TAX CLUB

Entitlement to Treaty Benefits: a Comparison of the Dutch and German Solutions

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Introduction

The subject matter to which this paper is devoted is somewhat broader than the specific provisions currently found in our more recent tax treaties which impose limitations on otherwise applicable treaty benefits.[1] Rather, it also encompasses an examination of the more general treaty provisions which indirectly impose limitations by restricting the class of persons to whom treaty benefits are extended.[2] The problem arises when the latter type of provision does not literally restrict treaty benefits to persons who are currently perceived by the source or taxing jurisdiction to have been contemplated by the contracting parties as the intended beneficiaries. In certain cases, specific limitation provisions have been included in treaties which were initially drawn broadly to serve the restrictive purpose for which they were intended.[3] Where a

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[1] See, e.g., Article 16, 1981 U.S. Model Income Tax Convention, 1 CCH Tax Treaties ¶211 (hereafter "1981 U.S. Model treaty"); Article 28, U.S.-German treaty; Article 12A, U.S.-Belgium treaty; Article, 24A, U.S.-France treaty; Article 26, U.S.-Netherlands treaty; Article 17, U.S.-Mexico treaty. A reference to a provision of an income tax treaty is to a provision of the treaty currently in force, unless otherwise indicated.

[2] See and compare, Article II(1)(f), U.S.-Swiss treaty (defining Swiss enterprise as a commercial or industrial undertaking carried on in Switzerland by a resident or corporation of Switzerland), with Article 3(1)(d), U.S.-U.K. treaty (not including a "carried on in" requirement in the enterprise definition); Article 4, 1981 U.S. Model treaty.

[3] See, e.g., Article 17, U.S.-U.K. treaty.

specific limitation provision does not exist, the Courts have indicated a willingness to deny treaty benefits that, although literally applicable, are found to be manifestly inconsistent with the perceived treaty objectives so as not to have been within the expectations of the parties.[4]

Judicially Imposed Limitations

Relying on the courts to resolve by judicial decree that which the treaty draftsmen were unable to resolve is always risky business. The limitation of treaty benefits area is but one case in point. Whenever an issue arises as to whether a treaty should be applied in accordance with its literal terms, a court must necessarily determine whether the application of the particular provision to the particular circumstance was within the expectation of the contracting parties. Although a court must start with the language of the treaty, the issue cannot always be resolved by resort to the treaty language alone.[5] Rather, the courts have looked to the context of the treaty provision,[6] its legislative history[7] and even the current mutual

[4] Coplin v. U.S., 56 AFTR 2d ¶85-5008 (Fed. Cir. 1985) ("Coplin II"), revg. Coplin v. U.S., 54 AFTR 2d ¶84-5241 (Ct. Cl. 1984) ("Coplin I"); Great Western Life Insurance Co. v. U.S., 82-1 USTC ¶9374 (Ct. Cl. 1982); cf. Compagnie Financiere de Suez et de L'Union Parisienne v. U.S., 492-F.2d 798, 74-1 USTC ¶9254 (Ct. Cl. 1974) (dictum); Johannson v. U.S., 64-2 USTC ¶9743 (5th Cir. 1964) (dictum).

[5] Great Western Life Insurance Co., supra n.4; cf. Articles 31 and 32, Vienna Convention on the Law of Treaties.

[6] See Aiken Industries Inc., 56 T.C. 925 (1971); acq, 1971-1 C.B. 1.

understanding of the contracting parties concerning the issue of intent in question.[8] However, the mere assertion by one of the contracting parties that the application of the benefit to the circumstance of the particular case is not consistent with its current treaty policy does not appear to be sufficient to cause a court to deny the benefit.[9] Rather, there must be a clear showing, using the tools of treaty interpretation referred to above, that the sought-for benefit was not intended to apply taking into account the policies in existence at the time the treaty was negotiated.

Indeed, much of the difficulty with relying on a judicial solution to the "problem" of unintended beneficiaries is in discerning the controlling intent which, in turn, requires an investigation into the underlying treaty policy. The task becomes more difficult as treaty policies change with the times. There do not appear to be too many general rules to which a court can point in determining whether the application of a benefit to a particular case is so fundamentally inconsistent with general treaty policy that it could not have been within the expectation

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[7] Coplin I, supra n.4.

[8] Coplin II, supra n.4.

[9] Compare Tedd N. Crow, 85 T.C. 376 (1985), with Rev. Rul. 79-152, 1979-1 C.B. 237; compare Coplin II, with Coplin I; cf. Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 74-331, 1974-2 C.B. 282; Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383.

of the contracting parties.[10] Rather, a court must examine the provisions in question in light of the purpose of the particular treaty. In so doing, a court might just as easily draw the conclusion that use of treaties by third-country residents is not manifestly inconsistent with the purpose of the particular treaty as it could draw the opposite conclusion. As another illustration, a court could just as easily conclude that avoiding even one tax while obtaining treaty benefits is not so abhorrent to general U.S. treaty policy as to interpret each treaty to include a subject to tax requirement, as it could draw the opposite inference.[11]

Nor does current policy always serve as a very useful guide in interpreting the intent of the treaty negotiators.[12] For example, it appears reasonably clear that the current U.S. policy is to include in each of its tax treaties one or more specific types of limitation on benefits provisions, including a so-called artiste and athlete clause,[13] which denies benefits simply because of the nature of one's profession; the general limitation on benefits clause,[14] which is intended to deny

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[10] But see Coplin II, supra n.4.

[11] Holmstrom v. PPG Industries, 512 F. Supp. 552 (W.D. PA 1981).

[12] Crow, supra n.9.

[13] See, e.g., Article 17, U.S.-U.K. treaty.

[14] See, e.g., Article 28, U.S.-German treaty.

benefits to third-country residents deriving benefits directly or indirectly who were not intended to be covered; the fiscal domicile clause,[15] limiting benefits to residents who are subject to home country tax on their world-wide income; and the so-called savings clause,[16] which is intended to preserve to the U.S. primary tax jurisdiction over its citizens and, under an extended version of the provision, its former citizens. But the underlying policies evidenced by the specific provisions referred to in the preceding sentence were not always the same nor do they appear particularly clear of purpose. Examples abound.

Artiste and Athlete Clause

In the past, the United States had expressly refused to discriminate against artistes and athletes in treaties,[17] but, of course, this policy did not prevent the Internal Revenue Service (the "Service") from refusing to permit benefits in egregious cases.[18] Subsequently, the policy changed and the Service issued its so-called "lend-a-star" rulings.[19] The rulings were soon followed by the introduction of the artiste and athlete clause in

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15 Article 4(1)(a), U.S.-German treaty.

16 See, e.g., Article 1(3), 1981 U.S. Model treaty.

17 See Protocol of Exchange, Supplementary Treaty of 1950, U.S.-Canada, I P-H Tax Treaties, ¶22,146.

18 Johansson, supra n.4.

19 Rev. Rul. 74-330, Rev. Rul. 74-331, supra n.9.

the U.K. treaty[20] and thereafter in other treaties[21] with deviations only in the income threshold. To what perceived evil the artiste and athletes clause is directed is no mystery: It was perceived that artistes and athletes are not within the class of persons to whom the commercial travelers exemption should extend because of the fear that artistes and athletes and their advisers are creative enough to use the commercial travelers provisions to avoid all taxes.[22] However, the restriction applies whether or not there is such avoidance. Furthermore, in certain circumstances the provision also denies benefits to entities furnishing the services of artistes and athletes which are incorporated and resident in the same country in which the artistes or athletes are resident, whether or not such entities would be entitled to benefits under a limitation on benefits provision of the type discussed in this paper. It may well be that a treaty which contains a limitation on benefits provision of the type described in this paper no longer requires a separate artiste and athlete clause.

Third-Country Residents as Intended Beneficiaries

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[20] Article 17.

[21] See, e.g., Article XVI, U.S.-Canada treaty; Article 15A, U.S.-France treaty; Article 17, U.S.-German treaty.

[22] U.S. Treasury Technical Explanation of the convention between the United States and the United Kingdom, 3 CCH Tax Treaties ¶10,941 at 44,553. The real problem may be in the breadth of the commercial travelers exemption.

As another example, it had been the U.S. policy to encourage U.S. investments by third-country residents through Netherlands Antilles corporations, even though it was clear third-country residents derived the major benefit of the extension of the treaty with the Netherlands to the Netherlands Antilles (the "Netherlands Antilles treaty") and even though it was or should have been apparent that such corporations paid little or no Antilles tax on their income.[23] Article XII of the treaty with the Netherlands (as applicable to the Netherlands Antilles) specifically permitted third-country residents to obtain benefits thereunder.[24] That provision, along with the source rules then extant, insofar as it applied to interest paid by a non-U.S. corporation, fostered the U.S. policy of encouraging the use of Antilles finance subsidiaries even though such use benefitted third country residents. Indeed, that a third country resident could obtain advantage through the use of

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[23] Rev. Rul. 75-23, 1975-1 C.B. 290. Rev. Rul. 75-23 was premised on the Antilles corporation being subject to the tax laws of the Antilles on the income in question. However, the income in question was included within the definition of U.S. real estate income and the Antilles interpreted Article V of the treaty to reserve to the United States exclusive jurisdiction to tax such income.

[24] Rev. Rul. 75-23. Compare Article 11(5), U.S.-German treaty; Article 12(5), U.S.-Netherlands treaty. Cf. Article 13(5), U.S.-Netherlands treaty, discussed infra.

an Antilles corporation did not even rise to the level of being an issue.[25] Nor should it have.

The Netherlands Antilles treaty was modified by protocol[26] so as to eliminate certain treaty benefits of an Antilles corporation which enjoyed special tax benefits in the Antilles unless the Antilles corporation were owned by certain qualified residents. The principle appeared to be that if an Antilles corporation were subject to a minimum level of taxation in the Antilles it could obtain treaty benefits even if owned by third-country residents. Conversely, if owned by Antilles individuals or Dutch corporate residents, benefits applied to an Antilles corporation even if the special reduced rate of tax also applied. Thus, the U.S. policy insofar as it applied to the Netherlands Antilles treaty was that "treaty shopping" (including base erosion) was "o.k." so long as special rates of tax were not enjoyed.[27] In other cases, treaty benefits also were not to apply

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[25] See London Displays Company N.V., 46 T.C. 511 (1966); see also Casanova Co., 87 T.C. 214 (1980), acq.

[26] 1963 Protocol modifying and supplementing the Extension to the Netherlands Antilles of the Convention, 2 CCH Tax Treaties ¶6239 ("1963 Protocol").

[27] And there were even exceptions to this. See Article I(2)(a), 1963 Protocol.

to an entity that obtained special tax benefits in the country of residence,[28] if owned predominantly by third-country residents.

Suffice it to say here that the U.S. policy relating to the Netherlands Antilles changed dramatically, resulting in the termination of the treaty with effect from January 1, 1988,[29] in large part because the United States felt its continued existence permitted currently unintended persons (i.e., third-country residents) to benefit therefrom. While one would therefore assume that third-country residents are not to be accorded treaty benefits as a matter of policy, policies do change. Consider, for example, Article 13(5) of the U.S.-Netherlands treaty.

Under Article 13(5) of the U.S.-Netherlands treaty, third-country residents receiving U.S.-source royalties from a Dutch resident in certain circumstances may obtain an exemption from U.S. tax.[30] A third-country resident may be entitled to an exemption from U.S. tax under Article 13(5) on U.S.-source royalties received from a Dutch resident which absent Article 13(5) would be subject to U.S. tax, provided

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[28] See Article 16, U.S.-U.K. treaty; Article XV, U.S.-Luxembourg treaty.

[29] Except for Article VIII thereof (relating to the receipt of interest income). See Rev. Proc. 89-53, 1989-2 CB 633.

[30] See Article 13(5)(d), U.S.-Netherlands treaty.

a. the Dutch resident payor does not receive a royalty in respect of the licensed intangibles from a U.S. resident;

b. the intangibles giving rise to the payment of the royalty are a component part of or are directly related to the active conduct of a trade or business by the Dutch resident payor; or

c. the Dutch resident payor nor the third country recipient maintains a permanent establishment ("p.e.") in the United States.

Consider the following example: T, a resident of a country which does not have tax treaty with the U.S., licenses a certain intangible to N, a Dutch corporation which does not maintain a U.S. p.e. Assume N sublicenses the intangible to U, a U.K. resident. Further assume U sublicenses the intangible to a U.S. resident. In such circumstances, and assuming the arrangements are respected (i.e., each recipient is considered the beneficial owner of the income it receives), it appears that the cascading royalty problem has been avoided at least insofar as T is concerned. In effect, the royalties paid by N to T would be treated as if it were not U.S.-source royalties, apparently without regard to whether N would be entitled to treaty benefits with respect to any U.S. source royalties it receives.

Similarly, a Dutch resident which may not be entitled to treaty benefits because of Article 26, or would otherwise be entitled only to partial benefits by virtue of Article 13(6)[31], would nevertheless be exempt from tax on the receipt of U.S.-source royalties from another Dutch resident, again apparently without regard to whether the payor or recipient Dutch resident would be entitled to treaty benefits. Thus, for example, a non-publicly traded Dutch corporation ("N") owned by third-country residents will be exempt from U.S. tax on the receipt of U.S.-source royalties from another Dutch corporation ("NL"), but only if such royalties are not attributable to a U.S. p.e. of the payor or recipient. Moreover, as noted above, in the case illustrated, royalties paid by N to third-country residents will be exempt from U.S. tax.

Subject-to-Tax Requirement, in General

Requiring an entity to be subject to a minimum level of tax in its country of residence would appear to advance the objective of limiting treaty benefits to situations in which, absent the benefit applying, there would be double taxation. If that were indeed an overriding treaty objective, one would expect to find a plethora of subject-to-tax requirements in U.S. tax treaties. However, they are few and far between.[32] To be sure,

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[31] See discussion, infra.

[32] Article VIII(1), U.S.-Ireland treaty; Article VIII(1), 1945 U.S.-U.K. treaty, III P-H Tax Treaties ¶89,101; cf. Article 4(5), U.S.-U.K. treaty.

the omission of a subject to tax requirement may be explained on the basis that treaty benefits are granted in the first place only to persons who are considered to be resident in the home country and that generally the term resident is defined narrowly enough as to exclude persons who are not subject to tax on the widest basis possible in the home country.[33] As so viewed, there is little need expressly to provide a subject-to-tax requirement.

That a resident is generally "subject-to-tax" on world-wide income in its home country does not necessarily end the inquiry of whether tax treaty benefits ought to apply to the income of such person, particularly if under the applicable home country tax laws such person may take measures to eliminate or reduce its tax liability to a de minimis amount. In Compagnie Financiere de Suez et de L'Union Parisienne v. U.S.,[34] a question arose as to whether a corporation should be regarded as a French corporation (i.e., created or organized under the laws of France), in which case a reduced U.S. withholding tax rate would have applied under the literal terms of the U.S.-French treaty then in force, or instead as a corporation that was created or organized under non-French law, in which case the reduced treaty

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[33] See Commentary on Article 4(II)(8), 1992 OECD Convention, 1 CCH Tax Treaties ¶191; Article 4(1)(a), U.S.-German treaty; cf. Article 4(5), U.S.-U.K. treaty. But cf. Protocol to 1939 U.S.-Sweden treaty, ¶(3); cf. Holmstrom v. PPG Industries, supra n.11.

[34] 492 F.2d 798, 74-1 USTC ¶9254 (Ct. Cl. 1974) (hereinafter "Suez").

benefit would not have applied. The court determined that the corporation was not created or organized under the laws of France and therefore the reduced treaty rate did not apply. Having made the only determination that appeared to be necessary to reach its decision, the court went on to indicate that even if the corporation had been created or organized in France or under the laws of France, which the Court felt it was not, the corporation would not qualify as a French corporation for purposes of the treaty[35] because the corporation was not subject to French income taxation on the receipt of the income in question and therefore denial of treaty benefits would not result in double taxation, the avoidance of which was the purpose of the treaty.

The dictum is somewhat disturbing for more than one reason. First, it appears to consider insignificant that one possible basis for the income in question not being subject to French income tax was the French exemption system for the avoidance of double taxation, a system with which the negotiators were familiar. Second, if taken to an extreme, the principles underlying the dictum would limit treaty benefits to those situations in which, in the absence of the relief granted by tax treaty, double taxation would actually result. Concededly, that double taxation may theoretically result in the absence of the benefit conferred by treaty is a valid basis for entering into

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[35] 74-1 USTC ¶9254, at 83,514.

the treaty; it cannot be the only basis for the treaty benefit to apply. Indeed, were the rule otherwise, one of the bases for entering into treaties (i.e., reducing source country taxation of residents of countries with foreign tax credit systems for the avoidance of double taxation) would be undercut.

To read the dictum more narrowly, as only applicable to income of corporations exempt from home country tax as a result of the exemption system for the avoidance of double taxation, does not yield a more convincing rationale, since such corporations should be treated no worse than corporations entitled to double taxation relief by means of a foreign tax credit system. Perhaps yet a more narrow reading is appropriate: a corporation which, under the laws of the purported home country, is not subject to any tax with respect to any income cannot be considered a person entitled to treaty benefits (i.e., a "resident").

Consider, in this connection, the case of a Dutch corporation owned 51% by Dutch residents with a permanent establishment in Switzerland engaged in the licensing of patents. Assume that the Swiss permanent establishment receives U.S.-source royalties subject to a minimal (10%) tax in Switzerland, but substantially exempt from Dutch tax[36] pursuant to the Dutch exemption system for the avoidance of double taxation. Should

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[36] In practice, it is understood the Dutch will exact some tax in this case.

such Dutch corporation be entitled to an exemption from U.S. tax with respect to U.S.-source royalties received by its Swiss p.e. pursuant to the royalty article, as the 1948 treaty between the U.S. and the Netherlands literally seemed to provide? Or, would a court have been correct in treating such corporation as not being "sufficiently Dutch,"[37] or not being a resident[38] under the dictum in Suez? This issue is not made academic by the latest form of limitation on benefits provision;[39] such a provision would not affect the entitlement to treaty benefits in the posited case unless the Dutch corporation were a non-publicly traded corporation which also "eroded its base," a term discussed more fully below.[40]

Articles 12(8) (relating to interest) and 13(6) (relating to royalties) of the U.S.-Netherlands treaty, added by the 1993 Protocol, by attempting to deal with the perceived abuse of the posited case, appear to have avoided the issue. Under Article 13(6), U.S.-source royalties received by, for example, a Swiss p.e. of a Dutch corporation will not be entitled to the

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[37] Under the 1948 U.S.-Netherlands treaty, the Article IX royalty exemption applied to Dutch corporations.

[38] Assuming the exemption applied only to residents as in the case of the 1992 U.S.-Netherlands treaty. See Article 13.

[39] See Article 26, U.S.-Netherlands treaty; but see Articles 12(8) and 13(6), U.S.-Netherlands treaty.

[40] Interestingly, in the posited case whether or not the company eroded its base would have little or no impact on its Dutch tax liability.

exemption from U.S. tax generally afforded by Article 13 of the treaty, but rather will be subject to a 15% rate of tax if the Swiss and Dutch taxes imposed on the profits of the Swiss p.e. together are less than 50 percent[41] of the rate of tax generally imposed on Dutch corporations (presumably with respect to income which is not entitled to an exemption from tax). Several observations are in order.

First, if, in the illustration, the aggregate tax imposed on the profits of the Swiss p.e. by Switzerland and the Netherlands meets the minimum threshold requirement, the exemption from tax afforded by Articles 12 and 13 for interest and royalties would literally not be disallowed by Articles 12(8) and 13(6), respectively, even if the profits of the Swiss p.e. were wholly exempt from Dutch tax. In such circumstances, an exemption from U.S. tax would be afforded under the U.S.-Netherlands treaty with respect to income which is wholly exempt from Dutch tax merely because the jurisdiction in which the p.e. is situated imposed some minimum level of tax which implicitly is imputed to the Netherlands resident.

A more interesting issue arises where the minimal level of taxes have not been imposed. For example, assume no taxes are imposed either by the Netherlands or the jurisdiction in which the p.e. is situated. In such circumstances, treaty benefits

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[41] With respect to income paid on or after January 1, 1998, "60 percent."

could still apply under the U.S.-Netherlands treaty: A complete exemption could apply if in the case of interest, the interest was derived in connection with or incidental to the active conduct of a trade or business in the jurisdiction in which the p.e. is situated, or in the case of royalties, the royalties were derived from intangibles developed from the p.e.[42] Thus, where the p.e. is sufficiently active in connection with the derivation of the income, treaty benefits otherwise accorded to interest and royalties would not be denied solely because the income in question has not been subject to a significant home country tax. Significantly, moreover, even where the p.e. is totally inactive, and aggregate taxes do not meet the required threshold, a 15% reduced treaty rate of tax literally appears to apply, provided the Dutch corporation in question is considered to be a resident of the Netherlands.[43]

Reduction in Effective Rate of Home Country Tax/Base Erosion

As noted above, if the home country provides a reduced rate of tax on the income of resident corporations which meet certain requirements, the U.S. may wish to deny benefits to

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[42] It appears that mere payment by the p.e. of the cost of development elsewhere would not be sufficient. See Joint Committee on Taxation, Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the U.S. and the Netherlands, 2 CCH Tax Treaties ¶6119 (hereinafter "Joint Committee Explanation") at 36,447-110.

[43] Cf. Article 4(1)(a); Suez, supra n.34.

corporations which qualify for such benefits.[44] More difficult cases arise where the home country provides no special rules but the effective rate of home country tax is considered to be sufficiently low that obtaining an exemption from U.S. tax under a treaty would have the effect of virtually eliminating all taxes. Where the reduction in the effective tax rate is brought about through deductible payments made to third-country residents, an issue of "treaty abuse" arises: the nominal owner of the income-concededly a resident of, and subject to tax in, the home country - avoids significant home country tax through payments to third-country residents. There are many examples of how this might work in practice, from the back-to-back interest payment structure struck down in Aiken Industries,[45] to more sophisticated approaches under which an affiliated company filing the equivalent of a consolidated return makes the deductible payments and to situations in which deductions are legitimately taken even where no payments are required. In the simpler cases, it becomes easier for a court to treat the treaty country corporation as an intermediary and therefore not a person to whom the treaty exemption should apply. Where the arrangements are

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[44] See and compare, Articles 12(8) and 13(6), U.S.-Netherlands treaty; Article XV, U.S.-Luxembourg treaty; Article I(1), 1963 Protocol. See also Article 16, U.S.-U.K. treaty.

[45] Supra n.6. See also Rev. Ruls. 84-152 and 84-153, supra n.9.

not entirely back-to-back, the courts are likely to have more difficulty convicting the usual suspects.

The Swiss Solution

Well before the more modern era of treaty interpretation the Swiss took note of the possibility for the abuse of its treaty with the U.S. through the use of Swiss companies. Apparently concerned that the continued abuse of the treaty system through the use of Swiss corporations could lead to pressure for changes beyond those which the Swiss were prepared to make, the Swiss took unilateral action in what is known as the Swiss decree.[46] Under the Swiss decree, the Swiss collect tax they feel was improperly avoided under the treaty and pay over such tax to their treaty partners. Tax is deemed to be improperly avoided under the decree if either (a) the Swiss entity has eroded its base (i.e., it has paid out by way of deductible expenses more than 50% of its income to persons not entitled to treaty benefits), or (b) the Swiss entity is owned in substantial part by non-Swiss persons and does not pay out by way of dividends an amount equal to at least 25% of the gross income to which a tax convention applies. Thus, under the Swiss decree, but perhaps not under a limitation on benefits provision of the modern variety, a Swiss corporation owned 100% by third-country

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[46] Decree of the Federal Council, December 14, 1962 and Circular Letter of December 31, 1962 interpreting the decree.

residents, that receives $100 of royalties, pays less than $50 of expenses to third-country residents and pays out at least $25 of dividends annually, avoids adverse consequences. Moreover, enforcement of the Swiss decree is up to the Swiss; the United States has no right to insist on its enforcement and, it is understood has no knowledge of the persons against whom it is enforced.

Recent Dutch and German Treaties

In the succeeding sections, Articles 26 and 28, respectively of the U.S. treaties with the Netherlands and Germany will be discussed in the context of the above discussion.[47] Before a more detailed discussion, a few general comments are in order.

Overview

From the preceding discussion it would seem that the applicable limitation on benefits provisions are intended to apply only if after application of the other treaty provisions which describe the persons to whom benefits would otherwise apply, including the fiscal domicile article,[48] the artiste and athlete clause[49] and the savings clause,[50] an operative provision of the treaty[51] applies. The provisions are structured differently, however. Rather than limiting benefits which are otherwise applicable, the limitation on benefits provisions of

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[47] Although Article 28 of the U.S.-German treaty at least once was to be the current U.S. model, see Statement of Asst. Secretary (Tax Policy), Kenneth W. Gideon, Department of Treasury, Sen. Foreign Relations Committee Hearings, 101st Cong., 2nd Sess. (1989), Article 26 of the U.S.-Netherlands treaty may also serve as a model where detail is required for additional certainty notwithstanding the complexity it entails. Indeed, apparently it has served as a model for Article 30 of the proposed U.S.-France treaty signed September 1, 1994.

[48] Articles 4.

[49] Articles 18 or 17.

[50] Article 24(1) and (1)(a).

[51] E.g., Article 14(7) (gains from the alienation of movable property not forming part of a permanent establishment or fixed base), Article 13 (royalties), Article 12 (interest), Article 10 (dividends), U.S.-Netherlands treaty.

the two treaties extend benefits to persons who fit within certain categories more fully described below. Thus, under Article 28 of the U.S.-German treaty a resident is entitled to treaty benefits if such person meets certain qualifications.[52] This structure has lead certain commentators to suggest that the provision more appropriately belongs in the fiscal domicile article,[53] in effect superimposing a qualification requirement on the term resident. In this connection, it is unclear that the distinction between viewing Article 28 of the U.S.-German treaty as a limitation on benefits, as the title of the Article seems to suggest, or a grant of benefits, as the language states, is not of much significance. For example, Article 28 either does not impose a limitation on benefits applicable to residents who are individuals, or specifically entitles individual residents to the benefits of the convention without regard to any other requirement; in either case, the result is the same.

The distinction may have some significance under Article 26 of the U.S.-Netherlands treaty, however. For example, as noted previously, subject to certain limitations, Article 13(5) appears to preclude the U.S. from imposing a tax on what otherwise would constitute U.S.-source royalties paid by one

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[52] Cf. IRC §884(e)(1)(B).

[53] Ellis, The U.S.-Netherlands Double Tax Convention, Outline of Presentation before Joint Meeting of U.S. and Dutch IFA Branches, August 23-24, 1990 (Amsterdam).

Dutch resident to another whether or not the recipient or payor Dutch residents are entitled to benefits under Article 26. Indeed, if entitlement to benefits under Article 26 were a prerequisite to the limitation on the U.S. taxing jurisdiction provided by the first clause of Article 13(5)(d), the purpose of such clause would be unclear.

The term resident of a contracting state, insofar as an individual is concerned, is defined in Article 4 as any person who is subject to tax in such state by reason of his domicile or residence, but does not include an individual subject to tax in the contracting state only on his income from within that state. Presumably, the latter qualification is not intended to disqualify any individual resident of the Netherlands or Germany who is exempt from Dutch or German tax on non-home country income solely as a result of the exemption system for the avoidance of double taxation.[54] However, it does appear to exclude from the definition of a resident a U.S. resident under U.S. internal law who is also a resident of another treaty country and under the other treaty is treated as a resident of the other treaty country for purposes of such other treaty with the United States.

In any event, an individual who meets the above description is entitled to treaty benefits even if he "erodes his tax base" by making deductible payments abroad. A U.S. citizen

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[54] Cf. Suez, supra n.34.

or "green card holder" is not automatically a resident of the U.S. for purposes of the treaty. Rather, for such an individual to be a resident for treaty purposes, his presence in the United States must be more substantial than his presence in any other country. If he does not qualify under this test, he will not be treated as a resident for treaty purposes even though his worldwide income is subject to U.S. tax. The policy against extending treaty benefits to such persons is not clear.[55] One possible rationale is that such a U.S. person is more likely to reduce his U.S. tax liability by deductible payments to third-country residents. Another possible rationale is that the Netherlands and Germany wished to avoid the situation in which an individual could opt for lower U.S. taxes as compared with higher Dutch or German taxes simply by obtaining a green card, such individual being hardly the type of person to whom the Netherlands or Germany would wish to extend benefits and hardly the type of person the U.S. really cares about. Whatever the rationale, the result is that the policy of our U.S. treaty partners to consider individuals as being resident of a contracting state only if they have significant contacts prevailed over the U.S. position of taxing nonresident U.S. citizens.

Pass-through Entities

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[55] Indeed, it is not the U.S. position in the 1981 U.S. Model treaty.

Estates and trusts are treated as residents for treaty purposes only to the extent of their income which is subject to tax in the home country as the income of a resident. Unlike under some other treaties,[56] partnerships are not specifically mentioned in Article 4 of the U.S.-Netherlands treaty because they are treated as conduits so that treaty benefits are determined at the partner level. By contrast, consider Article 4 of the U.S.-German treaty which treats a partnership as a resident to the extent of the income thereof which is subject to tax as the income of a resident. In the latter case, a partnership with two partners, one an individual resident of Germany under the Article 4 definition, and the other a German corporation, will be considered a resident of Germany with respect to the individual German resident's distributive share of the income of the partnership. It should also be considered a resident of Germany with respect to the income of the partnership attributed to the German corporate partner whether or not such corporation qualifies for treaty benefits under Article 28 of the U.S.-German treaty, since qualification under Article 28 is not a prerequisite for residency classification. However, whether the German corporate partner qualifies under Article 28 will affect

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[56] See e.g., Article 4(i)(b), U.S.-Italy treaty; Article 4(i)(b), U.S.-German treaty.

whether it is entitled to treaty benefits with respect to its partnership income.[57]

If the partnership referred to above admitted a third-country resident as a third partner (and assuming all allocations are equal), it would be treated as a resident of Germany for treaty purposes only to the extent of two-thirds of its income.[58] As a result, only two-thirds of its income would be entitled to treaty relief.[59] If a fourth partner were admitted who was a resident of the U.S. for treaty purposes, the partnership would also be considered a U.S. resident to the extent of the U.S. resident's distributive share of the partnership income. In these circumstances, a person (i.e., the partnership) can be resident in both contracting states.[60] Because a partnership is

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[57] See Example V, Understanding Regarding the Scope of the Limitation on Benefits Article in the U.S.-German treaty, 2 CCH Tax Treaties ¶3252 (hereafter "MOU").

[58] Whether a special allocation to the German resident partners of income to which the treaty could apply would withstand the substantial economic effect rules of IRC §704 is beyond the scope of this paper.

[59] If the partnership were a U.S. partnership, it must resolve the issue of treaty entitlement for withholding purposes. If, however, the partnership were not a U.S. partnership, U.S. withholding could be required on all payments to the partnership regardless of the treaty entitlements of its partners. Treas. Reg. section 1.1441-3(f). However, it is not the current policy of the U.S. to require withholding on income to which a treaty benefit applies. Technical Explanation to U.S.-German treaty, 1 CCH Tax Treaties, ¶3255 at 28,230.

[60] Cf. Article 4(3). That provision provides that where a person other than an individual is resident in both contracting states, the competent authorities shall endeavor

treated as a conduit for purposes of the U.S.-Netherlands treaty the distinctions noted above do not appear to be relevant.

Other pass-through entities are not dealt with directly under the U.S. treaties with Germany and the Netherlands.[61] Thus, for example, a U.S. corporation for which an "S election" is in effect (and which is not a resident of Germany or the Netherlands[62]) is considered a resident of the United States for purposes of the treaty. Moreover, this result would appear to obtain even if the S corporation had as its only shareholder a nonresident U.S. citizen who did not meet the substantial presence test for a year and as a consequence would not be viewed as a U.S. resident for purposes of the treaty for such year. Whether such a corporation would be granted/denied benefits under Article 28 of the U.S.-German treaty will be considered below. Suffice it to say here that such an S corporation will meet the ownership test of Article 28(1)(e) since, for purposes of the ownership test, U.S. citizens qualify as good shareholders

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to determine the contracting state in which the person should be considered resident for purposes of the treaty. If the competent authorities cannot make such determination, the person shall be considered resident in neither contracting state. Since Article 4(3) appears to deal only with issues of conflict, it should not affect the conclusion stated in the text regarding a dual resident partnership.

[61] Cf. Articles 10(2) of each treaty, relating to dividends from regulated investment companies and their equivalents and real estate investment trusts.

[62] Article 4(3).

regardless of whether they also are U.S. residents within the meaning of Article 28.[63] If the shareholder of the S corporation were instead an alien green card holder, the S corporation would meet the ownership test only if such green card holder were a resident of the U.S. for treaty purposes, e.g., he also met the substantial presence test referred to above, and was subject to U.S. tax on his non-U.S. source income.

Persons Other than Individuals

In order for a person other than an individual, partnership, estate or trust to obtain treaty benefits, it must qualify as a resident within the meaning of Article 4 and be entitled to benefits under the limitation on benefits provision.[64] As in the case of an individual, a contracting state or political subdivision thereof automatically qualifies.[65] The term "contracting state" is not defined, but presumably means with respect to each contracting state, its government and each integral part thereof. It is not clear, however, whether the term includes a controlled entity[66] of the government. If not,

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[63] See also Article 26(8)(g)(ii), U.S.-Netherlands treaty.

[64] Article 26, U.S.-Netherlands treaty; Article 28, U.S.-German treaty. See also Articles 35 and 36, U.S.-Netherlands treaty with respect to certain exempt organizations.

[65] Article 28(1)(b), U.S.-German treaty; Article 26(1)(b), U.S.-Netherlands treaty.

[66] See Treas. Reg. §1.892-2T(3) for the definition of controlled entity.

any such controlled entity must pass muster under the more general rules of the applicable limitation on benefits provision applicable to other corporations. However, it is clear that a controlled entity will qualify under the ownership test of the applicable limitation on benefits provision. As will be described below, qualification under the ownership test of itself does not require the conclusion that the corporation is entitled to benefits.

A not-for-profit organization, including pension trusts, trade associations and the like, is entitled to benefits if more than fifty percent of its beneficiaries, members or participants are persons entitled to treaty benefits.[67] Furthermore, pension trusts and pension funds qualify if the organization sponsoring such fund, trust or entity is itself entitled to benefits.[68] Thus, pension fund more than 50 percent of the participants of which are not residents may still qualify if it is a pension fund for employees of an entity that qualifies.

Safe Harbor

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[67] Article 28(1)(f), U.S.-German treaty; Article 26(1)(e), U.S.-Netherlands treaty.

[68] Paragraph 28, Protocol to U.S.-German treaty; Article 8(j), U.S.-Netherlands treaty; Treasury Explanation to U.S.-Netherlands treaty, 2 CCH Tax Treaties ¶6121, at 36,447-174 (hereinafter "Treasury Explanation").

Apart from the special rules noted above, treaty benefits are accorded to a resident person, if such person meets a safe-harbor test,[69] or is able to convince the competent authority of the source state that it should otherwise be entitled to benefits (the "subjective test").[70] There are three different safe harbor tests under the U.S.-German treaty and additional safe harbor tests under the U.S.-Netherlands treaty. If a corporate resident is able to meet any one of them, it is entitled to treaty benefits regardless of whether it can meet another one of the tests. Thus, for example, a corporation that is engaged in the active conduct of a trade or business and which derives income which is incidental thereto (i.e., it meets the active trade or business safe harbor) is automatically entitled to treaty benefits with respect to such income, even if it is owned entirely by third-country residents (i.e., it does not meet the stock ownership safe harbor[71] and even if it pays out by way of deductible expenses an amount equal to more than fifty percent of its gross income (i.e., it does not meet the base erosion safe harbor).[72] Similarly, a resident corporation with respect to

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[69] Article 28(1)(c), (d) or (f), U.S. German treaty; Article 26(1)(c), (d), 26(2), (3), (4), (6), U.S.-Netherlands treaty.

[70] Article 28(2), U.S.-German treaty; Article 26(7), U.S.-Netherlands treaty.

[71] Article 28(1)(e)(aa), U.S.-German treaty.

[72] Article 28(1)(e)(bb), U.S.-German treaty; Article 26(1)(c)(i), U.S.-Netherlands treaty.

which there is substantial and regular trading on a recognized stock exchange in its principal class of shares (i.e., a corporation meeting the publicly-traded safe harbor)[73] is entitled to treaty benefits even if it cannot meet the active trade or business safe harbor or the ownership and base erosion safe harbors. A German corporation which does not meet the active trade or business safe harbor or the publicly-traded safe harbors is not, however, automatically entitled to benefits under the U.S.-German treaty unless it meets both the ownership and base erosion safe harbors.[74] By contrast, a Dutch corporation may qualify under Article 26 of the U.S.-Netherlands treaty if it meets either the publicly traded, active trade or business, ownership and base erosion, or headquarter company tests.

In either case, neither third-country resident ownership nor base erosion is a ground for denial of treaty benefits with respect to income which is incidental to an active trade or business carried on in the country of residence; nor are such factors a ground for a denial of any treaty benefits to a corporation meeting the publicly-traded safe harbor. However, there is no safe-harbor entitlement with respect to income that is not incidental to an active trade or business carried on in the country of residence of a corporation that does not meet the

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[73] Article 28(1)(d), U.S.-German treaty; Article 26(1)(c)(i), U.S.-Netherlands treaty.

[74] Article 28(1)(e).

publicly-traded safe harbor if either the ownership or base erosion safe harbors have not been met.

These distinctions apparently have been drawn on the basis that a corporation meeting one of the safe harbors is not a likely vehicle for use by unintended beneficiaries. For example, a publicly-traded corporation is considered an unlikely vehicle for treaty abuse because it is perceived to be difficult for its income to be manipulated in favor of third-country resident shareholders or obligees. Moreover, it is considered likely that its shareholders are resident in the country where its shares are listed, although both this assumption and its significance are questionable.

A corporation engaged in an active conduct of a trade or business is also considered an unlikely candidate presumably because the decision regarding where to establish a significant presence is likely to be affected primarily by business rather than tax considerations and therefore the "shopping" element in the "treaty shopping" issue is considered likely to be missing. That such a corporation can, subject to conduit and other abuse of law principles, erode its tax base in its country of residence is also considered less of a problem than in the case of a more passive company. Indeed, the concern regarding limitation on benefits arose with respect to companies which generally could not meet the active business test.

The more difficult analysis involves the passive company. Clearly, the intent is not to grant benefits to a company which erodes its tax base because such a company would avoid tax in the home country. But if the corporation does not erode its base and therefore its income is subject to tax in its country of residence,[75] it is unclear why it is considered necessary for the corporation also to meet a stock ownership test. The short answer frequently given is that if there were no stock ownership requirement in a treaty, that treaty could be viewed as a treaty with the world, leaving little incentive for other countries to negotiate tax treaties with the United States. As noted above, the situation already exists with respect to active businesses and publicly-traded corporations so it is not clear to this observer how significant the response really is. Be that as it may, it is likely we will continue to have a stock ownership requirement.[76]

Derivative Benefits

Related to why it is thought a stock ownership requirement is necessary is the issue of whether acceptable stock ownership should be limited to residents of the two contracting states, or whether derivative benefits ought to be allowed where

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[75] Cf. Article 13(6), U.S.-Netherlands treaty.

[76] See Article 18, Proposed Protocol amending U.S.-Canada treaty; Article 17(d)(i), Proposed U.S.-Sweden treaty; Article 30(1)(d) proposed U.S.-France treaty.

shareholders are resident in third countries that have treaties with similar tax benefits. The issue is not a new one. In our treaty with Jamaica[77] and in at least one version of the U.S. model limitation on benefits provision,[78] ownership by residents of countries with tax treaties that have substantially similar benefits was found to be acceptable. The theory of permitting derivative ownership is that if similar benefits could have been obtained by the shareholders, their use of the treaty country corporation could not have been motivated by a principal purpose of obtaining treaty benefits. Notwithstanding this, most subsequent treaties have not included such a provision.[79] Where a treaty has included a principal purpose test,[80] it has been stated that the test will be met if there is no overall tax reduction or if there are substantial business activities in the country of residence.[81]

A similar issue arises under the base erosion safe harbor. Should deductible payments made to third-country

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77 Article 17(3)(b), U.S.-Jamaica treaty.

78 1 CCH Tax Treaties ¶213.

79 But see, Article 17(1)(g), U.S.-Mexico treaty; Article 26(4), U.S.-Netherlands treaty, Article 30(4)(b), proposed U.S.-France treaty.

80 See, e.g., Article 26(2), U.S.-Cyprus treaty.

81 U.S. Treasury Technical Explanation; U.S.-Cyprus treaty, 1 CCH Tax Treaties, ¶2350 at 23,044. As noted below, Article 26(7) of the U.S.-Netherlands treaty expands substantially on the principal purpose test.

residents who are entitled to substantially similar treaty benefits with respect to such payments be treated as good or bad? It has been argued that the derivative benefit approach is too difficult to administer.[82] First, it is argued that to be administered properly consideration must be given to whether the benefit claimed to be similar is in fact similar. Furthermore, the determination would have to continue up the chain. However, this seems to be no more of a problem than would be the case with pass-through entities discussed above. Second, it is argued that there is no clear way to deal with differences in rates. Thus, for example, is a 10% dividend withholding rate sufficiently similar to a 5% rate? Perhaps one solution would be to impose the rate applicable to the ultimate owner where the ownership test is not met. Third, it is argued that the granting of derivative benefits removes incentives for the negotiation of treaties. It is unclear whether one can demonstrate that this is a real issue. In the past the United States had treaties with the world (i.e., the Netherlands Antilles treaty) and yet the United States was able to negotiate and renegotiate treaties. Finally, it is argued that there will be difficulty administering an exchange of information provision between the third country and the United States. Notwithstanding these arguments, limited

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[82] See Bennett, The U.S.-Netherlands Tax Treaty Negotiations: A U.S. Perspective, IFA Joint Meeting U.S. and Dutch Branches, Amsterdam (1990).

derivative benefit provisions have been included in the U.S. treaties with the Netherlands and Mexico and in the proposed treaty with France.

Having discussed certain of the principles, we now turn to the specifics of the safe harbor tests. We start with the active business requirement, a subjective rule made up to look objective.

Active Conduct of a Trade or Business

In order to determine whether the active conduct of a trade or business safe harbor applies, a number of determinations must be made: First, a determination must be made as to whether the activities of the corporation or a related corporation[83] constitute the active conduct of a trade or business[84] other than the making or managing of investments carried on by a person that is not a bank or insurance company (the "Active Business Test"). Second, one must determine whether the income for which treaty relief is sought is derived in connection with that business (the "Derived in Connection Test"). Third, one must determine whether the trade or business of the income recipient is substantial in relation to the income producing activity (the "Substantiality Test").[85]

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[83] Examples II and III, MOU; Article 26(2)(e), U.S.-Netherlands treaty.

[84] Cf. Treas. Reg. §§1.884-5T(e)(2) and 1.367(a)-2T(b)(2).

[85] Article 26(2)(a), U.S.-Netherlands treaty provides as an alternative to meeting the Derived in Connection Test and

In making the active conduct of a trade or business determination it appears that precedents under section 367 may be used as a guide.[86] Under those provisions, a trade or business is defined as a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. For a business to be considered actively carried on, its officers and employees must carry out substantial managerial and operational activities therewith, although incidental activities may be carried on by independent contractors.[87] If the sole activity of the corporation and corporations related to it in the country of residence is the performance of administration or head office and related financing activities a question may arise as to whether such corporation will pass muster under the active trade or business test. Treasury has thus far taken the position that a Belgian company which qualifies as a Belgium Coordination Center is not likely to pass muster,[88] although it may well be that the real concern is that such a company is

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the Substantiality Test that the U.S. income be "incidental to that trade or business in the [Netherlands]."

[86] S. Exec. Rept. 101-27, Comm. on Foreign Relations, 101st Cong., 2nd. Sess. (1989), II P-H Tax Treaties ¶39,067; see Reg. §1.367(a)-1T(b)(2)(a). Technical Explanation at 36,447-186.

[87] Reg. §1.367(a)-2T(b)(2)(b).

[88] Rept. of Comm. on Foreign Relations on the Protocol to the Tax Convention with Belgium, 1 CCH Tax Treaties ¶1356, at 17,059. See also by implication Article 26(3), U.S.-Netherlands treaty.

subject to special tax legislation in Belgium.[89] Thus, it may be that the active trade or business test is intended to cover only entities which are not subject to special rates of reduced tax, but such a restriction might be articulated more clearly. For example, not all head office companies will be viewed as involved simply in the management of investments.[90] At this point it might be helpful to focus on the detailed active conduct of a trade or business safe harbor found in Article 26(2) of the U.S.-Netherlands treaty.

The first requirement under Article 26(2) is that the entity in question be engaged in the active conduct of a trade or business in the Netherlands. The Technical Explanation states the following regarding this issue:

> [T]he United States competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation will generally be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities Technical Explanation at 36,447-186.

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[89] Cf. Article 26(3)(f), U.S.-Netherlands treaty.

[90] Paragraph B, MOU.

The Technical Explanation does not explain the requirement that the trade or business be actively conducted in the Netherlands. It may be intended that the regulations under I.R.C. §367(a) are to be consulted for this purpose as well.

The regulations under I.R.C. §367(a) deal separately with (i) the definition of "trade or business", (ii) whether a trade or business is actively conducted, and (iii) whether such active conduct occurs outside the U.S.[91] In addition to the principles paraphrased in the portion of the Technical Explanation quoted above, the regulations provide that a "trade or business" is ordinarily a group of activities that includes "every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit," and ordinarily includes the collection of income and the earning of expenses.[92]

The regulations provide that in order for a corporation to be engaged in the active conduct of a trade or business, the officers and employees of the corporation (or of related entities, provided such officers and employees of related entities are supervised on a day-to-day basis by, and the costs with respect thereto are borne by, the corporation conducting the trade or business) must carry out "substantial managerial and

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[91] Treas. Reg. §1.367(a)-2T(b)(2), (3) and (4)

[92] Treas. Reg. §1.367(a)-2T(b)(2).

operational activities."[93] More specifically, the regulations provide that "[w]hether a trade or business that produces . . . royalties is actively conducted shall be determined under the principles of §1.954-2(d)(1) (but without regard to whether the . . . royalties are received from an unrelated person)."

The current version of the I.R.C. §954 regulations referred to above is in Treas. Reg. §1.954-2T(b)(5) and -2T(d)(1), which provide that whether royalties are derived in the active conduct of a trade or business is determined on the facts and circumstances, and that royalties will be considered to be so derived if derived from licensing one of the following:

> (i) Property which the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation, or production of, or in the acquisition of and addition of substantial value to, property of such kind, or
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> (ii) Property which is licensed as a result of the performance of marketing functions by such licensor and the licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and which is substantial in relation to the amount of royalties derived from the licensing of such property.[94]

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[93] Treas. Reg. §1.367(a)-2T(b)(3).

[94] Treas. Reg. §1.954-2T(d)(1). A foreign organization is "substantial" for purposes of (ii) above if its "active licensing expenses" are at least equal to 25% of its "adjusted licensing profit." Treas. Reg. § 1.954-2T(d)(2)(ii); see Treas. Reg. § 1.954-2T(d)(2)(iii), (iv).

Assuming a Dutch corporation derived royalties from licensing property developed and created by it, such corporation would be considered to be actively conducting its licensing businesses under (i) above.

The final (and in many cases the most difficult) issue under the Active Business Test is whether the Dutch corporation in question would be considered to be engaged in such active conduct in the Netherlands. Neither the text of Article 26(2) nor the Technical Explanation elucidate this requirement. Assuming for the moment that the I.R.C. §367 regulations are relevant to this issue, the only guidance offered by such regulations is that in order for a trade or business to be conducted outside the United States, the "primary managerial and operational activities of the trade or business" generally must be conducted outside the United States.[95] If applied in the context of Article 26(2), this would require that the primary managerial and operational activities of the trade or business be conducted in the Netherlands. With respect to managerial activities, this test is presumably met by the Dutch corporation in question, i.e., whatever managerial activities are necessary in its licensing business occur, for example, in the Netherlands. Operational activities, however, may be a different matter. To be sure, in a licensing business the day-to-day licensing

[95] Treas. Reg. §1.367(a)-2T(b)(4).

operations may be carried out in the Netherlands. However, it is possible that the "operational activities" of the company would be considered to consist of the development of the intangible. The Joint Committee Explanation of Article 13(6) of the U.S.-Netherlands treaty assumes that development will not be considered to have taken place (by implication, in the Netherlands) merely by virtue of payment of development costs from the Netherlands.

Derived In Connection Test. The Derived in Connection Test requires that the U.S. income-producing activity be a line of business that "forms a part of or is complementary to" the Dutch trade or business. Article 26(2)(b). The Technical Explanation explains that --

> a business activity generally will be considered to "form a part of" a business activity conducted in the other state if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. In order for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they

> should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. . . . Royalties generally will be considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Technical Explanation at 36,447-187.

It is possible to interpret the above language to mean that so long as a Dutch corporation were engaged in an active licensing business in the Netherlands, the U.S.-source royalties earned by it would be considered to be derived in connection with such trade or business, as the U.S. income is derived from the very intangibles created by the Dutch business (or is at the very least "complementary" thereto). On the other hand, it could be argued that in order to qualify, the income must be from the licensing of intangible property actually created in the Netherlands.

The latter argument is supported somewhat by the regulations under I.R.C. §884 (to which the Senate Foreign Relations Committee report on the treaty refers (with a "cf."

cite) in discussing the Derived in Connection Test). These regulations provide that a foreign corporation is a "qualified resident" of its country of residence with respect to a U.S. trade or business (and thus is eligible for income tax treaty protection from the U.S. branch profits tax) if (1) it is engaged in the active conduct of a trade or business in its country of residence (determined by reference to the I.R.C. §367(a)(3) regulations), (2) it has a "substantial presence" in such country (defined in terms of assets, gross receipts and payroll ratios), and (3) the U.S. trade or business is an "integral part" of an active trade or business in such country.[96] The "integral part" test is met if the two trades or businesses "comprise, in principal part, complementary and mutually interdependent steps in the United States and its country of residence in the production and sale or lease of goods or in the provision of services."[97] Subject to certain exception not applicable here, the regulations provide that the test is not met if a U.S. trade or business "sells goods that are not, in principal part, manufactured, produced, grown, or extracted by the foreign corporation in its country of residence."[98]

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[96] Treas. Reg. §1.884-5(e)(1).

[97] Treas. Reg. §1.884-5(e)(4)(i).

[98] Id. The exceptions include (i) where the foreign corporation takes physical possession of the goods in a warehouse in its country of residence, (ii) where 50% or more of the foreign corporation's worldwide gross income from the sale or lease of property of the type sold in the

These rules, if applied to Article 26(2), could be interpreted to require that in order for U.S.-source royalties to meet the Derived in Connection Test, the underlying intangible must be produced in the Netherlands. The better argument, however, would appear to be that the I.R.C. §884 standard should not be applied in this context because the "integral part" test in those regulations set forth a higher standard than the "forms a part of" or "complementary" standard required under the Derived in Connection Test. Thus, because the U.S. activity need only be "complementary to" the Dutch trade or business in order to meet the Derived in Connection Test, the relationship between the U.S.-source royalties and the licensing businesses of the Dutch corporation should be considered to be sufficient notwithstanding the absence of production activity in the Netherlands.

Substantiality Test. The Substantiality Test requires that the Dutch trade or business be substantial in relation to the U.S. income-producing activity. Whether this test is met is determined by reference to the Dutch business' share of the U.S. business, the nature of the activities performed and the relative contributions made to the conduct of the business in both states.[99] The treaty provides a safe harbor for substantiality

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U.S. is derived from the sale or lease of such property for consumption, use or disposition in the country of residence, and (iii) a de minimis rule. Treas. Reg. § 1.884-5(e)(4)(i), (iii), (iv).

[99] Article 26(2)(c).

if, for the preceding year, the average of the following three ratios exceeds 10% and each ratio exceeds 7.5%:

a. The value of the assets used or held for use in the active conduct of the Dutch trade or business over the value of the assets used or held for use by the trade or business producing the income in the U.S.

b. The gross income derived from the active conduct of the Dutch trade or business over the gross income derived by the trade or business producing the income in the U.S.

c. The payroll expense of the trade or business for services performed in the Netherlands over the payroll expense of the trade or business for services performed in the U.S.

Article II of the "Agreed Minutes" of the negotiators of the treaty provides that where a Dutch resident that is engaged in the active conduct of a trade or business in the Netherlands derives U.S. income without being engaged in the active conduct of a trade or business in the U.S. and does not own shares in the person from which the income is derived, Article 26(2) is satisfied if the Derived in Connection Test is satisfied, i.e., the Substantiality Test is deemed to be met.[100]

Headquarter Company

As noted previously, it is not entirely clear whether the activities relating to the supervision, administration, or

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[100] See also Technical Explanation at 36,447-190 ("if neither the recipient nor a person related to the recipient . . . has an ownership interest in the person from whom the income is derived, the substantiality test always will be satisfied").

financing of a group of companies would rise to the level of an active trade or business. For example, a Dutch company which performed only those activities for companies which were not actively engaged in a trade or business in the Netherlands may or may not obtain the active trade or business safe harbor. However, such a company may be entitled to treaty benefits by virtue of Article 26(3), provided it is subject to tax in the Netherlands at the regular rates.[101] To obtain the benefit of this special rule, the headquarter activities must be undertaken in the Netherlands for companies actively engaged in business in at least five countries each of which generates 10 percent of the gross income of the group. It does not need to own shares in such companies. Furthermore, the business activities carried on in any one country (other than the Netherlands) must generate less than 50 percent of the gross income of the group. In addition, the headquarter's company cannot obtain more than 25 percent of its gross income from the U.S., and such income obtained from the U.S. must be derived in connection with, or be incidental to, the business carried on by the group.[102]

Stock Ownership

In order to qualify under the stock ownership test for a year, more than 50 percent of the beneficial interests in the

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[101] Article 26(3)(f).

[102] The gross income ratios may be averaged for the preceding four years. Article 26(3).

person (i.e., trust or estate) or company must be owned directly or indirectly by any combination of the following (collectively "qualified persons"): (a) an individual resident of either contracting state or a U.S. citizen, (b) a contracting state or political subdivision thereof, (c) a corporation which meets the public trading safe harbor, (d) an entity which is a qualified not-for-profit organization, and (e) a company which meets the stock ownership and base erosion safe harbor.[103] Conspicuously absent from this list are corporations which meet the active business safe harbor, or the headquarter company safe harbor. Also absent from this list is a corporation which, while not qualifying for a safe harbor, obtains benefits through a competent authority proceeding.

Thus, for example, consider the case of a German corporation which is owned predominantly by third country residents, but which meets the active business test. Such a company will qualify for benefits under the U.S.-German treaty with respect to income incidental to its German business, but a wholly-owned German subsidiary of that company cannot qualify in its own right under the stock ownership test. However, such a subsidiary may qualify for benefits with respect to income which is incidental to the business of the German parent.

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[103] Article 26(8)(g), U.S.-Netherlands treaty; see also Article 28(1)(e)(aa), U.S.-German treaty.

An alternate ownership test is provided for Dutch corporations.[104] A Dutch corporation will qualify under that test if more than 30 percent of the vote and value of its shares is owned by qualified persons resident in the Netherlands, and more than 70 percent of the vote and value of the shares are owned by qualified persons (including for this purpose U.S. citizens and residents) and European Community residents who are residents in countries having a comprehensive tax treaty with the United States providing treaty benefits which are no less favorable than the rate of tax applicable under Articles 10, 11, 12 or 13. Thus, for example, a Dutch corporation which is owned directly and indirectly as to 40 percent by qualified persons resident in the Netherlands and 60 percent by qualifying European Community residents, meets the alternate ownership test. However, a Dutch corporation owned as to 25 percent by a U.S. citizen, 25 percent by a qualified person who is resident in the Netherlands, and as to 50 percent by qualifying European Community residents would not meet this test.

It should also be noted that under both the regular and alternative ownership tests, ultimate ownership is what counts.

Base Erosion

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[104] See Article 26(4)(a), U.S.-Netherlands treaty. A Dutch corporation qualifying under Article 26(4) is entitled only to the benefits of Articles 10, 11, 12 and 13.

Under the U.S.-German treaty, an entity fails to meet the base erosion test[105] for a year if it directly or indirectly "uses" an amount which is in excess of 50 percent of its gross income to meet liabilities for deductible expenses (or for items which give rise to tax benefits) to persons who are not qualified persons. Under the U.S.-Netherlands treaty, a proscribed base reductions occurs if deductible expenses paid to non-qualified persons equals or excess 50 percent of "gross income."[106] An alternate test applies in the case of a Netherlands corporation under the U.S.-Netherlands treaty.[107] Under the alternate test, a Netherlands corporation meets the base reduction test if less than 70 percent of such person's gross income is used to make deductible payments directly or indirectly to non-qualified persons; and less than 30 percent of such gross income is used to make deductible payments to persons who are resident in a member state of the European communities.[108]

While the reference to directly or indirectly is not spelled out in the material relating to the U.S.-German treaty, the

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[105] Referred to as the "base reduction test" under Article 26, U.S.-Netherlands treaty.

[106] Article 28(i)(e)(bb), U.S.-German treaty; Article 26(5)(i), U.S.-Netherlands treaty.

[107] See Article 26(5)(ii).

[108] To be considered a member state for this purpose, the state must have in effect comprehensive income tax conventions with both the U.S. and the Netherlands. Article 26(8)(h).

Technical Explanation relating to the U.S.-Netherlands treaty makes it clear that it is intended to cover a situation of a payment to a qualified person who makes a further onward payment to a non-qualified person where the two payments are related.[109] While not expressly stated in the treaty, Agreed Minutes, or Protocol, the Joint Committee Explanation indicates that it is understood that a proportionate part of a payment to a qualified person owned in part by a non-qualified person would be treated as a payment to a non-qualified person.[110] However, this would seem to go too far. Furthermore, it is presently unclear whether a payment by a related party would be considered an indirect payment, for example, where such payment would give rise to a tax benefit for a consolidated group or fiscal unity.

The language of Article 28(i)(e)(bb) seems somewhat broader than the language of Article 26(5)(a)(i) and (ii). Under the German treaty, the proscribed use occurs where a payment is used to meet a liability to a non-qualified person. Still broader language is contained in the branch profits tax regulations: an amount is considered used in the taxable year in which the satisfaction of a liability in respect thereof gives rise to a tax benefit, including an increase in the basis of the asset for U.S. tax purposes.[111] Under Article 26(5)(c) of the

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[109] Technical Explanation at 36,447-202.

[110] Joint Committee Explanation at 36,447-86.

[111] Treas. Reg. §1.884-5T(c).

U.S.-Netherlands treaty, literally in order for a payment to be considered bad, it must give rise to a deduction. In light of the specific exclusionary language referred to below relating to the capitalized cost of tangible property, it might be argued that a payment which increases the basis of intangible property subject to subsequent amortization deductions could be included as a proscribed payment. Similarly, whether a deduction which does not involve a payment is to be considered at all is less than clear. In this connection, payments made for the purchase or use of tangible property are in any event not to be included. Presumably, therefore, a deduction for depreciation of the capitalized cost of any tangible property should not be considered.[112] An amortization deduction in respect of the capitalized cost of an intangible should also not be considered if the term "payment" is to be given its ordinary meaning. But, as noted above, a case may be made for the inclusion of the capitalized cost of such an intangible at least when a payment is made in connection therewith.

As noted above, there has been a proscribed base erosion/reduction if in the taxable year an amount equal to a proscribed percentage of the gross income of the payor for such year is used to make deductible payments to non-qualified

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[112] In addition, certain other payments which give rise to a deduction are not to be considered, including remuneration at arm's length for services performed in the country of residence of the payor. Article 26(5)(c).

persons. Under the U.S.-German treaty, gross income means gross income as commonly understood. That is not the case under the U.S.-Netherlands treaty; under the latter treaty, for this purpose gross income for the taxable year is not the gross income realized in that year, but rather is deemed to be an amount equal to the higher of (a) the gross income for the year immediately preceding the year in which the deductible payments in question were made, and (b) the average of the annual amounts of gross income for the four taxable years preceding such current year.[113] An issue not expressly dealt with is whether the deferred payment of an accrued expense which if paid currently, would be included as a deductible payment, should be included as a proscribed payment in the year of accrual or payment, although it would seem that the year of payment should control. Assuming, as appears likely, the year of payment controls, a proscribed base erosion could be avoided by deferring a portion of any required payment. Thus, for example, assuming that a Dutch corporation were to receive $100 of gross income in 1994, its first year of operation, with respect to which it is obligated to make payment of $90 to non-qualified persons, it could avoid a proscribed base reduction by accruing the related $90 deduction in 1994 but by paying in respect thereof no more than: $49.5 in 1995, $24.5 in 1996, and the $16 balance in 1997.[114]

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[113] Article 26(5)(b).

Publicly Traded Exception

A corporation meets this safe harbor if there is substantial and regular trading on a recognized stock exchange in its principal class of shares. For purposes of Article 28 of the U.S.-German treaty, the term "recognized stock exchange" includes any exchange listed with the SEC, the NASDAQ System, any German stock exchange on which registered dealings in shares takes place and any other exchange agreed upon by the competent authorities.[115] For purposes of Article 26 of the U.S.-Netherlands treaty, the term "recognized stock exchange" includes stock exchanges registered with the SEC, and the Amsterdam, London, Frankfurt, Paris, Brussels, Hamburg, Madrid, Milan, Sydney, Tokyo, and Toronto exchanges.[116] It also includes NASDAQ and the parallel market of the Amsterdam stock exchange, except in the case of a "closely-held corporation."[117]

The term "substantial and regular" used in both the German and Netherlands treaties with the United States is similar

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Income	Actual Gross Income	Deemed Gross Permitted Payment
1994	100	N.A.
1995	0	100 <50
1996	0	50 <25
1997	0	33.33 <16.67

[115] Article 28(3), U.S.-German treaty; See Article 26(8)(d)(iv), U.S.-Netherlands treaty.

[116] Article 26(8)(d)(ii). Agreed minutes accompanying 1993 Protocol to U.S.-Netherlands treaty, ¶VI ("Agreed Minutes").

[117] Article 26(8)(e).

to the "primarily and regularly traded" language of I.R.C. §884(e)(4)(B).[118] The term regularly traded has been interpreted somewhat narrowly,[119] except for the case of stock that is traded during the taxable year on an established securities market in the United States. The substantially and regularly traded language has also been given a restrictive meaning. Under Article 26(8)(f) of the U.S.-Netherlands treaty, for the "substantially and regularly traded" requirement to be met with respect to the principal class of shares for a year trading of a more than a de minimis amount must be effected on one or more recognized stock exchanges during every month during such year, and the aggregate number of shares of that class traded on such exchanges during the previous taxable year must be at least six percent of the average outstanding shares of that class during that tax year. Unlike the branch profit tax regulations, no special rule is provided for short taxable years.[120] Significantly, the requirement of a minimum volume of trading for the previous taxable year raises the issue of whether a corporation may qualify in the first year it issues its shares to the public.[121]

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[118] See Treas. Reg. §1.884-5T(d)(3).

[119] See Treas. Reg. §1.884-5T(d)(4)(i), (ii), (iii).

[120] Treas. Reg. Section 1.884-5T(d)(4)(i)(B).

[121] Cf. Article 26(8)(1), U.S.-Netherlands treaty.

It should be remembered that the trading requirement is with respect to the principal class of shares. For a class of shares to constitute the principal class of shares under the U.S.-Netherlands treaty, it must represent more than fifty percent of the voting power and value of all shares. If no one class of shares meets this test, then multiple classes may make up the principal class.[122] For example, assume a Dutch corporation had two classes of shares, ordinary or common shares, and preferred shares. Further assume that the preferred shares represented more than 50% of the value and the common shares more than 50% of the voting power. In these circumstances, the common and preferred together constitute the principal class,[123] so that if the preferred shares were not publicly traded, the substantial and regular trading requirement apparently could not be met.[124]

Significantly, unlike the case of the branch profits tax area[125] direct and indirect wholly-owned subsidiaries of a German corporation meeting the publicly-traded safe harbor are not treated as having met the test. However, such a company will

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122 Article 26(8)(a).

123 See also Article 28(8)(a) and (c) for the effect of a "disproportionate class of shares".

124 See Technical Explanation at 36,447-172, Example 3.

125 IRC §884(e)(4)(B)(ii). See also Article 17(1)(f), U.S.-Spain treaty (not yet in force).

be treated as having met the stock ownership safe harbor. Thus, while a corporation meeting the publicly-traded safe harbor may erode its base and still qualify, its wholly-owned direct or indirect subsidiaries can qualify only if they either meet the active business safe harbor or do not erode their base. However, if more than fifty percent of the shares of a U.S. or Dutch corporation is owned by five or fewer companies which are either U.S. or Dutch residents which would meet the publicly traded safe harbor, such U.S. or Dutch company will be entitled to benefits of the treaty if it were not a "conduit company"[126] or if it were to meet a so-called "conduit base reduction test."[127] Similarly, a Dutch corporation which is a subsidiary of a Dutch or U.S. corporation meeting the publicly-traded safe harbor is not automatically treated as qualifying under Article 26.

Determinations of Treaty Entitlements

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[126] Article 26(1)(c)(ii), U.S.-Netherlands treaty. A conduit company is defined generally as one which makes deductible payments equal to or greater than 90 percent of its receipts in a taxable year. Article 26(8)(m).

[127] Article 26(1)(c)(iv). The conduit base reduction test is met by a person if (i) less than 50% of such person's gross income is used, directly or indirectly to make deductible payments in the current taxable year to persons that are not qualified persons (i.e., U.S. or Dutch residents (Article 26(5)(d)), or (ii) in the case of a Dutch corporation less than 70% of such persons' gross income is used to make deductible payments to persons who are not qualified persons; and less than 30% of such person's gross income is used to make deductible payments to persons who are neither qualified persons nor EC residents.

It will not always be easy to determine whether a corporation qualifies under one or more of the safe harbor tests previously discussed, and the Service has announced that it will not entertain requests for rulings on the "inherently factual" issue of whether the safe harbor tests have been met.[128] Notwithstanding that in general a taxpayer may not obtain a ruling from the Service regarding entitlement under a limitation on benefits provision of a treaty, a taxpayer may request a certification from the Dutch tax authorities to the effect that one of the safe harbor tests have been met.[129] The effect of obtaining such a certification is less than clear, however. At first blush, it would seem that a certification will assist only in convincing a person not to withhold. However, it is unclear that a certification will add any additional comfort to that which can be obtained by a Form 1001. It should be noted that the U.S. competent authority is required to consult with the Dutch competent authority before denying benefits under Article 26(7), discussed below. A certification from the Dutch tax authorities would be some indication that the Dutch believe treaty benefits should be applied. Accordingly, it may well be that a certification will take on greater significance.

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[128] Rev. Proc. 94-7, ¶3.01(2), 1994-1 I.R.B. 174.

[129] Notice 94-85, 1994-35 I.R.B. 20.

In any event, a Dutch corporation which believes it does not qualify for a safe harbor may nevertheless request a determination from the U.S. competent authority that it should be granted treaty benefits pursuant to Article 26(7). Article 26(7) provides that the competent authority is to take into account whether the establishment, acquisition, or maintenance of the entity requesting the determination, had as one of its principal purposes the obtaining of benefits under the treaty. Paragraph XIX of the Memorandum of Understanding accompanying the treaty indicates that the U.S. competent authority may consider:

1. The date of incorporation in relation to the date the treaty come into force.

2. The continuity of the historical business and ownership of the corporation.

3. The business reason for the corporation residing in its state of residence.

4. The extent to which the corporation is claiming special tax benefits in its country of residence.

5. The extent to which the corporation's business activity in the other state (i.e. the U.S.) is dependent on the capital, assets, or personnel of the corporation in its state of residence; and

6. The extent to which the corporation would be entitled to comparable treaty benefits if organized or resident in the country of residence of the majority of its shareholders.

7.With these factors in mind it appears that a Dutch corporation which: has been around for a considerable period, has continuity of activity and ownership, can point to some business reason for its residence in the Netherlands, does not claim any special tax benefits in the Netherlands, and conducts business activity in the Netherlands through regular offices maintained by it in the Netherlands which activities are conducted by its own employees, ought to be able to make out a good case for qualification, even if comparable benefits cannot be shown.

8.Summary

9. The above indicates there is no clear-cut U.S. treaty policy on a number of issues, but rather there are almost as many policies as there are treaties. Furthermore, the policies change and therefore current statements are not necessarily indicative of original treaty intent. Given this background, it is difficult to predict whether a practice perceived by the Service to result in one of the many manifestations of the abuse of law doctrine as applied to treaties will be so considered by a court absent a very clear showing of legislative intent. The introduction of objective criteria in the form of specific safe harbors to limitation on benefits provisions should reduce the need for the application to the treaty area of the judicial made rules of abuse of law. The details contained in the limitation on benefits provision found in the U.S.-Netherlands treaty, although complex, are likely to lead to greater certainty of

result, although this may well depend on how the certification and competent authority procedures are administered.