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United States and the Netherlands Sign Protocol to Income Tax Treaty

Protocol Amending the United States-Netherlands Income Tax Treaty, March 8, 2004.

Overview

On March 8, 2004, the United States and the Netherlands signed a protocol (the "Protocol") to amend the Netherlands-United States Income Tax Treaty (the "Treaty"), which went into effect on December 31, 1993. The principal change in the Protocol is the elimination of withholding tax on certain dividends from 80 percent owned subsidiaries.

Withholding Tax on Dividends and Branch Profits Tax

In line with the recent U.S.-U.K. and U.S.-Japan treaties and the amendments to the U.S.-Australia and U.S.-Mexico treaties, the Protocol provides a full withholding tax exemption for dividends paid by U.S. and Dutch corporations to corporate shareholders that have owned shares representing at least 80 percent of the dividend paying corporation's voting stock for the 12 month period ending on the dividend declaration date and that satisfy one of the following conditions (from the limitation on benefits provision as revised by the Protocol).

Under the second leg of the test, the dividend receiving company is eligible for the exemption if it (i) owned directly or indirectly at least 80 percent of the voting power of the dividend paying corporation stock before October 1, 1998, (ii) has its principal class of shares (and any disproportionate class of shares) listed and regularly traded on one or more recognized stock exchanges (although the stock must be listed on a Dutch or American exchange or NASDAQ, it appears that the regularly traded test may be satisfied on other exchanges), (iii) has at least 50 percent of the aggregate voting power in its shares owned by five or fewer companies that satisfy the publicly traded test in the preceding clause, (iv) is owned or controlled by seven or fewer "equivalent beneficiaries" (which include individuals or entities that are residents of an EU, EEA, or NAFTA country and are entitled to income tax treaty benefits in a treaty with the U.S. or the Netherlands) and satisfies a "base erosion test" (i.e., it does not make excessive deductible payments to persons not eligible for Treaty benefits), or (v) receives a discretionary ruling from the competent authority in the dividend source country.

The Protocol does not change the five percent withholding tax rate on dividends paid to a 10 percent corporate shareholder not eligible for the exemption and the 15 percent rate on other dividends. The Protocol expands the 15 percent tax rate on REIT dividends, currently only applicable to REIT dividends if (i) the recipient is a Dutch investment company, or (ii) the recipient is an individual whose aggregate interest in the REIT does not exceed 25 percent. Under the Protocol the 15 percent rate also applies to dividends paid (x) on publicly traded REIT shares to a shareholder that does not own more than five percent of any class of stock of the REIT, and (y) by a REIT whose real estate holdings are diversified (no single parcel exceeds 10 percent of the gross value of all property held by the REIT) and to a 10 percent or less shareholder.

Under the Protocol no branch profits tax applies to the U.S. branch of a Dutch corporation if the branch would be eligible for the dividend withholding tax exemption if it were a separately incorporated subsidiary.

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Fiscally Transparent Entities and Limitation on Benefits

At present the Treaty does not specifically address income realized by a fiscally transparent entity. The Protocol brings the concepts of the I.R.C. § 894 regulations into the Treaty by providing, among other things, that an item of income derived by an entity that either the U.S. or the Netherlands treats as fiscally transparent, is treated as derived by a resident of either the U.S. or the Netherlands only to the extent the item of income is treated under the internal law of the residence country as income of the resident.

The Protocol replaces the current complex limitation on benefits ("LOB") provision with one that is simpler and generally more consistent with recent U.S. income tax treaties. Broadly speaking, a U.S. or Dutch resident may be eligible for Treaty benefits if he or she or it is (i) an individual, (ii) a governmental entity, (iii) a company (including a subsidiary thereof) that is listed and regularly traded on a "recognized stock exchange," (iv) a pension or not for profit entity described in the new provision, (v) an entity that is controlled by publicly traded entities and satisfies a base erosion test, (vi) an entity that is owned or controlled by seven or fewer equivalent beneficiaries and satisfies a base erosion test, (vii) engaged in a trade or business in the other country and the income at issue arises in connection with that trade or business, (viii) a headquarters company for a multinational group of companies, (ix) a shipping or air transport company that satisfies the alternative rules applicable to those companies, or (x) in receipt of a ruling from the competent authority of the source state.

The new LOB provision does add a "substantial presence" requirement to the publicly traded test. This test states that a company will fail the publicly traded test if (i) it is not managed and controlled in the country in which it is a resident, and (ii) its stock is not primarily traded on a stock exchange within the company's "primary economic zone" (for Dutch companies this means the EU and the EEA and for U.S. companies it means NAFTA countries).

Effective Date

The Protocol will not go into effect until the parties exchange instruments of ratification, which in the U.S. follows approval by at least two-thirds of the Senate that is voting. Withholding tax provisions are effective for amounts paid or credited on or after the first day of the second month following the ratification date. All other provisions are effective on January 1 of the year following the ratification date. Any person may elect to apply the current Treaty provisions for an additional year after the changes would otherwise go into effect.

Planning Considerations

Since the Protocol is expected to go into effect by the end of the year, all U.S. taxpayers with Dutch operations or income from the Netherlands and all Dutch taxpayers with U.S. operations or U.S. source income should review their tax planning. In particular, taxpayers may consider deferring dividends that would be subject to withholding tax under current rules but not when the Protocol goes into effect. It should be noted in this regard that Japanese tax authorities have recently threatened to challenge strategies to delay payments pending activation of the new U.S.-Japan income tax treaty (which eliminates withholding tax on royalties as well on certain subsidiary dividends). The risk of such a challenge in the case of dividends may be less severe because dividends are inherently more discretionary with the board of directors. Taxpayers that qualify for the Treaty under the current LOB provision should review the new LOB provision. Taxpayers that have not used Dutch companies due to the current LOB provision may want to revisit their planning in light of the new LOB provision.

For additional information contact; Bob Cole (202-756-3306); Kevin Rowe (212-210-9505), or Edward Tanenbaum (212-210-9425).

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