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

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the existing income tax treaty between the United States and Denmark (the "proposed protocol").[2] The proposed protocol was signed on May 2, 2006. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol for July 17, 2007.[3]

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

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[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 Denmark* (JCX-46-07), July 13, 2007. References to "the Code" are to the U.S. Internal Revenue Code of 1986, as amended.

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

[3] For a copy of the proposed protocol, *see* Senate Treaty Doc. 109-19.

I. SUMMARY

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

The proposed protocol modifies several provisions in the existing treaty (signed in 1999). The rules of the proposed protocol generally are similar to rules of recent U.S. income tax treaties, the 2006 U.S. model income tax treaty ("U.S. model"), and the 2005 model income tax treaty of the Organisation for Economic Co-operation and Development ("OECD model").[4] However, the existing treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models.

The proposed protocol expands the "saving clause" provision in Article 1 (Personal Scope) of the existing treaty to allow the United States to tax certain former citizens and long-term residents regardless of whether their termination of citizenship of residency has as one of its principal purposes the avoidance of tax. This provision generally allows the United States to apply special tax rules under section 877 of the Code as amended in 2004.

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol would retain both the generally applicable maximum rate of withholding at source of 15 percent and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. However, like several other recent treaties and protocols, the proposed protocol would provide for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. As in the current treaty, special rules would apply to dividends received from RICs and REITs, with some new modifications applicable to dividends from REITs, similar to provisions included in other recent treaties and protocols.

The proposed protocol amends Article 19 (Government Service) of the existing treaty to correct a drafting error that inappropriately expands the scope of an exception to the general rule governing the taxation of certain government pensions

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[4] The 2006 U.S. model replaced an earlier U.S. model income tax treaty that dated to 1996. This pamphlet generally compares the provisions of the proposed protocol with the provisions of the 2006 U.S. model because that model took effect less than six months after the signing of the proposed protocol.

For a comparison of the U.S. model with its 1996 predecessor, *see* Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

The proposed protocol replaces Article 22 (Limitation on Benefits) of the existing treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. model and more recent U.S. income tax treaties. Like the U.S. model, the proposed protocol includes a requirement to determine whether a company's public trading or management constitutes an adequate connection to its residence in a treaty country to prevent certain companies from qualifying for treaty benefits.

The proposed protocol will enter into force on the later of the dates on which the respective treaty countries have notified each other in writing that the requirements for ratification have been satisfied.

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

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

A. U.S. Tax Rules

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

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

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

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

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

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

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

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

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

B. U.S. Tax Treaties

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

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

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

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

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

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

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

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

III. OVERVIEW OF TAXATION IN DENMARK[5]

A. National Income Taxes

Overview

Denmark imposes a tax at the national and local levels upon net income from employment, investment, and business activities. Income taxes are imposed on individuals at progressive rates and on companies, associations, and estates at a flat rate. In general, residents of Denmark are subject to taxation on all income, whether arising in Denmark or abroad. The definition of income within each enumerated category is, as in the United States, expansive and generally includes capital gains. The tax is computed on an annual basis, and the timing of income and deductions for companies is determined on an accrual basis.

Individuals

Individuals resident in Denmark are taxed in Denmark on their worldwide income. The rate of income tax imposed upon an item of income depends upon its characterization as personal income, capital income, or share income.

Personal income includes wages, company profits, fringe benefits, and pension income. Capital income is defined as the net value of many items, including income from interest, capital gains on the disposal of shares, dividends not subject to share income taxation (including dividends from investment companies), and profits or losses from the rental of private property. The net sum of personal income and capital income forms taxable income. On the national level, income levels above DKK 39,500 ($6,990) are taxed at a rate of 5.5 percent.[6] Income levels between DKK 272,600 ($48,243) and DKK 327,200 ($57,905) are taxed at a rate of 6 percent, and income levels above DKK 327,200 ($57,905) are taxed at a rate of 15 percent. An individual is granted a fixed personal deduction of DKK 39,500 ($6,990) (DKK 29,300 ($5,185) in the case of children under the age of 18). Employees earning a salary generally may deduct costs and expenditures incurred to produce income, such as travel costs to and from work and dues paid to trade unions. Other employee expenses are deductible to the extent they exceed DKK 5,200 ($920). Municipal, local, and church taxes are extensive, ranging from 28.5 to 36.7 percent. There is an overall ceiling on tax at 59 percent.

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[5] The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part Christian Emmeluth, *Business Operations in Denmark*, Tax Management Portfolio No. 959-3rd (2006). *See* IBFD European Taxation Analysis, Denmark, available at http://checkpoint.riag.com (current as of September 1, 2006); Danish Ministry of Taxation, Tax in Denmark 2007, at http://www.skm.dk/foreign/english. The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition.

[6] The quoted tax rates and local currency amounts apply to 2007. U.S. dollar equivalents were calculated using the exchange rate for January 1, 2007 according to OANDA's FX Converter, available at http://www.oanda.com.

"Share income," including distributions from domestic and foreign companies (unless the company is an investment company), and gains and losses on the disposal of shares owned for more than three years, is not considered part of personal income. It is taxed separately at a rate of 28 percent for income of up to DKK 45,500 ($8,052) and at a rate of 43 percent for share income exceeding DKK 45,500 ($8,052). Beginning in 2008, the rate increases to 45 percent for share income exceeding DKK 100,000 ($17,697).

Corporations

Domestic Danish corporations are taxed on their worldwide income at a rate of 28 percent. Under recently enacted legislation, the corporate income tax rate is reduced to 25 percent, effective from the 2007 tax year.[7] No additional local taxes are imposed on corporate profits. Capital gains are generally aggregated with all other income for taxation at the corporate rate. Gains arising from the sale of shares by a corporation are exempt from tax provided that the date of sale was three or more years from the date of acquisition. Otherwise, such gains are taxable at ordinary corporate rates. Dividends received by a Danish corporation from a Danish or foreign corporation are generally taxable; however, for both domestic-source and foreign-source dividends, if the recipient corporation owns at least 15 percent (10 percent after December 31, 2008) of the payor corporation, and has held the shares for a continuous period of at least one year, the dividends received are generally exempt from tax if they are declared within such holding period. Recently enacted legislation adds another condition that inbound dividends must satisfy to qualify for exemption from Danish corporate income tax—the payor corporation must be either (i) resident in the European Union, the European Economic Area, or a country with which Denmark has a tax treaty; (ii) controlled by the recipient company; or (iii) subject to Danish cross-border tax consolidation. Under both prior law and the recent legislation, if certain of these conditions are not met, and complete tax exemption is thus unavailable, the dividends might nevertheless be subject to Danish income tax at an effective rate that is less than the statutory Danish corporate income tax rate.

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[7] The reduction in the corporate income tax rate was included in legislation that also amended the controlled foreign corporation ("CFC") regime to comply with European Union requirements, made net financing expenses deductible only if they pass the existing thin capitalization test as well as a new asset test and an "earnings before income tax" test, and tightened tax depreciation on long-life assets. Other changes are described in the accompanying text. Bech-Bruun, "Tax: New Danish Interest Deduction Limitations and CFC Rules," June 2007, available at http://www.bechbruun.com (last accessed on July 12, 2007).

B. International Aspects of Taxation in Denmark

Individuals

Individuals resident in Denmark generally are taxed on their worldwide income. Residence is broadly interpreted for this purpose. Individuals who acquire residences in Denmark and actually take up residence in Denmark, as well as individuals who are present in the country for a period of more than six months, are generally considered Danish residents for tax purposes. Residents of Denmark who are employed abroad for a period of at least six months generally are exempt from Danish taxation of their wages and salaries for personal work performed during the stay abroad. However, if the provisions of a tax treaty grant Denmark the right to tax this income, the income will be taxed at one-half the normal rate.

Denmark provides a special elective tax regime for certain foreign expatriates who become residents of Denmark in connection with being employed by Danish-resident employers. The lower rate of tax provided under this regime is available only for up to 36 months within 10 years of the date when the employment in Denmark started. Under the special regime, salary income is taxed at a flat rate of 25 percent (including local taxes) and may be subject to social security assessments. Other income of an electing expatriate is taxed in accordance with the ordinary provisions of Danish tax law. The election may be made when the expatriate begins work, or later, provided certain conditions are met at the time when the employee takes up his or her position in Denmark. Once made, the election is irrevocable. To qualify to make the election, an expatriate must reside in Denmark, must receive a cash salary (after deducting social security payments) of at least DKK 58,600 ($10,371) a month, and must not have been subject to full or limited tax liability in Denmark for the three years before employment. In addition, the expatriate must work principally in Denmark, and, for five years before employment, the expatriate must not have been directly or indirectly involved with the management of the company and must not have had a controlling interest in the company.

Nonresidents are subject to tax on specific items of Danish-source income, including income derived from remuneration in Denmark by a resident employer, income from a permanent establishment or a professional service supplied in Denmark, and income and capital gains derived from real property located in Denmark. Dividends derived from Danish-registered companies are subject to a 28-percent withholding tax.

Corporations

Companies resident in Denmark generally are taxed on their worldwide income. However, there is an exception in the case of income derived from a permanent establishment abroad, which is generally exempt from tax. Foreign corporations (those without a registered place of business in Denmark and not effectively managed in Denmark) are subject to tax only on Danish-source income. This includes income derived from a permanent establishment in Denmark, income derived from the lease or sale of real property in Denmark, and interest payments and dividends received from Danish registered companies. However, dividends distributed by a Danish company to a nonresident company are generally exempt from Danish withholding tax, provided that (i) the recipient foreign company owns at least 15 percent (10 percent after December 31, 2008) of the Danish company for a continuous period of at least one year, and (ii) the dividends are declared within that holding period.

A Danish resident company may be subject to corporate income tax on the income of its CFCs. Under the recently enacted legislation referred to previously, the CFC regime includes all financial subsidiaries in all jurisdictions, including Denmark. For the CFC regime to apply to a subsidiary, the Danish parent company must hold more than 50 percent of the votes in the subsidiary; more than 50 percent of the subsidiary's income must be CFC income, which includes interest income, taxable dividends, and capital gains; and more than 10 percent of the subsidiary's total assets must be financial assets.

Relief from double taxation

In the absence of a treaty, Denmark generally provides double tax relief by way of a credit against Danish tax. This foreign tax credit may not exceed the lesser of the income tax paid abroad or the Danish tax payable on the same income.

C. Other Taxes

Inheritance, gift, and wealth taxes

Assets inherited from a closely related decedent exceeding DKK 248,900 ($44,048) are subject to a 15-percent inheritance tax. Beneficiaries that are not closely related, as defined by Danish law, are subject to an additional tax at a rate of 25 percent (making the total effective tax rate 36.25 percent). A gift tax of 15 percent is levied on gifts to descendents, stepchildren, sons and daughters-in-law, the spouse of a deceased child or stepchild, and parents. A rate of 36.25 percent applies to gifts to stepparents and grandparents. A gift to a spouse or registered partner is not subject to tax. All other gifts are subject to ordinary income tax. Denmark does not levy a wealth tax.

Social security

Social security contributions are levied on gross income. The current rate for employees and self-employed individuals is eight percent. No contributions are levied on employers. The amount contributed is deductible for income tax purposes.

Indirect taxes

Denmark imposes a value-added tax ("VAT") at all stages of production and distribution of goods and services. The generally applicable rate is 25 percent, although certain goods and services are exempt from the VAT altogether. Excise duties are levied on certain consumer goods such as alcohol, tobacco, mineral water, and ice cream. A national real property tax is imposed on home owners at a rate of one percent of the assessed value of the property, or three percent of the assessed value, to the extent that the assessed value exceeds DKK 3,040,000 ($537,996). Denmark also imposes a varying annual weight tax on vehicles, as well as a vehicle registration tax of up to 180 percent of the cost price of the vehicle.

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

A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for business persons in one country who might aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who might aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that will arise from different transactions, but may also increase or decrease that burden. Where there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment has the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed protocol it may be beneficial to examine the cross-border trade and investment between the United States and Denmark. Whether measured by trade in goods or services or by direct and non-direct cross-border investment, the United States and Denmark engage in significant cross-border activity. The income from cross-border trade and investment generally is subject to net-basis income tax in either the United States or Denmark and in many cases also is subject to gross basis withholding tax in the source country.

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

Cross-border trade

The current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. While detail regarding the balance of payments between the United States and Denmark is not publicly available, one can document that the value of trade between the United States and Denmark is large. In 2005, the United States exported $1.9 billion of goods and services to Denmark and imported $5.1 billion in goods from Denmark. This made Denmark the United States' 49th largest merchandise export destination and the 43rd largest source of imported merchandise.[8]

Numerous disparate activities consititute trade in services. Among the sources of receipts from exported services are payments for transportation of goods, travel by persons and passenger fares, payments for professional services such as management consulting, architecture, engineering, and legal services, financial services, insurance services, computer and information services, and film and television tape rentals. Also included in receipts for services are the returns from investments in intangible assets in the form of royalties and license fees. In 2005, U.S. parent businesses received approximately $200 million in royalty and license fees from their affiliates in Denmark. In 2005, U.S. affiliates paid approximately $140 million in royalties and license fees to their Danish parents.[9]

Cross-border investment

Income from foreign assets is categorized as income from "direct investments" and income from "non-direct investments." Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as "portfolio investments," and bank deposits and loans. Hence, the income from non-direct investments generally is interest, dividends, or gains.

Commensurate with the size of the Danish economy in comparison to other European countries, the value of cross-border investment, between the United States and Denmark is

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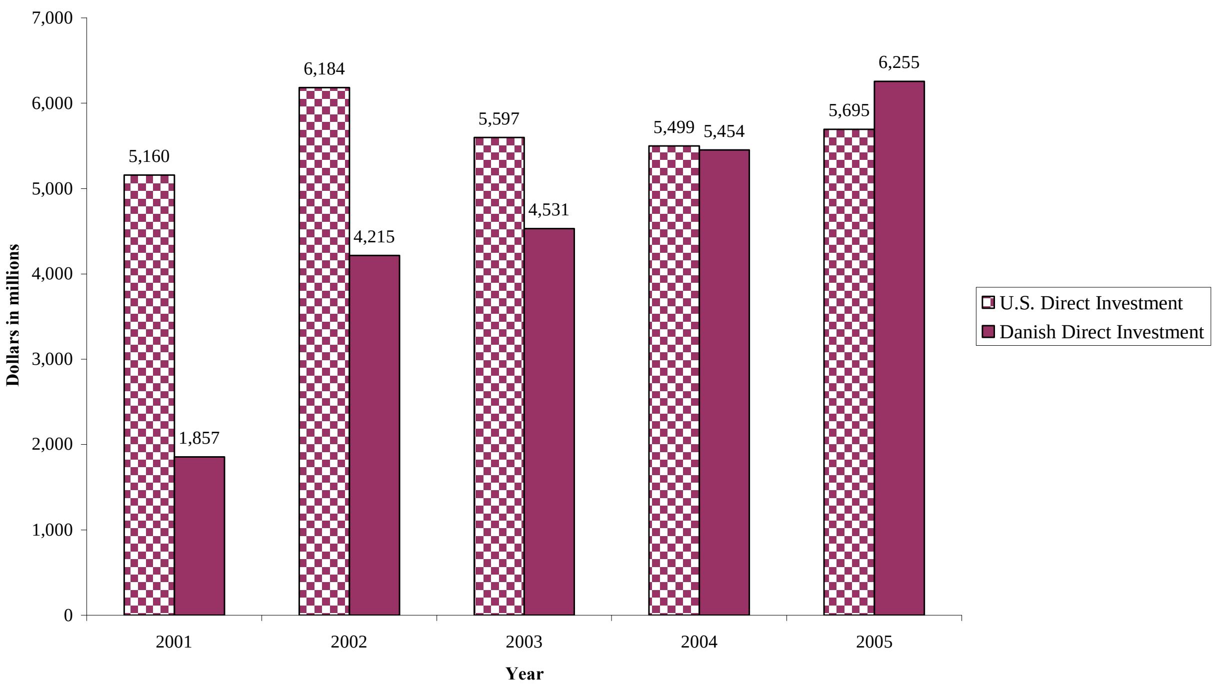
8 Bureau of Economic Analysis, U.S. Department of Commerce, "U.S. International Trade in Goods and Services, Annual Revision for 2005," June 9, 2006.

9 Bureau of Economic Analysis, U.S. Department of Commerce, "International Economic Accounts," www.bea.gov/international, May 2007.

smaller than that of cross border investment between the United States and other European countries. In 2005, U.S. persons held direct investments in Denmark valued at $5.7 billion on a historic cost basis and Danish persons held direct investments in the United States valued at $6.3 billion. Figure 1, below, documents the value in U.S. direct investment in Denmark and Danish direct investment in the United States on an historical cost basis at year-end for 2001 through 2005.

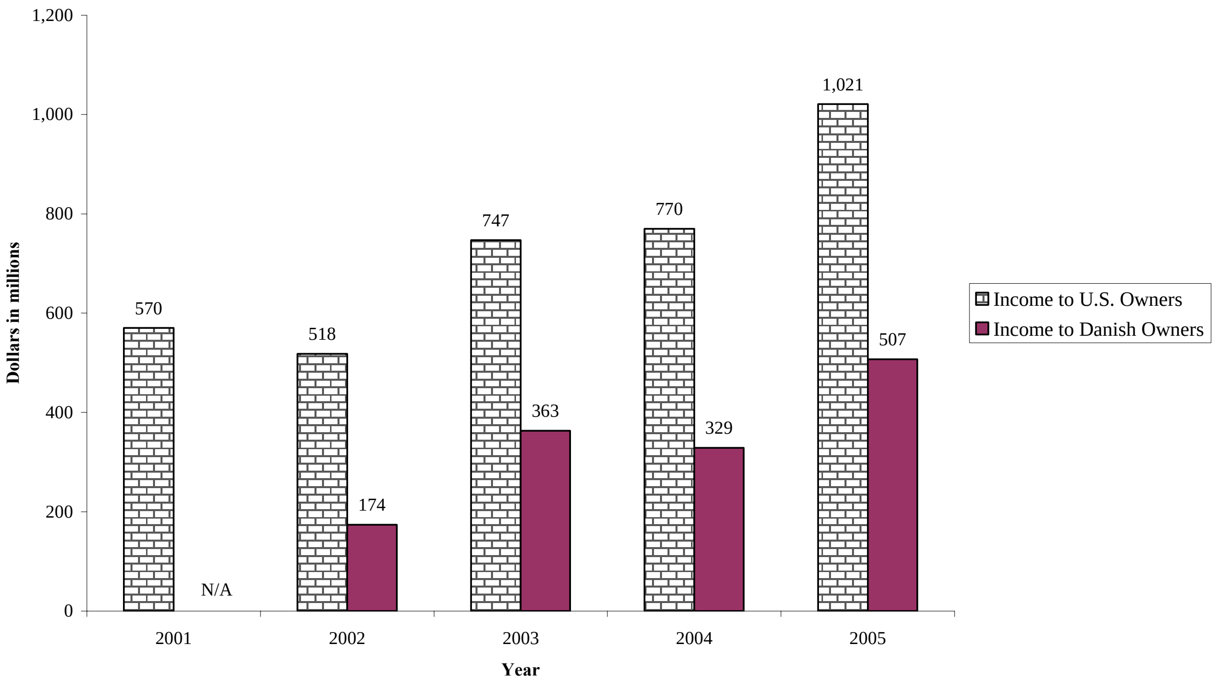
Figure 1.−Value of U.S. Direct Investments in Demark and Danish Direct Investments in The United States on an Historical Cost Basis, Year-End 2001-2005
[millions of dollars]



Source: Bureau of Economic Analysis, U.S. Department of Commerce, May 2007.

U.S. direct investments in Denmark produced approximately $1.0 billion in income (net of withholding taxes) to U.S. persons in 2005. Danish direct investments in the United States produced approximately $0.5 billion in income (net of withholding taxes) to Danish persons in 2005. Figure 2, below, details income from U.S. direct investments in Denmark and Danish direct investments in the United States (net of withholding taxes) for the period 2001-2005.

Figure 2.−Income From U.S. Direct Investments in Denmark and Danish Direct Investments in The United States (net of withholding taxes), Year End 2001-2005
[millions of dollars]



Note: Certain data not disclosed to maintain confidentiality.
Source: Bureau of Economic Analysis, U.S. Department of Commerce, May 2007.

The data presented above do not report the amount of U.S. or Danish portfolio investment holdings of stocks and bonds (including holdings of U.S. government securities). The Bureau of Economic Analysis generally only reports portfolio holdings by country for the several largest portfolio investment countries.

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

The data presented above report the amount of direct investment in Denmark by U.S. persons and the amount of direct investment in the United States by Danish persons. Data from tax returns reflect the magnitudes of cross-border investment and trade and income flows reported above. In 2003, U.S. corporations with Danish parent companies had $0.4 billion of income subject to tax and paid $0.1 billion in U.S. Federal income taxes.[10] U.S. corporations, including U.S. parent companies of Danish controlled foreign corporations, reported the receipt of $0.9 billion of dividends from Danish corporations in 2002.[11] Of the $0.9 billion in dividends reported, approximately $0.2 billion reflected the grossed up value of net dividends to account for deemed taxes paid to Denmark. U.S. corporations recognized about $1.3 billion in taxable income originating in Denmark, including the dividend amounts just cited. This income was subject to an average Danish corporate income tax rate of approximately 31.1 percent (after allowing for apportionment and allocation of certain expenses incurred in the United States).

Data for withholding taxes from 2000 show that Denmark and the United States collected approximately the same amounts of receipts, with each country withholding under $100 million annually, by withholding tax on respective payments to each other.[12] Data on withholding taxes may not be accurate indicators of cross-border investment and income flows, because a taxpayer can often control the amount and timing of dividend payments to the home country and pays withholding tax only when these payments are made.

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[10] James R. Hobbs, "Foreign Controlled Domestic Corporations, 2003," *Internal Revenue Service, Statistics of Income Bulletin*, Summer 2006, pp. 67-112.

[11] Data Release, "Corporate Foreign Tax Credit, 2002," *Internal Revenue Service, Statistics of Income Bulletin*, Fall 2006, pp. 285-318.

[12] Data Release, "Foreign Recipients of U.S. Income, 2000," *Internal Revenue Service, Statistics of Income Bulletin*, Summer 2003, pp. 177-186.

D. Analyzing the Economic Effects of Income Tax Treaties

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

Generally, a treaty-based reduction in withholding rates will directly reduce U.S. tax collections in the near term on payments from the United States to foreign persons, but will increase U.S. tax collections on payments from foreign persons to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this dampening of collections on payments to foreign persons and related decrease in foreign tax credits will begin to reverse. The present protocol's reductions in dividend withholding rates will reduce U.S. withholding tax collections on dividend payments from the United States to Denmark. Over the longer term, the withholding tax rate changes coupled with other changes in the protocol are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

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

V. EXPLANATION OF PROPOSED PROTOCOL

Article I. General Scope

The general scope article describes the persons who may claim the benefits of the proposed protocol. It also includes a “saving clause” provision similar to provisions found in most U.S. income tax treaties. By reason of the saving clause, unless otherwise specifically provided in the treaty, either treaty country may continue to tax its citizens who are residents of the other treaty country as if the treaty were not in force. For purposes of the proposed protocol (and, thus, for purposes of the saving clause), the term “residents,” which is defined in Article 4 (Residence), includes corporations and other entities as well as individuals. According to the Treasury Department's Technical Explanation (hereinafter referred to as the “Technical Explanation”), if a resident of Denmark performs professional services in the United States, and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of Denmark is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (i.e., without regard to Code section 894(a)).

The proposed protocol modifies the saving clause to reflect changes in U.S. tax law relating to the present treaty provision under which a former citizen or long-term resident of the United States may be taxed under United States law for the period of ten years following the loss of citizenship or long-term resident status. The saving clause is modified to permit the United States to tax a former citizen or former long-term resident under section 877 of the Code (i.e., for 10 years following the loss of such status). Under the proposed protocol, the provision no longer includes the requirement of a purpose to avoid tax.

Section 877 of the Code provides special rules for the imposition of U.S. income tax on former U.S. citizens and long-term residents for a period of ten years following the loss of citizenship or long-term resident status.

Under U.S. domestic law, an individual is considered a “long-term resident” of the United States if the individual (other than a citizen of the United States) was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. However, an individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for such year under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

Article II. Dividends

Overview

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains both the generally applicable maximum rate of withholding at source of 15 percent and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. Like several other recent treaties and protocols, however, the proposed protocol provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. A zero rate also generally applies to dividends received by a pension fund. As in the current treaty, special rules apply to dividends received from RICs and REITs, with certain modifications to the current rules applicable to dividends from REITs. The modified REIT rules are similar to provisions included in other recent treaties and protocols.

Internal taxation rules

United States

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

Under U.S. law, the term “dividend” generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

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

A REIT is a U.S. domestic 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. To qualify for the deduction for dividends paid, a REIT must distribute most of its income. As a result of the deduction for dividends paid, a REIT generally does not pay Federal income tax. Except for capital gain dividends, a distribution of REIT earnings is generally treated by the recipient as a dividend rather than as income of the same type as the underlying earnings.[13] This distribution is subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, the receipt of a distribution from a REIT is generally

[13] Because a REIT generally does not pay corporate level tax, certain U.S. benefits of dividend treatment are not available. A U.S. corporate shareholder is not generally entitled to a dividends-received deduction for REIT dividends. REIT dividends generally are not qualified dividends eligible for the 15-percent rate available for individual shareholders.

treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT.[14]

A REIT generally is organized to allow investment in primarily passive real estate investments. As such, income of a REIT often includes rentals from real estate holdings or interest from loans secured by real estate mortgages. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have the rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law. U.S.-source interest income of foreign persons is not subject to U.S. withholding tax in certain circumstances. A REIT dividend does not, however, pass through interest characterization of the REIT's underlying earnings.

U.S. internal law also generally treats a RIC as both a corporation and as an entity not subject to corporate tax to the extent it distributes substantially all of its income. The purpose of a RIC is to allow investors to hold diversified portfolios of securities. Dividends paid by a RIC generally are treated as dividends received by the payee, and the RIC generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, before January 1, 2008, net short-term capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has net capital gains. Nonresident aliens and foreign corporations generally are not subject to tax on capital gains. A distribution before January 1, 2008 to a nonresident alien or foreign corporation made by a RIC that is (or, if certain exceptions were disregarded, would be) a U.S. real property holding corporation, however, is treated as gain recognized by that nonresident alien or foreign corporation from the sale or exchange of a U.S. real property interest to the extent the gain is attributable to gain from sales or exchanges of U.S. real property interests.[15]

Similarly, a RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")[16] generally may designate a dividend it

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[14] There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Sec. 897(h)(1). These distributions are treated as dividends under U.S. internal law.

[15] The exception described in the immediately preceding footnote also applies for distributions by RICs.

[16] Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation that is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the

pays before January 1, 2008 as derived from that interest income, to the extent of that income. Nonresident aliens and foreign corporations are not subject to tax on interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to the interest income.

Denmark

Dividends paid by Danish registered companies to nonresident individuals and nonresident companies generally are subject to a 28-percent gross-basis withholding tax. Dividends paid to a nonresident company, however, generally are exempt from Danish tax if the nonresident company owns at least 15 percent of the dividend-paying company.[17]

Proposed protocol limitations on internal law

In general

Under the proposed protocol, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in that other country. The dividends also may be taxed by the country in which the payor company is resident, but the rate of tax is limited. Under the proposed protocol, source-country taxation of dividends (that is, taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower rate of five percent applies if the beneficial owner of the dividends is a company that owns directly at least 10 percent of the share capital of the dividend-paying company.[18]

The term "beneficial owner" is not defined in the current treaty or in the proposed protocol and therefore is defined under the internal law of the country imposing tax (that is, the source country). The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country. Further, companies holding shares through fiscally transparent entities, such as partnerships, are considered to hold their proportionate interests in those shares.

The proposed protocol provides a zero rate of withholding tax for dividends received in three broad circumstances. First, the proposed protocol provides a zero rate for certain

RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

[17] The minimum ownership required for exemption from withholding tax on dividends was 20 percent before 2007. After 2008, the minimum required ownership is 10 percent.

[18] The 10-percent ownership requirement in the proposed protocol is based on ownership of "share capital." The Technical Explanation states that the 10-percent ownership requirement is satisfied by ownership of at least 10 percent of a company's voting shares.

intercompany dividends in cases in which there is a sufficiently high (80-percent) level of ownership (often referred to as "direct dividends"). Second, a zero rate applies for dividends paid by a resident of one treaty country and beneficially owned by a pension fund that is a resident of the other treaty country and is entitled to treaty benefits under the limitation on benefits rule applicable to pension funds, provided that the dividends are not derived from the carrying on of a business, directly or indirectly, by the fund or through an associated enterprise. Third, a zero rate is allowed for dividends paid by a resident of one treaty country and beneficially owned by a qualified governmental entity that is a resident of the other treaty country and that does not control the dividend-paying entity. A qualified governmental entity is defined in Article 3 (General Definitions), paragraph 1(i), of the treaty. The technical explanation notes that the proposed protocol's exemption from source-state taxation of dividends paid to qualified governmental entities is analogous to the exemption provided by U.S. internal law in section 892.

Zero rate for direct dividends

Under the proposed protocol, when a company that is a resident of one treaty country receives and beneficially owns dividends paid by a company that is a resident of the other treaty country, the source-country withholding tax rate is reduced to zero if the company that receives the dividends has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. Under the current treaty, these dividends may be taxed at a five-percent rate. The 80-percent ownership requirement under this provision may be satisfied by either direct or indirect ownership (through one or more residents of either treaty country).[19]

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than the requirements that normally apply under the proposed protocol. Specifically, in order to qualify for the zero rate, the dividend-receiving company must (1) satisfy the public trading test or the taxable non-stock corporation requirement of the limitation-on-benefits article; (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) satisfy the derivative benefits test of the limitation-on-benefits article; or (4) receive a favorable determination from the competent authority with respect to the zero-rate provision.

The Technical Explanation states that these additional restrictions are intended to prevent companies from reorganizing to become eligible for the zero rate. As an example, the Technical

[19] The IRS has ruled privately, in connection with a situation arising under the zero-rate provision in the income tax treaty between the United States and the United Kingdom, that entities disregarded under the U.S. entity classification regulations also are disregarded for purposes of determining whether certain ownership requirements of the zero-rate provision are satisfied. Thus, stock owned through a disregarded entity (established under the laws of a third country) was treated as owned directly for purposes of applying the holding period requirement of that provision (which, according to that treaty's Technical Explanation, required direct ownership). *See* Priv. Ltr. Rul. 200522006 (June 3, 2005).

Explanation describes a situation in which a company resident in a third country that does not have a zero-rate treaty provision with the United States might contribute the stock of a wholly owned U.S. subsidiary to a wholly owned Danish subsidiary to secure the benefit of the zero rate on a dividend from the U.S. subsidiary. In that case, the Technical Explanation explains that treaty shopping could occur notwithstanding the Danish company's satisfaction of the active trade or business test with respect to the dividend. For this reason, the proposed protocol does not allow the benefits of the zero rate to be claimed by a company that meets only the active trade or business test of the limitation-on-benefits article.

The Technical Explanation notes that, in the case of a Danish company that receives dividends from a U.S. subsidiary, the derivative benefits test might be satisfied if the Danish company is wholly owned, for example, by a publicly traded company resident in a European Union ("EU"), European Economic Area ("EEA"), or North American Free Trade Agreement ("NAFTA") country with which the United States has a zero-rate treaty provision.[20] In the case of a U.S. company receiving dividends from a Danish subsidiary, the derivative benefits test could be satisfied if the U.S. company is wholly owned by a company resident in the EU, because the EU Parent-Subsidiary Directive would exempt from withholding tax a dividend paid directly by the Danish company to an EU parent company.

The proposed protocol also modifies the application of the derivative benefits test under the zero-rate provision to ensure that certain joint ventures may qualify for the zero rate. Specifically, in determining whether a shareholder of a dividend-receiving company is an equivalent beneficiary, each such shareholder is treated as owning shares in the dividend-paying company with the same percentage voting power as the shares held by the dividend-receiving company for purposes of determining entitlement to the zero rate. Thus, as the Technical Explanation describes, a Danish company owned 49 percent by another Danish company and 51 percent by a company resident in another EU country that has an identical zero-rate provision with the United States may qualify under the derivative benefits test for the zero rate on a dividend received from a wholly-owned U.S. company even though neither shareholder of the dividend-receiving company would meet the 80-percent ownership test individually.

The diplomatic notes accompanying the signing of the proposed protocol provide guidance about the exercise of competent authority discretion to grant the benefits of the zero-rate provision. Those notes state that the U.S. competent authority generally will use its discretion to allow a zero rate of withholding tax on dividends paid to a Danish company if (1) the company satisfies the limitation on benefits article requirement regarding the active conduct of a trade or business in Denmark; (2) the company meets the base erosion requirement of the limitation on benefits article; (3) and more than 80 percent of the voting power and value of the shares in the company is owned by one or more taxable nonstock corporations that satisfy the limitation on benefits requirements applicable to those nonstock corporations. The diplomatic notes provide that the competent authority may choose not to grant the benefits of the zero-rate provision if it determines that a significant percentage or amount of the dividend income at issue will inure to the benefit of a private person who is not a resident of Denmark.

[20] These countries currently are Mexico, the Netherlands, Sweden, and the United Kingdom.

Dividends paid by U.S. RICs and REITs

The proposed protocol generally denies the five-percent and zero rates of withholding tax to dividends paid by U.S. RICs and REITs.

The 15-percent rate of withholding generally is allowed for dividends paid by a RIC. The 15-percent rate of withholding is allowed for dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual or a pension fund, in either case holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is diversified (that is, the value of no single interest in real property held by the REIT exceeds 10 percent of the total interests of the REIT in real property).

The Technical Explanation indicates that the restrictions on availability of the lower rates are intended to prevent the use of RICs and REITs to gain inappropriate U.S. tax benefits. For example, a company resident in Denmark could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 15 percent on dividends on those shares. Absent the additional RIC restrictions, there is a concern that such a company instead might purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and thereby obtain a lower withholding tax rate by holding the portfolio through the RIC (transforming portfolio dividends generally taxable at 15 percent into direct investment dividends taxable under the treaty at zero or five percent).

Similarly, the Technical Explanation provides an example of a resident of Denmark that directly holds real property and is required to pay U.S. tax either at a 30-percent rate on gross income or at graduated rates on the net income from the property. By placing the property in a REIT, the investor could transform real estate rental income into dividend income, taxable at the lower rates provided in the proposed protocol. The limitations on REIT dividend benefits are intended to protect against this result.

The proposed protocol provides that the rules described above for dividends paid by RICs and REITs will apply to dividends paid by Danish-resident companies that are similar to U.S. RICs and REITs. Whether a Danish company is similar to a U.S. RIC or REIT will be determined by mutual agreement of the competent authorities. The diplomatic notes accompanying the proposed protocol state that a Danish undertaking for collective investment in transferable securities that is required to distribute its income currently will be treated as similar to a U.S. RIC, whereas an undertaking that is permitted to accumulate its income will not be treated as similar.

Definitions and special rules and limitations

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

The proposed protocol's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country, or performs in the source country independent personal services from a fixed base located in that country, and the dividends are attributable to that permanent establishment or fixed base. In these cases, the dividends are taxed as business profits (Article 7) or income from independent personal services (Article 14), as the case may be.

The proposed protocol prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country, unless the dividends are paid to a resident of the first country or are attributable to a permanent establishment or fixed base in that country.

The proposed protocol allows each treaty country to impose a branch profits tax on a company that has income attributable to a permanent establishment in that country, derives income from real property in that country that is taxed on a net basis under the treaty, or realizes gains taxable in that country under the treaty. In the case of the United States, the tax is limited to the "dividend equivalent amount," consistent with the branch profits tax under U.S. internal law (Code section 884). In the case of Denmark, which currently does not impose a branch profits tax under its internal law, the tax is limited to an amount that is analogous to the dividend equivalent amount. The rate of branch profits tax is generally limited to five percent, but a zero rate applies where limitation-on-benefits requirements parallel to those applicable to the zero-rate provision for dividends are satisfied.

The proposed protocol defines a pension fund as a legal person, whether or not exempt from tax, organized under the laws of one treaty country to provide a pension or other similar benefits to employees, including self-employed individuals, under a plan, provided that more than 50 percent of the beneficiaries, members, or participants are individuals resident in either treaty country.

Relation to other Articles

The Technical Explanation notes that the saving clause of paragraph 4 of Article 1 of the treaty (Personal Scope) permits the United States to tax dividends received by its residents and citizens (subject to special foreign tax credit rules in paragraph 2 of Article 23 (Relief from Double Taxation) of the treaty) if the proposed protocol had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 22 of the treaty (Limitation on Benefits).

Article III. Government Service

The proposed protocol amends subparagraph b) of paragraph 2 of Article 19 (Government Service) of the present treaty to correct a drafting error. Paragraph 2(a) of the present treaty provides a general rule that a pension paid from public funds of a treaty country or a political subdivision or local authority thereof to an individual in respect of services rendered to that country (or subdivision or authority) in the discharge of governmental functions is taxable only in that country. Proposed paragraph 2(b) provides an exception under which the pension is taxable only in the other treaty country if the individual is a resident of and a national of that country. In the absence of this amendment, paragraph 2(b) of the present treaty incorrectly refers to pensions paid to “a resident or a national” rather than pensions paid to “a resident and a national.”

Article IV. Limitation on Benefits

In general

The proposed protocol replaces the rules of Article 22 (Limitation on Benefits) of the present treaty with rules that are similar to the limitation-on-benefits provisions included in recent U.S. income tax treaties. The new rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in Denmark or the United States.

The proposed protocol is intended to limit double taxation caused by the interaction of the tax systems of the United States and Denmark as they apply to residents of the two countries. At times, however, residents of third countries attempt to benefit from a treaty by engaging in treaty shopping. Treaty shopping by a third-country resident may involve organizing in a treaty country a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents.

Generally, a resident of either treaty country is entitled to the benefits accorded by the proposed protocol if the resident has any one of seven attributes and satisfies any other specified conditions for obtaining benefits. The seven attributes are that the resident is (1) an individual; (2) one of the two countries or a political subdivision or local authority of one of the two countries, or an agency or instrumentality of that country, subdivision, or authority; (3) a company that satisfies a public company test or that is a subsidiary of a public company; (4) a legal person that is generally exempt from tax in its residence country and that is established and maintained in that country exclusively for a religious, charitable, educational, scientific, or other similar purpose; (5) an entity that is established and maintained in its country of organization to provide a pension or other similar benefits under a plan and that satisfies a beneficiary test; (6) an entity that satisfies an ownership test and a base erosion test; or (7) in the case of Denmark, a taxable nonstock corporation described below. A resident that has none of these seven attributes may be entitled to treaty benefits with respect to certain items of income under the derivative benefits test or the active business test.

Special rules for income govern entitlement to treaty benefits for income from shipping and air transport.

Special anti-abuse rules govern certain items of income derived from the United States by an enterprise resident in Denmark in so-called “triangular cases.”

A person that does not satisfy any of the requirements described above may be entitled to the benefits of the treaty if the source country’s competent authority so determines.

Seven attributes for qualification for all treaty benefits

Individual

Under the proposed protocol, an individual resident of the United States or Denmark is entitled to all treaty benefits. If, however, such an individual receives income as a nominee on behalf of a third-country resident, and thus is not the beneficial owner of the income, benefits may be denied.

Governments

The proposed protocol provides that the United States and Denmark, and any political subdivision or local authority of either of the two countries, and an agency or instrumentality of that country, subdivision, or authority are entitled to all treaty benefits.

Publicly traded companies and subsidiaries

A company that is a resident of Denmark or the United States is entitled to all treaty benefits if the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges (the "regular trading test") and either (1) the company's principal class of shares is primarily traded on a recognized stock exchange in its country of residence or, in the case of a Danish company, on a recognized stock exchange in the European Union or in any other European Economic Area country or, in the case of a U.S. company, on a recognized stock exchange located in another state that is a party to the North American Free Trade Agreement (the "primary trading test"), or (2) the company's primary place of management and control is in its country of residence (the "management and control test"). Certain key elements of the regular trading test, primary trading test, and management and control test are described below.

The term "principal class of shares" means the ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the "principal class of shares" means that class or those classes of shares that in the aggregate represent a majority of the aggregate voting power and value of the company.

A company that is resident in one treaty country has a "disproportionate class of shares" if any outstanding class of shares is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company's income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, a company resident in Denmark meets this test if it has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States.

The term "shares" includes depository receipts for shares.

A class of shares is considered to be "regularly traded" in a taxable year if (1) trades in that class are effected on one or more stock exchanges other than in de minimis quantities during every quarter of the year; and (2) the aggregate number of shares or units of that class of shares traded on that exchange or those exchanges during the twelve months ending on the day before the beginning of that taxable year is at least six percent of the average number of shares or units outstanding in that class (including shares held by taxable nonstock corporations) during that twelve-month period. The Technical Explanation notes that trading on one or more recognized stock exchanges may be aggregated for purposes of meeting the "regularly traded" requirement.

The term “recognized stock exchange” means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; the Copenhagen Stock Exchange; the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, Helsinki, London, Oslo, Paris, Stockholm, Sydney, Tokyo, and Toronto; and any other stock exchange agreed upon by the competent authorities of the treaty countries.

The term “primarily traded” is not defined in the proposed protocol and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(3). Based on that provision, the Technical Explanation states that stock of a corporation is primarily traded if the number of shares in the company’s principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident exceeds the number of shares in the company’s principal class of shares that are traded during that year on established securities markets in any other single foreign country.

A company the principal class of shares (and any disproportionate class of shares) of which is regularly traded on a recognized stock exchange but which does not satisfy the primary trading test (that is, the requirement that a company’s principal class of shares be primarily traded on a recognized stock exchange in the required area) may claim treaty benefits if it satisfies the management and control test -- that is, if the company’s primary place of management and control is in the treaty country of which it is a resident. According to the Technical Explanation, a company’s primary place of management is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that country than in the other treaty country or any third country, and if staff that support the management in making those decisions are also based in that residence country.

The Technical Explanation notes that the management and control test should be distinguished from the “place of effective management” test used by many countries and in the OECD model to establish residence. The place of effective management test often has been interpreted to mean the place where the board of directors meets. Under the proposed protocol, by contrast, the primary place of management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

A company that does not satisfy the regular trading test and either the primary trading test or the management and control test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits under either of two other alternatives for companies. First, a Danish resident company is entitled to treaty benefits if one or more taxable nonstock corporations ("TNC," as defined below) entitled to benefits under the special rules for those corporations (described below) own shares representing more than 50 percent of the voting power of the company and all other shares are listed on a recognized stock exchange and are primarily traded on a recognized stock exchange located within the European Union or in any other European Economic Area state. The Technical Explanation states that this rule is intended to ensure that a corporation whose voting shares are substantially owned by a Danish TNC is not precluded from qualifying as a publicly-traded company so long as the rest of its shares satisfy a public trading test. The Technical Explanation notes that the special rule is necessary because the following ownership structure is common in Denmark. A TNC holds all of a special class of shares of another company ("Class A shares"). This special class of shares has a disproportionate amount of the voting power of the company but has little or no right to dividends. The subsidiary company issues another share class ("Class B shares") that has preferential dividend rights. All the Class A shares owned by the TNC are listed but not traded on the Copenhagen stock exchange, and any Class A shares not held by the TNC and all Class B shares are both listed and traded on that exchange.

Under the second alternative (the "subsidiary rule"), a company resident in either treaty country is entitled to treaty benefits if shares representing at least 50 percent of its aggregate voting power and value (and at least 50 percent of any disproportionate class of its shares) are owned, directly or indirectly, by five or fewer companies that satisfy either (1) the regular trading test and either the primary trading test or the management and control test or (2) the TNC requirements just described, provided in either case that, in the case of indirect ownership, each intermediate owner is a resident of the United States or Denmark. This subsidiary rule allows certain subsidiaries of publicly-traded companies to be eligible for all benefits under the treaty.

Tax-exempt organizations

A charitable organization or other legal person is entitled to treaty benefits if it is organized under the laws of the United States or Denmark and is established and maintained in that country exclusively for a religious, charitable, educational, scientific, or other similar purpose. The Technical Explanation notes that a tax-exempt organization other than a pension fund qualifies for benefits without regard to the residence of its beneficiaries or members.

Pension funds

A legal person organized under the laws of a treaty country to provide, under a plan, a pension or other similar benefits to employees (including self-employed individuals), is entitled to all the benefits of the treaty, regardless of whether it is exempt from tax, if more than 50 percent of the legal person's beneficiaries, members, or participants are individuals resident in either the United States or Denmark. According to the Technical Explanation, for purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the organization.

Ownership and base erosion tests

An entity that is a resident of one of the treaty countries is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

An entity that is a resident of a treaty country satisfies the ownership test if on at least half the days of the taxable year at least 50 percent of each class of the entity's shares or other beneficial interests is owned, directly or indirectly, by residents of that treaty country who are entitled to treaty benefits under the limitation-on-benefits article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds, provided that in the case of indirect ownership, each intermediate owner also is a resident of that treaty country.

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable year, as determined in that person's country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds. Arm's-length payments made in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank that is not related to the entity making the payment do not count against the entity in determining whether the 50-percent threshold is reached.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Residence) and they otherwise satisfy the ownership and base erosion tests.

Taxable nonstock corporation

A TNC resident in Denmark is entitled to treaty benefits if it satisfies a two-part test described below. A TNC is defined as a foundation that is taxable in accordance with paragraph 1 of Article 1 of the Danish Act on Taxable Nonstock Corporations *(fonde der beskattes efter fondsbeskatningsloven).* In general, according to the Technical Explanation, a TNC is an entity used to preserve control of operating companies through control of the operating company's voting shares. A TNC generally is subject to income tax at the same rate and in the same manner as a regular Danish corporation except that a TNC may deduct charitable contributions and may deduct distributions to family members of the founder of the TNC so long as these family members are fully taxable residents in Denmark.

The two-part test represents a modification of the ownership and base erosion tests described previously. The Technical Explanation states that the proposed protocol treats TNCs as similarly as possible to other Danish corporations but notes that because TNCs do not have owners, the ownership test cannot apply. Under the first part of the two-part test, the amount paid or accrued in the taxable year and in each of the three preceding taxable years, directly or indirectly, to persons who are not entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds must not exceed 50 percent of the TNC's gross income, as determined under

Danish law (excluding its tax-exempt income). Arm's-length payments in the ordinary course of activities of a charitable nature and authorized by the Danish laws on taxable nonstock companies *(lov om erhvervsmæssige fonde and lov om fonde og visse foreninger)* for services or tangible property do not count against the taxpayer in determining whether the 50-percent limitation is reached.

The second part of the two-part test is satisfied if the amount paid or accrued, in the form of both (1) deductible payments (not including arm's-length payments in the ordinary course of activities of a charitable nature and authorized by the Danish laws on taxable nonstock companies *(lov om erhvervsmæssige fonde and lov om fonde og visse foreninger)* for services or tangible property) and (2) non-deductible distributions, in the taxable year and in each of the preceding three taxable years, directly or indirectly, to persons who are not entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds does not exceed 50 percent of the amount of the TNC's total income (including its tax-exempt income).

Derivative benefits rule

The proposed protocol includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. Under these derivative benefits rules, a treaty country company is eligible for treaty benefits for an item of income only if the company satisfies both an ownership requirement and a base erosion requirement.

A company satisfies the ownership requirement if shares representing at least 95 percent of the company's aggregate voting power and value, and at least 50 percent of any of the company's disproportionate class of shares, are owned directly or indirectly by seven or fewer persons who are equivalent beneficiaries. The term "disproportionate class of shares" has the same definition as the definition previously described.

A company satisfies the base erosion requirement for an item of income only if, in the taxable year in which the income item arises, the amount of the deductible payments or accruals the company makes, directly or indirectly, to persons who are not equivalent beneficiaries is less than 50 percent of the company's gross income for the year, as determined in the company's country of residence. Deductible payments do not include arm's-length payments in the ordinary course of a business for services or tangible property and payments in respect of financial obligations to a bank that is not related to the company making the payment. The Technical Explanation notes that the base erosion requirement under the derivative benefits rule is the same as the base erosion test described previously (that is, the test that is included in the rules for determining whether a treaty country resident has one of the seven attributes for qualification for all treaty benefits), except that, for the derivative benefits rule, deductible payments made to equivalent beneficiaries, not just to residents of a treaty country entitled to treaty benefits, are excluded from the payments that count toward the 50-percent limitation.

An equivalent beneficiary must be a resident of a European Union member state, a European Economic Area state, a North American Free Trade Agreement party, or Switzerland (together, "qualifying countries") and must satisfy either of two criteria described below.

The first criterion includes two requirements. First, the person must be entitled to all treaty benefits under a comprehensive income tax treaty between a qualifying country and the country from which the benefits of the U.S.-Denmark treaty are being claimed (an "applicable treaty"), and this entitlement to treaty benefits must result from satisfaction of limitation-on-benefits provisions analogous to the proposed protocol's rules, described above, for individuals, governments, publicly-traded companies, tax-exempt organizations, and pension funds. If the applicable treaty does not include a comprehensive limitation-on-benefits article, this first requirement is satisfied only if the person would meet the proposed protocol's requirements for entitlement to treaty benefits as an individual, a government, a publicly-traded company, a tax-exempt organization, or a pension fund. Second, for income from dividends, interest, or royalties, the person must be entitled under an applicable treaty to a rate of tax on that income that is at least as low as the rate applicable under the U.S.-Denmark treaty, as modified by the proposed protocol (the "tax rate test").

The Technical Explanation gives the following example to illustrate the operation of the tax rate test. A U.S. company is wholly owned by a Danish company that in turn is wholly owned by an Italian company. Assume the Danish company otherwise satisfies the requirements of the zero-rate dividend provision, and assume that if the Italian company received a dividend directly from the U.S. company, the applicable dividend withholding tax rate under the U.S.-Italy treaty would be five percent. Under these facts, the Italian company would not be an equivalent beneficiary under the rules described above because it would not be entitled to a withholding tax rate at least as low as the applicable rate (zero) under the U.S.-Denmark tax treaty as modified by the proposed protocol.

For dividend, interest, or royalty payments arising in Denmark and beneficially owned by a resident of the United States, the proposed protocol includes a special rule for determining whether a company that is a resident of an EU member state satisfies the tax rate test for purposes of determining whether the U.S. resident is entitled to treaty benefits for the payments. The special rule provides that the EU member state resident satisfies the tax rate test if a dividend, interest, or royalty payment arising in Denmark and paid directly to that EU member state resident would be exempt from withholding tax under an EU directive even though the income tax treaty between Denmark and that EU member state would permit imposition of a higher withholding tax rate on that payment than is permitted by the U.S.-Denmark tax treaty, as amended by the proposed protocol. The Technical Explanation states that this special rule takes account of the fact that withholding taxes on many inter-company dividend, interest, and royalty payments are exempt within the EU under various EU directives. The special rule is necessary, according to the Technical Explanation, because many EU member countries have not re-negotiated their tax treaties to reflect the EU directives' elimination of withholding tax.

Under the second criterion for determining whether a resident of a qualifying country is an equivalent beneficiary, the resident must be a Danish or U.S. resident that is entitled to treaty benefits under one of the rules described previously for individuals, governments, publicly-traded companies, tax-exempt organizations, and pension funds. Under this rule, according to the Technical Explanation, a Danish individual is an equivalent beneficiary for an item of income received by another treaty country resident regardless of whether the individual would have been entitled to receive the same benefits if it had received the income directly. The Technical Explanation states that this criterion was included to clarify that ownership by certain residents of a treaty country does not disqualify a U.S. or Danish company from treaty benefits under the derivative benefits rules. If, for example, 90 percent of a Danish company is owned by five companies that are residents of EU member states and that satisfy the first criterion described previously (the applicable treaty rules and the tax rate test), and 10 percent of the Danish company is owned by a U.S. or a Danish individual, the Danish company still can satisfy the requirements of the ownership test of the derivative benefits rules.

Active business test

Under the proposed protocol, a resident of one treaty country is entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country and (2) the income from the other country is derived in connection with or is incidental to that trade or business. The proposed protocol provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless the business is banking, insurance, or securities dealing carried on by a bank, an insurance company, or a registered securities dealer.

The term "trade or business" is not defined in the current treaty or in the proposed protocol. According to the Technical Explanation, under paragraph 2 of Article 3 (General Definitions) of the current treaty, when determining whether a resident of Denmark is entitled to the benefits of the treaty under the active business test with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the law of the United States. Accordingly, the Technical Explanation states, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived "in connection with" or be "incidental to" the resident's trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that "forms a part of" or is "complementary to" the trade or business conducted in the residence country by the income recipient.

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

The Technical Explanation states that for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services but should be part of the same overall industry and should be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary, according to the Technical Explanation, to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first out of earnings and profits of the treaty-benefited trade or business and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

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

The proposed protocol provides that if a resident of a treaty country or any of its associated enterprises carries on a trade or business activity in the other country that gives rise to an item of income, the active business test applies to the item of income only if the trade or business activity in the residence country is substantial in relation to the trade or business activity in the source country. The determination is made separately for each item of income derived from the source country.

The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (that is, activities that have little economic cost or effect with respect to the company business as a whole). The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each treaty country, the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country. According to the Technical Explanation, in making each determination or comparison, due regard will be given to the relative sizes of the U.S. and Danish economies.

The proposed protocol provides that, in determining whether a person is engaged in the active conduct of a trade or business in a treaty country, activities conducted by persons "connected" to that first person are deemed to be conducted by that first person. A person is "connected" to another person if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least

50 percent of the aggregate value of the beneficial equity interest in the company), or another person possesses, directly or indirectly, that requisite interest in each of the two entities. A person is also considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

Shipping and air transport

The proposed protocol includes a special rule for treaty benefits for income from shipping and air transport described in Article 8. A resident of one treaty country that derives from the other treaty country income from shipping or air transport and that is not eligible for treaty benefits under the rules described above is entitled to benefits for the income if at least 50 percent of the beneficial interest in the resident (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's stock) is owned directly or indirectly (1) by persons eligible for treaty benefits under the rules for individuals, governments, publicly-traded companies, tax-exempt organizations, and pension funds, or by citizens of the United States, or individuals who are residents of a third state, or (2) by a company or a combination of companies the stock of which is primarily and regularly traded on an established securities market in a third state. The third state referred to in these rules must, under its national law or in an agreement or treaty with the source country, grant to citizens and corporations of the source country an exemption under similar terms for profits from shipping and air transport.

The Technical Explanation notes that the tests described above duplicate the results provided by U.S. domestic tax law in section 883 and therefore afford little benefit beyond that already provided.

The triangular case

The proposed protocol provides a special anti-abuse rule that, according to the Technical Explanation, addresses a Danish resident's use of the following structure to earn interest income from the United States. The Danish resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The Danish resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the Danish resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between Denmark and the third country, Denmark does not tax the income earned by the permanent establishment. Consequently, the income is not taxed in Denmark or the United States, and is only lightly taxed in the third country.

Under the proposed protocol, the United States may impose withholding tax on the interest payments if the tax actually paid on the income in the third country is less than 60 percent of the tax that would have been payable to Denmark if the income were earned in Denmark and were not attributable to the permanent establishment in the third country.

Although the example in the Technical Explanation involves interest income, the triangular provision also applies to royalties. Any interest or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision does not apply to a person's interest income derived from the United States if the income is derived in connection with or is incidental to the active conduct of a trade or business carried on by the permanent establishment in the third state (other than the business of making, managing, or holding investments for the person's own account, unless the business is banking or securities activities carried on by a bank or a registered securities dealer). The triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself.

Grant of treaty benefits by the competent authority

Under the proposed protocol, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the other treaty country determines that the establishment, acquisition, or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty. The competent authority of the source country is required to consult with the competent authority of the residence country before denying treaty benefits under this provision.

According to the Technical Explanation, the competent authority's discretion under this provision is broad. The competent authority, for example, may grant all treaty benefits, may grant benefits only with respect to a particular item of income, and may set time limits on the duration of any relief granted.

Article V. Entry into Force

Article V of the proposed protocol relates to the ratification, entry into force, and effective date of the provisions of the proposed protocol.

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

The article provides that the proposed protocol will remain in effect as long as the treaty remains in force.

VI. ISSUES

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

In general

When certain conditions are met, the proposed protocol eliminates withholding tax on dividends paid by a company that is resident in one treaty country to a company that is a resident of the other treaty country and that owns at least 80 percent of the stock of the dividend-paying company (often referred to as "direct dividends"). The elimination of withholding tax on direct dividends is intended to reduce the tax barriers to direct investment between the two treaty countries.

Under the present treaty, direct dividends may be taxed by the source country at a maximum rate of five percent. The United States imposes withholding tax on direct dividends under its internal tax law, but Denmark generally does not. Consequently, the effect of the zero-rate provision would be to exempt from U.S. withholding tax dividends that U.S. subsidiaries pay to Danish parent companies. The zero-rate provision also may provide certainty that dividends paid by Danish subsidiaries to U.S. parent companies will be free of Danish withholding tax even if Denmark's internal law changes.

Until 2003, no U.S. income tax treaty provided for a complete exemption from dividend withholding tax, and the U.S. and OECD models do not provide an exemption. By contrast, many bilateral income tax treaties of other countries eliminate withholding taxes on direct dividends between treaty countries, and the EU Parent-Subsidiary Directive repeals withholding taxes on intra-EU direct dividends. Recent U.S. income tax treaties and protocols with Australia, Japan, Mexico, the Netherlands, Sweden, and the United Kingdom include zero-rate provisions. The Senate ratified those treaties in 2003 (Australia, Mexico, United Kingdom), 2004 (Japan, Netherlands), and 2006 (Sweden). The zero-rate provisions in those treaties are similar to the provision in the proposed protocol.[21]

Description of provision

Under the proposed protocol, the withholding tax rate is reduced to zero on dividends paid by a treaty country resident company and beneficially owned by a company that is a resident of the other treaty country and that has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. The 80-percent ownership requirement under this provision may be satisfied by either direct or indirect ownership (through one or more residents of either treaty country).

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[21] The treaty with Japan provides a zero-percent rate at a lower ownership threshold than the threshold in the proposed protocol and the other treaties (more than 50 percent as opposed to at least 80 percent).

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than normally apply under the proposed protocol. To qualify for the zero rate, the dividend-receiving company must: (1) satisfy the public trading test of the limitation-on-benefits article (or, in the case of a Danish company, be majority owned by taxable nonstock corporations entitled to treaty benefits); (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) satisfy the derivative benefits test of the limitation-on-benefits article; or (4) receive a favorable determination from the competent authority.

Issues

In general

The proposed protocols with Denmark, Finland, and Germany and the proposed treaty with Belgium would bring to ten the number of U.S. income tax treaties that provide a zero rate for direct dividends. Because zero-rate provisions are a relatively recent but now prominent development in U.S. income tax treaty practice, the Committee may wish to consider the costs and benefits of zero-rate provisions; the Treasury Department's criteria for determining when a zero-rate provision is appropriate; and certain specific features of zero-rate provisions such as ownership thresholds, holding-period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements.

Costs and benefits of adopting a zero rate with Denmark

Tax treaties mitigate double taxation by resolving potentially conflicting source and residence country claims of taxing rights for a particular item of income. Under most income tax treaties, source countries wholly or partly yield to residence countries the right to tax most dividends (other than dividends attributable to a permanent establishment that a company has in the source country). Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a low rate (five percent, for example) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow the possibility of double taxation. If the residence country allows a foreign tax credit for source-country withholding tax, double taxation may be mitigated or eliminated, but the effect of a credit is to violate the residence country's primary right to tax dividend income. If a residence country imposes limitations on its foreign tax credit (as the United States does with its overall and basket limitations), withholding taxes may not be fully creditable and some double taxation may remain. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. Removing a barrier to cross-border investment is a principal argument for the proposed protocol's zero-rate provision.

Direct dividends may present an appropriate circumstance for eliminating withholding tax. A company deriving business income in the United States or Denmark generally is subject to net-basis income tax in that country on the business income, and when it pays a dividend out of the income to a company in the other country, the dividend income generally is taxed in that other country (subject to allowable foreign tax credits). If the dividend-paying company is at least 80-percent owned by the dividend-receiving company, the dividend-receiving company may be viewed as a direct investor (and taxpayer) in the source country rather than as a portfolio investor. A portfolio investor would be less likely to be subject to net-basis taxation in the source country; a source-country withholding tax on dividends paid to a portfolio investor therefore might be viewed as more appropriate than a withholding tax on direct dividends.

Because Danish internal law does not generally impose a withholding tax on direct dividends, the zero-rate provision mainly would benefit direct investment in the United States by Danish companies, and generally would not affect direct investment in Denmark by U.S. companies. In other words, the potential benefits of the provision would accrue chiefly in situations in which the United States is importing capital, not when it is exporting capital.

The zero-rate provision may provide certainty that Danish-source dividends paid to U.S. direct investors will be exempt from withholding tax whether or not the Danish internal law exemption remains. This certainty may facilitate long-range foreign business planning by U.S. companies. The provision also would protect the U.S. fisc against increased foreign tax credit claims if the Danish internal law exemption were repealed.

Many countries have included zero-rate dividend provisions in their income tax treaties for longer than the United States has. These countries include OECD members Austria, Denmark, Finland, France, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, and non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. The EU Parent-Subsidiary Directive also eliminates withholding tax on direct dividends between EU companies. Many countries have eliminated withholding taxes on dividends as a matter of internal law. Thus, although the zero-rate provision in the proposed protocol is part of a relatively recent development in U.S. income tax treaties, there is substantial international precedent. This international precedent may be a reason in itself why the zero-rate provision in the proposed protocol is appropriate: by eliminating withholding tax on direct dividends between the United States and Denmark, the proposed protocol joins many existing income tax treaties and domestic and international tax rules in reducing tax barriers to foreign direct investment.

<u>General direction of U.S. tax treaty policy</u>

Because zero-rate provisions are common in U.S. income tax treaties that have entered into force since 2003, the Committee may wish to examine the Treasury Department's criteria for determining the circumstances under which a zero-rate provision may be appropriate. Although zero-rate provisions are common in recent U.S. treaties, recent treaties with Bangladesh, France, and Sri Lanka do not include zero-rate rules. The U.S. model also does not provide a zero dividend withholding tax rate. In previous testimony before the Committee, the Treasury Department has indicated that zero-rate provisions should be allowed only under treaties that have restrictive limitation-on-benefits rules and that provide comprehensive information exchange. Even in those treaties, according to previous Treasury Department statements, dividend withholding tax should be eliminated only based on an evaluation of the overall balance of benefits under the treaty. The Committee may wish to ask what overall balance considerations might prompt the Treasury Department not to seek a zero-rate provision in a treaty that has limitation-on-benefits and information-exchange provisions meeting the highest standards.

<u>Specific design features</u>

The Committee also may wish to examine certain specific design features of zero-rate provisions, features such as ownership thresholds, holding-period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements.

The Committee may wish to ask the Treasury Department what factors support a minimum ownership requirement of 80 percent and what factors may argue for a lower ownership threshold. The Committee also may wish to ask the Treasury Department why a 12-month holding period strikes a proper balance between the competing considerations of, on the one hand, preventing short-term shifting of ownership to claim the zero rate and, on the other hand, of allowing the zero rate in connection with ordinary, non-abusive structures.

The Committee may wish to ask whether the rule of the proposed protocol (and the provisions in certain other recent U.S. income tax treaties) allowing indirect ownership through a treaty-country resident reflects the likely resolution of this issue for future provisions. The IRS has ruled privately, in connection with a situation arising under the U.S.-U.K. zero-rate provision, that entities disregarded under the U.S. entity classification regulations also are disregarded for purposes of determining whether certain ownership requirements of the zero-rate provision are satisfied. Thus, stock owned through a disregarded entity (established under the laws of a third country) was treated as owned directly for purposes of applying the holding period requirement of that provision (which, according to that treaty's Technical Explanation, required direct ownership).[22] The Committee may wish to ask the Treasury Department whether the approach taken in this private ruling under the U.S.-U.K. treaty reflects a more general approach that the Treasury Department and the IRS are likely to take in applying zero-rate provisions to structures involving disregarded entities.

The Committee may wish to ask whether the proposed protocol's special limitation-on-benefits conditions for qualification for the zero rate -- for example, the active trade or business and ownership and base erosion tests -- are likely to be included in future treaties, and how these special provisions might change as zero-rate provisions become more widespread in the U.S. income tax treaty network.

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[22] *See* Priv. Ltr. Rul. 200522006.

B. Treaty Shopping

In general

The proposed protocol includes limitation on benefits rules that are similar to the limitation on benefits rules in other recent U.S. income tax treaties; in the proposed protocols with Finland and Germany and the proposed treaty with Belgium; and in the U.S. model. These rules are intended to prevent the indirect use of the U.S.-Denmark income tax treaty by persons who are not entitled to its benefits by reason of residence in Denmark or the United States.

When a resident of one country derives income from another country, the internal tax rules of the two countries may cause that income to be taxed in both countries. One purpose of a bilateral income tax treaty is to allocate taxing rights for cross-border income and thereby to prevent double taxation of residents of the treaty countries. Although a bilateral income tax treaty is intended to apply only to residents of the two treaty countries, residents of third countries may attempt to benefit from a treaty by engaging in treaty shopping. This treaty shopping may involve organizing in a treaty country a corporation that is entitled to the benefits of the treaty or engaging in income-stripping transactions with a treaty-country resident. Limitation on benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping.

Although the limitation on benefits rules in the proposed protocol are similar to the rules in other recent and proposed U.S. income tax treaties and protocols and in the U.S. model, they are not identical, and the Committee may wish to inquire about certain differences. In particular, the Committee may wish to examine the rules for publicly-traded companies, derivative benefits, and certain triangular arrangements. The Committee also may wish to ask the Treasury Department about special limitation on benefits rules applicable to Danish taxable nonstock corporations.

Publicly-traded companies

A company that is a resident of a treaty country is eligible for all the benefits of the proposed protocol if it satisfies a regular trading test and either a management and control test or a primary trading test. A company satisfies the regular trading test if its principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges. Under the management and control test, the company's primary place of management and control must be in the treaty country of which the company is a resident. The primary trading test requires that a company's principal class of shares be primarily traded on a recognized stock exchange located in the treaty country of which the company is a resident or, in the case of a Danish company, on a recognized stock exchange in another EU or EEA country, or in the case of a U.S. company, in another NAFTA country. A recognized stock exchange specifically includes, in addition to U.S. and Copenhagen exchanges, the stock exchanges of

Amsterdam, Brussels, Frankfurt, Hamburg, Helsinki, London, Oslo, Paris, Stockholm, Sydney, Tokyo, and Toronto.[23]

The Committee may wish to inquire about the primary trading test in the proposed protocol. That test is similar to the primary trading test in the proposed protocol with Finland, the proposed treaty with Belgium, and the recent protocol with Sweden but differs from the test in the U.S. model and the test included in the proposed protocol with Germany. Under the primary trading test in the U.S. model and in the proposed protocol with Germany, the required trading must occur on a stock exchange in the treaty country of which the relevant company is a resident; trading on a stock exchange in another country may not be used to satisfy the test. A possible rationale for this narrower primary trading test, and for the management and control test that may be satisfied instead of the primary trading test, is that a publicly-traded company should be eligible for treaty benefits only if it has a nexus with its country of residence. A company that is a resident of the United States or Denmark may not have this nexus if it satisfies the proposed protocol's primary trading test because of trading on an exchange in a third country. The Committee may wish to ask the Treasury Department about the circumstances that justify allowing trading on third country exchanges to be used to satisfy the primary trading test. In particular, the Committee might ask when it is more appropriate to consider trading in the economic areas of the treaty countries (for example, NAFTA, EU, and EEA countries) than to consider only trading in the treaty countries of which companies are resident. The Committee also may wish to inquire whether trends toward greater or lesser integration in Europe might affect Treasury Department considerations when negotiating about primary trading rules.

Although the proposed protocol's primary trading test is similar to the tests in the recent protocol with Sweden, the proposed protocol with Finland, and the proposed treaty with Belgium, the stock exchanges specifically included in the definition of "recognized stock exchange" (under both the regular trading test and the primary trading test) differ among the three protocols and the treaty. The Committee may wish to inquire about the criteria the Treasury Department considers when negotiating over the definition of a recognized stock exchange.

Taxable nonstock corporations

According to the Technical Explanation, Danish taxable nonstock corporations are vehicles used to preserve control of operating companies through ownership of those operating companies' voting shares. The proposed protocol includes special rules intended to allow treaty benefits when (1) the voting shares of a Danish company that satisfies the regular trading test are owned by Danish taxable nonstock corporations or (2) a Danish taxable nonstock corporation satisfies requirements analogous to the base erosion test. Without the special rules for the first circumstance, a publicly-traded Danish company whose voting shares are predominantly owned

[23] Trading on only recognized stock exchanges located in the United States, Denmark, or (for Danish companies) an EEA or EU country, or (for U.S. companies) a NAFTA country may be used to satisfy the primary trading test. Trading on recognized stock exchanges located in any country may be used to satisfy the regular trading test.

by a Danish taxable nonstock corporation might not qualify for treaty benefits because it would not satisfy the regular trading test. Similarly, in the absence of the special rules for the second circumstance, Danish taxable nonstock corporations would not qualify for treaty benefits because those corporations do not have owners and therefore cannot satisfy the ownership test. (The ownership and base erosion tests are discussed above in the description of Article IV of the proposed protocol.)

The Committee may wish to ask the Treasury Department about the role played by Danish taxable nonstock corporations in the Danish economy and society and about why this role justifies special rules to grant treaty benefits.

Derivative benefits

Like the proposed protocols with Finland and Germany and the proposed treaty with Belgium, and like other recent treaties, the proposed protocol includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners (referred to in the proposed protocol as equivalent beneficiaries) would have been entitled to the same benefits for the income had those owners derived the income directly.

The derivative benefits rules may grant treaty benefits to a treaty country resident company in circumstances in which the company would not qualify for treaty benefits under any of the other limitation on benefits provisions. The U.S. model does not include derivative benefits rules. The Committee may wish to inquire about the circumstances that justify inclusion of these rules in new treaties notwithstanding their absence from the U.S. model.

Triangular arrangements

The proposed protocol includes special anti-abuse rules intended to deny treaty benefits in certain circumstances in which a Danish resident company earns U.S.-source income attributable to a third-country permanent establishment and is subject to little or no tax in the third jurisdiction and Denmark. Similar anti-abuse rules are included in other recent treaties and in the proposed protocols with Finland and Germany and the proposed treaty with Belgium. The U.S. model, however, does not include rules addressing triangular arrangements. The Committee may wish to ask the Treasury Department about the circumstances that justify inclusion of the anti-abuse rules notwithstanding their absence from the U.S. model. In particular, the Committee may wish to inquire whether the Treasury Department will insist on inclusion of anti-abuse rules whenever a treaty partner's internal tax rules provide an exemption for the income of a third-country permanent establishment of a treaty partner resident.