NYC Bar Report on Derivative Benefits Provisions in Tax Treaties

By the New York City Bar Committee on Taxation of Business Entities

Mark Stone, chair of the New York City Bar Committee on Taxation of Business Entities, in a report on the derivative benefits provisions in U.S. income tax treaties, urges Treasury to provide guidance on determining the scope of dividend payment relief due to uncertainties in calculating the relevant stock ownership. The report makes policy-based proposals to the Senate Foreign Relations Committee and Treasury that, if adopted, would significantly broaden the scope of the derivative benefits provision. One proposal would extend derivative treaty benefits under the U.S. income tax treaty with Canada (which is currently before the Senate Foreign Relations Committee) and other treaties to allow comprehensive treaty benefits in lieu of the more limited withholding tax benefits currently available. Another proposal would eliminate the ''at least as low as'' requirement, which serves to deny all treaty benefits, and replace it with a ''look through'' or ''higher of'' rule that would prevent treaty shopping while still allowing equivalent beneficiaries to retain some or all of the treaty benefits that they would have enjoyed if they had received income directly rather than through a holding company. Geographic restrictions on the availability of derivative benefits would also be eliminated.

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This report, which is submitted on behalf of the New York City Bar, by its Committee on Taxation of Business Entities, considers various aspects of the ''derivative benefits'' provision found in the Limitation on Benefits Article (LOB article) of certain U.S. income tax treaties. The report recommends guidance regarding certain aspects of ''equivalent beneficiary'' status and also makes certain policy-based proposals.[1]

I. Introduction

A number of the U.S. income tax treaties that have entered into force since 1992 contain within their LOB articles a ''derivative benefits'' provision designed to ensure that an entity owned by nonresident ''equivalent beneficiaries'' may qualify for treaty benefits, even if the other LOB tests are not satisfied, where it is clear that such entity was not used for impermissible ''treaty-shopping'' purposes. We believe there is a need for guidance in determining the scope of the dividend payment relief under such derivative benefits provisions, due to the uncertainties involved in calculating the relevant stock ownership, and propose several clarifications.

More fundamentally, as a matter of sound tax treaty policy, we question the desirability of the ''at least as low as'' requirement and propose adoption of a ''look-through'' rule (or, alternatively, a ''higher of'' rule) instead. We are also of the view that certain limitations on the scope of the derivative benefits provision do not serve any important tax treaty policy. We therefore recommend that derivative benefits provisions be standard in all comprehensive U.S. income tax treaties and that equivalent beneficiary status not be restricted to residents of certain jurisdictions. Finally, we recommend expanding derivative benefits to include all treaty benefits where that is not presently the case.

The discussion below provides a general explanation of the LOB article including the derivative benefits test, describes the areas in which guidance is needed in connection with derivative benefits for dividend payments, and explains our recommendations in detail.

II. General Explanations

A person generally will be entitled to the benefits of an income tax treaty between the United States and a foreign country (each typically referred to as a ''State'' or a ''Contracting State'') only if, among other requirements, such person (1) is a resident of a Contracting State within the meaning of the treaty and (2) satisfies the requirements of the LOB article of the treaty.[2]

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[1]The report was prepared by an ad hoc committee of the Committee on Taxation of Business Entities of the New York City Bar. The principal authors of the report are Michael J. Miller and Mark Stone. Significant assistance was provided by Peter H. Blessing, Jeffrey C. Trossman, and Ian Shane. Helpful comments were provided by John P. Barrie.

[2]There are a few older U.S. income tax treaties that do not contain LOB articles, including most notably the 1979 Hungary-U.S. Income Tax Treaty.

The LOB article is premised on the view that a resident of a Contracting State must have some connection to that country beyond mere residence in order to benefit from that country's income tax treaty with the United States. Thus, the LOB article limits the ability of third-country residents to engage in ''treaty shopping'' by establishing legal entities in either the United States or a foreign country to obtain the benefits of a U.S. income tax treaty.

Each LOB article sets forth a number of objective tests. A resident of a Contracting State that satisfies any of those objective tests generally is entitled to the benefits of the applicable income tax treaty, regardless of whether such resident was formed or availed of for a tax-avoidance purpose. The common objective tests include (1) a public company test, (2) an ownership and base erosion test, (3) an active trade or business test, and (4) in some cases, a derivative benefits test.

Pursuant to the derivative benefits test, a company that does not satisfy any of the other LOB tests may nevertheless qualify for treaty benefits if, among other requirements, a specified percentage (typically 95 percent) of its shares is owned, directly or indirectly, by seven or fewer ''equivalent beneficiaries'' and a base erosion test is satisfied. An ''equivalent beneficiary'' generally means any person that:

> 1. In connection with certain European country treaties, is a resident of a member state of the EU, any state of the European Economic Area, a party to North American Free Trade Agreement, or, in some cases, Switzerland (each, a ''Qualifying Country'');
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> 2. Is entitled to the benefits of a comprehensive income tax treaty between such Qualifying Country and the Contracting State from which treaty benefits are claimed and satisfies certain LOB requirements (even if that treaty has no LOB article); and
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> 3. In the case of dividends, interest, royalties, and possibly certain other items, would be entitled, under the treaty between the Qualifying Country and the Contracting State in which the income arises, to a rate of tax with respect to the particular class[3] of income for which benefits are claimed that is ''at least as low as'' the rate provided for under the treaty between the Contracting States.

The treaty language setting forth the ''at least as low as'' requirement is fairly straightforward. For example, the 2001 U.K.-U.S. Income Tax Treaty (the U.K. Treaty) provides that a would-be equivalent beneficiary entitled to the benefits of a comprehensive U.S. income tax treaty will satisfy such requirement only if such person ''with respect to income referred to in Article 10 (Dividends), 11 (Interest) or 12 (Royalties) of this Convention, would be entitled under such convention to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is *at least as low as* the rate applicable under this Convention[.]''

The Treasury Department's Technical Explanation describes the test as follows:

> In order to satisfy the additional requirement necessary to qualify as an ''equivalent beneficiary'' under paragraph 7(d)(i) with respect to dividends, interest, or royalties, the person must be entitled to a rate of withholding tax that is at least as low as the withholding tax rate that would apply under the Convention to such income. Thus, the rates to be compared are: (1) the rate of withholding tax that the source State would have imposed if a qualified resident of the other Contracting State was the beneficial owner of the income; and (2) the rate of withholding tax that the source State would have imposed if the third State resident received the income directly from the source State.

Thus, the ''at least as low as'' requirement is designed to prevent residents of a third state from using an entity that is a resident of one of the Contracting States to obtain a more favorable rate of withholding tax on payments sourced in the other Contracting State than would otherwise be available to them.

The choice was made to accomplish this objective by disallowing treaty benefits for any item of income for which the ''at least as low as'' requirement is not satisfied. Such disallowance is illustrated in the following example:

> X, a U.K. resident corporation, is wholly owned by Y, a publicly traded Italian corporation that qualifies for all benefits of the 1984 Italy-U.S. Income Tax Treaty (the Italian Treaty). X earns interest from U.S. sources that does not qualify for the portfolio interest exemption and wishes to claim an exemption under Article 11(1) of the U.K. Treaty. X will qualify for the benefits of that treaty only if it satisfies the derivative benefits test.

Y is not an equivalent beneficiary because Y would be subject to U.S. withholding tax at a 15 percent rate under the Italian Treaty,[4] which is not as low as the 0 percent rate available to a qualified resident of the United Kingdom. The result is that X's interest income is subject to U.S. withholding tax at a 30 percent rate. Once Y fails to qualify as an equivalent beneficiary, X cannot satisfy the derivative benefits test, and thus does not qualify for treaty benefits, with respect to its interest income.[5]

Another possible mechanism for preventing the type of abuse at which the ''at least as low as'' requirement was directed would have been to allow X to enjoy the same 15 percent withholding rate that would have been available to Y if Y had earned the relevant interest income directly, rather than through X. The approach that has been adopted, however, does not allow for such ''fine tuning.'' Thus, the ''at least as low as'' requirement appears to be binary: Either the test is satisfied and treaty benefits are available, or the test is not satisfied and treaty

[3]Some treaties refer to the ''item of income'' rather than the ''particular class of income'' for which benefits are claimed.

[4]*See* Article 11(2) of the Italian Treaty. Assume that Article 11(3) of that treaty, which provides a complete exemption in certain limited circumstances, does not apply.

[5]This conclusion assumes that the U.S. competent authority has not provided a discretionary grant of treaty benefits.

benefits are not available. We discuss the propriety of such policy in the subsequent section of this report.

III. 'At Least as Low as' Uncertainties

When derivative benefits are sought for interest or royalties paid by a U.S. person to a foreign holding company claiming treaty benefits, and the holding company has a shareholder that is a third-country resident entitled to the benefits of a U.S. income tax treaty, few questions, if any, arise as to whether such shareholder satisfies the ''at least as low as'' requirement. While the holding company and the shareholder may each be entitled to various tax rates under their respective U.S. income tax treaties on various types of interest or royalty income, once the relevant type of income is identified, one rate should be applicable under each treaty and it should be perfectly clear whether the rate applicable to the shareholder is ''at least as low as'' that applicable to the holding company.

On the other hand, when derivative benefits are sought for dividends paid by a U.S. subsidiary to a holding company claiming treaty benefits, and the holding company has one or more shareholders that are each entitled to the benefits of a U.S. income tax treaty, questions arise as to whether such shareholder or shareholders satisfy the ''at least as low as'' requirement, because the reduced rate of withholding tax to which any shareholder would be entitled under its U.S. income tax treaty generally depends on how much stock such shareholder should be deemed to own in the U.S. subsidiary paying the dividend, and questions arise as to how such deemed stock ownership should be determined for this purpose. A number of these questions are addressed below.

A. Stock Attribution Issues

1. Overview. In many circumstances, the rate of withholding tax on dividends varies depending on whether one or more ownership tests are satisfied. For example, under most U.S. income tax treaties, a 5 percent withholding rate is available for corporate shareholders that own 10 percent or more of the voting stock of the corporation paying the dividend; and the withholding rate is increased to 15 percent if this 10 percent ownership test is not satisfied.[6] More recently, a number of U.S. income tax treaties allow for zero withholding on dividends (ZWD) if, among other requirements, the shareholder is a corporation owning 80 percent of the voting stock of the corporation paying the dividend.[7]

Therefore, the rate of withholding that would be imposed on the hypothetical payment of a dividend to the shareholder of the company that actually receives the dividend depends on how much stock the shareholder should be considered to own in the corporation paying the dividend. Typically, a shareholder of the company claiming treaty benefits will not directly own any stock in the corporation paying the dividend and, therefore, would not literally qualify for either the 5 percent rate or for ZWD. It seems clear, however, that this is not the intended approach.

2. ZWD attribution rule. For purposes of applying the ''at least as low as'' requirement with respect to ZWD, many treaties including ZWD and derivative benefits provisions specifically provide that the shares owned by the corporation claiming treaty benefits may be attributed to the would-be equivalent beneficiary.[8] For example, Article 23(7)(d) (flush language) of the U.K. Treaty provides as follows:

> For the purposes of applying paragraph 3 of Article 10 (Dividends) in order to determine whether a person, owning shares, directly or indirectly, in the company claiming the benefits of this Convention, is an equivalent beneficiary, such person shall be deemed to hold the same voting power in the company paying the dividend as the company claiming the benefits holds in such company.[9]

Thus, for example, if a publicly traded Dutch corporation (Deo) entitled to the benefits of the Dutch Treaty owns 100 percent of the stock of a U.K. holding company (UKco), and UKco in turn owns 100 percent of the stock of a U.S. subsidiary (USco), it seems clear that, for purposes of applying the ''at least as low as'' requirement to determine whether Deo should be considered an equivalent beneficiary with respect to a claim of ZWD from USco, Deo would be deemed to own 100 percent of the voting power of USco.

Suppose instead that Deo owns only 92 percent of the stock of UKco and that a second publicly traded Dutch corporation (Dco2) owns the other 8 percent of the stock of UKco. Since derivative benefits will be available only if at least 95 percent of the stock of UK is owned by equivalent beneficiaries, UKco will be entitled to treaty benefits only if Dco2 is also considered an equivalent beneficiary. But for purposes of determining whether

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[6]*See* Article 10(2) of the 2006 U.S. Model Income Tax Convention. The 15 percent rate also applies to payments to individuals.

[7]*See, e.g.*, Article 10(3) of the U.K. Treaty; Article 10(3) of the 1982 Australia-U.S. Income Tax Treaty, as amended by a protocol signed in 2001; Article 10(3) of the 1992 Mexico-U.S. Income Tax Treaty, as amended by a protocol signed in 2002 (the Mexican Treaty); Article 10(3) of the 1994 Sweden-U.S. Income Tax Treaty, as amended by a protocol signed in 2005 (the Swedish Treaty); Article 10(3) of the 2006 Belgium-U.S. Income Tax Treaty (the Belgian Treaty); Article 10(3) of the Germany-U.S. Treaty, as amended by a protocol signed in 2006 (the German Treaty); Article 10(3) of the 1999 Denmark-U.S. Income Tax Treaty, as amended by a protocol signed in 2006 (the Danish Treaty); Article 10(3) of the 1989 Finland-U.S. Income Tax Treaty, as amended by a protocol signed in 2006 (the Finnish Treaty); Article 10(3) of the 1992 Netherlands-U.S. Income Tax treaty, as amended by a protocol signed in 2004 (the Dutch Treaty). Pursuant to Article 10(3) of the 2003 Japan-U.S. Income Tax Treaty, a more-than-50 percent ownership requirement applies.

(Footnote continued in next column.)

[8]*See, e.g.*, Article 28(8)(e)(aa) (flush language) of the German Treaty; Article 22(8)(h) (flush language) of the Danish Treaty; Article 16(7)(g) (flush language) of the Finnish Treaty; Article 26(8)(f) (flush language) of the Dutch Treaty.

[9]Such flush language was added by a protocol that was signed concurrently with the U.K. Treaty.

Dco2 is an equivalent beneficiary, how much stock of USco should Dco2 be deemed to own?[10]

The attribution language quoted above provides that Dco2 ''shall be deemed to hold the *same voting power*'' in USco that UKco owns for purposes of ZWD.[11] Read literally, that language seems to treat Dco2 as if it owned 100 percent of the voting stock of USco, even though it owns only 8 percent of the stock of UKco. This appears inappropriate, and the committee questions whether such an overly generous result was intended. We are of the view that, as a policy matter, proportionate attribution is appropriate in such circumstances.[12] In any case, a revenue ruling or other guidance clarifying the operation of the deemed ownership rules would be helpful, particularly with respect to treaties that do not contain an attribution rule.[13]

The Committee is aware that, under our recommended proportionate attribution rule, Deo would lose the benefit of ZWD, otherwise allowable under the present ''full attribution'' language in the UK Treaty, and to which it would have been entitled if it directly held its indirect 92 percent interest in USco, because Dco2 would not be considered an equivalent beneficiary with respect to ZWD. This result could be avoided, however, if the ''look-through'' approach proposed in section IV of this report were adopted.

The impropriety of allowing ''full attribution'' may be more evident in fact patterns where neither equivalent beneficiary would be entitled to ZWD if the holding company seeking derivative treaty benefits were not interposed. Suppose that a Dutch holding company (Deo) owns 100 percent of the stock of a U.S. subsidiary (USco). The stock of Deo is 50 percent-owned by a publicly traded U.K. corporation (UKco) and 50 percent-owned by a publicly traded German corporation (Gco). If the Dutch holding company were not interposed, neither UKco nor Gco would qualify for ZWD, because neither would satisfy the 80 percent ownership requirement. The Committee is of the view that UKco and Gco should not be able to obtain the benefit of ZWD, to which they would not otherwise be entitled, by holding their shares of USco through Deo. The derivative benefits provision should not operate to reward treaty shopping in this manner.

3. Other attribution issues. Although the ZWD attribution rule clearly is helpful, there are a number of other scenarios where additional guidance is required (or where changes in existing guidance may be desirable).

a. Directly owned stock. Suppose, for example, that a publicly traded Italian corporation (Ico) entitled to the benefits of the Italian Treaty owns 100 percent of a U.K. holding company (UKco). Ico owns 67 percent of a U.S. subsidiary (USco) directly, and the other 33 percent is owned through UKco.

In order for UKco to be entitled to derivative treaty benefits, Ico must be an equivalent beneficiary; and for Ico to be an equivalent beneficiary, it must be entitled to a 5 percent withholding rate under the appropriate set of assumed facts. For an Italian corporation to qualify for a 5 percent dividend withholding rate, it must own more than 50 percent of the voting stock of USco.[14] For purposes of determining the withholding rate to which Ico would be entitled under the Italian treaty, how much voting stock of USco should Ico be considered to hold? If Ico were considered to hold solely the 33 percent owned by UKco, that would be insufficient.

The ZWD attribution rule set forth above states that, for purposes of determining equivalent beneficiary status (i.e., applying the ''at least as low as'' requirement) with respect to ZWD, the potential equivalent beneficiary shall be deemed to own the ''same'' voting power in the company paying the dividends as is held by the company that actually received the dividend. This rule, which by its terms applies only for ZWD purposes, should be read to treat such ownership (or least proportionate ownership as discussed above) as owned in addition to any shares directly owned, and should not be read to suggest that any voting stock actually owned by the potential equivalent beneficiary must be disregarded. It would be helpful if the IRS issued a revenue ruling or other guidance clarifying that, whatever the scope of the applicable ''attribution'' rules (discussed further below), in no circumstance must any voting stock actually owned by the potential equivalent beneficiary be disregarded.

b. Holding company not wholly owned. Suppose that a Luxembourg holding company (Leo) owns 100 percent of the stock of a U.S. subsidiary (USco). A publicly traded U.K. corporation entitled to the benefits of the U.K. Treaty (UKco) owns 92 percent of the stock of Leo, and the remaining 8 percent of the stock of Leo is owned by a publicly traded Dutch corporation entitled to the benefits of the Dutch Treaty (Deo). Leo will be entitled to derivative treaty benefits with respect to dividends received from USco only if UKco and Deo are both equivalent beneficiaries.[15]

To be an equivalent beneficiary with respect to the 5 percent withholding rate, Deo must be deemed to own 10 percent of the voting stock of USco. Whether this ownership requirement is satisfied depends on whether Deo should be considered to own all of the USco voting stock owned by Leo or whether Deo should only be considered to own an amount of USco stock that is proportionate to

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[10]*See also* Section III.A.3 of this report addressing similar attribution issues outside the ZWD context.

[11]*See* Article 23(7)(d) (flush language) of the U.K. Treaty (emphasis added).

[12]It may, however, be appropriate to permit ''full attribution'' to an equivalent beneficiary that owns a 95 percent-or-greater interest in the holding company. For example, if Deo owned 95 percent of the stock of UKco, and UKco owned 80 percent of the stock of USco, deeming Deo to own 80 percent of the stock of USco in order to treat Deo as an equivalent beneficiary would not necessarily be unreasonable.

[13]*See* Article 21(8)(g) of the Belgian Treaty.

[14]*See* Article 10(2)(a) of the Italian Treaty.

[15]In order for Leo to qualify for derivative benefits, at least 95 percent of the stock of Leo must be owned by equivalent beneficiaries. *See* Article 24(4) of the 1996 Luxembourg-U.S. Income Tax Treaty (the Luxembourg Treaty).

Deo's ownership interest in Leo. We are of the view that proportionate attribution is appropriate as a policy matter.[16]

As stated above, the ''at least as low as'' requirement is designed to prevent residents of one Contracting State from using an entity that is a resident of a third country to obtain more favorable treaty benefits (e.g., a lower rate of withholding tax) than would otherwise be available to them. Keeping this policy in mind, it seems that the appropriate question to ask is ''How much voting stock would Deo have in USco if Leo were not interposed?'' Presumably, the answer is 8 percent, and it therefore appears that this is the amount of voting stock in USco that Deo should be considered to hold. Since this is less than 10 percent, it seems that Deo should not be considered an equivalent beneficiary with respect to the 5 percent withholding rate on dividends. Therefore, it appears that Leo should not qualify for a 5 percent withholding rate on dividends from USco under the derivative benefits provision of the Luxembourg Treaty. Guidance on this point would be helpful.[17]

The Committee is aware that, under our recommended proportionate attribution rule, UKco would lose the benefit of the 5 percent withholding rate to which it would have been entitled if it directly held its indirect 92 percent interest in USco, because Deo would not be considered an equivalent beneficiary with respect to the 5 percent rate. This result could be avoided, however, if the ''look-through'' approach proposed in Section IV of this report were adopted.

c. Potential equivalent beneficiary is an individual. Suppose that a Luxembourg holding company (Leo) owns 100 percent of the stock of a U.S. subsidiary (USco). A publicly traded U.K. corporation entitled to the benefits of the U.K. Treaty (UKco) owns 50 percent of the stock of Leo, and the remaining 50 percent of the stock of Leo is owned by an individual U.K. resident (UKR). Leo will be entitled to a 5 percent withholding rate on dividends received from USco only if UKco and UKR are both equivalent beneficiaries with respect to the 5 percent rate.[18]

Inasmuch as UKR would be subject to a 15 percent withholding rate on dividends received from USco, the possibility of UKR satisfying the ''at least as low as'' requirement may at first seem doubtful. The Exchange of Notes and Technical Explanation to the Luxembourg Treaty, however, suggest a different approach.

The Exchange of Notes provides as follows:

> For purposes of determining under subparagraph 4(c) if a comprehensive income tax Convention between one of the Contracting States and a third State provides with respect to dividends a rate of tax that is equal to or less than the rate of tax provided under the Convention, it is understood that the following two tax rates must be compared:
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> a) the rate of tax to which each of the persons described in subparagraph 4(a) would be entitled if they directly held their proportionate share of the shares that gave rise to the dividends; and
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> b) the rate of tax to which the same persons, if they would be residents of the Contracting State of which the recipient is a resident, would be entitled if they directly held their proportionate share of the shares that gave rise to the dividends.

The Technical Explanation restates the rate comparison rule set forth in the Exchange of Notes and provides an example that the reader should find familiar:

> [A]ssume that a U.S. company pays a dividend to LuxCo, a company resident in Luxembourg. LuxCo has two equal shareholders, a corporation resident in the United Kingdom and an individual resident in the United Kingdom. Both are residents of a member State of the European Union within the meaning of subparagraph 4(d)(i). Each person's proportionate share of the dividend payment is 50 percent of the dividend. If the UK corporation had received this portion of the dividend directly, it would be subject to a withholding tax of 5 percent under the income tax treaty between the United States and the United Kingdom. If the individual had received his portion of the dividend directly, it would be subject to a withholding tax of 15 percent under the U.S.-U.K. treaty. These rates are the same rates that would apply if they were residents of Luxembourg. Therefore, the test under subparagraph 4(c) is satisfied with respect to this dividend payment.

According to the example, the Luxembourg holding company should qualify for a 5 percent withholding rate because the withholding rate for *individuals* is the same under both the Luxembourg and U.K. treaties. This approach would avoid the undesirable result of causing the Luxembourg holding company to lose treaty benefits, but, as illustrated in the example below, the comparison of individual withholding rates prescribed therein seems inappropriate. If the U.K. individual shareholder is to be considered an equivalent beneficiary, it should be because he is no better off owning shares of the U.S. subsidiary through a Luxembourg company than through a U.K. company (the logical jurisdiction in which a U.K. individual shareholder might be expected to form a holding company). If the Luxembourg holding company had instead been a U.K. holding company, it would have been entitled to a withholding rate at least as low as 5 percent; and this is the reason that the ''at least as low as'' requirement should be considered satisfied.

This point may be illustrated by supposing instead that an individual resident of France (FR) owns 100 percent of the stock of a Dutch holding company (Deo),

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[16]*See also* Section III.A.2. addressing similar attribution issues in the context of ZWD.

[17]A separate issue is whether Leo may nevertheless qualify for a 15 percent withholding rate because UKco and Deo are both entitled to withholding rates that are at least as low as 15 percent. The availability of a 15 percent withholding rate in this type of scenario is addressed in Section III.B. of this report.

[18]In order for Leo to qualify for derivative benefits, at least 95 percent of the stock of Leo must be owned by equivalent beneficiaries.

which in turn owns 100 percent of the stock of a U.S. subsidiary (USco). Under the ZWD provision of the Dutch Treaty, Deo qualifies for ZWD, provided, of course, that it qualifies for derivative treaty benefits. If the rate comparison test of the Luxembourg Exchange of Notes and Technical Explanation were applied here, Deo would qualify for ZWD, because the withholding rate on dividends paid to individuals is 15 percent under both the Dutch Treaty and the 1994 France-U.S. Income Tax Treaty (French Treaty). Inasmuch as the French Treaty does not have a ZWD provision, this would permit FR to reduce the U.S. withholding tax by choosing to form a Dutch holding company instead of, for example, a French holding company.

The Committee respectfully suggests that this result is inappropriate and that the rate comparison test should be based on the relevant corporate rates, not individual rates.

B. The 'Zero Withholding Problem'

Consider the following example from the Technical Explanation to the U.K. Treaty:

> USCo is a wholly owned subsidiary of UKCo, a company resident in the United Kingdom. UKCo is wholly owned by FCo, a corporation resident in France. Assuming UKCo satisfies the requirements of paragraph 3(a) of Article 10 (Dividends), UKCo would be eligible for a zero rate of withholding tax. The dividend withholding rate in the treaty between the United States and France is 5 percent. Thus, if FCo received the dividend directly from USCo, FCo would have been subject to a 5 percent rate of withholding tax on the dividend. Because FCo would not be entitled to a rate of withholding tax that is at least as low as the rate that would apply under the Convention to such income (i.e., zero), FCo is not an equivalent beneficiary within the meaning of paragraph 7(d)(i) of Article 23 with respect to zero rate of withholding tax on dividends.

As would be expected, the example makes it clear that UKCo cannot qualify for ZWD under the derivative benefits provision of the LOB article, because the would-be equivalent beneficiary, FCo, would have been subject to withholding at a 5 percent rate, which clearly is not as low as 0 percent.

However, the example concludes that the French company "is not an equivalent beneficiary . . . *with respect to zero rate of withholding tax on dividends.*"[19] The implication, it seems, is that FCo may be treated as an equivalent beneficiary as to some other rate of withholding on dividends.

At first blush, it is not obvious how such a favorable result might be justified. As indicated above, the "at least as low as" requirement appears to be binary: Either the test is satisfied and treaty benefits are available, or the test is not satisfied and treaty benefits are not available. Since the UKCo in the example above would be entitled to ZWD, and FCo would not, it is not immediately apparent how any treaty benefits would be available.

The Technical Explanation to the U.K. Treaty, however, contains the following additional example that suggests a more favorable outcome:

> A U.K. resident company, Y, owns all of the shares in a U.S. resident company, Z. Y is wholly owned by X, a German resident company that would not qualify for all of the benefits of the U.S.-Germany income tax treaty but may qualify for benefits with respect to certain items of income under the "active trade or business" test of the U.S.-Germany treaty. X, in turn, is wholly owned by W, a French resident company that is substantially and regularly traded on the Paris Stock Exchange. Z pays a dividend to Y. Y qualifies for benefits under paragraph 3 of Article 23, assuming that the requirements of subparagraph 3(b) of Article 23 are met. Y is directly owned by X, which is not an equivalent beneficiary within the meaning of subparagraph 7(d)(i) of Article 23 (X does not qualify for all of the benefits of the U.S.-Germany tax treaty). However, Y is also indirectly owned by W and W may be an equivalent beneficiary. Y would not be entitled to the zero rate of withholding tax on dividends available under the Convention because W is not an equivalent beneficiary with respect to the zero rate of withholding tax since W is not eligible for such rate under the U.S.-France income tax treaty. *W qualifies as an equivalent beneficiary with respect to the 5 percent maximum rate of withholding tax* because (a) it is a French resident company whose shares are substantially and regularly traded on a recognized stock exchange, within the meaning of the Limitation on Benefits Article of the U.S.-France income tax treaty and (b) the dividend withholding rate in the treaty between the United States and France is 5 percent. *Accordingly, U.S. withholding tax on the dividend from Z to Y will be imposed at a rate of 5 percent in accordance with subparagraph 2 (a) of Article 10.*[20]

The example concludes that W, the French company, qualifies as an equivalent beneficiary with respect to the 5 percent rate of withholding tax, even though it is not entitled to the zero withholding rate to which Y, the U.K. company, would have been entitled if it qualified for treaty benefits.[21] The example does not attempt to explain how the "at least as low as" requirement was determined to be satisfied.

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[19]Emphasis added.

[20]Emphases added.

[21]Although the example could have been written more clearly, it is obvious that Y satisfies the requirements for ZWD. The example states that "Y would not be entitled to the zero rate of withholding tax on dividends available under the Convention *because W is not an equivalent beneficiary with respect to the zero rate of withholding tax* since W is not eligible for such rate under the U.S.-France income tax treaty." (Emphasis added.) Thus, the example makes it clear that ZWD is unavailable solely due to the lack of a suitable equivalent beneficiary.

A similar example appears in the Memorandum of Understanding (the Dutch MOU) agreed to by the United States and the Netherlands in connection with the 2004 protocol to the Dutch Treaty:

> A Netherlands resident company, Y, owns all of the shares in a U.S. resident company, Z. Y is wholly owned by X, a U.K. resident company that would not qualify for all of the benefits of the U.S.-U.K. income tax treaty but may qualify for benefits with respect to certain items of income under the ''active trade or business'' test of the U.S.-U.K. treaty. X, in turn, is wholly owned by W, a French resident-company that is substantially and regularly traded on the Paris Stock Exchange. Z pays a dividend to Y. For purposes of this example, assume that Y does not qualify for benefits under paragraph 2 of Article 26 (Limitation on Benefits). Y does qualify for benefits under paragraph 3 of Article 26, however, assuming that the requirements of subparagraph 3 b) of Article 26 are met. Y is directly owned by X, which is not an equivalent beneficiary within the meaning of subparagraph 8 f) of Article 26 (X does not qualify for all of the benefits of the U.S.-U.K. tax treaty). However, *Y is also indirectly owned by W, which is an equivalent beneficiary for purposes of the benefits provided by paragraph 2 a) of Article 10* within the meaning of subparagraph 8 f) of Article 26 (because W is a French resident company whose shares are substantially and regularly traded on a recognized stock exchange, within the meaning of the Limitation on Benefits Article of the U.S.-France income tax treaty). *Accordingly, U.S. withholding tax on the dividend from Z to Y will be imposed at a rate of 5% in accordance with subparagraph 2 a) of Article 10.*[22]

Much like the second above-described example from the Technical Explanation to the U.K. Treaty, this example from the Dutch MOU concludes that W is an equivalent beneficiary with respect to the 5 percent withholding rate.[23]

The example in the Dutch MOU does not expressly state that Y satisfies the requirements for ZWD, but this would appear to be implied. In any case, nothing in the example states that its conclusion is dependent on Y's failure to qualify for ZWD. Although a bit more clarity would have been nice, the Dutch MOU plainly stands for the proposition that a corporation may be entitled to withholding on dividends at a 5 percent rate under the derivative benefits provision of the Dutch Treaty if the equivalent beneficiary qualifies for such rate, regardless of whether the corporation claiming such treaty benefits would (if it were a qualified resident) qualify for ZWD.

Although the Treasury Department's position, as set forth in the U.K. Technical Explanation and the Dutch MOU, appears quite generous, it is possible to reconcile such position with the language of the ''at least as low as'' requirement.

As indicated above, the U.K. Treaty, for example, provides that the ''at least as low as'' requirement is satisfied if the potential equivalent beneficiary that is entitled to the benefits of a comprehensive U.S. income tax treaty ''with respect to income referred to in Article 10 (Dividends), 11 (Interest) or 12 (Royalties) of this Convention, would be entitled under such convention to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention[.]''[24]

Thus, the rate that must be compared with the rate available to the would-be equivalent beneficiary is the rate ''applicable'' to the relevant class of income under the U.K. Treaty. Arguably, the rate that is ''applicable'' under the U.K. Treaty is the rate of tax available under whatever article, paragraph, subparagraph, or other provision of such treaty that the taxpayer chooses to invoke. Under this approach, 5 percent would be the ''applicable'' rate for purposes of applying the ''at least as low as'' requirement, if the taxpayer claims (or is deemed to claim) a 5 percent withholding rate under Article 10(2)(a), rather than a 0 percent rate under Article 10(3).[25]

This approach can also be reconciled with the portion of the U.K. Technical Explanation providing that ''the rates to be compared are: (1) the rate of withholding tax that the source State would have imposed if a qualified resident of the other Contracting State was the beneficial owner of the income; and (2) the rate of withholding tax that the source State would have imposed if the third State resident received the income directly from the source State.'' Arguably, the hypothetical qualified resident referred to in clause (1) above should be assumed not to claim a lower rate of withholding tax than that actually claimed by the taxpayer. That assumption does not exactly jump out from the language of the Technical Explanation, but it seems a plausible explanation for the Treasury Department's conclusion that the ''at least as low as'' requirement is satisfied.

Dutch companies that wish to claim a reduced rate of U.S. withholding tax under the Dutch Treaty in circumstances comparable to those of the example in the Dutch MOU should be able to rely on that example, which represents a part of the agreement between the United States and the Netherlands. The Technical Explanation to the U.K. Treaty is not part of the agreement between the United States and the United Kingdom, but the second

[22]Emphases added.

[23]The Technical Explanation to the 2004 protocol to the Dutch Treaty also includes an example similar to the first above-described example from the Technical Explanation to the U.K. Treaty. In this example, a U.S. corporation is wholly owned by a Dutch corporation that would satisfy all of the requirements for ZWD under the Dutch Treaty. The Dutch corporation is in turn owned by an Italian corporation that would only be entitled to a 5 percent withholding rate under the Italian Treaty. The example concludes that the Italian corporation ''is not an equivalent beneficiary . . . with respect to the elimination of withholding tax on dividends.'' The apparent implication of such language is that the Italian corporation might be an equivalent beneficiary with respect to some other withholding rate, but this is not expressly stated.

[24]*See* Article 23(7)(d)(i)(B) of the U.K. Treaty.

[25]Substantially the same argument may be made with respect to the Dutch MOU.

above-cited example from such Technical Explanation should nevertheless provide some comfort to U.K. holding companies in comparable circumstances.

In the case of companies that do not even have favorable language in the relevant Technical Explanation to rely on, the anxiety level may be considerable. For example, the Technical Explanation to the 2005 protocol to the Swedish Treaty includes an example comparable to the first above-quoted example from the Technical Explanation to the U.K. Treaty, indicating that the parent corporation is not an equivalent beneficiary with respect to ZWD, but neither that example nor any other states that a 5 percent withholding rate may be available.[26]

There are also variations on the dividend rate for derivative benefits purposes that are even further removed from the comfort described above. Suppose that a Dutch company (Deo) owns 100 percent of the stock of a U.S. subsidiary (USco). Deo is wholly owned by a publicly traded Spanish company (Sco) entitled to the benefits of the 1990 Spain-U.S. Income Tax Treaty (the Spanish Treaty).

In order for Deo to be entitled to ZWD or the 5 percent rate for dividends received from USco, Sco would need to so qualify under the Spanish Treaty. Since the Spanish Treaty does not have a ZWD provision, Sco clearly cannot be considered an equivalent beneficiary with respect to ZWD.[27] Sco similarly cannot be considered an equivalent beneficiary with respect to the 5 percent withholding rate, because the lowest withholding rate available for dividends under the Spanish Treaty is 10 percent.

It appears, however, that Deo should be permitted to claim a 15 percent rate under the derivative benefits provision of the Dutch Treaty, because Sco would be entitled to a withholding rate that is at least as low as such 15 percent rate (i.e., 10 percent). Nevertheless, clarification that such treaty benefits are allowed would be helpful.

In order to address the uncertainties described above, it would be helpful if the IRS issued a revenue ruling or other guidance confirming that, for purposes of applying the ''at least as low as'' requirement in the dividend setting, the relevant withholding rate that must be matched by the potential equivalent beneficiary is the withholding rate available under whatever article, paragraph, subparagraph, or other provision of the treaty that the taxpayer seeking derivative treaty benefits chooses to invoke.

IV. 'Look-Through', 'Higher of' Recommendations

The example below illustrates the application of the ''at least as low as'' requirement:

> X, a German resident holding corporation, is 100 percent-owned by Y, a French publicly traded corporation. X earns U.S.-source patent royalties that would (if treaty benefits were available) qualify for the 0 percent rate of withholding under Article 12 of the German Treaty. Pursuant to Article 12 of the French Treaty, however, Y would be subject to a 5 percent rate on such patent royalties. Thus, the ''at least as low as'' requirement clearly is not satisfied, and X does not qualify for derivative treaty benefits. In the absence of such treaty benefits, X is subject to U.S. withholding tax at a 30 percent rate.[28]

As is evident from this example, failure to meet the ''at least as low as'' requirement results in a complete loss of all treaty benefits for the patent royalties earned by the German corporation. This result seems overly harsh and, in the view of the committee, is not needed to prevent treaty shopping.

Allowing the German corporation to enjoy the same reduced withholding rate of 5 percent to which its French parent would have been entitled if it earned the royalty directly, rather than through its German holding company, clearly seems sufficient to prevent abuse. Accordingly, the committee recommends adoption of a ''look-through'' rule in lieu of the present ''at least as low as'' requirement. Under the proposed look-through rule, the entity claiming derivative treaty benefits would be entitled to a reduced withholding rate based on the reduced withholding rates to which its equivalent beneficiaries would have been entitled under their respective U.S. income tax treaties if they had directly received their shares of the payment received by such entity; provided, of course, that the withholding rate would not in any event be lower than that to which the entity claiming treaty benefits would otherwise be entitled. Thus, for example, if the entity claiming treaty benefits would be entitled to a 0 percent withholding rate and its two 50 percent shareholders would be entitled to withholding rates of 5 percent and 10 percent, respectively, 50 percent of the payment would be eligible for a 5 percent withholding rate and 50 percent of the payment would be eligible for a 10 percent rate, provided that all other requirements for derivative benefits are satisfied.[29] Under the proposed look-through approach, the 95 percent (or other) ownership requirement would be unnecessary and would therefore be eliminated.

The committee is cognizant of the need to thwart treaty abuse by preventing residents of one treaty jurisdiction from enjoying enhanced treaty benefits by interposing (purposively or otherwise) an entity that is a resident of a treaty jurisdiction with a more favorable U.S. income tax treaty. The proposed look-through rule would accomplish this objective by ensuring that such entity would not achieve a reduction in withholding tax that is any greater than the aggregate reduction to which

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[26]The Technical Explanations to one treaty and several protocols that recently entered into force (i.e., with Belgium, Denmark, Finland, and Germany) each contain a similar example.

[27]*See* Article 10 of the Spanish Treaty.

[28]Assume that X has not received a discretionary grant of treaty benefits from the U.S. competent authority pursuant to Article 28(7) of the German Treaty.

[29]If one of the shareholders in the example above were not an equivalent beneficiary, the portion of the payment allocable to such shareholder's interest in the holding company would be subject to withholding tax at a 30 percent rate.

the equivalent beneficiaries would have been entitled if such entity had not been interposed. Further punishment (i.e., disallowance of all treaty benefits by reason of failure to satisfy the present ''at least as low as'' requirement) is neither necessary nor appropriate.[30]

A similar (but less desirable) alternative would be to adopt a ''higher of'' rule. Under a ''higher of'' approach, the 95 percent (or other) ownership requirement would be retained and the entity claiming derivative treaty benefits would be entitled to a reduced withholding rate equal to the higher of the rates to which such entity and its equivalent beneficiaries would be entitled under their respective U.S. income tax treaties.[31] Thus, for example, if the entity claiming treaty benefits would be entitled to a 0 percent withholding rate and its two 50 percent shareholders would be entitled to withholding rates of 5 percent and 10 percent, respectively, the entity would (if all other requirements for derivative benefits are satisfied) be entitled to a 10 percent rate under the proposed ''higher of'' rule.[32] Note that the amount of withholding under the ''higher of'' rule is in this instance greater than under the look-through approach, because even the portion that is allocable to the shareholder in the more favorable treaty jurisdiction is subject to withholding tax at the higher 10 percent rate.

As stated above, the committee is cognizant of the need to prevent treaty shopping. A ''higher of'' rule would also accomplish this objective, by allowing the entity claiming derivative treaty benefits to enjoy a reduced rate of withholding tax that is no lower than the highest rate for which any equivalent beneficiary would have been eligible if such entity had not been interposed. Further punishment (i.e., disallowance of all treaty benefits by reason of failure to satisfy the present ''at least as low as'' requirement) is not warranted.

Amendments to section 894 of the code, introduced in Congress in 2007 under two separate bills, are consistent with our proposals.[33] Both bills would in certain circumstances limit or deny treaty benefits by increasing the withholding tax imposed on certain deductible payments (particularly interest and royalty payments) made to a related party ultimately owned by a foreign parent corporation. In the event that the foreign parent corporation is also entitled to the benefits of a U.S. income tax treaty, the Doggett Bill would require withholding on such payments at a rate that is the higher of the rate applied under the payee's treaty and the foreign parent company's treaty.[34] The Rangel Bill would not apply in such circumstances.[35] Both proposals would deny treaty benefits entirely if the foreign parent corporation is not eligible for the benefits of any U.S. income tax treaty. Notably, neither proposal would require a complete denial of treaty benefits to the payee where the rate of withholding tax to which the foreign parent corporation

[30]In this regard, we note that in circumstances involving conduit financing arrangements, neither the IRS nor the Treasury Department has attempted to punish taxpayers by disallowing the treaty benefits that would have been permitted if the conduit financing vehicle had not been interposed. *See Del Commercial Properties Inc. v. Commissioner*, T.C. Memo. 1999-411, *aff'd* 251 F.3d 210 (D.C. Cir. 2001). In *Del Commercial*, a Canadian corporation's use of a Dutch financing vehicle was disregarded, with the result that a complete exemption from withholding tax under the Dutch Treaty was not allowed, but the entitlement of the Canadian corporation to a 15 percent rate of withholding tax under the 1980 Canada-U.S. Income Tax Treaty (the Canadian Treaty) was not questioned. Furthermore, the ''anti-conduit'' rules set forth in reg. section 1.881-3, pursuant to section 7701(1) of the Internal Revenue Code of 1986, as amended (the code), expressly provide that, once the participation of a ''conduit entity'' is disregarded, the ''financing entity'' may claim treaty benefits for payments made pursuant to the ''conduit financing arrangement.'' Reg. section 1.881-3(a)(3)(ii)(C). We recognize that the purpose of the ''anti-conduit'' rules and the prior case law, which focus solely on beneficial ownership, is distinguishable from that of the LOB article, but all of these rules serve the broader purpose of preventing treaty shopping. In each case, disallowing the benefits of such treaty shopping without further punishment should be sufficient.

[31]Note that a precedent already exists in the LOB article for such provisions. A number of U.S. income tax treaties include, within their LOB articles, so-called ''triangular'' provisions designed to prevent a resident of the other Contracting State from enjoying treaty benefits for certain income arising in the United States while avoiding taxation in the other Contracting State by earning such income through a permanent establishment situated in a third jurisdiction and also paying relatively minimal tax in such third jurisdiction. *See* Article 24(5) of the Luxembourg Treaty; Article 21(6) of the Belgian Treaty; Article 22(6) of the Danish Treaty; Article 16(5) of the Finnish Income Tax Treaty; Article 30(5) of the French Treaty; Article 23(7) of the 1997 Ireland-U.S. Income Tax Treaty; Article 22(6) of the 1997 South Africa-U.S. Income Tax Treaty; Article 17(5) of the Swedish Treaty; Article 22(4) of the 1996 Switzerland-U.S. Income Tax Treaty (the Swiss Treaty). Certain items of income to which such provisions apply (typically interest and royalties) are taxed at a 15 percent rate in lieu of any lower rate for which such items would otherwise qualify under other provisions of the applicable treaty.

[32]It is assumed for purposes of this example that the applicable derivative benefits provision requires 95 percent ownership by equivalent beneficiaries. In the event that an equivalent beneficiary is not needed to satisfy such 95 percent ownership requirement, and such equivalent beneficiary's withholding rate exceeds that of the other equivalent beneficiaries, such higher withholding rate would be disregarded. For example, if a corporation seeking derivative treaty benefits would be entitled to a 0 percent withholding rate, and it has a 99 percent shareholder that would be entitled to a 5 percent withholding rate, the ''higher of'' rate would be 5 percent, even if the corporation also has a 1 percent shareholder that would be entitled to a 15 percent withholding rate.

[33]H.R. 3160, 110th Cong. 1st Sess. (hereafter the Doggett Bill); H.R. 3970, 110th Cong. 1st Sess. (hereafter the Rangel Bill).

[34]The Doggett Bill, if enacted in its current form, would not override benefits permitted for the typical qualified holding company discussed in this report, since the derivative benefits provisions already require satisfaction of an ''at least as low as'' requirement.

[35]It provides, in effect, at section 3204, that otherwise allowable treaty benefits for the same activities set forth in the Doggett Bill will not reduce treaty benefits unless the foreign parent is not eligible for any treaty benefits.

would be entitled under its own U.S. income tax treaty is higher than that to which the payee would otherwise be entitled.[36]

As stated above, it is our recommendation that a look-through rule, or alternatively a ''higher of'' rule, be adopted in lieu of the present ''at least as low as'' requirement in the derivative benefits provision of the LOB article. We recognize that this would require a change in current treaty language and treaty policy, but our recommendation is consistent with what we understand to be the intent of the derivative benefits provision and is consistent with other anti-treaty shopping measures that have been adopted and proposed.

Pending amendments to treaties to reflect the look-through or ''higher of'' policy, we suggest that the U.S. competent authority seek to enter into MOUs with the competent authorities of those countries with which we have treaties that include derivative benefits provisions, and that such MOUs grant treaty benefits in all circumstances where substitution of the look-through or ''higher of'' rule for the ''at least as low as'' requirement would result in an allowance of derivative benefits. Such grant would be pursuant to the authority of each such CA to grant treaty benefits in such circumstances as it may deem appropriate, i.e., where the entity seeking such benefits has not been established, acquired, or maintained with a principal purpose of obtaining such benefits.[37] While the grant of treaty benefits under the look-through or ''higher of'' rule would only constitute a limited grant of treaty benefits, we are of the view that the CA's discretion to grant full treaty benefits necessarily includes the power to grant limited treaty benefits as well.

V. Questioning Geographic Restrictions

With the exception of U.S. income tax treaties with Canada and Mexico, all of the other treaties containing derivative benefits provisions in their LOB articles are with European nations.[38] Under those treaties, a person may be considered an equivalent beneficiary only if such person is a resident of the EU, the EEA, NAFTA or, in some cases, Switzerland.[39]

Both the impetus for derivative benefits, and the geographical restrictions on who may be an equivalent beneficiary, may in significant part be attributable to the European Community Treaty (EC Treaty) requirement of non-discrimination as interpreted by the ECJ.[40] The EC Treaty (formally the Treaty of Rome) contains four freedoms that can apply to taxation policy. Two of these freedoms are arguably applicable to member states' tax treaties. These are the freedom of establishment for businesses,[41] and the freedom of movement of capital.[42] In the area of taxation, the ECJ has interpreted such non-discrimination principles extremely broadly. Accordingly, EU member states may possibly be considered to violate such non-discrimination principles merely by entering into a tax treaty with another country that permits such other country to improperly discriminate against an EU enterprise on the basis of where in the EU its owners reside.

We understand that claims of such EC Treaty concerns, rather than U.S. treaty policy principles, may in large part have been the impetus for the derivative benefits provisions that appear in the U.S. income tax treaties with European countries,[43] and that allowing non-European persons to qualify as equivalent beneficiaries, or including such provisions in other U.S. income tax treaties, is not necessary to address such EC Treaty issues.[44] Nevertheless, we are aware of no reason why the derivative benefits provision may not be used to serve broader U.S. treaty policy objectives. Certainly, there does not appear to be anything in the EC Treaty that would prohibit non-Europeans from qualifying as equivalent beneficiaries.[45]

Regardless of the original impetus for adding derivative benefits provisions to certain U.S. income tax treaties, such provisions serve the valuable purpose of allowing treaty benefits in circumstances that present no opportunity for abuse because no treaty shopping objective would be accomplished. Including such provisions only in certain treaties, or allowing only residents of certain jurisdictions to qualify as equivalent beneficiaries, would appear to undercut such purpose for no apparent reason.[46]

For example, as a matter of tax treaty policy, we question why a dividend payment by a U.S. subsidiary of a Dutch corporation which is 100 percent owned by a Japanese publicly traded company should be ineligible

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[36]Other than as noted above, the Committee, in this report, is not addressing either bill.

[37]*See e.g.*, Article 21(7) of the Belgian Treaty; Article 22(6) of the Swiss Treaty. *Cf. also* PLR 200201025 (reiterating that the expansion of derivative treaty benefits pursuant to Paragraph 7 of the MOU entered into by the U.S. and Swiss competent authorities prior to the entry into force of the Swiss Treaty was pursuant to the authority of Article 22(6) of the Swiss Treaty).

[38]Treasury has not adopted a derivative benefits provision in either the 1996 or the 2006 Model Income Tax Conventions.

[39]For example, all of the recent tax treaties and protocols that entered into force in 2007 (with Belgium, Denmark, Finland, and Germany) contain such geographic restrictions.

[40]*See Commission of the European Communities v. French Republic,* Case 270/83 (1986).

[41]Article 43, which is extended to companies by Article 48.

[42]Article 56.

[43]The extent to which such concerns may have been exaggerated by EU treaty negotiators that wished to secure derivative benefits provisions is beyond the scope of this report.

[44]From an EU perspective, the class of equivalent beneficiaries could have been restricted to European residents, but the United States insisted that NAFTA residents also qualify.

[45]Apart from the Freedom of Movement of Capital (Article 56), the EC Treaty is applicable only to nationals and residents of the EU and is therefore unconcerned with non-EU nationals and residents. *See ICI v. Calmer,* Case C-264/96 (1998).

[46]With respect to the latter point, there is nothing to suggest that unrestricted third country use was contemplated and rejected for any good policy reason. Rather, the geographic restrictions appear to remain in place merely as a result of legacy treatment.

for any treaty relief,[47] while the same payment would be eligible if the publicly traded parent corporation were German instead of Japanese. In either scenario, the publicly traded corporation has a treaty with the United States that provides for equivalent tax rates on dividends, and thus does not accomplish any treaty shopping benefit by holding its U.S. subsidiary through a Dutch holding company rather than holding it directly. The same principles would be equally applicable, and a grant of derivative treaty benefits would appear to be equally appropriate, if the holding company were Japanese and the publicly traded parent corporation were Dutch or German.[48]

In this regard, the Canadian Treaty presents a good model in two important respects. First, it includes a derivative benefits provision even though Canada is not in the EU; second, it allows residents of any jurisdiction to qualify as equivalent beneficiaries.[49] The Technical Explanation to the Third Protocol to the Canadian Treaty, which incorporated the LOB article,[50] provides no insight as to why the treaty did not follow the earlier geographic limitation model of some of the treaties the United States had with certain European nations or Mexico. Nor do the technical explanations in the other treaties provide any rationale for imposing a geographic limitation.

In the absence of any published explanation, it appears that the inclusion or exclusion of geographic restrictions on who may be equivalent beneficiaries is based solely on historical precedent, rather than any meaningful tax treaty policy. It also appears that the failure to include derivative benefits provisions in our income tax treaties with most non-European countries is primarily if not entirely attributable to historic precedent. As evidenced by the derivative benefits provision in the Canadian Treaty, however, there appears to be no compelling reason why our treaties with non-European countries cannot include derivative benefits provisions or why such provisions cannot allow residents of any treaty country to qualify as equivalent beneficiaries.

Accordingly, our Committee recommends that derivative benefits provisions be standard in all comprehensive U.S. income tax treaties, and that equivalent beneficiary status not be restricted to residents of only some jurisdictions. Pending implementation of such treaty changes, we further recommend that Treasury consider entering into MOUs with other competent authorities to allow derivative treaty benefits where the existing LOB articles do not include such provisions, and to expand existing derivative benefits provisions to permit residents of any treaty country to qualify as equivalent beneficiaries.

VI. Comprehensive Benefits Recommendations

All of the derivative benefits provisions included in treaties and protocols that entered into force in 2007 are comprehensive.[51] That is, they provide not only withholding tax benefits, but all benefits of the treaty including, for example, an exemption for business profits not attributable to a PE. However, at least three treaties, including the Canadian Treaty, limit derivative benefits to withholding taxes.[52]

The limited scope of the Canadian Treaty's derivative benefits provision has not previously been a concern for U.S. holding companies, because the LOB provision in that treaty has previously applied only to Canadian residents seeking treaty benefits from the United States. When the Fifth Canadian Protocol becomes effective, however, the LOB provision will also apply to U.S. residents seeking treaty benefits from Canada, in lieu of the less restrictive anti-treaty shopping rules applicable under present Canadian tax law.[53]

Consider the following:

Example 1. UK parent, a publicly traded UK corporation, owns 100 percent of the shares of Canco, a Canadian operating company the value of whose shares are not principally derived from Canadian real estate. UK parent sells Canco shares and realizes gain. The gain is taxable to UK parent under the Canadian Income Tax Act. However, under Article 13 of the UK Canada income tax treaty, UK parent is exempt from Canadian tax on the gain.

Example 2. UK parent, a publicly traded UK corporation, owns 100 percent of the shares of U.S. holding corporation (Holdco). Holdco owns 100% of Canco, a Canadian operating company the value of whose shares is not principally derived from real estate. Holdco sells Canco shares and realizes gain which is taxable under the Canadian Income Tax Act.

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[47]In the absence of the changes proposed herein, the Dutch holding company would not qualify for derivative treaty benefits, because the publicly traded Japanese parent corporation would not qualify as an equivalent beneficiary.

[48]Consistent with the apparent policy of including derivative benefits provisions solely in U.S. income tax treaties with members of the EU (and parties to NAFTA), the LOB provision included in the current U.S. income tax treaty with Japan does not include a derivative benefits provision. Therefore, a Japanese holding company could not in any circumstances qualify for derivative treaty benefits.

[49]*See* Article XXIXA(4)(a) of the Canadian Treaty.

[50]A Fifth Protocol amending the Canadian Treaty was signed September 21, 2007 (hereinafter, the Fifth Canadian Protocol), but has not entered into force.

[51]*See* Article 21(3) of the Belgian Treaty; Article 22(3) of the Danish Treaty (added by Article IV of the protocol signed in 2006); Article 16(3) of the Finnish Treaty (added by Article VI of the protocol signed in 2006); and Article 28(3) of the German Treaty (added by Article XIV of the protocol signed in 2006). This is also true of most comparable provisions included in treaties and protocols that entered into force prior to 2007.

[52]*See* Article 17(1)(g) of the Mexican Treaty; Article XXIXA(4) of the Canadian Treaty; and Article 22(3) of the Swiss Treaty. In connection with the Swiss Treaty, see the discussion in this section of the report on the expansion of benefits pursuant to the MOU.

[53]Canada has no other treaties with codified LOB rules. The Canada Revenue Agency has attempted to apply the ''general anti-avoidance rule'' to combat perceived abuses, but has not been successful. *See Canada v. MIL (Investments) S.A.*, 2007 FCA 236.

Under the existing Canadian Treaty (prior to such time as the Fifth Canadian Protocol takes effect), Holdco in Example 2 is not subject to the LOB requirement, so Holdco is exempt from Canadian income tax on gain under Article XIII of the Canadian Treaty. Upon entry into force of the Fifth Canadian Protocol, however, Holdco will not qualify for the benefits of Article XIII and will therefore be subject to Canadian tax.[54] Even though Holdco satisfies the ownership test required to qualify for derivative benefits, because all of its shares are owned by UK parent, such derivative benefits do not include the benefits of Article XIII.

This result gives rise to a significant risk of double taxation that we submit is not necessary to prevent treaty shopping. The ultimate shareholder, UK parent, is otherwise eligible for treaty benefits under its treaty with Canada, so no improper benefit is obtained by the use of the U.S. tax treaty with Canada. There is nothing in the public pronouncements from Treasury or the Canadian Department of Finance to suggest that the limited scope of the derivative benefits provision in the Canadian Treaty is premised on any tax treaty policy.

Accordingly, the Committee recommends that the more limited derivative benefits provisions set forth in several U.S. income tax treaties be expanded to provide for comprehensive treaty benefits. Pending modification of existing treaties and new protocols, we respectfully recommend that Treasury consider entering into MOUs with the appropriate competent authorities to allow for such additional treaty benefits as soon as possible. In particular, the Committee believes that immediate action should be taken to ensure that, when the Fifth Canadian Protocol takes effect, treaty benefits will not be lost in the manner illustrated in the examples above. Accordingly, we believe that negotiation of an MOU with Canada should be given a high priority.[55]

VII. Conclusion

We appreciate consideration of our recommendations, and would be pleased to discuss them with appropriate persons.

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[54]Holdco is not a qualifying person under the LOB article because it fails the ownership test. Furthermore, Holdco almost certainly would not qualify for the active trade or business test. Therefore, in the absence of a discretionary grant of treaty benefits by the Canadian competent authority, Holdco will only qualify for the benefits of the Canadian Treaty to the extent such benefits are granted under the derivative benefits provision.

[55]Notably, precedent exists for such action in the Swiss Treaty. The Swiss Treaty contains a derivative benefits provision similar to the present Canadian Treaty and the Fifth Canadian Protocol in that it is limited, by its terms, to withholding taxes. Article 22(3) of the Swiss Treaty. Pursuant to paragraph 7 of the MOU agreed to by the competent authorities prior to entry into force of the treaty, however, the parties agreed to allow more comprehensive derivative benefits.