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Limitation on Benefits, An Overview

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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 should be extended in the first place.[2] The problem arises when the latter type of provision does not literally restrict treaty benefits to persons who are currently perceived 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 specific

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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 (not yet in force) (hereafter "proposed U.S.-German treaty"); Article 12A, U.S.-Belgium treaty; Article, 24A, U.S.-France 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.

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 solve by judicial decree that which the treaty draftsmen were unable to solve is always risky business. The limitation of treaty benefits area is but one case in point. Whenever an issue arises as to whether the terms of 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 be resolved by resort to the treaty language alone.[5] Rather, the courts have looked to the context of the treaty provision,[6] its

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4 Coplin v. U.S., 56 AFTR 2d ¶85-5008 (F. 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 Finance de Suez Et de L'Union Parisienne v. U.S.; 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.

legislative history[7] and even the current mutual 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 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 does 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

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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.

expectation 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 third country resident use of treaties 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 not being subject to even one tax while obtaining treaty benefits is not so abhorrent to general U.S. treaty policy so as to require a subject to tax requirement to be in each treaty either expressly or by implication, as it could draw the opposite inference.

Nor does current policy always serve as a very useful guide in interpreting the intent of the treaty negotiators.[11] 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,[12] which denies benefits simply because of the nature of one's profession, the general limitation on benefits clause,[13] which is intended to deny benefits to third country residents deriving benefits directly or indirectly who were not intended to be covered, the fiscal

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10 But see Coplin II, _supra_, n.4.

11 Crow, _supra_, n.9.

12 See, _e.g._, Article 17, U.S.-U.K. treaty.

13 See, _e.g._, Article 28, proposed U.S.-German treaty.

domicile clause,[14] limiting benefits to residents who are subject to home country tax on their world-wide income, and the so-called savings clause,[15] 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,[16] but, of course, this policy did not prevent the IRS from refusing to permit benefits in egregious cases.[17] Subsequently, the policy changed and the Service issued its so-called "lend-a-star" rulings.[18] The rulings were soon followed by the introduction of the artiste and athlete clause in the U.K. treaty[19] and thereafter in other treaties[20] with deviations only in the income

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14 Article 4(1)(a), proposed U.S.-Germany treaty.

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

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

17 Johansson, supra n.4.

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

19 Article 17.

20 See, e.g., Article XVI, U.S.-Canada treaty; Article 15A, U.S.-France treaty; Article 17, proposed U.S.-German treaty.

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.[21] However, the restriction applies whether or not there is such avoidance. Furthermore, 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 limitations on benefits provision of the type described in this paper no longer requires a separate artiste and athlete clause, but that is a subject for another day.

Third Country Residents as Intended Beneficiaries

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 "Antilles

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21 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.

treaty" and even though it was or should have been apparent that such corporations paid little or no Antilles tax on their income.[22] Article XII of the treaty with the Netherlands (as applicable to the Netherlands Antilles) specifically permitted third country residents to obtain benefits thereunder.[23] That provision, along with the source rules then extant, insofar as they 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 an Antilles corporation did not even rise to the level of being an issue.[24] Nor should it have.

The extension of the treaty with the Netherlands to the Netherlands Antilles (the "Netherlands Antilles treaty") was modified by protocol[25] so as to eliminate certain treaty benefits

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22 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 it was the Antilles interpretation of Article V of the treaty that it specifically reserved to the U.S. exclusive jurisdiction to tax such income.

23 Rev. Rul. 75-23. Compare Article 11(5), proposed U.S.-German treaty.

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

25 1963 Protocol modifying and supplementing the Extension to the Netherlands Antilles of the Convention, 2 CCH-Tax Treaties ¶6239 ("1963 Protocol").

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.[26] In other cases, treaty benefits also were not to apply to an entity that obtained special tax benefits in the country of residence,[27] if owned predominantly by third country residents.

Subject to Tax Requirement, in General

That an entity is subject to a minimum level of tax in its country of residence appears to go 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, we would expect to find a plethora of subject to tax requirements. However, they are few and far

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

27 See Article 16, U.S.-U.K. treaty; Article XV, U.S.-Luxembourg treaty.

between.[28] To be sure, 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 so as to exclude persons who are not subject to tax on the widest basis possible in the home country. As so viewed, there is little need to expressly provide a subject to tax requirement.[29]

That a resident is generally "subject to tax" on world-wide income in the 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 company 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.[30], 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

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28 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.

29 See Commentary on Article 4(II),1977 OECD Convention; Article 4(1)(a), proposed U.S.-German treaty; *cf*. Article 4(5), U.S.-U.K. treaty.

30 492 F.2d 798, 74-1 USTC ¶9254 (Ct. Cl. 1974) (hereafter "Suez").

then in force, or a corporation that was created or organized under non-French law, in which case the reduced treaty 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[31] 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 in the first place.

The _dictum_ is somewhat disturbing on more than one ground. 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 result in fact. Concededly, that

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31 74-2 USTC ¶9254, at 83,514.

double taxation may result in theory in the absence of the benefit conferred by treaty is a valid basis for entering into 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 (which reduce source country taxation to 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 completely exempt from Dutch tax[32] pursuant to the Dutch exemption system for the avoidance of double taxation. Should such Dutch corporation be entitled to the exemption from U.S. tax afforded by Article IX of the U.S.-Netherlands treaty as the treaty literally seems to provide? Or, would a court be correct in treating such corporation as not being "Dutch,"[33] or not being a resident[34] under the meaning of Suez? This issue is more than academic since the latest form of limitation on benefits provision[35] would not affect the entitlement to treaty benefits in the posited case unless the Dutch corporation "eroded its base," a term discussed more fully below.[36]

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

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

33 Under the current U.S.-Netherlands treaty, the Article IX royalty exemption applies to Dutch corporations.

34 Assuming the exemption applied only to residents as in the case of our more modern treaties. See Article 12, proposed U.S.-German treaty.

35 See Article 28, proposed U.S.-German treaty; Article 16, proposed U.S.-Finland treaty.

36 Interestingly, in the posited case whether or not the company eroded its base would have no impact on its Dutch tax liability. Perhaps, the solution would be to limit benefits to enterprises and define that term as defined in the U.S.-Swiss treaty and in the U.S.-Netherlands treaty to commercial undertakings wholly or partly carried on within the home country.

certain requirements, the U.S. may wish to deny benefits to corporations which qualify for such benefits.[37] 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,[38] 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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37 See Article XV, U.S.-Luxembourg; Article I(1), 1963 Protocol. See also Article 16, U.S.-U.K. treaty.

38 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 which the Swiss were prepared to make the Swiss took unilateral action in what is known as the Swiss decree.[39] 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 dividend 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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39 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 which pays out at least $25 of dividends annually, avoids adverse consequences. Moreover, enforcement of the Swiss decree is up to the Swiss, the U.S. has no right to insist on its enforcement and it is understood has no knowledge of the persons against whom it is enforced.

In the succeeding section, I will discuss Article 28 of the recently ratified U.S.-German treaty in the context of the above discussion.[40] Before a more detailed discussion, a few general comments are in order.

Article 28, U.S.-German Treaty, Overview

From the preceding discussion it would seem the provisions of Article 28 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,[41] the artiste and athlete clause[42] and

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40 I have chosen Article 28 of the proposed U.S.-German treaty because it appears 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 on Treaties, 101st Cong., 2nd Sess. (1989). Hereafter, unless otherwise indicated all references to an article of a treaty are to provisions of the proposed U.S.-German treaty.

41 Article 4.

42 Article 17.

the savings clause,[43] an operative provision of the treaty[44] applies. The provision is structured differently, however. Rather than limiting benefits which are otherwise applicable, Article 28 extends benefits to persons who fit within certain categories more fully described below. Thus, under Article 28, a resident is entitled to treaty benefits if such person meets certain qualifications.[45] This structure has lead certain commentators to suggest that the provision more appropriately belongs in the fiscal domicile article,[46] in effect superimposing a qualification requirement on the term resident. However, it is unclear that the distinction between viewing Article 28 as a limitation on benefits, as the title of the Article seems to suggest, or 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. However, as

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43 Protocol, Article 1(a).

44 E.g., Article 13(5) (gains from the alienation of immovable property not forming part of a permanent establishment or fixed base), Article 12 (royalties), Article 11 (interest), Article 10 (dividends).

45 Cf. IRC §884(e)(1)(B).

46 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).

will be described below there can be a difference in result in certain cases. An integration of the two provisions might avoid certain of the anomalies.

Resident

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 Germany who is exempt from German tax on non-German income solely as a result of the exemption system for the avoidance of double taxation.[47] 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 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, he must have a substantial presence in the United

47 Cf. Suez, supra.

States within the meaning of IRC section 7701(b) or must have other ties to the United States.[48] If he does not qualify under the substantial presence test or have other significant U.S. ties, 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.[49] One possible rationale is that a nonresident U.S. citizen is more likely to reduce his U.S. tax liability by deductible payments to third country residents. Another possible rationale is that Germany wished to avoid the situation in which an individual could opt for lower U.S. taxes as compared with higher German taxes by obtaining a green card, hardly the type of person to whom 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 German treaty policy 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

Partnerships, estates and trusts are treated as residents for treaty purposes only to the extent of their income

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[48] Treasury Department Technical Explanation of the Convention and Protocol Between the United States of America and the Federal Republic of Germany, 1 CCH-Tax Treaties ¶3255.

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

which is subject to tax in the home country as the income of a resident. Thus, 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, since qualification under Article 28 is not a prerequisite for residency classification. However, whether the German corporate partner qualifies under Article 28 will affect whether it is entitled to treat benefits with respect to its partnership income.[50]

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.[51] As a result, only two-thirds of its income would be

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50 See Example V, Understanding Regarding the Scope of the Limitation on Benefits Article in the Convention, 1 CCH-Tax Treaties ¶3252 (hereafter "MOU").

51 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 Section 704 is beyond the scope of this paper.

entitled to treaty relief.[52] 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.[53]

Other pass-through entities are not dealt with directly.[54] Thus, for example, a U.S. corporation for which an "S election" is in effect (and which is not a resident of Germany[55]) is considered a resident of the United States for purposes of the treaty. Moreover, this result would appear to

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52 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); Article 29. However, it is not the current policy of the U.S. to require withholding on income to which a treaty benefit applies. Technical Explanation, 1 CCH-Tax Treaties, ¶3255 at 28,230.

53 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 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.

54 Cf. Article 10(2) relating to dividends from regulated investment companies and their German equivalent and real estate investment trusts.

55 Article 4(3).

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 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 regardless of whether they also are U.S. residents within the meaning of Article 28. 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 of section 7701(b), 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 Article 28.[56] As in the case of an individual, a contracting state or political subdivision thereof

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[56] See also Article 27 with respect to certain exempt organizations.

automatically qualifies under Article 28.[57] 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[58] of the government. If not, any such controlled entity must pass muster under the more general rules of Article 28 applicable to other corporations. However, it is clear that a controlled entity will qualify under the ownership test of Article 28(1)(e)(aa). 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.[59] Furthermore, pension trusts and pension funds qualify under Article 28 if the organization sponsoring such fund, trust or entity is itself entitled to benefits under Article 28.[60] Thus, a person, more than 50 percent of the participants of which are

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57 Article 28(1)(b).

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

59 Article 28(1)(f).

60 Paragraph 28, Protocol.

not residents, may still qualify if it is a pension fund for employees of an entity that qualifies.

Safe Harbor

Apart from the special rules noted above, treaty benefits are accorded to a resident person, if such person meets a safe-harbor test,[61] or is able to convince the competent authority of the source state that it should otherwise be entitled to benefits (the "subjective test").[62] There are three different safe harbor tests. 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[63]) and even if it pays out by way of deductible

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[61] Article 28(1)(c), (d) or (f). The application of this rule to partnerships is unclear. As noted above, the residence of a partnership is determined by reference to the residence of the partners thereof. While literally a partnership could also be required to itself qualify as a resident under Article 4 and under Article 28 for any resident partner to obtain a benefit, this does not appear to be intended. See Example V, MOU.

[62] Article 28(2).

[63] Cf. Article 28(1)(e)(aa).

expenses an amount equal to more than fifty percent of its gross income, (*i.e.*, it does not meet the base erosion safe harbor).[64] Similarly, a resident corporation with respect to 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)[65] 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 corporation which does not meet the active business safe harbor or the publicly-traded safe harbors is not, however, automatically entitled to benefits unless it meets both the ownership and base erosion safe harbors.[66]

Stated differently, 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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64 *Cf*. Article 28(1)(e)(bb).

65 Article 28(1)(d).

66 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 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 I would question this assumption and its significance.

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 subjects its income to tax in the country of residence, it is unclear why it is considered necessary to also have a stock ownership test. The short answer frequently given is that if there is no stock ownership requirement in a treaty, that treaty can be viewed as a treaty with the world, leaving little incentive for other countries to negotiate tax treaties with the U.S. 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.

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 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[67] and in at least one version of the U.S.

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[67] Article 17(3)(b), U.S.-Jamaica.

model limitation on benefits provision,[68] 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, subsequent treaties have not included such a provision. Where a treaty has included a principal purpose test,[69] it has been stated that the test will be met if there is no overall tax reduction or if there is substantial business activities in the country of residence.[70]

A similar issue arises under the base erosion safe harbor. Should deductible payments made to third country residents be counted as good payments if the payee is entitled to substantially similar treaty benefits with respect to such payments? Indeed, had that been the situation in Aiken Industries there would have been no need for the court to consider the conduit issue. However, given a limitation on benefits provision of the type considered in this paper, one could be much worse off running payments through an intermediary financing company than would be the case if the payments were

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68 1 CCH-Tax Treaties ¶213.

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

70 Treasury Explanation - U.S.-Cyprus treaty, 1-CCH Tax Treaties, ¶2350 at 23,044.

received directly. In a cascading royalty payment situation, in which the intermediary is a resident of a treaty and the ultimate payee is entitled to treaty benefits under the treaty its country of residence has with the United States, there could nevertheless be a U.S. withholding tax in the same manner as if the treaty resident were not a treaty resident at all. In these circumstances, there would be a U.S. withholding tax that would not apply if, under Aiken Industries, the intermediary were not treated as the beneficial owner. But given a limitation on benefits provision similar to Article 28, the IRS is unlikely to argue for such nominee treatment.

It has been argued that the derivative benefit approach is too difficult to administer.[71] 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 no more to be 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 of the ultimate owner where the ownership test is not met? Third, it is argued that the granting of derivative

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

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 U.S. had treaties with the world (i.e., the Netherlands Antilles treaty) and yet the U.S. 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. Perhaps a solution here would be to permit the benefit only if information were to be forthcoming.

Having discussed certain of the principles, we now turn to the specifics of the safe harbor tests. We start out 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[72] constitute the active conduct of a trade or business[73] other than the making or managing of investments carried on by a person that is not a bank or insurance company. Second, one must determine whether the income for which a claim is made is incidental to the business.

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72 Examples II and III, MOU.

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

In making the active conduct of a trade or business determination it appears that precedents under sections 884 and 367 may be used as a guide.[74] 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.[75] 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,[76] although it may well be that the real concern is that such a company is subject to special tax legislation in Belgium. Thus, it may be that the active trade or business test is intended to cover only entities which are not

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[74] 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).

[75] Reg. §1.367(a)-2T(b)(2)(b).

[76] Rept. of Comm. on Foreign Relations on the Protocol to the Tax Convention with Belgium, 1 CCH - Tax Treaties ¶1356, at 17,059.

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.[77]

Assuming that the activities in question rise to the level of an active trade or business either conducted by the resident corporation claiming the benefit or a related[78] person one must still determine whether the income for which a benefit is claimed is related thereto. Several examples are provided in the MOU. The examples appear to indicate that dividends will be treated as being incidental to an active trade or business if the payor and payee (including any related persons) are involved in the same or an integrated business, and the activities in the home country are substantial in relation to the activities in the source country. While no definition for the term related is provided, it does appear that such term is intended to include affiliated corporations. Whether a substantial shareholder that is not also part of a consolidated group would qualify as a related person and, if so, the level of its share ownership that is needed to qualify are not yet spelled out. The examples also appear to indicate that interest will be considered to be incidental if it is derived from the temporary investment of working capital of the business. Although the examples do not

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[77] Paragraph B, MOU.

[78] The MOU does not define the term related. Cf. Article 3(2).

address the point, it is probable that interest paid on loans used to finance the activities of an integrated business should also qualify. The few examples which are provided leave open a number of other possible cases which presumably may be dealt with under the competent authority procedure of Article 28(2) to which we will turn below.

Stock Ownership

In order to qualify under the stock ownership test for a year, more than 50 percent of the beneficial interests in the person (i.e., trust or estate) or company must be owned directly or indirectly by any combination of the following (collectively "qualified persons"): (a) a 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, or an entity which is a qualified not-for-profit organization.[79] Conspicuously absent from this list is a corporation which meets only the active business 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

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[79] Article 28(1)(e)(aa).

company will qualify for benefits 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.

How one measures beneficial interest and equally important at what time during the year such interest is to be measured is not spelled out. Similar issues arise under section 884 and it is certainly possible that proof will be required in a manner similar to that required under the section 884 regulations.[80]

Base Erosion

An entity fails to meet the base erosion test 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. The reference to directly or indirectly is not spelled out, but it appears to have been intended to cover a situation of a payment to a qualified person who makes a further onward payment to a non-qualified person. It is presently unclear whether it would cover a situation in which a related party makes the payment so

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80 See Feingold and Berg, Whither the Branches, 44 Tax L. Rev. 205, 253-4 (1989).

as to give rise to a tax benefit for a consolidated group or fiscal unity. Nor is it clear whether the term "use" is intended to be synonymous with the term payment. Under 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.[81] This raises as a possibility that amortization deductions for a prepaid expense will not be treated as having been used in any year other than the year the prepaid expense is actually paid. In the year of payment, however, the prepaid expense will be considered to have been used for a proscribed purpose in its entirety if paid to a non-qualified person. A similar issue arises in the case of the deferred payment of an accrued expense, since it will not be known until the year of payment whether the payee is a qualified person.

<u>Publicly Traded Exception</u>

A corporation meets this safe harbor if there is substantial and regular trading on a recognized stock exchange in its principal shares. 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

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81 Reg. §1.884-5T(c).

takes place and any other exchange agreed upon by the competent authorities.[82]

The term "substantial and regular" appears somewhat less restrictive than the "primarily and regularly traded" language of section 884(e)(4)(18).[83] The term regularly traded has been interpreted somewhat narrowly,[84] except for the case of stock that is traded during the taxable year on an established securities market in the United States. Query whether this principle will be applied to a German stock exchange meeting the definition of recognized stock exchange?

Significantly, unlike the case of the branch profits tax area[85] direct and indirect wholly owned subsidiaries of a corporation meeting the publicly traded safe harbor are not treated as having met the test. However, such a company will 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.

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82 Article 28(3).

83 See Reg. §1.884-5T(d)(3).

84 See Reg. §1.884-5T(d)(4)(i), (ii), (iii).

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

The Subjective Test

A corporation that does not meet a safe harbor test may still qualify. However, in order to do so such company must convince the competent authority in the source country that benefits should otherwise apply. It is contemplated that the convincing may be done in the form of a request for advance determination.[86]

The competent authority is expected to take into account such relevant facts and circumstances as the business purpose for the structure and location of the income earning activity and the nexus between the company and the activities giving rise to the income. Furthermore, the competent authority has in effect been directed to take into account the importance of economic integration between the European communities.

The one example provided in the MOU would permit benefits to be granted where each of three European community resident corporations was engaged in an active business in its respective home country, they entered into a joint venture company for significant business purposes, established its headquarters in one of the three countries and substantial headquarter functions were conducted from the offices of the

[86] Paragraph B, MOU. Cf. Reg. §1.884-5T(f); PLR 8912052; PLR 9023011.

company.[87] It should be noted that benefits were allowed in this example apparently without regard to whether: the company was engaged in an active business, the income in question was incidental to its business, or the company eroded its base.

Summary

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. Whether there will be greater certainty of result may well depend on whether guidelines are established concerning the facts upon which competent authority relief will be granted. Finally, whether the criteria used in the current version of the limitation on benefits provision will yield results which make good treaty policy will continue to be interesting to watch.

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[87] Example VII, MOU.

LIMITATION ON BENEFITS
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