

## Dividend Withholding for Third Country Investors under the United States-Netherlands Antilles Tax Treaty

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## DIVIDEND WITHHOLDING FOR THIRD COUNTRY INVESTORS UNDER THE UNITED STATES-NETHERLANDS ANTILLES TAX TREATY

The Internal Revenue Code imposes an income tax of 30% on dividends paid by U.S. corporations to foreign corporations or nonresident aliens.<sup>1</sup> The United States-Netherlands Antilles tax treaty (Treaty),<sup>2</sup> a bilateral agreement, permits taxation of dividends paid by U.S. corporations to recipients in the Netherlands Antilles (Antilles) at less than the 30% statutory rate. The purpose of this and other U.S. bilateral tax treaties<sup>3</sup> that allow U.S. corporations to withhold tax on dividends at less than the 30% statutory rate<sup>4</sup> is to prevent double taxation. Presumably, treaty countries themselves impose significant rates of taxation on income received from abroad.<sup>5</sup> The Antilles, however, is a tax haven as well as a treaty country. It permits persons who are neither residents nor citizens of the Antilles to incorporate investment companies upon which it levies unusually low levels of taxation.<sup>6</sup> Third country investors<sup>7</sup> may—at least in theory—invest in

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1. I.R.C. §§ 871 (individuals), 881 (corporations). The tax is deducted and withheld at the source, I.R.C. §§ 1441-1442, generally by the payor corporation, Schneidmann, *Dividend Withholding under the United States-Netherlands Antilles Tax Treaty*, 31 TAX LAW. 437, 439 n.14 (1978). The 30% rate does not apply to income “effectively connected with the conduct of a trade or business within the United States.” I.R.C. §§ 871(a)(1), 881(a). This Note will use the term “income” as not including “effectively connected” income.

2. Convention on Income Taxes, Apr. 29, 1948, United States-Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855, *extended by* Protocol Facilitating Extension to the Netherlands Antilles, June 15, 1955, 6 U.S.T. 3696, T.I.A.S. No. 3366, *modified by* Protocol Modifying and Supplementing the Extension to the Netherlands Antilles of the Convention of April 29, 1948, Oct. 23, 1963, United States-Netherlands, 15 U.S.T. 1900, T.I.A.S. No. 5665 [hereinafter cited as Treaty].

3. U.S. tax treaty partners include most Western developed countries and some less developed countries. Conspicuous by their absence are the members of OPEC (except Nigeria), Latin American and Asian nations, and most of Africa. See 1 TAX TREATIES (CCH) ¶ 61 (1977) (Table 1); Gifford, *Permanent Establishments Under the Nondiscrimination Clause in Income Tax Treaties*, 11 CORNELL INT’L L.J. 51, 51-52 n.1 (1978).

4. I.R.C. §§ 894(a), 7852(d); Treas. Reg. § 1.871-12 (1974).

5. SENATE COMM. ON FOREIGN RELATIONS, TAX CONVENTIONS AND PROTOCOLS WITH LUXEMBOURG, THE NETHERLANDS, SWEDEN, AND JAPAN, S. EXEC. REP. NO. 10, 88th Cong., 2d Sess. 51 (1964), *reprinted in* 1965-1 C.B. 633, 669 [hereinafter cited as SENATE EXECUTIVE REPORT].

6. See generally ALGEMENE BANK NEDERLAND N.V., TAXATION IN THE NETHERLANDS ANTILLES (2d ed. 1972); [1969] NETHERLANDS ANTILLES INCOME TAX SERVICE (FTLA).

7. The term “third country investor” as used in this Note denotes an investor who is neither a citizen nor a resident of either treaty country. In the case of the Antilles Treaty,

the United States through Antilles investment companies and thereby take advantage of the reduced Treaty tax rates on dividends.

Although the United States has attempted to restrict the use of this tax avoidance scheme by third country investors,<sup>8</sup> several recent private letter rulings<sup>9</sup> issued by the Internal Revenue Service appear to confirm the validity of this type of arrangement. The letter rulings, however, do not contain any elucidation of the Service's reasoning in permitting the lower withholding rates. This Note will analyze the dividend provisions of the Treaty and explore the reasons for and implications of the letter rulings. It will then evaluate the IRS approach, concluding with recommendations for resolving the problems created by this approach.

## I

### STRUCTURE OF DIVIDEND TAXATION UNDER THE ANTILLES TREATY

#### A. PROVISIONS OF THE TREATY AND PROTOCOL

As originally signed, the Treaty reduced the 30% statutory withholding rate to a 15% rate<sup>10</sup> or, in the case of dividend payments by U.S. subsidiaries to Antilles parent corporations, to a 5% rate.<sup>11</sup> This scheme of dividend taxation was premised upon the existence of a substantial income tax rate in the Antilles.<sup>12</sup> But the Antilles provides special tax benefits for companies

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investors who are citizens, residents, or corporations of the Netherlands are often treated as Treaty country investors.

8. See notes 20-21 *infra* and accompanying text.

9. Letter Rul. No. 7815026, [1978] IRS LETTER RULING REP. (Jan. 12, 1978); Letter Rul. No. 7748013, [1977] IRS LETTER RULING REP. (Aug. 30, 1977); Letter Rul. No. 7746046, [1977] IRS LETTER RULING REP. (Aug. 17, 1977); Letter Rul. No. 7742058, [1977] IRS LETTER RULING REP. (July 25, 1977); Letter Rul. No. 7742048, [1977] IRS LETTER RULING REP. (July 22, 1977); Letter Rul. No. 7739080, [1977] IRS LETTER RULING REP. (July 1, 1977). Hereinafter letter rulings will be cited by number only.

10. Treaty, *supra* note 2, art. VII(1). This provision states:

The rate of United States tax on dividends derived from a United States corporation by a resident or corporation of the Netherlands not engaged in trade or business in the United States through a permanent establishment shall not exceed 15 percent . . . .

11. Treaty, *supra* note 2, art. VII(1). This provision states:

[S]uch rate of tax shall not exceed 5 percent if such Netherlands [Antilles] corporation controls, directly or indirectly, at least 95 percent of the entire voting power in the corporation paying the dividend, and not more than 25 percent of the gross income of such paying corporation is derived from interest and dividends, other than interest and dividends from its own subsidiary corporation. Such reduction of the rate to 5 percent shall not apply if the relationship of the two corporations has been arranged or is maintained with the intention of securing such reduced rate.

12. SENATE EXECUTIVE REPORT, *supra* note 5, at 51, 1965-1 C.B. at 669. At the time of the Treaty's extension to the Antilles, the Treasury Department reviewed the Antilles tax laws and found them satisfactory. Letter from John Foster Dulles, Secretary of State, to Dwight D. Eisenhower, President of the United States (July 20, 1954), *reprinted in 2 TAX TREATIES*

incorporated under its laws.<sup>13</sup> For example, the Antilles permits certain investment companies to elect special income tax treatment as "article 13, 14, or 14A corporations."<sup>14</sup> Companies that make this "low tax election" under Antilles law pay a maximum profit tax of 3%. Moreover, the Antilles does not impose any tax on dividends paid by Antilles corporations to non-resident shareholders.<sup>15</sup> Even under the higher 15% Treaty rate of U.S. taxation, the total income tax burden of any Antilles investment company could be as low as 17.55%.<sup>16</sup> Qualification for the 5% Treaty rate would of course further reduce the tax burden. Third country investors took full advantage<sup>17</sup> of this loophole in U.S. taxation of the investment earnings of nonresidents.<sup>18</sup> As a result, the United States not only lost revenue, but experienced political difficulties as well.<sup>19</sup>

These problems led the United States and the Antilles to negotiate a Protocol to the Treaty.<sup>20</sup> The Protocol modifies the Treaty to provide that Treaty tax rates shall not apply to dividends paid to Antilles companies that have made the low tax election under articles 13, 14, or 14A.<sup>21</sup> But an

(CCH) ¶ 5853 (1971). The "tax haven" aspects apparently came into existence between the time the Netherlands requested extension of the Treaty to the Antilles, pursuant to article XXVII of the Treaty, and the date on which the extension went into effect. See Lowe, *Curaçao Investment Companies: Some Shoals in a Tax Haven*, 16 TAX L. REV. 177, 178 (1961).

13. See, e.g., M. GRUNDY, *GRUNDY'S TAX HAVENS* 109-21 (3d ed. 1974); M. LANGER, *HOW TO USE FOREIGN TAX HAVENS* 187-202 (1975).

14. National Ordinance on Profit Tax of 1940, as amended, arts. 13, 14, 14A (Neth. Antilles). These articles provide for special taxation of certain types of corporations at one-tenth the normal Antilles tax rate of up to 30%. SENATE EXECUTIVE REPORT, *supra* note 5, at 50, 1965-1 C.B. at 668.

15. M. LANGER, *supra* note 13, at 193.

16. SENATE EXECUTIVE REPORT, *supra* note 5, at 50, 1965-1 C.B. at 666. This figure is computed as follows:

$$\begin{aligned} & [15\% (\text{U.S. tax}) \times 100\% \text{ of income}] + \\ & [3\% (\text{Antilles tax}) \times 85\% \text{ of income (100\% less 15\% U.S. tax)}] \\ & = 17.55\% \text{ tax rate.} \end{aligned}$$

17. Nearly 1000 Antilles investment corporations came into existence between 1955 and 1963. *Id.* at 51, 1965-1 C.B. at 669.

18. The United States also gave up its statutory right under I.R.C. § 245(a) to impose a tax on foreign recipients of dividends paid by Antilles corporations that earned 50% or more of their gross income over the previous three years in the United States. Article XII of the Treaty provides that "[d]ividends and interest paid by a Netherlands [Antilles] corporation shall be exempt from United States tax except where the recipient is a citizen, resident, or corporation of the United States." Treaty, *supra* note 2, art. XII. This provision further reduces the power of the United States to tax the investment income of nonresidents of the Antilles.

19. Several Latin American countries, for example, felt that the "United States was encouraging flight capital from Latin America to be invested in U.S. securities through Netherlands Antilles corporations . . ." M. LANGER, *supra* note 13, at 194.

20. Treaty, *supra* note 2, Protocol Modifying and Supplementing the Extension to the Netherlands Antilles of the Convention of April 29, 1948, Oct. 23, 1963, United States-Netherlands, 15 U.S.T. 1900, T.I.A.S. No. 5665 [hereinafter cited as Protocol].

21. Protocol, *supra* note 20, art. I(1); see note 14 *supra* and accompanying text.

exception to this provision—the “major ownership exception”—allows an Antilles company receiving dividends from a U.S. firm to qualify for Treaty rates if the company “owns”<sup>22</sup> at least 25% of the U.S. firm’s stock, regardless of whether the company has made the low tax election.<sup>23</sup> In order to qualify for the lower 5% Treaty rate, the Treaty provisions require 95% ownership of the U.S. firm by the Antilles corporation.<sup>24</sup>

The Treaty and Protocol each impose limitations on the amount of income a U.S. firm may derive from “passive investment.”<sup>25</sup> The Treaty requires that, in order to qualify for Treaty benefits, the U.S. firm paying dividends may not obtain more than one-quarter of its income from passive investment, other than dividends from subsidiaries. The IRS has further narrowed this 25% passive investment income requirement by imposing time and evidentiary limitations.<sup>26</sup> To qualify for the Protocol’s major ownership exception, the U.S. firm must derive less than 60% of its income from passive investment.<sup>27</sup> But unlike the Treaty, the Protocol apparently requires inclusion of dividends received from subsidiaries in calculating this figure.<sup>28</sup> If a corporate arrangement qualifies for the major ownership exception, it must still meet the Treaty’s 25% limit on passive investment in

22. Article I(2)(a) of the Protocol requires “ownership,” while article VII(1) of the Treaty requires a certain percentage of direct or indirect “control.”

23. Protocol, *supra* note 20, art. I(2)(a).

24. Treaty, *supra* note 2, art. VII(1). There is apparently no definite rule on what type of stock must be owned, *see id.* art. VII, or on whether ownership or mere control is required, Protocol, *supra* note 20, art. I(2)(a).

25. “Passive investment” is investment that does not involve any contribution other than money on the part of the investor. Some examples are stocks, bonds, and loans.

26. The Service has interpreted the 25% requirement to mean “not more than 25 percent of the gross income of the paying corporation for the three-year period immediately preceding the taxable year in which the dividend is paid . . . .” 26 C.F.R. § 505.302(c)(1) (1978). *See also* Rev. Rul. 74-275, 1974-1 C.B. 376; 26 C.F.R. § 505.302(e)(1) (1978) (U.S. firm must withhold at 15% if dividends paid in first year).

Another requirement to qualify for favorable Treaty tax rates is that the Antilles corporation must “not [be] engaged in trade or business in the United States through a permanent establishment.” Treaty, *supra* note 2, art. VII(1). The Treaty specifically states that a subsidiary of an Antilles corporation that engages in trade or business in the United States shall not constitute a “permanent establishment.” *Id.* art. II(1)(i). Thus, this requirement is straightforward and should be easy to satisfy.

27. Protocol, *supra* note 20, art. I(2)(a).

28. The Service has not explicitly analyzed the relationship of these two passive investment percentages. In a recent letter ruling, however, the taxpayer was a U.S. holding company whose income was completely derived from dividends paid by its subsidiaries. The U.S. company was wholly owned by an Antilles company. The Antilles company did not make the low tax election. Instead it chose to be taxed under article 8A, *see* notes 31-32 *infra* and accompanying text, thus completely avoiding the requirements of the Protocol. The Protocol would not have permitted the U.S. company to withhold at Treaty rates, because of its high percentage of dividend income. In contrast, the Treaty’s specific exception for dividend payments by subsidiaries permitted the U.S. company to withhold tax on dividends paid to the Antilles company at the 5% rate. Letter Rul. No. 7815026.

order to obtain the Treaty's 5% withholding rate.<sup>29</sup>

The Treaty also contains an intent requirement. In order to qualify for the 5% rate, the "relationship of the two corporations [may not have] been arranged or . . . maintained primarily with the intention of securing [the 5%] rate."<sup>30</sup> Although it may defy credulity that complicated corporate arrangements involving investment in the United States through an Antilles investment company could arise out of any other purpose, the IRS apparently does not interpret this requirement too strictly.

After the Protocol went into effect the Antilles enacted article 8A,<sup>31</sup> which permits Antilles investment companies to elect to be taxed on U.S. source income at a special higher rate of 15% of net dividend income. The IRS has ruled that it does not consider article 8A corporations to have made a "low tax election." Thus, these corporations are not subject to the Protocol's limitations on the Treaty's tax benefits.<sup>32</sup>

Despite the attempt of the Protocol to close the loopholes in the Treaty, two major incentives continue to lure third country investors to invest in the United States through Antilles investment companies. First, the maximum tax burden on U.S. source dividends received by an article 8A corporation cannot exceed 27.75%<sup>33</sup> and will usually amount to 24% or less.<sup>34</sup> This rate is preferable, at least to some degree, to the regular U.S. statutory rate of 30%. Second, the major ownership exception permits an article 13, 14, or 14A investment company—if it buys at least 25% of the stock of an American corporation and thereby qualifies for Treaty tax rates—to enjoy Treaty rates on dividends received from the United States while still paying only the nominal Antilles profit tax.<sup>35</sup>

## B. THE LETTER RULINGS

Should the IRS permit third country investors, who incorporate wholly owned Antilles corporations through which to invest in the United States,

29. Treaty, *supra* note 2, art. VII(1).

30. *Id.* In applications for the 15% Treaty tax rate, this requirement need not be considered at all. Letter Rul. Nos. 7746046, 7748013.

31. National Ordinance on Profit Tax of 1940, as amended, art. 8A (Neth. Antilles); see M. LANGER, *supra* note 13, at 196 (discussion of article 8A).

32. Rev. Rul. 65-16, 1965-1 C.B. 626.

33. The Antilles imposes its tax of 15% on *net* dividend income, that is, on the amount of dividend income remaining after subtracting the U.S. tax of 15%. The result is as follows:

$$\begin{aligned} & [15\% \text{ (U.S. tax)} \times 100\% \text{ of income}] + \\ & [15\% \text{ (N.A. tax)} \times 85\% \text{ of income (100\% less 15\% U.S. tax)}] \\ & = 27.75\% \text{ tax rate.} \end{aligned}$$

M. LANGER, *supra* note 13, at 199.

34. This figure reflects allowable deductions. *Id.*; see Kaplan, *Taxation of Dividends and Interest Under the U.S.-Antilles Treaty*, 6 TAX MNGM'T INT'L J. 15, 16 (1977).

35. See note 23 *supra* and accompanying text.

to enjoy Treaty tax rates on dividends received? The IRS has not answered this question definitively by issuing a revenue ruling, a revenue procedure, or a regulation. But it has addressed the question in several recent private letter rulings.<sup>36</sup> These rulings have permitted U.S. corporations to withhold tax at less than the statutory rate on dividends paid to Antilles corporations that are wholly owned by third country investors. Although the letter rulings have no precedential value,<sup>37</sup> they indicate the Service's general position on the subject.

Each of the rulings involves a corporate arrangement that complies with the literal requirements of the Treaty and Protocol. In all but one of the rulings, the Antilles corporation apparently made the low tax election.<sup>38</sup> But since these Antilles corporations owned at least 25%<sup>39</sup> and usually owned 95%<sup>40</sup> of the stock of the U.S. corporations from which they received dividends, they fell within the Protocol's major ownership exception<sup>41</sup> and were eligible for Treaty tax rates. The one ruling not involving a low tax election concerned an Antilles corporation that had elected to be taxed under article 8A.<sup>42</sup> As a result, the Antilles corporation was eligible for the benefits of Treaty tax rates regardless of whether it complied with the requirements set forth in the Protocol.<sup>43</sup>

The U.S. corporations in the rulings—the dividend payors—each met the passive investment requirements<sup>44</sup> of the Treaty and Protocol. In several cases, the Service permitted withholding at the 5% rate,<sup>45</sup> finding that the passive investment income of the U.S. corporation did not exceed 25%.

36. Note 9 *supra*.

37. I.R.C. § 6110(j)(3). Before a U.S. corporation can withhold tax on dividends paid at less than the 30% statutory rate, it must proceed in one of two ways: (1) request a favorable ruling from the Service, Rev. Proc. 66-40, 1966-2 C.B. 1245, §§ 2(b)(1)(iii), 5 (§ 5 describes the information required as comparable to that in 26 C.F.R. § 505.302(c)(2)(i)-(iv) (1977), which does not include the ownership of the Antilles corporation); or (2) receive a copy of a "certificate of status" for the Antilles corporation-payee, issued by the appropriate Antilles authority, Rev. Proc. 66-40, 1966-2 C.B. 1245, §§ 2(b)(1)(i)-(ii), 4. The U.S. corporation must then file a copy of this certificate with the Service. *Id.* § 4(a)(3).

38. Letter Rulings 7739080, 7742058, and 7748013 state that the Antilles corporation is entitled to the benefits of either article 13 or article 14. *See* note 14 *supra* and accompanying text. Letter Ruling 7746046 contains no specific statement regarding the low tax election. The ruling does, however, cite article I(2) of the Protocol, which exempts article 13 and 14 corporations from the Protocol's limitations if they fall within the major ownership exception. *See* notes 22-23 *supra* and accompanying text.

39. Letter Rul. No. 7746046.

40. Letter Rul. Nos. 7739080, 7742058, 7748013.

41. *See* notes 22-23 *supra* and accompanying text.

42. Letter Rul. No. 7815026. For a discussion of article 8A, see notes 31-32 *supra* and accompanying text.

43. *See* note 28 *supra*.

44. *See* notes 25-29 *supra* and accompanying text.

45. Letter Rul. Nos. 7742048, 7815026.

In other cases, the Service allowed withholding at the 15% rate.<sup>46</sup> In still other situations, the U.S. corporation had not operated long enough for the IRS to determine how much of its income was attributable to passive investment.<sup>47</sup> In these situations, the Service allowed withholding at the 15% Treaty rate pending proof that the U.S. corporation satisfied the stricter passive investment requirement necessary to qualify for the 5% rate.<sup>48</sup>

Despite the Treaty's intent requirement, which must be met in order to obtain the 5% rate, the IRS rarely questioned the structure of the corporate relationships presented in the rulings. In at least one ruling, the Service allowed the 5% rate with no mention whatever of the intent requirement.<sup>49</sup> When the IRS did express concern about intent, tax counsellors were able to marshal nontax justifications for vesting ownership of a U.S. company in an Antilles corporation that is wholly owned by a third country investor. Such justifications included access to foreign financial centers, ease of expansion into foreign markets, and the favorable business climate of the Antilles.<sup>50</sup>

## II

### INTENT OF THE DRAFTSMEN

Although the IRS may have been correct in finding that the taxpayer in each of the rulings met the literal requirements of the Treaty and Protocol, the Service's failure to look behind the technical compliance of the corporate arrangements may undermine important goals of bilateral tax treaties. In attempting to determine whether the Service ruled correctly in giving Treaty tax benefits to third country residents investing in the United States through Antilles investment companies, the first step is to consider the intent of the draftsmen of the Treaty and Protocol.

Upon first examination of the Treaty, its intent seems clear: to provide reciprocal measures for limiting both double taxation and tax avoidance.<sup>51</sup> The Treaty specifically states that one of its goals is the "prevention of fiscal

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46. Letter Rul. Nos. 7746046, 7748013.

47. Letter Rul. Nos. 7739080, 7742058.

48. See notes 29-30 *supra* and accompanying text.

49. Letter Rul. No. 7815026.

50. See Letter Rul. No. 7739080; *id.*, Background File (on file at the *Cornell International Law Journal*). In this ruling, the tax advisor had composed extensive descriptions of the advantages of the Antilles location and of the international character of the company. *Id.* Apparently the IRS accepted these representations as evidencing nontax reasons for the corporate structure. The Service gave the taxpayer permission to withhold at the 15% rate for one year, after which it could reapply for the 5% rate. Letter Rul. No. 7739080.

51. The Treaty and Protocol, as presently applied, certainly aid in preventing double taxation, since—far from being burdened with double taxation—third country investors may be taxed at just over half the rate that appears to be contemplated. See note 16 *supra* and accompanying text. In addition, the Treaty contains a competent authority provision, enabling an



evasion with respect to taxes on income."<sup>52</sup> To this end, the agreement contains provisions for the exchange of information between U.S. and Antilles tax authorities,<sup>53</sup> and for reciprocal enforcement assistance.<sup>54</sup> The intent requirement necessary to qualify for the 5% Treaty rate also indicates that the draftsmen sought to deny Treaty benefits to schemes designed to facilitate tax avoidance or evasion. Nevertheless, the original Treaty apparently provided numerous opportunities for abuse by foreign investors, as is evidenced by the large number of Antilles investment companies that came into existence during the period when only the Treaty was in force.<sup>55</sup>

Such problems prompted U.S. tax authorities to negotiate the Protocol. The express intent of the Protocol was to curb the use of nonresident-owned Antilles investment companies to avoid U.S. taxation.<sup>56</sup> While the Senate was considering ratification of the Protocol, the Treasury Department expressed concern over the increased use of the Treaty as a tax avoidance device during the period subsequent to its extension to the Antilles.<sup>57</sup> The Treasury noted that the Treaty had not been "intended to *reduce* the tax burden of the investor."<sup>58</sup> In addition, the fact that U.S. tax authorities negotiated provisions cutting off tax benefits to low-tax-election Antilles corporations indicates their intent to prevent the use of these corporations to escape the full tax on dividends coming from the United States.

Despite these indications of an intent to exclude low-tax-election Antilles corporations from Treaty tax rates, the Protocol's major ownership exception seems to bring about a contrary result. The legislative history of this provision offers no explanation of why it was included in the Protocol, and there is no counterpart to the major ownership exception in the original Treaty.

The draftsmen of the Protocol realized that they were not closing all of the loopholes in the Treaty. For example, they decided against eliminating Treaty article XII, which surrenders the right of the United States to tax U.S. source dividends paid by Antilles corporations to their shareholders.<sup>59</sup> The Treasury reasoned that such a "secondary tax" would discourage foreign portfolio investment in the United States and thus would harm the

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aggrieved taxpayer to petition his country's tax authorities to attempt to negotiate a compromise with officials of the other nation. Treaty, *supra* note 2, art. XXI.

52. *Id.* preamble.

53. *Id.* art. XXI.

54. *Id.* art. XXII.

55. See note 17 *supra*.

56. SENATE EXECUTIVE REPORT, *supra* note 5, at 50-52, 1965-1 C.B. at 669.

57. *Id.* at 50-51, 1965-1 C.B. at 669.

58. *Id.* at 51, 1965-1 C.B. at 669 (emphasis added).

59. *Id.* at 47, 52, 1965-1 C.B. at 666, 669. Without this provision, the United States could tax the shareholders of the Antilles corporation if the corporation had received 50% or more of its gross income from U.S. sources in the preceding three years. I.R.C. § 245(a).

U.S. balance of payments position.<sup>60</sup> This rationale does not, however, justify the inclusion of the major ownership exception, since this provision appears to promote long-term direct investment, rather than portfolio holdings, by nonresidents.<sup>61</sup>

Although the express intent of the Protocol was to prevent the use of the Treaty as a tax avoidance device by third country investors, the major ownership exception does not comport with this stated intent. Such a conflict between intent and operative provisions calls for an examination of past judicial interpretation of tax treaties, the Internal Revenue Code and the policies that underlie both. This analysis may illuminate principles that the Service should employ in determining whether to extend Treaty benefits to third country investors.

### III

#### PRINCIPLES OF TAX POLICY

##### A. JUDICIAL INTERPRETATION OF TAX TREATIES: THE *AIKEN* REPRESENTATION

The taxpayers in several of the rulings represented to the IRS that the Antilles corporation receiving dividends is under no obligation to pay any portion of those dividends to any other person or entity, subject only to the rights of creditors.<sup>62</sup> The corporation, if it were under such an obligation, would be vulnerable to attack under several recent cases—including *Aiken Industries, Inc. v. Commissioner*<sup>63</sup>—in which the IRS successfully challenged conduit arrangements that conferred tax treaty benefits on third country investors. Several requests for permission to obtain Antilles Treaty tax rates have therefore included this “*Aiken* representation,” apparently to ensure against an IRS finding that the Antilles corporation is merely a conduit for transferring profits to third country investors.<sup>64</sup>

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60. SENATE EXECUTIVE REPORT, *supra* note 5, at 52, 1965-1 C.B. at 669.

61. This is particularly true because the concern of the Treasury was focused on “our present imbalance of international payments,” *id.* at 52, 1965-1 C.B. at 669 (emphasis added), and not on the longer run.

62. Letter Rul. No. 7739080, at 2 (“Nothing in the corporate charter or by-laws . . . would require or cause it to turn over dividends received by it to any other person or entity and [it] will exercise dominion and control over dividends paid out.”); Letter Rul. No. 7742058, at 2 (“The corporate charter . . . does not require it to distribute dividends it receives to any other party.”); Letter Rul. No. 7815026, at 2 (“[It] will have no obligation to pay any portion of dividends received by it . . . to any other person and, subject to the rights of its creditors, will be free to use such dividends as it sees fit.”).

63. 56 T.C. 925 (1971).

64. Letter Rul. Nos. 7739080, 7742058, 7815026. If no such assertion had been made, the IRS might have considered the third country investor to have constructively received the dividends, thus negating the Treaty’s residency requirement. See Treaty, *supra* note 2, art. II(1)(c)-(d).

*Aiken* involved a Bahamian parent corporation that made a loan to a U.S. subsidiary and received a note bearing 4% interest in return. The parent then assigned the note to a Honduran subsidiary in consideration for notes totaling the same amount, also bearing 4% interest. The U.S. subsidiary made interest payments directly to the Honduran subsidiary, which in turn paid interest on its notes to the Bahamian parent. The purpose of this elaborate arrangement was to take advantage of the interest payments exemption in the United States-Honduras tax treaty.<sup>65</sup> The Tax Court stated that "while . . . a tax avoidance motive is not inherently fatal to a transaction, . . . such a motive standing by itself is not a business purpose which is sufficient to support a transaction for tax purposes."<sup>66</sup> After examining the structure of the "corporate family," the court found that the Honduran subsidiary "was merely a conduit for the passage of interest payments from [the U.S. subsidiary] to [the Bahamian parent], and it cannot be said to have received the interest as its own."<sup>67</sup> Such an arrangement fell outside the intent of the treaty, and therefore the corporations could not take advantage of the treaty tax rate.<sup>68</sup>

Although *Aiken* is the only case decided on the ground of a corporate conduit arrangement, two other cases might contribute to an IRS analysis of whether to allow dividend withholding under the Antilles Treaty. In *Perry R. Bass*,<sup>69</sup> the Tax Court examined whether a corporation and the taxpayer who owned and controlled it were separate entities. Bass, an individual taxpayer, had established a Swiss corporation and had conducted operations through it in order to take advantage of the United States-Switzerland tax treaty.<sup>70</sup> The court set forth the rule that although a taxpayer may use any legal method to minimize his tax liability,<sup>71</sup> if he uses a corporation it must be "a viable business entity, that is, it must have been formed for a substantial business purpose or actually engage in substantive business activity."<sup>72</sup> In *Bass*, the court found that the corporation was in fact a viable entity and thus could take advantage of the treaty tax rates.<sup>73</sup>

The Court of Claims, in determining whether a corporation qualified

65. Convention for the Avoidance of Double Taxation, June 25, 1956, United States-Honduras, 8 U.S.T. 219, T.I.A.S. No. 3766, *terminated*, Dec. 31, 1966.

66. 56 T.C. at 934. Similarly, in *Knetsch v. United States*, 364 U.S. 361, 366 (1960), the Supreme Court stated: "[I]t is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."

67. 56 T.C. at 934.

68. *Id.*

69. 50 T.C. 595 (1968).

70. *Id.* at 601; Income Tax Convention, May 24, 1951, United States-Switzerland, 2 U.S.T. 1751, T.I.A.S. No. 2316.

71. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

72. 50 T.C. at 600.

73. *Id.* at 602.

for tax treaty benefits, utilized several factors to ascertain the corporation's nationality. In *Compagnie Financière de Suez v. United States*,<sup>74</sup> the Egyptian Government nationalized a company that had been created and operated under Egyptian law for over 100 years. France then enacted legislation stating that the company was governed by French law. This led the company to claim that, as a French corporation, it qualified for the tax rate established by the United States-France tax treaty.<sup>75</sup> The Court of Claims examined the circumstances of the company's creation, operations, and prior tax payments. It found that the French legislature's action and certain other ties to France did not alter the fact that the company was an Egyptian corporation<sup>76</sup> and was therefore not eligible for the treaty tax rate.<sup>77</sup>

Each of these cases reveals the willingness of courts to probe the superficial structure of a corporate relationship to determine whether the parties qualify for treaty benefits. Taxpayers may certainly arrange transactions to produce the lowest tax legally possible. But the transaction must not be a sham,<sup>78</sup> and it should fall within the intent of the treaty that created the exemption.<sup>79</sup> But the IRS has apparently demanded no assurances that Antilles corporations such as those in the letter rulings actually have "dominion and control"<sup>80</sup> over the dividends they receive to qualify for Treaty benefits. Although the taxpayers in some rulings made an *Aiken* representation,<sup>81</sup> others did not.<sup>82</sup> Whether or not the taxpayer made an *Aiken* representation, the IRS has not scrutinized the Antilles corporations to determine if they were in fact mere conduits for channeling dividends to third country investors. Indeed, the IRS seems generally unconcerned about the possibility of third country investors reaping Treaty benefits through the medium of an Antilles investment corporation.<sup>83</sup>

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74. 492 F.2d 798 (Ct. Cl. 1974).

75. Convention with Respect to Taxes on Income and Property, July 28, 1967, United States-France, 19 U.S.T. 5280, T.I.A.S. No. 6518.

76. 492 F.2d at 809.

77. *Id.* at 811.

78. See, e.g., *Higgins v. Smith*, 308 U.S. 473, 476 (1940); *Harbour Properties, Inc.*, 32 T.C.M. (CCH) 580, 632-33 (1973).

79. See, e.g., *Maximov v. United States*, 299 F.2d 565, 568 (2d Cir. 1963), *aff'd*, 373 U.S. 49 (1963); *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). But see *Perry R. Bass*, 50 T.C. 595 (1968) (corporation with no apparent purpose beyond tax reduction allowed to take advantage of tax treaty).

80. Letter Rul. No. 7739080, at 2.

81. See note 62 *supra*.

82. Letter Rul. Nos. 7746046, 7748013.

83. The use of the *Aiken* representation raises the question of the status of preferred shareholders. If a third country investor owns preferred stock, which is entitled to receive dividends under all or nearly all circumstances, does the corporation have an "obligation" to pay dividends to him? Alternatively, a third country investor might structure the Antilles corporation so that his contribution was in the form of a loan. Does his right to receive interest

## B. THE CODE: SUBSTANCE OVER FORM

U.S. income tax law, both in the Code and in its administrative implementation, has been hostile to use of the corporate form for evasion or avoidance of tax liability. The goal of taxing the substance and not merely the form<sup>84</sup> of transactions has prompted the enactment of several anti-tax avoidance sections of the Code. Although none of these sections apply directly to the use of the Antilles Treaty by third country investors,<sup>85</sup> the provisions illustrate the type of transaction or arrangement considered suspect by Congress and the IRS.

Legislative and administrative attempts to elevate substance over form have focused on specific facts and circumstances, the taxpayer's motives, or a combination of the two. The "facts and circumstances" approach is typified by the "branch rule."<sup>86</sup> Enacted as a regulation pursuant to Subpart F,<sup>87</sup> the rule applies to branches of controlled foreign corporations (CFC's) that do business outside the country in which the CFC is incorporated.<sup>88</sup> The Service will examine the arrangement, using specific numerical standards,<sup>89</sup> to determine whether the corporate structure as a whole has enjoyed significant tax savings by operating through branches rather than through wholly owned subsidiaries.<sup>90</sup> If the Service determines that such tax savings have occurred, it will treat the branch as a wholly owned subsidiary, thus rendering the U.S. shareholder of the CFC taxable on the branch's profits.<sup>91</sup>

Alternatively, the Service may look to the taxpayer's intent to determine whether he is misusing the corporate form. Perhaps the best example of a provision authorizing such an examination is section 269 of the Code.<sup>92</sup> Pursuant to this section, the IRS may disallow any tax benefits<sup>93</sup> that a

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payments, rather than dividends, mean that he is a "creditor," and thus not covered by an *Aiken* representation?

84. See notes 78-79 *supra* and accompanying text.

85. The most obvious reason for the inapplicability of the provisions to third country investors is that these investors usually are not actual or potential U.S. taxpayers.

86. Treas. Reg. § 1.954-3(b) (1964). See M. MOORE & R. BAGLEY, U.S. TAX ASPECTS OF DOING BUSINESS ABROAD 130-31 (1978).

87. I.R.C. §§ 951-964. Subpart F taxes U.S. shareholders of controlled foreign corporations on their pro rata share of the corporation's income, if certain control tests are met. For detailed discussions of the provisions of Subpart F, see Note, *Controlled Foreign Corporations: Determining Control Under Subpart F*, 11 CORNELL INT'L L.J. 343 (1978); M. MOORE & R. BAGLEY, *supra* note 86, at 115-46.

88. Treas. Reg. § 1.954-3(b)(1)(i)(a) (1967).

89. *Id.* §§ 1.954-3(b)(1)(i)(b), 1.954-3(b)(4).

90. *Id.* § 1.954-3(b)(1)(i)(b).

91. *Id.* For other statutory patterns that utilize a "facts and circumstances" approach, see I.R.C. §§ 267, 541-547, 551-558.

92. I.R.C. § 269.

93. Treas. Reg. § 1.269-1(a) (1962).

taxpayer would otherwise obtain by acquiring a corporation, if the taxpayer's principal purpose in making the acquisition was to evade or avoid federal income tax.<sup>94</sup> The regulations, in outlining the circumstances that may produce such a determination, stress a variety of business-related factors.<sup>95</sup> Another set of Code provisions<sup>96</sup> imposes an excise tax on certain transfers. The taxpayer can exempt himself from this tax by showing that he did *not* make the transfers "in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."<sup>97</sup>

Finally, some Code sections and the regulations promulgated pursuant to them employ both a "facts and circumstances" approach and an intent standard in determining whether to give effect to the corporate form for tax purposes.<sup>98</sup>

### C. OTHER CONSIDERATIONS

Third country investors who benefit from the Antilles Treaty undermine the usefulness of treaties as a means of preventing double taxation. The Service's failure to curb this misuse of the Treaty amounts to giving away a benefit that would otherwise become part of a treaty package providing similar advantages for each country.<sup>99</sup> If the United States were to insist on a quid pro quo for tax concessions such as lower dividend withholding rates, foreign investors would have an incentive to press their governments to negotiate tax treaties with the United States. Conversely, if residents of nontreaty countries can obtain treaty tax rates by merely channeling their money through the Antilles or another treaty country, the nontreaty countries will lose part of their incentive to seek tax treaties with the United States.

In addition, granting these benefits to third country investors without careful examination of the underlying corporate arrangements is inequitable because it favors the wealthy investor. To qualify for the major ownership exception and thus to reap Treaty tax benefits as well as low Antilles profit tax rates, an investor must own at least 25% of a U.S. corporation. Such a large investment is beyond the means of most individuals. Ob-

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94. I.R.C. § 269(a).

95. Treas. Reg. § 1.269-2(b) (1962).

96. I.R.C. §§ 1491-1494.

97. *Id.* § 1492(2).

98. *See id.* §§ 482, 531-537.

99. A similar point was made by opponents of a recent proposal to eliminate all withholding tax on dividends paid by U.S. corporations to foreign investors. *Foreign Portfolio Investments in the United States, Hearing Before the Subcomm. on International Finance and Resources of the Senate Comm. on Finance, 94th Cong., 2d Sess. 37 (1976)* (statement of Hugh J. Ault); *id.* at 25 (statement of Peggy Musgrave).

taining these benefits also requires sophisticated tax planning—again, a province of the wealthy investor.

#### IV

#### RECOMMENDATIONS

Past judicial interpretation of tax treaties, the Code, and policy considerations all suggest that the Service should discourage third country investors from using Antilles companies for reducing taxes on U.S. investments.

##### A. TREATY RENEGOTIATION

The most comprehensive resolution of the present situation would be a renegotiation of the Treaty to eliminate loopholes and consequently to enhance the ability of U.S. tax authorities to deal with tax avoidance under the Treaty. Renegotiation of the Treaty should have as its goal the elimination of the tax avoidance opportunities that stem from entering into a tax treaty with a tax haven. First, the negotiators should attempt to eliminate the major ownership exception. This would prevent third country investors from obtaining both Treaty tax rates and Antilles low tax benefits. Renegotiation could thus accomplish the original intent of the Protocol's draftsmen, which was to curtail avoidance of U.S. income taxes. Second, the United States should attempt to eliminate article XII from the Treaty. This article surrenders the right of the U.S. to impose a secondary tax on dividends paid to third country investors by Antilles corporations. If the United States were to reclaim this right, as it has done in negotiations with other tax havens,<sup>100</sup> tax authorities could recapture excess dividends paid by U.S. corporations to Antilles shareholders.

##### B. ADMINISTRATIVE ACTIONS

It is unlikely, however, that renegotiation will occur in the foreseeable future.<sup>101</sup> The Service should therefore act immediately to promulgate regulations stating its intention to examine corporate arrangements that benefit third country investors. The regulations should provide a method

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100. At the same time that the Senate approved the Protocol, it also examined the tax treaty the United States had just signed with Luxembourg, Convention with Respect to Taxes on Income and Property, Dec. 18, 1962, United States-Luxembourg, 15 U.S.T. 2355, T.I.A.S. No. 5726. That treaty permitted the United States to impose a secondary tax on dividends paid to third country investors by Luxembourg low-tax corporations. SENATE EXECUTIVE REPORT, *supra* note 5, at 12, 1965-1 C.B. at 641; *id.* at 47, 1965-1 C.B. at 666. For a general discussion of article XII of the Treaty, see note 18 *supra*; notes 59-60 *supra* and accompanying text.

101. Part of the problem with renegotiation is that many other treaties are currently under negotiation or renegotiation. As of May 1977, the United States was negotiating treaties with at least 14 other countries. See 2 TAX TREATIES (CCH) ¶ 9748 (May 31, 1977).

for determining whether these corporate structures are mere conduits or in fact have some legitimate business purpose. Such a regulation would find support not only in general principles of tax law—judicial, legislative, and administrative—but also as a means of implementing the express intent of the Treaty and Protocol.

The IRS should inform taxpayers of the factors that will support a finding that the Antilles corporation is a conduit and thus not entitled to Treaty tax rates. The Service should require the taxpayer to make the *Aiken* representation that the Antilles corporation is under no obligation to pay dividends to its shareholders. In most cases, however, this should not end the inquiry. To limit tax avoidance, the IRS should insist on some nexus between the Antilles corporation in question and the Antilles, beyond the mere filing of papers. Also, the Service should consider the number of third country shareholders of each Antilles corporation. An investment company with only one third country investor is more likely to be a conduit than one owned by several such investors.

The primary emphasis of the regulation should be on whether the corporate arrangement has some legitimate, nontax, business purpose. The IRS has already evidenced some concern about this question,<sup>102</sup> but it should clarify the factors that will indicate or negate a finding that a business purpose exists. For example, where the third country investor has access to the profits of the Antilles company without substantial restrictions, the Service should disallow Treaty tax benefits.<sup>103</sup> In less egregious cases, the IRS should utilize a reasonableness standard similar to that employed in certain sections of the Code. It should consider the taxpayer's justifications for the corporate structure and whether the arrangement appears to be appropriate for these stated purposes.<sup>104</sup>

Finally, perhaps in conjunction with this examination, the Service should employ an intent test. Where so much of the purpose of a corporate arrangement is tax-related, it would be unrealistic to demand that the taxpayer have no intent to "avoid" taxes. Nevertheless, the regulations should disallow Treaty benefits where the "principal purpose" of the arrangement is tax evasion or avoidance.<sup>105</sup> This standard should enable tax authorities to deny Treaty tax rates to a sham Antilles corporation, while permitting an

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102. For example, the Service pressed at least one tax planner to justify using an investment company located in the Antilles. After several exchanges, the IRS eventually accepted the asserted business purposes as sound. Letter Rul. No. 7739080, Background File (on file at the *Cornell International Law Journal*); see note 50 *supra*.

103. For an analogous standard, see Treas. Reg. § 1.451-2 (1957). This regulation permits the Service to find that a taxpayer has constructively received income when he has control over its receipt. *Id.* § 1.451-2(a).

104. See I.R.C. § 269; notes 86-91 *supra* and accompanying text.

105. See notes 92-97 *supra* and accompanying text.



investor with a legitimate business purpose to incorporate in the Antilles and to enjoy Treaty benefits.

### CONCLUSION

The United States-Netherlands Antilles tax treaty gives third country investors who incorporate in the Antilles the opportunity to reduce the rate of tax they must pay on dividend income received from U.S. corporations. Attempts to limit these advantages have met with limited success, despite numerous policy justifications for restricting the availability of Treaty tax rates. This situation calls for a new approach by U.S. tax authorities, preferably renegotiation of the Treaty to eliminate loopholes and improve enforcement. For the present, the IRS should issue regulations indicating its intention to curb abuses of the Treaty and setting out standards for denying Treaty benefits to corporate arrangements created solely for tax avoidance purposes.

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