[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE KINGDOM OF THE NETHERLANDS IN RESPECT OF THE NETHERLANDS ANTILLES

TO BE CONSIDERED

BY THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

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, describes the proposed protocol to the income tax treaty between the United States and the Kingdom of the Netherlands in respect of the Netherlands Antilles. The proposed protocol was signed on October 10, 1995.[2] The proposed protocol amends Article VIII (Interest) of the 1948 treaty between the United States and the Kingdom of the Netherlands as applicable to the Netherlands Antilles. The Senate Committee on Foreign Relations will consider the proposed protocol at its next Committee business meeting.

Part I of the pamphlet provides a summary with respect to the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains an explanation of the proposed protocol. Part IV contains a discussion of the issues with respect to the proposed protocol.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and the Kingdom of the Netherlands in Respect of the Netherlands Antilles* (JCS–9–96), September 16, 1996.

[2] For a copy of the proposed protocol, see Senate Treaty Doc. 104–23, January 3, 1996.

I. SUMMARY

The Convention between the United States of America and the Kingdom of the Netherlands with Respect to Taxes on Income and Certain Other Taxes was signed on April 29, 1948 ("1948 Convention"). The 1948 Convention was extended to the Netherlands Antilles by exchange of notes dated June 24, 1952, August 7, 1952, September 15, 1955, November 4, 1955, and November 10, 1955. The 1948 Convention as applicable to the Netherlands Antilles was amended by protocols signed on June 15, 1955 and October 23, 1963.

On June 29, 1987, the United States gave notice of termination of the 1948 Convention as it applied to the Netherlands Antilles. On July 10, 1987, the United States modified its notice of termination. Pursuant to such modification, the termination did not apply to Article VIII (Interest) and certain ancillary provisions of the 1948 Convention. Accordingly, following the partial termination, Article VIII (Interest) of the 1948 Convention continues to apply with respect to the Netherlands Antilles.

In 1992, the United States and the Netherlands signed a new Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income ("1992 Convention"). The 1992 Convention, which entered into force on December 31, 1993, replaced the 1948 Convention. However, pursuant to its terms, the 1992 Convention does not affect the agreement extending the 1948 Convention to the Netherlands Antilles (as modified by the partial termination). The 1992 Convention does not extend to the Netherlands Antilles.

Article VIII of the 1948 Convention, as extended to the Netherlands Antilles, generally provides for an exemption from U.S. tax for interest (other than mortgage interest) from U.S. sources derived by a resident or corporation of the Netherlands Antilles that is not engaged in a trade or business in the United States through a permanent establishment. The proposed protocol would amend Article VIII of the 1948 Convention to limit the exemption from U.S. tax to interest paid on debt instruments issued on or before October 15, 1984 by a U.S. person to certain related controlled foreign corporations.

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

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

A. U.S. Tax Rules

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

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

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation is subject to U.S. tax at a rate of 1 or 4 percent of the premiums. These taxes generally are collected by means of withholding.

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

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the tax-

able year, and (2) certain gains from the disposition of interests in U.S. real property.

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

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

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

B. U.S. Tax Treaties

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

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit,

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

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

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

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

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

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

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

III. EXPLANATION OF PROPOSED PROTOCOL

Article I

Article I of the proposed protocol amends Article VIII of the 1948 Convention to limit the exemption from U.S. tax for U.S. source interest paid to residents of the Netherlands Antilles. Under the amendment, the exemption applies only to interest paid with respect to debt instruments issued on or before October 15, 1984 to a related controlled foreign corporation which was in existence before October 15, 1984 and the principal purpose of which is the issuing of debt obligations or the holding of short-term obligations and the lending of the proceeds of such obligations to affiliates.

According to the Treasury Department's Technical Explanation (hereinafter referred to as the "Technical Explanation"), U.S. tax principles generally will apply for purposes of determining whether a debt instrument was issued on or before October 15, 1984. In this regard, the Technical Explanation provides that the principles of Rev. Rul. 85–163, 1985–2 C.B. 249, will apply to treat any debt instrument issued after October 15, 1984 pursuant to a binding written agreement entered into on or before such date as having been issued on or before such date, including a debt instrument issued upon the exercise of a warrant or the conversion of a convertible obligation if such warrant or convertible obligation was issued on or before such date. The Technical Explanation further states that the principles of section 957 of the Internal Revenue Code will apply in determining whether a Netherlands Antilles company is a controlled foreign corporation and the principles of Code section 482 will apply in determining whether any person is an affiliate of a controlled foreign corporation.

Article II

Article II of the proposed protocol provides that the proposed protocol is subject to ratification in accordance with the applicable procedures of the United States and the Netherlands. The proposed protocol provides that it will enter into force upon the later of June 30, 1996 or the exchange of instruments of ratification. The proposed protocol further provides that it will not enter into force at all if it has not entered into force prior to January 1, 1997.

IV. ISSUES

The proposed protocol limits the continued applicability of Article VIII of the 1948 Convention in order to prevent residents of third countries from inappropriately deriving the benefit of the exemption from U.S. tax on U.S.-source interest. The United States' partial termination of the 1948 Convention as it applies to the Netherlands Antilles was due to concerns about treaty-shopping abuses in connection with the convention. The Technical Explanation states that the continued availability of the exemption under Article VIII has given rise to a substantial loss of revenue attributable to the persistent abuse of the exemption by third country residents. The Technical Explanation further states that the continued availability of Article VIII of the 1948 Convention as it applies to the Netherlands Antilles hinders the Treasury Department's ability to negotiate effective anti-treaty-shopping provisions in new treaties with other countries.

The proposed protocol preserves the exemption provided under the 1948 Convention for interest on certain debt instruments issued on or before October 15, 1984. This continued exemption applies to certain debt instruments issued pursuant to financing arrangements that were structured in reliance on the existence of such exemption.

Some U.S. companies established subsidiaries in the Netherlands Antilles in order to issue debt in the international capital markets. Under this structure, the Netherlands Antilles subsidiary issued Eurobonds in the international market. The Netherlands Antilles subsidiary then loaned the proceeds of these Eurobonds to its U.S. parent or to another U.S. affiliate. The U.S. parent or affiliate thus issued to the Netherlands Antilles subsidiary a debt obligation that corresponded to the Eurobonds issued by the subsidiary. The Netherlands Antilles subsidiary receives interest from the U.S. parent or affiliate on the debt obligation of such parent or affiliate and pays interest on the Eurobonds it issued. The Netherlands Antilles subsidiary relies on Article VIII of the 1948 Convention as extended to the Netherlands Antilles in order to avoid the U.S. 30-percent withholding tax on the interest received from the U.S. parent or affiliate. The interest paid by the Netherlands Antilles subsidiary on the Eurobonds is not subject to any tax by the Netherlands Antilles.

This structure for the international issuance of debt was used by U.S. companies prior to the enactment of the Deficit Reduction Act of 1984 ("1984 Act"). Before its amendment by the 1984 Act, the U.S. 30-percent withholding tax applied to all U.S.-source interest income of nonresident alien individuals and foreign corporations (other than interest on bank deposits and short-term original issue discount). Thus, interest paid to foreign persons on a debt obligation of a U.S. company generally was subject to this 30-percent withholding tax. Although U.S. tax treaties contained provisions that would reduce or eliminate this U.S. withholding tax, the procedures for claiming the benefits of a tax treaty were too cumbersome for use in connection with a public offering of debt. Accordingly, U.S. companies were effectively precluded from issuing debt directly in the international capital markets.

The 1984 Act provided an exception from the U.S. 30-percent withholding tax for interest on certain portfolio debt obligations that enabled U.S. companies to issue international debt offerings directly. This exception applies to (1) certain obligations issued in bearer form pursuant to procedures designed to ensure that the obligations are held only by non-U.S. persons and (2) certain obligations issued in registered form for which the payor has received a statement that the beneficial owner of the obligation is not a U.S. person. Pursuant to one of several specified limitations, this exception does not apply to interest paid to a controlled foreign corporation by a related person. This exception is effective for interest received after July 18, 1984 (the date of enactment of the 1984 Act) with respect to obligations issued after such date.

In connection with the enactment of this exception, the 1984 Act included a special rule with respect to certain interest paid in connection with back-to-back obligations of the type described above. Under this rule, interest paid on an obligation of a U.S. person to a related controlled foreign corporation is treated for tax purposes as paid to a resident of the country in which the controlled foreign corporation is incorporated. In addition, it was intended under this rule that the corresponding obligation of the controlled foreign corporation be recognized as an obligation of the controlled foreign corporation. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS–41–84), December 31, 1984, p. 397. This special rule applies only to interest paid on obligations issued before June 22, 1984 (the date of conference action on the 1984 Act) to a controlled foreign corporation that was in existence on or before such date. In order to be eligible for this special rule, the controlled foreign corporation must satisfy certain other requirements, including a requirement that the principal purpose of the controlled foreign corporation be the issuance or holding of debt obligations and the lending of the proceeds thereof to affiliates and a requirement that the debt-equity ratio of the controlled foreign corporation be not more than a specified ratio.

On October 15, 1984, the Internal Revenue Service published Rev. Rul. 84–153, 1984–2 C.B. 383, which specifically addresses the applicability of the exemption under Article VIII of the 1948 Convention in the case of this type of back-to-back financing arrangement. The ruling provides that a Netherlands Antilles subsidiary that participates in this type of arrangement and that is not eligible for the special rule provided in the 1984 Act is considered a mere conduit; as such, the interest payments to such subsidiary are not eligible for the exemption from U. S. tax under Article VIII of the 1948 Convention.

The requirements for continued exemption under the proposed protocol basically mirror the requirements of the special rule provided in 1984 Act. However, the proposed protocol reflects the October 15, 1984 date on which the IRS revenue ruling was published rather than the June 22, 1984 date of the 1984 Act rule. The Technical Explanation states that application of the continued exemption to debt instruments issued on or before October 15, 1984 reflects the Internal Revenue Service practice of extending the 1984 Act rule to debt instruments issued on or before the date the reve-

nue ruling was published. The Technical Explanation further notes that although the proposed protocol does not explicitly condition the continued exemption on satisfaction of all of the requirements specified in the 1984 Act rule, failure to satisfy such requirements (e.g., failure to meet the specified debt-equity ratio requirement) generally will result in the controlled foreign corporation being treated as a mere conduit that is not eligible for the benefits of Article VIII of the 1948 Convention.

As noted above, continuation of Article VIII of the 1948 Convention as it applies to the Netherlands Antilles raises significant treaty-shopping concerns. However, a complete termination of the Article VIII exemption could trigger a disruption of the market with respect to outstanding Eurobonds. Indeed, the market disruption that occurred when the United States originally gave notice of the termination of the 1948 Convention as it applied to the Netherlands Antilles led to the subsequent modification of that termination notice to reinstate Article VIII. The Committee may view the proposed protocol's limitation on the applicability of Article VIII as appropriately curbing the treaty-shopping abuse while preserving the exemption from U.S. tax for interest on certain debt instruments that were issued in reasonable reliance on the existence of such exemption.