Internal Revenue Service

Number: **200551016**
Release Date: 12/23/2005
Index Number: 9114.03-27

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:INTL:BR1
PLR-134998-05
Date:
September 20, 2005

Legend

Company =
Parent =
Subsidiary =
Country A =
State B =
Date C =
Date D =
Date E =
Date F =
Amount G =

Dear

This is in response to your letter dated Date C, as supplemented by letters dated Date D and Date E, requesting a ruling on behalf of Company under Article 26 (Limitation on Benefits) of the U.S.-Netherlands income tax treaty ("Treaty") that the term "gross income" for purposes of the base erosion test in paragraph 3(b) includes U.S.-source dividends that are exempt from corporate income tax in the Netherlands under a participation exemption regime.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Company, a Netherlands holding company, is seeking the benefits of Article 10 (Dividends) of the Treaty with respect to dividends to be received from Subsidiary, a State B corporation and Company's U.S. subsidiary. Company is an indirect, wholly owned subsidiary of Parent, a publicly traded Country A company. Company represents that it will qualify for treaty benefits under the derivative benefits test contained in Article 26(3) of the Treaty if the dividends to be received from Subsidiary in the amount of Amount G are included in "gross income" for purposes of determining whether Company satisfies the base erosion prong of that test in Article 26(3)(b). The issue arises because Company's shareholding in Subsidiary qualifies for the participation exemption regime in the Netherlands, under which dividends are exempt from corporate income tax. Company's eligibility for the participation exemption was confirmed in an advance transfer ruling settlement agreement between Company and the Netherlands tax authorities dated Date F.

The derivative benefits test in Article 26(3) of the Treaty generally entitles a resident of a contracting state to treaty benefits if the owner of the resident would have been entitled to the same benefit had the income in question flowed directly to that owner. Article 26(3) provides as follows:

> Notwithstanding that a company that is a resident of a State may not be a qualified person, it shall be entitled to all the benefits of this Convention otherwise accorded to residents of a State with respect to an item of income if it satisfies any other specified conditions for the obtaining of such benefits and:
>
> > a) shares representing at least 95 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) of the company are owned, directly or indirectly, by seven or fewer persons who are equivalent beneficiaries; and
> >
> > b) less than 50 percent of the company's gross income for the taxable year in which the item of income arises is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments that are deductible for the purposes of the taxes covered by this Convention in the State of which the company is a resident (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank, provided that where such a bank is not a resident of a State such payment is attributable to a permanent establishment of that bank located in one of the States).

The term "equivalent beneficiaries" used in Article 26(3) is defined in Article 26(8) of the Treaty and generally includes residents of each contracting state and residents of countries that are members of the European Union or parties to the North American Free Trade Agreement. To qualify as an equivalent beneficiary with respect to dividends, interest, royalties, or branch tax, a resident of a third country must be entitled to a rate of withholding tax under a treaty between the third country and the source country that is at least as low as the withholding tax rate that would apply to such income under the Treaty.

The Memorandum of Understanding ("MOU") that accompanied the March 8, 2004, Protocol amending Article 26 of the Treaty defines the term "gross income" for purposes of Article 26. Paragraph XV of the MOU provides:

> It is understood that the term "gross income" means the total revenues derived by a resident of a State from its principal operations, less the direct costs of obtaining such revenues.

The Treasury Department Technical Explanation of the Protocol states that a company satisfies the base erosion test in Article 26(3)(b)

> if less than 50 percent of its gross income for the taxable period is paid or accrued, directly or indirectly, to a person or persons who are not equivalent beneficiaries in the form of payments deductible for tax purposes in company's State of residence. This test is the same as the base erosion test in clause (ii) of subparagraph (f) of paragraph 2, except that deductible payments made to equivalent beneficiaries, rather than amounts paid to residents of a Contracting State, are not counted against a company for purposes of determining whether the company exceeded the 50 percent limit.

The reference to subparagraph (f) of paragraph (2) refers to an alternative safe harbor under Article 26 known as ownership/base erosion. The Technical Explanation describes the base erosion test contained in Article 26(2)(f)(ii) as follows:

> The base erosion prong of clause (ii) of subparagraph (f) is not satisfied with respect to a person if 50 percent or more of the person's gross income for the taxable year is paid or accrued to a person or persons who are not residents of either Contracting State, in the form of payments deductible for tax purposes in the payer's State of residence. For this purpose, Paragraph XV of the Understanding states that the term "gross income" means total revenues derived by a resident of a Contracting State from its principal operations, less the direct costs of obtaining such revenues. In the case of the United States, the term "gross income" has the same meaning as such term in section 61 of the Code and the regulations thereunder.
>
> To the extent they are deductible from the taxable base, trust distributions are deductible payments. However, depreciation and amortization deductions, which do not represent payments or accruals to

> other persons, are disregarded for this purpose. Deductible payments also do not include arm's length payments in the ordinary course of business for services or tangible property or with respect to financial obligations to banks that are residents of either Contracting State or that have a permanent establishment in either Contracting State to which the payment is attributable.

The Joint Committee on Taxation Explanation of the Protocol contains an overview of Netherlands tax law, including a summary of the participation exemption:

> The Companies Income Tax Act provides for a participation exemption, which is applicable to both domestic and foreign shareholdings. Corporate tax need not be paid on the profits generated by the participation. The exemption allows for the avoidance of double taxation when the profits of a subsidiary are distributed to its parent company. A participation exists if the taxpayer (1) holds at least five percent of the nominal paid-up capital of a company, or (2) holds less than five percent, but ownership of the shares is necessary for the conduct of normal business, or the acquisition of the shares serves a general interest. All profits gained from shareholdings are exempt from taxation unless shares in a foreign corporation are held as an investment or the foreign company in which the shares are held is not subject to tax on its profits in the foreign country. A 25 percent withholding tax is imposed on dividends from corporations resident in the Netherlands, unless the participation exemption applies. Dividends received from a qualifying subsidiary company are exempt from tax in the hands of the parent company. Similarly, capital gains realized on the disposition of shares of such a subsidiary company are exempt.

For purposes of Article 26 of the Treaty, paragraph XV of the MOU sets forth the meaning of the term "gross income." Based on the representations made in this case, we conclude that the dividends Company expects to receive from Subsidiary are part of the total revenues derived by Company from its principal operations, notwithstanding that the dividends are exempt from corporate income tax in the Netherlands under a participation exemption regime. Accordingly, Company should include the amount of the dividends in "gross income" for purposes of applying the base erosion test under Article 26(3)(b).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to Company's representative.

Sincerely,

Elizabeth U. Karzon
Chief, Branch 1
Office of Associate Chief Counsel
(International)

cc: