[JOINT COMMITTEE PRINT]

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

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE

ON OCTOBER 27, 1993

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty; and the proposed protocol to that treaty, between the United States and the Kingdom of the Netherlands ("the Netherlands"). The proposed treaty was signed on December 18, 1992, and amplified by diplomatic notes signed the same day. The proposed treaty would replace the existing income tax treaty between the two countries that was signed in 1948 and modified and supplemented by a supplementary treaty signed in 1965. The proposed protocol was signed on October 13, 1993, and was amplified by diplomatic notes signed that day. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty and the proposed protocol on October 27, 1993.

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty (the "U.S. model"), and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed treaty contains certain deviations from those documents.

Part I of the pamphlet summarizes the principal provisions of the proposed treaty. Part II presents a discussion of issues that the proposed treaty presents. Part III provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in Part IV by a detailed, article-by-article explanation of the proposed treaty.[2] Part V is a detailed explanation of the proposed protocol.[2a]

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and the Kingdom of the Netherlands* (JCS–15–93), October 26, 1993.

[2] For a copy of the proposed treaty, see Senate Treaty Doc. 103-6, May 12, 1993.

[2a] For a copy of the proposed protocol, see Senate Treaty Doc. 103–19, October 25, 1993.

I. SUMMARY

In general

The principal purposes of the proposed income tax 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 income taxes of the two countries. The proposed treaty is intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is also intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, the objectives of the treaty are achieved principally by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard treaty provisions that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 15). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 15-18). The proposed treaty provides that dividends and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10 and 14). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis or not at all (Articles 10, 12, and 13).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief from the potential double taxation by allowing a foreign tax credit in the country of residence, or, in the case where the Netherlands is the country of residence, allowing in some cases a proportional exemption of U.S. source income from Dutch tax (Article 25).

The proposed treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 24(1)). In addition, the proposed treaty contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the

two countries (Article 1(2)); that is, the treaty only will be applied to the benefit of taxpayers.

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model treaty. It also differs in significant respects from the present treaty with the Netherlands. (The present treaty predates the 1981 U.S. model treaty.) Some of these differences are as follows:

(1) Perhaps most significantly, the proposed treaty contains a limitation on benefits, or "anti-treaty shopping," article. The present treaty has no such article. The proposed treaty provision retains in some respects the outline of the limitation on benefits provisions contained in recent U.S. treaties and in the branch tax provisions of the Internal Revenue Code and Treasury Regulations. However, to an unprecedented degree the proposed treaty provision is more detailed, and in some respects may be more generous to foreign persons, than recently negotiated provisions in other treaties.

(2) Because the foregoing provision of the proposed treaty is believed to be inadequate to prevent all significant forms of tax treaty abuse, the treaty provides that either additional Dutch laws must be enacted to prevent income tax avoidance or evasion in certain cases, or the two countries must agree on a provision aimed at such income tax avoidance or evasion, which agreement must be laid down in a separate protocol to the proposed treaty. The proposed treaty may leave open the possibility that a Dutch resident company with a branch in a third-country tax haven will be entitled to treaty protection against the imposition of U.S. tax, even though the company is also availing itself of the internal law provisions of both the third country and the Netherlands in order to eliminate all substantial non-U.S. tax on its income. The Dutch law or protocol to be adopted must, under the terms of the proposed treaty, deal with the situation where a Dutch enterprise derives foreign source interest or royalties attributable to a permanent establishment in a third country, and the permanent establishment is both exempt from Dutch tax and subject to special or low taxation because of a "tax haven" regime. On October 13, 1993 a protocol for this purpose was signed. The protocol would relax the treaty limits on source country taxation with respect to interest and royalty income that bears less than full taxation in the recipient's residence country. The proposed protocol nevertheless requires source country tax reductions not required under a corresponding anti-abuse provision in a version of the Limitation on Benefits article that was proposed in 1981 at the time that the last U.S. model treaty was proposed.

(3) The U.S. excise tax on insurance premiums paid to a foreign insurer generally is covered; that is, it is treated as a tax that may be eliminated by the treaty. This is a departure from the present treaty and other older U.S. tax treaties, although this tax is covered in some more recent treaties, such as the present treaties with Finland, France, Germany, Hungary, India, Italy, Spain, and the United Kingdom. The excise tax on premiums paid to foreign insurers is covered under the U.S. model treaty.

(4) Like the U.S. model treaty, but unlike the present treaty, the proposed treaty covers the U.S. excise taxes with respect to private

foundations. The proposed treaty, like the model, does not cover social security taxes.

(5) Like the present treaty, but unlike the U.S. model treaty, the proposed treaty covers the U.S. accumulated earnings tax and the personal holding company tax.

(6) By contrast with the present treaty, the proposed treaty introduces rules for determining when a person is a resident of either the United States or the Netherlands, and hence is entitled to benefits under the treaty. The proposed treaty, like the U.S. and OECD model treaties, provides tie-breaker rules for determining the residence for treaty purposes of "dual residents," or persons who, but for the tie-breaker rules, would have resident status in each of the treaty countries. These rules differ in some respects from the rules in the U.S. model treaty, but are consistent with rules in certain recent U.S. treaties. For example, under the proposed treaty, the Netherlands need not treat U.S. citizens or green card holders as U.S. residents unless they have a substantial presence, a permanent home, or an habitual abode in the United States. The U.S. model, by contrast, provides for the other country to reduce taxes on all U.S. citizens, regardless of where they reside. The United States frequently has been unable to negotiate coverage for nonresident citizens in its income tax treaties. Exceptions include treaties with Cyprus, Malta, Hungary, New Zealand, and Sweden. The proposed treaty, unlike the U.S. model treaty, does not treat a dual resident company as a resident of the country under whose laws it was created. Under the proposed treaty, any dual resident other than an individual will be treated as a resident of one or the other country only if the competent authorities can agree; if not, in the case of a company, the proposed treaty (unlike the U.S. model) expressly provides that the person generally shall be treated as a resident of neither country for purposes of enjoying treaty benefits, and hence is entitled to few treaty benefits.

(7) In the case of income derived by a partnership, the U.S. model treaty and U.S. treaties generally apply only to the extent that the income is subject to tax in a treaty country as the income of a resident, either in the partnership's hands or in the hands of its partners. The proposed treaty omits this language. The Treasury Department has indicated that this omission does not result in the application of a different rule, however.

(8) The proposed treaty defines the "United States" and "Netherlands" more broadly than the present treaty to include expressly the U.S. and Dutch portions of the continental shelf. These areas are now included in those definitions under the present treaty only because of changes in internal laws since the present treaty was drafted. Coupled with other treaty provisions, these definitions generally allow each country to tax certain income earned by residents of the other from the exploitation of natural resources, such as oil, found along the first country's portion of the continental shelf. Moreover, rights to the resources found there are treated as real property situated in that country under the proposed treaty.

(9) The business profits article of the proposed treaty omits the force of attraction rules contained in the present treaty and the Code, providing instead that the business profits to be attributed to the permanent establishment shall include only the profits de-

rived from the assets or activities of the permanent establishment. This is consistent with the U.S. model treaty.

(10) The proposed treaty, like the U.S. model treaty and similar to the present treaty, provides that profits of an enterprise of one treaty country from the operation of ships or aircraft in international traffic are taxable only in that country. However, unlike the U.S. model treaty, the proposed treaty generally does not include nonincidental bareboat leasing profits, or profits from the use or rental of containers and related equipment, in the category of profits to which this rule applies. Instead, they are covered by the business profits article.

(11) Like the associated enterprises article of the U.S. model treaty, the proposed treaty contains a "correlative adjustment" clause not found in the present treaty. Under the present treaty, each country may tax an enterprise resident in that country on profits that were, by virtue of its participation in the management or the financial structure of an enterprise of the other treaty country, reduced by non-arm's-length conditions agreed to or imposed upon the second enterprise. Under the correlative adjustment provision, the proposed treaty generally requires the other country to adjust any tax liability it previously imposed on an enterprise for profits reallocated to an associated enterprise by the other first country.

(12) Like the present treaty, but unlike the U.S. model and recent U.S. treaties, the proposed treaty omits language expressly permitting the use of internal law standards such as section 482 of the Code. The Treasury Department has indicated that this omission does not result in the application of a different rule than that applicable under the model, in light of current Treasury practice in the implementation of section 482.

(13) Under the proposed treaty, as under the model treaty, direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting shares of the payor) generally will be taxable by the source country at a rate no greater than 5 percent. The present treaty has a similar rate schedule, but in order to qualify for the direct dividend withholding rate, a higher ownership threshold must be met (either 25 percent stock ownership by one recipient corporation residing in the other country, or 25 percent ownership by a group of recipient corporations resident in that country each of which owns at least 10 percent), and must be met for the period ending on the date the dividend is paid and beginning at the start of the paying corporation's previous taxable year. (Different rules, discussed below, are provided for dividends from a regulated investment company (RIC), real estate investment trust (REIT), or Dutch investment organization (*beleggingsinstelling*).)

(14) Under the present treaty, the prohibition on source country tax on direct investment dividends exceeding 5 percent does not apply in certain cases where more than 25 percent of the gross income of the payor for the prior taxable year consisted of interest and dividends. The proposed treaty eliminates this rule, replacing it with rules similar to those adopted in recent treaties and protocols that allow source country tax in excess of 5 percent on direct investment dividends from a RIC or REIT. The proposed treaty al-

lows a withholding rate of 15 percent on dividends if those dividends are paid by a RIC or a *beleggingsinstelling*, regardless of whether the RIC or *beleggingsinstelling* dividends are paid to a direct or portfolio investor. The proposed treaty eliminates the present treaty's reduction of U.S. withholding tax on dividends if those dividends are paid by a REIT, unless the dividend is beneficially owned by an individual Dutch resident holding a less than 25-percent interest in the REIT, or by a Dutch company that is a *beleggingsinstelling*, in which case the 15-percent rate applies. Dutch withholding taxes on dividends from a *beleggingsinstelling* generally are unrestricted to a similar extent if the *beleggingsinstelling* invests in real estate sufficiently to meet the relevant requirements for a U.S. corporation to be treated as a REIT.

(15) Unlike the present treaty as interpreted by the Treasury Department, the proposed treaty expressly permits the United States to impose the branch profits tax. However, under the proposed treaty, the branch tax only applies to dividend equivalent amounts with respect to profits earned after the proposed treaty takes effect; other recent treaties permit the taxation of dividend equivalent amounts with respect to all post-1986 profits. The present and proposed treaties also expressly prevent imposition of any other form of second-level withholding tax. The U.S. branch profits tax may be imposed at a rate not exceeding 5 percent under the proposed treaty.

(16) Although the proposed treaty, like the present treaty, the U.S. model, and several U.S. treaties, generally provides for absence of source country taxation on interest (including the branch level tax on excess interest deductions), the proposed treaty expressly allows the United States to impose withholding tax at the dividend rate on income from any arrangement, including debt obligations, carrying the right to participate in profits. Thus the United States can, consistent with the proposed treaty, impose withholding tax on deductible interest paid under an "equity kicker" loan. Similarly, the proposed treaty permits the Netherlands to impose withholding tax at the dividend rate on income from a profit-sharing bond. There is no similar provision in the present treaty or the U.S. or OECD models. The internal laws of both the Netherlands and the United States (under a provision added to the Code in the Omnibus Budget Reconciliation Act of 1993) impose withholding tax in such cases. Moreover, it is understood that under the present treaty, the Netherlands imposes dividend withholding tax on payments under a profit-sharing bond.

(17) The interest article in the proposed treaty expressly provides that it does not interfere with the jurisdiction of the United States to tax under its internal law an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (REMIC). Currently, internal U.S. law applies regardless of treaties (such as the present treaty) that were in force when the REMIC provisions were enacted.

(18) Subject to exceptions, the present and proposed treaties expressly prevent imposition of U.S. tax on certain interest paid by Dutch corporations. The proposed treaty makes the exemption reciprocal and conforms it more closely to the U.S. model.

(19) Income from the rental or licensing of cinematographic films and films, tapes, and other means of reproduction for use in radio or television broadcasting is not treated as royalty income under the the proposed treaty, and, although not specified in the proposed treaty, the Treasury Department has indicated that such income is treated as business profits under the proposed treaty (Article 7). Under the present treaty, such income generally would be treated as royalties. Under both treaties, however, a treaty country generally would not be entitled to tax a resident of the other country on such income, unless the income was attributable to a permanent establishment in the first country.

(20) Unlike the royalties articles in the present treaty and the U.S. and OECD model treaties, the royalties article in the proposed treaty has a general limitation on the taxation of royalties paid by residents of the other country. The effect of this provision is in some cases to override the U.S. rule sourcing royalties, and therefore fixing primary tax jurisdiction, in the place of use. Except in cases where an enumerated exception applies, the proposed treaty generally prevents the United States from imposing withholding tax on royalties paid by Dutch residents to third-country residents, even if under the Code, such royalties are U.S. source income and, had the payor been a resident of any other country, would have been subject to a U.S. gross-basis tax. One of the exceptions allows the United States to impose tax on a royalty in the case of back-to-back licenses, employing a passive Dutch intermediary, for the use of intangible property in the United States; this exception allows the United States to tax a royalty paid by a Dutch licensee or such rights to a third country resident, if the Dutch licensee has in turn licensed its rights to a U.S. resident or permanent establishment.

(21) The proposed treaty partially retains U.S. tax jurisdiction, under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), over gains of Dutch residents from the disposition of "U.S. real property interests," a term that includes not only real property but also certain stock and other interests indirectly representing real property. Dutch residents have been fully subject to FIRPTA, which in part conflicts with and overrides the present treaty, since 1985. However, the proposed treaty would give certain Dutch residents a step-up in basis for purposes of computing gain on disposition of the interests. This step-up would apply only to Dutch residents who, since June 18, 1980, have owned U.S. real property interests the gains from which would not have been taxable in the United States if the present treaty had not been overridden by FIRPTA. The step-up forgives U.S. tax on such gain attributable to the period prior to the date FIRPTA overrode the present treaty (January 1, 1985). A similar but more broadly applicable step-up was provided under the 1983 protocol to the U.S.-Canada treaty, although that protocol (unlike the proposed treaty) was negotiated and came into force before the effective date of the FIRPTA treaty override.

(22) Similar to the U.S.-Canada treaty, the proposed treaty requires each treaty country to coordinate with the other country the tax rules that apply to a corporate reorganization or other case where a resident of the other country qualifies for nonrecognition

treatment in its country of residence. Under this rule each treaty country may be required to defer any tax that it would otherwise impose on an alienation by a resident of the other country, to the extent and for the period that tax would have been deferred if the alienator had been its own resident (but no longer and in no greater amount than in the other country). Deferral is only required to the extent that the competent authorities are satisfied that the tax ultimately can be collected.

(23) The proposed treaty, like the present treaty, permits the Netherlands to impose its statutory tax on gains from the disposition by a former Dutch resident, now resident in the United States, of stock in a Dutch resident company if the U.S. resident and related individuals own 25 percent or more of any class of stock in the Dutch company, and the U.S. resident was a Dutch resident within the previous 5 years. The Netherlands must allow a foreign tax credit for U.S. tax in such a case. The treaty gives the United States reciprocal taxation rights in this respect, although internal U.S. tax law generally would impose tax in this situation only in a limited class of cases involving tax avoidance.

(24) The proposed treaty provisions relating to independent personal services generally conform to those of the U.S. model treaty. Under the present treaty, independent personal services generally can be taxed in the country where the services are performed, unless the person earning the income is present in the source country less than 184 days during a taxable year. Under the proposed treaty, like the U.S. model treaty, independent personal services performed by a resident of one country in the other country can only be taxed by the source country if the income is attributable to a fixed base regularly available to the individual in the source country for the purpose of performing his or her activities.

(25) The proposed treaty prohibits source country tax on remuneration of a treaty country resident employed as a member of the regular complement of a ship or aircraft operating in international traffic. This is the same as the U.S. model provision, but differs from the present treaty (which provides no special rule for such employment income) and from the OECD model, which permits taxation in such case by the country in which the place of effective management of the employer is situated.

(26) Like some other U.S. treaties, the proposed treaty allows directors' fees and similar payments made by a company resident in one country to a resident of the other country to be taxed in the first country if the fees are paid for services performed in that country. The U.S. model treaty and the present treaty, on the other hand, treat directors' fees as personal service income. Under the U.S. model treaty, the country where the recipient resides generally has primary taxing jurisdiction over personal service income and the source country tax on directors' fees is limited. By contrast, under the OECD model treaty the country where the company is resident has full taxing jurisdiction over directors' fees and other similar payments the company makes to residents of the other treaty country, regardless of where the services are performed. Thus, the proposed treaty represents a compromise between the U.S. model and the OECD model treaty positions.

(27) The proposed treaty generally allows source country taxation of an entertainer or athlete who earns more than $10,000 there during a taxable year, without regard to the existence of a fixed base or other contacts with the source country. The U.S. model treaty has a similar rule, but with a $20,000 threshold. The present treaty has no such provision, but might in some cases permit less source country taxation of entertainers and athletes due to its 183-day threshold for source country taxation of independent personal services.

(28) Like the present treaty and the U.S. model treaty, the proposed treaty generally provides for taxation of private pensions and annuities only by the country where the recipient resides. Unlike those treaties, however, the proposed treaty allows the taxation by the other country of deferred compensation for employment in that country, in limited cases where the income recipient resided in that other country at some time during the previous five years; the residence country in such a case must also reduce its tax on such income.

(29) The proposed treaty provides for the treatment of alimony payments, unlike the present treaty. The proposed treaty is similar to the U.S. model to the extent that it provides that alimony is taxable only by the country in which the recipient resides. Contrary to the U.S. model, the proposed treaty does not provide for the treatment of payments for child support.

(30) The proposed treaty, unlike the present treaty, expressly provides for the taxation of social security benefits and other public pensions not arising from government service. Like the U.S. model, and many existing U.S. treaties, it permits only the source country to tax such benefits.

(31) The proposed treaty modifies the present treaty's rule, similar to the U.S. model rule, that compensation paid by a treaty country government to its citizen for services rendered to that government in the discharge of governmental functions may only be taxed by that government's country. Under the proposed treaty, as under the OECD model treaty and other U.S. treaties, such compensation generally may only be taxed by the recipient's country of residence, provided the recipient is a national of that country, or (in the case of remuneration other than a pension) the recipient did not become a resident of that country solely for the purpose of rendering the services.

(32) Unlike the model treaties, but like the present treaty and a number of existing U.S. treaties with other countries, the proposed treaty generally prohibits host country tax on the teaching income of a resident of one country who visits the other (host) country for two years or less to teach at an educational institution. Also unlike the models, but like the present and some other existing treaties, this same rule also applies under the proposed treaty to income received as a researcher engaged in research for the public benefit.

(33) The present and proposed treaties, unlike the U.S. and OECD models, also preclude the host country from taxing certain amounts received by temporarily visiting students, researchers and trainees as remittances from abroad, grants, or compensation (not in excess of $2000 per year) for services they perform.

(34) The proposed treaty, unlike the present treaty, contains the standard "other income" article, found in the model U.S. and OECD treaties and some existing treaties, such as the U.S. treaty with the United Kingdom, under which income not dealt with in another treaty article generally may be taxed only by the residence country.

(35) Like all treaties, the proposed treaty is limited by a "saving clause," under which the treaty is not to affect (subject to specific exceptions) the taxation by either treaty country of its residents or its nationals. Exceptions to the saving clause are similar to those in the U.S. model and other U.S. treaties, but more extensive than the exceptions to the saving clause in the present treaty.

(36) The proposed treaty modifies the Internal Revenue Code rule under which, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, and the property is disposed of within 10 years after the cessation, the determination of whether any income or gain attributable to the disposition of the property is taxable on a net basis must be made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a trade or business in the United States, and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year for which the income or gain is taken into account. Under the proposed treaty, the gain of a Dutch resident so taxable by the United States is limited to the gain that accrued during the time that the property formed part of the business property of a permanent establishment or fixed base in the United States (the same rule applies to Dutch tax on a U.S. resident in the reverse situation). Moreover, the tax may not be imposed on such gains at the time when realized and recognized under the laws of that other country if that date is beyond 3 years of the date on which the property ceases to be part of the business property or the permanent establishment or fixed base. Thus, the proposed treaty substantially shortens the 10-year window, following removal of the property from the U.S. business, in which a disposition of the property by a Dutch resident remains subject to U.S. tax, as well as limiting the portion of the gain subject to U.S. tax.

(37) The proposed treaty replaces the double taxation article of the present treaty with a provision that, like the present treaty as applied, generally is consistent with the limitations imposed by U.S. law. In some cases, however, the proposed treaty may provide a more generous credit to a person claiming the foreign tax credit against U.S. tax. Notable features are described below:

- In contrast to the rule under the present treaty, but like that in the U.S. model treaty and recent U.S. treaties, the amount of credit the United States is required to allow for Dutch tax under the proposed treaty is not limited on a per-country basis; that is, it is not limited by the proportion of the U.S. tax which taxable income from Dutch sources bears to worldwide taxable income.
- Unlike the present treaty, but like the U.S. model treaty and recent U.S. treaties, the proposed treaty obligates the United States to provide a U.S. company

so-called "indirect credits" for Dutch income taxes paid by a Dutch company in which the U.S. company owns sufficient voting stock.

- Under the proposed treaty, unlike the present treaty, the Netherlands state share in the profit from exploitation of natural resources is treated as a covered tax and will be treated as a creditable income tax for U.S. foreign tax credit purposes. The profit share applies to income from the extraction of oil and gas in the Netherlands, including its territorial sea and its part of the continental shelf. In computing the profit share, a credit is allowed for Dutch corporate income taxes paid, and other special deduction and allowance rules apply. Absent this provision of the proposed treaty, the Dutch state profit share may not be creditable under U.S. Treasury Department regulations. It is not clear whether the amount of the credit limitation under the proposed treaty for the state profit share is similar to the limitation under the corresponding provisions of U.S. treaties with the United Kingdom and Norway.
- Unlike the present treaty, but like recent U.S. treaties, the proposed treaty includes the so-called "three-bites-of-the-apple" rule, applicable to U.S. citizens resident in the Netherlands. When the person earns income that in the hands of a Dutch resident not a U.S. citizen would be partially or wholly exempt from U.S. tax under the treaty, the Netherlands will allow a credit, limited to the amount of U.S. tax that would be permitted by the treaty (were the Dutch resident not a U.S. citizen). The United States, in turn, is required to provide a credit for the Dutch tax, and to resource the income if necessary to avoid double taxation.

(38) The proposed treaty modifies the foreign tax credit and exemption provisions of the present treaty that apply to the Netherlands in its taxation of Dutch residents. Insofar as the present treaty requires the Netherlands to reduce its tax on a Dutch resident receiving a U.S.-source dividend by no more than 15 percent of the dividend, that treatment is retained under the proposed treaty, but with the result that a REIT dividend subject to 30-percent U.S. withholding tax is eligible for a reduction of Dutch tax no greater than 15 percent of the dividend. Also, the reduction of tax in the case of director's fees or income of an entertainer or athlete, earned by a Dutch resident and taxed in the United States (in the latter two cases because the income exceeds the $10,000 ceiling on income exempt from tax at source), is allowed only to the extent of U.S. tax paid, rather than the full amount of Dutch tax otherwise due on such income.

(39) Under the proposed treaty, each country will be allowed to tax under its domestic laws residents of the other country engaged in offshore activities for more than 30 days in a calendar year in connection with the exploration for, or exploitation of, sea bed mineral resources situated in that country. This provision, which is not in the present or U.S. and OECD model treaties but is similar to

provisions in the U.S. treaties with Norway and the United Kingdom, will affect, for example, U.S. independent drilling contractors that use movable drilling rigs to undertake exploratory drilling for oil in the Dutch sector of the North Sea and other service companies that carry on ancillary services in connection with drilling.

(40) The proposed treaty expands the non-discrimination rule in the present treaty, in some respects conforming it to the U.S. model, and in other respects providing additional benefits. The present treaty prohibits discrimination under the laws of one country against citizens of the other country resident in the first country, against local permanent establishments of citizens or corporations of the other country, and against local corporations owned by citizens or corporations of the other country. The proposed treaty prohibits discrimination under the laws of one country against nationals of the other country in the same circumstances as nationals of the first country, regardless of residence. The proposed treaty also prohibits discrimination against the deductibility of amounts paid to residents of the other country, or against enterprises owned by residents of the other country. In a provision found neither in the U.S. model nor other U.S. treaties (except for a similar provision in the U.S. treaty with France), the proposed treaty also requires each country to treat certain contributions to foreign pension plans similarly to contributions to domestic qualified plans.

(41) The proposed treaty permits a treaty country to deny a refund arising out of a competent authority case unless that country was notified of the existence of the case within 6 years of the end of the taxable year at issue. This limit is not in the U.S. model or the present treaty, although a similar limit is in the U.S. treaties with Finland and Canada.

(42) Like the U.S. model treaty, the proposed treaty makes express provision for competent authorities to mutually agree on topics that would arise under the present treaty, but are not mentioned in the present treaty's mutual agreement article, such as the characterization of particular items of income, the common meaning of a term, the application of procedural aspects of internal law, and the elimination of double taxation in cases not provided for in the treaty. Also like the U.S. model, the proposed treaty makes express provision for competent authorities to mutually agree on topics that would arise under the proposed treaty, namely, the dollar thresholds in the artistes and athletes article and the students and trainees provisions.

(43) The proposed treaty, like the U.S. treaty with Germany and the proposed treaty with Mexico, provides for a binding arbitration procedure to be used to settle disagreements between the two countries regarding the interpretation or application of the treaty. The arbitration procedure can only be invoked by the agreement of both countries. The effective date of this provision is delayed until the two countries have agreed that it will take effect, to be evidenced by a future exchange of diplomatic notes.

(44) The proposed treaty contains a provision that requires the competent authorities to consult on establishing a basis for the full implementation of the proposed treaty whenever the internal law of one of the treaty countries is or may be applied in a manner that may impede the full implementation of the proposed treaty. This

language was apparently intended to obligate the United States to engage in consultations in the event of future internal U.S. legislation that conflicts with, and overrides, provisions in the proposed treaty.

(45) Like the present treaty but unlike the U.S. model, the exchange of information article in the proposed treaty does not obligate the parties to exchange information about national-level taxes (such as excise taxes) that are not otherwise "covered taxes" under the treaty, as listed under Article 2.

(46) As interpreted in the Understanding accompanying the proposed treaty, the exchange of information provision obligates the United States in some cases to request certain records from the Netherlands through an exchange of information under the treaty *before* issuing an administrative summons for those records. By contrast, an intention was expressed in legislative history accompanying the Omnibus Budget Reconciliation Act of 1989 that the Internal Revenue Service (IRS) *not* be *required* to attempt to use a treaty procedure before issuing a summons with respect to information that might be obtained under that treaty.

(47) The proposed treaty contains a provision requiring each country to undertake to lend administrative assistance to the other in collecting taxes covered by the treaty. This provision, carried over with minor modifications from the present treaty, is more detailed than the administrative assistance provision in the U.S. model treaty. Among other things, the proposed treaty provision specifies that one country's application to the other for assistance must include a certification that the taxes at issue have been "finally determined."

(48) The proposed treaty provides for a three-year limitation on refunds of excess source country withholding on dividends, interest, and royalties, which begins to run at the end of the calendar year in which the tax was levied.

(49) Unlike the model treaty and other U.S. treaties with the exception of the treaty with Canada, the proposed treaty provides that each country will exempt dividends and interest from source taxation when earned by an employee benefit organization resident in the other country and generally exempt from its tax. This provision does not apply to business income or related party income. Unlike the corresponding provision described below for exempt religious, charitable, and other organizations, the employee benefit plan exemption is not expressly limited to income that would be exempt if earned by a generally tax-exempt plan resident in the source country.

(50) Unlike the model treaties, but similar to present treaties with Germany and Canada and the proposed treaty with Mexico, the proposed treaty also provides that each country will exempt from tax organizations operated for religious, charitable, scientific, educational, or public purposes and treated as tax-exempt for that reason in the other country, if the organization would, but for its foreign activities and place of organization, qualify for exemption from tax in the first country.

(51) The proposed treaty omits provisions of the present treaty dealing with pre-1936 U.S. tax liabilities of Dutch residents, the Dutch capital accretions tax and extraordinary capital tax liabil-

ities of persons who left the Netherlands between May 1939 and 1945, and the territorial extension of the present treaty to overseas parts of the Kingdom of the Netherlands, and overseas territory of the United States.

(52) The proposed treaty takes effect on the first day of January in the year following the date of entry into force. However, during the first 12 months when the proposed treaty is in effect, taxpayers may elect to be taxed instead as if the present treaty continued to have effect.

(53) The termination of the present treaty by the entry into force of the proposed treaty does not affect territorial extensions of the present treaty. In 1955, prior to its amendment by the 1963 protocol and the 1965 supplementary convention, the U.S.-Netherlands income tax treaty was extended to the Netherlands Antilles. In general, the extension was terminated effective in 1988, but the interest article as extended remains in force. That article is different from the interest articles in both the present and the proposed treaties, and generally exempts from U.S. taxation U.S. source interest on any form of indebtedness (other than interest from mortgages secured by real property) paid to unrelated persons.

II. ISSUES

The proposed treaty presents the following specific issues:

(1) Anti-abuse provisions

In general

In a fundamental departure from the present U.S.-Netherlands income tax treaty, the proposed treaty addresses significant issues of tax treaty abuse. In general, when seeking Senate advice and consent to the ratification of any income tax treaty, the Administration historically has represented that the purpose of the treaty is to benefit residents of the treaty countries through avoidance of double taxation and prevention of fiscal evasion. This is true of both the present and the proposed treaties with the Netherlands. However, residents of third countries and their tax advisers have, over the years, discovered ways of exploiting U.S. treaties; moreover, treaties have been successfully used to avoid all tax on U.S. income. In recognition that this is contrary to the purpose for which the United States enters into income tax treaties, the Treasury Department has sought for approximately 30 years, if not more, to ensure that new treaties are not susceptible to these abuses, and that existing treaties are amended to cure abuses which have been discovered. However, until recently, U.S. and Dutch negotiators had made little visible progress toward bilaterally curing the abuse potential inherent in the present Dutch treaty, which was originally signed in 1948 and has not been amended since 1966. Some believe that the difficulty reflected a belief that the Netherlands *itself* derived a benefit from the use of the present treaty as a device for *third-country* residents to achieve reductions of U.S. tax on U.S. income.

Among existing U.S. income tax treaties, it is believed that the present Dutch treaty has been notable in its susceptibility to abuse. The combination of Dutch internal law and the Dutch treaty network, including the present treaty, makes it possible in some cases for persons including residents of third countries to earn U.S. income relatively free of all tax, U.S., Dutch, or otherwise. Dutch law in many cases exempts Dutch residents from tax on foreign income, including foreign income that bears very little tax; in addition, payments by a Dutch resident to a foreign resident can be structured at times to bear little or no Dutch withholding tax, either due to Dutch internal law which generally exempts interest and royalties from withholding tax, or due to tax treaties that exempt or favor dividends as well. Finally, the present treaty ensures a U.S. dividend withholding rate as low as that available under U.S. treaties with any other country, forbids U.S. withholding tax on U.S. source interest and royalties, and forbids so-called "second-level" U.S.

withholding taxes on dividends or interest paid by a Dutch company but attributable to its U.S. income.

The Committee may wish to consider whether, in light of all the relevant circumstances, the proposed treaty adequately addresses the issue of curbing abuse.

Treaty shopping

The effort by residents of third countries to obtain treaty benefits 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 attempt to secure a lower rate of tax by, for example, lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may attempt to do this by establishing in that treaty country a subsidiary, trust, or other investing entity which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The proposed treaty, like a number of U.S. income tax treaties, generally limits the class of treaty country residents eligible for benefits. Benefits are bestowed only upon those treaty country residents with a sufficient additional nexus, beyond simple residence, to the treaty country. In its outlines, the anti-treaty shopping provision of the proposed treaty is somewhat similar to the anti-treaty shopping provision in the branch tax provisions of the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties. In its details, on the other hand, the proposed treaty is in many ways unprecedented. The degree of detail relative to all other treaties is notable in itself for several reasons. First, 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 the treaty; this diminution represents a bilateral commitment, not alterable by future internal U.S. legislation, unless that legislation would override the treaty. (To the same extent as is provided under other treaties, the IRS generally is not limited under the proposed treaty in its discretion to *allow* treaty benefits under the anti-treaty shopping rules.) In addition, the detail in the proposed treaty represents added guidance for taxpayers that may be absent under other treaties, although detail of this magnitude may itself engender a need for further guidance or clarification. In general, the provisions of the anti-treaty shopping article of the proposed treaty tend to be at least somewhat more lenient than the comparable rules in the U.S. regulations under the branch tax, and other U.S. treaties, although every existing anti-treaty shopping standard potentially may be satisfied through the exercise of more or less broad discretion of the Secretary of the Treasury. The proposed treaty is also one of the first to provide mechanical rules under which so-called "derivative benefits" are afforded.[3] Under these rules, a Dutch entity is afforded benefits based in part on its ulti-

[3]The U.S. income tax treaty with Jamaica and the proposed U.S. income tax treaty with Mexico would also provide for such benefits, but in a much more limited way.

mate ownership by a third country resident who would be entitled to U.S. treaty benefits under an existing treaty between the United States and the third country.

Anti-treaty shopping articles in treaties often have an "ownership/base erosion" test. To qualify for benefits under such a test, an entity must meet two requirements, one concerning the connection of its owners to the treaty countries (the "ownership" requirement), the other concerning the destination of payments that it deducts from its income (the base reduction or "erosion" requirement). The ownership requirement in one anti-treaty shopping provision proposed at the time the U.S. model treaty was proposed allows benefits to be denied to a company residing in a treaty country unless more than 75 percent of its stock is held by individual residents of the same country. The proposed treaty (like other U.S. treaties and an anti-treaty shopping branch tax provision in the Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include entities and individuals resident in either treaty country (and citizens of the United States). For some purposes, the proposed treaty, unlike previous treaties, broadens the class of qualifying shareholders to take into account also residents of member countries in the European Communities (the "EC") with which the United States and the Netherlands each has a bilateral income tax treaty. Thus, the ownership requirement under the proposed treaty is somewhat more generous to taxpayers than some predecessor requirements. Counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits. Counting for this purpose residents of EC member countries may generally also limit abuses in light of the treaties between the United States and those countries.

The base erosion requirement in recent treaties allows benefits to be denied if 50 percent or more of the resident's gross income is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to certain classes of persons not entitled to treaty benefits. A similar test applies under the branch tax. The "base reduction" test in the proposed treaty modifies this test in several respects. First, it does not count the use of income to meet liabilities, contracted at arm's length, to obtain tangible property in the ordinary course of business, or services performed in the payer's residence country. In some cases, payments to residents of EC member countries are also afforded favorable treatment. Thus, the base reduction test in the proposed treaty is different, and maybe more favorable to taxpayers, than its predecessors.

Another provision of the anti-treaty shopping article requires a source country to allow benefits with respect to income derived in connection with the active conduct of a trade or business in the residence country that is substantial in relation to the income-producing activity, or derived incidentally to that trade or business. (This active trade or business test generally does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) To the extent described above, the proposed treaty's active business test is similar to its predecessors. In con-

trast to the practice followed in the drafting of other such treaty tests, however, the way in which the proposed treaty's active business test is to operate is laid out in great detail in the treaty itself, as well as in the accompanying Understanding. In some cases, the details mirror provisions in the branch tax regulations, but may be more generous to taxpayers. Like some recent U.S. treaties, the proposed treaty attributes to the treaty resident active trades or businesses conducted by other entities. The proposed treaty provides for greater certainty in this regard than its predecessors. The attribution rules in the proposed treaty may result in more taxpayers being eligible for treaty benefits, and permit in some cases the treatment of third country business operations within the EC as if they were carried on in the Netherlands.

The proposed treaty is similar to other U.S. treaties and the branch tax rules in affording treaty benefits to certain publicly traded companies. The treaty definition of "publicly traded" is explained in much greater detail in the proposed treaty than in any existing U.S. treaty. Again as in the case of the active business test, in some cases this elaboration mirrors the branch tax regulations, but is less rigorous. Also like the branch tax rules, the treaty allows benefits to be afforded to the wholly-owned subsidiary of a publicly traded company. Unlike any predecessor, the proposed treaty provides that benefits must be afforded to certain joint ventures of publicly traded companies, including in some cases joint ventures involving publicly traded companies resident in EC member countries other than the Netherlands. However, the proposed treaty requires that if benefits are to be afforded a company resident in a treaty country on the basis of public trading in the stock of the company's shareholder or shareholders, then the company seeking treaty benefits must also meet one of two additional tests that measure base erosion. That is, the company either must not be a "conduit company" or, if it *is* a conduit company, the company must meet a "conduit company base reduction test." A conduit company is one that pays out currently at least 90 percent of its aggregate receipts in deductible payments (including royalties and interest, but excluding those at arm's length for tangible property in the ordinary course of business or services performed in the payer's residence country). A conduit company meets the conduit base reduction test if less than a threshold fraction (generally 50 percent) of its gross income is paid to associated enterprises subject to a particularly low tax rate (relative to the tax rate normally applicable in the payer's residence country).

The proposed treaty also guarantees benefits to a resident that is a "headquarter company" of a multinational corporate group. A headquarter company is one that provides a group which is sufficiently geographically dispersed with substantial supervision and administration (including group financing if that is not its primary function).

Like other treaties and the branch tax rules, the proposed treaty gives the competent authority of the source country the power to allow benefits where the anti-treaty shopping test are not met. The Understanding accompanying the treaty elaborates on the standards for applying these rules, and requires each competent authority to consult the other before issuing an adverse ruling. For exam-

ple, the Understanding appears to commit the United States to afford treaty benefits to any widely held Dutch investment company that holds stocks and securities the income from which is not predominately U.S. source, as long as the company employs in the Netherlands a substantial staff actively engaged in the company's stock and securities trading.

The practical difference between the proposed treaty tests and predecessor tests will depend upon how they are interpreted and applied. For example, the active business tests in other treaties theoretically might be applied leniently (so that any colorable business activity suffices to preserve treaty benefits), or it may be applied strictly (so that the absence of a relatively high level of activity suffices to deny them). Given the bright line rules unique to the proposed treaty, the range of interpretation under it may be narrower. It may be possible that a relatively narrow reading of the active business test in other treaties and the branch tax regulations could theoretically be stricter than the proposed treaty tests, and could operate to deny benefits in potentially abusive situations more often.

Exempt foreign income of a Dutch resident

By themselves, the anti-treaty shopping rules do nothing to prevent the proposed treaty from reducing or eliminating U.S. tax on income of a Dutch resident in a case where no other substantial tax is imposed on that income. Moreover, broad classes of persons other than Dutch residents, for example certain publicly traded corporations, may be the ultimate beneficial owners of Dutch entities that qualify for treaty benefits under the anti-treaty shopping article. As mentioned above, a Dutch resident may in some cases be wholly or partially exempt from Dutch tax on foreign (i.e., non-Dutch) income.

For example, assume that a Dutch corporation establishes a permanent establishment outside the Netherlands such that neither the Netherlands nor the place where the branch is located taxes its income. The branch earns U.S. source income of a type that may be entitled to treaty relief from U.S. tax under a U.S.-Dutch treaty like the present or proposed treaties. For U.S. tax purposes, the branch is not a "person" subject to tax. The corporation of which the branch is a part is treated as earning the income earned by the branch. Since the corporation is a Dutch resident, the present or proposed treaty may require the United States to reduce or eliminate its tax on the income of the branch, even though the branch's income is not subject to significant tax by any other country.

Neither the present nor the proposed treaty denies U.S. income tax reductions simply because the reduction would otherwise apply to income with respect to which a Dutch resident pays little or no tax. The same can be said about other treaties between the United States and countries that exempt certain third-country income from tax: were the Dutch resident in this example instead a resident of any other country with which the United States has an income tax treaty, and were that country to exempt the resident's third-country income from tax, the U.S. tax reductions generally available under that treaty also would not be denied. By contrast, one limitation on benefits provision proposed at the time that the U.S. model

treaty was proposed provides that any relief from tax provided by the United States to a resident of the other country under the treaty shall be inapplicable to the extent that, under the law in force in that other country, the income to which the relief relates bears significantly lower tax than similar income arising within that other country derived by residents of that other country.

In recognition that the absence of such a rule poses a serious policy concern, the proposed treaty provides that either additional Dutch laws must be enacted to prevent income tax avoidance or evasion in certain cases, or the two countries must agree on a provision aimed at such income tax avoidance or evasion, which agreement must be laid down in a separate protocol to the proposed treaty. The Dutch law or protocol to be adopted must, under the terms of the proposed treaty, deal with the situation where a Dutch enterprise derives foreign-source interest or royalties attributable to a permanent establishment in a third country, and the permanent establishment is subject to little or no taxation in the Netherlands and the third jurisdiction because of a "tax haven" regime. The latter term includes, but is not necessarily limited to, regimes intended to encourage use of the third country for tax avoidance purposes with respect to investment income. The proposed protocol would amend the proposed treaty to combat abuse in certain cases where U.S. source interest or royalties are earned by a Dutch resident's permanent establishment in a third jurisdiction, and are subject to low aggregate Dutch and third-jurisdiction tax. Where the protocol applies, its effect is to permit the United States to impose a 15-percent withholding tax on the interest and royalties, notwithstanding the proposed treaty's general exemption of interest and royalties from source country tax.

In the past, the Committee has stated its belief that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible. The Committee has further expressed its concern that, in exercising any latitude Treasury has to adjust the operation of a treaty, the treaty rules as applied should adequately deter treaty shopping abuses. The present income tax treaty between the United States and the Netherlands does not contain anti-treaty shopping or other anti-abuse rules. On the other hand, implementation of the tests for treaty shopping set forth in the treaty, or of the tests for treaty abuse set forth in the proposed protocol, raise factual, administrative, and other issues. For example, although the proposed protocol addresses an abuse not addressed in U.S. treaties currently in force, the proposed protocol does not allow the United States to impose source tax on interest and royalties in *all* cases resulting in low overall tax; nor does the proposed protocol allow the United States to impose tax on items *other than* interest and royalties that may be subject to low overall tax. This contrasts with the proposed model treaty provision, described above, which denies treaty benefits for all types of low-taxed income. The primary issue is whether the anti-abuse rules in the proposed treaty provision are adequate under the circumstances.

(2) Real property gains

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), a foreign person is taxed by the United States on gain

from the sale of direct ownership interests in U.S. real property as if the gain were effectively connected with a trade or business conducted in the United States. Generally, the right of the United States to impose tax on this gain was not restricted under the terms of the present treaty,[4] nor is it restricted under the proposed treaty. Also, under FIRPTA a foreign person is subject to U.S. tax on the gain from disposing of stock in a U.S. corporation having (at any time in the previous 5 years) 50 percent or more of its gross asset value comprised of U.S. real property interests. (Such a corporation may be a referred to as a "U.S. real property holding corporation".) Both real property itself, and stock in a corporation with the requisite real property holdings, are referred to in the Code as "U.S. real property interests."

Generally, the United States was forbidden to tax gains from stock constituting a U.S. real property interest under the terms of the present treaty. FIRPTA generally applies to sales after June 18, 1980. The legislation specifically overrides contrary rules in existing treaties if those rules conflict with its provisions. In such an override case, however, the legislation took effect on January 1, 1985. Since that date the U.S. tax on stock gains under FIRPTA has applied to Dutch residents notwithstanding the present treaty.

Under FIRPTA, a foreign person is taxed on the entire gain realized on the sale of a U.S. real property interest regardless of when purchased. Congress decided not to give a step-up in basis (or "fresh start") to fair market value as of the effective date of the legislation. The proposed treaty, by contrast, does provide for a fresh start in certain circumstances. Under the proposed treaty, certain Dutch investors get an effective step-up in the basis of certain of their U.S. real property interests (for purposes of computing the U.S. tax on sale of the property interests) to January 1, 1985 (the effective date of FIRPTA's override of existing treaties). The step-up applies to cases—e.g., recognition of gain on the stock in a U.S. real property holding corporation—where the present Dutch treaty would have prohibited taxation but for the FIRPTA treaty override. This treatment generally applies if a Dutch investor either owned the interest on June 18, 1980, the general effective date of FIRPTA, or acquired it in a non-recognition transaction from a Dutch investor who owned it on that date.

In 1984, the Committee reported on a proposed treaty and proposed protocols with Canada that also provided a basis step-up in applying FIRPTA to gains of Canadian residents.[5] Unlike the step-up in the proposed Dutch treaty, the Canadian treaty provided a step-up generally for all U.S. real property interests, rather than only U.S. real property interests in the form of stock in a U.S. corporation. In its report, the Committee stated its belief that it was clearly the intent of Congress in 1980 that the United States should tax foreign investors when they derive gain on the disposition of an interest in U.S. real estate, even when the foreigner is a resident of a treaty partner. Accordingly, the Committee did not think that treaty provisions should restrict in any way the United

[4] See Article V, which provides that "Income from real property (including gains derived from the sale of such property, . . .) . . . may be taxed in the Contracting State in which such property is situated."

[5] Exec. Rep. No. 98-22, 98th Cong., 2d Sess. (1984).

States' right under FIRPTA to tax foreign investors on gains from the disposition of U.S. real estate. The Committee decided not to recommend a reservation in connection with the then-proposed Canadian treaty. However, the Committee made it clear that its decision in that case not to recommend a reservation on the FIRPTA issue should not be taken as precedent in ongoing or future treaty negotiations. The Committee stated that it would continue to consider seriously recommending a reservation on any treaty provision, *including a fresh-start*, that restricts the right of the United States under FIRPTA to tax gains of foreign investors on dispositions of U.S. real property interests.[6]

Since that time, several U.S. income tax treaties have been negotiated or renegotiated. Residents of other countries have not been afforded this kind of basis step-up for U.S. tax purposes. Moreover, such a step-up did not apply to Dutch investors that disposed of U.S. real property interests between 1985 and the effective date of the proposed treaty. Some may argue that Dutch investors making future dispositions should not obtain such preferential treatment on their U.S. real estate investments. Conversely, others may argue that to the extent the present treaty would have exempted gain from tax at source, had the gain been recognized before 1985, a step-up in basis would be a reasonable transition rule.

(3) Creditability of the Dutch state profit share

Under the proposed treaty, the share of the Dutch government in profits from exploiting Dutch natural resources such as oil and gas will be treated as an income tax and creditable for U.S. tax purposes, subject to special computation limitations. In the absence of this provision, the state profit share may not be creditable under Treasury regulations. The treaty credit, because it will probably be larger than the income tax credit otherwise allowed under the regulations, may reduce the U.S. taxes collected from U.S. oil companies operating in the Dutch sector of the North Sea. For these reasons, and also because it is no longer U.S. treaty policy generally to give treaty credits for special taxes on foreign oil and gas extraction income, it can be argued that the treaty should not allow a credit against U.S. tax for the state profit share. On the other hand, it can be argued that fairness requires that the treaty allow a credit since credits are allowed for arguably comparable oil and gas taxes imposed by the United Kingdom and Norway under the U.S. income tax treaties with those countries currently in force. Since the ratification of those treaties, a proposed U.S. income tax treaty with Denmark containing a similar provision was reported on favorably by the Committee in 1985. However, the Senate has yet to give its advice and consent to ratification thereof.

It can be argued in favor of the provision that the credit is subject to special computation limitations under the treaty that may in some cases be more restrictive than those applying under Code to the credit for foreign oil and gas extraction income taxes (sec. 907). However, the special limitations in the proposed treaty are drafted differently than the corresponding limitations in the U.K. and Norway treaties. In general neither of those treaties requires

[6] *Id.* at 10.

the United States to provide credits, against U.S. tax on income from activities subject to the otherwise non-creditable petroleum tax, in excess of the product of the maximum applicable U.S. tax rate times the income, from sources in the particular treaty country, from activities subject to the otherwise non-creditable petroleum tax. The staff understands that it was not the intention of the negotiators that the proposed treaty would require the United States to provide credits in excess of the product of the U.S. statutory corporate tax rate times the income subject to the profit share that is derived from Dutch sources, determined under U.S. principles. There may be some uncertainty whether the language of the proposed treaty makes this intention clear. If so, the Committee may wish to consider whether and how this matter ought to be clarified in advance of ratification of the proposed treaty.

(4) Summonses to designated agents

Under the Code, any domestic corporation that is 25-percent owned by one foreign person, and any foreign corporation that conducts a trade or business in the United States (a "reporting corporation"), must furnish the IRS with such information as the Secretary may prescribe regarding transactions carried out directly or indirectly with certain foreign persons treated as related to the reporting corporation ("reportable transactions").

In addition, the Code provides that in order to avoid certain consequences with respect to certain reportable transactions, each foreign person that is a related party of a reporting corporation must agree to authorize the latter to act as its agent in connection with any request or summons by the IRS to examine records or produce testimony related to any reportable transaction. Failure of a related party to designate a reporting corporation as its agent for accepting service of process in connection with reportable transactions, or, under certain circumstances, noncompliance with IRS summonses in connection with reportable transactions or other matters, can result in the application of the so-called "noncompliance rule." This rule permits the Secretary of the Treasury to determine the tax consequences to the reporting corporation of certain transactions or other items in his or her sole discretion, based on any information in the knowledge or possession of the Secretary or on any information that the Secretary may obtain through testimony or otherwise.

The legislative history accompanying the enactment of these rules indicates an expectation that where records of a related party are obtainable on a timely and efficient basis under information-exchange procedures provided under a tax treaty, the IRS generally would make use of those procedures before issuing a summons to the designated agent on behalf of the related party.[7] Treasury regulations contain this language.[8] For this purpose, the regulation provides that information is available on a timely and efficient basis if it can be obtained within 180 days of the request. However, the legislative history also indicates a cognizance of undue audit delays that have been caused by the Service's inability to quickly

[7] Committee on Finance, *Explanation of Provisions Approved by the Committee on October 3, 1989*, Senate Finance Committee Print, 101st Cong., 1st Sess., pp. 115-116 (1989).
[8] Treas. Reg. sec. 1.6038A-6(b).

obtain relevant information through treaty procedures, and a recognition that exigent circumstances (for example, the imminent expiration of the limitations period) may arise that would make the use of a treaty procedure undesirable. Thus, an intention is expressed in the legislative history that the Service not be required to attempt to use a treaty procedure before issuing a summons with respect to information that might be obtained under that treaty. The regulation provides that the absence or pendency of a treaty request may not be asserted as grounds for refusing to comply with a summons or as a defense against the assertion of the noncompliance penalty adjustment.

The issue is whether the proposed treaty, as interpreted in the Understanding that accompanies it, would modify the intended operation of these rules in a case where a U.S. resident or permanent establishment that is a "reporting corporation" under the above rules has neither possession of nor access to records that may be relevant to the U.S. income tax treatment of a transaction between it and a foreign related party (or, in the case of a permanent establishment, the U.S. tax treatment of any other item), and the records are under the control of a Netherlands resident and are maintained outside the United States. In such a case, the Understanding provides that the United States is obligated to request those records from the Netherlands through an exchange of information under this article of the proposed treaty *before* issuing a summons for those records to the reporting corporation, provided that under all the circumstances presented, the records will be obtainable through the request on a timely and efficient basis. The Understanding further provides that records will be considered to be available on a timely and efficient basis if they can be obtained within 180 days of the request or such other period agreed upon in mutual agreement between the competent authorities, except where the statute of limitations may expire in a shorter period. On the one hand, the regulation appears to contemplate use of the same procedures as are contemplated under the Understanding. On the other hand, the treaty may be interpreted by some as depriving the IRS of some of the discretion it retains under the regulation. However, it also may be argued 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.

(5) Exchange of information

In many respects, the present treaty is similar to the U.S. model treaty and other U.S. treaties in its provisions on the exchange of information. The exchange of information provision serves the function of preventing fiscal evasion, one of the two principal reasons for which the United States enters into tax treaties. The U.S. model and many other U.S. treaties provide that this provision shall apply, notwithstanding the provisions of Article 2 (Taxes Covered), to taxes of every kind imposed by a treaty country. By contrast, the proposed treaty's exchange of information provision is

limited to exchanges regarding taxes otherwise covered in the proposed treaty. Thus, each country is required to exchange information about income taxes covered by the proposed treaty; neither country is required to exchange information about excise taxes, for example, that are not covered by the treaty. In the case of estate taxes, the operative exchange of information rules are those of the U.S.-Netherlands treaty on estates and inheritances signed in 1969, rather than those of the proposed treaty. The latter are more consistent with the U.S. model treaty than are the rules of the 1969 treaty.

It may be argued that the justification for this deviation from the model lies in the fact that the exchange of information article in the present U.S.-Netherlands income tax treaty is similarly limited in operation to information concerning taxes otherwise covered in the treaty. On the other hand, it may be argued that the absence of agreement to the U.S. model provision represents a significant limitation on the benefits to the U.S. government, and therefore U.S. taxpayers in general, that will accrue in return for the tax concessions offered to Dutch residents in the proposed treaty.

(6) Exempt organizations and employee benefit plans

Unlike the present treaty and most other U.S. tax treaties, the proposed treaty would exempt charitable organizations of either country from tax imposed by the other, but only to the extent that the organization would be eligible for an exemption from U.S. tax were it organized and operated solely in the source country, and only to the extent of income not earned from carrying on a trade or business or from a related person. An exemption also is provided for pension funds and other employee benefits plans, limited to items referred to in the interest and dividend articles. Unlike charitable organizations, employee benefit plans, at least in the United States, hold a very substantial fraction of all savings. Therefore, the employee benefit plan exemption may affect large pools of capital. The proposed exemption for employee benefit plans is not a feature of the U.S. model treaty, and to date no U.S. treaty other than that with Canada has included a similar provision.

Unlike the charitable organization exemption, the employee benefit plan exemption does not expressly condition source country exemption of foreign organizations on parity of treatment with domestic organizations. Conceivably, then, the language of the proposed treaty may suggest that, for example, the United States would be obligated to exempt a Dutch pension plan from U.S. tax that would be imposed on a comparable U.S. plan. The Committee may wish to consider whether there is any such disparity under the proposed treaty, and if so whether this particular difference between the language governing charities and pension funds is appropriate. It may be that the reasons Congress enacted the U.S. income tax exemption of U.S. qualified employee benefit plans are not all equally applicable to the U.S. source income of Dutch employee benefit plans referred to in the interest and dividend articles of the proposed treaty. In cases where the Congress has not chosen to exempt domestic plans, the reasons may a fortiori suggest that foreign plans should be similarly nonexempt.

(7) Insurance excise tax

The proposed treaty, unlike the present treaty, covers the U.S. excise tax on insurance premiums paid to foreign insurers. Thus, for example, a Dutch insurer or reinsurer without a permanent establishment in the United States can collect premiums on policies covering a U.S. risk or a U.S. person free of this tax. However, the tax is imposed to the extent that the risk is reinsured by the Dutch insurer or reinsurer with a person not entitled to the benefits of the proposed treaty or another treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" clause.

Although waiver of the excise tax appears in the 1981 U.S. model treaty, waivers of the excise tax have raised serious Congressional concerns. For example, concern has been expressed over the possibility that they may place U.S. insurers at a competitive disadvantage to foreign competitors in U.S. markets, if a substantial tax is not otherwise imposed (e.g., by the treaty partner country) on the insurance income of the foreign insurer (or, if the risk is reinsured, the reinsurer). Moreover, in such a case waiver of the tax does not serve the purpose of treaties to avoid double taxation, but instead has the undesirable effect of eliminating all taxation.

The U.S.-Barbados and U.S.-Bermuda tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Committee expressed the view that those waivers should not have been included. The Committee stated that waivers should not be given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress.[9] Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties. The waiver of the tax in the treaty with the United Kingdom (where the tax was waived without the so-called "anti-conduit rule") has been followed by a number of legislative efforts to redress perceived competitive imbalance created by the waiver.

The issue is whether the waiver of the insurance excise tax in the proposed treaty is consistent with the Committee's view of good tax treaty policy. The Treasury Department's Technical Explanation of the proposed treaty states that the Department's review of the Netherlands' taxation of the income of Dutch insurance companies indicated that it results in a burden that is substantial in relation to the U.S. tax on U.S. insurance companies.

(8) Branch profits tax

A foreign corporation engaged in the conduct of a trade or business in the United States is subject under the Code to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the accumulated U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. This provision was added to the Code in the Tax Reform Act of 1986 (the "1986 Act"). Under the Code, the dividend equivalent amount is limited by (among other things) aggregate earnings and profits accumulated in taxable years beginning after December 31, 1986.

[9] Such consultations took place in connection with the proposed treaty.

In enacting the branch tax, Congress recognized the value of U.S. income tax treaties for U.S. persons engaging in international commerce. Congress further recognized that most U.S. income tax treaties in force were not negotiated to allow the United States to impose a branch profits tax, because the United States did not impose such a tax at the time of negotiation. Although Congress generally believed that a branch profits tax does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together no worse than U.S. corporations and their shareholders, it understood that most treaty nondiscrimination articles relating to permanent establishments arguably operated to consider corporations and their shareholders separately in determining whether discriminatory tax rules exist. Congress generally did not intend to override U.S. income tax treaty obligations that arguably prohibit imposition of the branch profits tax even though as later-enacted legislation the 1986 Act's branch tax provisions normally would do so. Congress adopted this position, however, only on the understanding that the Treasury Department would renegotiate outstanding treaties that prohibit imposition of the tax.[10]

Numerous income tax treaties have been adopted or amended since the 1986 Act, and an additional number have been submitted for advice and consent to the Senate. Save for the proposed treaty, these post-1986 treaties all permit imposition of the branch profits tax with respect to post-1986 earnings generally. The proposed treaty, by contrast, permits such imposition only with respect to earnings in years following ratification of the proposed treaty. The Committee may wish to consider the appropriateness of this difference, or its potential effect as precedent for future treaty negotiations. Some may argue that because the present treaty, as interpreted by the Treasury Department, would exempt a dividend equivalent amount from U.S. tax, a "fresh start" as of the date that the proposed treaty takes effect would be a reasonable transition rule. Conversely, others may argue that the 1986 Act provides for its own fresh start as of 1987, and taxpayers were on notice since 1986 of an intent to amend U.S. treaties to permit the imposition of the branch profits tax, thus rendering it unnecessary to provide an additional transition rule in the proposed treaty.

(9) Effect of subsequent legislation on implementation of the treaty

In diplomatic notes accompanying the treaty, the State Department and its Dutch counterpart, on behalf of their respective governments, confirmed that they recognized the principle that the treaty, once in force, is binding upon both parties and must be performed by them in good faith and in accordance with generally accepted rules of international law. The notes further confirmed their authors' recognition that they should avoid enactment or interpretation of legislation or other domestic measures that would prevent the performance of their obligations under the treaty. The Technical Explanation indicates the Treasury Department's belief that

[10] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 100th Cong., 1st Sess., p. 1038 (1987).

the Dutch government, for example, unlike the U.S. government, is powerless to alter its tax laws, regardless of the merits of the alteration, if doing so conflicts with a treaty in force. The negotiators, recognizing the possibility of significant changes in the national taxation laws which may affect implementation of the treaty, were able to agree in principle that in such a case an appropriate amendment of the treaty might be necessary.

The Constitution provides that "Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land."[11] The Supreme Court has interpreted this language to mean that the internal U.S. legal status of treaties is equivalent to that of Federal statutes.[12] A provision of the Code adopted in 1988 codifies the applicability of this principle to the relationship of treaties and the Code.[13] If two U.S. statutes conflict, the one adopted later controls; when a statute and a treaty provision conflict, generally the one adopted later controls.

The internal tax laws of many countries, including those of the United States and the Netherlands, provide some sort of regime for taxing either the foreign income of domestic persons, the domestic income of foreign persons, or both. In the general case, either type of income, then, is potentially subject to two autonomous tax systems each of which is, at best, designed to mesh with other tax systems only in broad general terms. Double taxation of the same income, or taxation of certain income by neither system, can result. Income tax treaties are agreements that provide the mechanism for coordinating two identified tax systems by reference to their particular provisions and the particular tax policies they reflect, and which have as their primary objectives the elimination of double taxation and the prevention of fiscal evasion. It has been argued that ultimately, meeting these objectives is a desirable goal that serves to improve the long term environment for commercial and financial dealings between residents of the treaty partners.

When a treaty partner's internal tax laws and policies change, it may be desirable that treaty provisions designed and bargained to coordinate the predecessor laws and policies be reviewed to determine how those provisions apply under the changed circumstances. There are cases where giving continued effect to a particular treaty provision does not conflict with the policy of a particular statutory change. In certain other cases, however, a mismatch between an existing treaty provision and a newly-enacted law may exist, in which case the continued effect of the treaty provision may frustrate the policy of the new internal law. In some cases the continued effect of the existing treaty provision would be to give an unbargained-for benefit to taxpayers or one of the treaty partners, especially if changes in taxpayer behavior result in a treaty being used in a way that was not anticipated when the original bargain was struck. At that point, the treaty provision in question may no

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[11] U.S. Constitution, Art. VI, cl. 2.

[12] See generally *Reid v. Covert*, 354 U.S. 1, 18 (1957); *Whitney v. Robertson*, 124 U.S. 190, 195 (1888); Henkin, *The Constitution and United States Sovereignty: A Century of Chinese Exclusion and its Progeny*, 100 Harv. L. Rev. 853, 872 (1987); L. Henkin, *Foreign Affairs and the Constitution* 163-64 (1975); *Restatement (Third) of the Foreign Relations Law of the United States* sec. 115, comment a. (1987).

[13] Code sec. 7852(d)(1).

longer eliminate double taxation or prevent fiscal evasion; if not, its intended purpose would no longer be served.[14]

Although the U.S. government has been aware of problems regarding the susceptibility of the present treaty to abuse for many years, it was unable to conclude a treaty to deal with these problems until 1992, and even that treaty acknowledged further gaps to be filled by future legislation or treaty negotiation. The history of the negotiation of the proposed treaty illustrates the extent to which two governments may be unable to agree on necessary changes long after they have been brought to light. Some have argued that the negotiations would have failed to reach the present stage but for evidence of the willingness of the Congress to resolve tax treaty abuse problems through unilateral legislation. On the other hand, it may be that uncertainty whether the Congress would in fact so act made the Dutch government unwilling to agree to anti-abuse provisions in the proposed treaty fully satisfactory from the U.S. perspective.

Thus, strict adherence to all existing treaty provisions pending bilateral agreement on changes may impose significant limitations on the implementation of desired tax policy.

(10) Arbitration of competent authority issues

The proposed treaty delegates to the executive branch the power to enter into, by exchange of diplomatic notes, an agreement under which a binding arbitration procedure may be invoked (if agreed by both competent authorities and the taxpayer or taxpayers involved) for the resolution of those disputes in the interpretation or application of the treaty that it are within the jurisdiction of the competent authorities to resolve.

Generally, the jurisdiction of the competent authorities under the proposed treaty is as broad as it is under any U.S. income tax treaties. For example, the competent authorities are empowered (in this as in other treaties) to agree on the attribution of income, deductions, credits, or allowances of an enterprise to a permanent establishment. They may agree on the allocation of income, deductions, credits, or allowances between associated enterprises and others under the provisions of Article 9 (Associated Enterprises), which is the treaty analogue of Code section 482. They may also agree on characterization of particular items of income, on the common meaning of a term, and on the application of procedural aspects of internal law. They may agree to raise the dollar thresholds in the articles dealing with entertainers and athletes, and with students and trainees. Finally, the competent authorities may agree on the elimination of double taxation in cases not provided for in the treaty. According to the Treasury Department's Technical Explanation of the rules, agreements reached by the competent authorities need not conform to the internal law provisions of either treaty country.

As an initial matter, it is necessary to recognize that there are appropriate limits to the competent authorities' own scope of re-

[14] See the discussion of the Senate Finance Committee's views on this subject in Sen. Rep. No. 100-445, 100th Cong., 2d Sess., p. 323 (1988).

view.[15] The competent authorities would not properly agree to be bound by an arbitration decision that purported to decide issues that the competent authorities would not agree to decide themselves. Even within the bounds of the competent authorities' decision-making power, there likely will be issues that one or the other competent authority will not agree to put in the hands of arbitrators. Consistent with these principles, the notes exchanged on the signing of the treaty provide that the competent authorities will not generally accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either treaty country.

In approving ratification of the U.S.-Germany treaty, the Committee indicated a belief that the tax system potentially may have much to gain from use of a procedure, such as arbitration, in which independent experts can resolve disputes that otherwise may impede efficient administration of the tax laws. However, the Committee also believed that the appropriateness of such a clause in a future treaty depended strongly on the other party to the treaty, and the experience that the competent authorities would have under the provision in the German treaty. To date there have been no arbitrations of competent authority cases under the German treaty, and few tax arbitrations outside the context of that treaty.

(11) Associated enterprises and permanent establishments

The proposed treaty, like most other U.S. tax treaties, contains arm's-length pricing and allocation provisions. The proposed treaty recognizes the right of each country to reallocate profits among related enterprises residing in each country, if a reallocation is necessary to reflect the conditions that would have been made between independent enterprises. Similarly, the proposed treaty requires each country to attribute to a permanent establishment the profits which the permanent establishment might be expected to make if it were a distinct and separate enterprise dealing independently with the entity of which it is a part. The Code, under section 482, provides the Secretary of the Treasury the power to make reallocations whenever necessary in order to prevent evasion of taxes or clearly to reflect the income of related enterprises. Under regulations, the Treasury Department implements this authority using an arm's-length standard, and has indicated its belief that the standard it applies is fully consistent with the proposed treaty. A significant function of the power to make reallocations is to ensure that the United States asserts taxing jurisdiction over its fair share of the worldwide income of a multinational enterprise.

Some have argued in the recent past that the IRS has not performed adequately in this area. Some have argued that the IRS cannot be expected to do so using its current approach. They argue

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[15] In discussing a clause permitting the competent authorities to eliminate double taxation in cases not provided for in the treaty, Representative Dan Rostenkowski, Chairman of the House Ways and Means Committee, submitted the following in testimony at 1981 hearings before the Senate Foreign Relations Committee:

> Under a literal reading, this delegation could be interpreted to include double taxation arising from any source, even state unitary tax systems. Accordingly, the scope of this delegation of authority must be clarified and limited to include only noncontroversial technical matters, not items of substance.

Tax Treaties: Hearings on Various Tax Treaties Before the Senate Committee on Foreign Relations, 97th Cong., 1st Sess., p. 58 (1981).

that the approach now set forth in the regulations is impracticable, and that the Treasury Department should adopt a different approach, under the authority of section 482, for measuring the U.S. share of multinational income.[16] Some prefer a so-called "formulary apportionment," which can take a variety of forms. The general thrust of formulary apportionment is to first measure total profit of a person or group of related persons without regard to geography, and only then to apportion the total, using a mathematical formula, among the tax jurisdictions that claim primary taxing rights over portions of the whole. Some prefer an approach based on the expectation that an investor generally will insist on a minimum return on investment or sales.[17]

A debate exists whether an alternative to the Treasury Department's current approach would violate the arm's-length standard embodied in Article 9 of the proposed treaty, or the nondiscrimination rules embodied in Article 28.[18] some, who advocate a change in internal U.S. tax policy in favor of an alternative method, fear that U.S. obligations under treaties such as the proposed treaty would be cited as obstacles to change. The issue is whether the United States should enter into agreements that might conflict with a move to an alternative approach in the future, and if not, the degree to which U.S. obligations under the proposed treaty would in fact conflict with such a move.

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[16] See generally *The Breakdown of IRS Tax Enforcement Regarding Multinational Corporations: Revenue Losses, Excessive Litigation, and Unfair Burdens for U.S. Producers: Hearing Before the Senate Committee on Governmental Affairs,* 103d Cong., 1st Sess. (1993) (hereinafter, Hearing Before the Senate Committee on Governmental Affairs).

[17] See *Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means,* 101st Cong., 2d Sess. 360-61 (1990) (statement of James E. Wheeler); H.R. 460, 461, and 500, 103d Cong., 1st Sess. (1993); sec. 304 of H.R. 5270, 102d Cong., 2d Sess. (1992) (introduced bills); see also *Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means,* 102d Cong., 2d Sess. (1992).

[18] Compare *Hearing Before the Senate Committee on Governmental Affairs* at 26, 28. ("I do not believe that the apportionment method is barred by any tax treaty that United States has now entered into.") (statement of Louis M. Kauder) *with* a recent statement conveyed by foreign governments to the U.S. State Department that "[w]orldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States" (letter dated 14 October 1993 from Robin Renwick, U.K. Ambassador to the United States, to Warren Christopher U.S. Secretary of State). See also *Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Committee on Ways and Means,* 102d Cong., 2d Sess. 224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department).

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

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

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 is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch-level excess interest tax, which amounts to 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (generally including interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such persons, the tax is 1 or 4 percent of the premium paid. These taxes generally are collected by means of withholding (hence these taxes are often called "withholding taxes").

Withholding taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States

has an income tax treaty. In addition, certain statutory exemptions from withholding taxes are provided. For example, interest on deposits with banks or savings institutions is exempt from tax unless the interest is effectively connected with the conduct of a U.S. trade or business carried on by the recipient. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio debt obligations is exempt from the 30-percent tax. Certain U.S. income tax treaties also provide for exemption from tax in certain cases.[19]

U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations 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 estate.

The source of income received by nonresident alien individuals and foreign corporations is determined under rules contained in the Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S. source income. Interest paid by the U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, interest paid by that person will be foreign source rather than U.S. source. Moreover, even though dividends paid by a corporation meeting this test (an "80/20" company) are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period is not subject to U.S. withholding tax. Conversely, dividends and interest paid by a foreign corporation are generally treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend will be considered U.S. source income. The U.S. source portion of such dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient of a dividend to the extent of such U.S. source portion unless a treaty prevents application of the branch profits tax on the paying Corporation.)

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

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[19] Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that its net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited however, by the amount of tax-exempt interest paid to related persons and the amount of interest paid on obligations guaranteed by related tax-exempt persons.

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be 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 their foreign income taxes 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 on U.S. source income. Therefore, the foreign tax credit provisions of the Code 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 consolidated (overall) basis (as opposed to a "per-country" basis). Pursuant to rules enacted as part of the Tax Reform Act of 1986 (the "1986 Act"), the overall limitation is computed separately for certain classifications of income (i.e., passive income, high withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the crediting of foreign taxes on certain types of traditionally high-taxed foreign source income against the residual U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

Prior to the Tax Reform Act of 1984 (the "1984 Act"), a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided lookthrough rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act provided that foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction).

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 for-

eign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if each country considers the same deduction allocable to income that it treats as foreign source income, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in situations were a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and 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.

The objective of limiting double taxation generally is accomplished in treaties by the agreement of each country to limit, in certain 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 by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The 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 some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each of the two countries. Treaties also 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 branch or other permanent establishment or fixed base in that jurisdiction. The treaties 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, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent withholding tax and agrees to reduce this tax (or in the case of some income, eliminate it entirely) in its tax treaties, 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. Such a treaty provision generally is referred to as a so-called "saving clause." Double taxation also may arise, not withstanding the existence of a treaty, because most countries will not exempt passive income from tax at the source.

Double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income is exempt from tax in the country of residence. The United States 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. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the 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 not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (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 the countries is further enhanced under the 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.

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, the treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

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 that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against enterprises owned by residents of the other country.

IV. EXPLANATION OF PROPOSED TAX TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and the Netherlands is presented below. Also presented below are explanations of the provisions of the Understanding agreed to by the negotiators, and other matters set forth in diplomatic notes exchanged at the time the proposed treaty was signed.[20]

Article 1. General Scope

The general scope article describes the persons who may claim the benefits of the proposed treaty.

The proposed treaty generally applies to residents of the United States and to residents of Netherlands, with specific exceptions designated in other articles (e.g., Articles 28 (Non-discrimination) and 30 (Exchange of Information and Administrative Assistance)) and discussed below. As discussed below under Article 24 (Basis of Taxation), however, the proposed treaty, like virtually all U.S. tax treaties, also contains a "saving clause" under which the parties generally remain free to tax their own residents and nationals without regard to the treaty. This follows other U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty. Residence is defined in Article 4.

The proposed treaty provides that it generally does not restrict any benefits accorded by internal law or by any other agreement between the United States and the Netherlands. However, this does not apply to the relation between Dutch internal law and the provisions of Article 25 (Methods of Elimination of Double Taxation). Thus, the proposed treaty will apply only where it benefits taxpayers, except that the double taxation relief (e.g., foreign tax credits, or exemptions from tax on foreign income) afforded to a Dutch resident or national with respect to U.S. income will be limited to that allowed under the proposed treaty, notwithstanding more favorable relief that might be available under internal Dutch law.

As set forth in the Treasury Department's Technical Explanation of the proposed treaty (hereinafter referred to as the "Technical Explanation"), the fact that the proposed treaty would only apply to a taxpayer's benefit does not mean that a taxpayer could inconsistently select among treaty and internal law provisions in order to minimize its overall tax burden. The Technical Explanation sets

[20] The diplomatic notes state that the negotiators developed and agreed upon the memorandum of understanding intending to give guidance both to the taxpayers and the tax authorities of the two countries in interpreting various provisions contained in the proposed treaty. A view is expresssed that as experience in administering the treaty is gained, the competent authorities may develop and publish amendments to the understandings and interpretations laid down in the memorandum of understanding. The diplomatic notes are intended to constitute a common and binding understanding, by the U.S. and Dutch Governments, of the treaty and of the contents and the role of the memorandum of understanding.

forth the following example. Assume a resident of the Netherlands has three separate businesses in the United States. One business is profitable, and constitutes a U.S. permanent establishment. The other two are trades or businesses that would earn effectively connected income as determined under the Code, but do not constitute permanent establishments as determined under the proposed treaty; one trade or business is profitable and the other incurs a net loss. Under the Code, all three operations would be subject to U.S. income tax, in which case the losses from the unprofitable line of business could offset the taxable income from the other lines of business. On the other hand, only the income of the operation which gives rise to a permanent establishment would be taxable by the United States under the proposed treaty. The Technical Explanation makes clear that the taxpayer could not invoke the proposed treaty to exclude the profits of the profitable trade or business and invoke U.S. internal law to claim the loss of the unprofitable trade or business against the taxable income of the permanent establishment.[21]

Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and the Netherlands, and to the Dutch government's share in the net profits of the exploitation of certain natural resources. It also applies to certain excise taxes.

United States

In general

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code, but excluding social security taxes. Unlike the U.S. model and many U.S. income tax treaties in force, but like the present treaty, the proposed treaty applies to the accumulated earnings tax and the personal holding company tax. In addition, the proposed treaty applies to the excise taxes with respect to private foundations and, subject to an "anti-conduit rule," to the U.S. excise tax imposed on insurance premiums paid to foreign insurers.

Tax on insurance premiums

Code rules.—Under the Code, the United States imposes an excise tax on certain insurance premiums received by a foreign insurer from insuring a U.S. risk or a U.S. person (Code secs. 4371-4374). Unless waived by treaty, the excise tax applies to those premiums which are exempt from U.S. net-basis income tax. Under the Code (in the absence of a contrary treaty provision), a foreign insurer is subject to U.S. net-basis income tax on income in situations where that insurance income is effectively connected with a U.S. trade or business. However, a foreign insurer insuring U.S. risks ordinarily will not be viewed as conducting a U.S. trade or business, and thus will not be subject to U.S. income tax, if it has no U.S. office or dependent agent and operates in the United States solely through independent brokers. In these situations, the insur-

[21] See Rev. Rul. 84-17, 1984-1 C.B. 10.

ance excise tax is imposed (except as otherwise provided in a treaty) on the premiums paid for that insurance.[22]

The excise tax may be viewed as serving the same function as the tax imposed on dividends, interest, and other types of passive income paid to foreign investors. In general, the excise tax applies to insurance covering risks wholly or partly within the United States where the insured is (1) a U.S. person or (2) a foreign person engaged in a trade or business in the United States. Under the Code, the excise tax generally applies to a premium on any such insurance unless the amount is effectively connected with the conduct of a trade or business in the United States and not exempt by treaty from the statutory net-basis tax.

The treatment of insurance income of foreign insurers is complicated somewhat in situations where, as is often the case, some portion of the risk is reinsured with other insurers in order to spread the risk. In situations where the foreign insurer is engaged in a U.S. trade or business and thus subject to the U.S. income tax, reinsurance premiums, whether paid to a U.S. or a foreign reinsurer, are allowed as deductions. Accordingly, the foreign insurer is taxable only on the income attributable to the portion of the risk it retains. However, while generally no excise tax is imposed on the insurance policy issued by the foreign insurer doing business in the United States, the one-percent excise tax on reinsurance is imposed if and when that insurer reinsures that U.S. risk with a foreign insurer not subject to U.S. net-basis income tax.

Proposed treaty.—The insurance excise tax described above is covered by the proposed treaty, but only to the extent that the foreign insurer does not reinsure the risks in question with a person not entitled to relief from this tax under the proposed treaty or another U.S. treaty.

More specifically, income of a Netherlands insurer from the insurance of U.S. risks or U.S. persons will not be subject to the insurance excise tax (except in situations where the risk is reinsured with a company not entitled to an exemption under this or another treaty). This waiver applies notwithstanding that insurance income is not attributable to a U.S. permanent establishment maintained by the Netherlands insurer, and hence not subject to U.S. net-basis tax pursuant to the business profits article (Article 7) and other income article (Article 23). This treatment is a departure from the present treaty, but is similar to that provided in some other recent U.S. tax treaties, for example, the treaties with Finland, France, Germany, Hungary, India, Italy, and Spain. The excise tax on premiums paid to foreign insurers is a covered tax under the U.S. model treaty.

In exempting from the U.S. income tax and the insurance excise tax all insurance income which is not attributable to a permanent establishment in the United States, the proposed treaty makes two changes in the statutory rules governing the taxation of insurance income of Netherlands insurers. First, any insurance income which is effectively connected with a U.S. trade or business but is not attributable to a U.S. permanent establishment will not be subject to

[22] The excise tax is currently imposed at a rate of four percent of the premiums paid on casualty insurance and indemnity bonds, and one percent of the premiums paid on life, sickness, and accident insurance, annuity contracts, and reinsurance (Code secs. 4371-4374).

U.S. income tax. This exemption is contained in the present treaty. As is true under the present treaty, those Netherlands insurers that continue to maintain a U.S. permanent establishment after the proposed treaty enters into force will remain subject to the U.S. income tax on their net U.S. insurance income attributable to the permanent establishment.

Second, Dutch insurers not engaged in a U.S. trade or business generally will no longer be subject to the insurance excise tax. This exemption is not contained in the present treaty. The insurance excise tax will continue to apply, however, when a Dutch insurer with no U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign reinsurer, other than a resident of the Netherlands or another insurer entitled to exemption under a different tax treaty (such as the U.S.-France treaty). The tax liability may be imposed on the Dutch insurer which, for withholding purposes, is treated in the same manner as a U.S. resident person transferring the premium to the foreign reinsurer. The excise tax also will apply to such reinsurance when the Dutch insurance company has a U.S. trade or business, but no U.S. permanent establishment, and thus will not be subject to U.S. *income* tax on the net income it derives on the portion of the risk it retains.

For example, assume a Dutch company not engaged in a U.S. trade or business insures a U.S. casualty risk and receives a premium of $200. The company reinsures part of the risk with a Danish insurance company (not currently entitled to exemption from the excise tax) and pays that Danish company a premium of $100. The four-percent excise tax on casualty insurance applies to the premium paid to the Dutch insurance company to the extent of the $100 reinsurance premium. Thus, the U.S. insured is liable for an excise tax of $4, which is four percent of the portion of its premium paid to the Dutch insurer which was used by the Dutch insurer to reinsure the risk. It is the responsibility of the U.S. insured to determine to what extent, if any, the risk is to be reinsured with a nonexempt person. Under an administrative procedure currently in effect, the burden of this responsibility effectively can be shared with the Dutch insurer (*see* Rev. Proc. 87-13, 1987-1 C.B. 596; and Rev. Proc. 92–39, 1992–1 C.B. 860).

Netherlands

In the case of the Netherlands, the proposed treaty applies to the income tax (*de inkomstenbelasting*), the wages tax (*de loonbelasting*), the dividend tax (*de dividendbelasting*), and the company tax (*de vennootschapsbelasting*), including the so-called Dutch state "profit share." This last term refers to the government share in the net profits of the exploitation of natural resources levied pursuant to the Mining Act 1810 (*Mijnwet* 1810) with respect to concessions issued from 1967, or pursuant to the Netherlands Continental Shelf Mining Act of 1965 (*Mijnwet Continentaal Plat* 1965). The state profit share is discussed in connection with the double taxation article (Article 25).

Other rules

For purposes of the non-discrimination article (Article 28), the treaty applies to taxes of all kinds imposed by the countries, in-

cluding any taxes imposed by their political subdivisions or local authorities.

The proposed treaty also contains a provision generally found in U.S. income tax treaties (including the present treaty) to the effect that it will apply to any identical or substantially similar taxes that either country may subsequently impose. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws. This clause is similar, but not identical, to U.S. model treaty language.

Article 3. General Definitions

Certain of the standard definitions found in most U.S. income tax treaties are contained in the proposed treaty.

The term "State" means the Netherlands or the United States, as the context requires. The term "States" means the Netherlands *and* the United States.

The term "the Netherlands" comprises the part of the Kingdom of the Netherlands that is situated in Europe, and the part of the sea bed and its sub-soil under the North Sea over which the Kingdom of the Netherlands has sovereign rights in accordance with international law for the purpose of exploration for and exploitation of the natural resources of such areas, but only to the extent that the person, property, or activity to which the treaty is being applied is connected with such exploration or exploitation.

The term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. When used in a geographical sense, it means the states and the District of Columbia. Under Code section 638, where the term is used in a geographical sense, it also includes the continental shelf: that is, the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. Under the proposed treaty, these same areas are considered part of the United States for treaty purposes, but only to the extent that the person, property, or activity to which the treaty is being applied is connected with such exploration or exploitation.

The term "person" includes an individual, an estate, a trust, a company, and any other body of persons. The Technical Explanation states that the negotiators agreed that the term "person" would be understood to include a partnership. A "company" is any body corporate or any entity which is treated as a body corporate for tax purposes.

An enterprise of a country is defined as an enterprise carried on by a resident of that country. The treaty does not define the term "enterprise."

Under the proposed treaty, a person is considered a national of one of the treaty countries if the person is an individual possessing citizenship or nationality of that country, or a legal person, partnership, or association deriving its status as such from the law in force in that country.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft operated by an enterprise of one of the treaty countries, except when the ship or aircraft is operated solely between places in one of the treaty countries. Accordingly, with respect to a Dutch enterprise, purely domestic transport in the United States is excluded. Moreover, as under the OECD, model but unlike the definition in the U.S. model, transport by a resident of a third country also is excluded.

The Dutch competent authority is the Minister of Finance or his duly authorized representative. The U.S. competent authority is the Secretary of the Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commissioner (International) of the IRS. On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms not defined in the treaty are to have the meanings which they have under the laws of the country applying the treaty.

Article 4. Residence

In general

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the treaty countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning a single treaty country as the country of residence when, under the internal laws of the treaty countries, a person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his or her worldwide income, while a nonresident alien is taxed only on his or her U.S. source income and on his or her income that is effectively connected with a U.S. trade or business. An individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident (Code sec. 7701(b)). A permanent resident for immigration purposes (i.e., a green card holder) also is a U.S. resident. The standards for determining residence provided in the Code do not alone determine the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States.) Under the Code, a company is domestic, and therefore taxable on its worldwide income, if it is organized in the United States or under the laws of the United States, a State, or the District of Columbia.

The proposed treaty generally defines "resident of one of the States" to mean any person who, under the laws of that country, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. Also included in the term is an exempt pension trust or an exempt organization that is treated as a resident of a treaty country under that country's internal law. As provided in

the Understanding, it is understood that for purposes of the treaty, the government of a treaty country, or of one of its political subdivisions or local authorities, is to be considered to be a resident of that country.

The term "resident of one of the States" does not include any person who is liable to tax in that country in respect only of income from sources in that country. In the case of income derived by, or paid by, and estate or trust (other than an exempt pension trust or an exempt organization), the term applies only to the extent that the income it derives is subject to that country's tax as the income of a resident, either in its hands or in the hands of its beneficiaries. For example, if the share of U.S. beneficiaries in the income of a U.S. trust is only one-half, the Netherlands would have to reduce its withholding tax pursuant to the proposed treaty on only one-half of the Dutch source income paid to the trust. In the case of income derived by a partnership, the U.S. model treaty and U.S. treaties generally apply only to the extent that the income is subject to tax in a treaty country as the income a resident, either in its hands or in the hands of its partners. The proposed treaty omits this language. The Technical Explanation indicates that this omission does not result in the application of a different rule, however, because under both U.S. and Dutch law, a partnership is treated as a pure conduit. Thus, a partnership would not be considered a resident of a treaty country under this article. Only the residence and the income of its partners would be relevant under the proposed treaty.

These provisions of the proposed treaty are generally based on the fiscal domicile article of the U.S. and OECD model treaties and is similar to the provisions found in other U.S. tax treaties.

An individual's contacts with a third country may negate that person's treatment as a U.S. or Dutch resident under the proposed treaty, notwithstanding that the individual is a U.S. resident or citizen under internal U.S. law, or a Dutch resident under internal Dutch law. If the third country has a comprehensive income tax treaty with the country (either the United States or the Netherlands) under whose law the individual is a resident or citizen, then the individual would not be a resident of the United States or the Netherlands, as the case may be, for U.S.-Dutch treaty purposes, unless the individual would be treated as a resident of that country, and not the third country, under the third country's treaty. If the third country has no such treaty, then the individual would not be a resident of the United States or the Netherlands, as the case may be, for U.S.-Dutch treaty purposes, unless the individual would be treated as a resident of that country, and not the third country, under the "tie-breaker" rules discussed below, set forth in the proposed treaty, that turn on the person's permanent home, center of vital interests, or habitual abode. Consistent with most U.S. income tax treaties, therefore, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not necessarily entitled to the benefits of the proposed treaty as U.S. residents.

Dual resident individuals

A set of "tie-breaker" rules is provided to determine residence in the case of an individual who, under the basic residence rules, would be considered to be a resident of both countries. Such a dual resident individual will be deemed to be a resident of the country in which he has a permanent home available to him. If this permanent home test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, i.e., his "center of vital interests." If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he shall be deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he shall be deemed to be a resident of the country of which he is a national. If he is a national of both countries or neither of them, the competent authorities of the countries are to settle the question of residence by mutual agreement.

Noncorporate entity dual residents

In the case of a person other than an individual or a company that is resident in both countries under the basic treaty definition, the proposed treaty, like the U.S. model, requires the competent authorities of the two countries to settle the question by mutual agreement and determine the mode of application of the treaty to the person.

Corporate dual residents

In general

In the case of a company that is resident in both countries under the basic treaty definition, the proposed treaty requires the competent authorities to endeavor to settle the question by mutual agreement, having regard to the company's place of effective management, the place where it is incorporated or otherwise constituted, and any other relevant factors. If they are unable to reach such an agreement, the company generally will be ineligible for benefits under the proposed treaty. However, the company will be entitled to claim benefits under the proposed treaty provisions on non-discrimination (Article 28), mutual agreement procedures (Article 29), entry into force (Article 37), and a portion of the double taxation provisions requiring the United States to give credits for certain Dutch taxes (Article 25, paragraph 4). In this the proposed treaty is similar to some existing U.S. treaties, but dissimilar to the U.S. model treaty, which does not specify absence of treaty benefits in cases where the competent authorities cannot agree. The Technical Explanation indicates that a dual resident corporation denied the benefits of the treaty may still be treated as a resident of either country where its residence is relevant to benefits claimed by another person under the proposed treaty. For example, a Dutch resident may claim the benefits of reduced U.S. withholding tax on a dividend paid by a dual resident corporation.

Stapled entities

According to the Understanding, it is understood that the mutual agreement procedure set forth above for dealing with dual resident companies will be applied to Dutch resident companies that are treated as U.S. residents under the Code provisions regarding so-called "stapled entities." Prior to the Tax Reform Act of 1984, taxpayers had entered into arrangements in which the stock of two (or more) entities was "stapled" or "paired" so that shareholders could not trade the stocks separately. Typically, the management of the stapled-stock entities was the same. In these cases some had argued that a foreign corporation stapled to a U.S. corporation could not be treated as a controlled foreign corporation, and the rules applying to U.S.-controlled foreign corporations would not apply; e.g., the foreign corporation's subpart F income could not be included in the income of the U.S. corporation. Under a provision enacted in the 1984 Act (Code sec. 269B), when a foreign and a domestic corporation are stapled entities, generally the foreign corporation will be treated as domestic. Therefore, the stapled foreign corporation will be subject to U.S. tax on its worldwide income.[23] In addition, the Treasury is authorized to prescribe such regulations as will be necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities, including among other things regulations providing the extent to which one of the stapled entities shall be treated as owning the other entity.

Subject to a grandfather for certain entities stapled as of June 30, 1983, the stapled stock provision generally overrode treaties that were in force when the 1984 Act became law. For example, the Code provides on the one hand that a foreign corporation stapled to a U.S. corporation is taxable as a U.S. corporation. A treaty may provide, on the other hand, that a corporation incorporated under the laws of the treaty partner is not taxable in the United States on industrial or commercial profits unless it has a U.S. permanent establishment (see, e.g., Article III(1) of the present treaty). In such a case, a foreign corporation stapled on June 30, 1983 to a U.S. corporation is entitled to applicable treaty benefits. The Code does not treat it as a U.S. corporation. Under the proposed treaty, that grandfathered treatment would be continued. With respect to entities to which no grandfather rule applies, the competent authorities may address double taxation that may arise upon application of section 269B. The staff understands, however, that it is not contemplated that the competent authorities would agree to tax treatment that undermines the anti-abuse purposes of section 269B. Thus, it is understood that the competent authorities would not agree to treat a Dutch corporation, stapled to a U.S. corporation, as a Dutch company entitled to treaty benefits, unless the U.S. competent authority was otherwise prepared to exercise its authority to exempt it from section 269B under the exception relating to foreign-owned corporations, or unless adequate provision was made

[23] Foreign-owned stapled entities may be exempt from this rule. Other stapled entity cases are also covered in section 269B. Stock in one corporation that constitutes a stapled interest with respect to stock of a second corporation generally is treated as owned by the second corporation for purposes of Code section 1563. The effects of this section 1563 treatment include denial of multiple surtax exemptions and denial of multiple accumulated earnings tax credits. Stapled entities generally are treated as one entity in determining whether any stapled entity is a REIT or RIC.

to subject the two corporations to the rules that apply to U.S.-controlled foreign corporations, treating the Dutch corporation as owned by the U.S. corporation.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties will apply, or whether those amounts will be taxed as business profits. Taxation of business profits is discussed under Article 7 (Business Profits). An exception to the "permanent establishment" threshold for taxing income is set forth in Article 27 (Offshore Activities).

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which an enterprise engages in business. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes any building site or construction or installation project, if the site or project lasts for more than 12 months. The 12-month period for establishing a permanent establishment in connection with a site or project corresponds to the rule of the U.S. model treaty.

The general rule is modified to provide that a fixed place of business that is used for any of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise and the maintenance of a stock of goods belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. These activities include as well the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character. Unlike the present treaty, the proposed treaty makes no reference to such activities as advertising, the supply of information, or scientific research. Nor is such a specification part of the U.S. or OECD models. The Technical Explanation mentions such activities as preparatory or auxiliary, however.

Under the U.S. model treaty, the maintenance of a fixed place of business solely for any combination of the activities described in the preceding paragraph will not constitute a permanent establishment. Under the proposed treaty, a fixed place of business used solely for any combination of these activities will not constitute a

permanent establishment, provided that the overall activity of the fixed place of business is of a preparatory or auxiliary character. Neither clause appears in the present treaty.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other country, then the enterprise generally will be deemed to have a permanent establishment in the first country in respect of any activities that person undertakes for the enterprise. Consistent with the U.S. and OECD model treaties, this rule does not apply where the contracting authority is limited to those activities (described above), such as storage, display, or delivery of merchandise, which are excluded from the definition of permanent establishment. Under the present treaty this exception only applies where the exercise of authority is limited to the purchase of goods or merchandise for the account of the enterprise. The proposed treaty contains the usual provision that no permanent establishment will be deemed to arise based on the agent's activities if the agent is a broker, general commission agent, or any other agent of independent status acting in the ordinary course of its business.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to whether the company is related to a company that is a resident of the other country or to a company that engages in business in that other country. Such relationships are thus not relevant; only the activities of the company being tested are relevant.

Article 6. Income from Real Property

This article covers income from real property. The rules covering gains from the sale of real property are in Article 14 (Capital Gains).

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be taxed in the country where the real property is located. Income from real property includes income from agriculture or forestry.

The term "real property" generally has the meaning that it has under the law of the country in which the property in question is situated. For property situated in the United States, the term means "real property" as defined by U.S. law. The term in any case includes property accessory to real property; livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufruct of real property; and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Thus, income from real property includes royalties and other payments in respect of the exploitation of natural resources (e.g., oil). Ships and aircraft are not real property.

The proposed treaty specifies the country in which the real property is situated in the case of real property comprised of exploration and exploitation rights to the sea bed, its sub-soil, and the natural resources found therein (including rights to interests in, or to benefits of, assets to be produced by such exploration or exploitation). Such real property is to be regarded as situated in the country in which, as defined in Article 3, the sea bed, sub-soil, and

natural resources are located. These rights are to be considered to pertain to the property of a permanent establishment in that country to the same extent that any item of real property located in that country would be considered to pertain to a permanent establishment in that country. This language, although not present in the model treaty, is consistent with the rule that would apply in its absence, taking into account the definitions of the United States and the Netherlands.

The source country may tax income derived from the direct use, letting, or use in any other form of real property. The rules of this article allowing source country taxation also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

Like the U.S. model treaty and certain other U.S. income tax treaties, the proposed treaty provides residents of one country with an election to be taxed on a net basis by the other country on income from real property in that other country. (U.S. internal law currently provides such a net-basis election for income of a foreign person from U.S. real property income (secs. 871(d) and 882(d)).) The proposed treaty provides that any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authorities of the treaty countries agree to terminate the election, pursuant to a request by the taxpayer made to the competent authority of the country in which the taxpayer is resident.

Article 7. Business Profits

U.S. Code rules

U.S. law distinguishes between the U.S. business income and the other U.S. income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The treatment of income as U.S. business income depends upon whether the source of the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (thus it is said to be taxed as if it were business income under a limited "force of attraction" rule).

In the case of foreign persons other than insurance companies, foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the

United States and the income is attributable to that place of business. For such persons, only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office.

The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code may be treated as U.S.-effectively connected without regard to the foregoing rules, so long as that income is attributable to its U.S. business. In addition, the net investment income of such a company that must be treated as effectively connected with the conduct of an insurance business within the United States is not less than an amount based on a combination of asset/liability ratios and rates of return on investments experienced by the foreign person in its world-wide operations and by the U.S. insurance industry.

Trading in stocks, securities, or commodities in the United States for one's own account generally does not constitute a trade or business in the United States, and accordingly, income from those activities is not taxed by the United States as business income. Thus, income from trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent, or from trading by a foreign person physically present in the United States generally is not taxed as business income. However, this rule generally does not apply to a dealer, or, in the case of trading in stocks or securities, to a corporation the principal business of which is trading in stocks or securities for its own account, if its principal office is in the United States.

The Code as amended by the Tax Reform Act of 1986 provides that any income or gain of a foreign person for any taxable year that is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition, the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Proposed treaty rules

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Profits from U.S. source income other than U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains, are treated as effectively connected with the conduct of a trade or business in the United States, and taxed as such by the United States, without regard to whether they were derived from business activities or business assets. Under the proposed treaty, by contrast, a fixed place of business must be present and the business profits must be attributable to that fixed place of business.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there are to be attributed to a permanent establishment the business profits which would reasonably be expected to have been derived by it if it were a distinct and separate entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. For example, this arm's-length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed to the permanent establishment whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, the proposed treaty provides that deductions are allowed for expenses, wherever incurred, that are incurred for the purposes of the permanent establishment. These deductions include executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or, if not the enterprise as a whole, at least a part of the enterprise that includes the permanent establishment). According to the Technical Explanation, under this language, which differs in minor respects from the U.S. model, the United States is free to use its current expense allocation rules, including rules for allocating deductible interest expense under Treas. Reg. sec. 1.882-5, in determining the deductible amount. Thus, for example, a Dutch company which has a branch office in the United States but which has its head office in the Netherlands will, in computing the U.S. tax liability of the branch, be entitled to deduct a portion of the executive and general administrative expenses incurred in the Netherlands by the head office, allocated and apportioned in accordance with Treas. Reg. sec. 1.861-8, for purposes of operating the U.S. branch.

The Understanding goes into additional detail in differentiating the profits of an enterprise as a whole from the profits of the enterprise's permanent establishment. It is understood that the profits of a permanent establishment will not be determined on the basis of the total income of the enterprise, but only on the basis of that portion of the income of the enterprise that is attributable to the

actual activity of the permanent establishment in respect of the business. Specifically, according to the Understanding, in the case of contracts for the survey, supply, installation or construction of industrial, commercial or scientific equipment or premises, or of public works, when the enterprise has a permanent establishment, the profits attributable to the permanent establishment will not be determined on the basis of the total amount of the contract, but shall be determined on the basis only of that part of the contract that is effectively carried out by the permanent establishment. The profits related to that part of the contract that is carried out by the head office of the enterprise will not be taxable in the country in which the permanent establishment is situated.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities.

The present treaty contains a "force of attraction rule" similar to, but broader than, the force of attraction rule contained in the Code as described above. Under the present treaty, an enterprise of one country is taxable by the other country both on industrial or commercial profits actually derived and those *deemed* to be derived through a permanent establishment in the other country. The proposed treaty eliminates this rule, providing instead that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. Thus the proposed treaty not only departs from the present treaty but also from the more limited force of attraction rule in the Code. The proposed treaty is consistent with the model treaties and other existing U.S. treaties in this respect.

The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not the business profits article, will govern the treatment of those items of income. Thus, for example, dividends are taxed under the provisions of Article 10 (Dividends), and not as business profits, except as provided in paragraph 5 of Article 10.

Finally, the proposed treaty provides that, to the extent that the U.S. excise tax on insurance premiums received by a foreign insurer is a covered tax under Article 2 of the treaty, the United States may not impose that tax on premiums which are the receipts of a business of insurance carried on by a Dutch enterprise, whether or not that business is carried on through a permanent establishment in the United States. As explained above, under the so-called anti-conduit rule, that tax is not a covered tax if the risk to which the premium applies is reinsured with a person not entitled to similar treaty benefits. Thus, a premium received by a Dutch insurance business remains subject to the U.S. excise tax imposed under the Code if the risk is so reinsured. The Technical

Explanation indicates that this rule is merely a restatement of the result obtained by applying the other provisions of the treaty to U.S. internal law.

Like the present Dutch treaty but unlike the U.S. model, the proposed treaty contains no definition of "business profits." Under the U.S. model, the term means income derived from any trade or business, including the rental of tangible personal property and the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting. Under the present treaty, income from the rental of tangible personal property and the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting are treated as royalties. The proposed treaty eliminates that rule, with the result, as explained in the Technical Explanation, that such income may be treated as business profits, consistent with the U.S. model; in other circumstances, they may simply be "other income."

The effect of the deferred payment rules and the deferred gain rules for determining U.S.-effectively connected income under the Code (sec. 864(c)(6) and (7)) on Dutch residents eligible for treaty benefits are dealt with in Article 24 (Basis of Taxation) of the proposed treaty.

Article 8. Shipping and Air Transport

Article 8 of the proposed treaty covers income from the operation of ships and aircraft in international traffic. The rules governing income from the sale of ships and aircraft operated in international traffic are in Article 14 (Capital Gains).

As a general rule, under the Code the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries, including the Netherlands, providing such reciprocal exemptions. Benefits accorded under such an agreement are not restricted by any inconsistent provisions of the proposed treaty.

Under the proposed treaty, profits which are derived by an enterprise of one country from the operation in international traffic of ships or aircraft ("shipping profits") will be exempt from tax by the other country, regardless of the existence of a permanent establishment in the other country. International traffic means any transport by ship or aircraft operated by an enterprise of one of the treaty countries, except where the ship or aircraft is operated solely between places in the other treaty country (Article 3(1)(h) (General Definitions)). Unlike the exemption provided in the present treaty, the exemption in the proposed treaty applies whether or not the ships or aircraft are registered in the first country. Thus, for example, the Netherlands would not tax the income of a U.S. resident operating a Liberian-flag vessel in international traffic.

As is true of some other existing U.S. treaties, the proposed treaty does not provide protection from source country taxation of income from bareboat leases of ships or aircraft in international traf-

fic to the same extent as the U.S. model treaty, which exempts such income from source country tax as income from the operation of ships or aircraft in international traffic. For example, the U.S. model provides for exemption from tax in the source country for a bareboat lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic, but that leases ships or aircraft for use in international traffic. Under the proposed treaty, the exemption for shipping profits does not apply to profits from the rental on a bareboat basis of ships or aircraft unless those profits are incidental to profits from international shipping income. A taxpayer such as a financial institution or a leasing company that does not operate ships or aircraft generally would look to the other articles of the proposed treaty for the rules governing the rental income. For example, if the income were properly characterized as business profits,[24] it would be exempt from tax by the source country unless it is attributable to a permanent establishment in that country.

Unlike the U.S. model, Article 8 of the proposed treaty also does not expressly cover income derived from the use, maintenance, or rental of containers (or trailers, barges, and related equipment for the transport of containers) used in international traffic. Again, a taxpayer with income from such activities would generally look to other articles of the proposed treaty for the treatment of such income (unless the income was itself treated as income from the operation of ships or aircraft[25]).

The shipping and air transport provisions apply to profits from participation in a pool, joint business, or international operating agency, assuming that the other provisions of the proposed treaty (e.g., the limitation on benefits article (Article 26)) permit such application. In that case, the proportionate share of each treaty country resident shall be treated as derived directly from the operation of ships or aircraft in international traffic.

In the diplomatic notes exchanged at the time the proposed treaty was signed, the United States Government gave its assurances to the Government of The Netherlands that, in the event a state or local government in the United States seeks to impose a tax on the income of airline or shipping companies resident in the The Netherlands in circumstances where the proposed treaty would preclude a Federal income tax on that income, the United States Government will contact the state or local government seeking to impose the tax in an effort to persuade that government to refrain from imposing the tax.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's length pricing provision. The proposed treaty recognizes the right of each country to make an allocation of income, deductions, receipts, allowances or outgoings to the profits taxable by that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions which would have been made between independent enterprises. The pro-

[24] Cf. Rev. Rul. 86-156, 1986-2 C.B. 297.
[25] Cf. Rev. Rul. 76-568, 1976-2 C.B. 492.

posed treaty provides that it is understood, however, that the fact that associated enterprises have concluded arrangements, such as cost sharing arrangements or general services agreements, for or based on the allocation of executive, general administrative, technical and commercial expenses, research and development expenses, and other similar expenses, is not in itself a condition giving rise to this right. The staff understands, however, that amounts provided under such arrangements may nevertheless be reallocated by the taxing authorities in accordance with this article, when necessary to implement the general substantive rule of the provision.

For purposes of the proposed treaty, an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. Enterprises are also related if the same persons participate directly or indirectly in their management, control, or capital. According to the Understanding, it is understood that for this purpose, in determining whether an enterprise participates directly or indirectly in the management, control or capital of another enterprise, an enterprise may be considered an associated enterprise with respect to an enterprise in which its only interest is represented by evidences of indebtedness, if the indebtedness provides the holder with the right to participate in the management, control or capital of the enterprise that issued the indebtedness, or such holder in practice participates in such management, control or capital.

Like the present Dutch treaty and the OECD model, the proposed treaty omits the paragraph of the U.S. model stating that this provision is not intended to limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between related persons when necessary in order to prevent the evasion of taxes or clearly to reflect the income of those persons. Nevertheless, the staff understands that under the proposed treaty the United States retains the right to apply its intercompany pricing rules (Code section 482, including, it is understood by Treasury, the "commensurate with income" standard for pricing transfers of intangibles) and its rules relating to the allocation of deductions (Code sections 861, 862, 863, and 864, and applicable regulations).

The Understanding provides that nothing in the forgoing (or the corresponding paragraph of the interest article (Article 12) shall prevent either treaty country from determining the appropriate amount of interest deduction of an enterprise not only by reference to the amount of interest with respect to any particular debt-claim but also by reference to the overall amount of debt capital of the enterprise. In the context of a mutual agreement procedure, the amount of the interest deduction shall be determined in a manner consistent with the principles of the above rule, by reference to conditions in commercial or financial relations which prevail between independent enterprises dealing at arm's length. Those principles are more fully examined and explained in OECD publications regarding "thin capitalization."

When a redetermination of tax liability has been properly made by one country, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redeter-

mined income. This "correlative adjustment" clause has no counterpart in the present treaty. In making that adjustment, due regard is to be given to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary. For example, under the mutual agreement article (Article 29), a correlative adjustment cannot necessarily be denied on the ground that the time period set by internal law for claiming a refund has expired. To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or nationality (discussed below in connection with Article 24 (Basis of Taxation)) will not apply in the case of such adjustments.

The Understanding provides that the competent authorities shall endeavor to resolve by mutual agreement any case of double taxation arising by reason of an allocation of income, deductions, credits or allowances caused by the application of internal law regarding thin capitalization, earnings stripping, or transfer pricing, or other provisions potentially giving rise to double taxation. In this mutual agreement procedure, the proper allocation of income, deductions, credits or allowances under the treaty will be determined in a manner consistent with the principles of the Associated Enterprises article by reference to conditions in commercial or financial relations that prevail between independent enterprises dealing at arm's length. Consistent with mutual agreement procedures of other income tax treaties, including those entered into by both treaty countries, a procedure under the mutual agreement procedure article concerning an adjustment in the allocation of income, deductions, credits or allowances by one of the countries might result either in a correlative adjustment by the other country or in a full or partial readjustment by the first-mentioned country of its original adjustment.

Article 10. Dividends

In general

The proposed treaty replaces the dividend article of the present treaty with a new article that makes several changes. First, the proposed treaty generally liberalizes the conditions under which the 5 percent direct dividend withholding rate limitation is imposed. Second, the proposed treaty permits exceptions to the general 5 percent and 15 percent source country tax rates on dividends from a regulated investment company (RIC), a real estate investment trust (REIT), or a Dutch investment organization (*beleggingsinstelling*). Third, the proposed treaty permits the application by the source country of the treaty's dividend tax rates to income from arrangements, including debt obligations, carrying the right to participate in profits.

Internal dividend taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S. source dividends (other than dividends paid by an "80/20 company" described in Code section 861(c)) paid to nonresident alien individuals and foreign corporations. The 30-per-

cent 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 like a U.S. person at the standard graduated rates, on a net basis.

Under U.S. law, the term dividend generally means any distribution of property made by a corporation to its shareholders, either from accumulated earnings and profits or current year earnings and profits. However, liquidating distributions generally are treated as payments in exchange for stock, and are thus not subject to the 30-percent withholding tax described above (see discussion of capital gains in connection with Article 14, below). Moreover, amounts paid on debt obligations carrying the right to participate in profits typically are treated as interest under U.S. law and as a result, such amounts may in some cases be exempt under the Code from U.S. withholding tax (see discussion of interest in connection with article 12, below).

U.S. source dividends are generally dividends paid by a U.S. corporation. Also treated as U.S. source dividends for this purpose are portions of certain dividends paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business. The U.S. source portion of such dividend is generally equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to its total gross income. No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax. The tax imposed on the latter dividends is often referred to as the "second level" withholding tax.

Under proposed regulations, certain other payments that substitute for dividends in a securities lending transaction are treated as dividends for tax purposes.[26] These regulations cover cases where, for example, a Dutch person owns dividend-paying stock in a U.S. corporation and "lends" the stock to a second person in exchange for a promise by the second person to make payments to the lender. The "borrower" is required to make payments to the lender during the term of the "loan" that are equivalent to the dividends paid with respect to the stock. This equivalent payment is referred to in the proposed regulations as a substitute dividend payment.

In general, corporations do not receive deductions for dividends paid under U.S. law. Thus, the withholding tax on dividends and branch profits taxes theoretically represent imposition of a second level of tax on corporate taxable income. Treaty reductions of these taxes reflect the view that where, for example, 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 5-percent rate on dividends paid to direct investors reflects the view that the source

[26] INTL-106-89, 1992-1 C.B. 1196. The proposed regulations would amend sections 1.861-2, 1.861-3, 1.871-7, 1.881-2, 1.894-1, and 1.1441-2 of the Treasury regulations.

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 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 (Code sec. 857(b)). One of those conditions is the requirement that at least 75 percent of its gross income is derived from certain enumerated real estate-related transactions. Another is that at the close of each quarter, at least 75 percent of the value of its assets must be represented by real estate assets, cash and cash items, and government securities.

In addition, 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. A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. Often, the principal income of a REIT is rentals from real estate holdings.

Because a REIT is taxable as a U.S. corporation, a distribution of earnings is treated as a dividend, rather than income of the same type as the underlying earnings. Distributions of rental income, for example, are not themselves considered rental income. This is true even though the REIT generally is not taxable at the entity level on the earnings it distributes. Because a REIT cannot be engaged in an active trade or business, its distributions are subject to U.S. withholding tax of 30 percent when paid to foreign owners.

Like dividends, U.S. source rental income of foreign persons is generally subject to U.S. withholding tax at a statutory rate of 30 percent (unless, in the case of rental income, the recipient elects to have it taxed in the United States on a net basis at the regular income tax rates). Unlike the tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties.

The Internal Revenue Code also generally treats RICs as both corporations and conduits 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.

Netherlands

At present, the Netherlands generally imposes a 25-percent withholding tax on certain Dutch source payments that include dividends (the *dividendbelasting* or "dividend tax" referred to in Article 2 (Taxes Covered)). The dividend tax generally applies to proceeds from shares, profit-sharing bonds, and certain certificates, including profit distributions and liquidation proceeds.[27]

[27] Under U.S. law, by contrast, liquidation proceeds generally are treated as capital gains, and are thus not subject to the corresponding U.S. 30-percent withholding tax. Moreover, the U.S. withholding tax rules applicable to U.S.-source income paid on profit sharing bonds may also result in an absence of U.S. withholding tax. The Dutch dividend tax, therefore, may apply to Dutch source income paid to a U.S. resident in a case where a corresponding U.S. source item of income paid to a Dutch resident might not be subject to U.S. withholding tax under the Code.

The dividend tax generally applies to Dutch source proceeds whether paid to individual or corporate residents or nonresidents.[28] The dividend tax does not apply to a dividend paid to a foreign corporation residing in a European Communities ("EC") member country, if the dividend is subject to Dutch tax law provisions enacted in response to the so-called "parent-subsidiary directive" approved by the EC Council of Ministers on July 23, 1990.[29] Moreover, the dividend tax does not apply (or applies at a reduced rate) to an amount paid to a nonresident eligible for the elimination or reduction of the dividend tax by treaty.

The dividend tax is creditable against the Dutch income or company tax imposed on a Dutch resident shareholder receiving the taxable amount (or in some cases a nonresident subject to Dutch income or corporate tax). An excess of the dividend tax over those taxes generally is refundable to a Dutch resident (or in some limited cases a nonresident subject to the Dutch income or corporate tax).

Like U.S. corporate tax law, Dutch tax law generally embodies the so-called "classical system" under which corporate income may be taxed at the corporate level, and then taxed again at the shareholder level upon a distribution, without a mechanism such as an imputation credit or a dividends paid deduction to integrate the two levels of tax. Also like U.S. tax law, Dutch law provides for special reduced corporate taxation in the case of certain Dutch resident corporations serving as investment vehicles. An investment organization that qualifies for such treatment is referred to as a "*beleggingsinstelling*" in Article 28 of the Netherlands Corporation Tax Act (Wet op de vennootschapsbelasting 1969). Its activities consist wholly or largely of stock, debt, or real estate investments, and it meets certain requirements concerning, among other things, stock ownership and the annual distribution of its profits. Generally, it is subject to a zero-percent corporate tax rate. Moreover, in a limited class of cases, the dividend tax does not apply to dividends paid by a *beleggingsinstelling* to Dutch residents.

Treaty reduction of dividend taxes

Under the proposed treaty, each country may tax dividends paid by its resident companies, but the rate of tax is limited by the proposed treaty if the beneficial owner of the dividends is a resident of the other country. Source country taxation generally is limited to 5 percent of the gross amount of the dividends if the beneficial owner of the dividends is a company which holds directly at least 10 percent of the voting shares of the payor corporation. The Understanding provides that a beneficial owner of dividends who holds depository receipts or trust certificates evidencing beneficial ownership of the shares in lieu of the shares themselves may also claim entitlement to this 5-percent rate under the proposed treaty.

Under the present Dutch treaty, source country tax may be imposed at a 15-percent rate, rather than only a 5-percent rate, un-

[28] An exception applies to certain dividends paid to Dutch corporations holding at least 5 percent of the stock of the payor. This exemption mirrors the so-called "participation exemption" (discussed below in connection with Article 25) under which Dutch corporations are exempt from tax on dividends paid by corporations (Dutch or foreign) in which the recipient owns at least a 5-percent interest.

[29] 90/435/EEC.

less a higher ownership threshold is met (either 25-percent stock ownership by one recipient corporation residing in the other country, or 25-percent ownership by a group of recipient corporations resident in that country each of which owns at least 10 percent), and is met for the period ending on the date the dividend is paid and beginning at the start of the paying corporation's previous taxable year.

Under the proposed treaty, the tax generally is limited to 15 percent of the gross amount of the dividends in cases involving dividends paid to residents of the other country not described above in connection with the proposed treaty.

The Understanding provides that where a person loans shares (or other rights the income from which is subject to the same taxation treatment as income from shares) and receives from the borrower an obligation to pay an amount equivalent to any dividend distribution made with respect to the shares or other rights loaned during the term of the loan, the person will be treated as the beneficial owner of the dividend paid with respect to those shares or other rights for purposes of the application of this article to the equivalent amount. Thus the proposed treaty would permit the United States to impose withholding tax on substitute dividend payments.

Under the present treaty, as, for example, under the U.S.-France income tax treaty, the prohibition on source country tax at a rate exceeding 5 percent does not apply in certain cases where more than 25 percent of the gross income of the dividend payor for the prior taxable year consisted of interest and dividends. The proposed treaty would eliminate this rule, and replace it with rules similar to those adopted in recent treaties and protocols that allow source country tax in excess of 5 percent on direct investment dividends from a RIC or REIT.[30]

The proposed treaty allows the Netherlands to impose at least a 15-percent tax on any dividend paid by a *beleggingsinstelling* in the sense of Article 28 of the Netherlands Corporation Tax Act. There is no limit in the proposed treaty on the tax that may be imposed by the Netherlands on certain dividends paid by a *beleggingsinstelling* if the company invests in real estate to the same extent as is required of a REIT under U.S. law. The staff understands that in order for the limitation to be lifted in this case, generally the *beleggingsinstelling* would have to meet a gross income test like that in Code section 865(c)(3) and an asset similar to that in section 865(c)(5). Such a dividend would thus be taxable by the Netherlands, assuming no change in present Dutch internal law, at the full 25-percent rate. The absence of treaty limitation in this case applies to a dividend that is beneficially owned by a U.S. resident individual holding a 25-percent or greater interest in the company. This absence of limitation also applies to Dutch withholding on a dividend the beneficial owner of which is a U.S. resident other than an individual, a RIC, or a REIT.

[30] The Technical Explanation indicates that distributions by a REIT that are attributable to gains from the disposition of a U.S. real property interest are not treated as dividends under the proposed treaty. Such distributions are covered by the provisions of Article 14 (Capital Gains).

Similarly, the proposed treaty allows the United States to impose a 15-percent tax on a U.S. source dividend paid by a RIC to a Dutch company owning 10 percent or more of the voting shares of the RIC, or a U.S. source dividend paid by a REIT to a Dutch company that is a *beleggingsinstelling* owning 10 percent or more of the voting shares of the REIT. In addition, there is no limitation in the proposed treaty on the tax that may be imposed by the United States on a dividend paid by a REIT that is beneficially owned by a Dutch resident, if the beneficial owner is either an individual holding a 25 percent or greater interest in the REIT, or a company that is not a *beleggingsinstelling*. Such a dividend thus would be taxable by the United States, assuming no change in present U.S. internal law, at the full 30-percent rate.

The limitations on source country taxation of dividends do not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Definition of dividends

Unlike the U.S. and OECD model treaties, the present treaty provides no express definition of the term dividend. The proposed treaty provides a definition of dividends that is broader than the definition in the U.S. model treaty and some U.S. treaties. Similar to the U.S. model treaty, the proposed treaty generally defines "dividends" as income from shares or other rights participating in profits. Dividends also include income from other corporate rights that is subjected to the same tax treatment as income from shares by the source country—i.e., the country in which the distributing company is resident. The proposed treaty also provides (unlike the U.S. model treaty) that in the case of the United States, the term dividends includes income from debt obligations carrying the right to participate in profits. In the case of the Netherlands, the term includes income from profit sharing bonds (*"winstdelende obligaties"*).

Thus, for withholding purposes, the proposed treaty would expressly permit withholding under Article 10 on interest paid on a loan with an "equity kicker." This represents a change from the present treaty, under which there is no explicit definition of dividend, and withholding on interest generally is prohibited. It is understood that this language permits the United States to impose withholding tax on a U.S. source payment. The staff further understands that this language does not have the further effect, together with Article 25, of requiring the United States to give an indirect foreign tax credit, under Code section 902, with respect to interest received by a U.S. corporation on a note issued by its Dutch subsidiary, although the note may have equity features.

Because the Dutch dividend tax applies to payments that, were they derived from U.S. sources, would not be subject to U.S. withholding tax (either under the terms of present internal U.S. law or other provisions of the proposed treaty), the effect of the proposed treaty will be to permit the Netherlands to continue to impose source-country taxation in a case where the United States does not now impose tax. By the same token, however, if future U.S. legislation were to impose withholding taxes in some cases where such taxes are not now imposed under the Code, the proposed treaty

might accommodate such changes (depending on the scope of the legislation) without giving rise to a treaty-statute conflict (assuming the proposed treaty were then in force).

Special rules and exceptions

The proposed treaty's reduced rates of tax on dividends will not apply if the beneficial owner of the dividend carries on business through a permanent establishment (or fixed base in the case of an individual who performs independent personal services) in the source country and the holding on which the dividends are paid forms part of the business property of the permanent establishment (or fixed base). Dividends paid on such holdings of a permanent establishment would be taxed as business profits (Article 7). Dividends paid on such holdings of a fixed base would be taxed as income from the performance of independent personal services (Article 15). In such a case, the effect of the deferred payment rules for determining U.S.-effectively connected income under the Code (sec 864(c)(6)) on Dutch residents eligible for treaty benefits are dealt with in Article 24 (Basis of Taxation) of the proposed treaty.

The proposed treaty contains a general limitation on the taxation of dividends paid by corporations that are not residents of the taxing country. Under this provision, the Netherlands may not, except in two cases, impose any taxes on dividends paid by a U.S. resident company that derives profits or income from the Netherlands, even if the dividends represent Dutch profits or income. The first exception is the case where the dividends are paid to Dutch residents. The second is the case where the holding in respect of which the dividends are paid forms part of the business property of a Dutch permanent establishment or pertains to a fixed base in the Netherlands. Similarly, the United States may not impose any tax on dividends paid by a Dutch corporation that derives U.S. profits or income (regardless whether the dividends represent U.S. earnings) unless the dividends are paid to a U.S. resident or the holding in respect of which the dividends are paid forms part of the business property of a U.S. permanent establishment or pertains to a U.S. fixed base. This rule is somewhat less restrictive of the United States' taxing jurisdiction than the corresponding rule in the present treaty. The latter provides that dividends paid by a Dutch corporation are exempt from U.S. tax in any case where the recipient is not a U.S. citizen, resident, or corporation.

Finally, the dividend article of the proposed treaty prohibits any tax by one treaty country on the undistributed profits of a company resident in the other treaty country, except as provided in the branch tax article (Article 11). The staff understands that this language is not intended to impair the right of the source country to impose corporate income tax otherwise permitted under the business profits article.

Article 11. Branch Tax

The proposed treaty would expressly permit the United States to collect the branch profits tax from a Dutch company, but only with respect to earnings of the latter accumulated during periods when the proposed treaty is in effect.

U.S. branch profits tax rules

A foreign corporation engaged in the conduct of a trade or business in the United States is subject under the Code to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the accumulated U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. This provision was added to the Code in 1986. Under the Code, the dividend equivalent amount is limited by (among other things) aggregate earnings and profits accumulated in taxable years beginning after December 31, 1986. The Code provides that no U.S. treaty shall exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country.

The Code defines a "qualified resident" as any foreign corporation which is a resident of a treaty country if can meet at least one of the following tests. First, any foreign corporation resident in a treaty country is a qualified resident of that country unless 50 percent or more (by value) of the stock of the corporation is owned (directly or indirectly within the meaning of Code section 883(c)(4)) by individuals who are not residents of the treaty country and who are neither U.S. citizens nor resident aliens, or 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are residents of neither the treaty country nor the United States. Second, a foreign corporation resident in a treaty country is a qualified resident if the stock of the corporation is primarily and regularly traded on an established securities market in the treaty country, or if the corporation is wholly owned (either directly or indirectly) by another foreign corporation which is organized in the treaty country and the stock of which is so traded, or is wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States.

Proposed treaty rules

The proposed treaty would allow the United States to impose the branch profits tax (as opposed to the branch level excess interest tax (Code sec. 884(f)), described below) on a Dutch resident corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on income from real property or gains from the disposition of real property interests. (The treaty would also allow the Netherlands to impose a branch profits tax on similar items earned by a U.S. corporation, but no such tax is currently imposed under Dutch internal law.) As is generally true of treaties negotiated or modified since the enactment of the branch profits tax in 1986, the proposed treaty would permit at most a 5-percent branch profits tax rate, and, in cases where a foreign corporation conducts a trade or business in the United States, but not through a permanent establishment, the proposed treaty would completely eliminate the branch profits tax that the Code imposes on such corporation. The proposed treaty adds an additional limitation not found in other post-1986-Act U.S. tax treaties: under the proposed treaty, the dividend equivalent amount is computed with reference only to profits accumulated in years for which the proposed treaty is in effect.

In general, the proposed treaty provides that the branch profits tax may be imposed by the source country only on that portion of the business profits of the foreign corporation attributable to its source country permanent establishment, or the corporation's real property income subject to tax on a net basis. In general, the branch profits tax may also be imposed by the source country on corporation's gains from the disposition of real property. However, the branch profits tax may not be imposed on income of the foreign corporation that is, under the proposed treaty, subject to tax by the source country as source country real property gains from the disposition of shares or other comparable corporate rights in a company.[31] For example, the United States may not impose branch profits tax on the income of a Dutch corporation from the sale of stock in a U.S. real property holding company.

The profit, income, or gain to be subjected to the branch profits tax must be reduced for all source country taxes chargeable on it, other than the branch profits tax. The taxable portion must be further reduced (but not below zero) by any increase for the year in the permanent establishment's net equity. By the same token, the taxable portion is increased by any decrease for the year in the permanent establishment's net equity. However, the latter increase cannot exceed the foreign corporation's accumulated profits, defined for any future year as the excess of (a) the foreign corporation's aggregate source-country profits for all then-prior taxable years during which the proposed treaty was in effect, over (b) the aggregate profits taxed under the branch profits tax during those prior years.

The proposed treaty permits the United States to impose its branch profits tax on the "dividend equivalent amount" (as that term is defined under the Code as it may be amended from time to time) to the extent that this definition is in conformity with the principles of the branch tax article. Currently the dividend equivalent amount of business profits attributable to a permanent establishment generally is the earnings and profits attributable to a U.S. permanent establishment, plus an additional amount representing any decreases in the permanent establishment's "U.S. net equity" and minus an amount representing any increase in the permanent establishment's U.S. net equity.

In light of the similarity between U.S. law and the principles laid down in the branch tax article, the Technical Explanation indicates that the proposed treaty permits the United States to impose the branch profits tax as set forth currently under section 884, so long as its operation is limited to the earnings of a Dutch corporation either from its U.S. permanent establishment or U.S. real property income and gains (other than stock gains from dispositions of stock in a U.S. real property holding company), and then only those amounts earned in years during which the proposed treaty is in effect.

None of the restrictions on the operation of U.S. or Dutch internal law branch tax provisions apply, however, unless the corporation seeking treaty protection meets the conditions of the proposed treaty's limitation on benefits article (Article 26). As described in

[31] The conditions under which such stock gains are taxable in country where the real property is situated are discussed below in connection with Article 14 (Capital Gains).

the discussion of Article 26 below, the limitation on benefits requirements of the proposed treaty are in some ways similar, but not identical, to the analogous provisions of the branch profits tax provisions of the Code described above.

Article 12. Interest

United States internal law

Subject to numerous exceptions (such as those for portfolio interest, bank deposit interest, and short term original issue discount), the United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. U.S. source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that meets the foreign business requirements of Code section 861(c) (e.g., an 80/20 company). Also subject to the 30-percent tax is interest paid to a foreign person by the U.S. trade or business of a foreign corporation. A foreign corporation is also subject to a branch level excess interest tax, which is the tax it would have paid had a wholly owned domestic corporation paid it the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business (sec. 884(f)).

Portfolio interest generally is defined as any U.S. source interest that is not effectively connected with the conduct of a trade or business and (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution.[32]

Under a provision enacted in the Omnibus Budget Reconciliation Act of 1993, the portfolio interest exemption is inapplicable to certain contingent interest income. For this purpose, contingent interest generally includes interest determined by reference to any of the following attributes of the debtor or any related person: receipts, sales, or other cash flow; income or profits; or changes in the value of property. In addition, contingent interest generally includes interest determined by reference to any dividend, partnership distribution, or similar payment made by the debtor or a related person. A number of exceptions apply, including an exception for interest determined by reference to changes in the value of, or yields on, certain actively traded property. In the case of an instrument on which a foreign holder earns both contingent and non-contingent interest, denial of the portfolio interest exemption applies only to the portion of the interest which is contingent interest.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit (REMIC), the REMIC is treated generally for U.S. tax purposes as a pass-through entity and the investor is subject to U.S. tax on some portion of the REMIC's income (which in turn is generally interest income). If the investor holds a so-called "residual interest" in the

[32] Certain additional exceptions to this general rule apply only in the case of a corporate recipient of interest. In such a case, the term portfolio interest generally excludes (1) interest received by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), and (2) interest received by a controlled foreign corporation from a related person.

REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor—referred to as the investor's "excess inclusion"—may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax under section 511, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor were otherwise eligible for such a rate reduction.

Netherlands internal law

The Netherlands generally does not impose tax on interest income of nonresidents, unless the interest income is earned in connection with a Dutch permanent establishment. As described above in connection with the dividend article, the Dutch dividend tax applies to proceeds from profit sharing bonds, and under the present treaty, such proceeds are treated as dividends rather than interest for Dutch withholding purposes. In addition, a nonresident individual or corporation may be subject to Dutch tax on net income derived from bonds or debts issued by a Dutch corporation, if the recipient owns a substantial interest in the corporation.

Proposed treaty limitations on internal laws

The proposed treaty generally provides that interest arising in one treaty country and beneficially owned by a resident of the other country may be taxed only by latter country, and not the country where the interest arose. That is, such income may not be taxed in the "source country." No such exemption applies, however, to an excess inclusion with respect to a residual interest in a REMIC. Thus, such inclusions may be taxed at 30 percent consistently with the proposed treaty. The proposed treaty does exempt Dutch corporations from imposition by the United States of the branch level excess interest tax. The proposed treaty thus generally exempts from the U.S. 30-percent tax on U.S. source interest paid to foreign persons, interest (within the treaty definition of that term) paid to Dutch residents. The treaty also exempts from Dutch taxes, in those few cases where any such tax might otherwise be applicable, Dutch source interest paid to U.S. residents. These reciprocal exemptions are similar to those in effect under the present treaty and in the U.S. model treaty.

The exemptions apply only if the interest is beneficially owned by a resident of one of the countries. Accordingly, they do not apply if the recipient of the interest is a nominee for a nonresident.

In addition, the exemptions will not apply if the beneficial owner of the interest carries on a business through a permanent establishment (or fixed base in the case of an individual who performs independent personal services) in the source country and the interest paid is attributable to the permanent establishment (or fixed base). In that event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 15). In such a case, the effect of the deferred payment rules for determining U.S.-effectively connected income under the Code (sec 864(c)(6)) on Dutch residents eligible for treaty bene-

fits are dealt with in Article 24 (Basis of Taxation) of the proposed treaty.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by stating that the amount of interest for purposes of applying this article will be the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 10 of the proposed treaty. As explained above in connection with Article 9 (Associated Enterprises), the Understanding provides guidance on the application of this paragraph.

Definition of interest

The treaty defines interest generally as income from debt-claims of every kind, whether or not secured by mortgage, and not carrying a right to participate in the debtor's profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. The treaty also defines interest to include an excess inclusion with respect to a REMIC, and other income that is treated as income from money lent by the taxation law of the source country. However, the term does not include income dealt with in the dividend article (Article 10). Thus, the interest exemption does not prevent the Netherlands from imposing the dividend tax on interest paid on profit sharing bonds, nor (staff understands) does it prevent the United States from imposing its withholding tax on contingent interest under the portfolio interest rules as amended in the 1993 Act. Penalty charges for late payment are not interest for purposes of the proposed treaty.

Source rule

The proposed treaty explicates what it means under the treaty for interest to arise in (i.e., to have its source in) a particular country. In general, interest will be deemed to arise in one of the treaty countries when the payor is that country itself, or a political subdivision, a local authority, or a resident of that country. However, an overriding rule applies in some cases where the payor (whether or not a resident of the United States or the Netherlands) has a permanent establishment or a fixed base in one of the treaty countries (and the debt on which the interest is paid was incurred in connection with that permanent establishment or fixed base), or has income otherwise subject to the branch profits tax in one of those countries. In such a case the interest is deemed to arise in the country in which the permanent establishment or fixed base is located, or in which the branch profits tax may be imposed. This rule applies only if the interest is borne by the permanent establishment or fixed base, or is allocable to the income subject to the branch tax.

Thus, for example, interest paid to a Dutch resident by the U.S. branch of a French company may be considered U.S. source income under the proposed treaty and therefore be exempt by treaty from

U.S. tax. In addition, if a Dutch company has a U.S. permanent establishment, then interest paid by the company that is deductible against the U.S.-taxable income of the U.S. branch is deemed to be U.S. source income, even if that interest is not paid by the U.S. permanent establishment.

Second-level withholding, and branch level tax, on interest

The proposed treaty contains a general limitation on the taxation of interest paid by residents of the other country. Under this provision, the Netherlands may not impose any tax on interest paid by a U.S. resident except where the interest is paid to a Dutch resident, is attributable to a permanent establishment or a fixed base situated in the Netherlands, or is Dutch source interest which is not paid to a U.S. resident. Similarly, the United States may not impose any tax on interest paid by a Dutch resident except where the interest is paid to a U.S. resident, is attributable to a U.S. permanent establishment or a fixed base, or is U.S. source interest which is not paid to a Dutch resident. For example, the provision permits the United States to impose withholding tax on interest paid by the U.S. permanent establishment of a Dutch corporation to a Canadian resident. The staff understands that the proposed treaty does not affect the right of the United States to impose income tax on the interest income of a third-country resident received from a Dutch resident (e.g., the interest income of a U.S. trade or business conducted by a Canadian corporation), because the proposed treaty generally applies only to persons who are residents of one or both of the treaty countries.

The proposed treaty contains language that exempts Dutch companies from the U.S. branch level excess interest tax by treating the excess interest as derived and beneficially owned by a Dutch resident. As explained above in connection with the source rule, such interest is treated as U.S. source interest. Thus, under the language described in the previous paragraph, the United States would be permitted to tax such interest if it were paid to someone other than a Dutch resident. The proposed treaty further provides, however, where the payer of interest is a resident of one of the treaty countries and has a permanent establishment in the other country, or has income otherwise subject to the branch profits tax, then to the extent that the amount of interest arising in the second country by reason of the permanent establishment or by reason of income subject to the branch profits tax exceeds the total amount of interest paid by the permanent establishment or in connection with income otherwise subject to the branch profits tax, this excess is treated as interest derived and beneficially owned by a resident of the first country.

Article 13. Royalties

Internal law

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons, and on gains from the disposition of certain intangible property to the extent that gains are from payments con-

tingent on the productivity, use, or disposition of intangible property. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangible property in the United States. Such royalties include motion picture royalties. The Netherlands generally imposes no tax on royalties derived by nonresidents, unless the royalties are earned in connection with a Dutch permanent establishment.

Proposed treaty limitations on internal law

The proposed treaty provides that royalties arising in one treaty country and beneficially owned by a resident of the other country may be taxed only by latter country, and not the country where the royalty arose. Thus, the proposed treaty generally exempts from the U.S. 30-percent tax on U.S. source royalties paid to Dutch residents. This exemption is similar to those provided in the present treaty and in the U.S. model treaty. The exemption applies only if the royalty is beneficially owned by a resident of the other country; it does not apply if the recipient of the royalty is a nominee for a nonresident.

The exemption will not apply where the recipient carries on a business through a permanent establishment (or fixed base in the case of an individual who performs or performed independent personal services) in the source country and the royalties are attributable to the permanent establishment (or fixed base). In that event, the royalties will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 15). In such a case, the effect of the deferred payment rules for determining U.S.-effectively connected income under the Code (sec 864(c)(6)) on Dutch residents eligible for treaty benefits are dealt with in Article 24 (Basis of Taxation) of the proposed treaty.

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties having an otherwise special relationship) by stating that the amount of royalties for purposes of applying this article will be the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length royalty, for whatever reason, will be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid to a parent corporation by its subsidiary may be treated as a dividend under local law and thus be entitled to the benefits of Article 10 of the proposed treaty.

Definition of royalties

Royalties are defined as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (excluding motion pictures or works on film, tape, or other means of reproduction for use in radio or television broadcasting); for the use of, or the right to use, any patent, trademark, trade name, brand name, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience. The term "royalties" also includes gains from the alienation of a right or property described

above which are contingent on the productivity, use, or disposition of such right or property.

Income from the rental or licensing of cinematographic films and films, tapes, and other means of reproduction for use in radio or television broadcasting is treated as business profits under the proposed treaty (Article 7). Under the present treaty, such income generally is treated as royalties. Under both treaties, however, a treaty country generally would not be entitled to tax a resident of the other country on such income unless the income was attributable to a permanent establishment in the first country.

Other rules

Unlike the interest article, the royalties article in the proposed treaty has no source rule. However, it does have a general limitation on the taxation of royalties paid by residents of the other country. Such a provision is absent from the present treaty and from the U.S. and OECD models. The effect of this provision is in some ways similar to a rule that sources royalties based on the residence of the payor, rather than on the place of use—the source rule under U.S. law. Under this provision, the United States may not impose any withholding tax on royalties paid by a Dutch resident to a Dutch resident or a third-country resident unless an exception applies. The proposed treaty imposes reciprocal restrictions on the right of the Netherlands to impose tax on royalties paid by U.S. persons. Where an exception does not apply, the treaty generally prevents the United States from imposing its withholding tax on royalties paid by Dutch residents to third-country residents, even if, under the Code, such royalties are U.S. source income and, had the payor been a U.S. resident, would have given rise to a U.S. gross-basis tax.

As applied to royalties paid by a Dutch resident to a resident of a country other than the United States, an exception to the general rule forbidding U.S. tax applies if the royalties are attributable to a permanent establishment or a fixed base situated in the United States. This rule allows the United States to impose its income tax on Dutch-paid royalty income of the U.S. branch of a Dutch corporation. An exception also applies if the contract under which the royalties are paid was concluded in connection with a U.S. permanent establishment or fixed base, the royalties are borne by the U.S. permanent establishment or fixed base, and the recipient of the royalties is not a Dutch resident. This rule allows the United States to impose its withholding tax on royalties paid to a third country resident by the U.S. permanent establishment of a Dutch company.

Finally, the proposed treaty contains an exception that allows the United States to assert, under limited circumstances, its Code-mandated jurisdiction to tax royalties based on U.S. use. Under this exception the United States may, in certain cases, impose tax on royalties paid by a Dutch resident to a third-country resident in respect of intangible property used in the United States if the payer has received a royalty paid by a U.S. resident (or borne by a U.S. permanent establishment or fixed base) for U.S. use of the same property. In order for this rule to apply, however, the use of the intangible property in question must not be a component part

of, nor directly related to, the active conduct of a trade or business in which the Dutch payor is engaged.

The staff understands that the proposed treaty does not affect the right of the United States to impose income tax on the Dutch-paid royalty income of a third-country resident (e.g., the Dutch-paid royalty income of a U.S. trade or business conducted by a Canadian corporation), because the proposed treaty generally applies only to persons who are residents of one or both of the treaty countries.

Article 14. Capital Gains

U.S. internal law

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests other than solely as a creditor (e.g., stock) in certain corporations that hold or held U.S. real property the fair market value of which is (or was) at least 50 percent of the fair market value of its total real property interests (U.S. and foreign) and its other business assets.

As originally enacted on December 5, 1980, FIRPTA applies to dispositions after June 18, 1980. However, for the period ending on December 31, 1984, gain was not taxed to the extent required by then-existing treaties. Further, FIRPTA provided that if any treaty was renegotiated to resolve conflicts between it and FIRPTA, and the new treaty resulting from that renegotiation was signed before 1985, then FIRPTA was not to override contrary existing treaty obligations for an additional period as specified in the renegotiation. This additional period would in no event last, however, more than two years after the date that the new treaty was signed.

The present Dutch treaty prohibits taxation in certain cases covered by FIRPTA. Under the terms of the present treaty, the United States generally would be prohibited from imposing tax on gains other than real property gains derived by a Dutch resident from the alienation of a capital asset (other than certain business-related gains and certain gains of Dutch residents present in the United States for an extended period). As used in the present treaty, however, the term "real property" generally has not been applied to include indirect interests in real property, such as for example stock in a real property-owning corporation, to the same extent as FIRPTA. Thus, before 1985, Dutch residents received relief from FIRPTA under the present treaty. After 1984, however, the present treaty has been overridden by FIRPTA in cases where there is a conflict.

The Code generally provides for the nonrecognition of gain that is realized upon certain exchanges of property or stock in connection with contributions of property to corporations, liquidations of

corporations, distributions of stock, and corporate reorganizations. Where a foreign corporation is involved in the transaction, however, these nonrecognition rules may in some cases be inapplicable. Recognition of gain may arise from treating a foreign corporation as not a corporation for purposes of the general nonrecognition rules (Code sec. 367(a) and (b)), or from an explicit rule requiring recognition of gain in a particular circumstance (e.g., sec. 367(d) and (e)).[33]

Under regulations, taxpayers in certain circumstances covered by exceptions under section 367 to the nonrecognition rules are able to enter into agreements with the IRS under which nonrecognition treatment is preserved, or recognition of gain is deferred.

Dutch internal law

Under Dutch law, the taxation of capital gains, of both residents and nonresidents, is generally limited to gains that are business income or income from personal services. However, both a resident individual, and in some cases a nonresident, may be subject to 20-percent Dutch tax on gain from the disposition of shares issued by a Dutch corporation, if the person is treated as having a substantial interest in the corporation. Under the present treaty, the Netherlands retains the right to impose this tax in some limited cases on Dutch citizens who are U.S. residents.

Dutch law also provides for nonrecognition of gain that is realized upon certain exchanges of property or stock in connection with contributions of property to corporations, liquidations of corporations, distributions of stock, and corporate reorganizations. Dutch and U.S. nonrecognition provisions are not necessarily mirror images of one another.

Proposed treaty limitations on internal law

Real property

Under the proposed treaty gains derived by a treaty country resident from the disposition of real property situated in the other country may be taxed in the other country. Real property situated in the other country for the purposes of this article includes real property referred to in Article 6 (Income from Real Property), and shares or other comparable corporate rights in a company that is a resident in the other country, the assets of which company consist, directly or indirectly, for the greater part of real property situated in that other country, and an interest in a partnership, trust, or estate, to the extent that it is attributable to real property situated in that other country. In the United States, the term real property situated in the other country includes a "U.S. real property interest" as defined under the Code both now, and as it may

[33] For example, the general rule under the Code treats a corporation that distributes property in complete liquidation as realizing gain or loss as if the property had been sold to the distributee (sec. 336(b)). If, however, a sufficient amount of the stock of the corporation is owned by another corporation, a nonrecognition rule applies: no gain or loss is recognized to the liquidating corporation. A provision in section 367, in turn, makes the nonrecognition provision inapplicable, except as provided in regulations, if the distributee is a foreign corporation (sec. 367(e)(2)). Even where the distributee is a foreign corporation resident in a treaty country, such treatment is not considered impermissibly discriminatory, because absence of tax to the subsidiary in this case represents a complete elimination of U.S. tax jurisdiction over any appreciation, while a similar absence in the case of a domestic distributee simply moves the appreciation into the hands of another U.S. taxpayer. *See* Notice 87-66, 1987-2 C.B. 376.

be amended from time to time without changing the general principles of the proposed treaty definition of real property situated in the United States. According to the Understanding, in determining for purposes of this rule whether the assets of a U.S.-resident corporation consists, directly or indirectly, for the greater part of U.S. real property, and whether the stock of the corporation is a "U.S. real property interest," the United States confirms that it will take into account the fair market value of all of the assets of the corporation, including intangible business assets such as goodwill, whether or not appearing as an asset on the balance sheet for tax purposes, going concern value and intellectual property. Under current U.S. law, generally only real property interests and business assets are relevant in the determination whether an interest in a corporation is a U.S. real property interest.[34] The staff understands that nothing in the Understanding requires the United States to alter its internal law in this respect, or any other respect.

The proposed treaty thus generally allows the United States to tax transactions of Dutch residents taxable under FIRPTA. However, concerning gains that are taxable by the source country under the proposed treaty but not under the terms of the present treaty (and therefore not taxable by the source country unless disposed of after 1984), the proposed treaty contains a special rule that applies to certain property that was owned by a resident of the other country continuously since June 18, 1980 (the effective date of FIRPTA) and which was not part of a permanent establishment or fixed base in the source country. The effect of the special rule is to give the owner of the property a step-up in basis for purposes of computing gain computed as provided in the proposed treaty. Under the special rule, for purposes of computing source basis taxation on the gain from the disposition of property, the gain realized on a disposition is to be reduced by the proportion of any gain attributable to the period the property was held by the person disposing of the property up to December 31, 1984. This method gives taxpayers the benefit of the assumption that capital assets that appreciate do so in the same amount during each month of the holding period. If, however, the taxpayer shows to the satisfaction of the competent authority of the source country that a greater than proportional part of the gain is reasonably attributable to that period, then the competent authority is to permit that greater portion to be excluded from tax.

The proposed treaty generally allows application of the special rule only if the resident who alienates the capital asset both owned the asset and resided in the same country continuously since June 18, 1980. The proposed treaty also generally allows application of the rule if the resident who alienates the asset acquired the asset in an alienation of property that qualified as a nonrecognition transaction for purposes of taxation in the source country, and has owned the asset continuously since then, assuming that the resident's initial basis in the alienated property was equal to either the basis of the property that the resident exchanged for the alienated asset, or the basis of the alienated asset in the hands of the person transferring the asset to the resident immediately prior to the

[34] Code sec. 897(c)(2); Treas. Reg. secs. 1.897-2(b)(1) and 1.897-1(f)(1)(ii).

transfer. For purposes of determining whether the alienation qualified as a nonrecognition transaction, Code section 897 is to be disregarded. Thus, the alienation may qualify notwithstanding the rules of section 897(d) or (e), which in some cases may have overridden nonrecognition treatment in the case of the exchange of a U.S. real property interest for an interest the sale of which would not be subject to U.S. tax.

The special rule does not apply, however, unless certain residence requirements were met during the period before the disposition of the asset. First, between January 1, 1992 and the date of alienation, the resident, and any other person who owned the asset during that period, must have been entitled to Article 14 treaty benefits under the limitation on benefits article (Article 26) of the proposed treaty. Second, during the period from June 18, 1980 through December 31, 1991, each person who owned the asset must have been a resident of the United States or the Netherlands under the present treaty.

In addition, the special rule does not apply to several kinds of transactions. First, it does not apply to alienation of an asset that, at any time on or after June 18, 1980, formed part of the property of a permanent establishment (or pertained to a fixed base) of a resident of one of the countries that was situated in the other country. Second, it does not apply to an alienation by a resident of one country of an asset that was acquired directly or indirectly by any person on or after June 18, 1980, in a transaction that did not qualify for nonrecognition (determined without regard to Code section 897), or in a transaction in which it was acquired *in exchange for* an asset that was acquired in a transaction that did not qualify for nonrecognition (determined without regard to Code section 897). Third, it does not apply to an alienation of an asset that was acquired, directly or indirectly, by any person on or after June 18, 1980, in exchange for described above in this paragraph, or the alienation of which could have been taxed by the other country under the present treaty.

Other capital gains

Gains from the alienation of personal that forms part of the business property of a permanent establishment which an enterprise of one country has in the other country, or gains from the alienation of personal property pertaining to a fixed base available to a resident of one country in the other country for the purpose of performing independent personal services, including gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such a fixed base, may be taxed in that other country.[35] The Technical Explanation indicates that this article permits gains from the alienation by a resident of one country of an interest in a partnership, trust, or estate that has a permanent establishment situated in the other country to be treated as gain under this paragraph of the proposed treaty. Thus, the proposed treaty permits the United States to tax gain from the disposition

[35] In such a case, the effect of the deferred payment rules and the deferred gain rules for determining U.S.-effectively connected income under the Code (sec 864(c)(6) and (7)) on Dutch residents eligible for treaty benefits are dealt with in Article 24 (Basis of Taxation) of the proposed treaty.

of an interest in a partnership that has a U.S. permanent establishment, regardless of whether the partnership interest is an interest in U.S. real property.[36]

Notwithstanding the foregoing rules on gains in connection with permanent establishments and fixed bases, the proposed treaty restricts the taxation of the gain on the *deemed* alienation of property (as provided under Dutch internal law) that is *deemed* to be used in a permanent establishment or fixed base under Article 27 (Offshore Activities) of the proposed treaty. This restriction applies to gains from the deemed alienation of tangible depreciable personal property, if such property either forms part of the business property of a permanent establishment which an enterprise of one treaty country is deemed to have in the other treaty country under paragraph 3 of the offshore activities article (Article 27), or pertains to a fixed base deemed to be available to a resident of one of the treaty countries under paragraph 5 of that article for the purpose of performing independent personal services. Under the proposed treaty, such gains are taxable only in the residence country if the period during which the property has the above-mentioned nexus to the deemed permanent establishment or fixed base is less than 3 months, and the actual alienation of the property does not take place within one year after the date of its deemed alienation. If this restriction applies, the proposed treaty allows the source country, in taxing the income of the deemed permanent establishment or fixed base, to compute depreciation for the property based on the lower of book or market value as of the date that the property became part of the business property of the permanent establishment or first pertained to the fixed base.

Gains of an enterprise of one of the treaty countries from the alienation of ships or aircraft operated in international traffic, and gains from alienation of personal property pertaining to the operation of such ships and aircraft operated in international traffic, are taxable only in the residence country of the person carrying on that enterprise. Gains described in the royalties article—i.e., gains derived from alienation of certain intangible property contingent on productivity, use, or disposition—are taxable in accordance with that article (Article 13).

Generally, gains from the alienation of any property other than that discussed above will be taxable under the proposed treaty only in the country where the alienator is a resident. As under the present treaty, however, this rule does not in all cases prevent the Netherlands from imposing its tax on gains from the disposition of a substantial interest in a Dutch corporation. Under the proposed treaty the Netherlands may tax gains, derived by an individual U.S. resident who resided in the Netherlands at any time during the preceding 5-year period, from the alienation of shares or other corporate rights participating in profits in a Dutch resident company, if at the time of the alienation the U.S. resident owns, either alone or together with related individuals, at least 25 percent of any class of the company's shares. For this purpose, the term "related individuals" means the alienator's spouse and his relatives (by blood or marriage) in the direct line (ancestors and lineal de-

[36] See Rev. Rul. 91-32, 1991-1 C.B. 107.

scendants) and his relatives (by whole or half blood or by marriage) in the second degree in the collateral line (siblings or their spouses).

By its terms this provision of the proposed treaty gives the United States and the Netherlands reciprocal taxation rights and obligations. However, it currently applies chiefly to Dutch tax on U.S. residents, because present internal U.S. tax law generally does not impose tax based on these criteria.

In corporate reorganizations and other cases, the proposed treaty, similar to the U.S.-Canada income tax treaty, requires each treaty country to coordinate its nonrecognition rules with those of the other country to some extent, in a case where a resident of the other country qualifies for nonrecognition treatment in its country of residence. This coordination rule imposes requirements on one treaty country when a resident of the other treaty country alienates property in the course of a corporate organization, reorganization, amalgamation, division or similar transaction, and the tax law of the second treaty country provides for nonrecognition or deferral of profit, gain, or income with respect to the alienation. In that case, the first treaty country generally is required to defer any tax that would it would otherwise impose with respect to the alienation, to the extent and for the period that tax would have been deferred if the alienator had been its own resident (but for no longer and in no greater amount than in the other country).[37]

However, this deferral is only required provided that the tax can be collected upon a later alienation, and the collection of the amount of tax in question upon the later alienation is secured to the satisfaction of the competent authorities of both countries. The competent authorities are to develop procedures for implementing this rule. According to the Understanding, it is understood that the limitation of source country tax does not apply to an alienation by a treaty country resident if the tax that would otherwise be imposed on such alienation by the other country cannot reasonable be imposed or collected at a later time. For example, under U.S. law, a foreign corporation that qualifies as a U.S. real property holding corporation is taxed in some circumstances if it transfers its assets to a U.S. corporation in a reorganization. In such a case, the Understanding provides that only if the shareholders of the foreign corporation agree to reduce basis (if and only to the extent available) by closing agreement can the tax that otherwise would be imposed on the alienation be reasonably imposed or collected at a later time.

Article 15. Independent Personal Services

Services income in general

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services

[37] Nothing in this limitation prevents, for example, the United States from taxing the U.S. subsidiary of a Dutch corporation on the distribution of its assets in complete liquidation, as provided in section 367(e)(2).

within the United States can be a trade or business within the United States (Code sec. 864(b)).

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is excluded from U.S. source income, and therefore not taxed by the United States in the absence of a U.S. trade or business, if certain criteria are met. The criteria are: (1) the individual is not in the United States for over 90 days during a taxable year, (2) the compensation does not exceed $3,000, and (3) the services are performed as an employee of or under a contract with a foreign person not engaged in a trade or business in the United States, or they are performed for a foreign office or place of business of a U.S. person.

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty (unlike the present treaty), income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) is treated separately from income from the performance of dependent personal services.

Independent personal services

Income from the performance of independent personal services by a resident of one country will be exempt from tax in the other country, unless the services are performed outside the residence country, and the individual performing the services has a fixed base regularly available to him in the second country for the purpose of performing the activities. In that case, the nonresidence country can tax only that portion of the individual's income which is attributable to the fixed base. The effect of the deferred payment rules and the deferred gain rules for determining U.S.-effectively connected income under the Code (sec. 864(c)(6) and (7)) on Dutch residents eligible for treaty benefits are dealt with in Article 24 (Basis of Taxation) of the proposed treaty.

The proposed treaty generally provides a broader exemption from source country tax for income from independent personal services than Article XVI of the present treaty provides for income from personal services income other than employment income. Generally, under the present treaty, an exemption from tax in one country is available to a resident of the other country only if his stay in the first country does not exceed 183 days. Thus the present treaty does not contain the fixed base limitation found in the proposed treaty.

The exemption from source country tax provided in the proposed treaty for independent personal services income is somewhat different than that contained in either the OECD or the U.S. model treaties, which also differ as between themselves. The differences are as follows: Under the U.S. model, the nonresidence country may only tax income from independent personal services if the services are performed there; under the OECD model, the nonresidence country may tax income from services provided in the residence country, assuming that the fixed base requirement is otherwise met.

For purposes of this article, independent personal services include independent scientific, literary, artistic, educational, or teach-

ing activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

Article 16. Dependent Personal Services

Under the proposed treaty, wages, salaries, and other similar remuneration derived from services performed as an employee in one country (the source country) by a resident of the other country will be taxable only in the country of residence if three requirements are met: (1) the individual is present in the source country for fewer than 184 days during the taxable year concerned; (2) his employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country. This degree of limitation on source country taxation is consistent with the present treaty, as well as the U.S. and OECD models.

The proposed treaty provides that compensation derived from employment as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only in the employee's country of residence.

This article is modified in some respects for directors' fees (Article 17), pensions (Article 19), government service (Article 20), and income of entertainers or athletes (Article 18) and teachers or researchers (Article 21).

Article 17. Directors' Fees

Under the proposed treaty, directors' fees and other remuneration derived by a resident of one country for services rendered in the other country as a member of the board of directors, a *bestuurder*, or a *commissaris* of a company which is a resident of that other country may be taxed in that other country.[38] However, the country where the recipient resides has exclusive taxing jurisdiction over directors' fees where the services are performed in that country.

This treaty rule for directors' fees differs from that of the present treaty and the U.S. model treaty. These generally treat directors' fees as personal service income. The proposed treaty rule also differs from the OECD model treaty, which places no limits on the ability of the country of residence of the company to tax the fees of that company's directors.

Article 18. Artistes and Athletes

Like the U.S. and OECD models, the proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes," or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 14 and 15) and business profits (Article 7) and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

[38] These Dutch terms refer to members of, respectively, the board of managing directors, or the board of supervisory directors, of a Dutch company.

Under this article, one country may tax an entertainer who is a resident of the other country on the income from his or her personal services as an entertainer in the first country during any year in which the gross receipts derived by him from such activities, including his reimbursed expenses, exceed $10,000 or its Dutch guilder equivalent. (As discussed below, the competent authorities may under certain circumstances adjust this threshold.) Thus, if a Dutch entertainer maintained no fixed base in the United States and performed (as an independent contractor) for one day of a taxable year in the United States for gross receipts of $2,000, the United States could not tax that income. If, however, that entertainer's gross receipts were $30,000, the full $30,000 (less appropriate deductions) would be subject to U.S. tax. This provision does not bar the country of residence from also taxing that income (subject to a foreign tax credit. (See Article 25 (Methods of Elimination of Double Taxation), below.)

The proposed treaty provides that if an entertainer or athlete is exempt under the treaty from tax in the source country because gross receipts do not exceed $10,000, the exemption can be applied by means of a refund of tax which may have been levied at the source. The refund application much be lodged after the end of the calendar year concerned, and within 3 years after that year.

The proposed treaty provides that where income in respect of activities exercised by an entertainer or athlete in his or her capacity as such accrues not to the entertainer or athlete, but to another person, that income may be taxed by the country in which the activities are exercised unless it is established that neither the entertainer or athlete nor persons related to him or her participate directly or indirectly in the profits of that other person in any manner, including the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income, or other income distributions. (This provision applies notwithstanding the business profits and independent personal service articles (Articles 7 and 15).) This provision prevents certain performers and athletes from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a third entity such as a personal holding company or a trust located in a country that would not tax the income.

The foregoing provisions are similar to provisions in the U.S. and OECD model treaty articles dealing with entertainers and athletes.

Article 19. Pensions, Annuities, Alimony

Under the proposed treaty, pensions and other similar remuneration beneficially derived by a resident of either country in consideration of past employment generally are subject to tax only in the recipient's country of residence. This rule is subject to the provisions of Article 20 (Government Service). Thus it generally does not apply, for example, in the case of pensions paid to a resident of one country attributable to services performed for government entities of the other, unless the resident of the first country is also a citizen of the first country.

Unlike the U.S. and OECD models, the proposed treaty allows source country taxation of a pension or similar remuneration in limited circumstances. That is, the nonresidence country may tax

remuneration paid in consideration of employment exercised in that country, if several conditions are met. First, the individual deriving this remuneration must have been a resident of the source country at some time during the 5-year period preceding the date of payment. Second, the remuneration must be paid in a form other than periodic payments, or paid as a lump sum in lieu of the right to receive an annuity. Third, the source country may not tax the portion of the remuneration or lump sum that is contributed to a pension plan or retirement account under such circumstances that, had the amount been received from a payer in the recipient's residence country, the imposition of tax on the payment by that country would be deferred until the amount of the payment was withdrawn from the pension plan or retirement account to which it was contributed.

Pensions and other payments under the provisions of a public social security system of a treaty country (and other public pensions[39]) paid by one country to an individual who is a resident of the other country or to a U.S. citizen will be taxable only in the paying country. (This rule is also subject to the provisions of Article 20 (Government Service).) This rule, which is not subject to the saving clause, exempts U.S. citizens and residents from U.S. tax on Dutch social security payments. Under this rule, only the United States may tax U.S. social security payments to U.S. persons residing in the Netherlands. The rule thus safeguards the United States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by nonresident individuals, while protecting any such individuals residing in the Netherlands from double taxation.

The proposed treaty provides that annuities may be taxed only in the country of residence of the person who beneficially derives them. (This rule is also subject to the provisions of Article 20 (Government Service).) An annuity is defined as a stated sum payable periodically at stated times during life or a specified or ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

The proposed treaty provides for the treatment of alimony, unlike the present treaty. Following the U.S. model treaty, the proposed treaty grants exclusing taxing rights with respect to alimony to the treaty country of residence of the recipient of the alimony. The term "alimony" as used in the article means periodic payments (made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support) that are taxable to the recipient under the laws of the country of which he is a resident. Unlike the U.S. model, child support payments are not covered in this article. Thus, to the extent that they are treated as income, they are covered only in Article 23 (Other Income).

Article 20. Government Service

The proposed treaty contains the standard provision that generally exempts the wages of employees of one country from tax by

[39] According to the Understanding, it is understood that the term "other public pensions" is intended to refer to U.S. tier 1 Railroad Retirement benefits.

the other country. Under the proposed treaty, remuneration, other than a pension, paid by a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) will generally be taxable in that country only. However, such remuneration will be taxable only in the other country (the country that is not the payor) if the services are rendered in that other country and the individual is a resident of that other country who either (1) is a national of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, the Netherlands would not tax the compensation of a U.S. citizen and resident who is in the Netherlands to perform services for the U.S. Government and the United States would not tax the compensation of a Dutch citizen and resident who performs services for the U.S. Government in the Netherlands.

Any pension paid by, or out of funds created by, a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) generally will be taxable only in that country. However, such pensions will be taxable only in the other country if the individual is both a resident and a national of that other country.

In the situations described above, the U.S. model treaty allows exclusive taxing jurisdiction to the paying country, but only in the case of payments to one of its citizens.

If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature), the provisions of Articles 16 (Dependent Personal Services), 17 (Directors' Fees) and 19 (Pensions, Annuities, Alimony) will apply to remuneration and pensions for services rendered in connection with the business.

Article 21. Professors and Teachers

The treatment afforded professors and teachers under the proposed treaty, corresponds generally to the treatment afforded them under the present treaty. There is no corresponding language in the U.S. or OECD models, although other U.S. treaties provide similar benefits.

Under the proposed treaty, an individual who visits the other country (the host country) for a period not more than two years for the purposes of teaching or engaging in research at a university, college, or other recognized educational institution, and who was immediately before that visit a resident of the other treaty country will under certain circumstances be exempt from tax in the host country on remuneration for such work. Eligibility for this treaty benefit is contingent on the length of stay in the host country. It applies only for a period not more than two years from the date he first visits the host country for this purpose. Moreover, if the visit exceeds two years, the host country may tax the individual under its internal law for the entire period of the visit, unless in a particular case the competent authorities of the two countries agree otherwise.

A similar rule applies, for example, under Article 20 of the U.S.-U.K. income tax treaty and Article 20 of the U.S.-German income tax treaty. Furthermore, under the former treaty, rules have been

prescribed that prevent an individual from avoiding the tax on income during the initial two years of the visit by exiting the host country briefly before the prescribed period expires, and then returning to continue work there. It is understood that similar rules would apply under the proposed treaty.

The exemption in this article does not apply to income from research if the research is undertaken not in the public interest but primarily for the private benefit of a specific person or persons. According to the Technical Explanation, the benefits of this article also will not be available to a person who during the immediately preceding period enjoyed the benefits of the other host country tax reductions described below, applicable to students and trainees.

Host country benefits are afforded by this article to any person who is neither a host-country citizen nor, where the United States is the host country, a lawful permanent resident of the United States, without regard to the saving clause.

Article 22. Students and Trainees

Like Article XVIII of the present treaty, the proposed treaty provides host country tax exemptions for temporarily visiting students, researchers, and trainees, with respect to certain amounts they receive that are either remittances from abroad, grants, or compensation for services they perform. The U.S. and OECD models also provide for some host-country exemptions for students and trainees, but the proposed treaty is more restrictive of host-country tax jurisdiction.

Under the proposed treaty, an individual temporarily present in a treaty country for full-time study at a recognized university, college, or school, or for training as a business apprentice, and who, immediately before visiting the host country, is a resident of the other treaty country, is exempt from host country tax on certain payments he or she receives for such time as may be reasonable or customarily required to effectuate the purpose of the visit. Where this rule applies, the host country may not tax remittances from abroad for the purpose of the individual's maintenance, education, or training. Nor may the host country tax any remuneration for personal services performed in the host country for any taxable year in an amount that does not exceed $2000 or its Dutch guilder equivalent. (As discussed below, the competent authorities may under certain circumstances adjust this threshold.)

A host country exemption is also available for temporary visitors engaged in study, research, or training solely as the recipient of a non-profit-sector grant, allowance, or award. The exemption applies, as above, only if immediately before visiting the host country the individual is a resident of the other treaty country. It applies only if the individual is present in the host country for not more than three years for the purposes of study, research, or training solely as a recipient of a grant, allowance, or award from a scientific, educational, religious or charitable organization or under a technical assistance program entered into by one of the countries, or one of their political subdivisions, or local authorities.[40]

[40] In contrast to the time limit under Article 21, if the visitor exceeds this time limit, his or her eligibility for benefits with respect to the first three years is not thereby eliminated.

Where this rule applies, the host country may not tax the amount of the grant, allowance or award. Nor may the host country tax any remuneration for personal services performed in the host country for any taxable year, provided that the services are in connection with the study, research or training or are incidental thereto, in an amount that does not exceed $2000 or its Dutch guilder equivalent.

Benefits under this article will not be available to a person who during the immediately preceding period enjoyed the benefits of the host country tax reductions, described above in connection with article 21, applicable to professors and teachers.

Host country benefits are afforded by this article to any person who is neither a host-country citizen nor, where the United States is the host country, a lawful permanent resident of the United States, without regard to the saving clause.

Article 23. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or the Netherlands. This article is substantially identical to the corresponding article in the U.S. model treaty.

As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country will be taxable only in the country of residence. This rule, for example, gives the United States the sole right under the treaty to tax income derived from sources in a third country and paid to a resident of the United States. This article is subject to the saving clause, so U.S. citizens who are Dutch residents would continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to the Netherlands.

The general rule just stated does not apply to income (other than income from real property (as defined in Article 6)) if the recipient of the income is a resident of one country and carries on business in the other country through a permanent establishment or a fixed base, and the income is attributable to the permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, will apply. The effect of the deferred payment rules and the deferred gain rules for determining U.S.-effectively connected income under the Code (sec. 864(c)(6) and (7)) on Dutch residents eligible for treaty benefits are dealt with in Article 24 (Basis of Taxation) of the proposed treaty. The prohibition on taxation by the country other than the residence country does apply, however, to income from real property that such country is not given permission to tax under Article 6. An example of such income is income from real property located in a third country.

Article 24. Basis of Taxation

This article contains the "saving clause" and the rules relating to deferred payments or gains. It also requires the countries to reach (absent the enactment of new Dutch legislation) an addi-

tional agreement to prevent tax avoidance or evasion that might otherwise be facilitated by the proposed treaty.

Saving clause

Like all U.S. income tax treaties, the proposed treaty is subject to a "saving clause." Under this clause, with specific exceptions described below, the treaty is not to affect the taxation by either treaty country of its residents or its nationals. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of the Netherlands as if the treaty were not in force. "Residents" for purposes of the treaty (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals who are not treated as residents of the other country under the treaty tie-breaker provisions governing dual residents (paragraphs 2-4 of Article 4 (Residence)).

Under Code section 877 ("Expatriation to avoid tax"), a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The proposed treaty contains the standard provision found in the U.S. model and most recent treaties specifically retaining the United States's right to tax former citizens. However, unlike the model provision, the provision in the proposed treaty does not apply to a national of the Netherlands. Even absent a specific provision the Internal Revenue Service has taken the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).

Exceptions to the saving clause are provided for certain benefits conferred by the treaty, namely: correlative adjustments to the income of enterprises associated with other enterprises the profits of which were adjusted by the other country (Article 9, paragraph 2); exemption from residence country tax (or in the case of the United States, citizenship country tax) on social security benefits and other public pensions paid by the other country (Article 19, paragraph 4); relief from double taxation (Article 25); nondiscrimination (Article 28); and mutual agreement procedures (Article 29).

In addition, the saving clause does not apply to the following benefits conferred by one of the countries with respect to an individual who is neither a citizen of the conferring country nor, the case of the United States, a "lawful permanent resident" in the conferring country: exemption from tax on compensation from government service to the other country (Article 20)); exemption from host country tax on certain income received by temporary visitors who are teachers, researchers, students, trainees, and business apprentices (Articles 21 and 22); and certain fiscal privileges of diplomats referred to in the treaty (Article 33). The term "lawful permanent resident" is defined under the Code and generally has the same meaning as the term "immigrant status" used in the corresponding provision of the U.S. model treaty. For U.S. purposes, an individual has "immigrant status" in the United States if he or she has been admitted to the United States as a permanent resident under U.S. immigration laws (i.e., he holds a "green card").

The exceptions to the saving clause in the proposed treaty generally are consistent with the U.S. model and recent U.S. treaties. By contrast, although the double taxation provisions in paragraphs (2) and (3) of Article XIX of the present treaty afford protections to citizens, residents and corporations with respect to tax imposed by their home country, the saving clause in paragraph (1) of Article XIX of the present treaty sets forth only one exception (which applies to the governmental employment income of a dual citizen individual).

Deferred income

In several proposed treaty provisions, a resident of one country is exempted from taxation by the other country unless the tax is on income attributable to a permanent establishment that the person has, or a fixed base available to the located person, in that other country.[41] However, the internal laws of the United States or the Netherlands may impose tax on income that, because of the date on which it is realized, has a nexus to a permanent establishment or fixed base that no longer exists. Or internal laws may impose tax on gains from the disposition of property that was associated with a permanent establishment or fixed base, but is not so associated at the time of its disposition.[42] This article provides rules for the taxation of income in these types of cases.

For purposes of implementing the proposed treaty provisions referred to above, any income, gain, or expense attributable to a permanent establishment or fixed base during its existence is taxable or deductible in the country where that permanent establishment or fixed base is situated, even if the payments are deferred until such permanent establishment or fixed base has ceased to exist. (This rule does not affect internal law rules regarding the accrual of income and expense.) Thus, the treaty permits the United States to apply the principles of Code section 864(c)(6) to the profits that rely for their taxability upon a nexus with a permanent establishment or fixed base.[43]

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[41] See paragraphs 1 and 2 of Article 7 (Business Profits), paragraph 5 of Article 10 (Dividends), paragraph 3 of Article 12 (Interest), paragraph 3 of Article 13 (Royalties), paragraph 3 of Article 14 (Independent Personal Services), and paragraph 2 of Article 23 (Other Income).

[42] As described above, for example, the Code as amended by the Tax Reform Act of 1986 (the "1986 Act") provides that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition, the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

[43] With respect to the language in the proposed treaty that conforms to the U.S. model, it is understood that no change to that language is necessary to conform the treatment of income derived from independent personal services with Code section 864(c)(6). An analogous rule applies to income for a taxable year from independent personal services performed in another year in which a fixed base was available. If a treaty country resident receives income for independent activities rendered by that resident, and the activities were performed in the other treaty country in a year during which the resident was present in the second country for more than 183 days (or the resident maintained a fixed base in the second country for more than 183 days), then that income is taxable by the second treaty country, regardless of whether payment for the activities was deferred to years in which the resident had no presence in the second country. (See Rev. Rul. 86-145, 1986-2 C.B. 297.)

In the case of gain realized on the disposition of property previously used or held in connection with a permanent establishment or fixed base, the proposed treaty is more restrictive on the operation of internal U.S. law. Under the proposed treaty, gains from the alienation of personal property that at any time formed part of the business property of a permanent establishment or fixed base that a resident of one of the treaty countries has, or had, in the other country may be taxed by that other country, but only to the extent that the gain is attributable to the period in which the personal property in question formed part of the business property of the permanent establishment or fixed base. Moreover, the tax may not be imposed on such gains at the time when realized and recognized under the laws of that other country if that date is more than 3 years from the date on which the property ceased to be part of the business property of the permanent establishment or fixed base. Thus, the proposed treaty substantially shortens the 10-year window, following removal of the property from the U.S. business, in which a disposition of the property by a Dutch resident remains subject to U.S. tax, as well as limiting the portion of the gain subject to U.S. tax.

There is neither a U.S. nor OECD model provision permitting imposition of a rule like the U.S. rule addressed by this provision of the proposed treaty. In several cases, U.S. treaties that have been updated by provisions now in force to take into account the 1986 Act amendments do not permit imposition of the rule,[44] or permit only limited imposition.[45]

Prevention of tax avoidance or evasion

The staff understands that, from the perspective of the Administration, the proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and the Netherlands. However, the staff also understands that a taxpayer might attempt to use the proposed treaty, or the present Dutch treaty, in order to avoid all tax on U.S. income. As discussed more fully below in connection with Article 25 (Methods of Elimination of Double Taxation), a Dutch resident may in some cases be exempt from Dutch tax on foreign (i.e., non-Dutch) income. Assume that a Dutch corporation establishes a permanent establishment (i.e., a branch) outside the Netherlands such that neither the Netherlands nor the place where the branch is located taxes its income. The branch earns U.S. source income of a type that may be entitled to treaty relief from U.S. tax under a U.S.-Dutch treaty like the present or proposed treaties.

For U.S. tax purposes, the branch is not a "person" subject to tax. The corporation of which the branch is a part is treated as earning the income earned by the branch. Since the corporation is a Dutch resident, it may be that the present or proposed treaty requires the United States to reduce or eliminate its tax on the income of the branch, even though the branch's income is not subject to significant tax by any country other than the United States.

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[44] See the treaties with France, Indonesia, and Tunisia.
[45] See the U.S.-German income tax treaty.

Neither the present nor the proposed treaty denies U.S. tax reductions generally in cases where Dutch residents pay little or no tax outside the United States. The limitation on benefits article in the U.S. model, on the other hand, provides that any relief from tax provided by the United States to a resident of the other country under the treaty shall be inapplicable to the extent that, under the law in force in that other country, the income to which the relief relates bears significantly lower tax than similar income arising within that other country derived by residents of that other country.

In recognition of this problem with the proposed treaty as signed, this article of the treaty provides that either additional Dutch laws must be enacted to prevent income tax avoidance or evasion in certain cases, or the two countries must agree on a provision aimed at such income tax avoidance or evasion, which agreement must be laid down in a separate protocol to the proposed treaty.

The Dutch law or protocol to be adopted must, under the terms of the proposed treaty, deal with the situation where a Dutch enterprise derives foreign-source interest or royalties attributable to a permanent establishment in a third country, and the permanent establishment is both exempt from Dutch tax, and subject to special or low taxation because of a "tax haven" regime. The latter term includes, but is not necessarily limited to, regimes intended to encourage use of the third country for tax avoidance purposes with respect to investment income. [A proposed protocol amending the treaty for this purpose was signed October 13, 1993. Its terms are discussed below in Part V of this pamphlet.

Article 25. Methods of Elimination of Double Taxation

U.S. internal law

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign source income. An indirect or "deemed-paid" credit is also provided. 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 an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid, or deemed to have been paid, by the foreign corporation on its accumulated earnings. (The foreign corporation may be deemed to have paid taxes paid by lower-tier foreign corporations.) The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received.

Only income tax (or tax in lieu thereof) is creditable

The foreign tax credit is available only for income, war profits, and excess profits taxes paid or accrued (or deemed paid) to a foreign country or a U.S. possession and for certain taxes imposed in lieu of them (secs. 901(b) and 903). Other foreign levies generally are treated as deductible expenses only. To be creditable, a foreign

levy must be the substantial equivalent of an income tax in the U.S. sense, whatever the foreign government that imposes the levy may call it. To be considered an income tax, a foreign levy must be directed at the taxpayer's net gain.

Treasury regulations promulgated under sections 901 and 903 provide detailed rules for determining whether a foreign levy is creditable (Treas. Reg. secs. 1.901-1 through 1.901-3, and 1.903-1). In general, a foreign levy is creditable only if the levy is a tax and its predominant character is that of an income tax in the U.S. sense. A levy is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country, such as the right to extract petroleum owned by the foreign country. The predominant character of a levy is that of an income tax in the U.S. sense if the levy is likely to reach net gain in the normal circumstances in which it applies and the levy is not conditioned on the availability of a foreign tax credit in another country.

Taxpayers who are subject to a foreign levy and also receive, directly or indirectly, a specific economic benefit from the levying country are referred to as dual capacity taxpayers. Dual capacity taxpayers may obtain a credit only for that portion of the foreign levy that they can establish is a tax and is not compensation for the specific economic benefit received. A taxpayer may so establish that a payment is a tax rather than compensation for a specific economic benefit received, under either a facts and circumstances method or under an elective safe harbor method.

A tax paid in lieu of a tax on income, war profits, or excess profits may constitute a creditable foreign tax. A foreign levy is a creditable tax "in lieu of" an income tax under the regulations only if the levy is a tax and is a substitute for, rather than an addition to, a generally imposed income tax. A foreign levy may satisfy the substitution requirement only to the extent that it is not conditioned on the availability of a foreign tax credit in another country.

Not all U.S. tax may be offset by credit

A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. Moreover, the foreign tax credit provisions contain rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee.

The foreign tax credit limitation generally is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income, subject to separate limitation rules. The limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the crediting of foreign taxes on certain types of traditionally high-taxed foreign source income against the U.S. tax on certain types of traditionally low-taxed foreign source income. Also, a special lim-

itation applies to the credit for foreign taxes imposed on oil and gas extraction income (Code sec. 907). Amounts claimed as taxes paid on such extraction income qualify as creditable taxes (if they otherwise so qualify) only to the extent they do not exceed the product of the highest U.S. corporate tax rate times the amount of that income. Excess amounts generally are neither creditable nor deductible, except to the extent that they may be carried over to another year.

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit alternative minimum tax (determined without regard to the net operating loss deduction). However, no such limitation will be imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met. The 90-percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

Dutch law

The Netherlands unilaterally mitigates double taxation in several ways. First, the general rule of Dutch law that mitigates double corporate-level taxation—the so-called "participation exemption"—generally exempts a taxable Dutch company from corporate income tax on income (including dividends and stock gains) derived in connection with a "participation" in another entity, including in many cases a foreign company. A participation may be deemed to exist on the basis of a 5-percent or more shareholding in the entity. Where the entity is foreign, the entity must be subject to certain types of foreign tax law in order for the participation exemption to apply.

Certain other types of foreign income of a Dutch resident (such as business profits derived through a foreign permanent establishment, income from employment abroad, or income from foreign real property) may be unilaterally exempt from Dutch tax on a pro rata basis. That is, Dutch tax on worldwide income is reduced in the same proportion that exempt foreign income bears to worldwide income. This is also referred to as "exemption with progression," in light of the fact that all worldwide income is included in the tax base for purposes of determining the marginal rate of Dutch tax that applies. Finally, foreign withholding taxes on certain dividends, interest, and royalties are in some limited cases (generally inapplicable to U.S. source items) unilaterally creditable against Dutch tax.

Treaty rules

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles of the proposed treaty that limit the right of a source country to tax

income. This article provides further relief where both the Netherlands and the United States would otherwise still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that this article applies.

The present treaty provides separate rules for relief from double taxation for the United States and the Netherlands. The present treaty generally provides for relief from double taxation of U.S. residents and citizens by the United States permitting a credit against its tax for the appropriate amount of taxes paid to the Netherlands on income from Dutch sources, but not to exceed that proportion of U.S. tax which income from Dutch sources bears to worldwide income. The present treaty generally provides for relief from double taxation of Dutch residents by requiring the Netherlands to provide, as far as may be in accordance with Netherlands law, a deduction from Dutch tax with respect to U.S. source income, in order to take into account U.S. federal income taxes paid. This in effect confirms that a Dutch resident is entitled to "exemption with progression" on U.S. source income to the extent allowed under Dutch internal law, if such income is "subject to tax" by the United States as that concept is used in Dutch law. Since exemption is not generally applicable to foreign source dividends, the present treaty additionally provides at least a partial (pro rata) exemption from Dutch tax on a dividend paid by a U.S. corporation, but the Dutch tax reduction is no greater than 15 percent of the dividend. Given the potential Dutch and U.S. taxes that are likely to be imposed on the U.S. source dividend income of a Dutch resident under the present treaty, this provision of the present treaty requires the Netherlands to provide double taxation relief similar to a foreign tax credit.

The proposed treaty modifies the system of the present treaty. The modifications include allowing a U.S. credit for the Dutch state profit share in profits from natural resources, and amending the rule applicable to U.S. citizens resident in the Netherlands.

United States

Foreign tax credit generally

The proposed treaty contains a general provision (paragraph 4 of Article 25) under which the United States must allow a national or resident a foreign tax credit for the appropriate amount of income taxes imposed by the Netherlands. (U.S. credits for the Dutch profit share generally are dealt with in paragraph 5 of Article 25, which is discussed below.) The proposed treaty also requires the United States to allow the deemed-paid credit, with respect to the appropriate amount of Dutch tax, to any U.S. corporate shareholder of a Dutch company who receives dividends in any taxable year from that company if the U.S. company owns 10 percent or more of the voting stock of the Dutch company.

The credit generally is to be computed in accordance with the provisions and subject to the limitations of U.S. law (as those provisions and limitations may change from time to time without changing the "general principles hereof"). This provision is similar to those found in many U.S. income tax treaties. Exceptions to this

principle are provided in cases involving credits for Dutch taxes imposed on the capital gains, or pension income, of a U.S. resident who resided in the Netherlands during the previous 5 years, under the circumstances where the treaty permits otherwise-forbidden source country taxation (Articles 14(9) and 19(2)).

The "appropriate amount" is to be based on the amount of income tax paid or accrued to the Netherlands, but the credit will not exceed the limitations (for the purpose of limiting the credit to the U.S. tax on foreign source income) provided by U.S. law for the taxable year. Under the proposed treaty, an additional provision applies to computation of foreign tax credit limitations with respect to credits for Dutch corporate income tax. This provision is discussed below in connection with the description of the proposed treaty provisions requiring U.S. foreign tax credits for the profit share.

The general provision of the double taxation article provides that Dutch taxes covered by the treaty (Article 2 (Taxes Covered)) are to be considered income taxes for purposes of the U.S. foreign tax credit. Unlike the U.S. model treaty and the present treaty, the proposed treaty does not contain the rule that credits allowed solely by reason of this article, when added to otherwise allowable credits for taxes covered by the treaty, may not in any taxable year exceed that proportion of the U.S. tax on income that Dutch source taxable income bears to total taxable income. Thus, under the general credit provision, any credit allowed solely by the treaty and not by the Code alone (e.g., a credit for the Dutch profit share) could be used to offset U.S. tax on income from third-country foreign sources, unless another limitation is provided for under the proposed treaty. Of the covered taxes under the treaty, apparently only the profit share may not be creditable for U.S. Code purposes. Thus, there are no credits allowed by paragraph 4 of Article 25 of the proposed treaty that are not allowed by the Code, unless that paragraph provides a U.S. foreign income tax credit for the profit share, and the profit share is not creditable under the Code. The staff understands that there was no intention to require that the profit share be creditable against U.S. income tax except to the extent, discussed in detail below, that such a credit is provided for in paragraph 5.

Dutch state profit share from exploitation of natural resources

In addition to income tax, the Netherlands collects a share of the profits from exploitation of natural resources in the Netherlands (including the Dutch part of the continental shelf). This levy is sometimes referred to as the "state profit share" or "profit share," and it generally affects oil and gas extraction income. Under the proposed treaty, a foreign tax credit will be allowed for the profit share when paid or accrued by U.S. nationals or residents, subject to limitations described below. In the absence of the proposed treaty, it is understood that the Dutch state profit share may not be creditable under U.S. Treasury Department regulations. The profit share is levied in addition to the regular Dutch corporate income tax. However, in computing the profit share the Netherlands allows a credit for corporate income tax paid. In computing the corporate income tax, the Netherlands allows a deduction for the profit share.

(Simultaneous equations must therefore be solved.) The rate and the income base for computing the profit share depend upon whether it is imposed under the Royal Decree of 1967 (which has a 50-percent rate) or the Royal Decree of 1976 (which has a 70-percent rate). In either case, special deduction and allowance rules different than those that apply in computing income tax may apply in computing the profit share. While it is no longer U.S. treaty policy generally to provide a credit for foreign levies on oil and gas extraction income like the Dutch state profit share, the U.S. income tax treaties with the Netherlands' North Sea competitors, the United Kingdom and Norway, do so.

Under the proposed treaty, the amount of U.S. tax credit allowed for the Dutch state profit share is limited with the intention that credits for Dutch income tax and the Dutch state profit share will shelter from U.S. tax an amount of income from activities subject to the profit share no greater than the Dutch source income (before deducting the profit share) from activities subject to the profit share. Such a limitation is similar in effect to that imposed under Code section 907 on the amount of the foreign tax credit allowed for foreign taxes paid on foreign oil and gas extraction income although, unlike the section 907 limitation, it operates on a per-country basis. It also resembles the limitations on the U.S. foreign tax credit for taxes on foreign oil and gas extraction income that are contained in the U.S. income tax treaties with the United Kingdom and Norway.

In the case of income subject to the profit share, the foreign tax credit may consist of a credit for the profit share and for the Dutch corporate income tax. Like the U.S.-U.K. treaty and unlike the U.S.-Norway treaty, the proposed treaty provides separate, but coordinated, limitations on the credits for each tax. In contrast to the U.K. treaty, the proposed treaty does not nominally direct the United States to allow a profit share credit to the extent of the residual U.S. tax liability on a single base comprised of Dutch source income, after credits for Dutch corporate income tax. Instead, the proposed treaty divides Dutch source income into two separate components: the "creditable profit share income base" and the "creditable company income tax base." Credits are allowed for the relevant Dutch levy up to the U.S. rate times the relevant base. In effect, the result is intended to be the same as if credit for the profit share cannot exceed the product of the maximum U.S. income tax rate (currently 35-percent in the case of a corporation) times Dutch-source income subject to the profit share (before deducting the profit share), less the Dutch corporate income tax. Further, credit for the Dutch corporate income tax on such income cannot, in effect, exceed the product of the maximum U.S. income tax rate and the Dutch-source income subject to the profit share (before deducting the profit share).

As mentioned above, the profit share credit limitation is based on the product of the U.S. rate and the creditable profit share income base. That base is defined as the excess of Dutch-source income subject to the profit share (before deducting the profit share) over the creditable company income tax base. The staff understands that for this purpose and for purposes of the rules described below, the Treasury Department intends that the amount of Dutch-source

income be computed on a net basis, under U.S. tax accounting principles, as is true generally for foreign tax credit purposes under the Code.[46]

The creditable company income tax base is defined as the product of the Dutch-source income subject to the profit share (before deducting the profit share) and the ratio of the "effective company income tax rate" to the maximum applicable U.S. tax rate. The effective company income tax rate is defined as the Dutch company tax on income subject to the profit share, divided by income subject to the profit share (before deducting the profit share).

The proposed treaty provides that the creditable amount of profit share is also subject to any other foreign tax credit limitations imposed by U.S. law, as it may be amended from time to time. A similar rule (described above in connection with paragraph 4 of Article 25) applies to credits for company tax. However, in applying the Code limitations to the Dutch corporate tax in a case where the profit share applies, the proposed treaty requires use of the creditable company income tax base. Because the Dutch company tax generally is imposed at a nominal 35-percent rate on a base from which the profit share is deducted, while under the treaty the U.S. foreign tax credit limitation will generally be computed by applying a nominal 35-percent (U.S.) rate to a base from which the profit share is *not* deducted, it may be typical for the ratio of the effective company income tax rate to the U.S. rate to be less than one. In such a case the creditable company income tax base will be less than Dutch-source income subject to the profit share (before deducting the profit share). As mentioned above, the creditable company income tax base is used in computing the U.S. foreign tax credit limitation that applies to the company tax. Thus, under the proposed treaty, a type of per-country limitation applies to the Dutch corporate income tax which may be less than the per-country limitation that would apply if sections 902, 904(a), (b) and (c), 907, and 960 of the Code were applied separately to Dutch-source income. In such a case credit may be allowed under the treaty for some portion of the Dutch state profit share.

The staff understands that it was intended that the creditable company income tax base will not be *greater* than Dutch-source income subject to the profit share (before deducting the profit share) as determined under the principles of U.S. tax law.

The proposed treaty permits a carryback and carryover of Dutch profit share that, under the special limitation, cannot be credited in the year paid or accrued. These taxes may be carried to those years specified under U.S. law (currently, the two preceding years and the five succeeding years) and credited in those years only against the U.S. tax on the creditable profit share income base (if any) for those years. An additional two-percent limitation on the amount of the carryback and carryover, included in the U.S. treaties with Norway and the United Kingdom, is omitted from the proposed protocol, reflecting the 1982 repeal of the corresponding carryback and carryover provisions of Code section 907 of the two-percent limitation. No deductions are allowed with respect to income taxes or profit share paid or accrued for a year with respect

[46] *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989).

to which credits are claimed for any amount of the profit share. Any profit share for which a credit is claimed under paragraph 5 of Article 25 is not creditable under the general foreign tax credit provision in paragraph 4. The staff understands that no profit share is creditable except to the extent that it is creditable after application of the special profit share limitations described above.

The Netherlands

In general, the proposed treaty requires the Netherlands to continue to employ its "exemption with progression" method with respect to most U.S. income, as it does under the present treaty and internal Dutch law. As explained above, under the exemption with progression method the income, while exempt from tax, is taken into the tax base for purposes of determining the proportion by which Dutch tax is reduced. However, while the present treaty simply confirms that Dutch internal law applies to U.S. source income, the proposed treaty specifies items of U.S. income to which the exemption with progression method will apply (regardless of internal Dutch law): if a Dutch resident or national earns income taxable by the United States under specified provisions of the proposed treaty, and such income is included in the taxpayer's Dutch tax base, then the Netherlands will reduce its tax in conformity with its internal law for the avoidance of double taxation. The income to be so treated includes income from U.S. real property and from employment in the United States. It includes business profits, dividends, interest, royalties, and income not dealt with in a specific article of the treaty, derived in connection with a business carried on through a U.S. permanent establishment. It includes income from the performance of independent personal services (insofar as such income is subject to U.S. tax), dividends, interest, royalties, and income not dealt with in a specific treaty article, in connection with a fixed base in the United States used in the performance of services.[47] It includes income from government employment and payments out of the U.S. social security system or other public pensions. To the extent that these latter payments are exempt from Dutch tax under the proposed treaty and also not subject to the saving clause, the proposed treaty nevertheless permits the Netherlands to include them in the Dutch tax base for purposes of computing the pro rata exemption.

Partial exemptions—in some cases the equivalent of a foreign tax credit—must be afforded to dividends and to income of entertainers, athletes, and corporate directors taxable at source by the United States under articles 10, 17, and 18. In the case of dividends, the Netherlands generally is obligated, as under the present treaty, to reduce otherwise applicable Dutch tax by a percentage of the dividend corresponding to the source country tax that the United States is permitted to impose, but not more than 15 percent. The Netherlands generally also is obligated to reduce Dutch tax on the income of entertainers, athletes, and directors by the amount of U.S. tax actually paid on that income in accordance with the treaty

[47] In a case where income is deemed to be earned in connection with a permanent establishment or a fixed base under the offshore activities article (Article 27), the Dutch tax reduction is contingent on the production of documentary evidence that tax has been paid in the United States.

articles dealing with those items of income. As is true in the case of the items exempted from Dutch tax, the treaty reduction of Dutch tax is only required to the extent that the items are included in the Dutch tax base. Moreover, the Netherlands is not required to reduce its tax on such items to a greater extent than would be required if these items of income (and only these items) were exempt from Dutch tax under internal Dutch law for the avoidance of double taxation.

U.S. citizens resident in the Netherlands

The proposed treaty, like other U.S. treaties, contains a special rule for U.S. citizens who are Dutch residents. In such a case the Netherlands will permit the U.S. citizen a credit against Dutch tax imposed on certain income that arises in the United States. This credit is limited to the tax that the citizen would have paid if he were not a U.S. citizen. In addition, the United States will allow the citizen a credit against his U.S. tax for any tax paid to the Netherlands after the Netherlands has allowed the credit for U.S. taxes. The credit comes after the Dutch tax is reduced by the deduction of U.S. taxes. The proposed treaty provides for a limited resourcing of income to give effect to this credit.

Stock gains and pensions taxable at source

As described above, the proposed treaty provides an exception in limited circumstances to the general rule allowing only the residence country to tax stock gains and pensions, which applies only if, among other things, the recipient of the gain or income resided in the other country at some time during the previous five years (Articles 19(2) and 14(9)). The proposed treaty provides that if the country other than that of residence imposes tax under this exception, then that other country must reduce its tax on the income, generally by the tax imposed by the residence country. However, the reduction need not exceed that part of the tax attributable to that income. The proposed treaty provides that, for the exclusive purpose of relieving double taxation in the United States under this provision, the income may be treated as arising in the Netherlands to the extent necessary to avoid double taxation.

Article 26. Limitation on Benefits

In general

The proposed treaty contains a provision, not found in the present Dutch treaty, intended to limit indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in the United States, the Netherlands, or in some cases, another member country of the European Communities (the "EC").[48]

The proposed treaty 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" and refers to the situation where a person who is not a resident of either country seeks cer-

[48] The members of the EC currently are Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom.

tain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident may be able to secure these benefits indirectly by establishing a corporation (or other entity) in one of the 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 (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

Summary of treaty provisions

The proposed new anti-treaty shopping article provides that a treaty country resident is entitled to treaty benefits in the other country only if it fits into one of several categories or otherwise finds favor with that country's competent authority, in the exercise of the latter's discretion. This provision of the proposed treaty is unprecedented among U.S. treaties in its level of detail. In this respect it is in some ways comparable to the regulation under the branch tax definition of qualified resident.[49] In several cases the rules set forth in the regulation and the proposed treaty differ. In other cases, however, the proposed treaty provides opportunities for treaty benefit eligibility which are not necessarily provided under the regulation.

As under other recent treaties, benefits are allowed under the proposed treaty if the resident is an individual, is itself one of the treaty countries or a political subdivision or local authority thereof, or else is a not-for-profit, tax exempt organization that also satisfies an ownership test. Similarly, treaty benefits are allowed to a person that satisfies a public company test or an active business test, or if the competent authority in the source country otherwise agrees to allow such benefits.

Unlike other recent U.S. tax treaties, treaty benefits are also allowed under the Dutch treaty to a company that does not meet the foregoing tests, but that functions as a headquarter company for a multinational corporate group. Treaty benefits are also allowed to a company owned by a limited group of publicly traded companies, including, to some extent, publicly traded companies resident in third countries that are EC members. In addition, treaty benefits are allowed to a company that meets one of two ownership/base erosion tests, both of which take into account payments to persons resident in third countries that are EC members, and one of which, applicable in the case of a Dutch company, takes into account ownership by EC member country residents. Finally, under a provision that is not contained in other treaties, but is similar to a provision of U.S. law, a treaty country resident is entitled to treaty benefits with respect to profits from the operation of ships or aircraft in

[49] Treas. Reg. 1.884-5T.

international traffic (which under the treaty generally are exempt from source country tax) if it meets an ownership test or a public company test that takes into account residents of, and securities markets in, third countries that similarly exempt such income in the hands of nonresidents.

According to the Understanding, it is understood that a taxpayer claiming benefits under the proposed treaty must be able to provide upon request sufficient proof to establish the taxpayer's entitlement to such benefits. It is further understood, however, that the need to provide proof that a taxpayer fulfills the requirements of this article can impose a severe administrative burden on the taxpayer.

It is understood, therefore, that the competent authorities will endeavor to develop by mutual agreement reasonable procedures for the periodic reporting of the facts necessary to support entitlement to benefits. In developing such procedures, the competent authorities will strive to minimize the frequency of reporting. For example, once an entitlement to benefits has been documented and in the absence of relevant changes in the facts and circumstances, a taxpayer should not be required annually to provide proof that the taxpayer is entitled to the benefits of the proposed treaty, provided that the taxpayer reports relevant changes in facts and circumstances.

Ownership/base erosion tests

Under present U.S. treaties that have a limitation on benefits article, there is usually a single ownership test and a single base erosion payment test, both of which must be met if an entity is to qualify for treaty benefits without recourse to other limitation on benefit rules. Under the proposed treaty, the same is true for a U.S. entity seeking treaty reductions of Dutch tax; however, a Dutch company can qualify for reductions of U.S. tax under the treaty if it meets a base reduction test together with either of two ownership tests.

Ownership tests

To meet the ownership test that can apply to both U.S. and Dutch entities, it is necessary that more than 50 percent of the beneficial interest in that entity be owned directly or indirectly by qualified persons. In the case of a company, qualified persons must own directly or indirectly more than 50 percent of the aggregate vote and value of all of its shares, and more than 50 percent of the shares of any so-called "disproportionate class of shares." For purposes of determining share ownership, the Technical Explanation states that the rules of Code section 883(c)(4) shall be applied, as they are applied for purposes of applying the ownership/base erosion test under the branch tax rules. Those rules treat stock owned (directly or indirectly) by or for an entity as being owned proportionately by its shareholders, partners, or beneficiaries.

If in the case of a Dutch resident company the alternative ownership test is met, along with the base reduction test (described below), then the Dutch company qualifies for reductions of U.S. tax under the dividend, branch tax, interest, and royalties articles of the proposed treaty. To meet the alternative ownership test, Dutch residents who are qualified persons must own directly or indirectly

more than 30 percent of the aggregate vote and value of its shares, and more than 30 percent of the shares of any disproportionate class of shares. Furthermore, more than 70 percent of all such shares must be owned, directly or indirectly, by qualified persons and residents of EC member countries.

As discussed above, a Dutch investment organization known as a *beleggingsinstelling* may be treated for Dutch law purposes in some ways analogously to a RIC under U.S. law; typically, neither type of company pays substantial tax in its country of residence. On the other hand, either type of company may earn foreign source investment income subject to foreign withholding taxes. In order to preserve the benefit of U.S. foreign tax credits for such taxes, U.S. law permits a pass-through of credits for taxes borne by a RIC to its shareholders (Code sec. 853). In order to preserve the benefit of Dutch double tax relief in a case where a *beleggingsinstelling* bears foreign withholding tax, the staff understands that Dutch law provides a benefit directly to the *beleggingsinstelling* that is linked to the amount of benefits that Dutch resident shareholders of the *beleggingsinstelling* would have received had they borne the foreign withholding taxes directly. Thus the degree of Dutch ownership of stock in a *beleggingsinstelling* may be relevant under Dutch law. According to the Understanding, it is understood that the proof such a *beleggingsinstelling* has of the number of its Dutch resident individual and corporate shareholders, as a result of the procedure used by it when claiming a reimbursement of tax withheld on its foreign dividend and interest income, can be used by the *beleggingsinstelling* to show that it meets the ownership tests described above.

Definitions

To be considered an EC member country for this or any other purpose of the limitation of benefits article of the proposed treaty, the country generally must either be the Netherlands or a member of the EC with which both the United States and the Netherlands have in effect a comprehensive income tax treaty. Of the 12 current members of the EC, currently all but Portugal meet these criteria. To be considered a resident of an EC member country for this or any other purpose of the limitation on benefits article of the proposed treaty, a person must be considered a resident of the member country under the principles of Article 4 (Resident) of the proposed treaty. Further, treating the member country as though it were the Netherlands, the person would have to be entitled to benefits under the proposed treaty upon application of the principles of the limitation on benefits rules in the proposed treaty for individuals, governments, tax-exempt non-profits, public companies and their subsidiaries, or under the general ownership/base erosion test that applies to both U.S. and Dutch entities (paragraph 1 of Article 26). Finally, the person must be otherwise entitled to the benefits of the treaty between that person's residence country and the United States.

For purposes of determining whether a company's shares are owned by EC member residents for purposes of the ownership test described above, only those shares are considered that are held by residents of countries with a comprehensive income tax treaty with the United States, and then only if the particular dividend, profit

or income subject to the branch tax, interest, or royalty payment in respect of which treaty benefits are claimed would be subject to a rate of tax under that treaty that is no less favorable than the rate of tax applicable to such company under Articles 10 (Dividends), 11 (Branch Tax), 12 (Interest) or 13 (Royalties) of the proposed treaty. In effect, this rule allows a third-country shareholder to receive "derivative benefits" indirectly with respect to U.S. taxes, under the U.S.-Dutch treaty, in the sense that the right to receive benefits under the U.S.-Dutch treaty derives from the right to benefits that generally would be available under the treaty in force between the United States and the country in which the shareholder resides. Alternatively, this rule allows the Dutch company 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.

The term "qualified person" means a person who is a U.S. citizen or who is entitled to benefits under the proposed treaty as an individual resident of the Netherlands or the United States, a public company or public company subsidiary (as described in the discussion of the public company test below), one of the treaty countries themselves, political subdivisions or local authorities of the countries, a tax-exempt organization (as described in the discussion of qualifying organizations below), or an entity that meets the general ownership test set forth above (not the ownership test described above that applies only to Dutch companies) and the base reduction test described below.

Thus the term "qualified person" is defined in part by reference to whether interests are owned by a qualified person. This circularity of definition may give rise to circumstances in which the question whether or not a person *is* a qualified person is not obviously and unambiguously answered by the words of the proposed treaty themselves. For example, assume that a qualified person is the direct owner of 51 percent of the beneficial interests in a taxable, nongovernmental entity. Assume that the other 49 percent is directly or indirectly owned by persons who are not qualified persons. Assume that the qualified person that owns the 51 percent interest is itself an entity that is a qualified person only by virtue of the direct or indirect ownership of 51 percent, and only 51 percent, of its beneficial interests by qualified persons. Only 26 percent of the beneficial interests in the first entity is ultimately beneficially owned by qualified persons. The staff understands that the first entity in this case should not be considered to meet the ownership test, nor was it the intent of the negotiators for such an entity to be so considered. The staff understands that the intended approach would leave the IRS free to deny qualified person treatment in any case where either indirect or direct owners are predominantly not qualified persons; and that it is in part for this reason that the public company, active business, and other tests are provided in addition to the ownership/base erosion tests. The staff understands that the Treasury Department believes that the intended result follows from the application of Code section 883(c)(4) (as described above) for purposes of determining share ownership.

The term "shares" includes depository receipts or trust certificates for shares. The term "disproportionate class of shares" means any class of shares of a company resident in one treaty country that entitles the holder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other country by particular assets or activities of the company.

Base reduction test

To qualify for treaty benefits under either ownership/base erosion test, the entity must (in addition to meeting one of the ownership tests described above) meet a base reduction test which is related to, but different than, the so-called "base erosion tests" commonly found in recent U.S. treaties, the U.S. model treaty, and the Code. These tests typically are met only if no more than 50 percent of the gross income of the entity is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons or entities other than certain persons entitled treaty benefits. They are intended to prevent a corporation, for example, from distributing (including paying, in the form of deductible items such as interest, royalties, service fees, or other amounts) most of its income to persons not entitled to benefits under the treaty.

A U.S. or Dutch entity meets the base reduction test under the proposed treaty if less than 50 percent of the entity's gross income is used, directly or indirectly, to make deductible payments in the current taxable year to persons that are not qualified persons, as defined above. If a Dutch entity fails the foregoing test, it may satisfy an alternative base reduction test that incorporates a "derivative benefits" concept. A Dutch entity meets the alternative base reduction test if less than 70 percent of its gross income is used, directly or indirectly, to make deductible payments to persons that are not qualified persons, and less than 30 percent of its gross income is used, directly or indirectly, to make deductible payments to persons that are neither qualified persons nor residents of EC member countries, as those terms are defined above. Just as it is understood that indirect ownership of qualified persons by nonqualified persons may affect the application of the ownership test (as discussed above), the staff understands that, to the extent that the ultimate beneficial owner of the recipient of deductible payments is other than a qualified person, it was the intent of the negotiators that at least a portion of the payments received by the recipient may be treated as received by a person other than a qualified person.

For purposes of the base reduction test, the term "gross income" means gross income for the first taxable year preceding the current taxable year,[50] provided that the amount of gross income for the first taxable year preceding the current taxable year will be deemed to be no less than the average of the annual amounts of gross income for the four taxable years preceding the current taxable year. Also for purposes of the base reduction test, the term "deductible payments" includes payments for interest or royalties,

[50] According to the Technical Explanation, the term "first taxable year preceding the taxable year" means the "preceding taxable year." Thus, staff understands that it refers to the taxable year immediately preceding the current taxable year.

but does not include payments at arm's length for the purchase or use of or the right to use tangible property in the ordinary course of business or remuneration at arm's length for services performed in the country of residence of the person making such payments. Types of payments may be added to or eliminated from the exceptions mentioned in the preceding definition of "deductible payments" by mutual agreement of the competent authorities. These limitations do not appear in other U.S. treaties or the model.

For these purposes, the competent authorities may by mutual agreement determine transition rules for newly-established business operations, newly-established corporate groups or newly-established headquarter companies.

Public company tests

Under present U.S. treaties that have a limitation on benefits article, there is usually a rule under which a company is entitled to treaty benefits if sufficient shares in the company are traded actively enough on a suitable stock exchange. Moreover, under the branch profits tax rules in the Code, a company is entitled to treaty protection from the branch tax if it meets such a test or if it is the wholly owned subsidiary of certain publicly traded corporations resident in a treaty country. The proposed treaty has similar rules that apply to U.S. and Dutch companies. In addition, treaty benefits are afforded to companies that are not wholly-owned by a publicly traded company resident in a treaty country, but rather majority-owned by five or fewer such treaty country residents. However, a separate class of potential treaty beneficiaries is distinguished from all other companies for this purpose: so-called "conduit companies," which, in order to obtain treaty benefits by virtue of ownership by publicly traded companies, must also satisfy a so-called "conduit base reduction test." Finally, the proposed treaty contains a special rule for Dutch companies, allowing treaty benefits based on ownership by publicly traded companies resident in EC member countries as well as the United States and the Netherlands.

Publicly traded treaty beneficiary

A company that is a resident of the Netherlands or the United States, the principal class of whose shares is listed on a recognized stock exchange located in either country, and is substantially and regularly traded on one or more recognized stock exchanges (regardless of location), is entitled to the benefits of the treaty regardless of where its actual owners reside or the amount or destination of payments it makes.

Treaty beneficiaries owned by publicly traded companies

A company that is not a conduit company, and that is a resident of the Netherlands or the United States, is entitled to treaty benefits if more than 50 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies which are residents of either treaty country, the principal classes of the shares of which are listed and traded as described above. A Dutch resident company that is not a conduit company is entitled to treaty benefits if at least 30 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly,

by five or fewer Dutch resident companies, the principal classes of the shares of which are listed and traded as described above, and at least 70 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies that are residents of the United States or of EC member states, the principal classes of shares of which are substantially and regularly traded on one or more recognized stock exchanges.

With respect to the public company tests, the references to shares that are "owned directly or indirectly" mean that each company in the chain of ownership that is used to satisfy the relevant ownership requirement must itself meet the relevant residence requirement. Thus, when a corporate resident of a treaty country is entitled to benefits under the treaty, and acquires a controlling interest in a corporate third-country resident that in turn owns a controlling interest in a second corporate resident of the treaty country, the second corporation may not be entitled to treaty benefits. According to the Understanding, it is understood that in these circumstances the competent authority of the other treaty country, in considering a request to grant treaty benefits notwithstanding inability to meet the objective tests under the limitation on benefits article (such a grant is authorized under paragraph 7 of the article), will consider favorably a plan of reorganization submitted by the second corporation, if that plan would result in the second corporation being entitled to treaty benefits within a reasonable transition period without regard to a grant under paragraph 7.

Conduit companies

A conduit company generally is a company that makes payments of interest, royalties and any other so-called deductible payments (as described above in connection with the "base reduction test") in a taxable year in an amount equal to or greater than 90 percent of its aggregate receipts of such items during the same taxable year. A bank or insurance company is not a conduit company, however, if engaged in the active conduct of a banking or insurance business and managed and controlled by associated enterprises that are qualified persons.[51] According to the Understanding, a bank only will be considered to be engaged in the active conduct of a banking business for this purpose if it regularly accepts deposits from the public or makes loans to the public, and an insurance company only will be considered to be 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.

Under the proposed treaty, a conduit company is entitled to treaty benefits if it is owned to the requisite extent by publicly traded companies of the appropriate residence—as described above—and it satisfies the conduit base reduction test.

This latter test is similar to the base reduction test described above, which is met if less than a fixed percentage (generally, 50

[51] For this purpose and other purposes of determining whether a conduit company is entitled to treaty benefits by virtue of its ownership by publicly traded companies, the definition based on common management, control, or capital in Article 9 (Associated Enterprises) generally applies, except that whether two enterprises are associated will be determined for this purpose without regard to the residence of either enterprise.

percent, but with variations in the case where a Dutch company takes into account the residence of the recipient in an EC member country) of gross income is used to make certain deductible payments to nonqualified persons. However, whether the conduit base reduction test is met or not is determined by comparing gross income not to all deductible payments, but to only those deductible payments made to an associated enterprise that are subject to an aggregate rate of tax (including withholding tax) in the hands of the recipient that is less than 50 percent of the rate that would be applicable had the payment been received in the country where the payor resides, and been subject to the normal taxing regime in that country.

Thus, for example, a wholly-owned subsidiary of a publicly traded company, which subsidiary receives only royalties or interest income, and that in turn pays out its entire receipts every year to persons that are not associated enterprises, is entitled to treaty benefits. However, the staff understands that if a resident of a country with which the United States does not have a treaty (or has a treaty providing less reduction of U.S. tax than the proposed treaty), or a group of such residents, wishes to receive U.S. income free of U.S. tax, and a publicly traded company sets up a wholly-owned Dutch subsidiary for the purpose of receiving such U.S. income and paying it out to the ultimate benefit of such residents, the Dutch subsidiary and the recipients of the payments could be considered to be associated enterprises.

According to the Understanding, it is understood that for this purpose, in determining whether an enterprise participates directly or indirectly in the management, control or capital of another enterprise, an enterprise may be considered an associated enterprise with respect to an enterprise in which its only interest is represented by evidences of indebtedness, if the indebtedness provides the holder with the right to participate in the management, control or capital of the enterprise that issued the indebtedness, or such holder in practice participates in such management, control or capital.

Other definitions

Several of the terms used under the public company tests are used in the ownership/base erosion tests explained above, and these terms are explained above as well. In addition, the term "principal class of shares" is generally the ordinary or common shares of the company, provided that this class represents the majority of the voting power and value of the company. When no single class represents the majority of the voting power and value of the company, the "principal class of shares" is generally those classes that in the aggregate possess more than 50 percent of the voting power and value of the company. In determining voting power, any shares or class of shares that are authorized but not issued are not counted, and in mutual agreement between the competent authorities, appropriate weight must be given to any restrictions or limitations on voting rights of issued shares. The "principal class of shares" also includes any "disproportionate class of shares," as described above. The proposed treaty provides that notwithstanding its definition of principal class of shares, that class may

be identified by mutual agreement between the competent authorities.

The term "recognized stock exchange" includes any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934, and the Amsterdam Stock Exchange. Except with respect to closely held companies, the term also includes the NASDAQ System owned by the National Association of Securities Dealers, Inc., or the parallel market of the Amsterdam Stock Exchange. Finally, the term generally includes and any other stock exchange agreed upon by the competent authorities of the two countries. However, the competent authorities may agree to treat stock exchanges as not recognized with respect to closely held companies. The term "closely held company" means a company of which 50 percent or more of the principal class of shares is owned by persons, other than qualified persons or residents of an EC member country, each of whom beneficially owns, directly or indirectly, alone or together with related persons more than 5 percent of such shares for more than 30 days during a taxable year. According to the Understanding, it is understood that the term "related persons" as used in this definition means associated enterprises under Article 9 (Associated Enterprises) and their owners. Further, the staff understands that the term includes persons related under Article 9 without regard to their place of residence.

This exception to the definition of a "recognized stock exchange" in the case of a closely held company, which generally has no counterpart in existing U.S. treaties, does have a counterpart in the regulations under Code section 884(e) for identifying a "qualified resident" eligible for treaty protection from the U.S. branch tax.[52] The regulation provides that stock in certain closely held companies will not be treated as "regularly traded." Thus, even though the proposed treaty (as explained below) has no special rule for closely held companies in defining the term "substantial and regular trading," the proposed treaty may, by excluding from the public company test companies traded on certain otherwise recognized exchanges, achieve a result that is in some cases similar to that achieved under the regulation. The class of closely held companies to which the regulatory rule applies, however, is defined somewhat differently than the term "closely held company" under the treaty.

The stock exchanges to be treated as "recognized" by agreement of the competent authorities are to include any stock exchanges listed in an exchange of notes signed at the later of the dates on which the respective governments have notified each other in writing that the formalities constitutionally required for the entry into force of the treaty in their respective countries have been complied with. According to the Understanding, the stock exchanges of Frankfurt, London and Paris will in any case be listed. The competent authorities of both States may agree to add or remove stock exchanges from the list.

The shares in a class of shares are considered to be substantially and regularly traded on one or more recognized stock exchanges in a taxable year if two requirements are met. Trades in that class

[52] Treas. Reg. sec. 1.884-5T(d)(4)(ii).

must be effected on one or more of such stock exchanges, other than in de minimis quantities, during every month. Further, the aggregate number of shares of that class traded on that stock exchange or exchanges during the previous taxable year must be at least 6 percent of the average number of shares outstanding in that class during that taxable year. Any pattern of trades conducted in order to meet the "substantial and regular trading" tests will be disregarded. However, according to the Understanding, a person claiming benefits under the proposed treaty need not prove that it has *not* engaged in a pattern of trades on a recognized stock exchange in order to meet these tests, but may need to *rebut* evidence that it has engaged in such a pattern for such a purpose.

These rules for defining substantial and regular trading, which generally have no counterpart in existing U.S. treaties, do have a counterpart in the regulations under Code section 884(e).[53] The proposed treaty rules generally are, however, easier to satisfy. For example, the regulatory counterpart to the treaty requirement of trades (other than in de minimis) every month of the year concerned is a requirement of trades on at least 60 days of the year. The regulatory counterpart to the treaty requirement that 6 percent of the shares be traded during the year is a requirement that at least 10 percent (or 30 percent if the issuer has less than 2500 record shareholders) of the aggregate number of shares be traded during the year.

Active business test

In general

Under the active business test, treaty benefits in the source country will be available under the proposed treaty to an entity that is a resident of the United States or the Netherlands, the ownership/base erosion and public company tests notwithstanding, if it is engaged in the active conduct of a trade or business in its residence country, and if the income derived from the source country either is incidental to that trade or business in the residence country, or is derived in connection with that trade or business and the trade or business of the income recipient is substantial in relation to the income producing activity.

An entity does not meet the active business test (and therefore cannot claim treaty benefits under this rule) by virtue of being engaged in the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company. As discussed above in connection with the conduit company definition, the Understanding provides that for this purpose, a bank only will be considered to be engaged in the active conduct of a banking business if it regularly accepts deposits from the public or makes loans to the public, and an insurance company only will be considered to be 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.

As described above, the active trade or business rule is consistent with similar tests in recent U.S. treaties, and replaces a more gen-

[53] Treas. Reg. sec. 1.884-5T(d)(4).

eral rule in the U.S. model treaty and some other U.S. income tax treaties that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty. However, unlike other treaties, and to some extent like the regulations under Code section 884(e), the proposed treaty (in its text and as elucidated in the Understanding) elaborates at length on the conditions under which the active business will, and will not, be considered to be met. Moreover, in certain circumstances the proposed treaty permits a Dutch resident to treat trade or business activity conducted throughout the EC as though it were conducted in the Netherlands, for purpose of applying the active business test. Finally, under the proposed treaty the competent authorities may by mutual agreement determine transition rules for newly-established business operations, newly-established corporate groups or newly-established headquarter companies.

Income derived in connection with a substantial business

The proposed treaty specifies that income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business which forms a part of, or is complementary to, the trade or business conducted in the residence country by the income recipient.[54]

Whether the trade or business of the income recipient is substantial will generally be determined by reference to its proportionate share of the trade or business in the source country, the nature of the activities performed, and the relative contributions made to the conduct of the trade or business in both countries.[55] A safe harbor is provided for this purpose. The trade or business of the income recipient will be deemed to be substantial under the proposed treaty if certain attributes of the residence-country business exceed a threshold fraction of corresponding attributes of the trade or business located in the source country that produces the source-country income. Under this safe harbor, the attributes are assets, gross income, and payroll expense. The level of each such attribute in the active conduct of the trade or business by the income recipient in the residence country, and the level of each such attribute in the trade or business producing the income in the source country, is measured for the prior year. For each separate attribute, the ratio of the residence country level to the source country level is computed.

In general, the safe harbor is satisfied if the average of the three ratios is greater than 10 percent, and each ratio separately is greater than 7.5 percent. If any separate ratio is equal to or less than 7.5 percent for the prior year, the average of the corresponding ratios in the three prior years may be substituted.

Under certain circumstances a Dutch person may elect to treat trade or business activity in other EC member countries as having

[54] Cf. Treas. Reg. sec. 1.884-5T(e)(1)(iii). (To satisfy the active business test, the activities that give rise to the U.S. income must be part of a U.S. business and that business must be an integral part of active trade or business conducted by the foreign corporation in its residence country; a business is an integral part if it comprises in principal part, complementary and mutually interdependent steps in the production and sale or lease of goods, or in the provision of services.)

[55] Cf. Treas. Reg. sec. 1.884-5T(e)(3). (A foreign corporation engaged in business in its residence country has a substantial presence in that country if certain of the attributes of that business, physically located in its residence country, equal at least a threshold percentage of its worldwide attributes.)

been located in the Netherlands for purposes of the active business test generally. Where the election applies, the safe harbor described above is applied in modified form. The election applies to activity, conducted in EC member countries other than the Netherlands, that is a component part of, or directly related to, the active trade or business conducted in the Netherlands. The election applies only, however, if each of the assets, income, and payroll attributes of the Dutch business exceeds 15 percent of the corresponding attribute for the relevant operations throughout the EC member countries.

If the above election is made, then in order to satisfy the safe harbor, the average of the three safe harbor ratios must be greater than 60 percent, and each ratio separately must be greater than 50 percent. If any separate ratio is equal to or less than 50 percent for the prior year, the average of the corresponding ratios in the three prior years may be substituted.

Income incidental to a trade or business

Income derived from one treaty country is incidental to a trade or business conducted in the other, residence country if the income is not produced by a line of business which forms a part of, or is complementary to, the trade or business conducted in the residence country by the income recipient, but the production of such income facilitates the conduct of the trade or business in the residence country. An example of such "incidental" income is income from the investment of the working capital of the residence country trade or business. If a Dutch person elects to treat activities conducted throughout the EC as activities conducted in the Netherlands, under the rules described above, then the income that is considered incidental to that combined trade or business cannot be greater than four times the amount of income that would have been considered incidental to the trade or business actually conducted in the Netherlands.

Attribution rules

Under the proposed treaty, the active business test takes into account the extent to which the person seeking treaty benefits either is itself engaged in business, or is deemed to be so engaged through the activities of related persons. If it is deemed to be so engaged on the basis of the activities of a related person, then for purposes of applying the substantiality test or other tests that turn on the amounts of income, assets, payroll or any other attribute of the person seeking treaty benefits, that person is considered to carry on its appropriate proportionate share of the trade or business of the related person. Attribution for this purpose, although generally not set forth in the literal language of the active business test language in other recent treaties, has been used under those treaties.[56]

Under the proposed treaty a treaty country resident is deemed to be engaged in the active conduct of a trade or business in its residence country (and is considered to carry on all, or, as the case may be, the proportionate share of such trades or businesses) if it

[56] See *Understandings Regarding the Scope of the Limitation on Benefits Article in the Convention between the Federal Republic of Germany and the United States of America*, Example II.

is a partner in a partnership that is so engaged, or if it owns, either alone or as a member of a group of five or fewer persons that are qualified persons, residents of an EC member country, or residents of an "identified state," a controlling beneficial interest in a person that is engaged in the active conduct of a trade or business in the country in which such owner is resident. An "identified state" includes any third country, identified by agreement of the competent authorities, which has effective provisions for the exchange of information with the residence country of the person being tested under these rules.[57]

A company resident in a treaty country is also deemed to be engaged in the active conduct of a trade or business in its residence country (and is considered to carry on all, or, as the case may be, the proportionate share of such trades or businesses) if it is a member of a group of companies that form or could form a consolidated group for tax purposes according to the law of the residence country (as applied without regard to the residence of such companies), and the group is engaged in the active conduct of a trade or business in that country. A similar principle applies if a treaty country resident is, together with another person that is so engaged, under the common control of a person (or a group of five or fewer persons) which (or, in the case of a group, each member of which) is a qualified person, a resident of an EC member state, or a resident of an "identified state" as that term is used above.

Finally, the activities of an owner of a treaty country resident may be attributed to it. Attribution to a treaty country resident applies if a controlling beneficial interest in the treaty country resident is held by a single person engaged in the active conduct of a trade or business in that same country. Attribution also applies if a controlling beneficial interest in the treaty country resident is held by a group of five or fewer persons, each member of which is engaged in activity, in that country, which is a component part of or directly related to the trade or business in that country.

For purposes of applying these rules, a person (or group) is considered to have "common control" of two persons if it holds a controlling beneficial interest in each such person. A person (or group) generally is deemed to own a "controlling beneficial interest" in another person if it holds directly or indirectly a beneficial interest which represents more than 50 percent of the value and voting power in the second person. However, the meaning of an indirect holding for purposes of this rule is limited in two ways. First, an interest of 50 percent or less of the value and voting power of any third person is not considered for purposes of determining the per-

[57] For this purpose, the Understanding provides that the following countries are regarded as an "identified State" having effective provisions for the exchange of information at the date of signature of the proposed treaty with the United States: Australia, Austria, Barbados, Belgium, Bermuda, Canada, Costa Rica, Cyprus, Denmark, Dominica, Dominican Republic, Egypt, Finland, France, Germany, Grenada, Honduras, Iceland, Ireland, Jamaica, Korea, Malta, Marshall Islands, Mexico, Morocco, New Zealand, Norway, Pakistan, Philippines, St. Lucia, Sweden, and Trinidad and Tobago.

And with the Netherlands: Aruba, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, China, Czechoslovakia, Denmark, Finland, France, Germany, Greece, Hungary, India, Ireland, Indonesia, Israel, Italy, Korea, Luxembourg, Malaysia, Malta, Morocco, Netherlands Antilles, New Zealand, Norway, Pakistan, Philippines, Poland, Romania, Singapore, South Africa, Spain, Sri Lanka, Surinam, Sweden, Thailand, Turkey, United Kingdom, Zambia, and Zimbabwe.

It is understood that countries may be added to or eliminated from the preceding lists by agreement between the competent authorities.

centage of indirect ownership held by the first person or group in the second person. For example, if a Dutch company owns 40 percent of the stock of another company, which in turn owns 30 percent of the stock of yet another company engaged in a Dutch trade or business, then the question whether the top-tier Dutch company is engaged in the trade or business of the bottom-tier company is determined without regard to the stock of the middle-tier company held by the top-tier company. Second, no person will be considered to be part of a group owning a controlling beneficial interest in an entity unless that person holds *directly* a beneficial interest which represents at least 10 percent of the value and voting power in such entity. Thus, for example, if a Dutch company owns 100 percent of the stock of another company, which in turn owns 100 percent of the stock of yet another company engaged in a Dutch trade or business, then the question whether the top-tier Dutch company is engaged in a Dutch trade or business is determined without treating it as having engaged in the activities of the bottom-tier company.

The Understanding provides two examples to illustrate the operation the attribution rules, and the calculation of the appropriate "proportionate shares" to be attributed. These examples are intended to illustrate that the proportionate share of activities of a resident of one of the countries that are a component part of, or directly related to, a trade or business conducted by another resident of that country who claims treaty benefits, may be attributed to the latter resident for purposes of applying the safe harbor rule under the substantial trade or business test. In addition, the proportionate share of activities of a resident of one of the countries attributable to a trade or business conducted in the other country will be used for purposes of that rule.

Further, according to the Understanding, it is understood that in applying the measurement of "substantiality," the attributes referred to in the safe harbor test as applied in a specific case will take into account the fact that there might be a less than 100 percent participation in the income-producing activity. For example, if a Dutch resident corporation has a 10-percent interest in a U.S. corporation, in applying the substantiality test to—for instance—dividends received from the US corporation, each of the U.S. corporations' attributes must be multiplied by the Dutch resident's percentage share in the U.S. corporation, in order to apply the safe harbor test.

The Understanding states that the same approach also applies where a treaty country resident may be treated as engaged in trade or business in the residence country by virtue of owning, either alone or as a member of a group of five or fewer persons that are qualified persons, residents of an EC member country, or residents of an "identified state," a controlling beneficial interest in a person that is engaged in the active conduct of a trade or business in the country in which such owner is resident. The Understanding provides an example further illustrating the result of this approach.

Finally, the Understanding clarifies the operation of the attribution rules when determining whether activity conducted in another EC member country is permitted to be treated as if conducted in the Netherlands under the active business test. According to the

Understanding, it is understood that the activity in the other country will be taken into account if it is conducted by any person which, had it conducted the activity in the Netherlands, would have its proportionate share of the activity attributed to the Dutch resident considered to conduct such activity under the attribution rules.

Headquarter companies

A treaty country resident is entitled to all the benefits of the proposed treaty if that person functions as a headquarter company for a multinational corporate group. A person is considered a headquarter company for this purpose only if each of several criteria is satisfied. The person seeking such treatment must provide a substantial portion of the overall supervision and administration of the group, which may include, but cannot be principally, group financing. The person must have, and exercise, independent discretionary authority to carry out these functions. It must be subject to the same income taxation rules in its residence country as persons engaged in the active conduct of a trade or business, as described above in connection with the active business test for treaty benefits under paragraph 2 of the limitation on benefits article.

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 headquarter company supervises and administers must be spread sufficiently among different countries. 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. 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. Moreover, 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. The competent authorities may by mutual agreement determine transition rules for newly established business operations, newly established corporate groups or newly established headquarter companies.

The Understanding provides substantial detail on what is means to provide a substantial portion of the overall supervision and administration of a group. According to the Understanding, it is understood that a person will be considered to be engaged in "supervision and administration" activities only if it engages in a number of the kinds of activities listed below. For example, a person will be considered a headquarters company if it performs a significant number of the following functions for the group: group financing (which cannot be its principal function), pricing, marketing, internal auditing, internal communications and management. A simple comparison of the amount of gross income that the headquarters company derives from its different activities cannot be used alone to determine whether group financing is, or is not, the company's principal function. The above-mentioned functions are intended to

be suggestive of the types of activities in which a headquarters company will be expected to engage; the list is not intended to be exhaustive.

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 it supervises must be substantial in comparison to the same activities for the same group performed within the multinational.

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 world-wide 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 headquarter company supervises. In the above case the Dutch headquarters company will be considered to provide a substantial portion of the overall supervision and administration of the group it supervises.

Non-profit organizations

An entity will also be entitled to benefits under the proposed treaty if it is a not-for-profit organization that, by virtue of that status, generally is exempt from income taxation in its treaty country of residence, provided that more than half the beneficiaries, members, or participants, if any, in the organization are qualified persons. The not-for-profit organizations described include, but are not limited to, pension funds, pension trusts, private foundations, trade unions, trade associations, and similar organizations. In all events, a pension fund, pension trust, or similar entity organized for purposes of providing retirement, disability, or other employment benefits that is organized under the law of a treaty country will be entitled to treaty benefits if the sponsor of the entity is itself entitled to treaty benefits.

Shipping and air transport

As described above in connection with Article 8 (Shipping and Air Transport), profits that are derived by an enterprise of one country from the operation in international traffic of ships or aircraft ("shipping profits") are exempt under the proposed treaty from tax by the other country, regardless of the existence of a permanent establishment in the other country. This treaty exemption is similar to the exemption from U.S. tax provided under the Code for income of a foreign person from the operation of ships or aircraft to or from the United States, if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents.

The reciprocal exemption provided under the Code has its own limitation on benefit provision. The exemption is not available to an entity unless the entity satisfies either an ownership test or a public company test. Similarly, the proposed treaty provides that its reciprocal exemption from taxation in the treaty country other than the residence country on shipping profits, is available to an entity resident in a treaty country that does not otherwise qualify for treaty benefits under the limitation on benefits article, if either an ownership test or a public company test is met. To meet the ownership test under the proposed treaty, more than 50 percent of the beneficial interest in the entity (or in the case of a company, more than 50 percent of the value of the stock of the company) must be owned, directly or indirectly, by qualified persons or by individuals who are residents of a third country which grants an exemption under similar terms for profits as mentioned in Article 8 of the proposed treaty to citizens and corporations of the treaty country other than the residence country. To meet the public company test, the entity must be a company the stock of which is primarily and regularly traded or an established securities market in a third country which grants a similar exemption to such citizens and corporations.

Grant of treaty benefits by the competent authority

Finally, the treaty provides a "safety-valve" for a treaty country resident that has not established that it meets one of the other more 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 so determines. In making this determination, the competent authority will take into account as its guideline whether the establishment, acquisition, or maintenance of the person, or the conduct of its operations, has or had as one of its principal purposes the obtaining of benefits under the proposed treaty. The competent authority of the source country will consult with the competent authority of the other country before denying the benefits of the treaty under this rule.

This provision of the proposed treaty is similar to a portion of the qualified resident definition under the Code branch tax rules, under which the Secretary of the Treasury may, in his sole discretion, treat a foreign corporation as a qualified resident of a foreign

country if the corporation establishes to the satisfaction of the Secretary that it meets such requirements as the Secretary may establish to ensure that individuals who are not residents of the foreign country do not use the treaty between the foreign country and the United States in a manner inconsistent with the purposes of the Code rule (Code sec. 884(d)(4)(D)).

The Understanding goes into substantial detail on the way in which this authority is expected to be administered. In general, the Understanding is much more detailed than any standards promulgated to date under the corresponding Code provision, and is also more detailed than the material accompanying present U.S. treaties with similar provisions (for example, the U.S.-Germany income tax treaty). The Understanding provides that in determining whether the establishment, acquisition, or maintenance of a corporation resident of one of the States has or had as one of its principal purposes the obtaining of benefits under the proposed treaty, the competent authority of the State in which the income in question arises may consider the following factors (among others):

(1) The date of incorporation of the corporation in relation to the date that the treaty enters into force;
(2) the continuity of the historical business and ownership of the corporation;
(3) the business reasons for the corporation residing in its country of residence;
(4) the extent to which the corporation is claiming special tax benefits in its country of residence;
(5) the extent to which the corporation's business activity in the other country is dependent on the capital, assets, or personnel of the corporation in its country of residence; and
(6) the extent to which the corporation would be entitled to treaty benefits comparable to those afforded by the proposed treaty if it had been incorporated in the country of residence of the majority of its shareholders.

According to the Understanding, it is understood that a company resident in one of the countries will be granted treaty benefits with respect to the income it derives from the other country, if the company:

(1) holds stocks and securities the income from which is not predominately from sources in the other country;
(2) has widely dispersed ownership; and
(3) employs in its country of residence a substantial staff actively engaged in trades of stocks and securities owned by the company.

By the same token, it is understood that treaty benefits will not be granted to an investment fund under this provision if any of the above-mentioned factors is absent.

Finally, according to the Understanding it is understood that the legal requirements for the facilitation of the free flow of capital and persons within the European Communities, together with the differing internal income tax systems, tax incentive regimes, and existing tax treaty policies among EC member countries, will be considered in exercising authority under this provision. The competent

authority is instructed in the proposed treaty to consider as its guideline whether the establishment, acquisition or maintenance of a company or the conduct of its operations has or had as one of its principal purposes the obtaining of benefits under the treaty. According to the Understanding, the competent authority may, therefore, determine under a given set of facts that a change in circumstances that would cause a company to cease to qualify for treaty benefits under the more objective anti-treaty shopping tests need not necessarily result in a denial of benefits. Such changed circumstances may include a change in the state of residence of a major shareholder of a company, the sale of part of the stock of a Dutch company to a person resident in another EC member country, or an expansion of a company's activities in other EC member countries, all under ordinary business conditions. The Understanding provides that the competent authority will consider these changed circumstances (in addition to other relevant factors normally considered in applying its discretion to allow treaty benefits) in determining whether such a company will remain qualified for treaty benefits with respect to income received from United States sources. If these changed circumstances are not attributable to tax avoidance motives, the Understanding provides that this also will be considered by the competent authority to be a factor weighing in favor of continued qualification.

It may be that, as a practical matter, a corporation that would satisfy the tests under the limitation on benefits article of the proposed treaty may generally also meet the definition of "qualified resident" for branch profits tax purposes in the Code. However, the proposed treaty and the Understanding provide extensive details not now provided under section 884 and the regulations thereunder. Moreover, some of those details obviously differ. Thus, it may be incorrect to assume that the tests in the proposed treaty and in the Code are substantially the same. For example, a Dutch corporation qualifies for treaty benefits under the proposed treaty if there is substantial and regular trading of its principal class of stock on a recognized stock exchange, as those concepts are defined in the proposed treaty, while that corporation would not meet the 1986 Act's public company test unless such company's stock were *primarily* traded on an established securities market (or the corporation were wholly owned by another corporation whose stock were primarily so traded), applying the rules of Treas. Reg. sec. 1.884-5T(d), which as noted above are different. Similarly, the derivative benefits rules, and the active business test and headquarters company tests in the proposed treaty require the United States to allow treaty benefits in cases where the Treasury Secretary arguably might exercise his discretion under section 884(d)(4)(D) to reach a different result in a particular case.

Article 27. Offshore Activities

This provision is similar to corresponding provisions in the U.S.-U.K. and U.S.-Norway treaties, and is intended to deal primarily with the activities of certain U.S. independent drilling contractors and their employees in the Dutch sector of the North Sea. As a practical matter, the provision makes it clear that the proposed treaty does not prevent the Netherlands from taxing the activities

of these drilling contractors or their employees under its domestic laws. While the provision was negotiated primarily to deal with activities of U.S. persons in the North Sea, it also makes it clear than Dutch activities in connection with activities on the U.S. continental shelf are subject to U.S. tax.

As discussed above in connection with Article 3 (General Definitions), the terms "Netherlands" and "United States" are defined to include the sea bed and sub-soil and their natural resources over which the countries exercise rights. Oil companies have entered into contracts with U.S. drilling companies and service and supply companies with respect to mineral exploration and exploitation in the North Sea through the use of movable drilling rigs. The proposed treaty limits the Netherlands's right to tax business profits of a U.S. company to profits that are attributable to a permanent establishment. The term "permanent establishment" may include "a building site or construction or installation project, . . . if it lasts more than twelve months," but it is not clear whether this language would encompass these drilling rigs. Furthermore, the activities of independent drilling contractors with respect to any one project frequently are completed in less than 12 months. In addition, individuals performing independent services in the North Sea who could establish that they did not themselves have a fixed base in the Netherlands might, under certain circumstances, be exempt from Dutch tax on their income from the performance of services.

The proposed treaty provides that an enterprise of a treaty country which carries on offshore activities in the other country for more than 30 days in a calendar year generally will be deemed to be carrying on in respect of those activities a business in that other country through a permanent establishment therein. (For purposes of measuring the period of activity, activities carried on by associated enterprises on a single project are aggregated. Enterprises are regarded as associated based on ownership of one-third or more of the enterprises' capital.) Similarly, a resident of one country who carries on in the other country, for a continuous period of 30 days or more, offshore activities that are professional services or other activities of an independent character in the other country generally will be deemed to be performing those activities from a fixed base in the other country. Finally, employment income in connection with offshore activities carried on through a permanent establishment in a treaty country may be taxed in that country to the extent that the employment is exercised offshore in that country. Staff understands that this right to tax extends to employment income from an activity that is only *deemed* to give rise to a permanent establishment under the other provisions of this article. These special rules on offshore activities do not apply where the activities of a person otherwise constitute for that person a permanent establishment as defined in Article 5 (Permanent Establishment). Similarly, the rules under this article do not apply where offshore activities of the person otherwise would constitute a fixed base under Article 15 (Independent Personal Services).

The special offshore activities rules permit income from such activities, whether business profits or income from personal services, to be taxed by the country in which the activities are performed under the business profits or personal services articles. "Offshore

activities" means activities carried on offshore in connection with the exploration of exploitation of the sea bed and its sub-soil and their natural resources, situated in one of the treaty countries. Under the rule deeming a permanent establishment to exist by virtue of offshore activities, the term "offshore activities" does not include the preparatory and auxiliary activities, as listed in the proposed treaty's general definition of "permanent establishment," that would not themselves give rise to a permanent establishment (Article 5, paragraph 4). Nor for this purpose does the term "offshore activities" include towing or anchor handling by ships primarily designed for that purpose and any other activities performed by such ships, or the transport of supplies or personnel by ships or aircraft in international traffic. According the Understanding, it is understood that transport of supplies or personnel between one of the treaty countries and a location where activities are carried on offshore in that country, or between such locations, is to be considered as transport between places in that country, and therefore not as "international traffic."

If the offshore activities take place in the United States and U.S. tax is imposed on a Dutch national or resident in accordance with the proposed treaty on the resulting income, then the Netherlands is obliged to reduce its tax on this income, in conformity with the rules of the double taxation article (Article 25, paragraph 2), so long as documentary evidence is produced that the U.S. tax has been paid.

Article 28. Non-discrimination

The proposed treaty contains a comprehensive nondiscrimination article relating to all taxes of every kind imposed at the national, state, or local level. It is similar to the nondiscrimination article in the U.S. model treaty and to provisions that have been embodied in other recent U.S. income tax treaties. It is broader than the nondiscrimination provision of the present treaty. The nondiscrimination article of the proposed treaty differs from the U.S. and OECD models in its treatment of contributions to foreign pension plans. The proposed treaty differs from the U.S. model in protecting all legal persons deriving their status as such from the United States, not only U.S. citizens. In the latter regard, the nondiscrimination article of the proposed treaty more closely resembles that of the OECD model treaty.

In general, under the proposed treaty, one country cannot discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its nationals in the same circumstances. This provision applies whether or not the nationals in question are residents of the United States or the Netherlands. A U.S. national who is not a resident of the United States and a Dutch national who is not a resident of the United States are not deemed to be in the same circumstances for U.S. tax purposes.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprise carrying on the same activities. Consistent with the U.S. and OECD model treaties, however, a country is not obligated to grant residents of the other country any

personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

In a provision not contained in the present treaty, each country is required (subject to the arm's-length pricing rules of Articles 9(1) (Associated Enterprises), 12(5) (Interest), and 13(4) (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Technical Explanation indicates that term "other disbursements" is understood to include a reasonable allocation of executive and administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises. The Technical Explanation confirms that the so-called "earnings stripping" rules under Code section 163(j) are consistent with this standard.

An analogous rule applies to pension plan contributions on behalf of an employee resident (or temporarily present) in a treaty country, where the plan is recognized for tax purposes in the other country. In the United States, for example, a contribution on behalf of an employee to a "qualified pension plan" may be both deductible from the employer's income and excluded from the employee's gross income for the year of the contribution, while a contribution to a plan that is not qualified may not be deductible to the employer until the year that it is included in the income of the employee.[58] The proposed treaty provides that in determining for tax purposes the employment income of a resident of, or temporary visitor to, a treaty country, that country may be required to treat a contribution to a pension plan recognized for tax purposes in the other country as a contribution paid to a pension plan that is recognized for tax purposes in the first country. In order for the first country to be so required, the employee must not be a national of the first country, and must have been contributing to the pension plan before becoming resident, or temporarily present, in the first country. In addition, the competent authority of the first country must agree that the pension plan corresponds to a pension plan recognized for tax purposes by that country.

The rule of nondiscrimination also applies under the proposed treaty to enterprises of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, will not be subjected in the first country to any taxation or any connected requirement which is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises.

The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) does not apply to the nondiscrimination article.

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[58] See Code secs. 402(a), 404(a), and 404A.

Article 29. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision, with some variation, which authorizes the competent authorities of the United States and the Netherlands to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under this article a resident of one country, who considers that the action of one or both of the countries will cause him to pay a tax not in accordance with the treaty, may present his case to the competent authority of the country of which he is a resident or citizen. The competent authority will then make a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, then that competent authority will endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the treaty. The provision authorizes a waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. The provision, however, contains its own limitations period, providing that the competent authority of the other country must have received notification that a case exists within 6 years from the end of the taxable year to which the case relates.

The six-year limitation on notification of the other competent authority is not the preferred U.S. treaty position nor is it in the present Dutch treaty. It is similar, however, to provisions in the U.S.-Canada and U.S.-Finland income tax treaties.[59] The OECD model treaty includes a three-year limitation on the time that may lapse between the first notification of the action resulting in taxation not in accordance with the treaty, and the presentation of the case to the competent authority. However, that time limitation generally cannot run until the taxpayer is formally on notice that a problem exists. Under the proposed treaty, a refund may be denied absent some reason to believe that a refund case will exist before the end of 6 years from the tax year in question.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty.

Like the U.S. model treaty, the proposed treaty makes express provision for competent authorities to mutually agree on the allocation of income, deductions, credits, or allowances, the determination of the source of income, the characterization of particular items of income, the common meaning of a term, the application of penalties, fines, and interest under internal law, increases (where appropriate in light of economic or monetary developments) in the dollar thresholds in provisions such as the artistes and athletes ar-

[59] See also Article 26(2) of the proposed U.S.-Mexico income tax treaty.

ticle and the students and trainees provisions, and the elimination of double taxation in cases not provided for in the treaty.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. This provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the treaty. It also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or the Netherlands.

The proposed treaty contains language under which, if a disagreement cannot be resolved by the competent authorities, they may agree to submit the disagreement for arbitration, provided that the taxpayer or taxpayers also agree in writing to be bound by the decision of the arbitration board. However, this portion of the treaty does not take effect until the United States and the Netherlands have so agreed in the future. This agreement is to be evidenced not by another treaty or protocol subject to Senate advice and consent, but rather by notes to be exchanged through diplomatic channels. According to the Understanding, it is understood that such diplomatic notes will be exchanged when the competent authorities of the two countries are satisfied with the experience under the voluntary arbitration provision of the U.S.-Germany income tax treaty, which went into force in 1991, or under the mandatory arbitration provision in the EC member country multilateral treaty on associated enterprises, which was signed in 1990 but has yet to come into force.[60] The Understanding provides for consultations between the competent authorities, after a three-year period following the proposed treaty's entry into force, to determine whether the conditions for this exchange have been fulfilled.

According to the Understanding, it is also understood that if and when the arbitration provision of the treaty takes effect, certain procedures set forth in the Understanding will apply. These procedures are substantially similar to the procedures set forth in notes exchanged by the United States and Germany in 1989 at the time that the present U.S.-Germany income tax treaty was signed, and in the proposed protocol to the proposed U.S. income tax treaty with Mexico. Subject to the general principles established in the Understanding, the procedures may be modified or supplemented by the competent authorities or, in the case of the arbitration board's own procedures, by the arbitration board itself (consistent with generally accepted principles of equity).

The competent authorities may agree to invoke arbitration if they fail to reach an agreement within two years of the date on which the case was submitted to one of them, but only after the other competent authority procedures spelled out in the treaty have been fully exhausted. The Understanding provides that the competent authorities will not generally accede to arbitration with respect to matters concerning either the tax policy or the domestic tax law of either treaty country.

The Understanding describes how an arbitration board will be chosen in each case. Each board will have at least three members.

[60] 90/436/EEC.

Each competent authority will appoint the same number of members, and these members will agree on the appointment of the other member or members of the board. The other member or members may be from the United States, the Netherlands, or another OECD member country. Further criteria for selecting the other member, or other members, of the arbitration board may be issued by the competent authorities. All board members and their staffs must agree in writing to be bound by applicable confidentiality and disclosure rules of both countries. If those provisions conflict, the most restrictive provisions will apply.

The competent authorities may agree on and instruct the arbitration board regarding specific rules of precedure, such as appointment of a chairman, precedures for reaching a decision, establishment of time limits, etc. Otherwise, the arbitration board shall establish its own rules of procedure consistent with generally accepted principles of equity. Taxpayers and/or their representatives shall be afforded the opportunity to present their views to the arbitration board.

The decision of a case by an arbitration board must be made on the basis of the treaty, giving due consideration to the domestic laws of the treaty countries and the principles of international law. The board will provide the competent authorities with an explanation of its decision. The decision, although binding with respect to the case at issue, will not have precedential effect. However, it is expected that the decisions ordinarily will be taken into account in subsequent cases involving the same taxpayer or taxpayers, the same issue or issues, and substantially similar facts. The Understanding states that arbitration board decisions may also be taken into account in other cases where appropriate.

The Understanding also provides for each treaty country to bear the costs of compensating its appointees, and half of the compensation of the appointees chosen by the arbitration board members. However, the arbitration board is given authority to allocate these costs differently, and each competent authority of a treaty country is given the authority to require the taxpayer or taxpayers to agree to bear that country's share of the costs as a prerequisite for arbitration.

Finally, the proposed treaty contains a provision that requires the competent authorities to consult on establishing a basis for the full implementation of the proposed treaty whenever the internal law of the one of the treaty countries is or may be applied in a manner that may impede the full implementation of the proposed treaty. If one of the competent authorities becomes aware of such actual or potential application, it is to inform the other in a timely manner, and consultations should begin within 6 months. The staff understands that this provision is intended to cover situations, among others, where internal law changes in conflict with the proposed treaty. In diplomatic notes accompanying the treaty, the State Department and its Dutch counterpart, on behalf of their respective governments, confirmed that they recognized the principle that the treaty, once in force, is binding upon both parties and must be performed by them in good faith and in accordance with generally accepted rules of international law. The negotiators further confirmed their recognition that they should avoid enactment

or interpretation of legislation or other domestic measures that would prevent the performance of their obligations under the treaty. The negotiators, recognizing the possibility of significant changes in the national taxation laws which may affect implementation of the treaty, were able to agree in principle that in such a case an appropriate amendment of the treaty might be necessary. The consultation language in the treaty provides a mechanism for initiating such amendments.

Article 30. Exchange of Information and Administrative Assistance

In general

This article, together with two following articles, form the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can properly administer the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or of the domestic laws of the two countries concerning taxes to which the treaty applies insofar as the taxation under those domestic laws is not contrary to the treaty. The proposed treaty specifies that the purposes for which information is to be exchanged include assessment, collection, administration, enforcement, prosecution before an administrative authority or initiation of prosecution before a judicial body, or determination of appeals with respect to the taxes covered by the treaty. The exchange of information is not restricted by Article 1 (General Scope). Therefore, third-country residents will be covered. However, like the present treaty but unlike the U.S. model the exchange of information article is restricted by Article 2 (Taxes Covered). Unlike the U.S. model, the proposed treaty does not obligate the parties to exchange information about national-level taxes (such as excise taxes) that are not listed under article 2.

Any information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in functions listed above in relation to taxes to which the treaty applies. Such persons or authorities can use the information for such purposes only.

As indicated in the Understanding, persons involved in the administration of taxes include the tax-writing committees of Congress and the U.S. General Accounting Office, for use in the performance of their role in overseeing the administration of U.S. tax laws. The Understanding further indicates that the role of Congress and the GAO in overseeing the administration of U.S. tax law is understood to be limited to ensuring that the administration of the tax law by the executive branch is honest, efficient, and consistent with legislative intent.

Exchanged information generally may be disclosed in public court proceedings or in judicial decisions. However, a treaty country may use information obtained under the treaty as evidence before a criminal court only if prior authorization has been given by

the competent authority of the country supplying the information. The competent authorities may mutually agree to waive the condition of prior authorization.

Upon an appropriate request for information, the requested country is to obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. A requested country is to use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country. It is intended that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that the provision be strictly reciprocal. For example, once the Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the U.S. investigators can no longer use an administrative summons to obtain information. If, however, the Netherlands could still use administrative processes to obtain requested information, it would be expected to do so even though the United States could not. The United States could not, however, tell Netherlands which of its procedures to use.

Where specifically requested by the competent authority of one country, the competent authority of the other country shall endeavor to provide the information in the form requested. Specifically, the competent authority of the second country will endeavor to provide depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, accounts, and writings) to the same extent that they can be obtained under the laws and practices of the second country in the enforcement of its own tax laws.

Information may also be released to the arbitration board established under the mutual agreement provisions described above, where necessary for carrying out the arbitration procedure. Conditions and requirements for such release are similar to those applicable to information exchanged between the competent authorities. Moreover, the members of the arbitration board are subject to the same secrecy obligations that apply to competent authorities receiving information exchanged under this article.

General conditions on the exchange or release of information are laid down in Article 32 (discussed below).

Summonses to designated agents

Under the Code, any domestic corporation that is 25-percent owned by one foreign person, and any foreign corporation that conducts a trade or business in the United States (a "reporting corporation"), must furnish the IRS with such information as the Secretary may prescribe regarding transactions carried out directly or indirectly with certain foreign persons treated as related to the reporting corporation ("reportable transactions").

In addition, the Code provides that in order to avoid certain consequences with respect to certain reportable transactions, each foreign person that is a related party of a reporting corporation must agree to authorize the latter to act as its agent in connection with any request or summons by the IRS to examine records or produce testimony related to any reportable transaction. Failure of a related party to designate a reporting corporation as its agent for ac-

cepting service of process in connection with reportable transactions, or, under certain circumstances, noncompliance with IRS summonses in connection with reportable transactions or other matters, can result in the application of the so-called "noncompliance rule." This rule permits the Secretary of the Treasury to determine the tax consequences to the reporting corporation of certain transactions or other items in his or her sole discretion, based on any information in the knowledge or possession of the Secretary or on any information that the Secretary may obtain through testimony or otherwise.

The legislative history accompanying the enactment of these rules indicates an expectation that where records of a related party are obtainable on a timely and efficient basis under information-exchange procedures provided under a tax treaty, the IRS generally would make use of those procedures before issuing a summons to the designated agent on behalf of the related party.[61] Treasury regulations contain this language.[62] For this purpose, the regulation provides that information is available on a timely and efficient basis if it can be obtained within 180 days of the request. However, the legislative history also indicates a cognizance of undue audit delays that have been caused by the Service's inability to quickly obtain relevant information through treaty procedures, and a recognition that exigent circumstances (for example, the imminent expiration of the limitations period) may arise that would make the use of a treaty procedure undesirable. Thus, an intention is expressed in the legislative history that the Service not be required to attempt to use a treaty procedure before issuing a summons with respect to information that might be obtained under that treaty. The regulation provides that the absence or pendency of a treaty request may not be asserted as grounds for refusing to company with a summons or as a defense against the assertion of the noncompliance penalty adjustment.

The Understanding would modify the intended operation of these rules in a case where a U.S. resident or permanent establishment that is a "reporting corporation" under the above rules has neither possession of nor access to records that may be relevant to the U.S. income tax treatment of a transaction between it and a foreign related party (or, in the case of a permanent establishment, the U.S. tax treatment of any other item), and the records are under the control of a Netherlands resident and are maintained outside the United States. In such a case, the Understanding provides that the United States is obligated to request those records from the Netherlands through an exchange of information under this article of the proposed treaty *before* issuing a summons for those records to the reporting corporation, provided that under all the circumstances presented, the records will be obtainable through the request on a timely and efficient basis. For purposes of this discussion, the Understanding provides that records will be considered to be available on a timely and efficient basis if they can be obtained within 180 days of the request or such other period agreed upon

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[61] Committee on Finance, *Explanation of Provisions Approved by the Committee on October 3, 1989*, Senate Finance Committee Print, 101st Cong., 1st Sess., pp. 115-116 (1989).

[62] Treas. Reg. sec. 1.6038A-6(b).

in mutual agreement between the competent authorities, except where the statute of limitations may expire in a shorter period.

As discussed above in connection with the limitation on benefits provision (Article 26), the proposed treaty affords benefits to residents that are "conduit companies" meeting a "conduit base reduction test." A conduit company is one that pays out currently at least 90 percent of its aggregate receipts in deductible payments (including royalties and interest, but excluding those at arm's length for the purchase, or use of or the right to use, tangible property in the ordinary course of business, or remuneration at arm's length for services performed in the payer's residence country). A conduit company meets the conduit base reduction test if less than a threshold fraction (generally 50 percent) of its gross income is paid to associated enterprises subject to a particularly low tax rate (relative to the tax rate normally applicable in the payer's residence country). According to the Understanding, it is understood that, for purposes of applying the conduit base reduction test, the competent authority will initially confine its requests for information on a resident of the other country to the subject of determining whether the resident is a conduit company. The Understanding provides that the competent authority will request additional information to determine whether the conduit base reduction test has been satisfied only *after* determining that the company is a conduit company.

Article 31. Assistance and Support in Collection

This article provides for administrative cooperation between the two countries in enforcing and collecting income tax claims. It is carried over from Article XXII of the present treaty without significant modification, although it is accompanied by a new detailed discussion in the Understanding. The article covers matters that are also the subject of a provision included in the exchange of information article of the U.S. model treaty, but is broader in scope and more detailed than the U.S. model treaty provision.

The proposed treaty provides that the countries are to undertake to assist and support each other in collecting the taxes to which the treaty applies, including interest, costs, and additions to such taxes and fines not of a penal character. Such assistance, however, is not to be accorded under this Article with respect to citizens, corporations, or other entities of the country whose assistance is requested except in cases where the treaty exemptions or rate reductions granted under the treaty have, according to mutual agreement between the competent authorities, been enjoyed by persons not entitled to those benefits. The Understanding notes that the competent authorities may under this Article grant assistance in collecting any tax deferred by operation of the Article 14 provision requiring coordination of nonrecognition provisions in the case of corporate reorganizations and other transactions.

The treaty specifies that each country may accept for enforcement and may collect revenue claims of the other country which have been finally determined. The Understanding provides that for purposes of this Article, a revenue claim is finally determined when the applicant country has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the

taxpayer to restrain collection in the applicant country have lapsed or been exhausted.

Pursuant to the Understanding, a country is not obliged to accede to a request for collection assistance if the applicant country has not pursued all appropriate collection action in its own jurisdiction, and in those cases where the administrative burden for the requested country is disproportionate to the benefit to be derived by the applicant country.

Where the request is accepted, the accepting country is to enforce and collect such revenue claims in accordance with the laws applicable to the enforcement and collection of its own taxes. It is not to be required to enforce executory measures (e.g., the seizure of the debtor's property) for which there is no provision in the law of the other country. The Understanding provides that the request may be accepted for collection by the competent authority, and if accepted, generally shall be collected by the accepting country as though the claim were that country's own revenue claim finally determined. However the claim will not have, in the accepting country, any priority accorded to the revenue claims of that country.

If the accepting country is the United States, the Understanding provides that the United States will treat the claim as an assessment under U.S. law against the taxpayer as of the time the application is received; if the accepting country is the Netherlands, that country will treat the claim as an amount payable under appropriate Dutch law, the collection of which is not subject to any restriction. The accepting country may, after notifying the applicant country, allow deferral of payment, or payment by installments, if its laws or administrative practice permit it to do so in similar circumstances. Any interest received by the accepting country as a result of the delay in receipt will be transferred to the competent authority of the applicant country.

When one country applies to the other for assistance in enforcing a revenue claim, its application must include a certification that the taxes have been finally determined under its own laws. Pursuant to the Understanding, the request for administrative assistance in the recovery of a tax claim must also be accompanied by an official copy of the instrument permitting enforcement in the applicant country and, where appropriate, certified copies of any other document required for recovery.

Under the Understanding, in general amounts collected under the Article are to be forwarded to the competent authority of the applicant country. Unless the competent authorities otherwise agree, the ordinary costs incurred in providing assistance are to be borne by the collecting country, and any extraordinary costs by the applicant country.

The Understanding provides that nothing in this article shall be construed as creating or providing any rights of administrative or judicial review of the applicant country's finally determined revenue claim by the country whose assistance is requested, based on any such rights that may be available under the laws of either country. On the other hand, if, at any time pending execution of a request for assistance under this Article, the applicant country loses the right under its internal law to collect the revenue claim,

its competent authority will promptly withdraw the request for assistance in collection.

Lastly, the Understanding provides that the competent authorities shall agree upon the mode of application of this Article. They may further agree to modify or supplement the procedures set forth in the Understanding, although they will continue to be bound by the general principles established therein.

Article 32. Limitation on Articles 30 and 31

As is true under the present treaty and the U.S. and OECD model treaties, the proposed treaty contains limitations on the obligations of the countries to supply information as prescribed in article 30, and to provide collection assistance and support as prescribed in article 31. Under the proposed treaty, a country is not required to carry out administrative measures at variance with the law and administrative practice of either country, or to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Article 33. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply in full to this article, so that, for example, U.S. diplomats who are considered Dutch residents generally may be protected from Dutch tax.

In addition, a member of a diplomatic mission or consular post of one treaty country located in any other country will be deemed to be a resident of the sending country if he is a national of that country, but only if he is subjected by the sending country to the same income tax obligations as are residents of that country. Thus, for example, a U.S. diplomat stationed in France, and owning stock in a Dutch company, would be eligible for any Dutch tax reductions under the proposed treaty on dividends from that stock paid to a U.S. resident owning that stock, assuming the other requirements of the article were met.

The proposed treaty also states that it does not apply to international organizations, to organs or officials thereof, or to persons who are members of a diplomatic mission, consular post, or permanent mission of a third country, if they are present in one of the treaty countries and not liable in either one to the same income tax obligations as are residents.

Article 34. Regulations

The competent authorities may by mutual agreement settle the mode of application of the dividend, branch tax, interest, royalties, and limitation on benefits articles of the proposed treaty (Articles 10, 11, 12, 13, and 26). In the case of dividends, interest, and royal-

ties, for example, the Technical Explanation indicates that this authorizes the competent authorities to specify the documentation required in order to permit withholding agents to deduct and withhold reduced amounts, or alternatively to require full withholding under the rates applicable by internal law, followed by refunds of the excess of collections over the amounts of tax permitted to be imposed by the treaty. With regard to these and other matters, the staff understands that the proposed treaty does not condition the effect of the listed articles on mutual agreement to a particular mode of application; in other words, each of these rules (including the limitation on benefits article) is self-executing (except for the exercise of the discretion of the competent authorities under paragraph 7 of the limitation on benefits article).

With respect to the exchange of information and tax collection assistance provisions of the proposed treaty, the proposed treaty carries over a provision in the present treaty authorizing the competent authorities, by common agreement, to prescribe rules concerning matters of procedure, forms of application and replies thereto, conversion of currency, disposition of amounts collected, minimum amounts subject to collection, and related matters. Finally, as provided in the present treaty, each competent authority may prescribe regulations necessary to carry out the other provisions of the proposed treaty, in accordance with the practices of each country.

The proposed treaty contains a three-year limitation on the time period within which a treaty country resident must apply for a refund of source-country tax imposed on dividends, interest, and royalties in excess of the amount chargeable under Articles 10, 12, or 13 of the treaty. Such an application must be lodged with the competent authority of the State having levied the tax, within a period of three years after the expiration of the calendar year in which the tax has been levied.

Article 35. Exempt Pension Trusts

The proposed treaty exempts interest and dividend income earned by certain employee benefit plans from source country taxation. The exemption applies to income referred to in the dividend and interest articles, if derived by a trust, company, or other organization constituted and operated exclusively to administer or provide benefits under one or more funds or plans established to provide pension, retirement or other employee benefits, and treated as a resident of one of the treaty countries, and generally is exempt from tax in that country, under its internal law. The proposed treaty's exemption does not apply, however, to income from carrying on a trade or business or from a related person other than a person that itself qualifies for the exemption.

This provision of the proposed treaty has no counterpart in the present or model treaties, but there is a similar provision in the U.S.-Canada income tax treaty. The Technical Explanation clarifies that it is not intended to apply to a dividend from a REIT treated under the Code as a disposition of real property. Unlike the charitable organization exemption, described below, the employee benefit plan exemption does not expressly condition source country exemption of foreign organizations on parity of treatment with do-

mestic organizations. Conceivably, then, the language of the proposed treaty may suggest that, for example, the United States would be obligated to exempt a Dutch pension plan from U.S. tax that would be imposed on a comparable U.S. plan. However, the staff understands that such a result was not intended by the negotiators. Moreover, the staff is informed that for purposes of determining whether income of a Dutch employee benefit plan is derived from carrying on a trade or business, and therefore not protected by the treaty from the operation of internal U.S. law, it is intended that internal U.S. law would apply. Thus any income of a type that would be treated as "unrelated business taxable income" under the Code would be ineligible for treaty protection under this article.

Article 36. Exempt Organizations

Each country generally will exempt from tax in respect of items of income organizations operated for religious, charitable, scientific, educational, or public purposes and treated as tax-exempt for that reason in the other country, if and to the extent that the organization would, but for the foreign location of its activities and place of organization, be exempt from tax in the first country. The exemption does not apply, however, to income from carrying on a trade or business or from a related person other than a person that itself qualifies for the exemption.

This provision of the proposed treaty has no counterpart in the present or model treaties, but there are similar provisions in the U.S.-Germany and U.S.-Canada income tax treaties, and the proposed treaty with Mexico. The competent authorities are to develop procedures for implementing this article.

Article 37. Entry Into Force

The proposed treaty will enter into force on the 30th day after the later of the dates on which each Government notifies the other in writing that its constitutionally required formalities have been complied with. The provisions of the proposed treaty generally take effect for taxable years and periods beginning on or after the first day of January in the year following the date of entry into force. In the case of taxes payable at source, the proposed treaty generally takes effect for payments made on or after that first day of January. Thus, if each Government notifies the other in writing on or before Wednesday, December 1, 1993, that its constitutionally required formalities have been complied with, the proposed treaty will enter into force on December 31, 1993, and its provisions will take effect generally with respect to income earned in 1994 and thereafter.

Taxpayers may elect temporarily to continue to claim benefits under the present treaty with respect to a period after the proposed treaty takes effect. For such a taxpayer the present treaty would continue to have effect in its entirety for the 12-month period from the date on which the provisions of the proposed treaty would otherwise take effect. In some cases, the present treaty already has no effect because of a contrary statute. An example is the FIRPTA override of the prohibition in the present treaty against taxing gain from disposition of a U.S. real property interest comprising stock in a U.S. corporation. The staff understands that nothing in this

article permits the taxpayer, during the first 12 months from the date on which the proposed treaty takes effect, to claim benefits to which it would not be entitled under present law, unless those benefits are allowed under the proposed treaty, applied in its entirety.

The present treaty ceases to have effect once the provisions of the proposed treaty take effect under the foregoing rules. However, the proposed treaty does not affect any agreement in force extending the present treaty in accordance with its terms. This language clarifies that the entry into force of the proposed treaty does not affect the relationship between the United States and the Netherlands Antilles.

Article 38. Termination

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it, through diplomatic channels, by giving notice at least six months before the end of any calendar year after the expiration of a period of five years from the date of its entry into force. A termination will be effective for taxable years and periods beginning after the end of the calendar year in which the notice has been given. With respect to taxes payable at source, a termination will be effective for payments made after the end of the calendar year in which the notice has been given.

V. EXPLANATION OF PROPOSED PROTOCOL

Article 1. Interest

The triangular case in general

Under present laws and treaties that apply to Dutch residents, it is possible for profits of a permanent establishment maintained by a Dutch resident in a third country to be subject to a very low aggregate rate of Dutch and third-country income tax. The proposed treaty, in turn, eliminates the U.S. tax on several specified types of income of a Dutch resident, and "Other Income" as that term is used in the proposed treaty. In a case where the U.S. income is earned by a third-country permanent establishment of a Dutch resident (the so-called "triangular case") the proposed treaty thus holds the potential of helping Dutch residents to avoid all (or substantially all) taxation, rather than merely avoiding double taxation. The Treasury Department has indicated that use of the proposed treaty to avoid taxation in this manner would constitute an abuse of the treaty. The need to forestall such abuse was the impetus for the requirement of Article 24 (Basis of Taxation) of the proposed treaty that additional rules be provided, either in Dutch legislation or in a protocol to the proposed treaty.

Dutch internal law has not been amended to address this problem. In its place, the proposed protocol would amend the proposed treaty to combat abuse of the treaty in certain cases where U.S. source interest or royalties are earned by a Dutch resident. The protocol provisions are drafted reciprocally to apply both to U.S. source interest of a Dutch resident, and Dutch source interest of a U.S. resident. However, under the laws and treaties now in force, the practical impact of the protocol will fall on items of U.S. source income earned by a Dutch resident. The proposed protocol does not allow the United States to impose source tax on interest and royalties in all cases resulting in low overall tax; nor does the proposed protocol allow the United States to impose tax on items other than interest and royalties that may be subject to low overall tax.

Source taxation of interest in the triangular case

The proposed protocol provides for an exception to the general rule in Article 12 of the proposed treaty that exempts interest from source country taxation. If the exception applies, the source country may impose a 15-percent tax on the gross amount of interest. Under the internal laws currently in force in the United States and the Netherlands, the practical effect of this provision is to permit the United States, in the cases to which it applies, to impose a 15-percent withholding tax on interest paid to a Dutch resident.

In order for this source country tax to be imposed, three conditions must be met. First, the interest must be beneficially owned by an enterprise of the other treaty country and attributable to a

permanent establishment of that enterprise in a third jurisdiction. That is, in the case of a Dutch recipient of the interest, the interest must be attributable to a permanent establishment that the Dutch resident maintains in a third country.

Second, the profits of that permanent establishment must be subject to a sufficiently low aggregate rate of tax, taking into account the taxes imposed in both the residence country and the third jurisdiction. Before 1998, the rate is sufficiently low for this purpose if it is less than 50 percent of the general rate of company tax applicable in the treaty country where the recipient resides. After 1997, the rate is sufficiently low if it is less than 60 percent of the general rate of company tax applicable in that treaty country. Under present Dutch law, corporations are subject to income tax at a 35-percent rate on taxable income over a threshold. It therefore is understood that 35 percent is presently the "general rate of company tax applicable in" the Netherlands. The interest income of a Dutch company's permanent establishment in a third country may be taxed in the United States, under the proposed protocol, if combined Dutch and third country tax is levied at less than 17.5 or 21 percent, as the case may be.

The staff understands, and the Technical Explanation indicates, that the aggregate rate of tax to which the permanent establishment is subject by the residence country and the third country means, for purposes of the proposed protocol, the aggregate "effective" tax rate: that is, the ratio of the actual tax paid divided by the profit, computed under U.S. principles. Consistent with this understanding, the Technical Explanation indicates that the principles employed under Code section 954(b)(4) (which allows a taxpayer to establish to the satisfaction of the Secretary that income of a foreign corporation was subject to an effective rate of income tax imposed by a foreign country greater than a fixed percentage of the Code's statutory corporate income tax rate) will be employed to determine whether profits are subject to an effective rate of taxation that is above the specified threshold.

Third, the interest must not be derived in connection with, or incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third jurisdiction (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company). The diplomatic notes exchanged at the time the proposed protocol was signed provide that it is understood for this purpose that interest derived from group financing or portfolio investments shall be considered to be part of the business of making or managing investments.

Article 2. Royalties

As in the case of interest, the proposed protocol also provides for an exception to the general rule in Article 13 of the proposed treaty that exempts royalties from source country taxation. If the exception applies, the source country may impose a 15-percent tax on the gross amount of royalties. Under the internal laws currently in force in the United States and the Netherlands, the practical effect of this provision is to permit the United States, in the cases to

which it applies, to impose a 15-percent withholding tax on royalties paid to a Dutch resident.

In order for this source country tax to be imposed, three conditions must be met. The first two match the conditions for imposing source country taxation on interest, while the third is somewhat different. First, the royalties must be beneficially owned by an enterprise of the other treaty country and attributable to a permanent establishment of that enterprise in a third jurisdiction.

Second, the profits of that permanent establishment must be subject to a sufficiently low aggregate rate of tax, taking into account the taxes imposed in both the residence country and the third jurisdiction. Before 1998, the rate is sufficiently low for this purpose if it is less than 50 percent of the general rate of company tax applicable in the treaty country where the recipient resides. After 1997, the rate is sufficiently low if it is less than 60 percent of the general rate of company tax applicable in that treaty country.

Third, the royalties must not be received as a compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself. The Technical Explanation indicates that this applies only when the intangible property has been developed in the third jurisdiction. Thus, the staff understands that an arrangement under which the permanent establishment shares the costs of developing property elsewhere does not render royalties received by the permanent establishment from licensing the property exempt from source country taxation.

Article 3. Basis of Taxation

The proposed protocol deletes the language in Article 24 (Basis of Taxation) of the proposed treaty that requires additional action with respect to the matters covered in this proposed protocol.

Article 4. Methods of Elimination of Double Taxation

The proposed treaty modifies the requirements imposed on the Netherlands to give double taxation relief in the case of business profits taxable in the United States under the proposed treaty, and in the case of interest and royalties taxable at source by the United States under the first two articles of the proposed protocol.

As described in connection with Article 25 (Methods of Elimination of Double Taxation) of the proposed treaty, the proposed treaty requires the Netherlands to continue to employ its "exemption with progression" method with respect to most U.S. income, and specifies items of U.S. income to which the exemption with progression method will apply (regardless of internal Dutch law): if a Dutch resident or national earns income taxable by the United States under specified provisions of the proposed treaty, and such income is included in the taxpayer's Dutch tax base, then the Netherlands will reduce its tax in conformity with its internal law for the avoidance of double taxation. Under the proposed treaty, the income to be so treated includes, among other items, business profits which according to the proposed treaty may be taxed in the United States. The proposed protocol amends the treaty so that the Netherlands is obligated to exempt U.S. business profits only insofar as such income is actually subject to U.S. tax. If the United States is permitted to tax business profits under the proposed trea-

ty but for some reason fails to do so, then under the proposed protocol, the Netherlands may tax treat those profits as not entitled to double taxation relief.

The proposed protocol also makes provision for relief from double taxation of U.S. source interest and royalties taxable by the United States under the first two articles of the proposed protocol, to the extent that such income is included under Dutch law in the basis of taxation, and not exempt. As described above, the Netherlands under the present or proposed treaties provides in effect a credit against the Dutch tax for U.S. tax imposed on dividends and certain other items. Under the proposed protocol, this type of double taxation relief would apply to U.S. source interest and royalties taxable by the United States under the first two articles of proposed protocol, if it is included in the basis of Dutch taxation and not exempt from Dutch tax, as the profits of permanent establishment, under internal Dutch law or a Dutch treaty provision. If this rule applies, the reduction in Dutch tax will be limited to the lesser of 15 percent of the interest and royalties, or the amount of the Dutch tax reduction which would be allowed if the items of income so included in the Dutch tax base, and only those items, were exempt from Dutch tax under the Dutch "exemption with progression" system.

Article 5. Limitation on Benefits

The proposed protocol modifies the test by which a subsidiary of one or more publicly traded companies is made eligible for treaty benefits by virtue of that fact. Under the proposed treaty, a company that is not a conduit company, and that is a resident of the Netherlands or the United States, is entitled to treaty benefits if more than 50 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer publicly companies which are residents of either treaty country. A Dutch resident company that is not a conduit company is entitled to treaty benefits if at least 30 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer publicly traded Dutch resident companies, and at least 70 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer publicly traded companies that are residents of the United States or of EC member states.

With respect to the public company tests, the references to shares that are "owned directly or indirectly" mean that each company in the chain of ownership that is used to satisfy the relevant ownership requirement must itself meet the relevant residence requirement. Under the proposed protocol, the only residence requirement that intermediate companies in the chain must meet is the requirement that they be resident in either treaty country or in an EC member country (as that term is defined in the proposed treaty as modified by the proposed protocol).

Article 6. Exempt Pension Trusts

The proposed protocol clarifies that the proposed treaty does not prevent the United States from taxing certain distributions received by a Dutch resident employee benefit plan from a U.S. real estate investment trust (REIT). As described in connection with Ar-

ticle 35 of the proposed treaty, dividend income earned by certain employee benefit plans is exempt from source country taxation. Under the Code, any distribution by a REIT to a foreign person shall, to the extent attributable to gain from the disposition by the REIT of U.S. real property interests, be treated as gain recognized by the foreign person from the disposition of such an interest. The proposed protocol clarifies that the dividend exemption in Article 35 of the proposed treaty does not apply to a distribution from a REIT that is treated under the Code as a disposition of real property.

Article 7. Entry into Force

The proposed protocol will enter into force on the later of the dates on which each Government notifies the other in writing that its constitutionally required formalities have been complied with. The provisions of the proposed protocol generally take effect for taxable years and periods beginning on or after the first day of January in the year following the date of entry into force of the proposed treaty. Thus, in general the protocol takes effect for the same years and periods for which the proposed treaty generally takes effect.

Notwithstanding this general rule, the proposed protocol provisions that amend the proposed treaty to permit source country taxation of interest and royalties, and that relate to the double taxation relief to be provided by the Netherlands with regard to such interest and royalties, take effect for payments made on or after the 30th day after the date on which the proposed protocol has entered into force. Thus, if the proposed treaty takes effect on January 1, 1994, but the proposed protocol enters into force at a later date, then the United States would not be entitled to impose tax at source under the protocol until sometime after January 1, 1994.

Exchange of Notes

In addition to the provisions and understandings reflected above, the diplomatic notes exchanged at the time the proposed protocol was signed (the "Notes") set forth these additional understandings:

Voting stock

For purposes of determining eligibility for treaty benefits generally, and, in particular, eligibility for reduced (5-percent) source-country taxation of direct investment dividends, it is necessary to establish the identity of the person owning corporate stock and any stock voting rights. The Understanding accompanying the proposed treaty provides that a beneficial owner of dividends who holds depository receipts or trust certificates evidencing beneficial ownership of the shares in lieu of the shares themselves may claim entitlement to this 5-percent rate under the treaty. Moreover, the Limitation on Benefits article (Article 26) generally provides that the term "shares" includes depository receipts thereof of trust certificates thereof.

The Notes provide that for the purpose of the proposed treaty's dividend article (Article 10) and limitation on benefits provision described above, it is understood that depository receipts or trust certificates of shares will be considered to possess the rights attached

to the shares which they replace, including the voting rights thereof.

Limitation on benefits

Active business test

Under the active business test in the limitation on benefits article, treaty benefits in the source country will be available under the proposed treaty to an entity that is a resident of the United States or the Netherlands, if it is engaged in the active conduct of a trade or business in its residence country, and if either the income derived from the source country is incidental to that trade or business in the residence country, or such income is derived in connection with that trade or business and the trade or business is substantial in relation to the income producing activity. Income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business which forms a part of, or is complementary to, the trade or business conducted in the residence country by the income recipient.

The Notes provide that if a person resident in one of the treaty countries is engaged in the active conduct of a trade or business in that country, and derives income from the other country without being engaged in the active conduct of a trade or business in the other country, and in addition such person does not own shares (other than shares that generate income incidental to the trade or business in the residence country) in the person from which the income is derived, then such person will be deemed to meet the active business test if either the income derived in the other State is derived in connection with the trade or business in the first-mentioned State, or the income derived in the other State is incidental to the trade or business in the first-mentioned State.

Under the proposed treaty, an entity does not meet the active business test (and therefore cannot claim treaty benefits under this rule) by virtue of being engaged in the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company.

The Notes clarify that it is understood for this purpose that interest derived from group financing or portfolio investments shall be considered to be part of the business of making or managing investments.

Under the proposed treaty, the active business test takes into account the extent to which the person seeking treaty benefits is deemed to be so engaged through the activities of related persons. A treaty country resident is deemed to be engaged in the active conduct of a trade or business in its residence country if it owns, as a member of a group of residents of an "identified state," a controlling beneficial interest in person so engaged. A similar principle applies if a treaty country resident is, together with another person so engaged, under the common control of a person (or a group of persons) which (or, in the case of a group, each member of which) is a resident of an "identified state." An "identified state" includes any third country, identified by agreement of the competent authorities, which has effective provisions for the exchange of infor-

mation with the residence country of the person being tested under these rules.[63]

The Notes add Portugal and Japan to the list of identified states.

Headquarter companies

A treaty country resident is entitled to all the benefits of the proposed treaty if that person functions as a headquarter company for a multinational corporate group. The person seeking such treatment must provide a substantial portion of the overall supervision and administration of the group, which may include, but cannot be principally, group financing.

The Notes provide that for this purpose, it is understood that these supervision and administration activities must be performed in the country of residence of the person performing such activities.

Public companies

A treaty country resident company is entitled to all the benefits of the proposed treaty if the stock of that company, or certain stockholders of that company, are sufficiently listed and traded on certain so-called "recognized stock exchanges." This term includes any other stock exchange agreed upon by the competent authorities of the two countries. The stock exchanges to be treated as "recognized" by agreement of the competent authorities are to include any stock exchanges listed in an exchange of notes signed at the later of the dates on which the respective governments have notified each other in writing that the formalities constitutionally required for the entry into force of the treaty in their respective countries have been complied with. According to the Understanding, the stock exchanges of Frankfurt, London and Paris will in any case be listed.

The Notes further provide that for these purposes, the principal stock exchanges of Frankfurt, London, Paris, Brussels, Hamburg, Madrid, Milan, Sydney, Tokyo and Toronto will be considered to be "recognized stock exchanges."

EC member country residents

For various purposes of obtaining eligibility for treaty benefits under the limitation on benefits article, it is useful to identify a person as a resident of a member country of the European Communities (the "EC"). To be considered an EC member country for this purpose, the country generally must either be the Netherlands or a member of the EC with which both the United States and the Netherlands have in effect comprehensive income tax treaties. To be considered a resident of an EC member country for this purpose, a person would have to be considered a resident of the member country under the principles of Article 4 (Resident) of the proposed treaty. Further, the person would have to be entitled to benefits under the proposed treaty (treating the member country as though it were the Netherlands) upon application of the principles of the limitation on benefits rules in the proposed treaty for individuals,

[63] For this purpose, the Understanding lists numerous countries regarded as an "identified State" having effective provisions for the exchange of information at the date of signature of the proposed treaty. It is understood that countries may be added to or eliminated from the list by agreement between the competent authorities.

governments, tax-exempt non-profits, public companies and their subsidiaries, or under the general ownership/base erosion test that applies to both U.S. and Dutch entities (paragraph 1 of Article 26). Finally, the person must be otherwise entitled to the benefits of the treaty between that person's residence country and the United States.

The Notes provide an addition understanding with respect to this requirement. The notes provide that it is understood that, in determining whether a person will be considered a "resident of a member state of the European Communities" for this purpose, such person will be considered to be otherwise entitled to the benefits of the treaty between that person's state of residence and the United States if that person is entitled to the benefits of such treaty with respect to the items of income derived from the United States under all provisions of such treaty with the exception of any provisions in such treaty relating to the limitation on benefits, except that such person must also satisfy any relevant provision relating to the limitation on benefits of such treaty, if Article 26 (Limitation on Benefits) of the proposed treaty does not contain a provision that is of the same or similar nature as the provision in such treaty. If Article 26 does contain such a provision, it is understood that the person must satisfy that provision of Article 26 of the Dutch treaty (treating the member country as though it were the Netherlands and the person as though it were a Dutch resident).

Exempt pension trusts

The proposed treaty exempts interest and dividend income earned by certain employee benefit plans from source country taxation. The proposed treaty's exemption does not apply, however, to income from a related person other than a person that itself qualifies for the exemption.

The Notes provide that for this purpose, a person is considered to be a related person if more than 80% of the vote or value of any class of the shares is owned by the person deriving the income.

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