

Anti-Deferral and Anti-Tax Avoidance

By Michael J. Miller

When Derivative Benefits and Zero Withholding on Dividends Collide: Are Any Treaty Benefits Available?*



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A number of U.S. income tax treaties include a “derivative benefits” provision that allows a corporation that does not otherwise satisfy the requirements of the treaty’s Limitation on Benefits (LOB) article to qualify for the treaty benefits if, among other requirements, substantially all of the corporation’s shares are owned by seven or fewer “equivalent beneficiaries.” Where derivative treaty benefits are sought for dividends, interesting problems arise if the corporation seeking such treaty access would be entitled to zero withholding (if it qualified for treaty benefits) but the would-be equivalent beneficiary is not. The language of the applicable treaty provisions would appear to deny treaty benefits in this situation; but, as discussed below, appearances may be deceiving.

Overview of Limitation on Benefits Article

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

The LOB article is premised upon the view that a resident of a Contracting State must have some connection to that country beyond mere residence in order to benefit from that country’s income tax treaty with the United States. Thus, the LOB article limits the



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ability of third-country residents to engage in “treaty shopping” by establishing legal entities in either the United States or a foreign country to obtain the benefits of a U.S. income tax treaty.

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

Derivative Benefits Test

Pursuant to the derivative benefits test, a company that does not satisfy any of the other LOB tests may nevertheless qualify for treaty benefits if, among other requirements, a specified percentage (typically 95 percent) of its shares is owned by seven or fewer “equivalent beneficiaries” and a base erosion test is satisfied.² An “equivalent beneficiary” generally means any person that:

- is a resident of a member state of the EU, any state of the European Economic Area, a party to NAFTA, or, in some cases, Switzerland (each, a “Qualifying Country”);
- is entitled to the benefits of a comprehensive income tax treaty between such Qualifying Country and the Contracting State from which treaty benefits are claimed and satisfies certain LOB requirements (even if that treaty has no LOB article); and
- in the case of dividends, interest, royalties, and possibly certain other items, would be entitled, under the treaty between the Qualifying Country and the Contracting State in which the income arises, to a rate of tax with respect to the particular class³ of income for which benefits are claimed that is “at least as low as” the rate provided for under the treaty between the Contracting States.

The treaty language setting for the “at least as low as” requirement appears fairly straightforward. For example, the 2001 U.S.-U.K. Income Tax Treaty (the “U.K. Treaty”) provides that a would-be equivalent beneficiary entitled to the benefits of a comprehensive

U.S. income tax treaty will satisfy such requirement only if such person “with respect to income referred to in Article 10 (Dividends), 11 (Interest) or 12 (Royalties) of this Convention, would be entitled under such convention to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention[.]”⁴

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

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

The true import of the “at least as low as” requirement is demonstrated by the following example:

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

Unfortunately, Y is not an equivalent beneficiary, because Y would be subject to U.S. withholding tax at a 15-percent rate under the Italian treaty,⁵ which is not as low as the zero-percent rate available to a qualified resident of the United Kingdom. The result is that X’s interest income is subject to U.S. withholding tax at a 30-percent rate. Once Y fails to qualify as an equivalent beneficiary, X cannot satisfy the derivative benefits test, and thus does not qualify for treaty benefits, with respect to its interest income.⁶

The complete denial of treaty benefits in such circumstances clearly seems inappropriate, since Y would have been entitled to a reduced withholding rate of 15 percent if it had earned the interest income directly, and there is no compelling reason to disallow the reduced withholding rate where Y indirectly earns such income through X. Reducing the withholding tax to 15 percent instead of eliminating such tax entirely should be sufficient to eliminate any potential treaty abuse.

Unfortunately, the “at least as low as” requirement is not designed for, and does not accomplish, such fine-tuning. Rather, that requirement merely “turns off” treaty benefits where the withholding rate that would have been available to the would-be equivalent beneficiary for the relevant class of income is too high.

Of course, it would not be particularly difficult to construct a rule that reaches more appropriate results. For example, in lieu of the “at least as low as” requirement, treaty abuse might be avoided by reducing the withholding rate to the highest rate allowed to any equivalent beneficiary under its own income tax treaty with the Contracting State in which the income arises.⁷ Whatever the merits of such approach, however, it is not reflected in the “at least as low as” requirement.

Interaction of Derivative Benefits with Zero Withholding on Dividends

Similar issues can arise if a foreign corporation attempts to qualify for derivative benefits for dividends, particularly if zero withholding is involved.

U.K. Treaty

The Technical Explanation to the U.K. Treaty sets the table with the following example:

USCo is a wholly owned subsidiary of UKCo, a company resident in the United Kingdom. UKCo is wholly owned by FCo, a corporation resident in France. Assuming UKCo satisfies the require-

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

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

Interestingly, and perhaps surprisingly, the example concludes that the French company “is

not an equivalent beneficiary ... *with respect to zero rate of withholding tax on dividends.*”⁸ The implication, it seems, is that FCo might be treated as an equivalent beneficiary as to some other rate of withholding on dividends. Without more, however, a prudent tax advisor would find it difficult to conclude that a would-be equivalent beneficiary subject to a five-percent withholding tax on dividends from U.S. subsidiaries under the French treaty is entitled to “a rate of tax ... that is at least as low as the rate applicable under [the U.K. Treaty].”

The Technical Explanation contains the following additional example that fulfills the promise of the example above:

A U.K. resident company, Y, owns all of the shares in a U.S. resident company, Z. Y is wholly owned by X, a German resident company that would not qualify for all of the benefits of the U.S.-Germany income tax treaty but may qualify for benefits with respect to certain items of income under

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the “active trade or business” test of the U.S.-Germany treaty. X, in turn, is wholly owned by W, a French resident company that is substantially and regularly traded on the Paris Stock Exchange. Z pays a dividend to Y. Y qualifies for benefits under paragraph 3 of Article 23, assuming that the requirements of subparagraph 3(b) of Article 23 are met. Y is directly owned by X, which is not an equivalent beneficiary within the meaning of subparagraph 7(d)(i) of Article 23 (X does not qualify for all of the benefits of the U.S.-Germany tax treaty). However, Y is also indirectly owned by W and W may be an equivalent beneficiary. Y would not be entitled to the zero rate of withholding tax on dividends available under the Convention because W is not an equivalent beneficiary with respect to the zero rate of withholding tax since W is not eligible for such rate under the U.S.-France income tax treaty. *W qualifies as an equivalent beneficiary with respect to the 5 percent maximum rate of withholding tax because (a) it is a French resident company whose shares are substantially and regularly traded on a recognized stock exchange, within the meaning of the Limitation on Benefits Article of the U.S.-France income tax treaty and (b) the dividend withholding rate in the treaty between the United States and France is 5 percent. Accordingly, U.S. withholding tax on the dividend from Z to Y will be imposed at a rate of 5 percent in accordance with subparagraph 2(a) of Article 10.*⁹

The example concludes that W, the French company, qualifies as an equivalent beneficiary with respect to the five-percent rate of withholding tax, even though it is not entitled to the zero withholding rate to which Y, the U.K. company, would have been entitled if it qualified for treaty benefits.¹⁰ The example does not attempt to explain how the “at least as low as” requirement was determined to be satisfied.

Dutch Treaty

The U.K. Treaty is not alone in taking such a generous view of the “at least as low as” requirement. The following example is part of a Memorandum of

Understanding (the “Dutch MOU”) agreed to by the United States and the Netherlands in connection with the 2004 Dutch Protocol:

A Netherlands resident company, Y, owns all of the shares in a U.S. resident company, Z. Y is wholly owned by X, a U.K. resident company that would not qualify for all of the benefits of the U.S.-U.K. income tax treaty but may qualify for benefits with respect to certain items of income under the “active trade or business” test of the U.S.-U.K. treaty. X, in turn, is wholly owned by W, a French resident-company that is substantially and regularly traded on the Paris Stock Exchange. Z pays a dividend to Y. For purposes of this example, assume that Y does not qualify for benefits

under paragraph 2 of Article 26 (Limitation on Benefits). Y does qualify for benefits under paragraph 3 of Article 26, however, assuming that the requirements of subparagraph 3 b) of Article 26 are met. Y is directly owned by X, which is

not an equivalent beneficiary within the meaning of subparagraph 8 f) of Article 26 (X does not qualify for all of the benefits of the U.S.-U.K. tax treaty). However, *Y is also indirectly owned by W, which is an equivalent beneficiary for purposes of the benefits provided by paragraph 2 a) of Article 10 within the meaning of subparagraph 8 f) of Article 26 (because W is a French resident company whose shares are substantially and regularly traded on a recognized stock exchange, within the meaning of the Limitation on Benefits Article of the U.S.-France income tax treaty). Accordingly, U.S. withholding tax on the dividend from Z to Y will be imposed at a rate of 5% in accordance with subparagraph 2 a) of Article 10.*¹¹

Much like the second above-described example from the Technical Explanation to the U.K. Treaty, this example from the Dutch MOU concludes that W is an equivalent beneficiary with respect to the five-percent withholding rate.¹²

The example in the Dutch MOU does not expressly state that Y satisfies the requirements for zero withholding. Nevertheless, it seems unlikely that the IRS could successfully contend that the favorable con-

From a policy perspective, it might seem that the “at least as low as” requirement should have the same meaning in each treaty in which such requirement appears.

clusion of such example applies only if Y does *not* qualify for zero withholding.¹³ Although a bit more clarity would have been nice, the Dutch MOU plainly stands for the proposition that a corporation may be entitled to withholding on dividends at a five-percent rate under the derivative benefits provision of the Dutch treaty if the equivalent beneficiary qualifies for such rate, regardless of whether the corporation claiming such treaty benefits would (if it were a qualified resident) qualify for zero withholding.

Reconciling the Examples with the Treaty Language

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

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

Thus, the rate that must be compared with the rate available to the would-be equivalent beneficiary is the rate “applicable” to the relevant class of income under the U.K. Treaty. Arguably, the rate that is “applicable” under the U.K. Treaty is the rate of tax available under whatever article, paragraph, subparagraph, or other provision of such treaty that the taxpayer chooses to invoke. Under this approach, five percent would be the “applicable” rate for purposes of applying the “at least as low as” requirement, provided that the taxpayer claims a five-percent withholding rate under Article 10(2)(a), rather than a zero-percent rate under Article 10(3).¹⁴

It requires somewhat more effort to reconcile this conclusion with the portion of the U.K. Technical Explanation providing that “the rates to be compared are: (1) the rate of withholding tax that the source State would have imposed if a qualified resident of the other Contracting State was the beneficial owner of the income; and (2) the rate of withholding tax that the source State would have imposed if the third State resident received the income directly

from the source State.”¹⁵ If the hypothetical qualified resident referred to in clause (1) above qualifies for, and claims, zero withholding, then the “at least as likely as” requirement would not be satisfied. It may be argued, however, that such hypothetical qualified resident should be assumed not to claim a lower rate of withholding tax than that actually claimed by the taxpayer. That assumption does not exactly “jump out” from the language of the Technical Explanation, but it seems as plausible as any other explanation for the Treasury's apparent conclusion that the “at least as low as” requirement is satisfied.

Ability of Taxpayers to Rely on the Examples

Dutch corporations that wish to claim a reduced rate of U.S. withholding tax under the Dutch treaty in circumstances comparable to those of the example in the Dutch MOU should be able to rely on that example, which represents a part of the agreement between the United States and the Netherlands. Presumably, the United States would not attempt to renege on that agreement; and even if it did, it is highly unlikely that a court would allow it.

U.K. corporations that wish to claim a reduced withholding rate in comparable circumstances may be on somewhat less solid ground, since the favorable example under the U.K. Treaty is set forth in the Technical Explanation, rather than an MOU. The Technical Explanation does not represent an agreement between the two parties to the treaty, and there is some question as to whether favorable language in a Technical Explanation would be binding on the government if a court determined such language to be contrary to the treaty that it purports to explain.¹⁶ It seems likely that a court would attempt to reconcile the two—possibly in the manner described above—but the language of the treaty may still make some taxpayers, and their tax advisors, a bit nervous, notwithstanding the favorable Technical Explanation.

The government may find it easier to deny derivative benefits in the case of the 2005 Swedish Protocol. As shown below, the Technical Explanation to the 2005 Swedish Protocol includes the following example:

USCo is a wholly owned subsidiary of SCo, a company resident in Sweden. SCo is wholly owned by ICo, a corporation resident in Italy. Assuming SCo satisfies the requirements of paragraph 3 of Article 10 (Dividends), SCo would be eligible for the elimination of dividend with-

holding tax. The dividend withholding tax rate in the treaty between the United States and Italy is 5 percent. Thus, if ICo received the dividend directly from USCo, ICo would have been subject to a 5 percent rate of withholding tax on the dividend. Because ICo would not be entitled to a rate of withholding tax that is at least as low as the rate that would apply under the Convention to such income (*i.e.*, zero), ICo is not an equivalent beneficiary within the meaning of paragraph 7(g) (i) of Article 17 with respect to the elimination of withholding tax on dividends.

The example concludes that ICo “is not an equivalent beneficiary ... *with respect to the elimination of withholding tax on dividends.*”¹⁷ The example does not, however, say that W is an equivalent beneficiary with respect to the five-percent rate; nor is there any other example that so provides. In light of the examples set forth in connection with the U.K. and Dutch treaties, it certainly is plausible that this was an oversight, and that the Treasury intends to allow the five-percent rate under the Swedish treaty as well; but nothing in the Technical Explanation clearly says so. A cautious taxpayer, or tax advisor, may be less comfortable under the Swedish treaty than under the U.K. or Dutch treaties.

Moreover, as of August 2007, a number of pending treaties with similar derivative benefits provisions, including the “at least as low as” requirement, do not yet have any Technical Explanations. The level of comfort available to taxpayers who wish to access derivative benefits under those treaties will depend in significant part upon the specific language set forth in the Technical Explanations (or other guidance) to those treaties.

From a policy perspective, it might seem that the “at least as low as” requirement should have the same meaning in each treaty in which such requirement appears.¹⁸ Therefore, a reasonable person might assume that the generous interpretation that unquestionably appears in the Dutch MOU (and

the U.K. Technical Explanation) should also apply for purposes of all comparable derivative benefits provisions. However, the IRS has at times resisted the notion that the same words must have the same meaning from treaty to treaty.

For example, notwithstanding that some treaties expressly limit the term “pension” to “periodic payments,”¹⁹ the IRS generally allows treaty benefits for lump-sum payments under the pension article. In a 2002 private letter ruling, however, the IRS indicated that if the other party to the applicable treaty does not consider lump-sum payments to qualify, the IRS will similarly disallow treaty benefits for lump-sum payments.²⁰

Clearly, the IRS feels that the term “periodic” may mean one thing for purposes of one treaty and something entirely different for purposes of another treaty. Therefore, if one of our treaty partners interprets the “at least as low as” requirement to disallow a reduced rate of dividend withholding tax where the corporation receiving the dividend could qualify for a lower withholding rate than its would-be equivalent beneficiary, the IRS might well take the same view for purposes of the treaty with that treaty partner.

Conclusion

As discussed above, the Treasury clearly seems inclined to allow derivative treaty benefits to corporations that satisfy the requirements for zero withholding on dividends, even if their equivalent beneficiaries would only be entitled to a five-percent withholding rate.²¹ In the future, however, the Treasury may change its policy entirely or, alternatively, may condition its favorable interpretation on reciprocity by the other Contracting State. Accordingly, notwithstanding the Treasury's current policy, taxpayers and their tax advisors may have difficulty getting comfortable that they can claim a reduced withholding rate where the “zero withholding problem” arises. It would be most helpful if the IRS and the Treasury issued guidance providing taxpayers with clear comfort on this issue.

ENDNOTES

* The author gratefully acknowledges the assistance of his colleague, Nathan K. Tasso, in the preparation of this column.

¹ There are a few older U.S. income tax treaties that do not contain LOB articles, including most notably the 1979 U.S.-Hungary Income Tax Treaty. For a detailed discussion of planning opportunities involving older

treaties without LOB articles, see Jeffrey L. Rubinger, *Tax Planning With U.S. Income Tax Treaties Without LOB Provisions*, 36 TAX MGMT. INT'L J. 3 (Mar. 9, 2007).

² Historically, relatively few LOB articles in U.S. income tax treaties have included a derivative benefits test. More recently, however, derivative benefits tests have become

far more common, but only in the case of treaties with EU countries. For example, such a test is included in the 2001 U.S.-U.K. Income Tax Treaty, the 2004 Protocol to the 1992 U.S.-Netherlands Income Tax Treaty (the “2004 Dutch Protocol”), 2005 Protocol to the 1994 U.S.-Sweden Income Tax Treaty (the “2005 Swedish Protocol”), pending

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- 2006 Protocol to the 1989 U.S.-Germany Income Tax Treaty (“Pending German Protocol”), pending 2006 Protocol to the 1999 U.S.-Denmark Income Tax Treaty (“Pending Danish Protocol”), pending 2006 protocol to the 1989 U.S.-Finland Income Tax Treaty (“Pending Finnish Protocol”), pending 2006 U.S.-Belgium Income Tax Treaty (“Pending Belgian Treaty”), and pending 2007 U.S.-Bulgaria Income Tax Treaty (“Pending Bulgarian Treaty”).
- ³ Some treaties, such as the 2005 Swedish Protocol and the Pending Belgian Treaty, refer to the “item of income” rather than the “particular class of income” for which benefits are claimed.
- ⁴ Art. 23(7)(d)(i)(B) (emphasis added). The language under the 1992 U.S.-Netherlands Income Tax Treaty, as modified by the 2004 Dutch Protocol, is substantially identical, except that the “at least as low as” requirement of that treaty also applies for purposes of the branch profits tax. Art. 26(8)(f)(i)(B).
- ⁵ Art. 11(2). Assume that Article 11(3) of that treaty, which provides a complete exemption in certain limited circumstances, does not apply.
- ⁶ This conclusion assumes that the U.S. competent authority has not provided a discretionary grant of treaty benefits.
- ⁷ A somewhat more generous, and more complicated, alternative would allow treaty benefits at a “blended” rate so that the total amount withheld equals the amount that would have been withheld if each equivalent beneficiary had received its proportionate share of the income received by the corporation claiming treaty benefits. For example, if an equivalent beneficiary entitled to a zero-percent withholding rate owned one-third of the stock of the corporation and an equivalent beneficiary entitled to a 15-percent withholding rate owned the other two-thirds, the “blended” rate would be 10 percent. $(0\% * 1/3) + (15\% * 2/3) = 0\% + 10\% = 10\%$.
- ⁸ Emphasis added.
- ⁹ Emphasis added.
- ¹⁰ Although the example could have been written more clearly, it is obvious that Y satisfies the requirements for zero withholding. The example states that “Y would not be entitled to the zero rate of withholding tax on dividends available under the Convention *because W is not an equivalent beneficiary with respect to the zero rate of withholding tax since W is not eligible for such rate under the U.S.-France income tax treaty.*” (Emphasis added.) Thus, the example makes it clear that zero withholding is unavailable solely due to the lack of a suitable equivalent beneficiary.
- ¹¹ Emphasis added.
- ¹² The Technical Explanation to the 2004 Dutch Protocol also includes an example similar to the first above-described example from the Technical Explanation to the U.K. Treaty. In this example, a U.S. corporation is wholly owned by a Dutch corporation that would satisfy all of the requirements for zero withholding under the applicable Dutch treaty. The Dutch corporation is in turn owned by an Italian corporation that would only be entitled to a five-percent withholding rate under the applicable Italian treaty. The example concludes that the Italian corporation “is not an equivalent beneficiary ... with respect to the elimination of withholding tax on dividends.” The apparent implication of such language is that the Italian corporation might be an equivalent beneficiary with respect to some other withholding rate, but this is not expressly stated.
- ¹³ Inasmuch as the example indicates that Y owns 100 percent of the stock of Z, it seems inconceivable that the drafter of the example would have assumed Y not to satisfy the requirements for zero withholding.
- ¹⁴ Substantially the same argument may be made with respect to the Dutch MOU.
- ¹⁵ With regard to the latter requirement, it appears to be clear that such third State resident is considered to hold the voting power in the dividend-paying company as the company actually receiving the dividend.
- ¹⁶ For a discussion of this issue, see Philip D. Morrison, *When a Helpful TE Provision Arguably Conflicts with a Treaty*, TAX MGMT. INT’L J. (June 9, 2007).
- ¹⁷ Emphasis added. This example is similar to the first example described above from the U.K. Technical Explanation and the comparable example from the Dutch Technical Explanation.
- ¹⁸ Assuming, of course, that no material difference in language suggests a different meaning was intended.
- ¹⁹ See, e.g., 1971 U.S.-Norway Income Tax Treaty, Art. 18(4)(a); 1975 U.S.-Iceland Income Tax Treaty, Art. 24(3); 1982 U.S.-Australia Income Tax Treaty, Art. 18(4).
- ²⁰ See LTR 200209026 (Nov. 29, 2001). Notably, the IRS’s focus on reciprocity is fairly new. For a number of years, the IRS simply took the view that lump-sum payments may qualify as periodic without looking to the view of the other party to the applicable treaty. See, e.g., LTR 8901053 (Oct. 13, 1988), LTR 8904035 (Oct. 31, 1988) and LTR 9041041 (July 13, 1990).
- ²¹ Pursuant to such grant of derivative treaty benefits, the withholding rate would be five percent.

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