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# COMMENTS

## The Termination of the United States-Netherlands Antilles Tax Treaty: What Were the Costs of Ending Treaty Shopping?

### I. INTRODUCTION

On June 29, 1987 the United States Treasury Department terminated the United States-Netherlands Antilles Tax Treaty (the "Treaty").<sup>1</sup> The United States and the Netherlands Antilles had attempted to preserve the Treaty for eight years. However, negotiations ended because of a loggerhead over the extent to which the Netherlands Antilles would maintain any tax haven status. Termination of the Treaty was a victory for the United States since third parties to the Treaty could no longer misuse it to evade United States taxes. Furthermore, the termination significantly advanced the continuing United States policy to eliminate "treaty shopping."<sup>2</sup> The manner, however, in which the Treas-

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<sup>1</sup> Convention with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, United States-Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855, *as amended*; Protocol Supplementing the Convention for the Purpose of Facilitating Extension to the Netherlands Antilles, June 15, 1955, United States-Netherlands, 6 U.S.T. 3696, T.I.A.S. No. 3366, *as extended*; Convention on Double Taxation of Income, Extension to Netherlands Antilles of Convention of Apr. 29, 1948, Nov. 10, 1955, United States-Netherlands, 6 U.S.T. 3703, T.I.A.S. No. 3367, *as amended*; Protocol Modifying and Supplementing the Extension to the Netherlands Antilles of the Convention of Apr. 29, 1948, Oct. 23, 1963, United States-Netherlands, 15 U.S.T. 1900, T.I.A.S. No. 5885, *as supplemented*; Convention Modifying and Supplementing the Convention of Apr. 29, 1948, Dec. 30, 1965, United States-Netherlands, 17 U.S.T. 896, T.I.A.S. No. 6061 [hereinafter Treaty].

<sup>2</sup> *Multilateral Treaties Seen as Effective Tool in Preventing International Tax Abuses*, 179 DAILY REP. FOR EXECUTIVES (BNA) G-3 (Sept. 17, 1987)[hereinafter *Multilateral Treaties*]. "Treaty shopping" is the practice whereby an investor in a nation that is not party to a tax treaty with the United States looks to invest in the United States through a country that is a party to a favorable tax treaty with the United States in order to reduce or eliminate his tax liability on his

ury Department handled the termination incurred a number of costs. First, the abrupt announcement unnecessarily upset the international bond market. Second and perhaps more significant in the long term, the unilateral termination undermined United States credibility as a treaty partner.

The Treaty addressed numerous areas of taxation, including patents and copyright royalties, and exemptions of governmental wages, salaries, and pensions. However, the Treaty's most significant provision was Article VIII, entitled "Rate of Tax on Dividends and Interest Derived from Treaty Country" and its ancillary provisions (collectively, "Article VIII"). Before 1984, the United States imposed a general 30% withholding tax on corporations which issued and paid interest on bonds (the "30% withholding tax" or "withholding tax"). Article VIII of the Treaty exempted bond issuers, which were foreign subsidiaries of United States corporations, from the 30% withholding tax. Moreover, the Netherlands Antilles did not tax payments made to foreign investors. Consequently, United States corporations widely used the Netherlands Antilles as a "conduit" to raise money cheaply.<sup>3</sup> A United States corporation would establish a finance subsidiary in the Netherlands Antilles and, through the subsidiary, issue bonds which were free from both domestic and Netherlands Antillean taxes.

In June 1984, Congress passed the Deficit Reduction Act of 1984 ("DEFRA"). DEFRA repealed the 30% withholding tax for all new Eurobonds. This repeal made the Treaty's exemption from the withholding tax no longer necessary for bonds issued after the date of enactment, July 18, 1984. United States corporations now could issue new bonds directly to foreign investors, rather than through subsidiaries such as those in the Netherlands Antilles. Furthermore, to avoid retroactive taxation of bonds issued before 1984 ("pre-1984 bonds"), DEFRA contained a "grandfather clause" for pre-1984 bonds. This grandfather clause, coupled with the Treaty, preserved the tax haven status of the Netherlands Antilles. Thus, holders of pre-1984 bonds fully expected their bonds to remain tax-free. Termination of the Treaty on June 29, 1987, however, immediately subjected pre-1984 bonds to the 30% withholding tax.<sup>4</sup>

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United States investments. See *infra* notes 37-47 and accompanying text. See also Marr, *Domestic Versus Euromarket Bond Sales: A Persistent Borrowing Cost Advantage*, 36 TAX NOTES (Sept. 28, 1987)(available on microfiche data base Doc. No. 87-6021).

<sup>3</sup> *Treasury to Seek Rule Protecting Antilles Bonds*, Wall St. J., July 3, 1987, at 5, col. 4 [hereinafter *Protecting Antilles Bonds*].

<sup>4</sup> *Id.* See *Hearings Before a Subcommittee of the Committee on Government Operations, House of Representatives*, 100th Cong., 1st Sess. 345 (1987) (statement of Alan W. Granwell, partner,

The immediate cost of the United States termination of the Treaty was its negative effect on the international bond market. Institutions all over the world that had issued or bought pre-1984 bonds remonstrated, because the Treasury Department had "chang[ed] the rules of the game" before the bonds matured.<sup>5</sup> Moreover, panic selling in the Eurobond market ensued, because the termination subjected the interest on approximately \$32 billion of pre-1984 bonds issued through the Netherlands Antilles to the withholding tax.<sup>6</sup> Finally, many bond issues contained call provisions which permitted the issuer to redeem the bonds if a withholding tax was imposed.<sup>7</sup> Such provisions allowed the issuers to call in the obligations at par value. Since the bonds actually had been selling at a premium, issuers who called their bonds and refinanced loans at lower rates received a windfall, while investors bore the loss.<sup>8</sup>

The strong resistance to announcement of the Treaty's termination made the Treasury Department realize it had failed to contemplate the legal problems which would arise in the international bond market.<sup>9</sup> The Treasury Department saw that it needed to re-establish expectation interests regarding pre-1984 bonds, yet it was unwilling to relinquish its success in defeating the tax haven tactic known as treaty shopping. On July 2, 1987, the Treasury Department announced that it would propose legislation which would guarantee the withholding tax exemption for pre-1984 bonds. Furthermore, because passage of such legislation appeared uncertain, on July 10th, the Treasury Department announced that it would specifically preserve Article VIII but would terminate all other provisions of the Treaty.<sup>10</sup>

The Treasury Department's handling of termination of the Treaty highlights the inherent tension between two fundamental government policies. On one hand, the United States government must raise revenue

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Cadwalader, Wickersham & Taft, and former international tax counsel, U.S. Treasury Department)[hereinafter Granwell Statement].

<sup>5</sup> *Treasury Reverses Decision on Taxing Antilles Bonds*, Washington Post, July 3, 1987, at G7, col. 1.

<sup>6</sup> *Protecting Antilles Bonds*, *supra* note 3.

<sup>7</sup> Letter from Paul M. Butler, Jr., Shearman & Sterling, to J. Roger Mentz, Assistant Secretary for Tax Policy, (July 6, 1987); 36 TAX NOTES (July 27, 1987)(available on Tax Notes microfiche data base Doc. No.87-4551) [hereinafter Butler Letter].

<sup>8</sup> *Protecting Antilles Bonds*, *supra* note 3.

<sup>9</sup> Rosen, *Treasury's Blunder in Paradise*, N.Y. Times, October 4, 1987, at F1, col. 5. J. Roger Mentz, at the time Deputy Assistant Secretary for Tax Policy, indicated that he thought the "market had taken the possibility of a treaty into account by building a price into the bond for such a contingency." *Id.* However, the possibility of bond calls was not identified, and it seemed that no independent study of the effect of the termination of the treaty on the bond market was made by the monetary branch of the department. *Id.*

<sup>10</sup> *Id.*

and compel tax compliance. On the other hand, monetary policies require a free flow of capital across national borders. These concerns conflict, because increased taxes and compliance procedures necessarily restrict the free flow of capital. The Netherlands Antilles incident, while closing down a tax haven, undermined the free functioning of the Eurobond market. Worse, it may have eroded investor confidence in United States securities, including the Treasury Department's own issues to fund the United States budget deficit.<sup>11</sup> Now, along with general risks of investment, a foreign investor may have to account for the instability of the United States tax laws.

The Netherlands Antilles incident also illustrates a growing unilateralism in United States foreign tax policy. Such unilateralism impairs the United States integrity as a treaty partner. For example, the Dutch government saw the United States actions as showing disdain for treaty obligations and violating the spirit of the General Agreement on Tariffs and Trade.<sup>12</sup> Coupled with treaty override provisions such as those in 1986 tax legislation and the Technical Corrections Bill,<sup>13</sup> the United States appears to be favoring a unilateral approach to the resolution of international tax problems. Many contend that such issues are appropriately addressed within the process of treaty negotiation.<sup>14</sup>

The purpose of this Comment is to analyze the legal problems arising from termination of the Treaty. The analysis underscores the difficulty in balancing two conflicting governmental policies: tax-raising concerns and monetarist goals. The Comment further considers long-term implications for United States foreign relations which flow from the Netherlands Antilles incident. The Comment concludes that, given the acceleration of the United States anti-treaty shopping policy over the past eight years, termination of the Treaty was an inevitable and necessary step. However, in executing its international tax policies, the United States cannot proceed as if in a vacuum. Here, the Treasury Department was short-sighted with respect to the immediate impact of termination on the Eurobond market, and with respect to foreign perceptions about the United States credibility as a treaty partner.

Part II of this Comment examines the history of the Treaty and its

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<sup>11</sup> *Id.*

<sup>12</sup> *Dutch Minister Warns Against Unilaterality in Trade Bill, Moves to Override Treaties*, 214 DAILY REP. FOR EXECUTIVES (BNA) G-7 (Nov. 6, 1987)[hereinafter *Dutch Minister Warns*].

<sup>13</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). Technical Corrections Bill, H.R. 2636 and S. 1350, 100th Cong., 1st Sess. § 112 (1987). Normally a treaty obligation will not be overridden by Congress. For a discussion of treaty override, see *infra*, notes 72-78 and accompanying text.

<sup>14</sup> *Dutch Minister Warns*, *supra* note 12.

role in the development of the Eurobond market. The Treaty provided the primary access for the United States to the Eurobond market. Its extensive use over the years as an investment vehicle underlies the present financial expectations of the Netherlands Antilles and Eurobond issuers and investors. Part III studies the development of the United States bilateral tax treaty policy with respect to the Netherlands Antilles. It lays down the fundamental principles and goals behind bilateral tax treaties, as well as the particular interests the United States and the Netherlands Antilles sought to protect through their agreement. Part IV analyzes the legal issues that were raised through the course of the Treasury Department's efforts to reestablish the position of the pre-1984 bonds. Finally, Part V discusses possible justifications for the Treasury Department's actions and speculates on the future of both the United States and the Netherlands Antilles without a tax treaty.

## II. HISTORY OF THE TREATY AND DEVELOPMENT OF THE EUROBOND MARKETS

The Treaty, which became effective in November 1955, was designed to relieve United States nationals of the burdens of double taxation.<sup>15</sup> In actuality, it provided United States issuers access to the Euromarkets, by bringing together domestic corporations which sought to expand their sources for capital and foreign investors who wanted anonymity and a high rate of return on their investment.<sup>16</sup>

Before the enactment of DEFRA in 1984, the United States generally imposed a 30% withholding tax on dividend, interest, and passive investment income paid by United States sources to nonresident aliens and foreign corporations.<sup>17</sup> The withholding tax effectively prohibited United States borrowers from directly entering the Euromarkets. To re-

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<sup>15</sup> *Report of the Senate Foreign Relations Comm. on Certain Double Taxation Conventions, reprinted in 2 TAX TREATIES (CCH) ¶ 5855, at 5838 (1971).* States enter tax treaties primarily to prevent the double taxation of income—that is, taxation of income earned in one country by persons or corporations residing in another country, where both the country of the source of the income and the country of the person's residence claim jurisdiction to tax the income. One of the assumptions in giving up source jurisdiction is that the income will be taxed by the treaty partner. Presumably then, the treaty partner has granted specific concessions or benefits to the source country or its taxpayers for the right to tax. Comment, *Revenue Rulings 84-152 and 84-153: The End of Treaty Shopping?*, 17 L. & POL'Y IN INT'L BUS. 577, 578, 586 (1985)[hereinafter *Revenue Rulings*]. See also Osgood, *Interpreting Tax Treaties in Canada, the United States, and the United Kingdom*, 17 CORNELL INT'L L.J. 255, 259 (1984); Vogel, *Double Tax Treaties and Their Interpretation*, 4 INT'L TAX & BUS. LAW. 4 (1986).

<sup>16</sup> Marr, *supra* note 2, at 33.

<sup>17</sup> There is a fundamental notion under international law of taxing jurisdiction at the source of the income. "Source income" refers to the country in which the income is deemed to have arisen. Osgood, *supra* note 15, at 258 n.9.

main competitive with foreign borrowers, the United States borrower would have had to "gross up" its payments to the investor to cover the 30% tax withheld at the source. Because the borrower would have to absorb this amount, the cost of borrowing in the Euromarket was unreasonably high.

The Treaty exempted the 30% withholding tax on dividend, interest, and passive investment payments made by United States corporations to nonresident aliens and foreign corporations. The Treaty further provided that interest payments on bonds made by a United States corporation to its subsidiary were tax-free.<sup>18</sup> Similarly, Netherlands Antillean law provided that payments made by subsidiaries within its borders to investors were tax-free. United States corporations took advantage of these provisions by establishing finance subsidiaries in the Netherlands Antilles. The subsidiaries would purchase bonds from their United States parents and issue the bonds to foreign investors. Any interest or dividends paid by the subsidiary to foreign investors were free of both United States withholding tax and Netherlands Antillean tax.<sup>19</sup>

The policy of the United States during the 1960s was to encourage the use of finance subsidiaries to reach foreign markets.<sup>20</sup> Exchange rates were fixed, and overseas borrowing helped prevent devaluation of the dollar.<sup>21</sup> During this period the Eurobond market developed into a major source of capital formation for United States borrowers.<sup>22</sup> Borrowers were attracted to the Eurobond market because entering the market avoided domestic restrictions and provided an opportunity to broaden

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<sup>18</sup> Treaty, *supra* note 1, art. VIII.

<sup>19</sup> Under the U.S.-Netherlands Antilles Tax Treaty, dividends received by a Netherlands Antilles company from United States sources were taxed at a 15% rate (five percent if the company was a 95% owned United States subsidiary), and interest and royalties were exempt from United States tax. The Netherlands Antilles imposed only a three percent tax rate on dividend, interest and royalty income received by Netherlands Antilles holding companies. Furthermore, that income which then passed onto a third country resident was not taxed by the United States. Finally, the dividend, interest or royalty would not be taxed under the tax laws of the country in which the individual resided. Thus, the tax burden of an individual who invested in the United States in this manner would be substantially less than through other methods of investment, i.e. the tax rate on interest income would be three percent, and the rate on dividends would be 17.55% instead of the statutory 30%. *Senate Foreign Relations Committee Report on the Protocol Between the United States and the Netherlands, Signed October 23, 1963, Modifying and Supplementing The 1955 Extension of the Netherlands Antilles of the 1948 Income Tax Convention*, reprinted in 2 TAX TREATIES (CCH) ¶ 5856B, at 5839-8 (1964)[hereinafter *Senate Report*].

<sup>20</sup> *Revenue Rulings*, *supra* note 15, at 589.

<sup>21</sup> *Id.* In addition, the government created foreign borrowing incentives through the Interest Equalization Tax and the Foreign Direct Investment Program. Similarly, the Internal Revenue Service softened its ruling requirements in determining whether obligations of finance subsidiaries would be exempt from the U.S. withholding tax. *Id.*

<sup>22</sup> *Id.* at 587.

borrowers' markets for securities.<sup>23</sup> These two factors made the cost of borrowing in the Eurobond market lower than in domestic markets.<sup>24</sup>

The foreign investor also had a number of reasons to resort to the Eurobond market.<sup>25</sup> The typical investor sought anonymity and a low risk, assured return on his money. Eurobonds were issued in bearer form, meaning that they were unregistered in the United States and were simply payable to the holder of the bond.<sup>26</sup> Netherlands Antillean financial secrecy laws and the issuance of bearer notes satisfied foreign investors' growing desire for financial secrecy.<sup>27</sup> In addition, the companies that issued bonds in the Euromarkets were large, well-known, blue chip corporations from politically and economically stable nations.<sup>28</sup> Finally, many of the notes that were issued carried guarantees by the United States parent company to the investor.<sup>29</sup>

Within ten years of the Treaty's adoption, it was recognized as a valuable bridge to foreign investors, despite its concurrent use as a tool for tax evasion.<sup>30</sup> During the late 1970s, United States interest rates rose

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<sup>23</sup> Marr, *supra* note 2, at 4.

<sup>24</sup> *Id.* at 30.

<sup>25</sup> A United States citizen is not permitted to earn tax-free income on Eurobonds. Since Eurobonds are bearer obligations, the United States investors may not hold or sell them without suffering certain sanctions such as the denial of a deduction for any loss sustained on a sale of the Eurobonds. The Internal Revenue Code provides some exceptions. For example, pension plans and other financial institutions may earn tax free income on Eurobonds, not because of the nature of the investment, but because of the status of the institution. Furthermore, certain other U.S. investors such as broker-dealers, and persons holding through financial institutions may hold, purchase, and sell these obligations in the secondary market without suffering a penalty. The obligations may not enter the United States, and the income on them must be reported. Thus, few Eurobond obligations should be found in the hands of U.S. investors. *Hearings Before a Subcomm. of the Comm. on Government Operations*, 100th Cong., 1st Sess. 4, at 30-31 (1987)(statement of O. Donaldson Chapoton, Acting Assistant Secretary for Tax Policy Department of the Treasury)[hereinafter Chapoton Statement].

<sup>26</sup> *Revenue Rulings*, *supra* note 15, at 588.

<sup>27</sup> Marr, *supra* note 2, at 32.

<sup>28</sup> *Id.*

<sup>29</sup> These guarantees included the payment of interest, premiums, and principal free of taxes withheld by the source country although usually the issuer reserved the right to call the bonds if the Internal Revenue Service (IRS) determined that the payments were not tax-exempt. *Revenue Rulings*, *supra* note 15, at 588-89.

<sup>30</sup> Residents of third countries which did not have tax treaties with the United States also formed investment companies in the Netherlands Antilles to take advantage of the favorable tax situation. These companies held their United States source investments and collected the dividends, interest and royalties for them. In 1963, the United States and the Netherlands Antilles added a protocol to rectify this situation. *Senate Report*, *supra* note 18.

The protocol increased the United States tax rate on dividends, interest and royalties paid to Netherlands Antilles investment companies to the full 30% statutory rate. However, the protocol did not change the 15% and zero percent rates on U.S. source dividends, interest, and royalties paid to a Netherlands Antilles corporation if (a) the recipient corporation was 100% owned by (1) resi-



relative to other world interest rates, thus making Eurodollar bonds an even more attractive investment. When investor demand for Eurodollar bonds increased, use of the Treaty accelerated. Over the thirty-two year life of the Treaty, the United States monetary policy bolstered the expectations of domestic issuers and foreign investors in the Euromarket. In effect, the Treaty promoted a system of capital movements which would not be easy to overturn.

### III. THE TREATY AS PART OF THE UNITED STATES BILATERAL TAX TREATY POLICY

Bilateral tax treaties, analogous to contractual agreements between states, establish rules for when a state will relinquish to another state both its taxing jurisdiction and some or all of its rights to tax revenue.<sup>31</sup> The "bargain" of bilateral tax treaties reflects the policy priorities of the treaty countries and reconciles their underlying domestic tax laws.<sup>32</sup> Tax treaties can encourage the international flow of investment capital. For example, a treaty may ensure that the country of "source" (the country of the issuer) will not excessively tax income derived from investments, on the assumption that the country where the investor resides will fully tax that income.<sup>33</sup> By eliminating the source income tax, the treaty removes a significant disincentive for potential investors to cross their national borders.

However, the specificity and complexity of bilateral tax treaties make loopholes easy to find. In particular, residents of countries that are not party to a treaty may be able to use the treaty to reduce their tax liability.<sup>34</sup> Thus, bilateral tax treaties attempt to limit such opportunities for avoidance and evasion of the taxes which treaty countries attempt to

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dents of the Netherlands, (2) Netherlands corporations, or (3) residents of the Netherlands Antilles; or (b) the income was reduced by a Netherlands Antilles corporation from a 25% owned U.S. subsidiary corporation if less than 60% of the payor's gross income consisted of passive income.

While the United States tried to limit the abuses under the Treaty, it specifically did not remove a provision that allowed an exemption for Netherlands Antilles companies paying dividends and interest to nonresidents. The reason for this decision was to protect the United States balance of international payments by encouraging foreign portfolio investment in the United States. *Senate Report, supra* note 18, at 5839-10, 5839-14. *See also id.* at 5839-9 ("Since it is estimated that a large portion of the assets held by Netherlands Antilles corporations . . . [are] held by corporations which derive 50% or more of their gross income from sources within the United States, it is feared that repeal of Article XII could cause a substantial liquidation of United States assets held by these corporations so as to avoid the statutory 50% rule which would be applicable in the absence of the present convention.")

<sup>31</sup> *Id.* at 8. *See also, Osgood, supra* note 15, at 259.

<sup>32</sup> *Revenue Rulings, supra* note 15, at 584.

<sup>33</sup> *Id.* at 578.

<sup>34</sup> *Id.* at 584.

impose. Finally, most treaties contain exchange of information provisions and establish mutual agreement and accommodation procedures for resolving conflicts concerning the application of the treaty.<sup>35</sup>

The United States traditionally has valued bilateral tax treaties. They have provided United States taxpayers with certainty regarding application of foreign tax rules, and with reduced foreign taxes on dividends and interest received in the United States from operators abroad.<sup>36</sup> Tax treaties have enhanced the competitiveness of United States businesses abroad. They benefit the United States Treasury Department by limiting the amount of foreign taxes on United States operations for which the United States must give credit under foreign tax rules. Finally, the United States and the countries with which they have treaties have exchanged much valuable information regarding tax collection procedures.<sup>37</sup>

#### A. The Problem of Treaty Shopping

“Treaty shopping” can be illustrated in two examples involving the United States as a party to a treaty. First, treaty shopping occurs when a person, who resides in a country that is not a treaty partner with the United States, indirectly invests in the United States through a country that is a treaty party. Second, treaty shopping occurs when a United States resident indirectly invests in the United States through a treaty partner. In both examples, the investor takes shelter in the tax haven of the treaty partner. The investor reduces the tax liability on any income she might earn, by paying the lower or nonexistent tax rates of the treaty partner, rather than those of the United States. Treaty shopping, the negative aspect of any bilateral tax treaty arrangement, has been especially notorious in the case of the Treaty.<sup>38</sup>

Treaty shopping has several adverse effects on the United States. The United States loses revenues when an investor whose country is not a treaty partner takes advantage of a United States treaty concession (such as an exemption from withholding taxes), and is not provided with a corresponding benefit from the investor’s country. The United States also loses revenue when its residents acquire investment earnings abroad

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<sup>35</sup> Osgood, *supra* note 15, at 260. Internal tax authorities are dependent on the official assistance of the other country involved, but that country is only bound to help as provided in the U.S.-Netherlands Antilles Tax Treaty. Vogel, *supra* note 15, at 9.

<sup>36</sup> Letter from James A. Baker III, Secretary of the Treasury Department, to Bob Packwood, Senate Finance Committee Chairman (April 7, 1986), 35 TAX NOTES 304 (April 21, 1986).

<sup>37</sup> *Id.* at 304.

<sup>38</sup> See *Multilateral Treaties*, *supra* note 2; *Revenue Rulings*, *supra* note 15.

but use a treaty to avoid paying United States taxes. In addition, treaty shopping undermines the United States leverage to negotiate new or revised treaties with countries whose residents treaty shop. Finally, it obstructs efforts to bargain with trading partners for concessions, such as lower withholding tax rates on income derived by United States citizens abroad. Without such concessions, United States multinational corporations may find it difficult to remain competitive internationally.<sup>39</sup>

One of the first steps the United States took to reduce treaty shopping was to include a "limitation of benefits" provision in the 1976 and 1977 drafts of the Model Income Tax Treaties.<sup>40</sup> Article 16 of both drafts provided that no exemption from withholding tax on interest, dividends, and royalty payments was available for an enterprise incorporated by a treaty partner if at least 25% of the enterprise was owned by non-residents of the treaty partner, and if the treaty partner's own tax on such income was less than the United States tax.<sup>41</sup> In 1981, the Treasury Department revised Article 16, so that it was even more difficult for enterprises to qualify for the tax exemption. However, in order to maintain existing, legitimate commercial activity,<sup>42</sup> the Department provided an exception for companies whose shares were publicly traded on a recognized exchange.<sup>43</sup>

The Treasury Department sought to reduce third-party treaty abuse by attempting to negotiate Article 16 into existing tax treaties. However, by June 1983, these efforts proved unsuccessful, and the United States cancelled eighteen out of nineteen treaties with countries that provided tax havens. The Treaty, however, was the exception.<sup>44</sup> In view of the

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<sup>39</sup> Chapoton Statement, *supra* note 24, at 28. See also Granwell Statement, *supra* note 4, at 5.

<sup>40</sup> Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, May 18, 1976, Treasury Dep't News Release, WS-861 [hereinafter 1976 U.S. Model Income Tax Treaty]; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, May 17, 1977, *reprinted in* 1 TAX TREATIES (CCH) ¶ 5153 [hereinafter 1977 U.S. Model Income Tax Treaty].

<sup>41</sup> 1976 U.S. Model Income Tax Treaty, *supra* note 40, art. 16; 1977 U.S. Model Income Tax Treaty, *supra* note 40, art. 16.

<sup>42</sup> Granwell Statement, *supra* note 4, at 3-4.

<sup>43</sup> Article 16 denied a corporation resident in the treaty partner country the benefits of a tax treaty unless (1) they were more than 75% owned by persons resident in the treaty country and (2) they did not use investment income from a related company in the other treaty country to pay obligations owed to nonresidents of the treaty country. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, June 16, 1981, *reprinted in* 1 TAX TREATIES (CCH) ¶ 5158 [hereinafter 1981 U.S. Model Income Tax Treaty].

<sup>44</sup> The Treaty did not contain a limitation of benefits provision. However, such a provision was included in the negotiated 1986 Treaty. See *infra*, notes 62-71 and accompanying text.

billions of Eurobonds involved in widespread conduit financings under the Treaty, the Treasury Department was reluctant to cancel it. Instead, the Department sought to avoid disruption of these investments by continuing the negotiations with the Netherlands Antilles that which had begun in 1979 and would continue through June 1987.<sup>45</sup>

Throughout the 1970s, the Internal Revenue Service ("IRS") also tried to reduce third-party treaty abuse. The IRS issued a number of rulings which challenged the validity of finance subsidiary operations on audit. Under several theories, the IRS argued that although the Eurobond obligations in form belonged to the finance subsidiary, but in substance, they were obligations of the domestic parent and thus subject to the 30% withholding tax.<sup>46</sup>

Congress took a preliminary step in limiting the issuance of long-term bearer bonds by passing the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").<sup>47</sup> TEFRA imposed stringent registration requirements on obligations and restricted interest deductions. Because both measures blocked the issuance of bearer tax-free bonds, they limited bond issuance through the Netherlands Antilles.<sup>48</sup>

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<sup>45</sup> Rosen, *supra* note 9, at F8.

<sup>46</sup> One of the theories was that the finance subsidiary was inadequately capitalized. See Comment, *The Repeal of the Thirty Percent Withholding Tax on Portfolio Interest Paid to Foreign Investors*, 6 NW. J. INT'L L. & BUS. 930, 939 n.36 (1984). Another theory was the "sham" theory. If a corporation was established in the Netherlands Antilles with no business purpose and with tax avoidance as its motive for creation, the IRS would disregard the corporation for purposes of tax exemption. Granwell Statement, *supra* note 4, at 16-18. Later, the IRS applied a test where the Treaty benefits would not extend to entities created solely to take advantage of the treaty in a way which would not otherwise be available. *Id.* Finally, the IRS applied source income rules to crack down on conduit financing. It adopted the rationale of *Aiken Industries, Inc.*, 56 T.C. 925 (1971), that treaty benefits only extend to the beneficial recipient and not to its agent. *Id.* But see Rev. Rul. 75-23, 1975-1 C.B. 290, declared obsolete in Rev. Rul. 87-80, 1987-35 I.R.B. 5 (The benefits of the Netherlands Antilles Tax Treaty extended to a Netherlands Antilles corporation which invested in United States real estate even though the shareholders were not Netherlands Antilles residents).

<sup>47</sup> Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982)(codified as amended in scattered sections of 26 U.S.C.)(hereinafter TEFRA).

<sup>48</sup> TEFRA denied deduction of interest on unregistered but "registered required" obligations. 26 U.S.C. § 163(f)(1)(Supp. IV 1987). Any obligation qualified as "registered required" unless it was issued by a natural person, and not offered to the public and had a maturity less than one year. 26 U.S.C. § 163(f)(2)(A)(Supp. IV 1987). An obligation was exempt from registration requirements if "it is sold under procedures reasonably designed to prevent sale or resale to U.S. persons, it bears interest payable outside the United States only, and it indicates on its face that U.S. holders are subject to penalties." 26 U.S.C. § 163(f)(2)(B)(Supp. III 1985). The Treasury Department retained the right to declare such obligations if found to be used for the avoidance of Federal taxes subject to the registration requirements. 26 U.S.C. § 163(f)(2)(C). In addition, TEFRA directed the Treasury Department to establish procedures for ensuring that treaty benefits were received only by those entitled to them. 26 U.S.C. § 324. For further explanation, see Granwell Statement, *supra* note 4, at 31-32. See generally, JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANA-

## B. The Deficit Reduction Act of 1984

Section 127 of DEFRA<sup>49</sup> contained the provisions that repealed the 30% withholding tax on interest received by nonresident aliens for portfolio indebtedness from United States borrowers. Without the withholding tax, there was no need for finance subsidiaries such as those in the Netherlands Antilles. Under DEFRA, foreign parties could invest directly in domestic corporations and in Treasury bonds rather than indirectly through finance subsidiaries.<sup>50</sup>

Because DEFRA created an incentive for United States parent corporations to assume the debt of their Netherlands Antillean subsidiaries, the Netherlands Antilles government risked losing the tax revenue it had been receiving from parent payments to subsidiaries.<sup>51</sup> In addition, DEFRA threatened to erode the Netherlands Antillean economy, which depended heavily on profits from its investment activities.<sup>52</sup> Because of these potential pernicious effects on the Netherlands Antilles, DEFRA provided that repeal of the withholding tax was effective only for interest paid on portfolio debt issued after July 18, 1984, the date of DEFRA's enactment.<sup>53</sup> Although this "grandfather" rule sought to reduce uncer-

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TION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, JCS 38-82, at 189-93 (Dec. 31, 1982).

<sup>49</sup> Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 495 (1984) (codified at I.R.C. §§ 163, 864, 871, 881, 1441-1442, 2105), explained in JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS 41-84 (Comm. Print 1984)[hereinafter DEFRA EXPLANATION].

<sup>50</sup> See STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS. TAX TREATMENT OF INTEREST PAID TO FOREIGN INVESTORS, at 17-18 (Comm. Print 1984) [hereinafter TAX TREATMENT OF INTEREST]. The proposed legislation included two provisions recharacterizing payments made by a United States owned finance subsidiary to third parties in a manner that prevented the parent company from taking foreign tax credits for taxes paid by the Netherlands Antilles subsidiary. The effect of the provisions was that "U.S. companies that cannot obtain an interest rate differential in the Eurobond market (relative to the domestic market) large enough to cover the costs of starting and operating a Netherlands Antilles subsidiary, including taxes that cannot be credited, will no longer obtain a net advantage from Eurobond issues. Thus the effect . . . would be to reduce Eurobonds issued through Netherlands Antilles finance subsidiaries." *Id.*

<sup>51</sup> The Netherlands Antilles received more than \$50 million per year in income taxes related to its international finance activities. Fialko, *Closing a Loophole: Corporate Tax Haven in Netherlands Antilles Is Bracing for a Disaster*, Wall St. J., Oct. 11, 1982, at 17, col. 1.

<sup>52</sup> Investment activities on the islands provided 17% of foreign exchange earnings, and seven percent of employment. *Id.*

<sup>53</sup> DEFRA EXPLANATION, *supra* note 48, at 392-94, 398. The "grandfather" exemption for interest payments on existing obligation issued through Netherlands Antilles finance subsidiaries, or "controlled foreign corporations" ("CFCs") would be treated as paid to a resident of the country in which the CFC is incorporated and thus be covered by the Treaty if certain conditions were met:

- 1) The interest must be paid by a "U.S. affiliate," defined as a United States person related (within the meaning of I.R.C. § 482) to the CFC.
- 2) The interest must be paid on an obligation of such U.S. person which was issued before June 22, 1984.

tainty about existing obligations of Netherlands Antilles subsidiaries, Congress emphasized that “[n]o inference [wa]s to be drawn from this special relief provision for applicable [controlled foreign corporations (“CFCs”)] regarding the proper resolution of other tax issues.”<sup>54</sup> In other words, the grandfather rule was not to serve as precedent for the United States tax treatment of other transactions involving tax treaties or domestic tax law.

Shortly after the enactment of DEFRA, the Treasury Department issued regulations and rulings that resolved remaining uncertainties about the tax status of interest paid to Netherlands Antilles subsidiaries.<sup>55</sup> First, in October 1984, the IRS issued two rulings (the “1984 rulings”) which identified two transactions that DEFRA did not explicitly exempt from the withholding tax: interest payments to a Netherlands Antilles subsidiary by a United States corporation, and interest payments to a Netherlands Antilles subsidiary by a United States subsidiary of a foreign corporation.<sup>56</sup> Although these transactions were similar to the one contemplated by DEFRA’s grandfather rule, neither was exempt from withholding tax under the Treaty.

The 1984 rulings helped to slow the use of Netherlands Antilles subsidiaries for entrance to the Eurobond market.<sup>57</sup> They also left a number of issues unresolved. Primarily, the rulings did not discuss whether the parent or its subsidiary was the true obligor in conduit arrangements.<sup>58</sup> Furthermore, the retroactive effect of the 1984 rulings was unclear. It was not until almost a year later that the IRS issued Revenue Ruling 85-

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3) The interest must be paid to a CFC which was in existence on or before June 22, 1984 and whose principle purpose on that date was issuing and holding obligations to related persons.

4) The CFC must meet certain requirements concerning maintenance of a specified debt equity ratio as set forth in revenue rulings issued in connection with the IET.

*Id.* at 397.

<sup>54</sup> *Id.* at 398. A CFC is a corporation in which more than 50% of the voting interest is owned by U.S. shareholders on any day in the corporate tax year. I.R.C. § 957(a).

<sup>55</sup> *Revenue Rulings*, *supra* note 15, at 602. For example, it limited the exemption of the 30% withholding tax to portfolio interest payments on publicly offered, long term, institutional debt obligations. 26 C.F.R. 35a.9999-5, Q. & A. 1, 8 (1985), *reprinted in* [1984] 10 FED. TAX REP. (CCH) ¶ 5 6856. *See also*, DEFRA EXPLANATION, *supra* note 49, at 394 (exemption of bearer debt if sold under TEFRA registration).

<sup>56</sup> DEFRA simply stated that certain existing obligations would be treated as payments of interest to residents of the Netherlands Antilles. DEFRA EXPLANATION, *supra* note 48, at 397-98. DEFRA explicitly does not apply to most private loan transactions in which both situations existed.

<sup>57</sup> Particular problems existed for transactions in gray areas of the law such as private loan transactions. However, the Netherlands Antilles persisted as a viable means for investing in U.S. real estate. Zagaris, *The Netherlands Antilles Offshore Sector Examines Its Future*, 73 TAXES INT’L 6 (Nov. 1985). One would need to evaluate the business purpose of the relationship, the integrity of the business transaction, how the loans would be structured, and whether an independent reason existed for basing an international finance subsidiary in the Antilles. *Id.*

<sup>58</sup> Granwell Statement, *supra* note 4, at 26.

163, which stated that the 1984 rulings applied to interest payments made on obligations issued prior to October 15, 1984.<sup>59</sup>

The 1984 rulings and Revenue Ruling 85-163 made it clear that the Department was campaigning against treaty shopping.<sup>60</sup> Opponents to these rulings argued that the IRS had gone beyond precedent and had abrogated treaty rights,<sup>61</sup> yet even they could not question the validity of the IRS's fight against treaty shopping. Moreover, the rulings were among the first signals to United States treaty partners that the IRS, and hence the Treasury Department, could unilaterally abrogate the treaty obligations of the United States.

### C. The 1986 United States-Netherlands Antilles Tax Treaty

The ongoing negotiations between the United States and the Netherlands Antilles resulted in their signing a new income tax treaty (the "1986 Treaty") on August 6, 1986.<sup>62</sup> Like the earlier Treaty, the 1986 Treaty epitomized the tension between a matured United States policy of combating tax-avoidance tactics<sup>63</sup> and a desire to maintain economic and political ties with the Netherlands Antilles. On one hand, the 1986

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<sup>59</sup> Rev. Rul. 85-163, 1985 I.R.B. 25.

<sup>60</sup> Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383. Both situations involved common Netherlands Antilles financing transactions, and the IRS's rulings were an attack on treaty shopping and on established methods of indirect accessing of the Euromarkets. The first transaction involved a back to back loan within a related group, i.e. between a Swiss parent and its United States subsidiary and its Antilles subsidiary. The second transaction occurred between a United States corporation and its Netherlands Antilles subsidiary which made a Eurobond offering. The IRS found that the Netherlands Antilles subsidiaries did not "derive" the interest payments from the United States corporations within the meaning of Article VIII(1) of the treaty. The IRS considered factors like the extent to which the Netherlands Antilles subsidiary had "complete dominion and control" over the interest payment, whether the subsidiary was a "mere conduit", whether the primary purpose of involving the subsidiary was to obtain treaty benefits and avoid U.S. taxes, and whether the subsidiary lacked "sufficient business or economic purpose" to overcome the conduit nature of the transaction. Because the Netherlands Antilles subsidiaries were mere conduits, the transactions were subject to the 30% withholding tax.

<sup>61</sup> Granwell Statement, *supra* note 4, at 28. In addition, "[the rulings] have raised concern among the treaty partners of the United States as to whether this is an attempt by the U.S. to unilaterally abrogate its treaty obligations." *Revenue Rulings, supra* note 15, at 615 n.189.

<sup>62</sup> Convention Between the Government of the United States of America and the Government of the Kingdom of the Netherlands in Respect of the Netherlands Antilles for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, *reprinted in* 2 Tax Treaties (CCH) ¶ 5895 (Aug. 1986)[hereinafter 1986 Treaty].

<sup>63</sup> Congress explicitly endorsed and encouraged the Treasury Department's anti-treaty shopping policy in 1984. "The committee understands that the Treasury Department has adopted a policy, to be implemented in current and future income tax treaty negotiations, that would limit treaty benefits to *bona fide* residents of the treaty country. The committee urges the Treasury Department to continue that policy and to insist on such a result in treaty negotiations." H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess., at 1343 (1984).

Treaty contained anti-treaty shopping and exchange of information provisions that followed the United States Model Income Tax Treaty.<sup>64</sup> These provisions limited the benefits that investors from non-treaty countries could receive. On the other hand, the 1986 Treaty seemed to favor the Netherlands Antilles. The 1986 Treaty contained grandfather clauses for Eurobond financing issued before the enactment of DEFRA and for benefits received under the earlier Treaty. Together, these clauses assured that the Netherlands Antilles would remain a tax haven for international investment.<sup>65</sup> In addition, a loophole that limited the withholding tax exemption to the treaty partners could be carved out of the detailed language of Article 16 of the 1986 Treaty.<sup>66</sup> Some critics also asserted that the 1986 Treaty could be interpreted in many ways that would allow otherwise ineligible taxpayers to receive treaty benefits.<sup>67</sup> Finally, the 1986 Treaty enhanced the position of international banks and institutions which provided wholesale financial services in the Netherlands Antilles, and it provided benefits for Netherlands Antillean-based insurance and reinsurance companies.<sup>68</sup>

Any progress in the United States-Netherlands Antilles negotiations that the 1986 Treaty represented ultimately proved illusory. Diplomatic notes of exchange issued at the signing of the 1986 Treaty provided that

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<sup>64</sup> 1986 Treaty, *supra* note 62, arts. 16 & 26. In addition, Article 16 only required 50% ownership by a treaty partner resident as opposed to the 75% required under the 1981 Model Income Tax Treaty. See *supra* note 43 and accompanying text.

As evidence of the United States' concessions to the Netherlands Antilles, Article 16 exempted international mutual funds and qualified real estate companies from the limitation on benefits to residents of a treaty nation. Control over potential abuses regarding certain portfolio investment and real property would have to be exercised through the exchange of information provisions in the 1986 U.S.-Netherlands Treaty. Davidson, *U.S. Signs New Income Tax Treaties with the Netherlands Antilles and Aruba*, 35 TAX NOTES 631 (August 18, 1986).

The exemption from the limitation on benefits provisions for international mutual funds provided that a mutual fund established in one of the contracting states would be entitled to treaty benefits, regardless of the residence of its owners, if it met certain standards regarding share ownership, fund activities, and the nature and diversification of its investment portfolio. *Id.* A qualified real estate company was excepted from the limitation on benefits, because it could receive a waiver for the second withholding tax on dividend payments it made. 1986 Treaty, *supra* note 62, arts. 16(6) & 10(5). In addition, it could choose to be treated as a United States corporation under § 897(i) of the Federal tax code. *Id.* at art. 24(6).

<sup>65</sup> *Id.*

<sup>66</sup> Article 16(2) reads,

The provisions of paragraph 1 . . . shall not apply if the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the first mentioned Contracting State (other than the business of making or managing investments for such persons, or a related person's account).

1986 Treaty, *supra* note 61, art. 16(2).

<sup>67</sup> Davidson, *supra* note 63, at 632.

<sup>68</sup> *Id.*



negotiations would reopen if "legislation is enacted which *materially affects* the treaty . . . in order to assess the impact of the legislation on the treaty and to negotiate amendments as may be necessary or appropriate to reestablish a balance of benefits."<sup>69</sup> A major reason for the provision was that the pending 1986 tax legislation contained proposals which could undermine concessions made to the Netherlands Antilles in the 1986 Treaty.<sup>70</sup> Subsequent passage of the Tax Reform Act of 1986 (the "1986 Act") and objections to its passage by the Netherlands Antilles were never resolved. Consequently, Congress never ratified the 1986 Treaty.<sup>71</sup>

#### D. The Tax Reform Act of 1986

The 1986 Act challenged the negotiations of the 1986 Treaty by promulgating a stringent "branch profits tax" that applied to newly defined treaty shopping situations, regardless of existing income tax treaty protections.<sup>72</sup> The branch profits tax and the treaty override provisions particularly threatened Netherlands Antillean investment in United States real estate which, after 1984, became the focus of Netherlands Antillean financial activity. The provisions also undermined the efficacy of the "limitation on benefits" provision of Article 16 of the 1986 Treaty.

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<sup>69</sup> Communication From the Government of the Netherlands Antilles to the Government of the United States of America, 36 TAX NOTES (Aug. 8, 1986), (available on Tax Notes microfiche data base Doc. No. 86 IWS 325)(emphasis added)[hereinafter Communication from the Government].

<sup>70</sup> *Id.*

<sup>71</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

<sup>72</sup> 26 U.S.C. § 884 (Supp. IV 1987).

The branch profits tax is an extension of the taxing jurisdiction of the United States over dividends and interest paid by foreign corporations "doing business in the United States." Under section 884, a thirty percent tax is imposed on the foreign corporation's "effectively connected earnings and profits." *Id.* In other words, the United States branch of a foreign corporation suffers a 30% tax on the earnings and profits it remits to its foreign parent.

Prior to the enactment of the branch profits tax, the Internal Revenue Code imposed a "secondary withholding" tax on a proportionate share of the dividends of a foreign corporation if more than half of such income was effectively connected with a United States trade or business. The main difference between the two is that under the secondary withholding tax no withholding was assessed until the foreign corporation as a whole actually distributed its profits. Therefore, the United States branch could remit and the foreign office could make use of the branch's profits without being subject to the tax. Under the secondary withholding rules a foreign corporation with a United States branch had a competitive edge over a foreign corporation with a United States subsidiary. The branch profits tax would eliminate that edge. The tax is not imposed on earnings or profits reinvested into the U.S. subsidiary or branch. *Id.* at § 884(b).

The second aspect of the branch tax is on interest payments made by the branch. *Id.* at § 884(f). Interest paid by the branch itself is "treated as if it were paid by a domestic corporation" to a foreign recipient, thus making it United States source interest income to the recipient and subject to a 30% withholding tax, unless exempt by statute or by treaty. Hammer & Roher, *U.S. Branch Taxation: A Venture into the Unknown*, 41 BULL. FOR INT'L DOCUMENT'N 3 (Jan. 1987).

This provision allowed nonresident owners of Netherlands Antilles real estate companies to enjoy the tax protections of the 1986 Treaty.<sup>73</sup>

The earlier Treaty, like most tax treaties, prohibited the imposition of a branch profits tax.<sup>74</sup> Section 884(e) of the 1986 Act, however, restricts the application of any treaty provisions modifying the branch-profits tax to those corporations which are substantially connected to the country with whom the United States has a treaty. Therefore, the full branch profits tax rate applied in treaty shopping situations.<sup>75</sup>

Under the earlier Treaty, income from real estate investments made through corporations qualified as dividends or interest which were free of a second-level withholding tax. In addition, gains from the sale of real estate would qualify as profits, taxable only if they were attributable to the trade or business through a permanent establishment in the state. Section 884's treaty override provisions would have eliminated the proposed 1986 Treaty provisions favoring the Netherlands Antilles, because

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<sup>73</sup> 26 U.S.C. § 884(e)(Supp. IV 1987). Basically treating shopping exists unless (1) the foreign corporation enjoys the status of a "qualified resident" of the other contracting state or (2) the income tax treaty permits a secondary withholding tax on dividends paid by foreign corporations. *See also* Technical Corrections Bill, H.R. 2636, 100th Cong. 1st Sess., at § 112(o) [hereinafter Technical Corrections Bill].

<sup>74</sup> *But see* Notice 86-17, 1986-2 C.B. 379, Effect of Branch Profits Tax. The branch profits tax will not generally be imposed on (1) the complete termination of a foreign corporation's U.S. trade or business, (2) certain liquidations or reorganizations of a foreign corporation that has conducted a U.S. trade or business, or (3) § 351 incorporation of a foreign corporation's U.S. trade or business. This could ameliorate the impact of the branch profits tax on Netherlands Antilles and other foreign corporations. *See* Granwell Statement, *supra* note 4, at 42. *See also* Notice 87-56, 35 I.R.B. 9 (1987).

The Treaty as well as the 1986 Treaty provided that business profits of an enterprise of one of the treaty nations could not be taxed by the other state unless the enterprise carried on trade or business through a "permanent establishment" in the other contracting state. Treaty, *supra* note 1, art. III; 1986 Treaty, *supra* note 62, art. 7. The Internal Revenue Code calls for the tax to be imposed on profits or earnings "connected with the conduct of trade or business," 26 U.S.C. § 884(c), which is a much lower standard than permanent establishment. Presumably, the 1986 Treaty would have prevented such lesser activities (those which would not create a permanent establishment) from being subject to the branch profits tax. Hammer & Rohrer, *supra* note 72, at 6.

In addition, the nondiscrimination provisions in both treaties arguably precluded the imposition of a branch profits tax. Article XXV of the Treaty provides that the citizens and subjects of one treaty country residing in the other country shall not be subject to more burdensome taxes than the citizens and subjects of that country. The 1986 Treaty explicitly included permanent establishments in the nondiscrimination provision. Congressional Records indicate that a treaty with a nondiscrimination article using the "permanent establishment" language of the 1981 U.S. Model Income Tax Treaty, as well as of the 1986 Treaty, precludes the imposition of the branch profits tax. *See id.*

Finally, many commentators have opined that "older treaties may not prevent application of the branch level tax on profits . . . but such viewpoint would render the nondiscrimination provisions meaningless in a business profit context . . . [C]learly the intent [of the negotiators] was to encompass and prevent all discrimination including applications of a branch profits tax." *Id.*

<sup>75</sup> Hammer & Rohrer, *supra* note 72, at 11.

the typical Netherlands Antilles real estate corporation had no local ownership.<sup>76</sup>

Furthermore, while the 1986 Treaty specifically excepted real estate corporations owned by nonresidents from the "limitations on benefits" provision, the Technical Corrections Bill provides that the 1986 Act "would apply *notwithstanding* any treaty obligation of the United States in effect on the date of enactment unless otherwise specified."<sup>77</sup> In addition, both the Treasury Department and Congress viewed the nondiscrimination clause of the 1986 Treaty as inadequate to prevent the imposition of the branch profits tax.<sup>78</sup>

Through the 1986 Act, Congress clearly stated its position on international tax relations. It would tolerate only limited treaty shopping. It wanted an increased tax base and thus had expanded its extraterritorial taxing jurisdiction. Congress felt the "limitation of benefits" exceptions for real estate companies should override the 1986 Treaty. Moreover, Congress felt these exceptions should override any bilateral treaty that permitted third-party exploitation. In short, Congress favored a policy of strict tax compliance over a policy of freer capital movements between nations.

The United States had embarked on a firm unilateral approach to effectuating international tax policy. This approach would prove somewhat short-sighted, because it distanced treaty partners of the United States and further isolated the United States in an increasingly international financial and commercial system. On the other hand, the strong stance of the United States could only mean it would take further measures to tighten its tax policy, including possible abrogation of the Treaty. Investors in the Euromarkets were warned.

### III. ANALYSIS OF LEGAL PROBLEMS FOLLOWING THE TREATY'S TERMINATION

#### A. Legal Basis for Termination

The United States gave notice of termination on June 29, 1987,

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<sup>76</sup> Halphen, *Effect of the 1985-1986 U.S. Tax Reform Bill on Foreign Investments in U.S. Real Estate*, 40 BULL. FOR INT'L DOCUMENT'N 115, 122 (Mar. 1986).

<sup>77</sup> Technical Corrections Bill, *supra* note 72, at § 112(y)(2)(C) (emphasis added).

<sup>78</sup> Halphen, *supra* note 74, at 122, n.17. The House Committee Report said, "a branch level [or profits] tax does not fairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together not worse than United States corporations and shareholders. Therefore the Committee believes that permitting the branch tax to override conflicting treaties is not improper . . . ." *Id.*

which was legal under Article XXVII of the Treaty.<sup>79</sup> Article XXVII permitted either contracting party to give a notice of termination of all or part of the Treaty, with such notice taking effect on the first of January following the expiration of six months after such notice.<sup>80</sup> Hence, the Treasury Department had to act swiftly when it became clear in early June 1987 that negotiations with the Netherlands Antilles were floundering. Notice of Treaty termination had to be given by June 30, 1987, in order for the termination to take effect on January 1, 1988.<sup>81</sup> Any delay in giving notice would have meant prolonging the existence of the Treaty and its accompanying abuses for another year.

Not surprisingly, the Netherlands Antilles government objected to the Treaty termination, basing its complaints on the progress that had been made on the 1986 Treaty. It argued that, under the diplomatic notes of exchange which were issued at the signing of the 1986 Treaty, the United States had promised to restore a "balance of benefits" between the two governments.<sup>82</sup> Thus, by unilaterally abrogating the Treaty, the United States had reneged on this obligation. However, it is more realistic to view the 1986 Treaty as an interim draft document which both parties expected to be significantly altered by the 1986 tax legislation.<sup>83</sup> Therefore, the United States was not subject to a binding obligation to agree to specific amendments to the 1986 Treaty.<sup>84</sup>

Not only was the Treaty's termination justified, but the Treasury Department's subsequent modification of its notice of termination on July 10, 1987 was well-founded.<sup>85</sup> Past practices in this area justified the Department's reinstatement of Article VIII until January 1, 1988. Analysis of the modification of notice of termination involves two considera-

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<sup>79</sup> Granwell Statement, *supra* note 4, at 37-38.

<sup>80</sup> The United States and the Netherlands formally agreed in September 1987 that all provisions would terminate January 1, 1988, except for Article VIII and its ancillary provisions. *U.S., Netherlands Formally Agree to Partial Termination of Tax Pact Applying to Antilles*, DAILY REP. FOR EXECUTIVES (BNA) G-2 (Sept. 16, 1987).

<sup>81</sup> Art. XXVIII(3) states in relevant part, "At any time . . . either of the Contracting States may, by a written notice of termination . . . terminate the application of the present Convention to any . . . territory to which the Convention, or one of its provisions, has been extended. In that case the present Convention, the provisions thereof specified in the notice of termination, shall cease to be applicable. . . after the first day of January following the expiration of a period of six months after the date of such notice." Treaty, *supra* note 1, at art. XXVIII(3)

<sup>82</sup> Rosen, *supra* note 9.

<sup>83</sup> Communication From the Government of the Netherlands Antilles, 35 TAX NOTES 9 (available on Tax Notes microfiche data base Doc. No. 86 IWS 325).

<sup>84</sup> Nauheim & Jacobson, *Proposed United States-Netherlands Antilles Income Tax Treaty: New Opportunities for Foreign Investment in U.S. Real Estate*, 15 TAX MANAGEMENT INT'L J. 462, 468 (Dec. 12, 1986).

<sup>85</sup> *Id.*

tions: whether notice of termination could be withdrawn and whether part of the Treaty could be terminated. The Treaty did not specifically state that notice of termination could be withdrawn. However, in 1961, the State Department's Assistant Legal Adviser for Treaty Affairs had responded to a related inquiry, by stating that so long as a notice of termination had not yet resulted in the termination of an applicable treaty, such notice could be withdrawn.<sup>86</sup>

Moreover, the United States had withdrawn notice of termination of a treaty on two previous instances. On November 6, 1933, the United States gave notice of termination of an extradition treaty which it had signed with Greece in 1931.<sup>87</sup> Subsequently the United States withdrew the notice after the two countries signed a protocol concerning a disputed article of the treaty. Similarly, on November 15, 1965, the United States gave notice of termination of the 1929 Warsaw Convention, then withdrew the notice the day before a six-month notification period under the Warsaw Convention was to have expired.<sup>88</sup> In the case of the Treaty, the Treasury Department's withdrawal of its original notice of termination was justified, given that such withdrawal was made only a few days after the Department gave its initial notice and given the continued uproar in the Eurobond market.

The Treasury Department concluded that it was legal to terminate only part of the Treaty "as long as the withholding tax exemption for *all* interest was retained in the treaty."<sup>89</sup> Its reasoning may have been that the plain wording of the Treaty allowed selective termination of its provisions.<sup>90</sup> If articles of a treaty can be selectively terminated, it follows that notice of termination of an entire treaty can be selectively withdrawn.<sup>91</sup>

#### B. Examination of the Solution: Legislation and Partial Treaty Termination

The Treasury Department's announcement on July 2, 1987, that it would propose legislation to preserve the withholding tax exemption on pre-1984 bonds was intended to ease investor concerns.<sup>92</sup> However, the announcement proved insufficient to quell the unrest, because the fate of

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<sup>86</sup> *Id.*, *supra* note 9.

<sup>87</sup> MS. Department of State, File 371.700/10-2461. *See* Butler Letter, *supra* note 7.

<sup>88</sup> Butler Letter, *supra* note 7.

<sup>89</sup> *Treasury's Blunder in Paradise*, *supra* note 9 (emphasis added). Ironically, the proposed legislation sought to limit the tax exemption on interest to pre-1984 bonds. Article VIII was broader in scope. In fact, the scope of the exemption remains an area of uncertainty.

<sup>90</sup> Treaty, *supra* note 1, at Art. XXVIII(3).

<sup>91</sup> Butler Letter, *supra* note 7.

<sup>92</sup> Granwell Statement, *supra* note 4, at 48.

the legislation remained uncertain. If nothing else happened and the legislation was not enacted, it appeared fairly clear that the provisions allowing issuers to call in pre-1984 bonds would remain operable.<sup>93</sup> Therefore, the Treasury Department modified its termination by reinstating Article VIII.<sup>94</sup> Modification of the notice of termination removed the legal basis for issuers to exercise the redemption provisions of the Eurobonds.<sup>95</sup>

The goal of modifying the notice of termination was to assure investors of the United States government's commitment to preserve efficient access to all capital markets.<sup>96</sup> Modification and legislation<sup>97</sup> recognized that the legitimate expectations of issuers and holders had been disrupted and should be restored in order, not only to prevent further disruption if bonds were called in, but, more importantly, to decrease skepticism about investing in the United States in the future.<sup>98</sup>

Once Article VIII was reinstated, the legislation became desirable, because the exemption under Article VIII was broader than necessary to maintain the tax exempt status of the Eurobonds.<sup>99</sup> The legislation exempts the 30% withholding tax on interest paid to a Netherlands Antilles CFC not connected with United States business from sources within the United States.<sup>100</sup>

Those applicable CFCs include corporations in existence and incorporated in the Netherlands Antilles *at all times* between October 15, 1984, and the date of the interest payment. The legislation preserves the United States interest exemption on not only the pre-1984 bonds, but also Eurobonds issued between the June 1984 enactment and the promulgation of the implementing regulations in October 1984. In addition, an "applicable CFC" entitled to the benefits of the legislation shall not be treated as engaged in trade or business within the United States with respect to its qualifying interest if such CFC was not engaged in trade or

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<sup>93</sup> Treasury Moves Quickly on Eurobond Legislation as Hill Interest in Bill See Growing, 130 DAILY REP. FOR EXECUTIVES (BNA) G-6 (July 9, 1987).

<sup>94</sup> *Treasury Plan to Alter Antilles Treaty Is Expected to Calm Eurobond Market*, Wall St. J., July 13, 1987, at 4, col. 2.

<sup>95</sup> U.S. Modifies Antilles Plan to Keep Eurobonds Free of Tax Withholding, Offers Legislation, DAILY REP. FOR EXECUTIVES (BNA) G-2 (July 13, 1987).

<sup>96</sup> Letter from J. Roger Mentz to James C. Wright, 36 Tax Notes (July 10, 1987) (available in Tax Notes microfiche data base Doc. No. 87-4819).

<sup>97</sup> *Dutch Minister Warns*, *supra* note 12.

<sup>98</sup> *The Antilles Heel*, Wall St. J., July 15, 1987, at 28, col. 1.

<sup>99</sup> Chapoton Statement, *supra* note 25, at 20.

<sup>100</sup> SENATE BUDGET COMM. BILL ON THE PROPOSED OMNIBUS BUDGET RECONCILIATION ACT OF 1987, Title VI, Part I 433 subpart E, § 4541, Treatment of Certain Interest Income of Netherlands Antilles CFC's.

business within the United States through a permanent establishment on June 30, 1987.<sup>101</sup>

Several uncertainties regarding the scope and applicability of the legislation exist.<sup>102</sup> For example, the definition of "applicable CFC" raises some technical problems. Under current law, the principle purpose test of lending the proceeds of CFC obligations to affiliates is applied as of the time of "each interest payment". Under the legislation the principle purpose test is applied "at all times" since October 15, 1984. The effect of the difference in wording is that a more stringent standard applies under the legislation than under DEFRA. This different standard could prevent a Netherlands Antilles finance subsidiary from qualifying as an applicable CFC even in the case where the principle purpose test failed for only one day. A more practical approach would have been to parallel the provisions of the 1984 Act by requiring the principal purpose test to be met on each interest payment date.<sup>103</sup>

Another problem with the definition of "applicable CFC" is that few Netherlands Antilles finance subsidiaries issued CFC obligations after October 15, 1984, and their principle function has been the servicing of outstanding obligations. Limiting the principle purpose test to "issuing" might cause those companies which engaged in other financial activities after the 1984 Act to have their CFC obligations excluded from the present withholding tax exemption.<sup>104</sup> Given that part of the rationale for the 1984 grandfather provision was to maintain some continued protection for Netherlands Antilles finance subsidiaries who serviced pre-1984 bonds, the insertion of the word "servicing" would be consistent with the prior legislative intent.

### C. Revenue Rulings

In August 1987, the IRS came out with two rulings which dealt

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<sup>101</sup> Granwell Statement, *supra* note 4, at 49.

<sup>102</sup> Concerns were raised about the scope of the exercise of warrant provision and the rollover provision. In addition, some voiced a desire to have the legislation enable the parent to take over its subsidiary's debt or to increase the debt equity ratio requirements. Such decrease in the capital requirement would make new funds available for U.S. business. See J.C. Penney letter to the Treasury Department, 36 TAX NOTES (Sept. 7, 1987)(available on Tax Notes microfiche data base Doc. No. 87-5472). The problem with this proposal is that it ignores the economic consequences on the Netherlands Antilles financial services industry which the spirit of the 1984 Act sought to preserve. See *supra* notes 82-84 and accompanying text.

<sup>103</sup> Letter from Kenneth Klein of Cadwalader, Wickersham & Taft to the Treasury Department (Aug. 24, 1987)(regarding proposed Antilles Eurobond legislation: definition of "applicable CFC's") 36 TAX NOTES (September 7, 1987).

<sup>104</sup> Letter from General Motors Corp. to the Treasury Department, 36 TAX NOTES (Sept. 14, 1987).

with the United States tax consequences of the partial termination of the Treaty.<sup>105</sup> The combined effect of the two rulings was, first, to create certainty about the status of Eurobond holders after the partial termination, and second, to underscore the policy that treaty shopping will not be tolerated.

The first ruling, Revenue Ruling 87-79,<sup>106</sup> held that Article VIII would continue to apply after December 31, 1987, the last day that the rest of the Treaty would be effective, and that the Article VIII exemption would continue to be limited to situations in which Revenue Ruling 84-153 did not apply. Revenue Ruling 84-153 related to the loss of treaty benefits in the case of conduit loans.<sup>107</sup> It also stated that Revenue Ruling 84-163, which made Revenue Ruling 84-153 inapplicable to obligations issued prior to October 15, 1984, would continue to apply after 1987 to guarantee benefits of Article VIII to a United States corporation which paid interest to a Netherlands Antilles finance subsidiary. Finally, it confirmed that provisions of DEFRA, affording treaty protection to pre-1984 bonds and rollovers of these bonds, would remain fully applicable.

The second ruling, Revenue Ruling 87-80,<sup>108</sup> declared that a 1975 ruling<sup>109</sup> was obsolete, because of the 1986 Act's branch profits tax treaty override provision, and because of the partial termination of the Treaty. Article XII of the Treaty provided generally that dividends and interest paid by a Netherlands Antilles corporation to a recipient not a citizen or resident of the United States was exempt from United States tax. Revenue Ruling 75-23 held that such payments made by a Netherlands Antilles corporation that was a member of a partnership doing business in the United States were exempt from United States tax under Article XII. However, starting January 1, 1987, the branch profits tax override section took effect for treaty provisions, including Article XII of the Treaty, in those cases where the recipient or payer of payments was not a "qualified resident" of the treaty country. In addition, qualified residents of the Netherlands Antilles would be unable to claim the benefits of Article XII after it terminated on December 31, 1987. Therefore, the 1975 ruling was obsolete.

Even though the grandfather provision of DEFRA would not apply

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<sup>105</sup> *IRS Advance Announcement 87-76 Released Aug. 12, 1987*, 155 Daily Rep. For Executives (BNA) J-1 (Aug. 13, 1987).

<sup>106</sup> Rev. Rul. 87-79, 1987-35 I.R.B. 7.

<sup>107</sup> See *supra* notes 55-61 and accompanying text.

<sup>108</sup> Rev. Rul. 87-80, 1987-35 I.R.B. 5.

<sup>109</sup> Rev. Rul. 75-23, 1975-1 C.B. 290.



to them, Revenue Ruling 87-79 declared that conduit attack would not be applied to pre-1984 bonds. In other words, post-1987 payments of interest on Eurobonds issued between June 1984 and October 15, 1985 were grandfathered.<sup>110</sup> However, Revenue Ruling 87-80, reemphasized the interdiction of the use of a treaty-protected entity for treaty shopping purposes.<sup>111</sup>

#### IV. JUSTIFICATIONS FOR TERMINATION OF THE TREATY AND SPECULATIONS ABOUT THE FUTURE OF THE UNITED STATES AND THE NETHERLANDS ANTILLES WITHOUT A TREATY

##### A. Culmination of the Campaign Against Treaty Shopping

The preceding analysis of the development of the United States' stance against treaty shopping shows that, from a tax policy standpoint, the Treasury Department's decision to terminate the Treaty had merit. The decision was entirely consistent with various past policies of the United States that attempted to combat treaty shopping without canceling the Treaty. For eight years, the Treasury Department had tried to negotiate a more restrictive treaty with the Netherlands Antilles. A negotiated treaty would have been premised on the anti-treaty shopping criteria in the Model Income Tax Treaty. In addition, the negotiations were accompanied by increasingly hostile Congressional directives against treaty shopping and by stringent IRS revenue rulings. The stances of both the executive and legislative branches were intolerant of any treaty shopping. When measures such as restrictive revenue rulings, legislation, and narrowly constructed treaties proved ineffective, termination of the Treaty was the only remaining choice.

Nevertheless, the Treasury Department's notice of termination unnecessarily upset the international bond market. The Treasury Department did not consider the effect of its decision on the Eurobond market. That information would not have been difficult to assess if the Treasury Department had consulted its monetarists.<sup>112</sup> In addition, a simple examination of the history of the Treaty would have revealed the important role Eurobond investments should have played in any decision regarding the status of the Netherlands Antilles. The staggering amount of outstanding Eurobonds was a major reason for prolonging the use of indi-

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<sup>110</sup> Granwell Statement, *supra* note 4, at 51.

<sup>111</sup> *Id.* at 52.

<sup>112</sup> Rosen, *supra* note 9. "[H]ad the monetarists been apprised of the decision to terminate the Antilles treaty, they would have objected. By bypassing the monetarists, the deed was done." *Id.*

rect methods of fighting treaty shopping and for drawing out the treaty negotiations for eight years. Similarly, tax concessions which had been granted, for example, in DEFRA, as well as a general historical build-up of investor expectations regarding the viability of these investments,<sup>113</sup> should have alerted the Treasury Department to the expectation interests of investors, issuers, and the Netherlands Antilles.

The Treasury Department could have avoided upsetting the Eurobond by partially terminating the Treaty in the first place.<sup>114</sup> In doing so, it would not have contradicted with an established monetary policy which was carefully orchestrated to permit a free-flow of capital across borders, and whose primary purpose was to enable the Administration to borrow in foreign markets free of restrictions which might erode investor confidence.<sup>115</sup> Instead, the Treasury Department had to adopt reactionary measures to reestablish the interests in the Eurobond market which it never intended to disrupt. Such reactionary steps only served to further undermine investor confidence in United States investments.<sup>116</sup> The solution of partial termination and legislation still poses uncertainties as to the scope of investments which will be exempt from a withholding tax.<sup>117</sup> However, once the legislation is enacted, it should govern rather than Article VIII, because its promulgation is later in time than Article VIII and its content is more specific than Article VIII. Fi-

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<sup>113</sup> See Letter from René Jaquet, Vice Chairman, The Association of International Bond Dealers, to James C. Baker, III, Secretary of the Treasury (July 8, 1987) 36 TAX NOTES (August 10, 1987) (available on Tax Notes microfiche data base Doc. No. 87-4939). "Since 1963, U.S. corporations were encouraged to raise capital overseas and the accepted vehicle to do so was the Netherlands Antilles finance subsidiary. The markets concluded that the role played by such subsidiaries was entirely consistent with U.S. government policy. In consequence, the markets absorbed larger and larger amounts of debt issued by the Netherlands Antilles subsidiaries of U.S. corporations." *Id.* If this is true then the markets are not necessarily an accurate reflection of United States policy, for DEFRA sent a very clear message that only certain debt obligation issued by Netherlands Antilles finance subsidiaries were condoned.

<sup>114</sup> Apparently, the Treasury Department looked into the possibility of partial termination early in 1987, and concluded that it would not be legal. However, the investigation never reached the upper decisionmaking levels of the Department. Rosen, *supra* note 9. The Article comments that cynics say the partial termination became legal only because the Treasury Department was forced to do it. *Id.*

<sup>115</sup> *Id.*

<sup>116</sup> See *supra* notes 9-11.

<sup>117</sup> The Dutch view Article VIII of the 1986 Treaty as fully effective and not limited to Eurobonds (to which the U.S. legislation limits the exemption). The position is based on the exchange of notes between the U.S. and the Netherlands Antilles in which representatives of both governments indicated that neither government intended to terminate Article VIII and its ancillary provisions. *Dutch Believe Article VIII of Partially Terminated U.S. Netherlands Antilles Tax Treaty Is Fully Operable*, 37 TAX NOTES (Feb. 8, 1988).

nally, the Treasury Department's handling of the Netherlands Antilles incident undermined United States credibility as a treaty partner.

### B. Foreign Policy Aspects

The United States unilateral termination of the Treaty is one of several recent unilateral steps taken with regard to foreign affairs. The cumulative effect of these measures has been to weaken the United States position in international affairs. The override provision in the 1986 Act branch profits tax and the even more stringent override provision in the Technical Corrections Bill are signals to both existing or potential treaty partners that treaty agreements are secondary to Congressional acts.<sup>118</sup> In addition, the pending trade bill<sup>119</sup> is unilateral in spirit, and has the European Community worried that "everything is done unilaterally."<sup>120</sup> Such unilateral behavior is the antithesis of successful foreign relations.

The United States, in the long run, can only hurt itself by showing a disdain for international solutions to problems. For example, with respect to the Netherlands Antilles, without a tax treaty the United States gives up its legal basis for tax cooperation with the Netherlands Antilles government.<sup>121</sup> The United States now could be at a disadvantage in administering tax compliance procedures in the Netherlands Antilles. Termination of the Treaty and its negative impact<sup>122</sup> on the Netherlands Antilles economy will only make the Netherlands Antilles less cooperative in the future.<sup>123</sup>

With the termination of the Treaty, the United States hopefully has

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<sup>118</sup> While this phenomena is perfectly legal and not a new consideration for treaty partners, in practice Congress does not explicitly override treaties. Treaty override appears to be a greater infringement on executive treaty-making power than merely having the Senate role in the treaty-making process.

<sup>119</sup> Under the bill, opportunities for companies to bring trade actions to the Administration would be expanded, and the President's authority to decide not to act on these would be restricted. *Dutch Minister Warns*, *supra* note 12.

<sup>120</sup> *Dutch Minister Warns*, *supra* note 12.

<sup>121</sup> Statement of Bruce Zagaris Before the Subcommittee on Commerce, Consumer and Monetary Affairs of the Committee on Government Operations, 36 TAX NOTES (Sept. 21, 1987)(available on Tax Notes microfiche data base Doc. No. 87-5917).

<sup>122</sup> One of the major blows to the Netherlands Antilles economy without the treaty will be to real estate investment companies which will be subject to the branch level tax. These companies probably will be reorganized to avoid the tax. See CURAÇAO INTERNATIONAL TRUST COMPANY N.V., NEWSLETTER (August 8, 1987)(available in the offices of NW. J. INT'L L. & BUS.). The Netherlands Antilles has also amended its tax laws in order to secure the tax-exempt status of Netherlands Antilles firms holding direct or indirect foreign real property interests. This legislation is designed to provide a continuation of the benefits of Article V of the Treaty. Turro, *Netherlands Antilles Legislation to Ameliorate U.S. Tax Treaty Termination*, 36 TAX NOTES (Nov. 23, 1987).

<sup>123</sup> Turro, *id.*

ended its long battle against treaty shopping. Winning the battle has not been without costs. Furthermore, these costs could have been reduced with more prudent planning and an ear to other interests at stake. With every battle, there are lessons to be learned. Adoption of the lessons from the Netherlands Antilles incident would make for a less disruptive tax policy in the future.

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