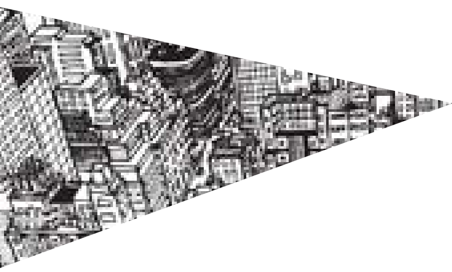

United States and Vietnam sign first income tax treaty

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Executive Summary

On 7 July 2015, the United States (US) and the Socialist Republic of Vietnam (Vietnam) met in Washington DC to sign their first income tax treaty (the Treaty) and simultaneously adopted a protocol (the Protocol) between the two jurisdictions for the avoidance of double taxation and the prevention of fiscal evasion of taxes on income. The Treaty and Protocol will enter into force after being ratified by each jurisdiction and after the two jurisdictions exchange instruments of ratification. For withholding taxes, the Treaty and Protocol will take effect for amounts paid or credited on or after 1 January of the calendar year immediately following the year of the Treaty's entry into force. For all other taxes, the Treaty and Protocol will take effect for tax years (Vietnam) and for tax periods (US) beginning on or after 1 January of the calendar year immediately following the year of the Treaty's entry into force. The Treaty is consistent with, although not identical to, the general approach of the 2006 US Model Income Tax treaty (the 2006 Model Treaty) and other recently negotiated US income tax treaties and protocols. Amongst others, this Alert highlights the following key provisions of the Treaty:

- The definition of permanent establishment is broadened to include the "furnishing of services, including consultancy services … .through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) … .for a period or periods aggregating more than six months within any twelve-month period."[1]
- The Treaty provides maximum allowable tax rates on certain cross-border payments of dividends, interests and royalties:
  - Dividends are taxed at a maximum rate of 5% if the beneficial owner is (i) a Vietnam company that owns directly at least 25% of the *voting stock* a US distributing company, or (ii) a US company that owns directly at least 25% of the *capital* of a Vietnam distributing company. All other dividends are taxed at 15%.

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- Interest is taxable at a maximum rate of 10%; if it is determined with reference to receipts, sales, income, profits or other cash flow of the debtor, to any change in the value of any property of the debtor or to any dividend, partnership distribution, or similar payment made by the debtor, it is taxed at a maximum of 15%.[2]
- Royalties paid for the use of, or the right to use, industrial, commercial, or scientific equipment are taxable at a maximum rate of 5% (with certain exceptions applying to rental on a bareboat basis of ships or aircraft). A 10% rate applies to royalties paid for the use of, or the right to use: (i) a copyright of literary, artistic, scientific, or other work (including cinematographic films and films or tapes used for radio or television broadcasting); or (ii) a patent, trademark, design or model, plan, secret formula, or process. Contrary to US rules, royalties will be sourced under the Treaty to the residence of the payer rather than sourced to the location where the property is used.

Detailed discussion[3]

Article 1 — Persons covered and general scope

Article 1 provides rules for persons covered and general scope that are consistent with the 200 Model Treaty and generally does not prevent a Contracting State[4] from taxing an entity that is treated as a resident of that State[5] under its local tax law. Notably, and also consistent with the 2006 Model Treaty, Article 1(6) provides that an item or income, profit, or gain derived by an entity that is fiscally transparent under the laws of either jurisdiction is considered derived by a resident of a Contracting State, provided that the item is treated under the laws of such Contracting State as an item of income, profit or gain of a resident.[6]

Article 5 — Permanent establishment rule

The permanent establishment provisions in Article 5 of the Treaty are generally consistent with the 2006 Model Treaty, except for some differences in Article 5(3). Under Article 5(3)(a) of the Treaty, a permanent establishment encompasses a building site, construction, exploration, assembly or installation project or supervisory activities … if such site, project or activities last more than six months (compared to the 12-month allotment provided by the 2006 Model Treaty). Moreover, the Treaty provides for a broader definition of permanent establishment than the 2006 Model Treaty by adding Article 5(3)(b), which provides that a permanent establishment encompasses the "furnishing of services, including consultancy services … .through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) … .for a period or periods aggregating more than 6 months within any 12-month period."

Article 6 — Income from immovable property (real property)

Article 6(1) provides that income from real property is taxable in the jurisdiction in which the property is located. The provisions in Article 6 of the Treaty are generally consistent with the 2006 Model Treaty, except that the Treaty does not contain an equivalent to Article 6(5) of the 2006 Model Treaty, which provides residents of one jurisdiction who own income-producing real property in the other jurisdiction with an election to tax such income on a net basis as if such income were business profits attributable to a permanent establishment.[7]

Article 7 — Business profits

The business profit provisions in Article 7 of the Treaty are generally consistent with the 2006 Model Treaty, except for Article 7(4) of the Treaty, which specifically allows for the use of formulary apportionment to determine profits properly attributable to a permanent establishment if such apportionment has been customary in a Contracting State. However, this provision requires that any such apportionment have a result in accordance with arm's-length principles.

Article 10 — Dividends

The Treaty provides maximum allowable source-country tax rates on certain dividends, interest and royalties. For dividends, Article 10(2)(a) provides that dividends are taxable at a maximum rate of 5% if the beneficial owner is a Vietnam company that owns directly at least 25% of the *voting stock* of a US distributing company, or is a US company that owns directly at least 25% of the capital of a Vietnam distributing company. All other dividends are taxable at 15%.[8] Unlike the 2006 Model Treaty, for companies as beneficial owners, the Treaty's 5% dividend rate requires a 25% ownership threshold, rather than the standard ownership threshold of 10%.

Similar to the 2006 Model Treaty, the Treaty also provides that dividends paid by a US regulated investment company (RIC) are taxable at a maximum rate of 15%.[9] Dividends paid by a US real estate investment trust (REIT) or a Vietnam real estate investment fund (VREIF) are taxable at a maximum rate of 15%, but only if certain thresholds are met.[10]

The Protocol clarifies that pension funds (including those which are RICs, REITs or VREIFs), which are beneficial owners of the distributing company, are not taxed in the State of residence of the distributing company, provided that such dividends are not derived from a trade or business by the pension fund or through associated enterprise.[11] However, REITs and VREIFs must meet certain ownership thresholds to qualify for this exemption.[12] These ownership thresholds also apply to RICs created under the laws of Vietnam after the date of signature of the Treaty if the competent authorities of the Contracting States agree that the RIC is equivalent to a RIC created under the laws of the US.[13]

Article 11 — Interest

Article 11 of the Treaty governs the maximum allowable taxation of interest payments. Contrary to the 2006 Model Treaty, the Treaty does not generally exempt cross-border interest payments from tax.[14] Rather, tax on interest is generally reduced to a 10% rate under the Treaty.[15] However, if interest payments are determined with reference to receipts, sales, income, profits or other cash flow of the debtor, to any change in the value of any property of the debtor or to any dividend, partnership distribution or similar payment made by the debtor, the payments can be taxed at a maximum rate of 15%.[16] Paragraph 7 of the Protocol further clarifies that Article 11(4) of the Treaty applies to interest arising in the US that is contingent interest of a type that does not qualify as portfolio interest under US law.

Notwithstanding, interest is taxable only in the Contracting State in which the recipient is a resident if the beneficial owner of such interest is a resident of that Contracting State and the interest is paid by the Contracting State in which the interest arises or by the central bank, a political subdivision or local authority thereof.[17]

Article 11(9) provides that the excess, if any, of the amount of interest allocable to the profits of a company resident in a Contracting State attributable to a permanent establishment in the other Contracting State, or subject to tax in the other Contracting States under Article 6 (Income from Real Property) or Article 13(1) (Gains from the Alienation of Property), is generally taxed at a maximum allowable rate of 10% under the Treaty.

Article 12 — Royalties

Article 12 of the Treaty governs the maximum allowable tax imposed on royalties. Contrary to US domestic law, as well as the 2006 Model Treaty, royalties are sourced for Treaty purposes to the residence of the payer rather than the location where the property is used. Moreover, Article 12(3) broadens the definition of "royalties" to include amounts paid for the use of, or the right to use, industrial, commercial, or scientific *equipment*. Such payments are taxable at a maximum rate of 5% (with certain exceptions applying to rental on a bareboat basis of ships and aircraft).[18] A maximum allowable 10% tax rate applies to royalties paid for the use of, or the right to use: (i) a copyright of literary, artistic, scientific, or other work (including cinematographic films and films or tapes used for radio or television broadcasting); or (ii) a patent, trademark, design or model, plan, secret formula, or process.[19] Furthermore, royalties are deemed to arise in a Contracting State when the payer is that State itself, a political subdivision or entity thereof, a local authority or a resident of that State.[20] However, royalties arising in connection with a permanent establishment or fixed base will be deemed to arise in the State in which the permanent establishment or fixed base is situated.[21]

Article 13 — Gains from the alienation of property
Article 13(1) generally provides that gains from real property may be taxed in both the State of residence and the State of source. Under Article 13(2)(a), the US retained its ability to tax gain derived by Vietnamese sellers of US real property interests (e.g., shares in a US real property holding corporation). Moreover, Article 13(2)(b) provides that gains from the alienation of capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of real property situated in Vietnam may be taxed in Vietnam. For this purpose, the Treaty defines "principally" to mean the value of real property exceeding 30% of the aggregate value of the assets held by the company.[22]

Article 23 — Limitation on benefits
The limitation on benefits provisions in Article 23 generally conform to the 2006 Model Treaty, except for the triangular provision of Treaty Article 23(6), which the 2006 Model Treaty does not contain.

Article 23(6) provides that benefits otherwise applicable under the Treaty will not apply when an enterprise in Contracting State A derives income from Contracting State B if: (i) such income is attributable to a permanent establishment of such enterprise in a third jurisdiction (State C), and (ii) the profits of that permanent establishment are subject to a combined aggregate effective rate of tax in Contracting State A and State C that is less than 60% of the general rate of company tax applicable in Contracting State A. If the provisions of Article 23(6) apply, any dividends, interest or royalties are subject to tax in Contracting State B at a maximum allowable rate of 15%.[23] Any other income is subject to tax under the provisions of the domestic law of Contracting State B.

Article 24 — Methods for eliminating double taxation
Article 24 of the Treaty generally conforms to the 2006 Model Treaty and provides relief from double taxation by conferring to citizens and residents of one Contracting State the benefit of a credit for income taxes paid to the other State or an exemption for income earned in the other State.[24]

In the case of Vietnam, double taxation is eliminated as follows:

- Vietnam residents are provided the benefit of a credit for income taxes paid on income, profits and gains taxable in the US The credit, however, is limited to the amount of tax that would have been imposed had the income been derived in Vietnam.
- An indirect tax credit is also provided to Vietnamese companies owning at least 10% of the *voting stock* of a company that is a resident of the US on the dividends distributed by that company to the extent the profits out of which the dividend is paid were taxed in the US.
- If a Vietnam resident derives income that is determined to be solely taxable in the US under the Treaty, Vietnam may take such income into account for determining the applicable tax rate on any remaining income of such Vietnam resident.

US residents and citizens are provided the benefit of a credit on income tax paid or accrued to Vietnam by such resident. In addition, US companies owning at least 10% of the *voting stock* of a Vietnam company are generally entitled to indirect tax credits on dividend paid by the Vietnam company.

Article 26 — Mutual agreement procedure
Article 26 confers certain benefits on citizens and residents of the Contracting States in order to reach and implement solutions to disputes between the two Contracting States that arise out of the interpretation and application of the Treaty. Consistent with the 2006 Model Treaty, no provision for mandatory arbitration is included to resolve these issues.[25]

Article 29 — Entry into force
Article 29(1) provides that the Treaty will enter into force once it is ratified by each jurisdiction and the two jurisdictions exchange instruments of ratification. The Protocol adopts an identical rule.

Furthermore, as of the date of entry into force, the provisions of Article 27 (exchange of information and administrative assistance) will apply.[26] For withholding taxes, the Treaty and Protocol will take effect for amounts paid or credited on or after 1 January of the calendar year immediately following the Treaty's entry into force.[27] For all other taxes, the Treaty and Protocol will take effect for tax years (Vietnam) and for taxable periods (US) beginning on or after 1 January of the calendar year immediately following entry into force.[28] Following Senate approval, the President must sign an instrument of ratification to complete the ratification process in the US.

Implications

The Treaty is the first comprehensive income tax treaty between the US and Vietnam. While the strides taken by the US and Vietnam are encouraging, taxpayers should keep in mind that the Treaty will not take effect until after ratification by both jurisdictions. On the US side, the Treaty may share the fate of other key treaties (e.g., Spain, Switzerland) that have reached a similar point in the process, but have been halted in the Senate Foreign Relations Committee (SFRC) due to its inability to approve any treaty by its usual process of unanimous consent. The Treaty, as with many other treaties, contains a provision on information exchange and administrative assistance to which Senator Rand Paul objects to consent without a floor debate arguing that the provision violates US taxpayers' Fourth Amendment privacy rights. In fact, the US Senate has not ratified a treaty since 2010 and any developments will need to be closely monitored. SFRC Chairman Bob Corker, on 9 July, said that he and his staff are conferring with Senator Paul to try to lift Paul's four-year hold on all pending tax treaties and/or protocols.

Endnotes

1. Article 5(3)(b).
2. In the US, this applies to interest that is contingent interest of a type that does not qualify as portfolio interest under US laws.
3. This Alert does not discuss Articles 2, 3, 4, 8, 9, 14-22, 25, 27, 28, and 30.
4. See Article 3(1)(c) for the definition of "Contracting State."
5. The term "State" means the US or Vietnam.
6. See 2006 Model Treaty, Article 1(6). See also US Technical Explanation Accompanying the US Model Income Tax Convention of 15 November 2006, Article 1(6), which illustrates this rule with the following example: If a US LLC with members who are residents of the other Contracting State elects to be taxed as a corporation for US tax purposes, the US will tax that LLC on its worldwide income on a net basis, without regard to whether the other Contracting State views the LLC as fiscally transparent.
7. See 2006 Model Treaty, Article 6(5).
8. See Article 10(2)(b).
9. See Article 10(3).
10. See Article 10(3).
11. See Protocol, paragraph 4 and 5.
12. See Protocol, paragraph 4 and 5.
13. See Protocol, paragraph 6.

14. See Article 11(1).
15. See Article 11(2).
16. Article 11(4).
17. Article 11(3).
18. Article 12(2)(a) and (3)(a).
19. Article 12(2)(b) and (3)(b).
20. See Article 12(5).
21. See Article 12(5).
22. Article 13(2)(b).
23. Article 23(6) will not apply to: (i) royalties received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself, or (ii) any other income derived from Contracting State B that is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the State C (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are banking or securities activities carried on by a bank or registered securities dealer).
24. See also 2006 Model Treaty, Article 23.
25. See 2006 Model Treaty, Article 25(3).
26. See Article 29(3).
27. See Article 29(2)(a).
28. See Article 29(2)(b).

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