EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE NETHERLANDS

Scheduled for a Hearing

Before the

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

On September 24, 2004

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

September 16, 2004
JCX-54-04

CONTENTS

Page

INTRODUCTION 1

I. SUMMARY 2

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES 4

A. U.S. Tax Rules 4
B. U.S. Tax Treaties 6

III. OVERVIEW OF TAXATION IN THE NETHERLANDS 8

A. National Income Taxes 8
B. International Aspects of Taxation in the Netherlands 10
C. Other Taxes 11

IV. THE UNITED STATES AND THE NETHERLANDS: CROSS-BORDER INVESTMENT AND TRADE 12

A. Introduction 12
B. Overview of International Transactions Between the United States and the Netherlands 13
C. Trends in Current Account Income Flows Between the United States and the Netherlands 15
D. Trends in the Financial Account Between the United States and the Netherlands 23
E. Income Taxes and Withholding Taxes on Cross-Border Income Flows 32
F. Analyzing the Economic Effects of Protocols to Income Tax Treaties 33

V. EXPLANATION OF PROPOSED PROTOCOL 34

Article 1. General Scope 34
Article 2. Resident 34
Article 3. Dividends 35
Article 4. Branch Tax 40
Article 5. Pension, Annuities, Alimony 41
Article 6. Basis of Taxation 44
Article 7. Limitation on Benefits 46
Article 8. Exchange of Information and Assistance and Support in Collection 58
Article 9. Outdated References 60
Article 10. Entry into Force 60

Page

VI. ISSUES 62

A. Zero Rate of Withholding Tax on Dividends from 80-Percent-Owned Subsidiaries 62

B. Expatriation to Avoid Tax by Former U.S. Citizens and Long-Term Residents 67

C. Treaty Shopping 70

D. U.S. Model Income Tax Treaty 74

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the existing income tax treaty between the United States and the Netherlands (the "proposed protocol").[2] The proposed protocol was signed on March 8, 2004. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol for September 24, 2004.[3]

Part I of the pamphlet provides a summary of the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of the Netherlands tax laws. Part IV provides a discussion of investment and trade flows between the United States and the Netherlands. Part V contains an article-by-article explanation of the proposed protocol. Part VI contains a discussion of issues relating to the proposed protocol.

---

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and the Netherlands* (JCX-54-04), September 16, 2004. References to "the Code" are to the U.S. Internal Revenue Code of 1986, as amended.

[2] The proposed protocol is accompanied by official understandings implemented by an exchange of diplomatic notes (the "notes," collectively).

[3] For a copy of the proposed protocol, *see* Senate Treaty Doc. 108-25.

I. SUMMARY

The principal purposes of the existing treaty between the United States and the Netherlands are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The existing treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

The proposed protocol modifies several provisions in the existing treaty (signed in 1992 and modified by protocol in 1993) to make it similar to more recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated ("OECD model"). However, the existing treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models.

The proposed protocol replaces Article 10 (Dividends) of the existing treaty with a new dividends article. This new article eliminates the withholding tax on certain intercompany dividends in cases in which an 80-percent ownership threshold is met. The new article preserves the maximum withholding tax rate of 15 percent on portfolio dividends, but provides a maximum withholding tax rate of five percent on dividends meeting a 10-percent ownership threshold. The proposed protocol also modifies Article 11 (Branch Tax) of the existing treaty to eliminate the branch profits tax for Dutch companies.

The proposed protocol replaces Article 26 (Limitation on Benefits) of the existing treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. model and more recent U.S. income tax treaties. Unlike the U.S. model and more recent U.S. income tax treaties, the proposed protocol includes a new requirement that tests for "substantial presence" in the country of residence to prevent certain companies from qualifying for treaty benefits.

The proposed protocol amends Article 19 (Pensions, Annuities, Alimony) of the existing treaty to include new rules related to cross-border pension contributions. These rules are intended to remove barriers to the flow of personal services between the two countries that could otherwise result from discontinuities under the laws of each country regarding the deductibility of pension contributions.

The proposed protocol expands the "saving clause" provision in Article 24 (Basis of Taxation) of the existing treaty to allow the United States to tax certain former long-term residents whose termination of residency has as one of its principal purposes the avoidance of tax. This provision generally allows the United States to apply special tax rules under section 877 of the Code as amended in 1996. The proposed protocol also updates the existing treaty to include the rules in the U.S. model related to fiscally transparent entities.

The proposed protocol in effect modifies Article 30 (Exchange of Information) and Article 31 (Assistance and Support in Collection) to facilitate information exchange between the two countries.

The proposed protocol updates Article 1 (General Scope) and Article 4 (Resident) of the existing treaty to bring it into conformity with the U.S. model and more recent U.S. income tax treaties.

Article 9 of the proposed protocol modifies outdated references in Article 2 (Taxes Covered), and updates Article 18 (Artistes and Athletes) and Article 22 (Students and Trainees) of the existing treaty to reflect the movement from the Netherlands guilder to the euro.

Article 10 of the proposed protocol provides for the entry into force of the modifications made by the proposed protocol.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

The United States taxes U.S. citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the

United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term “resident” so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the "IRS"), and the treaty partner's tax authorities, also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than the tax it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

III. OVERVIEW OF TAXATION IN THE NETHERLANDS[4]

A. National Income Taxes

Overview

The Netherlands imposes individual income tax under the Income Tax Act of 2001 and corporate tax under the Companies Tax Act of 1969. Netherlands tax law uses a ‘source of income’ model. Only income derived from a ‘source’ is subject to taxation. Source income arises only in cases where a taxpayer undertakes an economic activity with the intent of deriving a benefit that can objectively be expected to materialize. As a result, activities that are unlikely to produce any positive amount of income (e.g., hobby farms, inventing) will not be deemed a source of income.

Individuals

Individuals resident in the Netherlands are taxed on their worldwide income. The income tax takes into account the origin of the income and distinguishes between three categories known as “boxes.” The income in each of the boxes is taxed at a different rate. The sum of the tax owed in each of the three boxes is the total income tax payable.

Box 1 includes taxable income from wages, profits, social security benefits, and pensions. The individual income tax rates are combined with contributions for social security. Social security contributions are due only on income up to €29,543.[5] The rate structure is progressive and extends from 33.4 percent for taxable income under €16,265 (this rate is comprised of one percent tax and 32.4 percent social security contributions) to 52 percent for marginal taxable income over €50,652. In addition to the income tax, income from employment is subject to the wages tax under the Wages Tax Act of 1964. Amounts withheld as wages tax are credited against any income tax due.

Box 2 includes substantial business interests, the income from which is subject to a flat tax of 25 percent. A taxpayer is regarded as having a substantial interest in a company if the taxpayer, either alone or together with a fiscal partner,[6] holds directly or indirectly, at least five percent of the company’s shares. Income from a substantial interest is the aggregate amount of dividends received and capital gains.

---

[4] The information in this section relates to Dutch law and is based on the Joint Committee staff’s review of publicly available secondary sources, including in large part a publication of the Dutch government. *See* Dutch Ministry of Finance, *Taxation in the Netherlands 2004.*

[5] As of mid-September 2004, one euro was worth approximately $0.822743.

[6] Fiscal partners are spouses and registered partners.

Box 3 includes income from savings and investment and is taxed at a flat rate of 30 percent. The tax is levied on an assumed yield of four percent, regardless of actual return. Investors thus pay 1.2 percent of their capital in taxes each year. Dividends are subject to a withholding tax of 25 percent (which is creditable against the income tax liability of residents and those of nonresidents where the dividend is attributable to Dutch-source income for which they are subject to ordinary taxation).

Corporations

Entities resident in the Netherlands are subject to corporate income tax on their worldwide income. All income earned by companies is deemed to be business income. Corporate income tax is levied at a rate of 29 percent on the first €22,689 of taxable profits and at 34.5 percent on the excess.[7] Losses may be carried forward and deducted from profits in a subsequent year. Profits distributed to shareholders are not deductible from taxable profits for purposes of the corporate income tax. A company distributing dividends is required to withhold tax at a rate of 25 percent. The tax withheld is creditable against the dividend recipient's individual income tax liability (usually classified as capital income in Box 3). There is no withholding on interest and royalty payments.

The Companies Income Tax Act provides for a participation exemption, which is applicable to both domestic and foreign shareholdings. Corporate tax need not be paid on the profits generated by the participation. The exemption allows for the avoidance of double taxation when the profits of a subsidiary are distributed to its parent company. A participation exists if the taxpayer (1) holds at least five percent of the nominal paid-up capital of a company, or (2) holds less than five percent, but ownership of the shares is necessary for the conduct of normal business, or the acquisition of the shares serves a general interest. All profits gained from shareholdings are exempt from taxation unless shares in a foreign corporation are held as an investment or the foreign company in which the shares are held is not subject to tax on its profits in the foreign country. A 25 percent withholding tax is imposed on dividends from corporations resident in the Netherlands, unless the participation exemption applies. Dividends received from a qualifying subsidiary company are exempt from tax in the hands of the parent company. Similarly, capital gains realized on the disposition of shares of such a subsidiary company are exempt.

Under certain conditions a parent corporation may be taxed as a group together with one or more of its subsidiaries. Group taxation allows losses of one company to be set off against profits of another company, and fixed assets may be transferred tax-free from one company to another. Group taxation is allowed only if all the companies involved are based in the Netherlands for tax purposes and the parent company holds at least 95 percent of the shares in the subsidiary.

[7] On August 19, 2004, the Netherlands government announced plans to cut the corporate tax rate from 34 percent to 31.5 percent. If approved, the plan to cut the corporate tax rate would go into effect in 2005.

B. International Aspects of Taxation in the Netherlands

Individuals

As mentioned above, individuals resident in the Netherlands are taxed on their worldwide income. Nonresidents are only taxed on income received from the Netherlands. Nonresidents are subject to tax on substantial interest income (Box 2) only if the substantial interest is in a company resident in the Netherlands. For nonresident taxpayers, a company is deemed to be resident in the Netherlands if it meets the traditional test for residency (tests discussed below) or if it has been a resident for at least five of the last 10 years. Nonresidents are only taxed on savings and investment income (Box 3) generated by savings and investments in the Netherlands. The profit base is the value of assets in the Netherlands less the value of debts connected with the assets. Assets in the Netherlands include real estate (and rights to real estate) in the Netherlands and rights to shares in the profits of a company the management of which is established in the Netherlands.

Corporations

Companies established in the Netherlands are residents for tax purposes. Whether a company is deemed to be established in the Netherlands is based on factual circumstances. Relevant factors include the place of actual management, the head office location, and the place where the general shareholder meeting is held. Under the Corporate Income Tax Act, all companies incorporated under Dutch law are conclusively regarded as being established in the Netherlands. As mentioned above, all Dutch companies are subject to tax on their worldwide income. Nonresident companies are subject to Dutch corporate income tax on taxable income from an enterprise carrying on business in the Netherlands and on taxable income from a substantial interest in a company established in the Netherlands.

In line with the EU Parent-Subsidiary Directive of 1990, the participation exemption was extended in 1992 to apply to acquisitions of interests in companies established in other EU member states. Qualification for the exemption requires ownership of at least 25 percent of the company’s share capital, or in some instances, at least 25 percent of the company’s voting rights.

Relief from Double Taxation

Resident taxpayers (persons and entities) may avoid double taxation on their foreign-source income and profits by operation of a bilateral tax treaty, or if no such treaty exists, under the 2001 Unilateral Decree on the Avoidance of Double Taxation.

C. Other Taxes

Inheritance, Gift, and Transfer Taxes

Inheritance tax is levied on assets (less any exemptions) acquired from the estate of an individual whose last place of residence was situated in the Netherlands. Tax rates depend upon the identity of the heir and the value of the property acquired. Gift tax is levied on the value of anything received by way of gift (less exemptions) from an individual resident in the Netherlands. A transfer tax is payable when certain domestic assets, such as real estate, pass by way of a gift from persons whose last place of residence was outside the Netherlands. There are no exemptions for the transfer tax. The rate structure for the gift tax and transfer tax parallels that of the inheritance tax.

Indirect Taxes

The Netherlands imposes a value-added tax, known as BTW in the Netherlands, which is a general consumption tax levied on all private spending and included in the price consumers pay for goods and services. The general rate is 19 percent, but there are exemptions and special rates for certain goods and services. Excise duties are also levied on certain consumer goods, such as alcohol, tobacco, and oil. Taxes are also levied on legal transactions, which include the acquisition of real estate, the procurement of insurance, and the raising of capital by domestic companies. Environmental taxes are levied on water, waste, fuel, and energy.

IV. THE UNITED STATES AND THE NETHERLANDS: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for business persons in one country who might aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who might aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that will arise from different transactions, but may also increase or decrease that burden. Where there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment has the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed protocol it may be beneficial to examine the cross-border trade and investment between the United States and the Netherlands.

When measuring by trade in goods or services or when measuring by direct and non-direct cross-border investment, the United States and the Netherlands are important components of each country's current and financial accounts. In 2003, aggregate cross-border investment between the United States and the Netherlands totaled $13.2 billion. Substantial cross-border investment by persons in both countries over the years has resulted in cross-border income flows in excess of $25 billion (real 2003 dollars) annually since 1997. The income from cross-border trade and investment generally is subject to income tax in either the United States or the Netherlands and in many cases the income is subject to withholding taxes.

B. Overview of International Transactions Between the United States and the Netherlands

The value of trade between the United States and the Netherlands is large. In 2003, the United States exported $28.4 billion of goods and services to the Netherlands and imported $18.1 billion in goods and services from the Netherlands.[8] These figures represent 10.6 percent of all exports from the United States and 4.6 percent of all imports into the United States. Similarly, the value of cross-border investment, U.S. investments in the Netherlands and Dutch investments in the United States is large. In 2003, U.S. investments in the Netherlands increased by $11.0 billion and Dutch investments in the United States increased by $2.2 billion.[9] The increase in U.S. investments in the Netherlands represents 7.9 percent of the increase in all U.S. assets abroad in 2003. The increase in Dutch-owned U.S. assets represents one percent of the increase in all foreign-owned assets in the United States in 2003. Table 1, below, summarizes the international transactions between the United States and the Netherlands in 2003.

Table 1 presents the balance of payments accounts between the United States and the Netherlands. Two primary components comprise the balance of payments account: the current account and the financial account.[10] The current account measures flows of receipts from the current trade in goods and services between the United States and the Netherlands and the flow of income receipts from investments by U.S. persons in the Netherlands and by Dutch persons in the United States. The financial account measures the change in U.S. investment in the Netherlands and the change in Dutch investment in the United States.

---

[8] Bureau of Economic Analysis, U.S. Department of Commerce, Data Release June 18, 2004. Reported figures represent the Bureau of Economic Analysis's preliminary estimates.

[9] *Ibid*.

[10] Prior to 1999, the U.S. Department of Commerce, Bureau of Economic Analysis reported and described international transactions by reference to the "current account" and the "capital account." Beginning in June 1999 the Bureau of Economic Analysis adopted a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled, as in Table 1: current account; capital account; and financial account. Under this regrouping, the "financial account" encompasses all transactions that used to fall into the old "capital account," so that the financial account measures U.S. investment abroad and foreign investment in the United States. The new (post-1999) system redefines the "current account" by removing a small part of the old measure of unilateral transfers and including it in the newly defined "capital account." The newly defined capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the newly defined capital account includes such transactions as forgiveness of foreign debt, migrants' transfers of goods and financial assets when entering or leaving the country, transfers to title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes the newly defined "capital account" transactions will be small in comparison to the current account and financial account.

Table 1.–International Transactions Between the United States and the Netherlands, 2003
($ billions, nominal)

Current Account Balance	**17.2**
Exports of Goods and Services from the United States and income receipts from the Netherlands	48.2
Merchandise	20.5
Services	7.9
Income receipts from U.S. assets in the Netherlands	19.9
Imports of goods and services from the Netherlands and income payments to the Netherlands	29.8
Merchandise	11.5
Services	6.6
Payments on Dutch-owned U.S. assets	11.7
Unilateral Transfers	-1.3
Financial Account Balance	**8.8**
Dutch Investment in the United States	2.2
Direct Investment[1]	-0.6
Private non-direct investment	n.a.[2]
Official	n.a.[2]
U.S. Investment in the Netherlands	11.0
Direct Investment	15.0
Private non-direct investment[1]	-4.0
Increase in government assets	0.0
Capital Account Transactions, net	**0.0**
Statistical Discrepancy	**8.4**

Notes:

[1] A negative number represents net dispositions of such assets.

[2] Foreign private holding and foreign official holdings of assets are combined in the data to avoid disclosure of holdings by foreign official agencies. The Bureau of Economic Analysis combines official asset holdings with other non-direct investment.

Source: Bureau of Economic Analysis, U.S. Department of Commerce, Data Release June 18, 2004.

C. Trends in Current Account Income Flows Between the United States and the Netherlands

Payments of Royalties

As Table 1 displays, the current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. Numerous disparate activities comprise trade in services. Among the sources of receipts from exported services are payments for transportation of goods, travel by persons and passenger fares, payments for professional services such as management consulting, architecture, engineering, and legal services, financial services, insurance services, computer and information services, and film and television tape rentals. Also included in receipts for services are the returns from investments in intangible assets in the form of royalties and license fees. In 2003, U.S. persons received approximately $1.8 billion in royalty and license fees from the Netherlands. The $1.8 billion paid by Dutch persons accounted for 3.7 percent of all royalties and license fees paid to the United States in 2003. The Department of Commerce reports that in 2002 the Netherlands ranked as the eighth largest payor of royalties and license fees of all U.S. trading partners. More than two-thirds of such receipts received were paid to U.S. parents from their affiliates in the Netherlands.[11] In 2003, Dutch persons received $1.7 billion in royalties and license fees from the United States. The $1.7 billion paid to Dutch persons constituted 8.5 percent of all royalties and license fees paid abroad by the United States. In 2002, the Netherlands was the fourth largest recipient of payments of royalties and license fees from the United States.[12] Figure 1 documents the cross-border payments of royalties and license fees between the United States and the Netherlands.[13] Even with virtually no growth in such receipts to the United States over the past decade, the aggregate amount of such cross-border flows has grown from less than $1.0 billion in 1986 (measured in real 2003 dollars) to more than $3.0 billion in 2003.

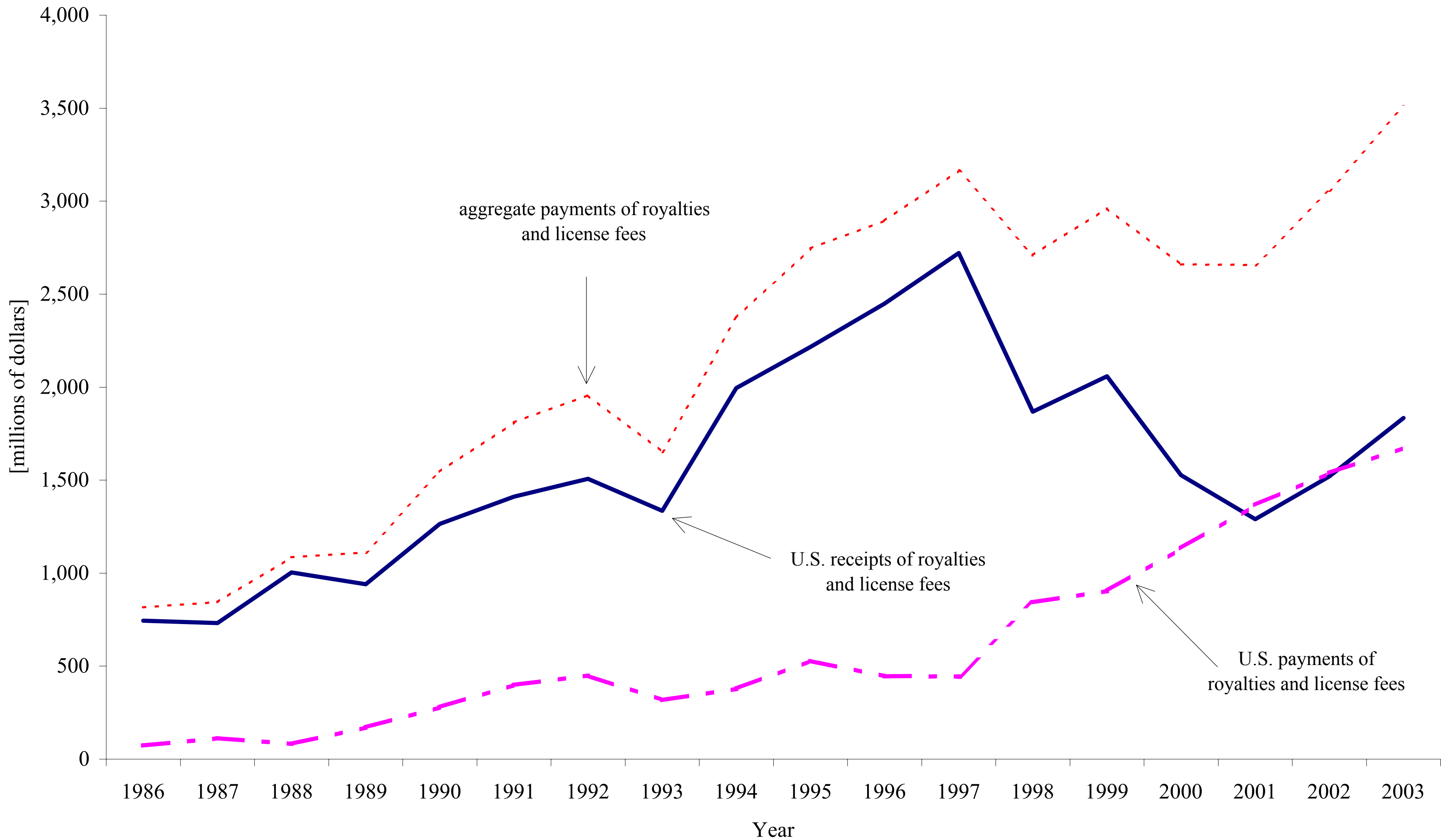
---

[11] Maria Borga and Michael Mann, "U.S. International Services: Cross-Border Trade in 2002 and Sales Through Affiliates in 2001," *Survey of Current Business*, vol. 83, October 2003, pp. 58-118, p. 92. The seven countries providing larger total payments of royalties and license fees in 2002 were Japan, the United Kingdom, Canada, Germany, Singapore, France, and Switzerland.

[12] *Ibid*, p. 93. Japan, Germany, and Switzerland received more total payments of royalties and license fees from the United States in 2002.

[13] In Figure 1 through Figure 4 a solid line represents payments to the United States from the Netherlands and a heavy broken line represents payments from the United States to the Netherlands. Figure 1 and Figure 2 also have a lighter broken line representing the sum of payments from the Netherlands and from the United States.

Figure 1.--U.S. and the Netherlands Payments of Royalties and License Fees, 1986-2003
[Millions of Real 2003 Dollars]



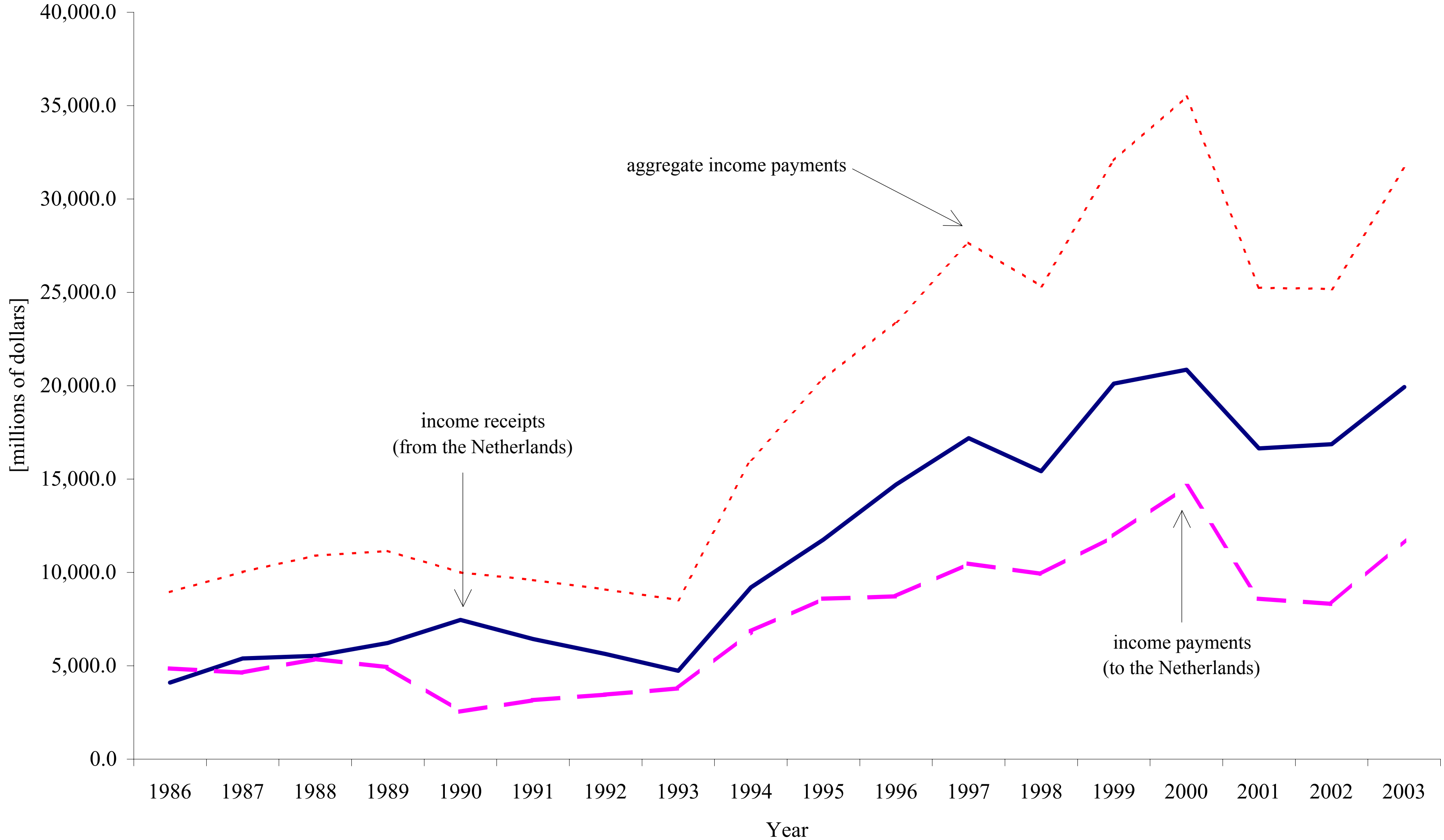
Source: JCT tabulations of data from Bureau of Economic Analysis.

Income receipts from investments

Overview

Figure 2 shows the growth in cross-border receipts between the United States and the Netherlands that has occurred in cross-border payments of income from Dutch assets owned by U.S. persons and from U.S. assets owned by Dutch persons. Measured in real dollars, income received by U.S. persons from the ownership of assets in the Netherlands has grown more than four and one half times since 1986. Over the same period, income received by Dutch persons from the ownership of assets in United States has grown almost two and one half times.

Figure 2.--U.S. and the Netherlands Receipts of Income from Investments, 1986-2003
[Millions of Real 2003 Dollars]



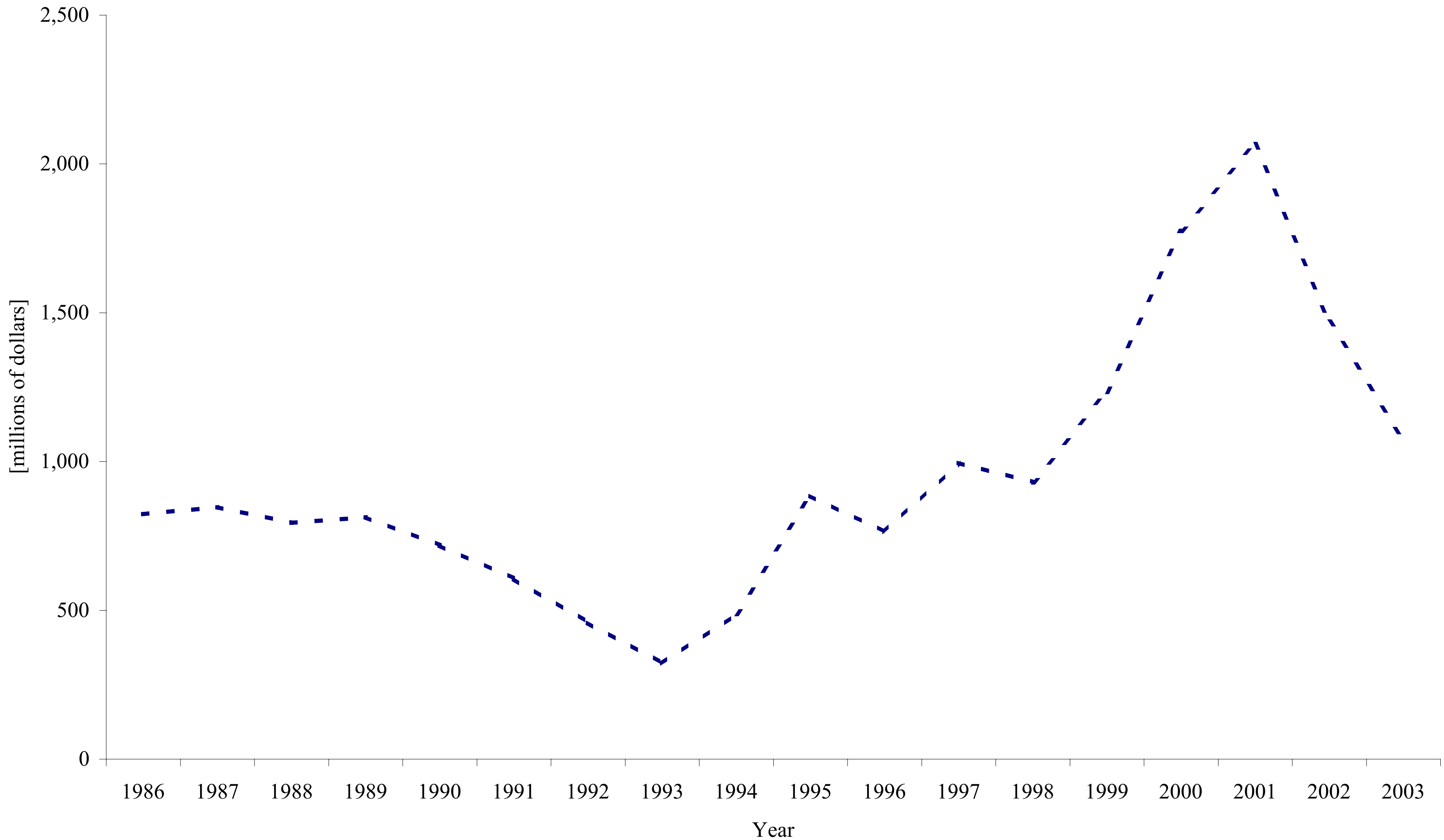
Source: JCT tabulations of data from Bureau of Economic Analysis.

Income from direct investment and income from non-direct investment

Income from foreign assets is categorized as income from "direct investments" and income from "non-direct investments." Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as "portfolio investments," and bank deposits and loans. Hence, the income from non-direct investments generally is interest or dividends. Dutch persons have substantial holdings of U.S. government bonds. Figure 3 shows the payments by the U.S. government to Dutch persons, largely interest on holdings of U.S. government bonds. Holdings of U.S. government bonds by Dutch persons have varied since 1986 and, as holdings have varied, interest received by Dutch persons has varied. Such payments totaled over $1.1 billion in 2003.[14]

[14] Comparable data are not available for holdings of governmental bonds of the Netherlands by U.S. persons. The interest from U.S. holdings of governmental bonds of the Netherlands is included in portfolio income in Figure 4 below.

Figure 3.--Real U.S. Government Payments to Dutch Persons, 1986-2003
[Millions of Real 2003 Dollars]

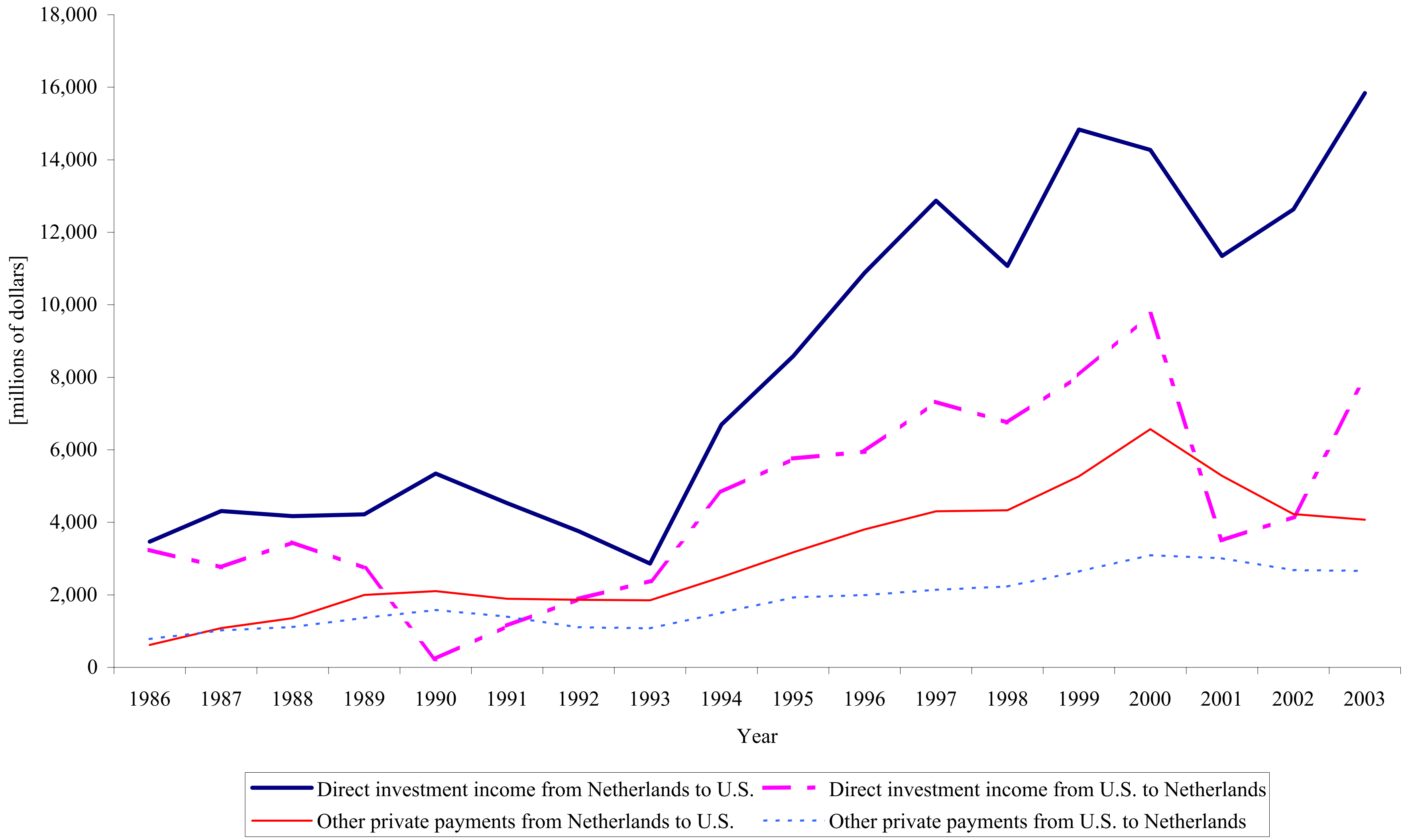


Source: JCT tabulations of data from Bureau of Economic Analysis.

While the flow of income to the Netherlands from Dutch holdings of U.S. government bonds is significant, Dutch persons earn greater income both from direct investments in the United States and from private, portfolio (non-governmental) and other non-direct investments in the United States. Income received by Dutch persons from direct investments has exceeded income received by Dutch persons from payments by the U.S. Government in every year since 1990, and over the past five years income from direct investments has averaged approximately four times the amount of income from U.S. Government payments. Income received by Dutch persons from private, portfolio and other non-direct investments has exceeded income received by Dutch persons from payments by the U.S. Government in every year since 1987, and over the past five years such income has averaged approximately twice the amount of income from U.S. Government payments.

In 2003, the income received by Dutch persons from direct investments in the United States totaled $8.0 billion and the income received by Dutch persons from portfolio (non-governmental) and other non-direct investments in the United States totaled $2.7 billion. In 2003, the income of Dutch persons from direct investments in the United States was roughly 50 percent of the income received by U.S. persons on their direct investments in the Netherlands, ($8.0 billion compared to $15.8 billion). The income received by U.S. persons on their portfolio and other non-direct investments in the Netherlands ($4.1 billion in 2003), was roughly 50 percent greater than the income received by Dutch persons from portfolio (non-governmental) and other non-direct investments in the United States ($2.7 billion in 2003). Figure 4 records the cross-border income flows from direct and portfolio and other non-direct investments between the United States and the Netherlands.

Figure 4.--U.S. and the Netherlands Income from Direct and Non-Direct Investments, 1986-2003
[Millions of Real 2003 Dollars]



Source: JCT tabulations of data from Bureau of Economic Analysis.

D. Trends in the Financial Account Between the United States and the Netherlands

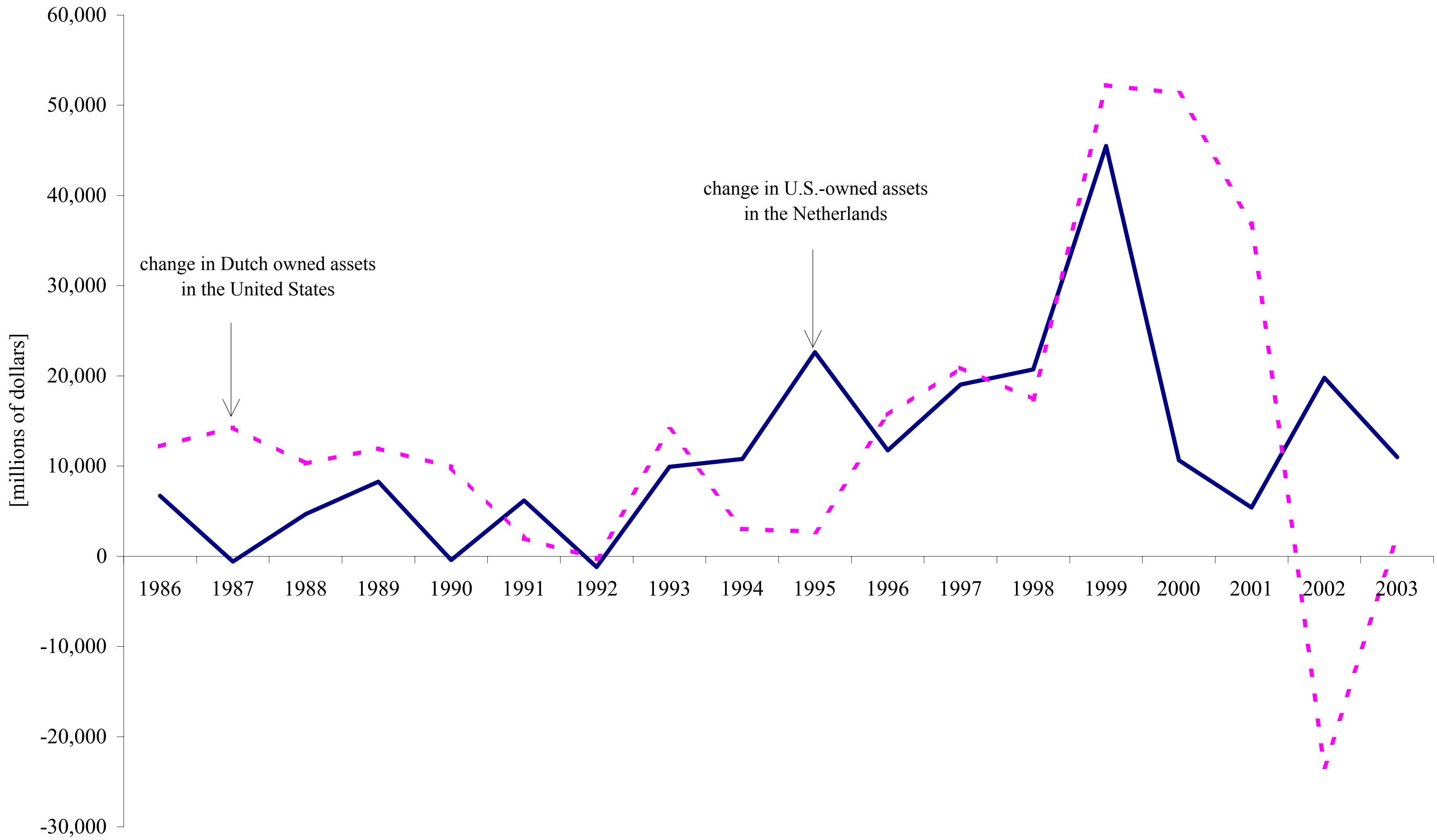
Overview

As discussed above, the current account of international transactions between the United States and the Netherlands records the current-year flow of receipts from current export of goods and services and the income flows arising from past investments. The financial account of international transactions between the United States and the Netherlands (the bottom portion of Table 1) measures the change in U.S ownership of Dutch assets and the change in Dutch ownership of U.S. assets. The importance of the financial account, as documented in preceding discussion, is that ownership of assets abroad generates future receipts of income. In 2003, aggregate cross-border investment between the United States and the Netherlands totaled $13.2 billion. As Table 1 documented, in 2003 the United States' financial account balance with the Netherlands was a positive $8.8 billion, *i.e*., in 2003, U.S. persons accumulated $8.8 billion more in additional assets in the Netherlands than Dutch persons accumulated in additional assets in the Netherlands. In the last half of the 1980s, Dutch persons accumulated U.S. assets at a greater rate than U.S. persons accumulated assets in the Netherlands. During the 1990s, U.S. persons accumulated assets in the Netherlands at a rate comparable to the rate of Dutch persons' accumulation of assets in the United States. Figure 5, below, shows the annual change in U.S.-owned Dutch assets and the annual change in Dutch-owned U.S. assets.[15]

Figure 6, Figure 7, Figure 8, and Figure 9 decompose these annual changes in asset ownership into direct investment and components of non-direct investment.

[15] In Figure 5 through Figure 9 a solid line indicates the net acquisition (purchase of assets, purchase of securities, bank deposit, or extension of credit) by U.S. persons of assets in the Netherlands, and a broken line indicates the net acquisition by Dutch persons of U.S. assets. If any line reports a negative number, there was a net disposition of such assets.

Figure 5.--U.S. and the Netherlands Financial Account Annual Change in Assets Owned, 1986-2003
[Millions of Real 2003 Dollars]



Source: JCT tabulations of data from Bureau of Economic Analysis.

Changes in Direct Investment

Figure 6 reports the annual change in U.S. direct investment in the Netherlands and the annual change in Dutch direct investment in the United States since 1986. Almost all years since 1986 have showed an increase in the amount of direct investment in assets of the one country by investors in the other country. The changes measured in direct investment occur because of increases or decreases in equity investment, changes in intra-company debt, the reinvestment of earnings, and currency valuation adjustments.

Total direct investment by U.S. persons in the Netherlands is large. Measured on an historical cost basis,[16] the value of U.S. direct investment in the Netherlands as of the end of 2003 was $178.9 billion. This comprised 10 percent of total U.S. direct investment overseas and represented the third largest U.S. direct investment position abroad in 2003 after the United Kingdom ($272.6 billion) and Canada ($192.4 billion).[17] The value of Dutch direct investment in the United States is $146.1 billion. This comprised 10.6 percent of total foreign direct investment in the United States and represented the fourth largest foreign direct investment position in the United States after the United Kingdom ($230.4 billion), Japan ($159.3 billion), and Germany ($148.8 billion).[18]

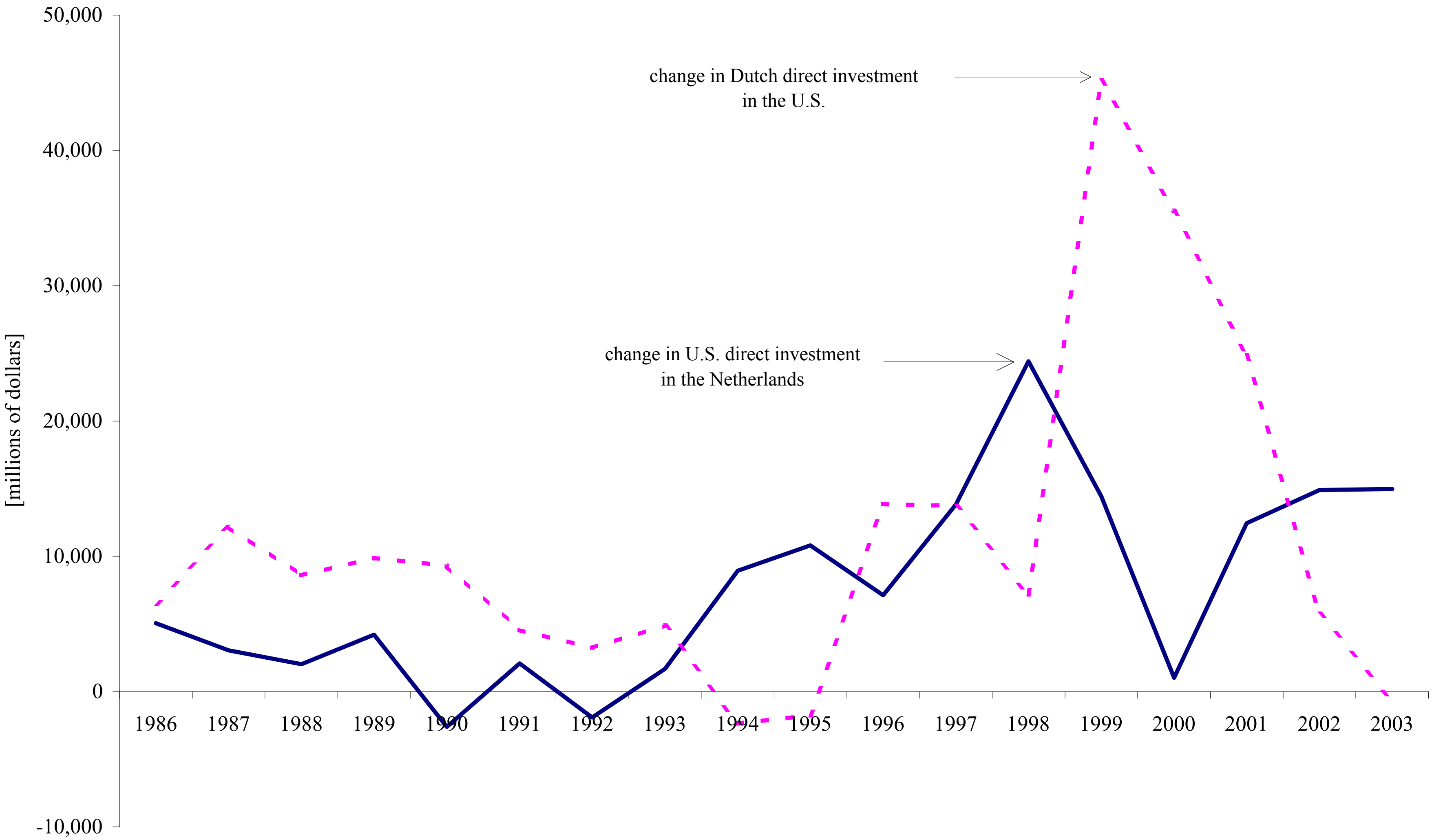
---

[16] The Bureau of Economic Analysis prepares detailed estimates of direct investment by country and industry on an historical cost basis only. Thus, the estimates reported reflect price levels of earlier periods. For estimates of aggregate direct investment the Bureau of Economic Analysis also produces current-cost and market value estimates.

[17] Maria Borga and Daniel R. Yorgason, "Direct Investment Positions for 2003: Country and Industry Detail," *Survey of Current Business*, vol. 84, July 2004, pp. 40-51.

[18] *Ibid*.

Figure 6.--Change in U.S. and the Netherlands Direct Investment, 1986-2003
[Millions of Real 2003 Dollars]



Source: JCT tabulations of data from Bureau of Ecomomic Analysis.

Changes in Non-Direct Investment

Non-direct investment generally may be thought of as consisting of two components, portfolio investment, that is, the purchase of securities, and lending activities. Figure 7 reports the annual change in the holdings of Dutch securities (stocks and bonds) by U.S. persons and the annual change in the holdings of U.S. securities (other than Treasury securities) by Dutch persons. In 2003, U.S. holdings of Dutch stocks and bonds decreased by $1.1 billion to a year-end estimated value of $147.5 billion.[19] Of this total, Dutch stocks account for $119.9 billion and Dutch bonds account for $27.6 billion.[20] Among U.S. holdings of foreign stocks, the value of Dutch stock held is fifth after holdings of U.K. equities, Japanese equities, Bermudan equities, and French equities by U.S. persons.[21] Dutch holdings of U.S. securities (other than Treasury securities) decreased by $4.2 billion in 2003, so that at the end of 2003, Dutch persons held $118.7 billion of U.S. corporate stocks and $28.7 billion of U.S. corporate bonds and the bonds of certain Federal agencies (other than general obligation Treasury bonds). In the case of equities, these holdings comprised 7.7 percent of total foreign holdings of U.S. equities and represented the fourth largest holdings of stocks, after the United Kingdom, Canada, and Japan. In the case of bonds, these holdings comprised 1.5 percent of total foreign holdings of such bonds and represented the fifth largest holdings of corporate and agency bonds, after the United Kingdom, Japan, Canada, and Germany.[22]

[19] Patricia E. Abaroa, "The International Investment Position of the United States at Year end 2003," *Survey of Current Business*, vol. 84, July 2004, pp. 30-39.

[20] *Ibid*.

[21] *Ibid*. Among U.S. holdings of foreign bonds, U.S. holdings of Dutch bonds is seventh in size after holdings of Canadian, British, German, French, Cayman Island, and Japanese bonds.

[22] *Ibid*.

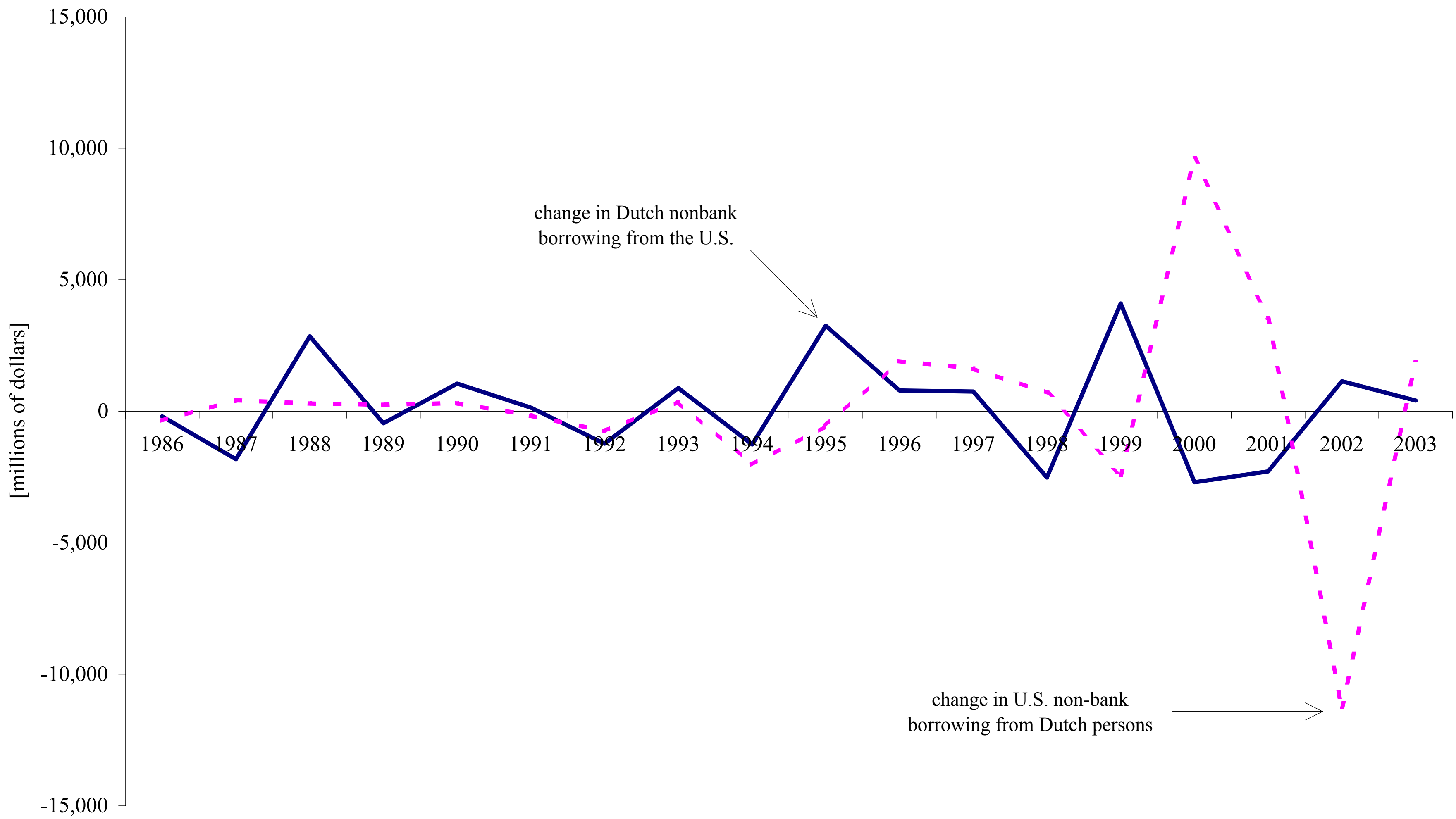
Figure 7.--Change in U.S. and the Netherlands Ownership of Portfolio Securities, 1986-2003
[Millions of Real 2003 Dollars]

Source: JCT tabulations of data from Bureau of Economic Analysis.

Lending activities, aside from the sale of debt securities, constitute the remaining source of non-direct cross-border investment. When a U.S. bank makes a loan to a foreign person abroad (including a foreign subsidiary), the U.S. bank is making a foreign investment. Non-bank U.S. persons also make foreign investments through lending activities. When a non-bank U.S. person makes a deposit in a foreign bank, the non-bank U.S. person is making a foreign investment. Likewise if a U.S. business draws on a line of credit from a bank in the Netherlands, the Dutch bank is making an investment in the United States. Such deposit and borrowing activity can be quite variable and changes in exchange rates and business activity abroad may lead to substantial variability in the annual level of such activity. Figure 8 indicates that neither deposits by non-banking U.S. persons in Dutch banks nor borrowing by non-banking U.S. persons from Dutch persons have displayed a definite trend since 1986.

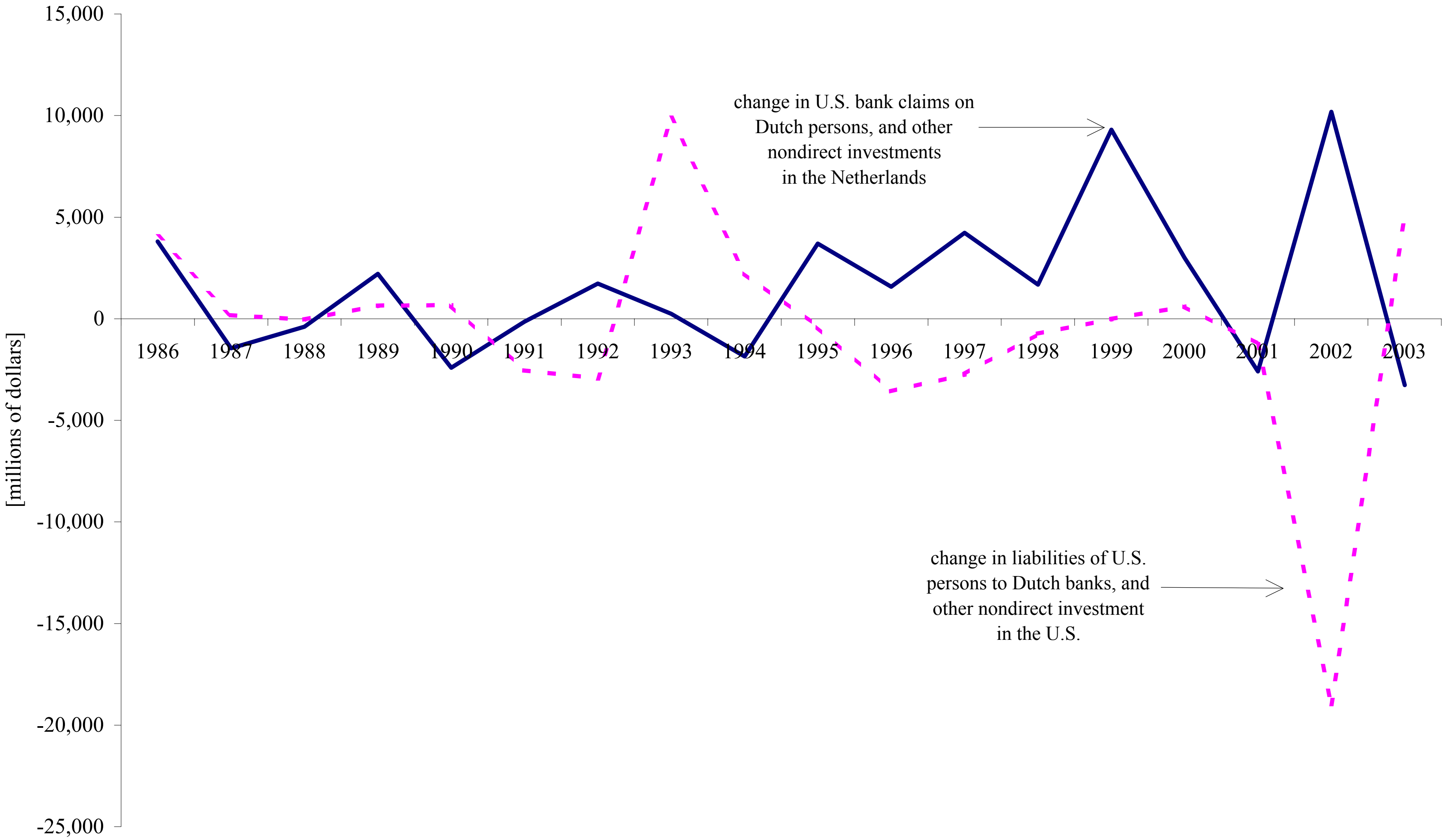
Figure 9 reports cross-border investment activity between the United States and the Netherlands by U.S. banks, including intra-affiliate loans. The solid line in Figure 9 displays no discernible trend since 1986 in lending by U.S. banks to the Netherlands. The broken line in Figure 9 includes data on U.S. bank borrowing from Dutch affiliates and deposits accepted from Dutch persons. However, in Figure 9, the broken line also includes annual changes in Dutch holdings of U.S. Treasury securities. As with U.S. bank lending activity, no discernible trend is evident.

Figure 8.--Change in U.S. and the Netherlands Non-Direct Investment by Persons Other Than Banks, 1986-2003
[Millions of Real 2003 Dollars]



Source: JCT tabulations of data from Bureau of Economic Analysis.

Figure 9.--Change in U.S. and the Netherlands Non-Direct Investment by Banks, 1986-2003
[Millions of Real 2003 Dollars]



Source: JCT tabulations of data from Bureau of Economic Analysis.

E. Income Taxes and Withholding Taxes on Cross-Border Income Flows

The data presented above show that U.S. persons own a substantial amount of direct investment in the Netherlands and Dutch persons own a substantial amount of direct investment in the United States. Data from tax returns reflect the substantial magnitudes of cross-border investment and trade and income flows reported above. In 2000, U.S. corporations with Dutch parent companies had $11 billion of income subject to tax and paid $3 billion in U.S. Federal income taxes. U.S. corporations, including U.S. parent companies of Dutch controlled foreign corporations, reported the receipt of $12 billion of dividends from Dutch corporations in 1999. Of the $12 billion in dividends reported, approximately $3 billion reflected the grossed up value of net dividends to account for deemed taxes paid to the Netherlands. U.S. corporations recognized about $15 billion in taxable income originating in the Netherlands, including the dividend amounts just cited. This income was subject to an average Dutch corporate income tax rate of approximately 21 percent.

Data for withholding taxes from the late 1990s show that the Netherlands and the United States collected approximately the same amounts of receipts, between $100 million and $200 million annually, by withholding tax on respective payments to each other.[23] The data suggest that controlled foreign corporations from each nation repatriated about the same amount, 50 percent, of current corporate earnings and profits. However, data from withholding taxes may be an inaccurate indicator of cross-border investment and income flows. With respect to dividend income from direct investments, a taxpayer can often control the amount and timing of tax paid, because a taxpayer only pays withholding tax when dividends are repatriated to the home country.

[23] For example, data for 1999 show that the United States collected $155 million from withholding tax on all U.S. payments to the Netherlands. Statistics of Income Division, Internal Revenue Service, "Foreign Recipients of U.S. Income, 1998 and 1999," *SOI Bulletin*, vol. 22, Summer 2002, p. 213. Data for 1999 also show that the Netherlands collected $105 million from withholding tax on Dutch payments to U.S. corporations filing Form 1118. This latter figure understates total Dutch collections because it only relates to payment to certain U.S. corporations and not all payments, but this difference is insubstantial. Brian Raub, "Corporate Foreign Tax Credit, 1999," *SOI Bulletin*, vol. 23, Fall 2003, pp. 269-72.

F. Analyzing the Economic Effects of Protocols to Income Tax Treaties

Among other things, tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant tax effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources will result and economic growth in both countries will be enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation of benefits provision should reduce the potential for outright evasion of U.S. and Dutch income tax liabilities.

Generally, a treaty-based reduction in withholding rates will reduce directly U.S. tax collections in the near term on payments from the United States to the Netherlands, but will increase U.S. tax collections on payments from the Netherlands to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this initial dampening of collections on payments to the Netherlands and related decrease in foreign tax credits will begin to reverse. The protocol's reductions in dividend withholding rates will reduce U.S. withholding tax collections on dividend payments from the United States to the Netherlands. At the same time, the reduction in Dutch withholding taxes will create a roughly equivalent reduction occurring in Dutch taxes available for crediting against U.S. tax, again assuming no change in the amount of such payments. Over the longer term, the withholding tax rate changes coupled with other changes in the protocol are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of a withholding change, or any other change in a treaty, would account for both tax and non-tax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

V. EXPLANATION OF PROPOSED PROTOCOL

Article 1. General Scope

Article 1 of the proposed protocol amends Article 1 (General Scope) of the present treaty to take account of mutual agreement procedures and non-discrimination procedures under other agreements, in particular, the General Agreement on Trade in Services ("GATS"). The provisions added by the proposed protocol constitute an exception to the rule in Article 1 of the present treaty that the treaty shall not restrict any exclusion, exemption, deduction, credit, or other allowance now accorded by the laws of the United States or the Netherlands or by any other agreement between them.

The proposed protocol provides that, notwithstanding any other agreement to which the United States and the Netherlands may be parties, a dispute about the interpretation or application of the treaty, including whether a taxation measure is within the scope of the treaty, is determined exclusively as provided under Article 29 (Mutual Agreement Procedure) of the present treaty.

The proposed protocol further provides specifically that the provisions of Article XVII of GATS (relating to national treatment) shall not apply to a taxation measure unless the competent authorities agree that the measure is not within the scope of Article 28 (Non-Discrimination) of the present treaty. For this purpose, a measure means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action. The Technical Explanation to the proposed protocol points out that consequently, no national treatment obligation undertaken by the United States or the Netherlands under GATS applies to a taxation measure unless the competent authorities agree, and that this result imposes no limitation on the most favored nation obligation under GATS because the present treaty and the proposed protocol include no most favored nation obligation. The Technical Explanation further notes that this provision of the proposed protocol applies specifically to GATS; in the event benefits are available to a United States or Netherlands resident under other agreements that are not available under Article 28 (Non-Discrimination) of the present treaty, the proposed protocol does not limit those benefits.

Article 2. Resident

The proposed protocol modifies Article 4 (Resident) of the present treaty. The proposed protocol eliminates from Article 4 of the present treaty a rule relating to the residence of estates and trusts. The treatment of such entities is determined under Article 6 of the proposed protocol (Basis of Taxation) as it relates to fiscally transparent entities.[24]

The proposed protocol does not otherwise alter the residence provisions of the present treaty. However, the notes accompanying the proposed protocol refer to the treatment of dual resident companies under the residence provisions of the present treaty. The notes provide that a company that is or would be a resident of either the United States or the Netherlands under that

[24] *See* the discussion of fiscally transparent entities under Article 6, *infra*, in this pamphlet.

country's domestic law is not treated as a resident of the country under the proposed protocol, if it is treated as a resident of a third country under a treaty between the third country and the United States or the Netherlands. The Technical Explanation gives as an example the case of a company organized in the Netherlands and managed and controlled in the United Kingdom. Although both the Netherlands and the United Kingdom would treat the company as a resident under its domestic law, the treaty between the Netherlands and the United Kingdom treats such a company as resident in the United Kingdom (the place of effective management). Thus, the company would not be eligible for benefits under the proposed protocol because it is not subject to tax as a resident in the Netherlands. The Technical Explanation states that this result confirms the result of Rev. Rul. 2004-76.[25]

Article 3. Dividends

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new dividend article that generally provides for full residence country taxation and limited source country taxation of dividends. The proposed protocol would retain the maximum rate of withholding at source of 15 percent and would provide for a five percent maximum rate for dividends from 10-percent owned corporations. It also would provide for a new zero rate of withholding tax on dividends from certain direct investments. Special rules are provided for dividends from regulated investment companies, real estate investment trusts, and similar Dutch entities.

Internal taxation rules

United States.–The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax on such dividends on a net basis at graduated rates in the same manner that a U.S. person would be taxed.

Under U.S. law, the term dividend generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits. However, liquidating distributions generally are treated as payments in exchange for stock and, thus, are not subject to the 30-percent withholding tax described above (see discussion of capital gains in connection with Article 13 below).

[25] 2004-31 I.R.B. 111. In Rev. Rul. 2004-76, the Internal Revenue Service ruled, "[i]f Corporation A is treated as a resident of Country Y and not of Country X for purposes of the X-Y Convention and, as a result, is not liable to tax in Country X by reason of its residence, it is not entitled to claim benefits under the U.S.-X Convention, because it is not a resident of Country X under the relevant article of the U.S.-X Convention. However, Corporation A is entitled to claim benefits under the U.S.-Y Convention as a resident of Country Y, if it satisfies the requirements of the applicable limitation on benefits article, if any, and other applicable requirements in order to receive benefits under the U.S.-Y Convention."

Dividends paid by a U.S. corporation generally are U.S.-source income. Also treated as U.S.-source dividends for this purpose are portions of certain dividends paid by a foreign corporation that conducts a U.S. trade or business. The U.S. 30-percent withholding tax imposed on the U.S.-source portion of the dividends paid by a foreign corporation is referred to as the "second-level" withholding tax. This second-level withholding tax is imposed only if a treaty prevents application of the statutory branch profits tax.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A real estate investment trust ("REIT") is a corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. In order to qualify for the deduction for dividends paid, a REIT must distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. Because a REIT is taxable as a U.S. corporation, a distribution of its earnings is treated as a dividend rather than income of the same type as the underlying earnings. Such distributions are subject to the U.S. 30-percent withholding tax when paid to foreign owners.

A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. As such, the principal income of a REIT often is rentals from real estate holdings. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have such rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties.

U.S. internal law also generally treats a regulated investment company ("RIC") as both a corporation and a conduit for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus, the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

<u>The Netherlands</u>.–The Netherlands generally imposes a 25-percent withholding tax on dividend payments to nonresidents. The withholding tax is creditable against the income tax liability of nonresidents where the dividend is attributable to Dutch-source income for which they are subject to ordinary taxation.

Proposed protocol limitations on internal law

In general.–Under the proposed protocol, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in such other country. Such dividends also may be taxed by the country in which the payor company is resident, but the rate of such tax is limited. Under the proposed protocol, source-country taxation of dividends (i.e., taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower rate of five percent applies if the beneficial owner of the dividend is a company that owns at least 10 percent of the voting stock of the dividend-paying company.

The term "beneficial owner" is not defined in the current treaty or proposed protocol and, thus, is defined under the internal law of the source country. The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country. Further, companies holding shares through fiscally transparent entities, such as partnerships, are considered to hold their proportionate interest in the shares. Consistent with internal U.S. tax law,[26] the notes provide that a securities lender that receives from the borrower payments in amounts that are equivalent to dividend distributions made with respect to the loaned shares is treated as the beneficial owner of the dividend paid with respect to such shares for purposes of this article.

In addition, the proposed protocol provides a zero rate of withholding tax with respect to certain intercompany dividends in cases in which there is a sufficiently high (80-percent) level of ownership (often referred to as "direct dividends"). The zero rate also would apply with respect to dividends received by a tax-exempt pension fund, provided that such dividends are not derived from the carrying on of a business, directly or indirectly, by such fund.

Zero rate for direct dividends.–Under the proposed protocol, the withholding tax rate is reduced to zero on dividends beneficially and directly owned by a company that has owned at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date the dividend is declared (subparagraph 3 of Article 10 (Dividends)). Under the current treaty, these dividends may be taxed at a five percent rate.

In certain circumstances, eligibility for the zero rate under the proposed protocol is subject to an additional restriction designed to prevent companies from reorganizing for the purpose of obtaining the benefits of the provision. Specifically, in cases in which a company satisfies the Limitation on Benefits article only under the "ownership/base-erosion," "active trade or business," "headquarters company," and/or "shipping/air transport" tests (subparagraph 2(f) and paragraphs 4, 5 and 6, respectively, of Article 26 (Limitation on Benefits)), the zero rate will apply only if the dividend-receiving company owned (directly or indirectly) at least 80 percent of

[26] Treas. Reg. secs. 1.861-2(a)(7), 1.861-3(a)(6), 1.871-7(b)(2), and 1.881-2(b)(2); Notice 97-66, 1997-2 C.B. 328.

the voting power of the dividend-paying company prior to October 1, 1998.[27] In other cases, the Limitation on Benefits article itself is considered sufficient to prevent treaty shopping. Thus, companies that qualify for treaty benefits under the "public trading," "derivative benefits," or discretionary tests (subparagraph 2(c) and paragraphs 3 and 7, respectively, of Article 26 (Limitation on Benefits)) will not need to meet the October 1, 1998 holding requirement in order to claim the zero rate.

Dividends paid by U.S. RICs and REITs and similar Dutch entities.–The proposed protocol generally denies the five percent and zero rates of withholding tax to dividends paid by RICs and REITs in the United States and beleggingsinstellings in the Netherlands.

The 15-percent rate of withholding generally is allowed for dividends paid by a RIC or a Dutch beleggingsinstelling (subject to a special rule for beleggingsinstellings that invest primarily in real estate). The 15-percent rate of withholding is allowed for dividends paid by a REIT or a Dutch beleggingsinstelling that invests in real estate to the same extent as a REIT, provided any one of four additional conditions is met: (1) the person beneficially entitled to the dividend must be an individual holding an interest of not more than 25 percent in the REIT or beleggingsinstelling; (2) the dividend must be paid with respect to a class of stock that is publicly traded and the person beneficially entitled to the dividend is a person holding an interest of not more than five percent of any class of stock of the REIT or beleggingsinstelling; (3) the person beneficially entitled to the dividend must hold an interest in the REIT or beleggingsinstelling of not more than 10 percent and the REIT or beleggingsinstelling is "diversified" (i.e., the gross value of no single interest in real property held by the REIT or beleggingsinstelling exceeds 10 percent of the gross value of the total interest of the REIT or beleggingsinstelling in real property); or (4) the dividend must be paid by a REIT to a beleggingsinstelling or by a beleggingsinstelling to a RIC or a REIT.

The Technical Explanation indicates that the restrictions on availability of the lower rates are intended to prevent the use of RICs and REITs in the United States and beleggingsinstellings in the Netherlands to gain unjustifiable source-country benefits for certain shareholders resident in the other country. For example, a company resident in the Netherlands could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 15 percent on dividends on those shares. Absent these restrictions, there is a concern that such a company could purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and thus obtain a lower withholding rate by holding a similar portfolio through the RIC (transforming portfolio dividends generally taxable at 15 percent into direct investment dividends taxable under the treaty at zero or five percent).

Similarly, the Technical Explanation provides an example of a resident of the Netherlands directly holding real property and required to pay U.S. tax either at a 30 percent rate

[27] It is understood that this is the date on which the Treasury Department announced that it was negotiating a zero rate of withholding with the United Kingdom, the first instance in which the United States was negotiating a zero rate. A similar restriction referring to this date now is contained in the income tax treaty with the United Kingdom, which the Senate ratified in 2003.

on gross income or at graduated rates on the net income. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the lower rates provided in the proposed protocol. The limitations on REIT dividend benefits are intended to protect against this result.

Special rules and limitations.–The proposed protocol's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country, or performs in the source country independent personal services from a fixed base located in that country, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such cases, the dividends effectively connected to the permanent establishment or the fixed base are taxed as business profits (Article 7) or income from independent personal services (Article 15), as the case may be. In the case of a permanent establishment that once existed, but that no longer exists, the "saving clause" (Article 24 (Basis of Taxation)), as amended by the proposed protocol, provides that this rule also applies to dividends that would be attributable to such a permanent establishment if it did exist in the year of payment or accrual.

The proposed protocol prevents the United States from imposing a tax on dividends paid by a Dutch company unless such dividends are paid to a resident of the United States or are attributable to a permanent establishment in the United States. Thus, this provision generally overrides the ability of the United States to impose a "second-level" withholding tax on the U.S.-source portion of dividends paid by a Dutch corporation. The proposed protocol also restricts the United States from imposing corporate level taxes on undistributed profits, other than a branch profits tax.

The proposed protocol generally defines "dividends" as income from shares (or other corporate participation rights that are not treated as debt under the law of the source country), as well as other amounts that are subjected to the same tax treatment as income from shares by the source country (e.g., constructive dividends).

Relation to other Articles

The Technical Explanation notes that the saving clause of paragraph 1 of Article 24 (Basis of Taxation) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 6 of Article 25 (Methods of Elimination of Double Taxation), as if the proposed protocol had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 26 (Limitation on Benefits). Thus, if a resident of the Netherlands is the beneficial owner of dividends paid by a U.S. company, the shareholder must qualify for treaty benefits under at least one of the tests of Article 26 in order to receive the benefits of this article.

Article 4. Branch Tax

Internal taxation rules

United States.–U.S. persons are subject to U.S. tax on their worldwide income. Foreign taxes may be credited against U.S. tax on foreign-source income of the taxpayer. For purposes of computing the foreign tax credit, the taxpayer's income from U.S. sources and foreign sources must be determined.

Nonresident individuals who are not U.S. citizens and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons (secs. 871(b) and 882). Foreign persons also are subject to a 30-percent gross basis tax, collected by withholding, on certain U.S.-source passive income (e.g., interest and dividends) that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

In general, dividends paid by a domestic corporation are treated as being from U.S. sources and dividends paid by a foreign corporation are treated as being from foreign sources. Thus, dividends paid by foreign corporations to foreign persons generally are not subject to withholding tax because such income generally is treated as foreign-source income.

An exception from this general sourcing rule applies in the case of dividends paid by certain foreign corporations. If a foreign corporation derives 25 percent or more of its gross income as income effectively connected with a U.S. trade or business for the three-year period ending with the close of the taxable year preceding the declaration of a dividend, then a portion of any dividend paid by the foreign corporation to its shareholders will be treated as U.S.-source income and, in the case of dividends paid to foreign shareholders, will be subject to the 30-percent withholding tax (sec. 861(a)(2)(B)). This rule is sometimes referred to as the "secondary withholding tax." The portion of the dividend treated as U.S.-source income is equal to the ratio of the gross income of the foreign corporation that was effectively connected with its U.S. trade or business over the total gross income of the foreign corporation during the three-year period ending with the close of the preceding taxable year. The U.S.-source portion of the dividend paid by the foreign corporation to its foreign shareholders is subject to the 30-percent withholding tax.

Under the branch profits tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of the U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a domestic corporation to its foreign shareholders. The branch profits tax is 30 percent of the foreign corporation's "dividend equivalent amount," which generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business (secs. 884(a) and (b)). In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (i.e., the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business) (sec. 884(b)). The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

If a foreign corporation is subject to the branch profits tax, then no secondary withholding tax is imposed on dividends paid by the foreign corporation to its shareholders (sec. 884(e)(3)(A)). If a foreign corporation is a qualified resident of a tax treaty country and claims an exemption from the branch profits tax pursuant to the treaty, the secondary withholding tax could apply with respect to dividends it pays to its shareholders. Several tax treaties (including treaties that prevent imposition of the branch profits tax), however, exempt dividends paid by the foreign corporation from the secondary withholding tax.

Netherlands.–The Netherlands does not impose a branch profits tax.

Proposed treaty limitations on internal law

Article 4 of the proposed protocol provides an exemption from the branch profits tax that parallels the provision of the proposed protocol providing a zero rate of withholding on dividends.

The United States is allowed under the current treaty to impose the branch profits tax (at a rate of five percent) on the business profits of a Dutch corporation that are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and are either attributable to a permanent establishment in the United States, or subject to tax on a net basis in the United States on income from real property or gains from the disposition of interests in real property. The tax is imposed on the "dividend equivalent amount," as described above.

Under the proposed protocol, the branch profits tax will not be imposed by the United States in cases in which a zero rate of withholding on dividends would apply if the Dutch company had conducted the U.S. branch business through a separate U.S. subsidiary. Thus, the branch profits tax will not be imposed in the case of a company that, before October 1, 1998, had a permanent establishment in the United States, or in the case of income or gains subject to tax on a net basis in the United States from real property or from the disposition of interests in real property. In addition, the branch profits tax will not apply to a Dutch company that is considered a qualified person by reason of being a publicly-traded company, or that is entitled to benefits with respect to the dividend equivalent amount under the derivative benefits or competent-authority discretion rules under Article 26 (Limitation on Benefits).

Article 5. Pension, Annuities, Alimony

The proposed protocol replaces the current rules regarding cross-border pension contributions found in paragraph 5 of Article 28 (Non-Discrimination) with new paragraphs 7 through 11 of Article 19 (Pensions, Annuities, Alimony). The proposed rules are intended to remove barriers to the flow of personal services between the two countries that could otherwise result from discontinuities under the laws of each country regarding the deductibility of pension contributions. With the exception of the addition of paragraph 11 to Article 19, the rules of the proposed protocol are similar to rules in the corresponding article of the United Kingdom treaty.

The proposed protocol provides that neither country may tax a resident on pension income earned through an exempt pension trust that is a resident of the other country until such income is distributed. When a resident receives a distribution from an exempt pension trust, such distribution is subject to taxation in accordance with the provisions of Article 19 currently in effect. For example, if a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in the Netherlands, the Netherlands is prevented from taxing currently the plan's earnings and accretions with respect to that individual. For purposes of this provision, roll-overs to another exempt pension trust in the same country are not treated as distributions.

Under the proposed protocol, if an individual who is a member of an exempt pension trust established under the law of one country performs personal services in the other country, whether or not the individual is resident in that other country, contributions made by or on behalf of the individual to the plan during the period he or she performs such personal services are deductible in computing his or her taxable income in the other country. Similarly, contributions made to the plan by or on behalf of his or her employer during such period, and benefits accrued under the plan, are not treated as part of his or her taxable income, and such contributions are allowed as a deduction in computing the employer's profits in the other country. For example, if a participant in a U.S. qualified plan goes to work in the Netherlands for a period of time, contributions made by the participant and his or her employer during that period are not included in the participant's income in the Netherlands, and the employer may deduct its contributions from its business profits in the Netherlands.

The rules of the immediately preceding paragraph apply only if: (1) contributions were made by or on behalf of the individual, or by or on behalf of the individual's employer to the exempt pension trust (or to a similar exempt pension trust for which the exempt pension trust has been substituted) before he or she began to exercise employment or self-employment in the other country; and (2) the competent authority of the other country has agreed that the exempt pension trust "generally corresponds" to an exempt pension trust recognized for tax purposes by that country. Moreover, the relief provided under these rules by the other country will not exceed the relief that would be allowed by that country to its residents for contributions to, or benefits accrued under, an exempt pension trust established in that country.

The proposed protocol also provides that a U.S. citizen who is resident in the Netherlands may exclude or deduct for U.S. tax purposes contributions to an exempt pension trust established in the Netherlands, provided such contributions are made during the period the U.S. citizen exercises taxable employment in the Netherlands and are attributable to such employment, and expenses related to such employment are borne by a Netherlands employer or Netherlands permanent establishment. Similarly, employer contributions to, or benefits accrued under, a Netherlands exempt pension trust are not treated as part of the employee's taxable income in the United States.

The benefits under the rules of the immediately preceding paragraph do not apply unless the U.S. competent authority has agreed that the exempt pension trust generally corresponds to an exempt pension trust established in the United States. The U.S. tax benefits under the rules of the immediately preceding paragraph are limited to the lesser of: (1) the amount of relief allowed for the contributions or benefits in the Netherlands; and (2) the amount of relief that would be allowed by the United States for contributions to, and benefits accrued under, a generally corresponding exempt pension trust established in the United States. Further, to the extent relief is available to the individual under this provision, the contributions made to (and benefits accrued under) a Netherlands exempt pension trust are counted when determining the individual's eligibility for benefits and contribution limits under a generally corresponding exempt pension trust established in the United States.

In accordance with the notes, the term "exempt pension trust" includes those arrangements that are treated as exempt pension trusts for purposes of Article 35 of the present treaty (Exempt Pension Trusts). The United States and the Netherlands entered into a competent authority agreement regarding the types of plans in each jurisdiction that qualify as exempt pension trusts.[28]

The proposed protocol specifically applies the current practices under paragraph 5(c) of Article 28 to the more detailed rules of the proposed protocol. Under longstanding Netherlands law, a premature withdrawal or lump-sum distribution from a pension plan is not considered to be a pension payment. The Netherlands requires its domestic pension plans to provide surety or to otherwise ensure that the participants are not able to avoid the Netherlands claim on such payments. Under proposed paragraph 11 of Article 19, the benefits of Article 5 of the proposed protocol apply with respect to an exempt pension trust established in the United States only if the pension trust undertakes to provide information and surety to the tax authorities of the Netherlands in accordance with the Netherlands law regarding foreign pension trusts. Thus, under both the current treaty and the proposed protocol, in order to "generally correspond" to a Netherlands exempt pension trust, a U.S. exempt pension trust must provide assurances to the Netherlands similar to those required of a Netherlands exempt pension trust.

In addition, residents of the Netherlands who become nonresidents are required under Netherlands domestic law to provide surety against such a premature withdrawal or lump-sum distribution from a pension plan. This requirement is not eliminated with respect to U.S. exempt pension trusts under either the present treaty or the proposed protocol. However, according to the notes, the competent authorities of the United States and the Netherlands agree to consult regarding reducing the burden of the multiple undertakings required of exempt pension trusts and their members.

---

[28] *See* Notice 2000-57, 2000-2 C.B. 389. U.S. pension arrangements considered to be exempt pension trusts include: (1) qualified retirement plans under section 401(a), including qualified cash or deferred arrangements and savings incentive match plans for employees ("SIMPLE") under section 401(k); (2) eligible deferred compensation plans under section 457(b); (3) tax-sheltered annuities under section 403(b); (4) individual retirement arrangements ("IRAs") under section 408, including Roth IRAs under section 408A; (5) SIMPLE IRAs under section 408(p); and (6) simplified employee pensions ("SEPs") under section 408(k).

Article 6. Basis of Taxation

Saving Clause

Like all U.S. income tax treaties and the U.S. model, the present treaty includes a "saving clause." Under this clause, with specific exceptions, the treaty does not affect the taxation by either treaty country of its residents or its citizens. Thus, the United States generally may continue to tax its citizens who are residents of the Netherlands as if the treaty were not in force.

The present treaty contains a provision under which the saving clause (and therefore U.S. tax jurisdiction) applies for U.S. tax purposes to a former U.S. citizen (other than Netherlands nationals) whose loss of citizenship status had as one of its principal purposes the avoidance of U.S. income tax. The provision is limited to the 10-year period following the loss of U.S. citizenship.

The proposed protocol expands the saving clause provision in the present treaty also to include former long-term residents (other than Netherlands nationals) whose termination of residency has as one of its principal purposes the avoidance of U.S. tax. This provision makes the treaty largely consistent with amendments to the U.S. tax rules in 1996 related to certain former citizens and former long-term residents.

Prior to 1996, the Code provided special rules for the imposition of U.S. income tax on former U.S. citizens for a period of 10 years following the loss of citizenship, if his or her loss of U.S. citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. The Health Insurance Portability and Accountability Act of 1996 made several changes to these special rules, including making these rules, as amended, applicable to certain former long-term residents of the United States.

The proposed protocol generally reflects this change to U.S law. The proposed protocol also generally follows the standard provision in the U.S. model. However, unlike U.S. law, the U.S. model or any other U.S. tax treaty, the provision does not apply to former long-term residents who are Netherlands nationals. Consequently, the saving clause does not reflect the full reach of the U.S. tax jurisdiction. However, the proposed protocol is consistent with the current treaty because the provision in the present treaty dealing with former U.S. citizens also does not apply to Netherlands nationals.

The term "long-term resident" is not defined under the proposed protocol and in accord with Article 3 (General Definitions) of the present treaty, the term is defined under the domestic laws of the two countries. The United States defines a "long-term resident" as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least eight of the prior 15 taxable years. An individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

Exceptions to the saving clause are provided for certain benefits conferred by Article 19 (Pensions, Annuities, Alimony) of the present treaty, as amended by the proposed protocol.

Fiscally transparent entities

The proposed protocol contains special rules for fiscally transparent entities. Under these rules, income derived through an entity that is fiscally transparent under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in that country as the income of a resident. For example, if a Dutch company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest income for U.S. tax purposes.

The Technical Explanation states that these rules for income derived through fiscally transparent entities apply regardless of where the entity is organized (*i.e.*, in the United States, the Netherlands, or a third country). The Technical Explanation also states that these rules apply even if the entity is viewed differently under the tax laws of the other country. As an example, the Technical Explanation states that income from U.S. sources received by an entity organized under the laws of the United States, which is treated for Dutch tax purposes as a corporation and is owned by a Dutch shareholder who is a Dutch resident for Dutch tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent.

The notes state that if an item of income is considered by a treaty country to be derived by a person who is a resident of that country by operation of the rules for fiscally transparent entities, and the same item is considered by the other country to be derived by a person who is a resident of that other country, neither country is prevented from taxing the item as the income of the person considered by that treaty country to have derived that item of income. This result is in accord with the saving clause (discussed above), because the rules for fiscally transparent entities are not an exception to the saving clause. For example, if a Dutch resident (“Z”) wholly owns a U.S. limited liability company (“Y”), which elects to be taxed as a corporation for U.S. tax purposes, and Y wholly owns a U.S. corporation (“X”), the United States is not prevented from exercising full taxing jurisdiction over Y, without regard to whether the Netherlands views Y as fiscally transparent. Accordingly, the United States may tax the dividends from X to Y and Y to X in accordance with its domestic law. However, with respect to the dividends from Y to Z, Article 10 (Dividends), as amended by the proposed protocol, determines the applicable rate of U.S. withholding tax, assuming the treaty is otherwise applicable.

The notes also state that the competent authority of a treaty country may grant the benefits of the treaty to a resident of the other treaty country with respect to an item of income, even though it is not treated as income of the resident under the laws of the other treaty country, in cases where the income would have been exempt from tax if it had been treated as the income of that resident. The notes provide the following example. Z is an exempt pension trust within the meaning of Article 35 (Exempt Pension Trusts) that is a resident of the Netherlands for purposes of the treaty. Z is a member of Y, a U.S. limited liability company that has elected to be treated as fiscally transparent for U.S. tax purposes and is treated as non-transparent under Netherlands law. Y owns shares in U.S. companies that currently pay dividends. Because the dividend income is not treated by the Netherlands as income of Z, Z would not be otherwise entitled to treaty benefits. However, the U.S. competent authority may determine that Z is entitled to benefits because Z would be exempt from tax on the income even if it were treated as having derived the income.[29]

Article 7. Limitation on Benefits

In general

The proposed protocol replaces Article 26 (Limitation on Benefits) of the present treaty with an article that reflects the limitation on benefits provisions included in more recent U.S. income tax treaties. These provisions are intended to limit the benefits of the treaty to qualified residents of the United States and the Netherlands.

The proposed protocol is intended to limit double taxation caused by the interaction of the tax systems of the United States and the Netherlands as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as "treaty shopping," which refers to the situation where a person who is not a resident of either treaty country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the third-country resident may be able to secure these benefits indirectly by establishing a corporation or other entity in one of the treaty countries, which entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries until the funds can be repatriated under favorable terms.

The proposed anti-treaty shopping article provides that a treaty country resident is entitled to all treaty benefits only if it is in one of several specified categories. Generally, a resident of either country qualifies for the benefits accorded by the proposed treaty if such resident is within one of the following categories of "qualified persons" (and satisfies any other specified conditions for obtaining benefits):

(1) An individual;

(2) One of the two countries or a governmental entity of one of the two countries;

(3) A company that satisfies a public company test and certain subsidiaries of such companies;

(4) An exempt pension trust that meets an ownership test;

(5) An organization operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes; or

---

[29] The competent authorities have already reached such an agreement with respect to exempt pension funds. Announcement 2003-21, I.R.B. 2003-17.

(6) An entity that satisfies an ownership test and a base erosion test.

Alternatively, a resident that does not fit into any of the above categories may claim treaty benefits under the headquarters company test. In addition, a resident may claim treaty benefits with respect to certain items of income under the derivative benefits test or the active business test. Finally, a person that does not satisfy any of the above requirements may be entitled to the benefits of the proposed treaty if the source country's competent authority so determines.

Individuals

Under the proposed protocol, individual residents of the United States and the Netherlands are entitled to all treaty benefits. However, if such an individual receives income as a nominee on behalf of a third country resident, and thus is not the beneficial owner of such income, benefits may be denied.

Governmental entities

The proposed protocol provides that the United States and the Netherlands, any political subdivision or local authority of the two countries, or any agency or instrumentality of the two countries is entitled to all treaty benefits.

Publicly traded companies

A company is a resident of the Netherlands or the United States if the principal class of its shares, and any disproportionate class of shares, is listed on a recognized U.S. or Netherlands stock exchange and is regularly traded on one or more recognized stock exchanges. In addition, the proposed protocol includes a new requirement that tests for "substantial presence" in the country of residence in order for a company to qualify for treaty benefits under the public company and ownership/base erosion tests. The proposed protocol requires that a company establish substantial presence by meeting one of the two requirements described below.

The first requirement determines whether public trading constitutes an adequate connection to the residence country. To satisfy the first requirement, each of two tests must be met. The first test compares trading in the country of which the company is not a resident to trading in the company's "primary economic zone." For the United States, the primary economic zone includes all NAFTA countries and for the Netherlands, the primary economic zone includes the European Economic Area ("EEA") and the European Union ("EU"). Thus, in the case of a Netherlands company, if more trading in its stock takes place on recognized stock exchanges in the United States than on recognized stock exchanges in the EEA and the EU, it will fail the first requirement. The second trading test compares trading within the company's primary economic zone with worldwide trading. In that case, if the stock of a company is not traded in its primary economic zone at all, or if trading in the primary economic zone constitutes less than 10 percent of total worldwide trading, the company will fail the first requirement. Thus, a Netherlands company that met the regularly traded test primarily through trading on the Johannesburg, Sydney, Tokyo or Toronto stock exchanges (i.e., exchanges other than those in the EEA and EU) might fail the first requirement.

However, even if a company fails the first requirement of the substantial presence test, it can still establish substantial presence if it meets the second requirement. The second requirement determines whether the company's primary place of management and control is in the country where it is a resident. The Technical Explanation notes that this test should be distinguished from the "place of effective management" test which is used by many countries to establish residence and by the OECD Model as a tiebreaker. The place of effective management test has been interpreted to mean the place where the board of directors meets. By contrast, under the proposed protocol the primary place of management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. According to the Technical Explanation, a company's primary place of management and control will be located in the country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries) in the residence country than in the other country or any third country, and the staffs that support the management in making those decisions are also based in the residence country.

The notes provide guidance regarding the persons who are to be considered "executive officers and senior management employees." The notes clarify that the relevant persons may be employees of subsidiaries if they make the strategic, financial and operational policy decisions. The Technical Explanation includes an example that further illustrates this point. If there are special voting arrangements that result in certain board members making certain decisions without the participation of other board members, that is a factor that would be taken into account.

The notes also include a special rule for dealing with integrated corporate groups, where staffs located in two different countries support the management of two publicly traded companies. A Netherlands company will be treated as satisfying the requirement of primary management and control with respect to the location of its staffs if the staffs conduct more management activities in the Netherlands and the other country than in any other country. The special rule only applies if the other country in which the staffs are located is in the primary economic zone of the Netherlands and has a tax treaty with the United States that would provide equivalent benefits to the proposed protocol. Currently, this rule is limited to integrated corporate groups consisting of a Netherlands publicly traded company and a U.K. publicly traded company and their direct and indirect subsidiaries.

The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; as well as the Amsterdam Stock Exchange and any other stock exchange subject to regulation by the Authority for the Financial Markets (or its successor) in the Netherlands. The notes specify that, for these purposes, certain exchanges that are part of Euronext will be considered to be subject to regulation by the Authority for the Financial Markets. The term also includes the Irish Stock Exchange, the Swiss Stock Exchange and the stock exchanges of Brussels, Frankfurt, Hamburg, Johannesburg, London, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto, and Vienna and any other stock exchange agreed upon by the competent authorities of the United States and the Netherlands.

The term “principal class of shares” means the ordinary or common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the “principal class of shares” means that class or any combination of classes of shares that represents, in the aggregate, a majority of the aggregate voting power and value of the company. For these purposes, the term “shares” includes depository receipts for shares or trust certificates for shares.

The term “disproportionate class of shares” means an outstanding class of shares which is subject to terms or other arrangements that entitle the holder to a larger portion of the company’s income, profit, or gain in the country than that to which the holder would be entitled in the absence of such terms or arrangements. A company resident in the Netherlands would meet this requirement if it has outstanding a class of “tracking stock” that pays dividends based upon a formula that approximates the company’s return on its assets employed in the United States.

Shares are considered to be “regularly traded” in a taxable period on one or more recognized stock exchanges if the aggregate number of shares of that class traded during the 12 months ending on the day before the beginning of that taxable period is at least six percent of the average number of shares outstanding in that class during that 12-month period. The notes provide that if a class of shares was not listed on a recognized stock exchange during this 12-month period, the class of shares will be treated as regularly traded only if that class meets the aggregate trading requirements for the taxable period in which the income arises. The Technical Explanation states that this requirement can be met by aggregating trading on one or more of the recognized stock exchanges.

In addition, a company that is a resident of the United States or the Netherlands is entitled to treaty benefits if at least 50 percent of the aggregate vote and value of the company’s shares is owned (directly or indirectly) by five or fewer companies that satisfy the test previously described, provided that each intermediate owner used to satisfy the control requirement is a resident of the United States or the Netherlands. This rule allows certain subsidiaries of publicly traded companies to take advantage of all benefits under the treaty.

Exempt pension trusts

An exempt pension trust is entitled to all the benefits of the proposed protocol if, as of the close of the end of the prior taxable year, more than 50 percent of the beneficiaries, members or participants of the organization are individuals resident in either the United States or the Netherlands or if the organization sponsoring the pension trust is a qualified person. According to the Technical Explanation, for purposes of this provision, the term “beneficiaries” should be understood to refer to the persons receiving benefits from the organization.

Tax-exempt and charitable organizations

Under the proposed protocol, an entity is entitled to treaty benefits if it is organized under the laws of the United States or the Netherlands and established and maintained exclusively for religious, charitable, educational, scientific or similar purposes (notwithstanding that all or part of its income is tax-exempt). There is no requirement that specified percentages of the beneficiaries of these organizations be residents of the United States or the Netherlands.

Ownership and base erosion tests

An entity that is a resident of one of the countries under the proposed protocol is entitled to treaty benefits if it satisfies an ownership test and a base erosion test. However, a company that would be a qualified person under the public company test but for the fact that it has no substantial presence in its country of residence may not qualify for benefits under the ownership and base erosion test.

Under the ownership test, on at least half the days of the taxable period, shares or other beneficial interests representing at least 50 percent of the entity's aggregate voting power and value (and 50 percent of any disproportionate class of shares) must be owned (directly or indirectly) by certain qualified persons described above (i.e., individuals, governmental entities, parent companies that meet the public company test, exempt pension trusts, or an organization operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes).

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable period is paid or accrued, directly or indirectly, in the form of deductible payments, to persons who are not residents of either treaty country. The notes provide that for this purpose, the term "gross income" means the total revenues derived by a resident of a country from its principal operations, less the direct costs of obtaining such revenues. The Technical Explanation states that in the case of the United States, the term "gross income" has the same meaning as under domestic law (i.e., section 61 of the Code and the regulations thereunder). In addition, for purposes of this test, deductible payments do not include arm's-length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank; provided that, if the bank is not a resident of one of the countries, such payment is attributable to a permanent establishment of that bank located in one of the countries.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents of one of the countries and they otherwise satisfy the requirements of the provision.

Derivative benefits rule

The proposed protocol contains a reciprocal derivative benefits rule. This rule effectively allows a Netherlands company, for example, to receive "derivative benefits" in the sense that it derives its entitlement to U.S. tax reductions in part from the U.S. treaty benefits to which its owners would be entitled if they earned the income directly. If the requirements of this rule are satisfied, a company that is resident in one of the treaty countries will be entitled to the benefits of the proposed protocol.

A company resident in one of the countries satisfies this rule if both ownership and base-erosion requirements are met. Under the ownership requirement, shares representing at least 95 percent of the aggregate voting power and value of the company must be owned, directly or indirectly, by seven or fewer persons who are "equivalent beneficiaries."

For this purpose, an equivalent beneficiary includes European Community states, EAA states and NAFTA countries, but only if one of two alternative conditions are satisfied. Under the first alternative condition, that resident must be entitled to all the benefits of a comprehensive tax treaty under specified clauses between its residence country and the country from which the benefits of the proposed treaty are being claimed. However, if such treaty does not contain a comprehensive limitation on benefits provision, the person must be a person that would be a qualified person under the tests described above (and in the case of trusts, without applying the ownership test for equivalent beneficiaries), if such person were a resident of the Netherlands or the United States under the proposed protocol. With respect to dividends, interest, and royalties, the resident must be entitled under such treaty to a rate of tax that is at least as low as the rate applicable to such income under the proposed protocol.

The Technical Explanation sets forth the following example. A U.S. company, USCo, is a wholly owned subsidiary of DCo, a company resident in the Netherlands. DCo is wholly owned by ICo, a corporation resident in Italy. Assuming DCo satisfies the requirements of paragraph 3 of Article 10 (Dividends), DCo would be eligible for a zero rate of withholding tax. The dividend withholding rate in the treaty between the United States and Italy is five percent. Thus, if ICo received the dividend directly from USCo, ICo would have been subject to a five percent rate of withholding tax on the dividend. Because ICo would not be entitled to a rate of withholding tax that is at least as low as the rate that would apply under the Convention to such income (*i.e.*, zero), ICo is not an equivalent beneficiary.

The proposed protocol provides a special rule to take into account the fact that withholding taxes on many intercompany dividends, interest and royalties are exempt within the European Union by reason of various EU directives, rather than by tax treaty. If a U.S. company receives such payments from a Netherlands company, and that U.S. company is owned by a company resident in a member state of the European Union that would have qualified for an exemption from withholding tax if it had received the income directly, the parent company will be treated as an equivalent beneficiary. The Technical Explanation notes that this rule is necessary because many EU member countries have not re-negotiated their tax treaties to reflect the rates applicable under the directives. Under the second alternative condition for qualifying as an equivalent beneficiary, the person must be a resident of either the United States or the Netherlands and be treated as a qualified person under the tests described above.

Under the second requirement to satisfy the derivative benefits rule, the company must satisfy the base erosion test similar to that described above, with certain modifications. The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable period is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries (as defined above) in the form of deductible payments for tax purposes in the company's country of residence. Thus, deductible payments made to equivalent beneficiaries, rather than amounts paid to residents of the United States or Netherlands, are not counted against a company for purposes of determining whether the company exceeds the 50 percent limit. The notes provide that for this purpose, the term "gross income" means the total revenues derived by a resident of a country from its principal operations, less the direct costs of obtaining such revenues. The

Technical Explanation states that in the case of the United States, the term “gross income” has the same meaning as under domestic law (i.e., section 61 of the Code and the regulations thereunder). In addition, for purposes of this test, deductible payments do not include arm’s-length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank; provided that, if the bank is not a resident of one of the countries such payment is attributable to a permanent establishment of that bank located in one of the countries.

Under the present treaty, the ownership prong of the derivative benefits provision has slightly different requirements. The test requires that some of the shares of the company claiming benefits be owned by Netherlands residents, but only 70 percent of the shares have to be owned by equivalent beneficiaries. The Technical Explanation notes that it is possible that some companies would qualify for benefits under the prior test, but not under the provisions in the proposed protocol, and vice versa. The Technical Explanation maintains that since satisfaction of the prior test demonstrates a close connection to the Netherlands, it remains a valid objective test. Accordingly, the notes provide that a company will be granted the benefits of the proposed protocol, pursuant to the competent authority discretion provision, in cases where more than 30 percent of vote and value of the company’s shares are owned by qualified residents of the United States or the Netherlands and more than 70 percent of the shares (and at least 50 percent of any disproportionate class of shares) is owned by seven or fewer equivalent beneficiaries, provided that the base erosion test has been met.

Active business test

Under the active business test, residents of one of the countries are entitled to treaty benefits with respect to income, profit, or gain derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, (2) the income is derived in connection with, or is incidental to, that trade or business, and (3) the trade or business is substantial in relation to the trade or business activity in the other country. The proposed protocol provides that the business of making or managing investments for the resident’s own account does not constitute an active trade or business unless these activities are banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer. For this purpose, a bank will be considered to be engaged in the active conduct of a trade or business only if it regularly accepts deposits from the public and makes loans to the public. Furthermore, an insurance company only is engaged in the active conduct of an insurance business if its gross income consists primarily of insurance or reinsurance premiums and investment income attributable to such premiums.

Because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company is not considered to be engaged in an active trade or business for purposes of this test. However, it can qualify for benefits if it meets the requirements of a headquarters company, described below.

The notes provide that an item of income is derived in connection with a trade or business if the income-producing activity in the source-country is a line of business that “forms a part of” or is “complementary” to the trade or business conducted in residence-country by the income recipient.

According to the Technical Explanation, a business activity generally will be considered to form part of a business activity conducted in the country of source if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the country of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation also states that 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. Where more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first out of earnings and profits of the treaty-benefited trade or business, and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

The notes provide that an item of income derived from the country of source is "incidental to" the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

The notes also elaborate on the purpose and application of the substantiality requirement to the general rule. The requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (*i.e.*, activities that have little economic cost or effect with respect to the company business as a whole).

The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each country (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country. In any case, making each determination or comparison, due regard will be given to the relative sizes of the U.S. and Netherlands economies.

Like the U.S. model and the present treaty, the notes provide a safe harbor under which the trade or business of the income recipient may be deemed to be substantial based on three ratios that compare the size of the recipient's activities to those conducted in the other country with respect to the preceding taxable year, or the average of the preceding three years. The three ratios compare: (i) the value of the assets in the recipient's country to the assets used in the other country; (ii) the gross income derived in the recipient's country to the gross income derived in the other country; and (iii) the payroll expense in the recipient's country to the payroll expense in the other country. The average of the three ratios must exceed 10 percent, and each individual ratio must exceed 7.5 percent. For purposes of this test, if the income recipient owns, directly or indirectly, less than 100 percent of the activity conducted in either country, only its proportionate share of the activity will be taken into account.

Headquarters company

Under the proposed protocol, a resident of the United States or the Netherlands is entitled to treaty benefits if that person functions as a headquarters company for a multinational corporate group. A person is considered a headquarters company for this purpose only if each of several criteria is satisfied.

Overall supervision and administration

The person seeking such treatment must provide a substantial portion of the overall supervision and administration of the group. The Technical Explanation provides that a person will be considered to engage in supervision and administration if it engages in a number of the following activities: group financing, pricing, marketing, internal auditing, internal communications, and management. However, such company cannot be principally involved in group financing. The above-mentioned functions are not an exhaustive list, but intended to be suggestive of the types of activities in which a headquarters company will be expected to engage. Furthermore, it is understood that in determining if a substantial portion of the overall supervision and administration of the group is provided by the headquarters company, the activities it performs as a headquarters company for the group must be substantial in comparison to the same activities for the same group performed by other entities within the multinational group.

For example, a Japanese corporation establishes a subsidiary in the Netherlands to function as a headquarters company for its European and North American operations. The Japanese corporation also has two other subsidiaries functioning as headquarter companies; one for the African operations and one for the Asian operations. The Dutch headquarters company is the parent company for the subsidiaries through which the European and North American operations are carried on. The Dutch headquarters company supervises the bulk of the pricing, marketing, internal auditing, internal communications and management for its group. Although the Japanese overall parent sets the guidelines for all of its subsidiaries in defining the worldwide group policies with respect to each of these activities, and assures that these guidelines are carried out within each of the regional groups, it is the Dutch headquarters company that monitors and controls the way in which these policies are carried out within the group of companies that it supervises. The capital and payroll devoted by the Japanese parent to these activities relating to the group of companies the Dutch headquarter company supervises is small relative to the capital and payroll devoted to these activities by the Dutch headquarters company. Moreover, neither the other two headquarter companies, nor any other related company besides the Japanese parent company, perform any of the above-mentioned headquarter activities with respect to the group of companies that the Dutch headquarters company supervises. In the above case, the Dutch headquarters company would be considered to provide a substantial portion of the overall supervision and administration of the group it supervises.

The proposed protocol does not require that the group that is supervised include persons in the other country. However, the Technical Explanation makes clear that it is anticipated that in most cases the group will include such persons, due to the requirement that the income derived by the headquarters company be derived in connection with or be incidental to an active trade or business supervised by the headquarters company (described below).

Active trade or business

Either for the taxable year concerned, or as an average for the preceding four years, the activities and gross income of the corporate group that the headquarters company supervises and administers must be spread sufficiently among different countries. To satisfy the active trade or business requirement, the group must consist of corporations resident in, and engaged in an active business in, at least five countries, and the income derived in the treaty country of which the headquarter company is not a resident must be derived in connection with, or be incidental to, that active business. The business activities carried on in each of the five countries (or five groupings of countries) must generate at least 10 percent of the gross income of the group.

Single country limitation

The business activities carried on in any one country other than the country where the headquarter company resides cannot generate 50 percent or more of the gross income of the group. As mentioned above, the proposed protocol states that if the gross income requirement under this clause is not met for a taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year. The Technical Explanation provides an example of such application:

Example:–DHQ is a corporation resident in the Netherlands. DHQ functions as a headquarters company for a group of companies. DHQ derives dividend income from a U.S. subsidiary in the 2004 taxable year. The state of residence of each of these companies, the situs of their activities and the amounts of gross income attributable to each for the years 2004 through 2008 are set forth below:

Company	**Situs**	**2008**	**2007**	**2006**	**2005**	**2004**
United States	U.S.	$100	$100	$95	$90	$85
United States	Mexico	10	8	5	0	0
United States	Canada	20	18	16	15	12
United Kingdom	U.K.	30	32	30	28	27
New Zealand	N.Z.	40	42	38	36	35
Japan	Japan	35	32	30	30	28
Singapore	Singapore	25	25	24	22	20
TOTAL		$260	$257	$238	$221	$207

Because the United States' total gross income of $130 in 2008 is not less than 50 percent of the gross income of the group, the provision is not satisfied with respect to dividends derived in 2008. However, the United States' average gross income for the preceding four years may be used in lieu of the preceding year's average. The United States' average gross income for the years 2004-2007 is $111.00 ($444/4). The group's total average gross income for these years is $230.75 ($923/4). Because $111.00 represents 48.1 percent of the group's average gross income for the years 2004 through 2007, the United States satisfies such provision.

Other country gross income limitation

No more than 25 percent of the headquarter company's gross income may be derived from the treaty country of which it is not a resident. Thus, if the headquarters company's gross income for the taxable year is $100, no more than $25 of this amount may be derived from the other country. As with the single country limitation calculation, the proposed protocol provides that if the gross income requirement under this clause is not met for the taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year.

Independent Discretionary Authority

The headquarters company must have and exercise independent discretionary authority to carry out the overall supervision and administration functions mentioned in the overall supervision and administration requirement, above. The Technical Explanation states that this determination is made separately for each function. Thus, if a headquarters company is nominally responsible for group financing, pricing, marketing, and internal auditing functions, and another entity is actually directing the headquarters company as to the group financing function, the headquarters company would not be deemed to have independent discretionary authority for group financing, but it may have such authority for the other functions.

Income taxation rules

The headquarters company must be subject to the generally applicable income taxation rules in its country of residence. The Technical Explanation states that this reference should be understood to mean that the company must be subject to the income taxation rules to which a company engaged in the active trade or business would be subject. Thus, if one of the countries has or introduces special taxation legislation that imposes a lower rate of income tax on headquarter companies than is imposed on companies engaged in the active conduct of a trade or business, or provides for an artificially low taxable base for such companies, a headquarters company subject to these rules is not entitled to the benefits under such provision.

In connection with or incidental to a trade or business

The income derived in the other country must be derived in connection with or be incidental to the active business activities referred to in the active trade or business requirement, above. For example, if a Netherlands company that satisfied the other requirements of this sub-section acted as a headquarters company for a group that included a United States corporation, and the group was engaged in the design and manufacture of computer software, but the U.S. company was also engaged in the design and manufacture of photocopying machines, the income that the Netherlands company derived from the United States would have to be derived in connection with or be incidental to the income generated by the computer business in order to be entitled to treaty benefits under this sub-section. Similarly, interest income received from the U.S. company also would be entitled to the benefits of the treaty under this paragraph as long as the interest was attributable to a trade or business supervised by the headquarters company. Interest income derived from an unrelated party would normally not, however, satisfy the requirements of this clause.

Derivative benefits for shipping and air transport income

The proposed protocol provides that shipping or air transport income, as defined in Article 8 (Shipping and Air Transport) of the present treaty, that is derived by a resident of one treaty country from the other treaty country, and that is not entitled to benefits of the proposed protocol under any of the tests mentioned above, is entitled to benefits under the proposed protocol if it meets one of two tests.

First, a resident of one of the countries is entitled to benefits with respect to shipping or air transport income if at least 50 percent of the beneficial interest in the person (in the case of a company, at least 50 percent of the aggregate vote and value of the stock of the company) is owned, directly or indirectly, by qualified persons or individuals who are residents of a third country that grants a similar exemption for shipping and air transport income to citizens and corporations of the other country. This provision is analogous to the relief provided under Code section 883(c)(1).

Alternatively, a resident of one of the two treaty countries is entitled to benefits with respect to shipping or air transport income if at least 50 percent of the beneficial interest in the person (in the case of a company, at least 50 percent of the aggregate vote and value of the stock of the company) is owned, directly or indirectly, by a company or combination of companies the stock of which is primarily and regularly traded on an established securities market in a third country, provided that the third country grants a similar exemption for shipping and air transport income to citizens and corporations of the other country. This provision is analogous to the relief provided under Code section 883(c)(3). The term "primarily and regularly traded on an established securities market" is not defined in the proposed protocol. The Technical Explanation states that in determining whether a resident of the Netherlands is entitled to benefits under the proposed protocol, the United States will apply the principles of Code section 883(c)(3)(A).

A resident of the Netherlands or the United States that derives shipping or air transport income from the other country but that does not meet all the requirements under the headquarter company test can still qualify for benefits under the proposed protocol if it meets the requirements of the publicly-traded test or the active trade or business test.

Grant of treaty benefits by the competent authority

The proposed protocol provides a "safety-valve" for a person that has not established that it meets one of the objective tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty. Under this provision, such a person may be granted treaty benefits if the competent authority of the source country determines that the establishment, acquisition, or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the proposed protocol. The Technical Explanation provides that in applying this provision, the competent authorities will consider the respective obligations of the Netherlands by virtue of its membership in the European Community and by it being a party to the EAA, and the respective obligations of the United States by virtue of it being a party to NAFTA. The notes specify that in particular, the competent authorities will consider any legal requirements for the facilitation of the free movement of capital and persons, the differing internal tax systems, tax incentive regimes and existing treaty policies among member states of the European Community or the EAA states, or parties to NAFTA.

The notes further provide that where certain changes in circumstances might cause a person to cease to qualify as a qualified person (as defined above), such changes need not result in the denial of benefits under the treaty. The Technical Explanation states that this rule recognizes the legal requirements for the free flow of goods and services within the European Communities and within NAFTA. The changes in circumstances contemplated by the notes include, all under ordinary business conditions: (1) a change in the country of residence of a major participant in the company, (2) the sale of part of the ownership interests in a company to a resident of a qualifying country, (3) or an expansion of a company's activities in another qualifying country. The notes provide that if the competent authority is satisfied that these changed circumstances are not attributable to tax avoidance motives, then this will be a factor weighing in favor of granting benefits in accordance with this provision.

The proposed protocol provides that the competent authority of the source country must consult with the competent authority of the residence country before refusing to grant benefits under this provision.

Article 8. Exchange of Information and Assistance and Support in Collection

Article 8 of the proposed protocol amends Article 32 of the present treaty. Article 32 of the present treaty sets out limitations on Articles 30 (Exchange of Information and Administrative Assistance) and 31 (Assistance and Support in Collection) of the present treaty.[30] In general, Article 8 of the proposed protocol provides further detail on the operation of these limitations and makes Article 32 more consistent with the U.S. model.

Paragraph 1 of Article 32 (as contained in Article 8 of the proposed protocol) is identical to Article 32 of the present treaty. It states that neither Articles 30 nor 31 shall be construed to impose the obligation to carry out administrative measures at variance with the law or administrative practice of either country, to supply information that is not obtainable under the

[30] The structure of the present treaty, which is maintained by the proposed protocol, is unusual for U.S. tax treaties (and at variance with both the U.S. model and the OECD model) insofar as it states some of the limitations on and operating rules for the exchange of information and assistance in collection provisions in a separate article (as opposed to putting them in the article to which they relate). This unusual structure does not affect the substantive operation of these treaty provisions.

law or administrative practice of either country, or to disclose trade or other commercial secrets the disclosure of which would be contrary to public policy.

Paragraph 2 of Article 32 (as contained in Article 8 of the proposed protocol) is new with respect to the present treaty. It is substantially the same as the first sentence of paragraph 3 of Article 26 of the U.S. model.[31] Paragraph 2 provides that, notwithstanding paragraph 1, the competent authorities of both countries have the authority to obtain and provide information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity, as well as information about persons holding interests, including bearer shares, in another person, regardless of any laws or practices of the country that might otherwise preclude the obtaining of such information.

Paragraph 3 of Article 32 (as contained in Article 8 of the proposed protocol) is also new with respect to the present treaty. Although it is not contained in Article 26 of the U.S. model, it does reflect current U.S. treaty policy. For example, a substantially similar provision was contained in the 2004 U.S. tax treaties with Japan[32] and Sri Lanka[33] and in the 2003 U.S. tax treaty with the United Kingdom.[34]

Paragraph 3 of the proposed protocol does not impose the obligation to obtain or provide information that would reveal confidential communications between a client and an attorney, solicitor, or other admitted legal representative where the communications are produced for the purposes of seeking or providing legal advice or of use in existing or contemplated legal proceedings. The Technical Explanation states that, in the case of the United States, the scope of the privilege for such confidential communications is coextensive with the attorney-client privilege under U.S. law.

The notes[35] require, in specified circumstances, that the United States seek records through the exchange of information provisions of the treaty before issuing a summons. This paragraph is identical to the parallel paragraph in the 1993 Memorandum of Understanding. It is not contained in the U.S. model nor is it contained in any other U.S. tax treaty.[36] The Senate

---

[31] The remainder of paragraph 3 of Article 26 of the U.S. model is contained in paragraph 2 of Article 30 of the present treaty, which is not amended by the proposed protocol.

[32] November 6, 2003, diplomatic note, paragraph 8.

[33] September 20, 2002, diplomatic note, page 2.

[34] July 24, 2001, diplomatic note, “With reference to Article 27 (Exchange of Information and Administrative Assistance)”.

[35] Paragraph XXXII of the proposed Memorandum of Understanding between the United States and the Netherlands.

[36] Accordingly, it does not appear to represent U.S. tax treaty policy and should not be considered a precedent for other treaties.

Foreign Relations Committee Report[37] accompanying the 1993 Memorandum of Understanding states: "The Committee does not believe that the treaty should be interpreted as depriving the IRS of the discretion it retains under the regulation.[38] The Committee believes that, by allowing the IRS to bypass the treaty exchange of information process in a case where, under all the circumstances presented, the records will not be obtainable through that process on a timely and efficient basis, the Understanding necessarily reserves to the IRS the discretion that it has under the regulation, and thus is consistent with Congressional intent." This statement would continue to be authoritative in administering the proposed protocol.

Article 9. Outdated References

Article 9 of the proposed protocol modifies outdated references in Articles 2 (Taxes Covered), 18 (Artistes and Athletes), and 22 (Students and Trainees) of the present treaty. The proposed protocol eliminates references in Article 2 of the present treaty to the Mining Act of 1810 and the Netherlands Continental Shelf Mining Act of 1965, and substitutes a reference to the Mining Act. The proposed protocol substitutes references to the euro for references to the Netherlands guilder in Articles 18 and 22 of the present treaty.

Article 10. Entry into Force

Article 10 of the proposed protocol relates to the entry into force of the modifications provided in the protocol.

The article provides that the proposed protocol will enter into force on the later of the dates on which the respective treaty countries have notified each other in writing that the formalities constitutionally required in their respective countries have been followed. With respect to withholding taxes, the provisions of the proposed protocol will have effect for amounts paid or credited on or after the first day of the second month next following the date on which the proposed protocol enters into force. With respect to other taxes, the provisions of the proposed protocol will have effect for taxable periods beginning on or after the first day of the January in the year following the date of entry into force of the proposed protocol.

Notwithstanding the entry into force of the proposed protocol, taxpayers may elect temporarily to continue to claim benefits under the present treaty with respect to a period after the proposed protocol takes effect if they would have been entitled to greater benefits under the present treaty. For such a taxpayer, the present treaty would continue to have effect in its entirety for a twelve-month period from the date on which the provisions of the proposed protocol would otherwise take effect.

The notes state that the two treaty countries will consult each other at regular intervals regarding the terms, operation and application of the treaty and proposed protocol to ensure that it continues to serve the purposes of avoiding double taxation and preventing fiscal evasion and will conclude further protocols to amend the treaty as they consider it appropriate.

---

[37] S. Exec. Rpt. 103-19, November 18, 1993.

[38] Treas. Reg. Sec. 1.6038A-6(b).

Notwithstanding that either treaty country may at any time request consultation with the other country on matters relating to the treaty that require urgent attention, the first such consultation will take place no later than the thirty-first day of December of the fifth year following the date on which the proposed protocol enters into force. Further consultations will take place thereafter at intervals of no more than five years.

VI. ISSUES

A. Zero Rate of Withholding Tax on Dividends from 80-Percent-Owned Subsidiaries

In general

The proposed protocol would eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met (paragraph 3 of Article 10 (Dividends)). The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two countries.

Under the present treaty, these dividends may be taxed by the source country at a maximum rate of five percent, a tax that both the Netherlands and the United States do impose as a matter of internal law. The principal immediate effects of the zero-rate provision on U.S. taxpayers and the U.S. fisc would be: (1) to relieve U.S. corporations of the burden of Dutch withholding taxes in connection with qualifying dividends received from Dutch subsidiaries; (2) to relieve the U.S. fisc of the requirement to allow foreign tax credits with respect to these dividends; and (3) to eliminate the withholding tax revenues currently collected by the U.S. fisc with respect to qualifying dividends received by Dutch corporations from U.S. subsidiaries.[39]

Until 2003, no U.S. treaty provided for a complete exemption from withholding tax under these circumstances, and the U.S. and OECD models currently do not provide for such an exemption. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its "Parent-Subsidiary Directive." In addition, in 2003 and 2004, the Senate ratified U.S. treaties and protocols with the United Kingdom, Australia, Mexico, and Japan that contain zero-rate provisions. These provisions are similar to the provision in the proposed protocol, although the treaty with Japan allows a lower ownership threshold (i.e., more than 50 percent, as opposed to at least 80 percent) than the UK, Australia, and Mexico provisions or the provision in the proposed protocol. Thus, the proposed protocol would be the fifth U.S. treaty to provide a complete exemption from withholding tax on direct dividends.

Description of provision

Under the proposed protocol, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has directly owned at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date the dividend is declared (paragraph 3 of Article 10 (Dividends)). Under the current treaty, these dividends may be taxed at a five percent rate.

---

[39] *See* Part IV of this pamphlet for an economic analysis of this provision and of the proposed protocol in general.

In certain circumstances, eligibility for the zero rate under the proposed protocol is subject to an additional restriction designed to prevent companies from reorganizing for the purpose of obtaining the benefits of the provision. Specifically, in cases in which a company satisfies the Limitation on Benefits article only under the "ownership/base-erosion," "active trade or business," "headquarters company," and/or "shipping/air transport" tests (subparagraph 2(f) and paragraphs 4, 5 and 6, respectively, of Article 26 (Limitation on Benefits)), the zero rate will apply only if (1) the dividend-receiving company directly or indirectly owned at least 80 percent of the voting power of the dividend-paying company prior to October 1, 1998, or (2) such company requests and obtains a discretionary ruling from the competent authority that it qualifies for the zero rate. In other cases, the Limitation on Benefits article itself is considered sufficient to prevent treaty shopping with respect to direct dividends. Thus, companies that qualify for treaty benefits under the "public trading," "derivative benefits," or discretionary tests (subparagraph 2(c) and paragraphs 3 and 7, respectively, of Article 26 (Limitation on Benefits)) will not need to meet the October 1, 1998 holding requirement in order to claim the zero rate.

Issues

In general

In view of the relative novelty of zero-rate dividend provisions in the U.S. treaty network, the Committee may wish to devote particular attention to the benefits and costs of taking this step. In addition, the Committee may wish to determine whether October 1, 1998 is the appropriate 80-percent ownership testing date for the proposed protocol with respect to eligibility for the zero rate on dividends received by companies that satisfy the Limitation on Benefits article only under the "ownership/base-erosion," "active trade or business," "headquarters company," and/or "shipping/air transport" tests.

The Committee also may want to determine whether the inclusion of the zero-rate provision in the proposed protocol (as well as in the U.K., Australia, Mexico, and Japan treaties) signals a broader shift in U.S. treaty policy, and under what circumstances the United States may seek to include similar provisions in other treaties. The Committee posed these questions in its tax treaty reports in 2003 and 2004, and it may wish to satisfy itself that these questions have been answered.[40]

Benefits and costs of adopting a zero rate with the Netherlands

Tax treaties mitigate double taxation by resolving the potentially conflicting claims of a residence country and a source country to tax the same item of income. In the case of dividends, standard international practice is for the source country to yield mostly or entirely to the

---

[40] *See* Senate Committee on Foreign Relations, *Report, Tax Convention with Japan*, S. Exec. Rpt. 108-9, March 4, 2004; Senate Committee on Foreign Relations, *Report, Tax Convention with the United Kingdom,* S. Exec. Rpt. 108-2, March 13, 2003; Senate Committee on Foreign Relations, *Report, Protocol Amending the Tax Convention with Australia,* S. Exec. Rpt. 108-3, March 13, 2003; Senate Committee on Foreign Relations, *Report, Protocol Amending the Tax Convention with Mexico,* S. Exec. Rpt. 108-4, March 13, 2003.

residence country. Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a relatively low rate (e.g., five percent) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist. To the extent that the residence country allows a foreign tax credit for the withholding tax, this remaining double taxation may be mitigated or eliminated, but then the priority of the residence country's claim to tax the dividend income of its residents is not fully respected. Moreover, if a residence country imposes limitations on its foreign tax credit,[41] withholding taxes may not be fully creditable as a practical matter, thus leaving some double taxation in place. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. The principal argument in favor of eliminating withholding taxes on certain direct dividends in the proposed protocol is that it would remove one such barrier.

Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee. Whether in the United States or in the Netherlands, the dividend-paying corporation generally faces full net-basis income taxation in the source country, and the dividend-receiving corporation generally is taxed in the residence country on the receipt of the dividend (subject to allowable foreign tax credits or, in the case of the Netherlands, the participation exemption). If the dividend-paying corporation is at least 80-percent owned by the dividend-receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-receiving corporation as having a more remote investor-type interest warranting the imposition of a second-level source-country tax.

Both the United States and the Netherlands currently impose withholding tax on some or all cross-border direct dividends as a matter of domestic law. Therefore, the zero rate provision would provide immediate and direct benefits to the United States as both an importer and an exporter of capital. The overall revenue impact of this provision is unclear, as the direct revenue loss to the United States as a source country would be offset in whole or in part by a revenue gain as a residence country from reduced foreign tax credit claims with respect to Dutch withholding taxes.

Although the United States only recently first agreed to bilateral zero rates of withholding tax on direct dividends, many other countries have a longer history of including such provisions in one or more of their bilateral tax treaties. These countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its "Parent-Subsidiary Directive." Finally, many countries have eliminated withholding taxes on dividends

---

[41] *See, e.g.*, Code sec. 904.

as a matter of internal law (e.g., the United Kingdom and Mexico). Thus, although the zero-rate provision in the proposed protocol is a relatively recent development in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment.

Appropriateness of October 1, 1998 testing date for limitation on zero rate

The October 1, 1998 testing date with respect to eligibility for the zero rate on dividends received by companies that satisfy the Limitation on Benefits article only under certain specific tests provided in that article apparently is modeled after a similar limitation on the zero rate for direct dividends in the U.S.-U.K. treaty. This limitation is intended to supplement the general limitation on benefits provisions in order to prevent companies from treaty-shopping by becoming eligible for the zero rate through reorganization. With regard to the U.S.-U.K. treaty, October 1, 1998 was chosen because it was the date on which the United States and the United Kingdom announced that they were negotiating the treaty. Thus, October 1, 1998 was the date on which companies presumptively were on notice that the negotiation of the U.S.-U.K. treaty could result in a zero rate on direct dividends.

It is appropriate to supplement the Limitation on Benefits article in the proposed protocol to prevent companies from treaty-shopping with respect to the zero rate on direct dividends. However, it not clear why October 1, 1998 is the appropriate testing date for the limitation with respect to companies that satisfy the Limitation on Benefits article only under the "ownership/base-erosion," "active trade or business," "headquarters company," and/or "shipping/air transport" tests. While the United Kingdom and the Netherlands share a particularly close economic relationship as members of the EU, especially in light of the Parent-Subsidiary Directive, it is not apparent how the announcement of U.S.-U.K. treaty negotiations would have encouraged companies to restructure in order to generate direct dividends between the United States and the Netherlands in anticipation of possible future treaty negotiations between the United States and the Netherlands that could result in a zero rate on such dividends.[42] The Committee may wish to inquire further with regard to the rationale for the October 1, 1998 testing date in the context of the proposed protocol.

General direction of U.S. tax treaty policy

Looking beyond the treaty relationship between the United States and the Netherlands, the Committee may wish to determine whether the inclusion of the zero-rate provision in the proposed protocol (as well as in the U.K., Australia, Mexico, and Japan treaties) signals a broader shift in U.S. tax treaty policy. Specifically, the Committee may want to know whether the Treasury Department: (1) intends to pursue similar provisions in other proposed treaties in the future; (2) proposes any particular criteria for determining the circumstances under which a

[42] Neither the October 1, 1998 testing date nor any other testing date is included in the Australia or Japan treaty zero rate provisions, although the October 1, 1998 testing date is included in the Mexico treaty.

zero-rate provision may be appropriate or inappropriate; (3) expects to seek terms and conditions similar to those of the proposed protocol in connection with any zero-rate provisions that it may negotiate in the future; and (4) intends to amend the U.S. model to reflect these developments.[43]

[43] *See* Part VI. D of this pamphlet for a discussion of the status of the U.S. model.

B. Expatriation to Avoid Tax by Former U.S. Citizens and Long-Term Residents

The saving clause of the present treaty applies to former U.S. citizens, other than Netherlands nationals, [44] whose loss of citizenship status had as one of its principal purposes the avoidance of U.S. income tax. The provision is limited to the 10-year period following the loss of U.S. citizenship. This provision is unlike the U.S. model, any other U.S. income tax treaties, and U.S. internal law because it excludes the treaty partner's nationals.

Like the U.S. model and recently negotiated U.S. income tax treaties, the proposed protocol expands the saving clause provision (and therefore U.S. tax jurisdiction) under the present treaty to include former long-term U.S. residents whose termination of residency had as one of its principal purposes the avoidance of U.S. income tax. Thus, the proposed protocol largely reflects the changes to the U.S. tax rules for former citizens and long-term residents as of 1996. However, unlike the U.S. model, any other U.S. income tax treaty, and U.S. internal law, this provision does not apply to the treaty partner's nationals.

Prior to 1996, section 877 of the Code provided special rules for the imposition of U.S. income tax on former U.S. citizens for a period of 10 years following the loss of citizenship; these special tax rules applied to a former citizen only if his or her loss of U.S. citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. The Health Insurance Portability and Accountability Act of 1996 ("HIPA") made several changes to these special rules, including making these rules, as amended, applicable to certain former long-term residents of the United States. For purposes of applying the special tax rules to former citizens and long-term residents, individuals who meet a specified income tax liability threshold or a specified net worth threshold generally are considered to have lost citizenship or resident status for a principal purpose of U.S. tax avoidance. Certain categories of individuals, including a very limited class of dual residents or citizens, may avoid being deemed to have a tax avoidance purpose for relinquishing citizenship or terminating residency by submitting a ruling request to the IRS for a determination as to whether the relinquishment of citizenship or termination of residency had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes.

There is a potential conflict between the present treaty and proposed protocol and section 877 because the saving clause specifically excludes former U.S. citizens and long-time residents who are nationals of the Netherlands. [45] The Code provides that neither a treaty nor a statute have

---

[44] In the case of individuals, Article 3 (General Definitions) of the present treaty defines a national as all individuals possessing the nationality or citizenship of the one of the treaty countries.

[45] *See* Letter from the Department of Treasury to Joint Committee on Taxation, *reproduced in*, Joint Committee on Taxation, *Review of the Present Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency*, (JCS-2-03), February 2003, Appendix A-22 ("[A] . . . potential conflict exists with the U.S.-Netherlands treaty, because that treaty provides that the saving clause does not apply to former U.S. citizens who are nationals of the Netherlands.").

preferential status, so that the later-in-time of a statute or a treaty controls (the so-called "later-in-time rule").[46] To the extent there is a conflict between section 877, as amended by HIPA, and an income tax treaty in force on August 21, 1996 (*i.e.*, HIPA's date of enactment), the legislative history to HIPA states: "[I]t is intended that the purpose of [section 877], as amended, not be defeated by any treaty provision."[47] However, any remaining treaty provision that remains in force 10 years after August 21, 1996 will take precedence over section 877, as amended by HIPA.[48] The legislative history to HIPA also discusses the need to renegotiate certain existing treaties to reflect the full reach of revised section 877: "The Treasury Department is expected to review all outstanding treaties to determine whether the [section 877] provisions, as revised, potentially conflict with treaty provisions and to eliminate any such potential conflicts through renegotiation of the affected treaties as necessary."[49]

As reflected in the legislative history to HIPA, if there is a conflict between the present treaty and section 877, as amended by HIPA, section 877 will prevail until August 21, 2006.[50] Thus, the United States may exercise its full tax jurisdiction until August 21, 2006 with respect to Netherlands nationals who are former U.S. citizens and whose loss of U.S. citizenship status had as one of its principal purposes the avoidance of U.S. income tax, even though the present treaty provides otherwise. After that date, the saving clause in the current treaty, with its specific exception for former citizens who are Netherlands nationals, will prevail over section 877.

Because the proposed protocol will enter into force after August 21, 1996, the proposed protocol would arguably prevail over section 877 under the later-in-time rule.[51] The saving

---

[46] Section 7852(d).

[47] Conf. Rep. No. 104-736, 104th Cong., 2d Sess., 329 (1996). This coordination rule applies to those provisions of section 877 that were amended by HIPA as well as those that were not amended by HIPA. Rev. Rul. 97-19, 1997-1 C.B. 394.

[48] Conf. Rep. No. 104-736, at 329; Rev. Rul. 97-19.

[49] Conf. Rep. No. 104-736, at 329.

[50] The present treaty was in force before August 21, 1996.

[51] Section 7852(d); *see also Crow v. Commissioner*, 85 TC 376 (1985) (holding that an individual who relinquished U.S. citizenship for a tax avoidance purpose would not be subject to U.S. taxation under the saving clause of the 1942 U.S.-Canada income tax treaty, in part, because the legislative history did not allow section 877 to override the treaty; the treaty was silent on the right of the U.S. to tax former citizens under section 877); Letter from the Department of Treasury to Joint Committee on Taxation, *reproduced in*, Joint Committee on Taxation, *Review of the Present Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency*, (JCS-2-03), February 2003, Appendix A-22, n. 1 (stating that "[b]ecause the treaties with Austria and Ireland entered into force after the enactment of the 1996 legislation, the 1996 legislation does not override those treaties with respect to former long-term residents"; these two treaties contain saving clauses that explicitly allow U.S. taxation of former citizens who loss of citizenship was tax-motivated, but do not explicitly refer to former

clause in the proposed protocol does not permit the United States to impose the special tax rules on Netherlands nationals who are former U.S. long-term residents and who terminate U.S. residency with a principal purpose of avoiding U.S. income tax. As discussed above, this provision is unlike the U.S. model or any other U.S. income tax treaties and does not reflect U.S. tax jurisdiction with respect to former long-term residents.

The Committee may wish to inquire as to why the present treaty was not updated to eliminate potential conflicts with section 877, as revised. The Committee may wish to satisfy itself that it is appropriate for the United States arguably to cede its tax jurisdiction with respect to Netherlands nationals who are former U.S. citizens and long-term residents and whose loss of citizenship status or termination of U.S. residency had as one of its principal purposes the avoidance of U.S. income tax. In addition, the Committee may want to satisfy itself that it is appropriate for the special tax rules for former U.S. citizens and long-term residents to apply differently to Netherlands nationals until August 21, 2006 depending on whether they are former citizens or former long-term residents, given that section 877 does not draw this distinction.

---

long-term residents). *But see* Rev. Rul. 79-152 (holding that section 877 applies to an individual who terminated U.S. citizenship to avoid U.S. income tax, even though the income tax treaty between the U.S. and the foreign country was silent on the right of the U.S. to tax former citizens under section 877).

C. Treaty Shopping

The proposed protocol, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed protocol generally is intended to benefit residents of the Netherlands and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to reduce the tax on interest on a loan to a U.S. person by lending money to the U.S. person indirectly through a country whose treaty with the United States provides for a lower rate of withholding tax on interest. The third-country investor may attempt to do this by establishing in that treaty country a subsidiary, trust, or other entity that then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty-shopping provision of the proposed protocol is similar to anti-treaty-shopping provisions in the Code (as interpreted by Treasury regulations) and in the U.S. model. The proposed protocol replaces the anti-treaty shopping provision in the present treaty to update it for modifications included in the U.S. model and other more recent U.S. income tax treaties. The degree of detail included in these provisions is notable in itself. The proliferation of detail may reflect, in part, a diminution in the scope afforded the IRS and the courts to resolve interpretive issues adversely to a person attempting to claim the benefits of a treaty; this diminution represents a bilateral commitment, not alterable by developing internal U.S. tax policies, rules, and procedures, unless enacted by legislation that would override the treaty. (In contrast, the IRS generally is not limited under the proposed protocol in its discretion to allow treaty benefits under the anti-treaty-shopping rules.) The detail in the proposed protocol does represent added guidance and certainty for taxpayers that may be absent under treaties that have somewhat simpler and more flexible provisions.

The provision in the proposed protocol is similar to the anti-treaty-shopping provisions in several recent U.S. income tax treaties; however, the anti-treaty-shopping provisions in the proposed protocol differ from those in the Code and other treaties in some respects. Most notably, the proposed protocol includes a new requirement that tests for "substantial presence" in the residence country in order for a public company to qualify for treaty benefits under the public company test or ownership/base erosion test. The proposed protocol requires that a company establish substantial presence by meeting one of the two requirements described below.

The first requirement determines whether public trading constitutes an adequate connection to the residence country. To satisfy the first requirement, each of two tests must be met. The first test compares trading in the country of which the company is not a resident to trading in the company's "primary economic zone." For the United States, the primary economic zone includes all NAFTA countries and for the Netherlands, the primary economic zone includes the European Economic Area ("EEA") and the European Union ("EU"). Thus, in the case of a Netherlands company, if more trading in its stock takes place on recognized stock exchanges in the United States than on recognized stock exchanges in the EEA and the EU, it will fail the first requirement. The second trading test compares trading within the company's primary economic zone with worldwide trading. In that case, if the stock of a company is not traded in its primary economic zone at all, or if trading in the primary economic zone constitutes less than 10 percent of total worldwide trading, the company will fail the first requirement. Thus, in the case of a Netherlands company that met the regularly traded test primarily through trading on the Johannesburg, Sydney, Tokyo or Toronto stock exchanges (i.e., exchanges other than those in the EEA and EU) might fail the first requirement.

However, even if a company fails the first requirement of the substantial presence test, it can still establish substantial presence if it meets the second requirement. The second requirement determines whether the company's primary place of management and control is in the country where it is a resident. This test should be distinguished from the "place of effective management" test that is used by many countries to establish residence and by the OECD model as a tiebreaker. The place of effective management test has been interpreted to mean the place where the board of directors meets. By contrast, the primary place of management and control test under the proposed protocol looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. A company's primary place of management and control will be located in the country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries) in the residence country than in the other country or any third country, and the staffs that support the management in making those decisions are also based in the residence country.

In determining which individuals are considered "executive officers and senior management employees," the proposed protocol looks generally to the decision-making activities of all executive officers and senior management employees that are members of the Executive Board or Board of Directors. Under a traditional, centralized management structure, the Executive Board or Board of Directors are generally those individuals who report to the corporate headquarter offices and make the strategic, financial and operational policy decisions for the company. Thus, the rule generally should work well in testing where the strategic policy decisions of the business are being carried out. However, given the changing corporate landscape, many companies operate under a more decentralized management structure, where many strategic policy decisions are delegated down to individuals that are directors of subsidiary companies. In this situation, individuals who are not board members may be carrying on the day-to-day management of the company; however, the rule in the proposed protocol still would look to members of the Executive Board or Board of Directors unless the individuals on the Board merely provide formal approval of decisions by others. While the rule provides certainty for persons applying this provision, the Committee may wish to satisfy itself that such rule is appropriate, given the test is aimed at ascertaining the real location of management and control.

There is a special rule for dealing with integrated corporate groups, where staffs located in two different countries support the management of two publicly traded companies. A Netherlands company will be treated as satisfying the requirement of primary management and control with respect to the location of its staffs if the staffs conduct more management activities in the Netherlands and the other country than in any other country. The special rule only applies if the other country in which the staffs are located is in the primary economic zone of the Netherlands and has a tax treaty with the United States that would provide equivalent benefits to the proposed protocol. Currently, this rule is limited to integrated corporate groups consisting of a Netherlands publicly traded company and a U.K. publicly traded company and their direct and indirect subsidiaries.

The new substantial presence test makes the public company test in the proposed protocol distinctly different from the U.S. model and more recent U.S. income tax treaties. The rules in the proposed protocol test for adequate connection to the residence country while the U.S. model and more recent U.S. income tax treaties only require that a public company is listed in one of the two treaty countries and regularly traded on a recognized stock exchange, thereby allowing a company to qualify for treaty benefits if all the trading takes place in the other country or a third country exchange. The new rules tighten the public company test by requiring nexus in the residence country and they address situations where a company may simply invert its corporate structure to change its residence status without changing the situs from which the business is carried on and where it is managed and controlled. In comparing the new rules to other recent U.S. income tax treaties, only the recently signed U.S.-Barbados protocol contains similar rules and the rules in that protocol are tighter than the anti-treaty shopping provisions in the proposed protocol. On the other hand, the recently ratified U.S.-Japan income tax treaty, which was being negotiated at the same time as the proposed protocol, does not include the substantial presence rules. This raises the question as to what Treasury's treaty policy is for negotiating tighter limitation on benefits provisions.

The proposed protocol also provides mechanical rules under which so-called "derivative benefits" are afforded. The U.S. model does not contain a derivative benefits provision.

Under these rules, a company is afforded treaty benefits if, among other things, the company is at least 95-percent owned by seven or fewer persons who are equivalent beneficiaries, defined generally as residents of EU, EEA or NAFTA countries who meet certain other conditions. In addition, the proposed protocol carries forward the rule under the present treaty, pursuant to the competent authority discretion provision, that provides that a company will be granted benefits in cases where more than 30 percent of vote and value of the company's shares is owned by qualified residents of the United States or the Netherlands and more than 70 percent of the shares (and at least 50 percent of any disproportionate class of shares) is owned by seven or fewer equivalent beneficiaries, provided that the base erosion test has been met.

The Committee has in the past expressed its belief that the United States should maintain its policy of limiting treaty-shopping opportunities whenever possible. The Committee has further expressed its belief that, in exercising any latitude Treasury has with respect to the operation of the treaty, the treaty rules should be applied to deter treaty-shopping abuses. On the other hand, implementation of the tests for treaty shopping set forth in the proposed protocol may raise factual, administrative, and other issues. The Committee may wish to satisfy itself that the anti-treaty-shopping rules in the proposed protocol are adequate under the circumstances.

Finally, some have speculated that developments in the European Union might call into question certain bilateral arrangements between an EU country and a non-EU country, such as tax-treaty benefits that are subject to standard limitation-on-benefits clauses. Of course, EU bodies do not have the authority to require the United States to grant any treaty benefits that the United States has not specifically negotiated. However, in light of the importance of limitation-on-benefits provisions to U.S. treaty policy, the Committee may wish to ask the Treasury Department for its views as to how the ongoing process of European integration might affect the operation and development of the U.S. network of bilateral tax treaties with EU member countries.

D. U.S. Model Income Tax Treaty

It has been longstanding practice for the Treasury Department to maintain, and update as necessary, a model income tax treaty that reflects the current policies of the United States pertaining to income tax treaties. Some of the purposes of this model are explained by the Treasury Department in its Technical Explanation of the U.S. model:

> [T]he Model is not intended to represent an ideal United States income tax treaty. Rather, a principal function of the Model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries. In this regard, the Model can be especially valuable with respect to the many countries that are conversant with the OECD Model. … Another purpose of the Model and the Technical Explanation is to provide a basic explanation of U.S. treaty policy for all interested parties, regardless of whether they are prospective treaty partners.[52]

U.S. model tax treaties provide a framework for U.S. treaty policy. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on often complicated treaty matters. In order to promote clarity, transparency, and meaningful Congressional oversight in this area, the U.S. model tax treaties should reflect the most current positions on U.S. treaty policy. Periodically updating the U.S. model tax treaties to reflect changes, revisions, developments, and the viewpoints of Congress with regard to U.S. treaty policy would ensure that the model treaties remain meaningful and relevant.[53]

With assistance from the staff of the Joint Committee on Taxation, the Committee on Foreign Relations reviews tax treaties negotiated and signed by the Treasury Department before ratification by the full Senate is considered. The U.S. model is an important part of this review process, because it helps the Senate determine the Administration's most recent treaty policy and understand the reasons for diverging from the U.S. model in a particular tax treaty. To the extent that a particular tax treaty adheres to the U.S. model, transparency of the policies encompassed in the tax treaty is increased and the risk of technical flaws and unintended consequences resulting from the tax treaty is reduced.

It is recognized that tax treaties often diverge from the U.S. model due to, among other things, the unique characteristics of the legal and tax systems of treaty partners, the outcome of negotiations with treaty partners, and recent developments in U.S. treaty policy. However, even without taking into account the central features of tax treaties that predictably diverge from the

---

[52] Treasury Department, Technical Explanation of the United States Model Income Tax Convention, at 3 (September 20, 1996).

[53] The staff of the Joint Committee on Taxation has recommended that the Treasury Department update and publish U.S. model tax treaties once per Congress. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, vol. II, pp. 445-447.

U.S. model (e.g., withholding rates, limitation on benefits, exchange of information), the technical provisions of recent U.S. tax treaties have diverged substantively from the U.S. model with increasing frequency. This development suggests that the U.S. model, which has not been updated since 1996, is becoming obsolete.

In testimony before the Committee in February 2004, the Treasury Department stated that it intended to update the U.S. model, and to work with the staffs of this Committee and the Joint Committee on Taxation in this regard.[54] The Committee may wish to inquire of the Treasury Department as to the current status of this project.

[54] Testimony of Barbara M. Angus, International Tax Counsel, U.S. Treasury Department, Before the Senate Committee on Foreign Relations Hearing on Pending Income Tax Agreements, February 25, 2004.