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BILATERAL TAX TREATIES AND PROTOCOL

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C O N T E N T S

APPENDIX

BILATERAL TAX TREATIES AND PROTOCOL

TUESDAY, OCTOBER 7, 1997

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The committee met, pursuant to notice, at 3:15 p.m., in room SD–419, Dirksen Senate Office Building, Hon. Chuck Hagel presiding.

Senator HAGEL. Good afternoon, and welcome.

Before we get started this afternoon, I would like to thank the panelists for taking part in this important discussion on bilateral international income tax treaties. Thank you.

This is an issue that is vital to our economic growth not only today but, as you all know, for the future. The main purposes of these treaties are to prevent international double taxation and tax evasion.

No one wants to be double taxed on their hard-earned income. They have a hard enough time here in the United States, dealing with unfair, complicated and restrictive tax codes. The last thing we need to do is subject our businesses and people to move taxation. These treaties accomplish that by setting down rules to determine whether the income source country or the resident's country will have the primary right to tax income, restricting the ability of the source income country to tax and reducing withholding tax rates on cross-border payments of interests, dividends and royalties.

Also these treaties grant the procedural authority to each country to agree to provide tax relief for a particular taxpayer who can establish that he is being taxed in a manner inconsistent with the treaties. Tax evasion is also dealt with under these treaties. The treaties put limitations on benefits, so that benefits are denied to unintended beneficiaries.

If we are to provide a level playing field in this global economy, everyone must be following the same rules. Unfortunately, in many areas of the world, U.S. companies are at a disadvantage compared to many of their European competitors. Today, the United States has income tax treaties in force with 46 countries worldwide, while the United Kingdom, for example, has 98, and France has 94. In fact, the average G–7 country has 67 income tax treaties in effect today.

In front of the Foreign Relations Committee today, we have seven treaties and one protocol to amend an existing treaty with Canada. Of the seven treaties, three are with new countries: South Africa, Thailand and Turkey. These three treaties are particularly important, as they may serve as examples for expanding our tax treaties with other new and developing countries in East Asia, Central Asia and Africa.

The other four treaties are also important, as they will modernize existing treaties with Austria, Ireland, Luxembourg, and Switzerland. As we move forward into the next millennium, the global economy that we now have today will even be more interrelated. We cannot sit back and let the rest of the world pass by the United States. We must give our businesses and individuals a chance to thrive in this ever-changing global economy. That is why it is so important that these international tax treaties are passed in a swift manner.

I come at this tax treaties maybe from a little different perspective than the rest of my colleagues. I come at this as a former businessman. I have started businesses and created jobs throughout the world and understand a little bit, from a practical perspective, the effects of these treaties. I understand what it takes to make sure that businesses will be successful and thrive in an international and competitive way.

It is not easy, but it can and must be done in order for their to be growth and prosperity in the United States. No companies are more vulnerable to onerous double taxation than new, small businesses, struggling to compete in today's global marketplace. These tax treaties will help U.S. companies expand, create jobs and keep the U.S. economy growing. These bilateral international tax treaties are important to the future of this Nation, its economy and our growth. Today, I hope that we will shed some light on the importance of these treaties and the impact they will have internationally and domestically. They will be important to strengthen the United States in the ever-growing global economy.

[The prepared statement of Senator Hagel follows:]

PREPARED STATEMENT OF SENATOR HAGEL

Before we get started this afternoon, I would like to thank the panelists for taking part in this very important discussion on bilateral international income tax treaties. This is an issue that is vital to economic growth of the United States, not only today, but also for the future.

The main purposes of these treaties are to prevent international double taxation and tax evasion.

No one wants to be double taxed on their hard earned income. We have a hard enough time here in the United States dealing with an unfair, complicated, and restrictive tax code. The last thing we need to do is subject our businesses and people to more taxation. These treaties accomplish that by setting down rules to determine whether the income source country or the residence country will have the primary right to tax income, restricting the ability of the source income country to tax, and reducing withholding tax rates on cross-border payments of interest, dividends, and royalties. Also these treaties grant the procedural authority to each country to agree to provide tax relief for a particular taxpayer who can establish that he is being taxed in a manner inconsistent with the treaties.

Tax evasion is also dealt with under these treaties. The treaties put "limitations on benefits" provisions in so that benefits are denied to unintended beneficiaries. If we are to provide a level playing field in this global economy, everyone must be following the same rules.

Unfortunately, in many areas of the world U.S. companies are at a disadvantage compared to many of their European competitors. Today, the United States has income tax treaties in force with 46 countries worldwide while the United Kingdom has 98 and France has 94. In fact, the average G-7 country has 67 income tax treaties in effect.

In front of the Foreign Relations Committee today, we have 7 treaties and 1 protocol to amend an existing treaty with Canada. Of the 7 treaties, three are with new countries, South Africa, Thailand, and Turkey. These three treaties are particularly important, as they may serve as examples for expanding our tax treaties with other new and developing countries in East Asia, Central Asia and Africa. The other 4 treaties are also important, as they will modernize existing treaties with Austria, Ireland, Luxembourg, and Switzerland.

As we move forward into the next millennium, the global economy that we have today will be even more interrelated. We can't sit back and let the rest of the world pass by the United States. We must give our businesses and individuals a chance to thrive in this ever changing global economy. That is why it is so important that these international tax treaties are passed in a swift manner.

I come at these tax treaties from a little different angle that the rest of my colleagues. I come at this as a businessman. I've started many businesses and created hundreds of jobs throughout this world. I understand what it takes to make sure that businesses will be successful and thrive. It is not easy, but it can and must be done in order for there to be growth and prosperity in the United States. No companies are more vulnerable to onerous double taxation than new small businesses struggling to compete in today's global marketplace. These tax treaties will help U.S. companies expand, create jobs, and keep the U.S. economy growing.

These bilateral international tax treaties are important to the future of this nation, its economy and growth. Today, I hope that we will shed some light on the importance of these treaties and the impact they will have internationally and domestically. They will be important to strengthen the United States in the ever growing global economy.

Before recognizing the first of our witnesses, I would like to recognize the subcommittee's Ranking Member, Senator Sarbanes, for any comments he may have.

Senator HAGEL. Now, before recognizing our distinguished panelists, I would like to recognize the subcommittee's ranking member, Senator Sarbanes. Senator Sarbanes.

Senator SARBANES. Well, Mr. Chairman, I will be very brief. I am anxious to hear the presentation. I am curious why, in some of these treaties, we seem to be making one-sided concessions. I will be interested in exploring that.

Recently, the Treasury developed a model treaty which seems to make some significant departures from the model treaty. I wonder what is the rationale for that.

Finally, this committee in the past has expressed an opinion on certain aspects of tax policy, in terms of provisions in treaties. That seems to have been ignored in a couple of instances here. So, when we get to the questioning period, I want to explore all of these areas.

Thank you.

Senator HAGEL. Senator Sarbanes, thank you.

Let me first introduce the three panels of witnesses, and then ask our first witness to proceed.

First, the Hon. Joseph H. Guttentag, Deputy Assistant Secretary, International Tax, Department of Treasury.

The second panel, Mr. Kenneth J. Kies, Chief of Staff, Joint Committee on Taxation.

And the third panel, Mr. Robert Mattson, on behalf of the National Foreign Trade Council and the U.S. Council for International Business, and also Assistant Treasurer, IBM.

With that, Mr. Secretary, please proceed. Good to have you.

STATEMENT OF JOSEPH H. GUTTENTAG, DEPUTY ASSISTANT SECRETARY, INTERNATIONAL TAX, DEPARTMENT OF TREASURY

Mr. GUTTENTAG. Thank you, Mr. Chairman and Mr. Sarbanes.

I will summarize my written statement, which I have submitted for the record, and request that my statement be included in the record.

Senator HAGEL. Without objection.

Mr. GUTTENTAG. Thank you, Mr. Chairman.

I am pleased today to be able to recommend, on behalf of the administration, favorable action on seven bilateral tax treaties and a protocol to our Canada tax treaty that the President has transmitted to the Senate and that are the subject of this hearing.

These agreements would provide significant benefits to the United States, as well as to our treaty partners, and Treasury requests the committee and the Senate to take prompt and favorable action on all of these agreements. We have submitted new agreements with five of our oldest treaty partners: Austria, Luxembourg, Switzerland, Ireland, and Canada; two agreements with completely new countries of increasing important significance to us: Turkey and Thailand; and the eighth agreement before you, the treaty with South Africa, brings that important country back into our tax treaty network after its change in government.

The new agreements will generate substantial benefits for U.S. taxpayers and the tax authorities, and will serve to expedite increased desirable international economic activity as an income tax treaty removes impediments to international trade and investment in many ways. First, it generally increases the extent to which exporters can engage in trading activity in the other country without triggering tax. When tax is imposed, it ensures appropriate deductions, and reduces the withholding tax on flows of income.

Second, it establishes rules that assign to one country or the other the primary right of taxation with respect to a particular piece of income, helping to prevent the double taxation that can occur if both countries impose tax on the same income. Third, the treaty provides a dispute resolution mechanism to prevent double taxation that sometimes can arise in spite of the treaty provisions.

Finally, and often most importantly, the treaty helps to create stability of tax rules, thereby encouraging this desirable economic activity. The tax treaties alleviate the burden of high source—based taxation by reducing the levels of withholding tax that the treaty partners may impose on these types of income. In general, United States policy is to reduce the rate of withholding tax on interest and royalties to zero; dividends normally are subject to tax at one of two rates: 15 percent with respect to portfolio investment, and 5 percent with respect to direct corporate investors.

The extent to which this policy is realized depends on a number of factors. Although generalizations are often difficult to make in the context of complex negotiations, it is fair to say that we are more successful in reducing these rates with countries that are relatively developed and where there are substantial and reciprocal income flows.

We also achieve lesser but still very significant reductions with countries where the flows tend to be disproportionately in favor of the United States. Lesser developed and newly emerging economies, where capital and trade flows are often disparate or sometimes completely one way, create obstacles to achieving our desired level of withholding, though we still find a treaty most desirable.

These rules are general guidelines, and they do not address every conceivable situation. Consequently, there will still be cases in which double taxation may occur. In such cases, the treaty provides a mechanism through the tax authorities of the two governments, known as the competent authorities, to consult and reach an agreement in which the taxpayer's income is allocated between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation.

All the aspects of tax treaties that I have been discussing so far involve benefits that the treaties provide to taxpayers, especially multinational companies, big and small. While providing these benefits certainly is a major purpose of any tax treaty, it is not the only purpose. The second major objective of our income tax treaty program is to prevent tax evasion and to ensure that treaty benefits only flow to those intended recipients.

Tax treaties ensure this in two ways. First, they provide for exchange of information between the tax authorities. Second, they contain provisions to limit the treaty benefits to real residents of the country, and to prevent treaty shopping.

Our tax treaties must provide appropriate tax treatment for categories of income which are specially treated under the Internal Revenue Code. One important example of such provisions are the REITs, the real estate investment trusts, created by Congress to help investors achieve diversified ownership in primarily passive real estate investments. In the case of foreign investors, the Congress provided for a 30 percent withholding tax, except for certain capital gain distributions.

These rules reflect U.S. tax policy, which is consistent with that of most countries. That is, each country reserves the right to impose a full tax on income from real property; and the other country must, therefore, give a credit or an exemption to prevent double taxation. Our existing treaty policy provides for a 30 percent withholding tax on REIT dividends, with a limited 15 percent exception. That is only for payments to individuals who own 10 percent or less of the REIT.

We have determined that reconsideration of our existing policy is appropriate for the reasons described in greater detail in our prepared testimony. Our new policy provides for a 15 percent withholding tax on shareholders of publicly traded REITs who hold 5 percent or less. Even if the REIT is not publicly traded, but its holdings are substantially diversified, the foreigner can hold up to 10 percent of the REIT. This new policy has been developed with, and has the support of, the staffs of this committee, the joint committee on taxation and the REIT industry. It will be reflected in our model treaty and in future treaty negotiations.

Furthermore, we do not object to a reservation in the Luxembourg treaty, pending before you, which would reflect this new policy in that treaty, as well as providing certain limited grandfathering. We are also going to use our best efforts to secure agreement with our current treaty partners, Austria, Ireland and Switzerland, to protocols to our new treaties to reflect this new policy.

Further details with which we agree and support are also set forth in Mr. Kies' written testimony.

The discussion of REIT taxation provides an example of why our tax treaty policy cannot be static, and our model treaty published last year, as well as the OECD model, are and will be ambulatory documents. We work on a continuing basis with our foreign colleagues to continually review our treaty policies and interpretations. It is to our advantage to have universally accepted policies and interpretations, and we work hard to achieve such goals.

If, however, we believe that inconsistencies are created with U.S. positions, we can, at any time, disavow our adherence. We have, over the years, working with this committee and the tax writing committees, achieved an appropriate balance between the certainty required in order to receive Senate advice and consent and the necessary flexibility to achieve our treaty goals. We must take into account that our treaties remain in place, unchanged sometimes for decades, and reasonable flexibility in interpreting the treaty—not changing it—is needed to deal with new and unanticipated developments.

For example, we are working internationally with our multinational businesses and foreign governments to ensure that tax laws do not impede the development of new technologies, exemplified by the Internet. At the same time, we need to ensure that we have the proper tools in place to prevent these new technologies from encouraging tax avoidance or evasion.

I do not intend to discuss the details of each of the eight agreements you have before you, but will of course be pleased to answer any questions you may have. Each treaty must be adapted to the individual facts and circumstances of the treaty partner. It is also important to remember that each treaty is a result of a negotiated bargain between two countries that often have conflicting objectives.

We have submitted technical explanations of each agreement that contain detailed discussions of each treaty and protocol. These technical explanations serve as an official guide to each agreement. We have furnished our treaty partners with a copy of the relevant technical explanation, and offered them the opportunity to submit their comments and suggestions.

Each of the treaties with Austria, Switzerland, Luxembourg, and Ireland are over 30 years old, and some are approaching 50. They all needed to be modernized to take into account the numerous changes in our economic relationships and tax laws over the past decade. All are very close to the current U.S. model, and contain appropriate versions of our anti-treaty shopping and information exchange provisions.

The treaty with Luxembourg was negotiated in tandem with a mutual legal assistance treaty, which provides essential tax information exchange provisions. We urge prompt approval of the tax treaty with Luxembourg, with the understanding that the treaty will not come into effect until the MLAT does.

The treaties with Turkey, Thailand and South Africa demonstrate agreement with countries in different stages of development. Although there are some developing country concessions in these agreements, they also reflect the greater awareness by many countries that United States principles of low rates of taxation at source and a stable tax system may be a better route toward encouraging foreign investment than revenue-losing tax holidays, combined with high withholding taxes.

The Canadian protocol reflects the need for continued monitoring of our bilateral agreement because of the enormous number, complexity and importance of our cross-border transactions. The protocol deals primarily with treatment of social security benefits, and reflects the need for review, which has already begun, of our current policies in that regard with this committee, the tax-writing committees, and the Social Security Administration.

We are continuing to maintain an active calendar or tax treaty negotiations. Early this summer, we initialed treaties with Estonia, Latvia and Lithuania. We are nearing completion of our negotiations with Bangladesh, Sri Lanka and Denmark, and are continuing negotiations with Venezuela and Italy. We also would like to extend our treaties to more countries, particularly in Latin America and Southeast Asia.

Let me conclude by again thanking the committee for its continued interest in the tax treaty program, and for devoting the time of the members and the staff to undertaking a meaningful review of the agreements that are pending before you. We appreciate your efforts this year and in past years to bring the treaties before this committee, and then to the full Senate, for its advice and consent to ratification. With your help over the past few years, we have brought into force 15 new agreements, and we look forward to adding the eight presently before you.

We urge the committee to take prompt and favorable action on all of the conventions and the protocol. Such action will send an important message to our trading partners and our business community. It will demonstrate our desire to expand the United States treaty network with income tax treaties, formulated to enhance the worldwide competitiveness of U.S. companies. It will strengthen and expand our economic relations with countries that have seen significant economic and political changes in recent years. It will make clear our intention to deal bilaterally, in a forceful and realistic way, with treaty abuse. Finally, it will enable us to improve the administration of our tax laws, both domestically and internationally.

I will be glad to answer any questions you might have. Thank you.

[The prepared statement of Mr. Guttentag follows:]

PREPARED STATEMENT OF MR. GUTTENTAG

Mr. Chairman and members of the Committee, I am pleased today to recommend on behalf of the Administration, favorable action on eight bilateral tax treaties and protocols that the President has transmitted to the Senate and that are the subject of this hearing. These agreements would provide significant benefits to the United States, as well as to our treaty partners. Treasury appreciates the Committee's interest in these agreements as demonstrated by the scheduling of this hearing. Treasury requests the Committee and the Senate to take prompt and favorable action on all of these agreements.

The treaties and protocols before the Committee today represent a cross-section of the United States tax treaty program. There are new agreements with five of our oldest treaty partners, Austria, Luxembourg, Switzerland, Ireland, and Canada. Two agreements are with new treaty partners of growing economic significance, Turkey and Thailand. The eighth agreement before you, the treaty with South Africa, brings that important country back into our tax treaty network after its change in government. The new agreements will generate substantial benefits for United

States taxpayers and tax authorities, and will serve to expedite and increase desirable international economic activity. Tax conventions, as explained in greater detail below, do not represent a zero sum exercise. Not only do United States-based businesses benefit from exemption from, or reduction of, foreign taxes, but additional tools are provided to enforce our tax laws, particularly with respect to international tax crimes, often related to money laundering and illegal drug traffic. Mutual agreement procedures not only minimize the risk of double taxation of our multinationals, as well as assuring appropriate taxation of foreign based companies, but also facilitate a fair allocation of tax revenues between our treaty partners and the United States.

To help frame our discussions of the pending agreements, I would like to describe in general terms the United States tax treaty program. The United States has a network of 48 bilateral income tax treaties, the first of which was negotiated in 1939. We have treaties with most of our significant trading partners. Approval of the treaty with Turkey, which is before you today, would achieve an important objective of having tax treaty relationships with all of the members of the Organization for Economic Cooperation and Development, the OECD.

The Department of the Treasury receives regular and numerous requests to enter tax treaty negotiations. As a result it has been necessary for us to establish priorities. These priorities are not new; they are reflected in our existing treaty network including the agreements the Senate approved last year as well as the treaties that you are considering today.

Consistent with both Administration and Congressional policies, the Treasury gives priority to renegotiating older treaties that lack effective anti-abuse clauses or otherwise fail to reflect current United States treaty policy. Examples in this category are the agreements with Austria, Luxembourg, Switzerland, and Ireland. We have made it clear to our treaty partners that we will not tolerate continuation of treaty relationships that fail to reflect important United States treaty policies. This policy was underscored last year by the termination of our treaties with Malta and Aruba, and by the termination protocol with respect to the Netherlands Antilles.

Another priority is to conclude treaties or protocols that are likely to provide the greatest benefits to United States taxpayers, such as when economic relations are hindered by tax obstacles. Such new agreements could include treaties with expanding economies with which we lack a treaty, or revised and improved treaties with existing treaty partners. Examples in this category include the treaties with Turkey, Thailand, and South Africa. As we complete our renegotiation of outdated treaties, we are able to increase the priority we place on negotiating tax treaties in countries and regions of increasing importance to the United States and United States business. Thus, a major focus of our tax treaty program in the next several years will be to continue and expand our treaty activities with countries in Latin America and Southeast Asia.

We also try to conclude treaties with countries that have the potential to be significant trading partners. The list of such countries has always been a long one, and it has become even longer since the creation of many new market-oriented economies in the former Soviet Union and eastern European countries. Treasury focuses its efforts in this category on those countries that have developed stable tax systems and that have the greatest potential for bilateral economic activities. We also take into account the concerns and interests of other governmental agencies and the private sector. The existence of a treaty will help remove tax impediments to trade and investment in such countries and thereby help establish economic ties that will contribute to the country's stability and independence, as well as improving its political relationships with the United States. In the past four years the Senate considered and approved treaties with five countries that fit this description: the Russian Federation, the Czech Republic, Slovakia, Kazakstan, and Ukraine. Other treaties in this category that have been initialed but not yet signed are with Estonia, Latvia, and Lithuania

In determining our country priorities as well as treaty positions, we consult regularly and usefully with many constituencies. We meet with the staff of this Committee and its members as well as staffs of the tax writing committees. We hear from many United States-based companies and trade associations which provide useful guidance particularly with respect to practical in-country problems they face. We are constantly working to ensure that new economic and commercial developments, such as the revolution in communication technology, are appropriately dealt with in our tax conventions.

The OECD provides a useful forum to consider these developments with our treaty partners. The development of new technologies in particular increases the need for international cooperation with respect to many tax policy and administration issues.

Benefits Provided by Income Tax Treaties

Irrespective of the category in which a particular country may fall, we seek to achieve the same two basic objectives through the treaty. First, to reduce income tax-related barriers to international trade and investment. An active treaty program is important to the overall international economic policy of the United States, and tax treaties have a substantial positive impact on the competitive position of United States businesses that enter a treaty partner's marketplace.

A second general objective of our tax treaty program is to combat tax avoidance and evasion. A treaty provides the tax administrations of both treaty partners with additional tools with which to improve international tax administration.

While the domestic tax legislation of the United States and other countries in many ways is intended to further the same general objectives as our treaty program, a treaty network goes beyond what domestic legislation can achieve. Legislation is by its nature unilateral, and cannot easily distinguish among countries. It cannot take into account other countries' rules for the taxation of particular classes of income and how those rules interact with United States statutory rules. Legislation also cannot reflect variations in the United States' bilateral relations with our treaty partners. A treaty, on the other hand, can make useful distinctions, and alter in an appropriate manner, domestic statutory law of both countries as it applies to income flowing between the treaty partners.

For example, a basic concept found in all of our treaties establishes the minimum level of economic activity that a resident of one country must engage in within the other before the latter country may tax the resulting business profits. These rules, the permanent establishment and business profits provisions, not only eliminate in many cases the difficult task of allocating income and resulting tax between countries but also serve to encourage desirable trade activities by eliminating, or reducing, what can often be complex tax compliance requirements.

Benefits to Taxpayers

An income tax treaty removes impediments to international trade and investment by reducing the threat of "double taxation" that can occur when both countries impose tax on the same income. I'd like to mention four different aspects of this general goal. First, an income tax treaty generally increases the extent to which exporters can engage in trading activity in the other country without triggering tax. Second, when that threshold is met and tax is imposed, it establishes rules that assign to one country or the other the primary right of taxation with respect to an item of income, it ensures appropriate deductions and reduces the withholding tax on flows of income. Third, the treaty provides a dispute resolution mechanism to prevent double taxation that sometimes can arise in spite of the treaty. Finally, and often most importantly, the treaty helps to create stability of tax rules thereby encouraging desirable economic activity. These benefits are not limited to companies and business profits. Treaties remove tax impediments to desirable scientific, educational, cultural and athletic interchanges, facilitating our ability to benefit from the skills and talents of foreigners including world renowned rock stars, symphony orchestras, astrophysicists and Olympic athletes. You will note that treaty benefits are not limited to profit-making enterprises as they deal with pension plans, Social Security benefits (as in the protocol with Canada), charitable organizations, researchers and alimony and child support recipients. I would like to discuss some of these aspects of an income tax treaty.

One of the principal ways in which double taxation is eliminated is by assigning primary taxing jurisdiction in particular factual settings to one treaty partner or the other. In the absence of a treaty, a United States company operating a branch or division or providing services in another country might be subject to income tax in both countries on the income generated by such operations (perhaps because of limitations on the foreign tax credit provided by the Code). The resulting double taxation can impose an oppressive financial burden on the operation and might well make it economically unfeasible.

The tax treaty lays out ground rules providing that one country or the other, but not both, will have primary taxing jurisdiction over branch operations and individuals performing services. In general terms, the treaty provides that if the branch operations have sufficient substance and continuity, and accordingly, sufficient economic penetration, the country where the activities occur will have primary (but not exclusive) jurisdiction to tax. In other cases, where the operations are relatively minor, the home country retains the sole jurisdiction to tax. These provisions are especially important in treaties with lesser developed countries, which in the absence of a treaty frequently will tax a branch operation even if the level of activity conducted in the country is negligible or where the line is not clear and frequently will not allow deductions for appropriate expenses. Under the favorable treaty rules, United States manufacturers may establish a significant foreign presence through which products are sold without subjecting themselves to foreign tax or compliance rules. Similarly, United States residents generally may live and work abroad for short periods without becoming subject to the other country's taxing jurisdiction.

High withholding taxes at source are an impediment to international economic activity. Under United States domestic law, all payments to non-United States persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Inasmuch as this tax is imposed on a gross rather than net amount, it imposes a high cost on investors receiving such payments. Indeed, in many cases the cost of such taxes can be prohibitive as a 30 percent tax on gross income often can exceed 100 percent of the net income. Most of our trading partners impose similar levels of withholding tax on these types of income.

Tax treaties alleviate this burden by reducing the levels of withholding tax that the treaty partners may impose on these types of income. In general, United States policy is to reduce the rate of withholding taxation on interest and royalties to zero. Dividends normally are subject to tax at one of two rates, 15 percent on portfolio investors and 5 percent on direct corporate investors.

The extent to which this policy is realized depends on a number of factors. Although generalizations often are difficult to make in the context of complex negotiations, it is fair to say that we are more successful in reducing these rates with countries that are relatively developed and where there are substantial reciprocal income flows. We also achieve lesser but still very significant reductions with countries where the flows tend to be disproportionately in favor of the United States. Lesser developed and newly emerging economies, where capital and trade flows are often disparate or sometimes one-way, create obstacles to achieving our desired level of withholding. These countries frequently find themselves on the horns of a dilemma. They know that they must reduce their high levels of taxation to attract foreign capital but, at the same time, they are unwilling to give up scarce revenues. Such prospective treaty partners may perceive that they are making a concession in favor of the United States without receiving a corresponding benefit when they reduce withholding rates. In some such cases, we will look at the level of overall rates of tax and avoid agreements which serve to transfer tax from a less developed foreign fisc to the United States. For this reason and others, the treaty withholding rates will vary. Furthermore, even if the treaty does not serve to reduce existing rates, it provides limitations and the certainty demanded by business decision-makers.

The rules provided in the treaty are general guidelines that do not address every conceivable situation, particularly, new developments. Consequently, there will be cases in which double taxation occurs in spite of the treaty. In such cases, the treaty provides mechanisms enabling the tax authorities of the two governments—known as the "competent authorities" in tax treaty parlance—to consult and reach an agreement under which the taxpayer's income is allocated between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation.

Prevention of Tax Evasion

All the aspects of tax treaties that I have been discussing so far involve benefits that the treaties provide to taxpayers, especially multinational companies but also others I have described. While providing these benefits certainly is a major purpose of any tax treaty, it is not the only purpose. The second major objective of our income tax treaty program is to prevent tax evasion and to ensure that treaty benefits flow only to the intended recipients. Tax treaties achieve this objective in at least two major ways. First, they provide for exchange of information between the tax authorities. Second, they contain provisions designed to ensure that treaty benefits are limited to real residents of the other treaty country and not to "treaty shoppers."

Under the tax treaties, the competent authorities are authorized to exchange information, including confidential taxpayer information, as may be necessary for the proper administration of the countries' tax laws. This aspect of our tax treaty program is one of the most important features of a tax treaty from the standpoint of the United States. The information that is exchanged may be used for a variety of purposes. For instance, the information may be used to identify unreported income or to investigate a transfer pricing case. In recent years information exchange has become a priority for the United States in its tax treaty program.

Recent technological developments which facilitate international, and anonymous, communications and commercial and financial activities can also encourage illegal activities. Over the past several years we have experienced a marked and important sea change as many of the industrialized nations have recognized the increasing importance of tax information exchange and that the absence thereof serves to encourage not only tax avoidance and evasion, but also criminal tax fraud, money laundering, illegal drug trafficking, and other criminal activity. Treasury is proud of the role it has played in moving these issues forward not only in our bilateral treaty negotiations but also in other fora such as the OECD and the OAS. We have observed that within the European Union there has been increasing recognition that the desired political and economic unity requires full disclosure and transparency.

To emphasize the importance of this subject, the Department of Justice has written a letter, in light of its obligations to enforce the tax laws, expressing its support for these treaties. A copy of the letter is appended to this testimony for the Committee's information.

A second major objective of U.S. tax treaty policy is to obtain comprehensive provisions designed to prevent abuse of the treaty by persons who are not bonafide residents of the treaty partner. This abuse, which is known as "treaty shopping," can take a number of forms, but its general characteristic is that a resident of a third state that has either no treaty with the United States or a relatively unfavorable one establishes an entity in a treaty partner that has a relatively favorable treaty with the United States. This entity is used to hold title to the person's United States investments, which could range from portfolio stock investments to major direct investments or other treaty-favored activity in the United States. By placing the investment in the treaty partner, the third-country person is able to withdraw the returns from the United States investment subject to the favorable rates provided in the tax treaty, rather than the higher rates that would be imposed if the person had invested directly into the United States. The United States treaty partner must of course cooperate by providing favorable tax treatment to the third country investor.

This Committee and the Congress have expressed strong concerns about treaty shopping, and the Department of the Treasury shares those concerns. If treaty shopping is allowed to occur, then there is less incentive for the third country with which the United States has no treaty to negotiate a treaty with the United States. The third country can maintain inappropriate barriers to United States investment and trade, and yet its companies can operate free of these barriers by organizing their United States transactions so that they flow through a country with a favorable United States tax treaty.

Although anti-treaty shopping provisions give us leverage in negotiating with other countries, we do not necessarily need to have tax treaties with every country in the world. There are usually very good reasons why the United States has not concluded a treaty with a particular country. For example, we generally do not conclude tax treaties with jurisdictions that do not impose significant income taxes, because there is little danger of double taxation of income in such a case and it would be inappropriate to reduce United States taxation on returns on inbound investment if the other country cannot offer a corresponding benefit in exchange for favorable United States treatment. The anti-treaty shopping provisions in our treaty network support this goal by preventing investors from enjoying the benefits of a tax-haven regime in their home country and, at the same time, the benefits of a treaty between the United States and another country. However, these situations often are not black or white. Some countries have adopted favorable tax regimes applicable to limited sectors of their economy and the United States believes that in many circumstances it is inappropriate to grant treaty benefits to companies taking advantage of such regimes. On the other hand there may be other elements of the economy as well as other factors that would make a treaty relationship useful and appropriate. Accordingly, in some cases we have devised treaties that carve out from the benefits of the treaties certain residents and activities. In other cases, we have offered to enter into an agreement limited to the exchange of tax information. We have a number of these agreements, particularly with Caribbean countries.

The Department of the Treasury has included in all its recent tax treaties comprehensive "limitation on benefits" provisions that limit the benefits of the treaty to bonafide residents of the treaty partner. These provisions are not uniform, as each country has its own characteristics that make it more or less inviting to treaty shopping in particular ways. Consequently, each provision must to some extent be tailored to fit the facts and circumstances of the treaty partners' internal laws and practices. Moreover, these provisions should be crafted to avoid interfering with legitimate and desirable economic activity. For example, we have begun to address directly in our negotiations the issue of how open-end United States regulated investment companies (RICS) should be treated under limitation on benefits provisions in order to facilitate cross-border investments from this important source of capital. Because these funds are required to stand ready to redeem their shares on a daily basis, we believe they generally should be entitled to treaty benefits to the same extent as closed-end RICS, which qualify for benefits under standard limitation on benefits provisions because they are publicly traded on stock exchanges.

However, the negotiators need to ensure that what may appear to be similar funds established in the treaty partner cannot be used to promote treaty shopping.

Transfer Pricing

Several of the aspects of income tax treaties that I have been describing are highly relevant to the resolution of transfer pricing issues. Transfer pricing relates to the division of the taxable income of a multinational enterprise among the jurisdictions where it does business. If a multinational manipulates the prices charged in transactions between its affiliates in different countries, the income reported for tax purposes in one country may be artificially depressed, and the tax administration of that country will collect less tax from the enterprise than it should. Accordingly, transfer pricing is an important subject not only in this country but in most other countries as well.

In analyzing the prices charged in any transaction between parties that are commonly controlled, it is necessary to have a benchmark by which to evaluate the prices charged. The benchmark adopted by the United States and all our major trading partners is the arm's-length standard. This standard is reflected in hundreds of existing tax treaties. Under the arm's-length standard, the price charged should be the same as it would have been had the parties to the transaction been unrelated to one another—in other words, the same as if they had bargained at "arm's-length."

Consistent with the domestic practice of all major trading nations, all of our comprehensive income tax treaties adopt the arm's-length standard as the agreed benchmark to be used in addressing a transfer pricing case. Adoption of a common approach to these cases is another benefit provided by tax treaties. A common approach consistently applied is a sine qua non for preventing both tax avoidance and double taxation. A common approach guarantees the possibility of achieving a consistent allocation of income between the treaty partners. Without such an assurance, it is possible that the two tax authorities would determine inconsistent allocations of income to their respective jurisdictions, resulting in either double taxation or under taxation. Double taxation would occur when part of the multinational's income is claimed by both jurisdictions. Under taxation would occur when part of the multinational's income is claimed by neither jurisdiction.

By adopting a common standard, the risks of double taxation and under taxation are minimized. Furthermore, when double taxation does occur, the competent authorities of the two countries are empowered to consult and agree on an equitable division of income based upon this common reference point. Without this common reference point, reaching mutual agreement would be difficult or impossible.

Distributions from Real Estate Investment Trusts (REITs)

Our tax treaties must provide appropriate tax treatment for categories of income which are specially treated under the Code. One important example of such provisions are the REITS, created by Congress to help investors achieve diversified ownership in primarily passive real estate investments. In the case of foreign investors, the Congress provided for a 30% withholding tax except for certain capital gain distributions. These rules reflected U.S. tax policy which is consistent with those of most other countries: each country reserves the right to impose a full tax on income from real property, leaving the residence country to alleviate any resulting double taxation.

REITs are created as U.S. corporations and their distributions are in the form of corporate dividends. Unlike corporations, however, they generally are not subject to tax at the corporate level and, if their distributions were not subject to full taxation, their income would not be subject to full taxation at the entity level or the shareholder level. Therefore, a decision must be made whether to characterize the distributions as distributions of real property rental income subject to at least one level of full U.S. taxation or as dividends subject to a lower rate.

It is has been U.S. policy since 1988 to treat REIT distributions as conduit distributions of real estate rental income. The policy originated in a 1988 directive, with which the Department of the Treasury agreed, from the Joint Committee on Taxation and the Senate Committee on Foreign Relations. The purpose of excluding certain REIT dividends from preferential dividend withholding tax rates under the treaties is to prevent foreign investors from utilizing a REIT conduit to convert high-taxed U.S. source rental income into lower taxed dividend income by passing the rental income through a REIT. This policy avoids a disparity between the taxation of direct real estate investments and real estate investments made through REIT conduits. Limited relief from this rule generally is provided in the case of REIT dividends beneficially owned by individuals holding less than a 10-percent interest in the REIT. Such REIT dividends qualify for the reduced withholding tax rates generally available in respect of dividends.

Economic changes since these policies were established ten years ago require that we review our position in order to insure that our treaty policies reflect the best interests of the United States. These interests include not discouraging, through our tax rules, desirable foreign investment. To that end we have consulted with representatives of the REIT industry and we are now satisfied that our current treaty policy should be modified. While the treaties before you represent policies with which we all have agreed, we now believe that it is appropriate to revise our treatment of REIT dividends under our treaties.

Our new policy takes into account that portfolio investments in a REIT whether by individuals or institutional investors may be indistinguishable in intent and results from similar investments in other corporate securities and should be afforded similar tax consequences in appropriate circumstances. In carrying out such a policy however, two other considerations are significant. First, we should maintain a reasonable neutrality with respect to the taxation of foreigners and U.S. citizens. A potential U.S. investor in a shopping mall should not be out bid by a foreigner because we have, through out treaty process, provided inappropriate tax benefits to the foreigner. Second, we should not provide such generous REIT benefits that foreigners choose to make economically distorted investments to our disadvantage. For example, we do not want a foreigner that is considering building a major job-producing new factory in the United States to choose instead to buy an existing office building because of inappropriately favorable tax treatment of the latter.

The proposal which we put before you today has been developed by the staff of the Joint Committee on Taxation in consultation with the staff of this Committee and Treasury and with the help of the REIT industry. Our existing treaty policy provides for a 30% withholding tax on REIT dividends with an exception for payments to individuals who hold 10% or less of the REIT. Our new policy retains the current treatment of individuals with 10% or smaller holdings of the REIT and, in addition, provides for a 15% withholding tax on dividends paid by (i) a publicly traded REIT to any shareholder who holds a 5% or smaller interest in the REIT, and (ii) a publicly traded or non-publicly traded REIT, the holdings of which are substantially diversified, to a shareholder who holds a 10% or smaller interest in the REIT.

We are going to reflect this new policy in our model treaty and in future treaty negotiations. Furthermore we support the proposal to insert a reservation to the Senate's advice and consent to our pending treaty with Luxembourg to reflect our new REIT policy in that treaty, as well as assuring "grandfathered" benefits for certain current investments. We are also going to use our best efforts to secure agreement with Austria, Ireland and Switzerland to protocols to our new treaties to reflect our new REIT policy.

We believe that the foregoing proposal goes as far as we can in accommodating the changes in the REIT industry consistent with sound tax policy designed to take into account the factors described above. Representatives of the REIT industry have been most helpful in providing us with information with respect to developments in the industry and changes in investment patterns since adoption of our 1988 policy and have indicated their support for the new policy.

Basis for Negotiations

Each of these treaties before you today reflects the basic principles of current United States treaty policy. The provisions in each treaty borrow heavily from recent treaties approved by the Senate and the U.S. model (which had not yet been published while most of the treaties were negotiated, but was available to U.S. negotiators in draft form) and are generally consistent with the 1992 OECD Model Income Tax Convention. The United States was and continues to be an active participant in the development of the OECD Model, and we are generally able to use most of its provisions as a basis for negotiations.

The U.S. model was published in September 1996. A model treaty is a useful device if used properly and kept current.

Based on our experience we anticipate that the United States model, like the OECD model, will not be a static document but will be modified as required to reflect changes in United States tax law or policy, economic, technical and other changes that may require further elaboration, clarification or even reversals of prior policies. There are no major inconsistencies between the US and OECD model, but rather the US model elaborates on issues in which the United States may have a greater interest or which result from particular aspects of United States law and policy. For example, our limitation of benefits provisions are generally not found in typical tax treaties of other OECD countries. We have also found it useful to expand on treaty coverage and treatment of pass-through entities such as our limited liability companies. The tax consequences resulting from the development of new financial instruments need to be internationally accepted and consistent. Despite the importance we attach to the OECD model and our continuing efforts with our colleagues to improve it and keep it current, most countries cannot accede to all of the provisions of that model, nor do we expect that all of our prospective treaty partners will agree with all of the provisions of our model. We believe that our new model and its accompanying explanation will find its principal benefits to be enabling all interested parties, including this Committee and the Congress and its staffs, the American business community, and our prospective treaty partners, to know and understand our treaty positions. We anticipate that American companies will be able to use the model to suggest modifications that may be required in connection with negotiations with a particular country based on the interaction of our two tax systems. For example, in my discussions of our policies with respect to information exchange and treaty shopping I noted the need to tailor these provisions to the specific circumstances, which will differ from country to country. We have presented our model to the OECD with the intention of working together to create even greater consistency concerning the important issues covered. We do not anticipate that the United States will ever sign a tax convention identical to the model; there are too many variables.

A nation's tax policy, as reflected in its domestic tax legislation as well as its tax treaty positions, reflects the sovereign choices made by that country in the exercise of one of its most important governmental functions, that of funding the government. Numerous features of the treaty partner's unique tax legislation and its interaction with United States legislation must be considered in negotiating an appropriate treaty. Examples include the treatment of partnerships and other transparent entities, whether the country eliminates double taxation through an exemption or a credit system, whether the country has bank secrecy legislation that needs to be modified by treaty, and whether and to what extent the country imposes withholding taxes on outbound flows of investment income. Consequently, a negotiated treaty needs to take into account all of these and other aspects of the treaty partner's tax system in order to arrive at an acceptable treaty from the perspective of the United States. Accordingly, a simple side-by-side comparison of two actual treaties, or of a proposed treaty against a model treaty, will not enable meaningful conclusions to be drawn as to whether a proposed treaty reflects an appropriate balancing of interests. In many cases the differences are of little substantive importance, reflecting language problems, cultural obstacles or other impediments to the use of particular United States or OECD language. The technical explanations which accompany our treaty, the discussions with the staffs of this Committee and its members, and the staffs of the tax law writing Committees, and most importantly, hearings such as this, will provide the Senate with the assurance that a particular treaty is, overall, in the best interests of the United States.

Discussion of Treaties and Protocols—Austria, Luxembourg, Turkey, Switzerland, Thailand, South Africa, Ireland, Canada

In addition to keeping in mind that each treaty must be adapted to the individual facts and circumstances of each treaty partner, it also is important to remember that each treaty is the result of a negotiated bargain between two countries that often have conflicting objectives. Each country has certain issues that it considers nonnegotiable. The United States, which insists on effective anti-abuse and exchange-of-information provisions, and which must accommodate its uniquely complex internal laws, probably has more nonnegotiable issues than most countries. Obtaining the agreement of our treaty partners on these critical issues sometimes requires other concessions on our part. Similarly, other countries sometimes must make concessions to obtain our agreement on issues that are critical to them. The give and take that is inherent in the negotiating process leading to a treaty is not unlike the process that results in legislation in this body. Treaties can each be different and yet represent an ideal treaty from the United States perspective with a particular country because of the specific economic relationships, domestic tax rules and other factors, and even though the treaty does not completely adhere to a model, whether that of the United States, the OECD or the treaty partner.

Each of the full treaties before the Committee today allows the United States to impose our branch profits tax at the treaty's direct-dividend rate. In addition, in conformity with what has become standard United States treaty policy, excess inclusions with respect to residual interests in real estate mortgage investment conduits (REMICS) are subject to the United States statutory withholding rate of 30 percent.

The proposed treaties also contain provisions designed to improve the administration both of the treaty and of the underlying tax systems, including rules concerning exchange of information, mutual assistance, dispute resolution and nondiscrimination. Each treaty permits the G6neral Accounting Office and the tax-writing committees of Congress to obtain access to certain tax information exchanged under treaty for use in their oversight of the administration of United States tax laws and treaties. Each treaty also contains a now-standard provision ensuring that tax discrimination disputes between the two nations generally will be resolved within the ambit of the tax treaty, and not under any other dispute resolution mechanisms, including the World Trade Organization (WTO).

Each treaty also contains a comprehensive limitation on benefits provision designed to ensure that residents of each State may enjoy treaty benefits only if they have a substantial nexus with that State, or otherwise can establish a substantial non-treaty-shopping motive for establishing themselves in their country of residence. Each treaty preserves the right of the United States to tax certain former citizens generally consistent with recently enacted amendments to the Code dealing with this issue.

Finally, some treaties will have special provisions not found in other agreements. These provisions account for unique or unusual aspects of the treaty partner's internal laws or circumstances. For example, in order to achieve the desired reciprocal taxation of business profits on a net basis, special provisions in the proposed treaty with Turkey, applicable only to Turkey, were required. Turkey also exemplifies a treaty partner in a significantly different level of economic development than the United States and many other OECD member countries. While the treaty is based on the OECD model it reflects various reservations made by Turkey to that model particularly with respect to withholding at source on interest, dividends and royalties. All of these features should be regarded as a strength rather than weakness of the tax treaty program, since it is these differences in the treaties which enable us to reach agreement and thereby reduce taxation at source, prevent double taxation and increase tax cooperation.

I would like to discuss the importance and purposes of each agreement that you have been asked to consider. We have submitted Technical Explanations of each agreement that contain detailed discussions of each treaty and protocol. These Technical Explanations serve as an official guide to each agreement. We have furnished our treaty partners with a copy of the relevant technical explanation and offered them the opportunity to submit their comments and suggestions.

Austria

The proposed new Convention with Austria signed in Vienna on May 30, 1996, along with the Memorandum of Understanding, replaces the existing Convention, which was signed in 1956. The proposed Convention generally follows the pattern of other recent United States treaties and the OECD Model treaty. The proposed new Convention contains changes made in order to create a closer alignment with our current income tax treaty policy.

First, the proposed Convention contains a new exchange of information provision which will allow each country greater access to information important to tax enforcement. These provisions are needed because the existing Convention is limited and does not provide an effective means for the United States to obtain relevant Austrian bank account information. As elaborated in the Memorandum of Understanding, the information exchange provisions make clear that United States tax authorities will be given access to Austrian bank information in connection with any penal investigation. The MOU clarifies that the term penal investigation applies to proceedings carried out by either judicial or administrative bodies and that the commencement of a criminal investigation by the C Investigation Division of the Internal Revenue Service constitutes a penal investigation.

Also, as the existing Convention contains no provision dealing with gains on disposition of personal property, the proposed new convention contains an article dealing with the taxation of capital gains. This provision is generally similar to that in recent United States treaties. Under the new Convention, however, and consistent with United States tax law, a Contracting State in which a permanent establishment or fixed base is located may also tax gains from the alienation of personal property that is removed from the permanent establishment or fixed base, to the extent that gains accrued while the asset formed part of a permanent establishment or fixed base. Double taxation is prevented because the residence State must exclude from its tax base any gain taxed in the other State.

The withholding rates on investment income in the proposed Convention are essentially the same as in the present treaty and are generally consistent with United States policy. Direct investment dividends are subject to taxation at source at a rate of 5 percent, and portfolio dividends are taxable at 15 percent. The proposed Convention contains a change that conforms the threshold of ownership required to obtain the lowest dividend withholding rate with the threshold in our most recent income tax conventions. Interest and royalties are generally exempt from tax at source. However, in the proposed Convention, as in the existing one, a tax may be imposed at a maximum rate of 10 percent on royalties in respect of commercial motion pictures, films and tapes; and the proposed Convention redefines the category to include royalties in respect of rights to use similar items used for radio and television broadcasting.

Consistent with current United States treaty policy, the proposed treaty provides for exclusive residence country taxation of profits from international carriage by ships or airplanes. The proposed Convention expands the scope of this provision to include income from the use or rental of containers and from the rental of ships and aircraft. Under the present Convention, such rental income is treated as royalty income, which may be taxed by the source country only if the income is attributable to a permanent establishment in that country.

Personal services income is taxed under the proposed Convention as under recent United States treaties with OECD countries. In addition, in recognition of the increasingly mobile nature of the work force, the proposed Convention provides for the deductibility, under limited circumstances, of cross-border contributions by individuals temporarily in one country who contribute to recognized pension plans in the other country.

Unlike the existing Convention, the proposed Convention contains a comprehensive antitreaty-shopping provision. A Memorandum of Understanding provides an interpretation of key terms. Austria's recent membership in the European Union and the special United States ties to Canada and Mexico under the North American Free Trade Agreement are an element in the . determination by the competent authority of eligibility for benefits of certain Austrian and United States companies. Recognized headquarters companies of multinational corporate groups are entitled to benefits of the Convention.

The proposed Convention also provides for the elimination of another potential abuse relating to the granting of United States treaty benefits in the so-called triangular cases to income of an Austrian resident attributable to a third-country permanent establishments of Austrian corporations that are exempt from tax in Austria by operation of Austria's law or treaties. Under the proposed rule, full United States treaty benefits will be granted in these triangular cases only when the United States-source income is subject to a sufficient level of tax in Austria and in the third country. As in the United States-France treaty, this anti-abuse rule does not apply in certain circumstances, including when the United States taxes the profits of the Austrian enterprise under subpart F of the Internal Revenue Code.

Also included in the proposed Convention are the provisions necessary for administering the Convention, including rules for the resolution of disputes under the treaty and the exchange of information. With the exception of the more limited access to bank information, the exchange of information provision in the proposed Convention is consistent with the U.S. Model.

Luxembourg

The proposed new Convention with Luxembourg, signed in Luxembourg on April 3, 1996, replaces the existing Convention, which was signed in 1962. The proposed Convention generally follows the pattern of the OECD Model Convention and other recent United States treaties with developed countries.

A new treaty is necessary for many reasons. The existing Convention does not provide an effective means for the United States to obtain information from Luxembourg financial institutions as part of the exchange of tax information under the Convention. It also does not contain adequate rules to prevent residents of third countries from improperly obtaining the benefits of the Convention by using companies resident in one of the treaty countries to invest in the other. Finally, as the present treaty entered into force more than three decades ago, it does not reflect the significant changes in United States tax and treaty policy that have developed since the present treaty entered into force.

To deal with the first issues, the fact that the present treaty does not contain a comprehensive provision to prevent treaty shopping or to provide for effective information exchange can lead to abuse (the current treaty contains a narrow limitation on benefits provision that denies treaty benefits to certain Luxembourg holding companies). The proposed Convention contains a comprehensive anti-treaty-shopping provision and, in conjunction with a new Mutual Legal Assistance Treaty which also is pending before this Committee, will allow the Internal Revenue Service significant access to Luxembourg bank information.

Regarding the changes in tax and treaty policy, the new Convention, for example, allows the United States to impose its branch tax on United States branches of Luxembourg corporations. Among other modernizations, it also eliminates the withholding tax on debt secured by real property, permits the United States to impose withholding tax on contingent interest, and eliminates the out-dated force of attraction rule so that a country can only tax the profits that are actually attributable to a permanent establishment in that country.

In parallel with Luxembourg's elimination of dividend withholding taxes for payments within the European Union, Luxembourg unilaterally eliminates the withholding tax for certain dividend payments between a Luxembourg subsidiary and its U.S. parent company in the proposed Convention. This practice generally puts the payments from Luxembourg subsidiaries to U.S. entities on the same footing as payments from Luxembourg subsidiaries to EU entities and is a significant benefit to U.S. companies doing business in Luxembourg. Apart from this exception, the withholding rates on investment income in the proposed Convention are generally the same as those in the present treaty. Interest and royalties are generally exempt at source, as under the present treaty. All United States-source and most Luxembourg-source direct investment dividends are subject to taxation at 5 percent at source.

The proposed Convention provides another major benefit to certain U.S. companies by modifying the present Convention rules to reflect current United States treaty policy with respect to ships and aircraft and related activities. The proposed Convention provides for exclusive residence country taxation of profits from international carriage by ships or aircraft. The reciprocal exemption from source country taxation also extends to income from the use or rental of containers and from the rental of ships and aircraft.

The proposed Convention also provides benefits to the U.S. fisc. It does this in two manners: First, it contains detailed rules that restrict the benefits of the Convention to persons that are not engaged in treaty shopping. Second, it expands the ability to exchange information about financial accounts. These provisions are important as they ensure that the Convention serves its second purpose of preventing fiscal evasion.

Under the limitations on benefits provision in the proposed Convention, a person must meet the test to be a qualified resident of a treaty country to be entitled to all of the benefits of the treaty. For example, companies may be entitled to benefits if they meet certain listed conditions. For example, publicly-traded companies will generally be entitled to treaty benefits if their principal class of shares is substantially and regularly traded on a recognized stock exchange. Other companies may be qualified to obtain benefits if they meet certain ownership and base erosion tests. In addition, the proposed Convention allows certain residents of the European Union or of the North American Free Trade Area to obtain derivative benefits. These provisions parallel those contained in recent treaties between the United States and Member States of the European Union. Consistent with U.S. treaty policy, individuals, governmental entities and not-for-profit organizations (provided more than half of the beneficiaries, members or participants, if any, in such organization are qualified residents) are entitled to all the benefits of the treaty.

The proposed Convention continues to carve out Luxembourg's "1929" holding companies from treaty benefits. It expands this coverage to include other companies that enjoy similar fiscal treatment, such as the investment companies defined in the Act of March 30, 1988. Headquarters companies are also not granted treaty benefits.

The proposed Convention also provides for the elimination of another potential abuse relating to the granting of United States treaty benefits in the so-called triangular cases to third country permanent establishments of Luxembourg corporations that are exempt from tax in Luxembourg by operation of Luxembourg's law or treaties. Under the proposed rule, full United States treaty benefits will be granted in these triangular cases only when the United States-source income is subject to a sufficient level of tax in Luxembourg and the third country.

Finally, the proposed treaty allows the competent authority to allow benefits even if the conditions outlined in the limitation on benefits article are not met. The competent authority has the ability to resolve unilaterally these cases and grant treaty benefits in other cases where the perceived abuses do not in fact exist. This latter situation may arise, for example, when the United States source income is effectively subject to United States tax under subpart F of the Code.

The modifications to the exchange of information article are a critical piece of the proposed treaty. Under its internal law, Luxembourg tax authorities may not obtain certain information from Luxembourg financial institutions. As clarified in the exchange of notes, certain information of financial institutions may be obtained and provided to certain United States authorities only in accordance with the terms of the treaty between the United States and Luxembourg on Mutual Legal Assistance in C Matters. That agreement sets forth the scope of that obligation. The ability to obtain this information is critical and we will not proceed to bring the Convention into force except in tandem with the Mutual Legal Assistance Treaty. We request that the Committee recommend that the Senate give its advice and consent to ratification on the understanding that instruments of ratification will not be exchanged until the exchange of instruments with respect to the Mutual Legal Assistance Treaty has occurred.

The proposed Convention waives the United States excise tax on certain insurance premiums paid to Luxembourg insurance companies, but does so in a more limited way that other United States tax treaties that waive the excise tax. This proposed Convention generally waives the excise tax on direct insurance premiums, but does not waive the tax on reinsurance premiums. Treasury agrees to waive the federal excise tax only if we are satisfied that the foreign country imposes a sufficient level of tax on insurance companies. In this case, we are satisfied that Luxembourg imposes a sufficient level of tax on direct business, but we are not satisfied that the effective tax rate on reinsurers is sufficient to justify waiving the excise tax on reinsurance premiums.

Turkey

The proposed treaty with Turkey, signed in Washington on March 28, 1996, will be the first income tax convention between the United States and Turkey and will complete the United States' network of income tax treaties with OECD member countries. The treaty represents a central component of the economic relationship between Turkey and the United States. The proposed treaty generally follows the pattern of the OECD Model Convention and other recent United States treaties. There are, however, variations that reflect particular aspects of Turkish law and treaty policy, their interaction with United States law, and the disparity in the Turkish and United States economies.

The treaty establishes maximum rates of source-country tax on cross-border payments of dividends, interest, and royalties. Dividends may be taxed at source at a maximum rate of 20 per cent, except when paid to a corporation in the other country that owns at least 10 percent of the paying corporation, in which case the maximum rate is 15 percent. The general maximum rate of withholding tax at source on interest under the proposed treaty is 15 percent, with lower rates applicable for certain classes of interest. Royalties generally are subject to tax at source at a maximum rate of 10 percent. Rental payments for tangible personal property are treated under the proposed treaty as royalties, but are subject to tax at a maximum rate of 5 percent at source.

The proposed treaty generally follows standard United States treaty policy by providing for exclusive residence country taxation of profits from international carriage by ships or airplanes and of income from the use or rental of ships, aircraft and containers. In this treaty, however, the reciprocal exemption does not extend to income from the non-incidental rental of ships or aircraft. Such income is treated as royalties and will be subject to a maximum tax at source of 5 percent.

The limitation of benefits provisions is consistent with other recent United States treaties. The proposed treaty contains administrative provisions consistent with United States treaty policy.

Switzerland

The proposed Convention and Protocol with Switzerland, signed in Washington on October 2, 1996, replace the existing Convention, which was signed in 1951. Many of the terms used in the Convention and Protocol are further explained in a Memorandum of Understanding that was negotiated at the same time. The new Convention generally follows the pattern of the OECD Model Convention, and of recent U.S. treaties with other developed countries. The proposed Convention and Protocol modernize many of the provisions of the existing convention and add new provisions that have become part of our treaty policy.

For example, under the proposed Convention, interest generally may be paid free of withholding in the source country, rather than being subject to the five percent withholding tax that may be levied under the existing treaty. Although the withholding rates on dividend and royalty income are essentially unchanged in the proposed Convention, the thresholds for, and exceptions from, those rates have been made consistent with other recent U.S. treaties. The proposed Convention also recognizes the growing importance of pooled capital, by providing that qualified pension funds may receive dividends from corporations resident in the other country free of source-country taxation.

The proposed Convention clarifies the treatment of capital gains and allows us to apply in full our rules regarding the taxation of gains from the disposition of U.S. real property interests. The proposed treaty also contains rules, found in a few other

U.S. treaties, that allow adjustments to the taxation of certain classes of capital gains in order to coordinate the timing of the taxation of gains. These rules serve to minimize possible double taxation that could otherwise result.

As with the recent U.S. treaties and the OECD Model, the proposed Convention provides generally for the taxation by one State of the business profits of a resident of the other only when such profits are attributable to a permanent establishment located in that other State. The present Convention grants taxing rights that are in some respects broader and in others narrower than those found in modern treaties. In addition, the proposed Convention preserves the U.S. right to impose its branch tax on U.S. branches of Swiss corporations. This tax is not imposed under the present treaty.

The proposed Convention provides, consistent with current U.S. treaty policy, for exclusive residence country taxation of profits from international carriage by ships or airplanes. This reciprocal exemption also extends to income from the rental of ships and aircraft if the rental income is incidental to income from the operation of ships or aircraft in international traffic. Other income from the rental of ships or aircraft and income from the use of rental of containers, however, are treated as business profits under Article 7. As such, these classes of income are taxable only in the country of resident of the beneficial owner of the income unless the income is attributable to a permanent establishment in the other Contracting State, in which case it is taxable in that State on a net basis.

The taxation of income from the performance of personal services under the proposed Convention is essentially the same as that under recent U.S. treaties with OECD countries. Unlike many U.S. treaties, the proposed Convention provides for the deductibility of cross-border contributions by a temporary resident of one country to certain pension plans in the other, under limited circumstances.

The proposed Convention contains significant rules to deny the benefits of the Convention to persons that are engaged in treaty shopping. The present Convention contains no such anti-treaty-shopping rules. Such provisions are found in all recent U.S. treaties. The Protocol and Memorandum of Understanding contain explanations and examples of the application of the Limitation on Benefits provisions.

The Limitation on Benefits article of the proposed Convention also eliminates another potential abuse by denying U.S. benefits with respect to income attributable to third-country permanent establishments of Swiss corporations that are exempt from tax in Switzerland by operation of Swiss law (the so-called "triangular cases"). Under the proposed rule, full U.S. treaty benefits generally will be granted in these triangular cases only when the U.S. source income is subject to a significant level of tax in Switzerland or in the country in which the permanent establishment is located.

The proposed Convention provides a U.S. foreign tax credit for the Swiss income taxes covered by the Convention, and for Swiss relief from double taxation with respect to the income of Swiss residents subject to U.S. taxation. Swiss relief may be in the form of a deduction, credit or exemption. In the case of social security benefits, a partial Swiss exemption is provided, which, when combined with the reduction in U.S. source-basis tax results in the avoidance of potential double taxation. The proposed Convention also provides for non-discriminatory treatment (ie., national treatment) by one country of residents and nationals of the other.

Also included in the proposed Convention are the rules necessary for administering the Convention, including rules for the resolution of disputes under the treaty and the exchange of information. The information exchange provisions, as elaborated in the Protocol and Memorandum of Understanding, make clear that U.S. tax authorities will be given access to Swiss bank information in cases of tax fraud. The Protocol includes a clear and broad definition of tax fraud that should facilitate information exchange. Furthermore, the new treaty provides that, where possible, information will be provided in a form that will make it acceptable for use in court proceedings.

The proposed Convention allows for the use of arbitration to resolve disputes that may arise between the Contracting States. However, the arbitration process may be implemented under the Convention only after the two Contracting State have agreed to do so through an exchange of diplomatic notes. Once implemented, a particular case may be assigned to an arbitration panel only with the consent of all the parties to the case.

The proposed Convention deals with cases where a Contracting State enacts legislation that is believed to modify the application of the Convention in a significant manner. In such cases, either Contracting State may request consultations with the other to determine whether an amendment to the Convention is appropriate in order to restore the original balance of benefits.

Thailand

The proposed treaty with Thailand, signed in Bangkok on November 26, 1996, will, if ratified, be the first tax treaty between the United States and Thailand to enter into force. An income tax treaty with Thailand was signed in 1965 but was returned to the President at his request in 1981 never having been formally considered by the Senate. The current proposed treaty is a major step in our efforts to expand our tax treaty network in Asia and will facilitate negotiating tax treaties with other important countries in the region. The proposed treaty generally follows the pattern of the U.S. Model treaty, with the deviations from the Model found in many recent U.S. treaties with other developing countries. There are also some further variations that reflect particular aspects of Thai law and treaty policy, the interaction of U.S. and Thai law, and U. S.-Thai economic relations.

The proposed treaty establishes maximum rates of source-country tax on cross-border payments of dividends, interest, and royalties. Direct investment dividends are taxable at source at a 10-percent rate, and portfolio dividends are taxable at a 15-percent rate. The proposed treaty provides for a 15-percent maximum rate of tax at source on most interest payments. Copyright royalties (including software) are subject to a 5-percent tax at source. Royalties for, the right to use equipment are subject to a 8-percent tax at source. Royalties for patents and trademarks are subject to a 15-percent tax at source. These rates generally are lower than those in many tax treaties Thailand recently has entered into.

The taxation of capital gains under the proposed Convention does not follow the usual pattern. Like some other U.S. treaties, it allows gains to be taxed by both Contracting States under the provisions of their internal law.

Consistent with recent U.S. treaties and the U.S. and OECD Models, the proposed Convention provides generally for the taxation by one State of the business profits of a resident of the other only when such profits are attributable to a permanent establishment located in that other State. The proposed Convention, however, grants rights to tax business profits that are somewhat broader than those found in the U.S. and OECD Models: It allows taxation of some income that is not attributable to a permanent establishment, but only if it can be shown that the income was shifted away from the permanent establishment to avoid tax. Thus this “limited force of attraction” rule is narrower than those found in the U.N. Model and section 864(c)(3) of the U.S. Internal Revenue Code.

The proposed Convention, consistent with current U.S. treaty policy, provides for exclusive residence-country taxation of profits from international carriage by aircraft. This reciprocal exemption also extends to income from the rental of aircraft if the rental activity is incidental to the operation of aircraft by the lessor in international traffic. However, income from the international operation of ships, including ship rental income that is incidental to such operations, is taxed at one-half of the tax rate otherwise applicable. Income from the use or rental of containers that is incidental to the operation of ships or aircraft in international traffic is treated the same as the income from the operation of the ships or aircraft in international traffic i.e., it is exempt if incidental to such aircraft operations, and taxed at half of the rate otherwise applicable if incidental to such operation of ships). Income from the rental of ships, aircraft or containers that is not incidental to the operation of ships or aircraft in international traffic is treated as business profits, and thus is taxable by the state other than the income recipient’s state of residence only on a net basis and only if attributable to a permanent establishment in the state. The current treaty policy of Thailand is to treat such income as royalties subject to tax at a rate of 8 percent of gross. Treatment as business profits was a concession gained by the United States.

The proposed Convention grants a taxing right to the host country with respect to income from the performance of personal services that is broader than that in the OECD or U.S. Model, but that is similar to that granted under other U.S. treaties with developing countries.

The proposed Convention contains detailed rules designed to restrict the benefits of the Convention to persons that are not engaged in treaty shopping. The provisions are similar to those found in the U.S. Model and in all recent U.S. treaties.

The information exchange provisions make clear that Thailand is obligated to provide U.S. tax officials such information as is necessary to carry out the provisions of the Convention. The U.S. negotiators are satisfied that, under this provision, Thailand is now able to provide adequate tax information, including bank information, to the United States whenever there is a Thai tax interest in the case. Under current Thai law, however, Thailand is not able to provide information under the tax treaty in non-criminal cases where there is no Thai tax interest. The proposed Convention contains an unusual provision designed to deal with this “tax interest” problem. The proposed Convention provides that Thailand generally is required to treat a U.S. tax interest as a Thai tax interest and the U.S. generally is required to treat a Thai tax interest as a U.S. tax interest. However, the "tax interest" provision does not take effect with respect to either country until the United States receives from Thailand a diplomatic note indicating that Thailand is prepared and able to implement the provision, which will not be possible until Thai law is changed. If the United States has not received such a diplomatic note by June 30 of the fifth year following the entry into force of the Convention, the entire Convention shall terminate on January I of the sixth year following entry into force.

The Convention remains in force indefinitely, except in the instance just described, but either State may terminate the Convention after 5 years from the date on which the Convention enters into force, with six-months' notice.

South Africa

The proposed treaty with South Africa, signed February 17, 1997, renews a treaty relationship that was interrupted when the previous convention was terminated in 1987 pursuant to the U.S. Anti-Apartheid Act. The proposed Convention with South Africa generally follows the pattern of the OECD Model treaty and other recent United States treaties.

The proposed Convention establishes maximum rates of withholding at source on investment income that are the same as those in the U.S. Model. The taxation of capital gains under the proposed Convention also follows the pattern of the U.S. Model.

As with recent U.S. treaties and the U.S. and OECD Models, the proposed Convention provides generally for the taxation by one State of the business profits of a resident of the other only when such profits are attributable to a permanent establishment located in that other State. The proposed Convention, however, grants rights to tax business profits that are somewhat broader in one respect than those found in the U.S. and OECD Models. Under the proposed Convention, an enterprise will have a permanent establishment in a Contracting State if its employees or other personnel provide services within that State for 183 days or more within a 12-month period in connection with the same or a connected project.

As with the treatment of business profits, personal service income is subject to rules that generally follow the U.S. Model rules. The 183-day personal service rule in the definition of permanent establishment, however, is also present in the definition of fixed base.

The proposed Convention, consistent with current U.S. treaty policy, provides exclusive residence-country taxation of profits from international carriage by ship or aircraft. This reciprocal exemption also extends to income from the rental of ships, aircraft and containers.

In the proposed Convention, the dollar threshold for host-country taxation of income of entertainers and sportsmen is $7,500, rather than $20,000, as in the U.S. Model. The proposed Convention, however, contains a rule allowing the Contracting States to increase the amount through an exchange of diplomatic notes.

The treatment of pensions differs, at the request of South Africa, from that in the U.S. Model. Pensions will be subject to limited source-country tax. The residence country may also tax, subject to a foreign tax credit if the source country has taxed. Like the U.S. Model, an individual employed in one country who belongs to a pension plan in the other may, subject to certain conditions, be allowed in his country of employment to deduct contributions to his plan in the other country.

As in the U.S. Model, the proposed Convention provides that income of a resident of a Contracting State not dealt with in the other articles of the Convention is taxable only in the country of residence of the recipient.

The proposed Convention contains significant Iiinitation on benefits rules similar to those found in the U.S. Model and in all recent U.S. treaties. The information exchange pro visions make clear that South Africa is obligated to provide U.S. tax officials such information, including bank information, as is necessary to carry out the provisions of the Convention. Consistent with U.S. policy, South African information will be available to U.S. authorities whether or not South Africa has a tax interest in the information.

The proposed Convention provides a U.S. foreign tax credit for the South African income taxes covered by the Convention, including the normal tax and the secondary tax on companies, and for a South African foreign tax credit for the U.S. income taxes covered by the Convention. The U.S. foreign tax credit is subject to normal limitations of U.S. law, including limitations relating to the amount of foreign source income of the U.S. taxpayer and denial of the credit for non-compulsory payments.

Ireland

The proposed Convention, Protocol and exchange of diplomatic notes between the United States and Ireland, which were signed in Dublin on July 28, 1997, would replace the present treaty between the two countries. The present treaty is the oldest U.S. tax treaty; it was signed in 1949. The proposed treaty updates the existing treaty to reflect the current laws and tax treaty policies of both countries. It fills a major void in the existing treaty by introducing a comprehensive limitation on benefits provision and a dispute resolution procedure.

The proposed treaty generally maintains the existing treaty's rates of tax on direct and portfolio dividends, which are 5 and 15 percent, respectively, Consistent with U.S. treaty policy, the threshold for qualifying for the direct investment rate has been reduced from 95 percent of the ownership of the equity of a company to ten percent. However, Ireland will exempt direct investment dividends paid to U.S. residents from any withholding tax. Ireland also will allow U.S. portfolio investors in Irish companies the tax credit provided to individuals resident in Ireland for a portion of the Irish corporation tax paid on distributed profits.

The proposed treaty maintains the existing treaty's general exemption at source for interest and royalty payments.

Unlike the existing treaty, the proposed treaty preserves the U.S. right to impose its branch profits tax in addition to the basic corporate tax on a branch's business.

The proposed treaty provides special rules for the taxation of activities associated with the offshore exploration for, and exploitation of, natural resources. These rules provide for somewhat shorter time thresholds than would otherwise apply for these activities to give rise to a permanent establishment. They also permit taxation of employee compensation associated with offshore activities. Other U.S. treaties with countries in this geographical area (for example, Norway, the United Kingdom, and the Netherlands) have similar provisions dealing with offshore activities.

The proposed treaty includes a comprehensive limitation on benefits provision to combat treaty shopping. The provision is broadly similar to the corresponding provisions in other recent U.S. treaties, but it has been tailored to accommodate the small size of the Irish economy and the historically large share of foreign ownership of Irish business. The limitation on benefits provision is most similar to the corresponding provision in the proposed treaty with Luxembourg.

The proposed treaty closes another gap in the current treaty by introducing a provision to resolve disputes by mutual agreement under the treaty. Such a provision is necessary in some cases to avoid double taxation.

The proposed treaty allows for the use of arbitration to resolve disputes that may arise between Ireland and the United States over the application of the treaty. However, the arbitration process may be implemented only after the two States have agreed to do so through an exchange of diplomatic notes. Once implemented, a case may be assigned to arbitration only with the consent of all the parties to the case.

Also included in the proposed treaty are rules for the exchange of information by the tax authorities of Ireland and the United States. The treaty provides for extensive exchange of information necessary to enforce tax laws and confirms that Ireland will obtain and provide any information relevant to the investigation or prosecution of a criminal tax matter.

Finally, the proposed treaty covers the U.S. excise tax imposed on insurance premiums paid to foreign insurers, but only where such insurance premiums are subject to the generally applicable tax imposed on insurance companies in Ireland. This proviso means that the excise tax may be imposed on insurance premiums paid to companies that receive the tax benefits associated with Ireland's International Financial Services Center (which is sometimes referred to as the "Dublin Docks"). This provision was included in the treaty after the Department of the Treasury determined that insurance companies subject to Ireland's generally applicable insurance tax regime face a substantial tax burden relative to the U.S. taxation of U.S. insurance companies, but companies benefiting from Ireland's International Financial Services Center do not face such a substantial tax burden.

The treaty will enter into force on the date the instruments of ratification are exchanged. The provisions with respect to taxes withheld at source will have effect on or after the first day of January following entry into force. With respect to other U.S. taxes, the treaty generally will have effect for taxable years beginning on or after that date. In the case of other Irish taxes, the treaty will have effect for financial years (in the case of the corporation tax) or years of assessment (in the case of the income and capital gains tax) beginning on or after that date. Like many U.S.

tax treaties that replace existing treaties, a provision allows residents to choose to apply the existing treaty for an additional year.

Canada

The proposed fourth Protocol to the Income Tax Convention between the United States and Canada was signed in Ottawa on July 29, 1997. The proposed Protocol is limited to two issues: the taxation of social security benefits, and the taxation of foreign real property holding companies.

The 1995 Protocol to the US-Canada Tax Convention, which became effective January 1, 1996, changed the taxation of social security benefits. Under the Convention prior to amendment by the 1995 Protocol, the country of residence of the recipient taxed social security benefits paid by the other country on a net basis but exempted 50 percent of the benefit. Under the present regime, the benefits are taxed at source at a rate of 25.5 percent by the US and 25 percent by Canada. However, Canada permits U.S. recipients of Canadian benefits to file a Canadian tax return and pay tax at regular graduated rates on net income.

This proposed Protocol returns to a system of residence-based taxation in which social security benefits are taxable in the country where the recipient lives. Therefore social security benefits will be taxed on a net basis at graduated rates and low-income recipients will not pay any tax. However, the taxation of benefits in the residence country takes into account how the benefits would have been taxed in the source country. For example, since the United States only includes 85 percent of the U.S. benefits in income, only 85 percent of U.S. benefits received by Canadians will be subject to Canadian tax.

The proposed Protocol is retroactively effective to January 1, 1996, the date the prior rule took effect, so that social security recipients will receive a refund of taxes previously paid although some recipients may be required to pay additional taxes to their country of residence. However, if as a result of the change, the residence-country tax would exceed amount of the refund, there will be neither a refund of source-country tax nor the imposition of additional residence-country tax. Consequently, no one will be subject to a higher rate of tax for the retroactive period. However, in the future some high-income recipients of benefits will be subject to a higher rate of tax if their average tax rate on these benefits in their country of residence is higher than the current rate of source-country withholding tax.

The proposed Protocol also denies each country the right to tax income from the sale of the stock of foreign corporations whose assets primarily consist of domestic real estate (e.g., real property holding companies). Both countries currently tax foreign persons on the sale of both domestic real estate and the stock of domestic corporations whose assets primarily consist of domestic real estate. The current Convention permits this tax and also permits the taxation of income from the sale of stock of foreign companies whose assets primarily consist of domestic real estate but neither country currently imposes such a tax. We believe that it is inappropriate to tax such sales, but a bill imposing such a tax was introduced in the last session of the Canadian Parliament. Although the Canadian Parliament was dissolved before these amendments were passed, they are expected to be re-introduced in the next session with the same effective date. The proposed Protocol amends the Convention to limit each country's right to tax gains from the sale of stock of real property holding companies to companies that are resident in that country. This provision will be retroactively effective to April 26, 1995, the date the previous Canadian legislation was proposed to be effective.

Treaties under Negotiation

We are continuing to maintain an active calendar of tax treaty negotiations. Early this summer we initialed treaties with Estonia, Latvia, and Lithuania. We are nearing completion of our negotiations with Bangladesh, Sri Lanka, and Denmark. We also are resuming negotiations with Venezuela and Italy. In addition, in accordance with the treaty program priority noted earlier, we continue to seek opportunities for tax treaty discussions and negotiations with several countries in Latin America and Southeast Asia.

Conclusion

Let me conclude by again thanking the Committee for its continuing interest in the tax treaty program, and for devoting the time of Members and staff to undertake a meaningful review of the agreements that are pending before you. We appreciate your efforts this year and in past years to bring the treaties before this Committee and then to the full Senate for its advice and consent to ratification. We also appreciate the assistance and cooperation of the staffs of this Committee and of the

Joint Committee on Taxation in the tax treaty process. With your and their help, we have, since the beginning of 1993, brought into force 15 new treaties and protocols, not counting the eight agreements presently being considered.

We urge the Committee to take prompt and favorable action on all of the Conventions and Protocols before you today. Such action will send an important message to our trading partners and our business community. It will demonstrate our desire to expand the United States treaty network with income tax treaties formulated to enhance the worldwide competitiveness of United States companies. It will strengthen and expand our economic relations with countries that have seen significant economic and political changes in recent years. It will make clear our intention to deal bilaterally in a forceful and realistic way with treaty abuse. Finally, it will enable us to improve the administration of our tax laws both domestically and internationally.

I will be glad to answer any questions you might have.

U.S. DEPARTMENT OF JUSTICE,
OFFICE OF LEGISLATIVE AFFAIRS,
WASHINGTON, D.C. 20530.
October 6, 1997

HON. JESSE HELMS,
Chairman,
Committee on Foreign Relations
U.S. Senate
Washington, D.C. 20510

DEAR MR. CHAIRMAN.

Seven income tax treaties and one protocol are pending before the Foreign Relations Committee, namely treaties with Austria, Switzerland, Ireland, Luxembourg, Turkey, South Africa, and Thailand, as well as a protocol with Canada. The Department of Justice urges that the Committee and the Senate approve these agreements at the earliest date practicable.

The civil and criminal enforcement actions of the Tax Division of the Justice Department are increasingly dependent on our ability to obtain foreign evidence. Therefore, it is especially helpful to us that the treaties forwarded by the President contain exchange of information provisions that will significantly enhance the ability of federal investigators and litigators to obtain foreign documents and testimony to enforce U.S. tax laws. These provisions will also improve the ability of federal authorities to obtain evidence in a form admissible for U.S. court proceedings.

In particular, we believe that the proposed tax-treaties with Austria, Switzerland, Ireland, and Luxembourg (in conjunction with the proposed mutual legal assistance treaty (MLAT) with Luxembourg) [1] will remove significant barriers currently facing U.S. tax enforcement. The tax treaties with those countries, along with the Luxembourg MLAT, have provisions that will assist U.S-tax authorities in obtaining information held by financial institutions located in those countries, which have very strict financial secrecy laws, for U.S. criminal tax offenses. We have had a substantial number of criminal cases in the past for which we needed financial information located in these jurisdictions. Furthermore, the proposed tax treaties with Austria, Switzerland, Ireland and Luxembourg provide for exchanging information, other than that held by financial institutions in these four countries, for both civil and criminal tax matters being investigated or enforced in court by federal tax authorities in the United States.

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[1] The proposed MLAT with Luxembourg is significant here because, during the negotiations for the Luxembourg Tax Treaty, the Luxembourg Tax Treaty Delegation, after thoroughly consulting with the principals in Luxembourg, emphatically stated that Luxembourg law precluded Luxembourg officials from obtaining and providing financial information held by a Luxembourg institution through an administrative process such as a tax treaty. On the other hand, the Luxembourg Delegation emphasized that such assistance could be arranged through a judicial process and suggested that we pursue the conclusion of an MLAT with Luxembourg that would allow access by U.S. tax authorities to Luxembourg financial information for criminal tax offenses. Accordingly, the United States has negotiated an MLAT with Luxembourg that covers most, if not all, U.S. criminal tax offenses and it is understood that the U.S. would view a failure by Luxembourg to provide assistance for criminal tax offenses under the MLAT as grounds for termination of the tax treaty.

The Department believes that all eight pacts will greatly enhance the tax enforcement capabilities of the United States government.

The Office of Management and Budget has advised that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

ANDREW FOIS,
ASSISTANT ATTORNEY GENERAL.

Senator HAGEL. Mr. Secretary, thank you.

Senator Sarbanes, would you like to begin? Whatever you want to do.

Senator SARBANES. Mr. Guttentag, have you had a chance to review the work of the joint committee on taxation with respect to these various tax treaties?

Mr. GUTTENTAG. Yes, I have.

Senator SARBANES. Have you prepared a memo or anything that responds to some of the questions they raise? Has that been done?

Mr. GUTTENTAG. Well, the questions that were raised, I believe we addressed those in our full statement, Mr. Sarbanes. Some of those were addressed in my oral statement. Is there something specifically that I could address?

Senator SARBANES. Well, I have not had a chance to go through your full statement. So I am not in a position to make the judgment of whether it responds to the points raised by the staff of the joint committee on taxation. They do a very thorough and comprehensive review. I have a high opinion of their work.

If it has not been answered, I think, Mr. Chairman, we ought to get that for the use of the committee.

Mr. GUTTENTAG. I would be glad to submit answers to the specific issues raised in each one of those cases.

Senator SARBANES. Well, let me take a few of them up with you.

Mr. GUTTENTAG. Certainly.

Senator SARBANES. Let me turn to the Austrian treaty first, and the stock gains. Apparently, we have made a one-sided concession, in which we allow Austria to impose a tax on stock gains through the year 2010 while the U.S. cannot impose a reciprocal tax. This may mean double taxation of capital gains for some U.S. investors. In fact, the Joint Tax Committee says:

> The committee may wish to consider whether the provision of the proposed treaty that permits Austria to tax capital gains from an alienation of the shares of certain Austrian companies through the year 2010 is appropriate as a matter of U.S. treaty policy. In this regard, the committee may wish to consider whether the inclusion of this provision in the proposed treaty will serve as a precedent for future treaties to permit similar one-side concessions, contrary to longstanding U.S. treaty policy.

Now, what is your explanation for this?

Mr. GUTTENTAG. We do, in our treaty policy, we like to eliminate any capital gains of shares of stock or, generally, most movable property. We do not include real estate, which of course is subject to that kind of tax.

Senator SARBANES. Actually, our model treaty and the OECD model both reflect this policy, do they not?

Mr. GUTTENTAG. That is right. That is correct. In the Austrian treaty, which is presently in effect, permits Austria to tax capital gains. So our position when we negotiated with Austria was to provide for no taxation of capital gains. They pointed out to us that because under the current treaty they permitted taxpayers to establish corporations in Austria free of Austrian tax on the basis that when the stock in those corporations was later sold, they would be able to tax it.

So their position was that they needed a type of grandfathering position which, until the year 2010, would allow them to tax those transactions. We believe that those are extremely few in number, and it is a very limited exception. We were able, thereby, by making this very limited exception, to achieve our overall policy. Because, generally, overall, there will be no Austrian taxes on capital gains, consistent with our model and the OECD model.

Senator SARBANES. So it is your position that you were, in effect, carrying through an existing provision in the current treaty?

Mr. GUTTENTAG. No; in the current treaty, there is no limit on Austrian capital gains. So we were able to put a provision in the new treaty which was consistent with our model—that there would not be any tax, with this limited exception.

Senator SARBANES. I see. Now, on the royalties, you went in the other direction. You expanded the exception, did you not, on royalties?

Mr. GUTTENTAG. Yes.

Senator SARBANES. Did you expand it?

Mr. GUTTENTAG. Yes. With respect to royalties, we do not consider we expanded that so much as we took into account new developments. The definition of movie and broadcast royalties that was put into the treaty 40 years ago or so did not take in account new technological developments, where we felt that it was appropriate—one, we do not believe it is appropriate—it is not our policy to provide for any tax in this area; but if there were to be a tax, we felt it was appropriate to include quite similar technologies to the radio and television broadcasting.

Senator SARBANES. Why would we do that if our objective is to eliminate source country tax on royalties? Why would you update it for the technology? We do not want to do that, do we?

Mr. GUTTENTAG. That was our bargaining. This was a bargain that we were able to reach with the Austrians. Taxation of royalties today means a lot more, I can tell you, Mr. Sarbanes, to American companies than it did at the time we negotiated this treaty. We do everything possible to make sure that those royalties flow into the U.S. free of any withholding tax. In order to do that, we have to make concessions. Because, in many cases, the flow of royalties into the United States from foreign countries is much greater than the flow in the other direction.

And you will have the opportunity to hear Mr. Mattson, from IBM, in the next panel. I think he will support this position, not only of the importance, but of the efforts made by Treasury to maintain that position.

Senator SARBANES. Well, it does not matter to the company; they do not pay a larger tax bill, do they?

Mr. GUTTENTAG. Very often they do, Mr. Sarbanes, because it depends whether they are able to offset those foreign taxes against their U.S. taxes. That depends on the particular position of the company. That is one reason why we try to eliminate the tax at source to the fullest extent possible.

Senator SARBANES. Well, I am not getting an answer to my question.

Mr. GUTTENTAG. Yes.

Senator SARBANES. Is U.S. treaty policy generally to eliminate source country tax on royalties?

Mr. GUTTENTAG. It certainly is. You can look at Austrian treaties, Mr. Sarbanes. We did better than with most other countries. In many of their treaties, there is a 10 percent rate which is applied across the board to any royalties paid to a parent company.

Senator SARBANES. What is the existing provision in the Austrian treaty?

Mr. GUTTENTAG. The present position is that the tax is a nil rate of tax on royalties, with the exception of the movie royalties.

Senator SARBANES. And those are 10 percent?

Mr. GUTTENTAG. That is right.

Senator SARBANES. Now you have expanded it. So it is not only movie royalties, but also radio and television; is that correct?

Mr. GUTTENTAG. That is right.

Senator SARBANES. Well, isn't that moving in exactly the opposite direction from our general treaty policy?

Mr. GUTTENTAG. It is moving only in the sense of the particular items which are included. One, we are now reflecting in this treaty the technology which presently exists, which did not exist back then. So if we would have written that provision back then, it would have contained this language.

Senator SARBANES. What happens to radio and television broadcasting now under the current treaty?

Mr. GUTTENTAG. They are taxed at 10 percent. Those royalties are taxed at 10 percent.

Senator SARBANES. Under the existing treaty?

Mr. GUTTENTAG. Under the existing treaty.

I think if you compare the withholding rates under the Austrian treaties with other countries and with the U.S., you will find that the U.S. rates are generally more favorable, including the royalty provisions. We did a good job in negotiating that treaty. It is fair. It is fair to Austria, but it is also fair to the U.S.

Senator SARBANES. Well, I am just trying to find out what you did at the moment, then we will evaluate it.

Mr. GUTTENTAG. OK.

Senator SARBANES. The Joint Tax Committee says the following:

> The proposed treaty expands the class of royalty payments that are subject to the 10 percent source country taxation. Under the present treaty, only motion picture film rentals are subject to source country taxation. Under the proposed treaty, source country taxation also applies to payments for the use of or the right to use tapes or other means of reproduction used for radio or television broadcasting. Consequently, a significantly expanded class of Austrian source royalties, beneficially owned by U.S. residents, will be subject to a 10 percent Austrian withholding tax under the proposed treaty.

Is that correct?

Mr. GUTTENTAG. Yes, their statement is correct.

Senator SARBANES. Well, I thought you just told me that under the current treaty there was a 10 percent tax on radio and television broadcasting.

Mr. GUTTENTAG. I am sorry; that was only on movie royalties. I do not believe we had television royalties to any extent back in 1956.

Senator SARBANES. Well, I was very careful in asking that question.

Mr. GUTTENTAG. Yes, I am sorry, Mr. Sarbanes.

Senator SARBANES. Mr. Chairman, I have some more questions. Maybe I had better yield to you, and then I will pick up on these other questions later.

Senator HAGEL. All right. I will ask a couple of questions, then we will go back.

Mr. Secretary, can you give me a general range of the Treasury's estimation of the effect of these treaties on revenue flow to or from the Treasury?

Mr. GUTTENTAG. Mr. Chairman, the Treasury does not provide or make any revenue estimates on our tax treaties, as opposed to tax legislation. We take into account, in general, the amount of economic activity. This is an impossible task to do, according to our experts in this area. General revenue estimating concepts do not work well if you just try to apply the rules that we would use in estimating revenue effects of legislation internationally.

In many cases, there are secondary effects which are extremely important—removing barriers—we cannot tell—for example—Mr. Sarbanes asked whether, when we lower taxes, who gets the benefit of that. Is it the company or is it the U.S. Treasury? If we did not lower the tax, would they be able to use it as a credit against their U.S. tax or would it just lower their overall burden?

Well, we take the position that these treaties go beyond just the tax revenue involved. As you suggested in your opening statement, the impact on companies, encouraging these kinds of desirable economic activity, is the real purpose of these treaties. To avoid double tax is the real purpose of these treaties. The revenue flows, we do not believe, are that critical to making these decisions as to whether a treaty is appropriate, even if we could do so.

Senator HAGEL. Thank you.

Is the Treasury satisfied that all the treaties now under consideration that we are talking about today are sound structurally and without flaws?

Mr. GUTTENTAG. Yes, we are, Mr. Chairman.

Senator HAGEL. How does that work? How do you determine that? Do you model that? Or how do you come to that conclusion?

Mr. GUTTENTAG. Well, we go into the treaty negotiation with our draft. We enter into a negotiation—I think it is quite similar, Mr. Chairman, to the kinds of negotiations that you have participated in, in the business world. If we make a concession, we ask for an offsetting concession, which may be in a completely different part of the agreement. We also take into account special rules which apply in the U.S. or in the foreign country. Then we look, before we initial any convention, to determine whether we believe we have reached an appropriate balance. We are satisfied, with each one of these conventions, that we have done so.

Senator HAGEL. Thank you.

I noted a recent GAO report had suggested that many foreign corporations do not pay their fair share of taxes. You are probably familiar with that report. Are you satisfied that what we are doing here today deals with that issue?

Mr. GUTTENTAG. Yes. One of the most important ways that our treaties deal with that issue is providing for information exchange. So that we can have direct contact between the tax authorities of both countries. When a foreign corporation, therefore, is engaged in business in the United States, we have access to data as necessary in order to assure ourselves that tax returns are accurate. Other provisions of the treaty are enforced to make sure no unintended benefits go to foreign-based companies or to U.S.-based companies.

So these treaties are most helpful in assuring, one, that there are fair shares of taxes are paid to the U.S., but, at the same time, avoiding any double tax.

Senator HAGEL. What, in your opinion, are the major distinctions between the limitations on benefits provisions of these treaties? Are there differences?

Mr. GUTTENTAG. Yes, there are differences. I do not think any two are identical, nor are they identical to our model treaty. Each country has its own internal laws dealing with problems which we have to deal with in our limitations of benefits articles. In some countries, these laws may seem to encourage foreigners to use that country for treaty shopping purposes. In other cases, the rules are closer to those of the United States, which does not provide such encouragement.

Other countries have already adopted rules, long before we did, to deal with this issue. Switzerland is one example that you have before you today which, back in 1962, adopted provisions to deal with treaty shopping, and which are reflected in the treaty with Switzerland, where we provided a meld of our limitations of benefits provisions and the Swiss provisions.

Other countries, we take into account their membership in economic units, membership in the European Union, membership in NAFTA, to make sure that we do not discourage or interfere with those economic relationships.

Senator HAGEL. Thank you.

Senator Sarbanes.

Senator SARBANES. Well, let me pursue the answer you just gave on exchange of information and its importance in these tax treaties as I understand it. In the light of that answer, I want to ask about the treaty with Ireland. As I understand it, the Irish protocol states that for the purposes of obtaining information under the proposed treaties, the laws and practices of Ireland do not permit its tax authorities to carry out inquiries on behalf of another country where there is no Irish liability for such tax.

Now, what that means is, in practice, the U.S. will not be able to obtain information upon request from Ireland, but that Ireland will be able to obtain information upon request from the U.S. How could we have committed ourselves to language that requires us to provide more information than Ireland must provide, and prohibits us from withholding information because they do? And I contrast this with the proposed treaty we have with the Thailand.

The joint committee says here in their report:

> The language of this provision in the proposed treaty does not permit the U.S. to decline to obtain information that is requested by Ireland solely because the United States is not able to obtain information on a reciprocal basis from Ireland. One issue is whether the committee views the exchange of information provisions of the

proposed treaty as sufficient to carry out the tax-avoidance purposes for which income tax treaties are entered into by the United States.

Some might consider the nonreciprocal nature of the provision on obtaining information to be unusual. The committee may wish to consider whether such a nonreciprocal provision is appropriate in the context of the proposed treaty. Some might also observe that other countries that have similar local law impediments to obtaining information, such as Thailand, have received less advantageous treatment with respect to U.S. treaties than Ireland has as a consequence of these impediments.

What is your response to that?

Mr. GUTTENTAG. Well, yes, Ireland does have a prohibition against providing information in a case in which they do not have a particular Irish tax interest in getting that information. That is true under the current treaty with Ireland.

What we do when we go into a treaty with a country such as Ireland with which we already have a treaty is we see how much we can improve it. We negotiated long and hard on their tax interest issue. What we have agreed to is that we are able to get information, even if Ireland does not have a tax interest, with respect to certain criminal cases; not civil cases, however. That would be under another provision, as explained in the diplomatic notes which are attached to the Irish treaty.

So we were able to make a step forward there that, while we cannot get information on a civil case, we can get information in criminal cases under the Irish Criminal Justice Act.

Now, on the issue of whether we should provide information, there is a rule of comity which is applied internationally in any treaty. That is, it should be applied equally. I believe that, while this matter of information exchange is handled by the Internal Revenue Service, not the Treasury, if it appeared that there was a flow of information to Ireland on a regular basis and difficulties in obtaining information from Ireland because of this limitation, I think that we would then have to reconsider whether we would be willing to provide information in this nonreciprocal form.

But we prefer not to put this in a treaty to see what happens in practice.

Senator SARBANES. What did you do in the Thailand treaty? There, in effect, you allow us not to provide information if they do not provide information.

Mr. GUTTENTAG. That is right. We made that reciprocal. But, again, in Thailand, we have a couple of different situations. One, Thailand is a new treaty country. We take the position that when we are entering into a treaty with a new country, and particularly if we think there are going to be difficulties and problems with tax information exchange, we are liable to take a much more stringent negotiating position. That we did in Thailand.

While we made this reciprocal, we also put in Thailand a provision that if Thailand is not able to eliminate their requirement of a tax interest in order to provide information within a period of 5 years, the treaty will terminate. No action is required by the United States. No action is required by the Senate.

So we have sent a clear message to Thailand that they must eliminate this restriction in their law which prohibits their giving us the information. They have indicated to us, the tax authorities with whom we dealt, that they are interested in eliminating this restriction. They were not able to do it because of provisions of

Thai law. We believe that putting it in the treaty in this way, that the benefits of the treaty will cause them to seriously consider enacting the legislation and keeping the treaty in force.

So we do approach these, Mr. Sarbanes, differently when we have an existing treaty relationship with a longstanding treaty partner and a new country.

Senator SARBANES. Well, now, the joint committee says that the nonreciprocal nature of the provision on obtaining information is unusual. Is that correct?

Mr. GUTTENTAG. It may be unusual to have a provision in the treaty under the tax interest provision like that. That may be unusual.

Senator SARBANES. How many tax treaties do we have?

Mr. GUTTENTAG. Well, we have that in the U.K. treaty; it also has a tax interest requirement.

Senator SARBANES. How many tax treaties do we have altogether?

Mr. GUTTENTAG. We have 48.

Senator SARBANES. Forty-eight. In how many of them would we find this provision, the nonreciprocal nature of the exchange of information? The reason I am picking up on this issue is that you devoted one of your answers to the chairman at some length on the importance of the exchange of information for achieving the purpose of these tax treaties. Then we find that one of the treaties that is here before us today, we really do not seem to have met that standard.

Out of the 48 treaties, how many of them would have such a provision, that is nonreciprocal in nature?

Mr. GUTTENTAG. At least I know that Japan, the U.K. and Ireland. Mr. Sarbanes, remember, while it is nonreciprocal, the question is: Are we satisfied that we are doing the best we can to get the required information that we are going to need, taking into account the choice of having a treaty or not having a treaty?

And we are satisfied that under the Irish treaty, having negotiated long and hard with Ireland, knowing that we will be able to get information dealing with the more important criminal cases, regardless of the limitation, that we are satisfied that we are doing the best we can. We are better off getting that information under the current tax treaty than not having a treaty at all.

Senator SARBANES. Wouldn't you say that the reciprocal exchange of information is probably one of the most important objectives that we seek in any tax treaty?

Mr. GUTTENTAG. I certainly believe so. Because we are looking at this in two parts, as we said, Mr. Sarbanes. One is to prevent double taxation; and the other is to prevent fiscal evasion. We believe that this blending of these two purposes of the treaty are both critical and, obviously, the exchange of information is most important. The U.S. has been in the lead in the world in encouraging further exchange of information and breaking down barriers to exchange of information. We believe we have been very successful and that we are going to push further.

We have been working with the OECD, under its information exchange article. The OECD article contains a commentary which says that tax interest is not a valid reason not to give information.

As I said, we were able to persuade, we were able to persuade the Irish Legislature to give us information concerning criminal cases. So we have made a major improvement over the existing treaty.

Senator SARBANES. Now, as I understand it, the proposed treaties with Luxembourg, Switzerland and Ireland waive the U.S. excise tax on insurance premiums paid to foreign insurers. Such waivers of the excise tax on reinsurance premiums may place U.S. insurers at a competitive disadvantage with respect to foreign competitors in U.S. markets if a substantial tax is not otherwise imposed on the insurance income of the foreign reinsurer.

Now, we heard about that from the insurance people previously when we considered some tax treaties. In fact, in this committee's report on the U.S.-Bermuda tax treaty, the committee expressed its view that the waiver of the insurance excise tax could have the undesirable effect of eliminating all tax on insurance income and should not have been included in the treaty. Congress subsequently enacted legislation to ensure the sunset of that waiver, and has undertaken repeated efforts to redress the competitive imbalance created by similar waivers in the Barbados and the U.K. treaties.

Now, in light of this fairly strong congressional reaction, why was this provision, then, included in the Luxembourg, Switzerland and Ireland treaties?

Mr. GUTTENTAG. Well, we listened very carefully, Mr. Sarbanes. In negotiating these treaties, we took the positions, as you have just expressed, very much to heart. We examined the tax laws of Ireland, Luxembourg and Switzerland most carefully to assure ourselves that any waiver we gave of the Federal excise tax was accompanied by a reasonable tax imposed by the country of residence of the insurance company to prevent any inappropriate competitive advantage by the foreign insurance company.

We determined that, in Switzerland, there was such a tax imposed on insurance companies. In Luxembourg, we believe that there was with respect to insurance, but not reinsurance. So, therefore, reinsurance is carved out of the Luxembourg treaty. With respect to Ireland, we believe that the insurance taxes were appropriate; however, for companies operating in the international financial service centers in Ireland, which obtain certain tax benefits, we determined that those companies should not be entitled to the benefits of our excise tax exemption and they were not given that exemption.

Senator SARBANES. Now, if those countries should repeal those taxes, what would happen?

Mr. GUTTENTAG. We would then go in to take away their benefits of their exemption from the Federal excise tax.

Senator SARBANES. That is provided for in the treaties?

Mr. GUTTENTAG. Any change in the tax laws requires a renegotiation of the treaty itself.

Senator SARBANES. If they change their own tax policy with respect to their own insurance companies?

Mr. GUTTENTAG. Right. If we did that, we would then immediately take steps to eliminate—if we believe that resulted in a competitive disadvantage for the U.S. industry, we would immediately take steps to renegotiate the treaty and remove that exemption. The countries involved, I can tell you, each one of the countries involved was subjected to such a searching examination, they are fully aware of our policy in this regard.

Senator SARBANES. In 1974, Turkey invaded Cyprus, and since then has occupied the north of Cyprus in the contrary to repeated U.N. resolutions which the United States has consistently supported, calling for the withdrawal of their forces and so forth. I take it that this tax treaty with Turkey would not provide any tax benefits for any U.S. or Turkish permanent establishment in the north of Cyprus, that area now occupied by Turkish forces; is that correct?

Mr. GUTTENTAG. You are correct, Mr. Sarbanes. This treaty only applies to Turkey as it is recognized by the United States, which does not include northern Cyprus.

Senator SARBANES. And I take it that Turkish Cypriots would not be eligible for benefits under this treaty, as distinct from Turkish citizens?

Mr. GUTTENTAG. That is correct.

We do have a tax treaty with Cyprus. Any benefits for residents of Cyprus would be controlled by that treaty.

Senator SARBANES. Both the Turkish and Swiss treaties give preferential treatment to profits from the operation of ships and aircraft over profits from the rental of ships and aircraft. In addition, the Swiss treaty fails to limit to the country of residence the right to tax income from the use, maintenance or rental of containers used in international traffic. This is the container issue, with which I am sure you are familiar.

Mr. GUTTENTAG. Right.

Senator SARBANES. The 1990 committee report on the Indonesia tax treaty included the following comment:

> In 1983, the committee rejected the notion that a justifiable distinction could be made between container leasing income and income derived from other international transportation activities. The committee also questioned at that time the appropriateness of placing taxpayers primarily engaged in container leasing activities at a competitive disadvantage vis-a-vis companies engaged in international shipping and air transport activities. The committee also instructed the Treasury Department to include only the U.S. model provision on this matter in all future treaties.

Well, I gather that has not been done and that the failure to cover container leasing once again puts this industry at a competitive disadvantage in these particular treaties; is that correct?

Mr. GUTTENTAG. We have come, I think, very close to providing exactly what the Senate has asked us to do in connection with the container leasing. The container leasing exemptions are provided in the treaties with Turkey, Luxembourg, Austria, South Africa, and Ireland. You mentioned Turkey, there is an exemption for containers in the Turkish treaty.

In the treaty with Switzerland, income from containers are treated as business profits. What is the significance of that?

That means that Switzerland cannot tax any of the income resulting from the use of containers unless the owner of those containers operates in Switzerland through a permanent establishment.

Mr. Sarbanes, we have kept in close connection and close contact with the container industry with respect to all of those treaties since the Senate indicated its interest in this area. We believe that while we have not in every treaty here complied exactly with the model and been able to achieve our model result, that we have arrived at results which the container industry understands and which they find to be in a better position than if we had no treaty, and which they find to be satisfactory.

Many of these countries have policies, Mr. Sarbanes, which are just as tough and as immovable as ours. If we were to try to have a treaty in which all of our model provisions and desires would be achieved, we would have far fewer than the 48 treaties that we have now. I am sure that you understand that and did not mean to imply otherwise.

Senator SARBANES. Well, Mr. Chairman, I know we have to vote. I would like to make this suggestion. I would like to repeat what I said at the outset—that Mr. Guttentag take the questions raised by the joint committee on taxation and provide to the committee a response to the issues that they posed.

Let me give you just an example of that, because I was told that their response is in the statement. But I am looking at your statement, and unless there is an appendix, which I have not seen, there is only a minor reference to Ireland on the question of exchange of information, about which we just had an extended discussion. Let me read it to you, because it is very brief:

> Also included in the proposed treaty are rules for the exchange of information by the tax authorities of Ireland and the United States. The treaty provides for extensive exchange of information necessary to enforce tax laws, and confirms that Ireland will obtain and provide any information relevant to the investigation or prosecution of a criminal tax matter.

Now, that is correct as far as it goes, but I do not think it goes very far in terms of addressing the issues that were raised by the Joint Tax Committee and the ones which we have just have discussed in some detail here. So I think there would be a benefit to receiving fuller responses. I understand you feel you have done a good job of negotiating these treaties, and I am not in a position now to say that is not the case.

I am just raising some questions. But it seems to me that the legitimate concerns that have been raised by the staff of the Joint Tax Committee need to be responded to by the Treasury for the benefit of this committee. I think we should ask for that.

Mr. GUTTENTAG. Well, I have tried to do the best I can during this relatively short time with these complicated issues.

Senator SARBANES. I understand.

Mr. GUTTENTAG. But we will be glad to give you that in writing, Mr. Sarbanes.

Senator SARBANES. Good, that would be very helpful.

Senator HAGEL. Secretary Guttentag, thank you.

I, too, have some additional questions that I would like to submit in writing for the record.

Mr. GUTTENTAG. Thank you.

Senator HAGEL. And we appreciate very much your time.

The subcommittee will stand in recess for about 15 minutes in order for Senator Sarbanes and I to vote. Then we would like very much, if Mr. Kies is still available, to have him come up. Thank you.

[Recess.]

Senator HAGEL. Mr. Kies, thank you for waiting. I do not know if you got a cup of coffee. In the old days, you said you would get a smoke, but we do not see that any more.

Mr. Kies, please proceed, and thank you very much for coming today.

STATEMENT OF KENNETH J. KIES, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mr. KIES. Thank you, Senator Hagel and Senator Sarbanes. Thank you for inviting the staff of the joint committee to be able to present testimony here today. I will be referring to my oral testimony. The committee also has written testimony that I would ask that you include in the record, as well.

I am accompanied by Barbara Angus, Tom Barthold, Barry Wold, and Oren Penn, who all worked on the pamphlets and also the testimony for the joint committee.

It is my pleasure to present our testimony at this hearing concerning the proposed income tax treaties with Austria, Ireland, Luxembourg, South Africa, Switzerland, Thailand, Turkey, and the proposed protocol amending the existing income tax treaty with Canada. As in the past, the staff of the joint committee has prepared pamphlets covering each of the proposed treaties and protocols. The pamphlets contain detailed descriptions of the provisions of the proposed treaties and protocols. The pamphlets also contain detailed discussion of issues raised by the proposed agreements. We consulted extensively with your committee staff in analyzing the agreements and preparing the pamphlets.

Five of the eight agreements at issue today would modify existing U.S. treaty relationships. Three of the agreements are with countries with which we have no treaty currently. Let me highlight some of the key features of the agreements.

In connection with consideration of these agreements, an issue was raised regarding the U.S. treaty policy with respect to the treatment of dividends from U.S. real estate investment trusts, referred to commonly as REIT's. U.S. tax treaties generally limit the maximum rate of withholding tax that may be imposed by the source country on portfolio dividends paid by a corporation resident in one country to residents of the other country.

Most commonly, the maximum rate of withholding tax on dividends is 15 percent. Treaties negotiated by the U.S. after 1988 contain specific rules excluding REIT dividends from the reduced rates of withholding tax generally applicable to dividends. Accordingly, under such treaties, REIT dividends may be subject to U.S. withholding tax at the full statutory rate of 30 percent. The U.S. REIT industry expressed concern that the exclusion of REIT dividends from the reduced withholding tax rates applicable to other dividends may inappropriately discourage foreign investment in U.S. REIT's.

The Treasury Department has worked extensively with the Joint Tax Committee and Foreign Relations Committee staffs, and representatives of the REIT industry to address this concern. As a result of significant cooperation among all parties, the U.S. treaty policy with respect to the treatment of REIT dividends has been modified. Under this new policy, REIT dividends paid to a resident of a treaty country will be eligible for the reduced rate of withholding tax applicable to portfolio dividends—typically 15 percent—in two new cases.

First, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 5 percent or less in each class of the REIT stock, and such dividends are paid with respect to a class of the REIT stock that is publicly traded. Second, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 10 percent or less in the REIT, and the REIT is diversified, regardless of whether the REIT stock is publicly traded.

This new policy with respect to the treatment of REIT dividends will be incorporated into the U.S. model treaty, and the Treasury Department will use its best efforts to negotiate protocols to amend the proposed treaties with Austria, Ireland and Switzerland to incorporate this policy.

In the case of Luxembourg, it is recommended that this policy be implemented by means of a reservation to the proposed treaty.

The proposed protocol with Canada would modify the income tax treaty that was signed in 1980. The proposed protocol would replace the provision in the existing treaty that provides for exclusive source country taxation of social security benefits with a provision that provides for exclusive residence country taxation of social security benefits. This represents a return to the approach that applied prior to the 1995 protocol. The proposed protocol also would modify the provision in the existing treaty allowing situs country taxation of gains from real property.

The proposed treaty with Austria is a comprehensive update of the 1956 treaty. The provisions of the proposed treaty generally comport with modern U.S. treaty policy. The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provision in the U.S. model treaty and other recent treaties.

The proposed treaty also includes an anti-abuse rule covering certain triangular cases which involve payments from the United States to the branch of an Austrian company located in a third country. Under this rule, the U.S. generally may tax, in accordance with its internal law, interest and royalties paid to a low-taxed, third country branch of an Austrian company.

The proposed treaty expands the class of royalty payments that is subject to a 10-percent source country tax to include payments for the use of films, tapes or other means of reproduction used for radio or television broadcasting.

The exchange of information provisions of the proposed treaty are substantially more useful than those of the current treaty. The information generally may be exchanged to carry out the purposes of the treaty or to carry out the domestic law of the countries concerning taxes covered by the information exchange article of the treaty. There are provisions in Austrian law that prohibit Austria from obtaining information from Austrian banks in non-penal investigations. However, bank information may be obtained for penal investigations. Accordingly, under the proposed treaty, bank information may be provided by Austria in connection with U.S. penal investigations, including the commencement of a criminal investigation by the IRS.

The proposed treaty with Ireland is a comprehensive update of the 1949 treaty. The provisions of the proposed treaty generally are consistent with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty shopping provision, which includes most of the elements of the anti-treaty-shopping provision found in the U.S. model treaty and other U.S. treaties. The proposed treaty includes a derivative benefits provision under which treaty benefits generally would be available to Irish companies that are owned by residents of countries that are members of the E.U. Or parties to NAFTA. Under this rule, the treaty benefits with respect to dividends, interest and royalties would be available only if the countries in which such owners are resident have treaties with the U.S. providing for benefits that are at least as favorable as those provided under the proposed treaty. However, this restriction on the availability of treaty benefits would take effect no earlier than 2 years after the proposed treaty takes effect. The proposed treaty also includes an anti-abuse rule, covering the so-called triangular case, similar to the provision in the Austrian treaty.

The proposed treaty provides an exemption for Irish insurance companies from the U.S. excise tax on insurance and reinsurance premiums paid to foreign insurers with respect to U.S. risks, subject to certain limitations, which Mr. Guttentag discussed with Senator Sarbanes.

The exchange of information article contained in the proposed treaty conforms in most respects to the corresponding articles of the U.S. and OECD model treaties. As is true under these model treaties, under the proposed treaty, the countries are to exchange such information as is necessary for carrying out the provisions of the proposed treaty or the domestic laws of the countries. There is one significant respect in which the exchange of information article does not conform to the corresponding article of the U.S. model treaty. Again, Senator Sarbanes and Mr. Guttentag discussed that exception, which relates to the not completely evenhanded approach which the treaty takes in that regard.

The proposed treaty with Luxembourg is a comprehensive update of the 1962 treaty. The provisions of the proposed treaty generally comport with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty-shopping provision which resembles the provisions in the U.S. model treaty. The proposed treaty includes a derivative benefits provision and an anti-abuse rule, covering the so-called triangular case, similar to those in the Irish treaty.

The proposed treaty provides an exemption for Luxembourg insurance companies from the U.S. excise tax on insurance premiums paid to foreign insurers with respect to U.S. risks, subject to certain limitations. However, unlike other U.S. tax treaties, the proposed treaty does not provide an exemption from the excise tax on reinsurance premiums paid to Luxembourg reinsurers. I believe Mr. Guttentag indicated the reason for that was that reinsurers are not taxed in a manner consistent with the way in which other insurers are taxed in Luxembourg.

The exchange of information provisions of the proposed treaty are more useful than those of the current treaty. Information generally may be exchanged to carry out the purposes of the treaty or to carry out the domestic laws of the countries concerning taxes covered by the information exchange article of the treaty. There are provisions in Luxembourg law that generally prohibit Luxembourg from obtaining information from Luxembourg financial institutions either for their own purposes or for purposes of the proposed treaty. However, such bank information may be obtained under certain circumstances involving criminal tax matters, pursuant to the proposed mutual legal assistance treaty with Luxembourg.

The proposed treaty with South Africa generally is consistent with other recent treaties that the U.S. has signed with developed countries. It is a straightforward reflection of current U.S. treaty policy, with only a few deviations. For example, the proposed treaty allows broader source-country taxation of business activities of residents of the other country by expanding the definition of a permanent establishment to include cases in which an enterprise provides services through its employees in a country if the activities continue for more than 183 days.

In addition, like many other U.S. treaties, the proposed treaty includes an anti-treaty-shopping provision, with an anti-abuse rule covering the so-called triangular case, as in the Irish and Luxembourg treaties.

The proposed treaty with Switzerland is a comprehensive update of the 1951 treaty. The provisions of the proposed treaty generally are consistent with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, with a derivative benefits provision and an anti-abuse rule dealing with the triangular case.

The proposed treaty provides an exemption for Swiss insurance companies from the U.S. excise tax on insurance and reinsurance premiums paid to foreign insurers with respect to U.S. risks. The exchange of information provisions of the proposed treaty are somewhat more useful than those of the current treaty, but are nonetheless more restrictive than the comparable provisions in tax treaties with other countries. Information generally may be exchanged to carry out the purposes of the treaty, but it may not be exchanged to carry out the domestic laws of the countries concerning taxes covered by the information exchange article of the treaty. Information may also be exchanged to prevent tax fraud.

The proposed treaty with Thailand would represent a new treaty relationship for the U.S. Under the proposed treaty, Thailand would agree to reduce its taxes on income that U.S. residents earn from sources in Thailand, The U.S. would agree to reciprocal reductions of its tax on U.S. income of Thai residents.

The proposed treaty follows preferred U.S. treaty positions in many respects. However, it differs from preferred U.S. treaty positions in other respects, primarily by not reducing source country taxation to the same extent as many U.S. tax treaties. In this regard, the proposed treaty is similar to other treaties that the United States has entered into with developing countries.

The exchange of information article contained in the proposed treaty conforms in most respects to the corresponding articles of the U.S. and OECD model treaties. As is true under these model treaties, under the proposed treaty, the countries are to exchange such information as is necessary for carrying out the provisions of the proposed treaty or the domestic tax laws of the countries. However, the proposed treaty would suspend the application of this provision until the U.S. receives from Thailand a diplomatic note indicating that Thailand is prepared and able to implement this provision, which will require that Thailand enact enabling legislation. This means that neither country will obtain information for the other until this diplomatic note is provided. Mr. Guttentag indicated that it is anticipated Thailand will take that action in the next couple of years.

Finally, the proposed treaty with Turkey would represent a new tax treaty relationship for the U.S. Turkey is the only OECD member country with which the U.S. has no tax treaty in force. Under the proposed treaty, Turkey would agree to reduce its tax on the income that U.S. residents earn from sources in Turkey, and the U.S. would agree to reciprocal reductions of its tax on U.S. income of Turkish residents.

The U.S. and Turkey also would agree that their tax administrators will exchange tax information where necessary to carry out tax laws, and will cooperate together to resolve problems in the coordination of the tax rules of the two countries that may arise in individual cases.

The proposed treaty follows preferred U.S. treaty positions in many respects. However, it differs from preferred U.S. treaty positions in other respects, primarily by not reducing source country taxation to the same extent as many U.S. tax treaties. In this regard, the proposed treaty is similar to the other treaties that the U.S. has entered into with developing countries.

These issues are discussed in more detail in the joint committee staff pamphlets on the proposed treaties and protocols. I would be happy to answer any questions that the committee may have.

[The prepared statement of Mr. Kies follows:]

PREPARED STATEMENT OF MR. KIES

My name is Ken Kies. I am Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation ("Joint Committee staff") at this hearing concerning the proposed income tax treaties with Austria, Ireland, Luxembourg, South Africa, Switzerland, Thailand, and Turkey and the proposed protocol amending the existing income tax treaty with Canada.

Overview

As in the past, the Joint Committee staff has prepared pamphlets covering each of the proposed treaties and protocols. The pamphlets contain detailed descriptions of the provisions of the proposed treaties and protocols, including comparisons with the 1996 U.S. model treaty, which reflects preferred U.S. treaty policy, and with other recent U.S. tax treaties. The pamphlets also contain detailed discussions of issues raised by the proposed treaties and protocols. We consulted extensively with your Committee staff in analyzing the proposed treaties and protocols and preparing-the pamphlets.

Five of the eight agreements at issue today would modify existing U.S. treaty relationships. The proposed protocol with Canada would make two modifications to the current treaty which was amended most recently in 1995. The proposed treaty with Austria would replace an existing treaty that has not been modified since 1956. The proposed treaty with Ireland would replace an existing treaty that has not been modified since 1949. The proposed treaty with Luxembourg would replace an existing treaty that has not been modified since 1962. The proposed treaty with Switzerland would replace an existing treaty that has not been modified since 1951. The other three treaties are with countries with which the United States does not currently have a treaty relationship. The proposed treaties with Thailand and Turkey would represent the entrance into tax treaty relationships where the United States has not previously had such a treaty. The final proposed treaty is with South Africa; the United States previously had a treaty with South Africa which was terminated in 1987, and no treaty currently is in force.

I will highlight some of the key features of these treaties and protocols and the issues they raise.

Common Issue

In connection with consideration of these treaties, an issue was raised regarding the U.S. treaty policy with respect to the treatment of dividends from U.S. Real Estate Investment Trusts ("REITs").

U.S. tax treaties generally limit the maximum rate of withholding tax that may be imposed by the source country on portfolio dividends paid by a corporation resident in one country to residents of the other country; most commonly, the maximum rate of withholding tax on dividends is 15 percent. Treaties negotiated by the United States after 1988 contain specific rules excluding REIT dividends from the reduced rates of withholding tax generally applicable to dividends. Accordingly, under such treaties, REIT dividends may be subject to U.S. withholding tax at the full statutory rate of 30 percent. The exclusion of REIT dividends from the reduced rates of withholding tax generally applicable to dividends reflects the view that REIT dividends should be treated in a manner that generally is comparable to the treatment of rental income earned on a direct investment in real property.

The REIT industry has expressed concern that the exclusion of REIT dividends from the reduced withholding tax rates applicable to other dividends may inappropriately discourage some foreign investment in REITS. The Treasury Department has worked extensively with your Committee staff, the Joint Committee staff, and representatives of the REIT industry in order to address this concern while maintaining a treaty policy that properly preserves the U.S. taxing jurisdiction over foreign direct investment in U.S. real property. As a result of significant cooperation among all parties to balance these competing considerations, the U.S. treaty policy with respect to the treatment of REIT dividends has been modified.

Under this policy, REIT dividends paid to a resident of a treaty country will be eligible for the reduced rate of withholding tax applicable to portfolio dividends (typically, 15 percent) in two cases. First, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 5 percent or less in each class of the REIT's stock and such dividends are paid with respect to a class of the REIT's stock that is publicly traded. Second, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 10 percent or less in the REIT and the REIT is diversified, regardless of whether the REIT's stock is publicly traded. In addition, the treaty policy with respect to the application of the reduced withholding tax rate to REIT dividends paid to individuals holding less than a specified interest in the REIT will remain unchanged.

For purposes of these rules, a REIT will be considered diversified if the value of no single interest in real property held by the REIT exceeds 10 percent of the value of the REIT's total interests in real property. Any interest in real property will not include a mortgage, unless the mortgage has substantial equity components. An interest in real property also will not include foreclosure property. Accordingly, a REIT that holds exclusively mortgages will be considered to be diversified. The diversification rule will be applied by looking through a partnership interest held by a REIT to the underlying interests in real property held by the partnership. Finally, the reduced withholding tax rate will apply to a REIT dividend if the REIT's trustees or directors make a good faith determination that the diversification requirement is satisfied as of the date the dividend is declared.

This new policy with respect to the treatment of REIT dividends will be incorporated into the U.S. model treaty. In addition, the Treasury Department will use its best efforts to negotiate protocols to amend the proposed treaties with Austria, Ireland, and Switzerland to incorporate this policy.

In the case of Luxembourg, it is recommended that this policy be implemented by means of a reservation to the proposed treaty presently under consideration. In addition, it is recommended that this reservation include a special rule for existing investment in REITs by Luxembourg residents. Under this special rule, in the case of any resident of Luxembourg who held an interest in a diversified REIT as of June 30, 1997, dividends paid to such resident with respect to that interest would be eligible for the reduced rate of withholding tax. However, this special rule would not apply to dividends paid after December 31, 1999, unless the stock of the REIT is publicly traded on December 31, 1999 and thereafter. The special rule would apply to existing investment in a REIT as of June 30, 1997 and to reinvestment in the REIT of both ordinary and capital dividends paid with respect to that investment. In addition, if a REIT in which there is a qualifying investment as of June 30, 1997 goes out of existence in a nonrecognition transaction, the special rule would continue to apply to the investment in the successor REIT if any.

Canada

The proposed protocol with Canada would modify the income tax treaty that was signed in 1980 and amended by protocols in 1983, 1984, and 1995.

The proposed protocol would replace the provision in the existing treaty that provides for exclusive source-country taxation of social security benefits with a provision that provides for exclusive residence-country taxation of social security benefits. Under the proposed protocol, U.S. social security benefits paid to Canadian residents would be subject to tax only in Canada, and Canadian social security benefits paid to U.S. residents would be subject to tax only in the United States. This represents a return to the approach that applied prior to the 1995 protocol. The amendment made by the proposed protocol would take effect for social security benefits paid after 1995, with a refund mechanism applying to taxes that have been paid with respect to post-1995 benefits.

The proposed protocol also would modify the provision in the existing treaty allowing situs-country taxation of gains from real property; under this provision, the country in which real property is situated may tax gains with respect to corporate stock if a sufficient portion of the corporation's assets consists of such real property. The protocol would limit this rule so that it applies only to stock of domestic corporations and not to stock of foreign corporations. Such a limitation is consistent with U.S. internal law regarding the taxation of gains from stock of real property holding companies.

Austria

The proposed treaty with Austria is a comprehensive update of the 1956 treaty. The provisions of the proposed treaty generally comport with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provisions in the U.S. model treaty and other recent treaties. The proposed treaty also includes an anti-abuse rule covering certain "triangular cases," which involve payments from the United States to a branch of an Austrian company located in a, third country. Under this rule, the United States generally may tax, in accordance with its internal law, interest and royalties paid to a low-taxed third-country branch of an Austrian company.

Under the proposed treaty, Austria may tax the disposition of stock of an Austrian company that was received upon the incorporation of a permanent establishment in Austria, if any inherent capital gains were not taxed at the time of the incorporation. This rule, which represents a unilateral concession by the United States, applies through the year 2010.

The proposed treaty expands the class of royalty payments that is subject to a 10-percent source-country tax. Under the existing treaty, only payments for the use of motion picture films are subject to source-country tax. Under the proposed treaty, source-country tax also applies to payments for the use of films, tapes or other means of reproduction used for radio or television broadcasting. The preferred U.S. treaty position is the elimination of source-country taxation of royalty income.

The OECD Commentary, which reflects agreed interpretations of the OECD model treaty, is to apply in interpreting any provision of the proposed treaty that corresponds to a provision of the OECD model treaty. This rule does not apply where either the United States or Austria has entered a reservation, or has included an observation, with respect to the OECD model treaty or its Commentary. In addition, this rule generally does not apply where a contrary interpretation is included in the Memorandum of Understanding with respect to the proposed treaty or in a published interpretation of the proposed treaty (e.g., the Treasury Department's Technical Explanation).

The exchange of information provisions of the proposed treaty are substantially more useful than those of the current treaty. Information generally may be exchanged to carry out the purposes of the proposed treaty or to carry out the domestic laws of the countries concerning taxes covered by the information exchange article of the proposed treaty. There are provisions in Austrian law that prohibit Austria from obtaining information from Austrian banks in non-penal investigations; however, bank information may be obtained for penal investigations. Accordingly, under the proposed treaty, bank information may be provided by Austria in connection with U.S. penal investigations, including the commencement of a criminal investigation by the Internal Revenue Service.

Ireland

The proposed treaty with Ireland is a comprehensive update of the 1949 treaty. The provisions of the proposed treaty generally are consistent with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which includes most of the elements of the anti-treaty shopping-provisions found in the U.S. model treaty and other recent U.S. treaties. The proposed treaty includes a "derivative benefits" provision under which treaty benefits generally would be available to Irish companies that are owned by residents of countries that are members of the European Union ("EU") or parties to the North American Free Trade Agreement ("NAFTA"). Under this rule, the treaty benefits with respect to dividends, interest, and royalties would be available only if the countries in which such owners are resident have treaties with the United States providing for benefits that are at least as favorable as those provided under the proposed treaty; however, this restriction on the availability of treaty benefits would take effect no earlier than two years after the proposed treaty takes effect. The proposed treaty also includes an anti-abuse rule covering the so-called "triangular case." This rule generally permits the United States to impose a 15-percent tax on dividends, interest, and royalties paid to a low-taxed third-country branch of an Irish company and to tax other payments to such a branch in accordance with U.S. internal law.

The proposed treaty provides an exemption for Irish insurance companies from the U.S. excise tax on insurance and reinsurance premiums paid to foreign insurers with respect to U.S. risks. However, this exemption applies only to the extent that the U.S. risk is not reinsured by the Irish insurer with a person that is not entitled to the benefits of an income tax treaty that similarly provides an exemption from such tax. Moreover, the exemption does not apply if the premiums paid to the Irish insurance company are not subject to the generally applicable tax imposed on insurance corporations in Ireland.

The proposed treaty includes an arbitration provision similar to the provision that was included in the 1989 U.S.-Germany tax treaty. However, like the provisions in several other recent treaties and the proposed treaty with Switzerland, the arbitration provision in the proposed treaty will take effect only upon a future exchange of diplomatic notes. It is intended that this arbitration approach be evaluated further once there has been some experience arbitrating cases under the U. S.-Germany treaty.

The exchange of information article contained in the proposed treaty conforms in most respects to the corresponding articles of the U.S. and OECD model treaties. As is true under these model treaties, under the proposed treaty the countries are to exchange such information as is necessary for carrying out the provisions of the proposed treaty or the domestic tax laws of the countries. There is one significant respect in which the exchange of information article does not conform to the corresponding article of the U.S. model treaty. The proposed treaty includes the standard provision that upon request a country shall obtain information to which the request relates in the same manner and to the same extent as if the tax of the requesting country were imposed by the requested country. However, this provision cannot be fully implemented with respect to requests by the United States. Because of restrictions in Irish internal law, the United States may obtain limited information from Ireland with respect to criminal offenses, but may not obtain information from Ireland with respect to civil offenses. Ireland may, however, obtain information from the United States generally with respect to both criminal and civil offenses.

Luxembourg

The proposed treaty with Luxembourg is a comprehensive update of the 1962 treaty. The provisions of the proposed treaty generally comport with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provisions in the U.S. model treaty and other recent treaties. The proposed treaty includes a "derivative benefits" provision under which treaty benefits generally would be available to Luxembourg companies that are owned by residents of countries that are members of the EU or parties to NAFTA. The proposed treaty also includes an anti-abuse rule covering the so-called "triangular case." This rule generally permits the United States to impose a 15-percent tax on dividends, interest, and royalties paid to a low-taxed third-country branch of a Luxembourg company and to tax other payments to such a branch in accordance with U.S. internal law.

The proposed treaty provides an exemption for Luxembourg insurance companies for the U.S. excise tax on insurance premiums paid to foreign insurers with respect to U.S. risks. This exemption applies only to the extent that the U.S. risk is not reinsured by the Luxembourg insurer with a person that is not entitled to the benefits of an income tax treaty that similarly provides an exemption from such tax. All existing U.S. tax treaties that provide exemptions from the U.S. excise tax on insurance premiums also provide exemptions from the U.S. excise tax on reinsurance premiums paid to foreign insurers. However, the proposed treaty does not provide an exemption from the excise tax on reinsurance premiums paid to Luxembourg reinsurers.

The exchange of information provisions of the proposed treaty are more useful than those of the current treaty. Information generally may be exchanged to carry out the purposes of the proposed treaty or to carry out the domestic laws of the countries concerning taxes covered by the information exchange article of the proposed treaty. There are provisions in Luxembourg law that generally prohibit Luxembourg from obtaining information from Luxembourg financial institutions either for their own purposes or for purposes of the proposed treaty. However, such bank information may be obtained—under certain circumstances involving criminal tax matters pursuant to the proposed Mutual Legal Assistance Treaty with Luxembourg.

South Africa

The proposed treaty with South Africa generally is consistent with other recent treaties that the United States has signed with developed countries. It is a straightforward reflection of current U.S. treaty policy, with only a few deviations. For example, the proposed treaty allows broader source-country taxation of business activities of residents of the other country by expanding the definition of a permanent establishment to include cases in which an enterprise provides services through its employees in a country if the activities continue for more than 183 days.

In addition, like many other U.S. treaties, the proposed treaty includes in the anti-treaty shopping provision an anti-abuse rule covering the so-called “triangular case.” This rule generally permits the United States to impose a 15-percent tax on interest and royalties paid to a low-taxed third-country branch of a South African company and to tax other payments to such branch in accordance with U.S. internal law.

Switzerland

The proposed treaty with Switzerland is a comprehensive update of the 1951 treaty. The provisions of the proposed treaty generally are consistent with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provisions in the U.S. model treaty and other recent treaties. The proposed treaty includes a “derivative benefits” provision under which treaty benefits generally would be available to Swiss companies that are owned by residents of countries that are members of the EU or the European Economic Area or parties to NAFTA. The proposed treaty includes an anti abuse rule covering the so-called “triangular case.” This rule generally permits the United States to impose a 15-percent tax on dividends, interest, and royalties paid to a low-taxed third-country branch of a Swiss company and to tax other payments to such a branch in accordance with U.S. internal law.

The proposed treaty provides an exemption for Swiss insurance companies from the U.S. excise tax on insurance and reinsurance premiums paid to foreign insurers with respect to U.S. risks. However, this exemption applies only to the extent that the U.S. risk is not reinsured by the Swiss insurer with a foreign person that is not entitled to the benefits of an income tax treaty that similarly provides an exemption from such tax.

The proposed treaty includes an arbitration provision similar to the provision that was included in the 1989 U.S.-Germany tax treaty. However, like the provisions in several other recent treaties and the proposed treaty with Ireland, the arbitration provision in the proposed treaty will take effect only upon a future exchange of diplomatic notes. It is intended that this arbitration approach be evaluated future once there has been some experience arbitrating cases under the U.S.-Germany treaty.

The exchange of information provisions of the proposed treaty are somewhat more useful than those of the current treaty, but are nonetheless more restrictive than the comparable provisions in tax treaties with other countries. Information generally may be exchanged to carry out the purposes of the proposed treaty, but it may not be exchanged to carry out the domestic laws of the countries concerning taxes covered by the information exchange article of the proposed treaty. Information may also be exchanged to prevent tax fraud. For example, in cases of tax fraud, Swiss banking secrecy provisions do not hinder the gathering of documentary evidence from banks or its being provided to the United States pursuant to the proposed treaty.

Thailand

The proposed treaty with Thailand would represent a new tax treaty relationship for the United States.

Under the proposed treaty, Thailand would agree to reduce its taxes on income that U.S. residents earn from sources in Thailand and the United States would agree to reciprocal reductions of its tax on U.S. income of Thai residents.

The proposed treaty follows preferred U.S. treaty positions in many respects. However, it differs from preferred U.S. treaty positions in other respects, primarily by not reducing source country taxation to the same extent as many U.S. tax treaties. In this regard, the proposed treaty is similar to other treaties that the United States has entered into with developing countries.

The proposed treaty would allow broader source-country taxation of business activities of residents of the other country. For example, the proposed treaty expands the definition of a permanent establishment to include cases in which an enterprise provides services through its employees in a country if the activities continue for more than 90 days.

The proposed treaty also would permit higher maximum rates of source-country tax on dividends, interest and-royalties, and would permit the imposition of source-country tax on certain equipment rental income. These maximum rates of source-country tax generally range from 10 to 15 percent in the case of dividends, 10 to 15 percent in the case of interest, and 5 to 15 percent in the case of royalties. The proposed treaty would treat equipment rental income as royalties subject to a maximum 8 percent source-country tax.

In addition, the proposed treaty would allow Thailand to tax gains derived by U.S. residents from the alienation of property in accordance with its internal law. Although the proposed treaty would permit the United States to impose tax in the reverse situation, U.S. internal law generally does not tax such gains of foreign persons, other than gains with respect to a U.S. real property interest.

The exchange of information article contained in the proposed treaty conforms in most respects to the corresponding articles of the U.S. and OECD model treaties. As is true under these model treaties, under the proposed treaty the countries are to exchange such information as is necessary for carrying out the provisions of the proposed treaty or the domestic tax laws of the countries. There is one significant respect in which the exchange of information article does not conform to the corresponding article of the U.S. model treaty. The proposed treaty includes the standard provision that upon request a country shall obtain information to which the request relates in the same manner and to the same extent as if the tax of the requesting country were imposed by the requested country. However, the proposed treaty also would suspend the application of this provision until the United States receives from Thailand a diplomatic note indicating that Thailand is prepared and able to implement this provision, which will require that Thailand enact enabling legislation. This means that neither country will obtain information for the other until this diplomatic note is provided.

The provision by Thailand of this diplomatic note also is an important element in the termination article of the proposed treaty. There are two ways in which the proposed treaty may terminate. The first is a voluntary mechanism under which either country may terminate the proposed treaty at any time after five years after it enters into force, provided that appropriate notification is given. The second, which is much more unusual, is a mandatory termination on January 1 of the sixth year following the year the proposed treaty enters into force, unless this diplomatic note with respect to Thailand's ability to implement the information exchange provision is received by the previous June 30th.

Turkey

The proposed treaty with Turkey would represent a new tax treaty relationship for the United States. Turkey is the only OECD member country with which the United States has no tax treaty in force.

Under the proposed treaty, Turkey would agree to reduce its taxes on the income that U.S. residents earn from sources in Turkey and the United States would agree to reciprocal reductions of its tax on U.S. income of Turkish residents. The United States and Turkey also would agree that their tax administrators will exchange tax information where necessary to carry out tax laws and will cooperate together to resolve problems in the coordination of the tax rules of the two countries that may arise in individual cases.

The proposed treaty follows preferred U.S. treaty positions in many respects. However, it differs from preferred U.S. treaty positions in other respects, primarily by not reducing source-country taxation to the same extent as many U.S. tax treaties. In this regard, the proposed treaty is similar to other treaties that the United States has entered into with developing countries.

The proposed treaty would allow broader source-country taxation of business activities of residents of the other country. It also would permit higher maximum rates of source-country tax on dividends, interest, and royalties, and would permit the imposition of source-country tax on certain equipment rental income. These maximum rates of source-country tax generally range from 15 to 20 percent in the case of dividends, 10 to 15 percent in the case of interest, and 5 to 10 percent in the case of royalties. The proposed treaty would treat equipment rental income as royalties subject to a maximum 5 percent source-country tax.

In addition, the proposed treaty would allow Turkey to tax gains derived by U.S. residents from shares and bonds of Turkish companies in certain cases. Although the proposed treaty would permit the United States to impose tax in the reverse situation, U.S. internal law does not tax such gains of foreign persons.

Conclusion

These issues are discussed in more detail in the Joint Committee staff pamphlets on the proposed treaties and protocols. I would be happy to answer any questions.

Senator HAGEL. Mr. Kies, thank you very much.

Mr. Kies, does the Joint Tax Committee recommend that this committee support ratification of these proposed treaties?

Mr. KIES. Senator Hagel, we have reviewed the treaties in great depth and, as Senator Sarbanes has pointed out, we have identified places where we think there are issues that the committee ought to look at. I guess our judgment is that, on balance, we have been persuaded, through the extensive discussions we have had with the Treasury Department about the negotiations that led to the provisions in the treaties, that these represent the best job that could be done given the negotiating pressures that the Treasury Department had to deal with.

We do think that the resolution of the REIT issue was essential, and that the way in which it has been resolved, particularly as it relates to Luxembourg where there was immediate pressure concerning potential investors from Luxembourg, effectively deals with the issues raised by the U.S. REIT industry. That reservation—which we have been told by Treasury can be rather quickly addressed—will address the REIT problems adequately. So, on that basis, we think the treaties should proceed.

Senator HAGEL. Let me follow up for a minute on a general issue that Senator Sarbanes engaged in with Secretary Guttentag. I know Senator Sarbanes will move into some of the questioning with you.

The current treaty with Ireland does not contain a limitation on benefits provision. Thus, if I understand this correctly, the proposed treaty greatly improves the current treaty relationship, and there are some other things. Are you concerned that certain treaty provisions here in this treaty will be abused during a period prior to its entry into force if we have no limitation on benefits provision?

Mr. KIES. Yes, Senator Hagel, I think that that is one of the major improvements that has occurred in the negotiation of this treaty, and that the sooner the treaty gets into force, the better, in that regard. So, notwithstanding the fact that the information exchange piece is not particularly attractive in terms of where it ideally could have come out, the other improvements over the existing treaty, I think, are highly desirable.

And I would say that the point that Mr. Guttentag made in comparing it to Thailand was an appropriate thing to bring to the committee's attention. Because, in the case of Thailand, we have no existing treaty; whereas in Ireland, there is an existing treaty over which this new treaty would make some significant improvements.

Senator HAGEL. The information exchange process, are there areas that we can improve in and in which you would make some suggestions to Treasury?

Mr. KIES. I think that the area of information exchange is one in which there is always going to be a continuing struggle to get the most desirable position from the U.S. perspective, because many countries are not immediately willing to share information in the same way that we are. But I think that Treasury is going to have to continually negotiate aggressively to try and get the most open information exchange provisions we can.

In the treaties before the committee, the provisions in the current treaties—for example, in Luxembourg, Austria and Switzerland—are quite limited. These treaties would make progress in that regard. The most significant progress is in Austria; the least significant probably is in Switzerland. But this is going to have to continue to be an area in which Treasury puts on as much pressure as they can to try and improve the information exchange provisions.

Senator HAGEL. Thank you.

Senator Sarbanes.

Senator SARBANES. I wonder if the joint committee could, in effect, help to sharpen up for the Treasury some of the issues you raise, so that they can then submit to the committee their response on how they handled them. There are a couple of questions I put earlier to the Treasury Deputy Secretary that actually I thought the responses were quite to the point, in terms of what the negotiating situation was and what they were able to do.

And it sounded as if, on the insurance issue, they had it pretty well covered. But there is very careful and thorough analysis of a number of important issues in these reports. I think we need a response to them from Treasury. I do not think we should just let these issues pass without addressing them, and then being able to make an informed judgment.

Furthermore, the question is whether we should try to use any understandings, or maybe even just committee report language, on some of these issues to establish some kind of marker for the Treasury Department for the future. There is always a danger of getting on a slippery slope. I mean, Treasury departs from the model treaty, and then they say, well, we had to do this in order to negotiate a treaty.

That may be quite true; I do not anticipate that we can take a cookie-cutter approach or that every country is simply going to take the model treaty. Obviously, they will not do that. But once you start down a path, then the next country points to what the previous country got and says, well, you did it for them, why can't you do that, plus perhaps a little more, for us? And then that unraveling process begins.

And so I think one of the functions this committee can perform is to try to hold the Treasury within some parameters so that does not happen.

Mr. KIES. Senator, I agree with you. I think there maybe are two ways in which we can be helpful in this regard. First is, throughout the preparation of the pamphlets, we did share those issues with Treasury representatives. But we would be happy to sit down with them and discuss even in more detail the issues we have raised there.

The second thing that I think we can be helpful on is that, in developing committee reports, where there is a clear explanation of why the Treasury took a position—for example, in the reinsurance point and the insurance point, that they carefully looked at the treaty country's tax treatment of insurance companies—that should be reflected in the committee report, because it essentially sends a signal to other countries that unless their countries have comparable insurance taxation rules, they will not be able to expect to get a waiver of the insurance excise tax. That is the type of thing that we ought to reflect in the committee reports so that that is part of the legislative history which will be in place when future negotiations occur.

So we will be happy to work with Treasury in both of those respects, and with the Foreign Relations staff.

Senator SARBANES. Thank you.

Thank you, Mr. Chairman.

Senator HAGEL. In view, Mr. Kies, of the hour—it is 5 o'clock—and in light of votes and other additions to our schedule, I would ask if Senator Sarbanes had any additional questions. I know we have another panel behind you.

Senator SARBANES. No, I do not have any more questions. I just want to thank the joint committee for their usual good work in preparing these studies.

Mr. KIES. Thank you, Senator Sarbanes.

Senator SARBANES. They have been helpful.

Senator HAGEL. And I echo that, as well, Mr. Kies and your colleagues. Thank you very much for the time.

Mr. KIES. Thank you, Senator Hagel.

Senator HAGEL. Mr. Mattson, please proceed whenever you are ready. Nice to have you. Welcome.

STATEMENT OF ROBERT N. MATTSON, CHIEF TAX OFFICER AND ASSISTANT TREASURER, INTERNATIONAL BUSINESS MACHINES CORPORATION, ON BEHALF OF THE NATIONAL FOREIGN TRADE COUNCIL AND THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

Mr. MATTSON. Thank you, Senator Hagel and Senator Sarbanes.

My name is Bob Mattson. I am Chief Tax Officer and Assistant Treasurer for the IBM Corporation. I appreciate the opportunity to appear today before this committee on behalf of the United States Council for International Business, as Vice Chairman of its Tax Committee, and the National Foreign Trade Council, as its former Tax Committee Chairman, which together represent the international business community and the United States' largest exporters. These trade associations work to enhance the competitiveness of U.S.-owned business by promoting sound and appropriate international tax policy and agreements.

I am accompanied today by Fred Murray, Vice President of Tax Policy of the National Foreign Trade Council; and Tim Sheehy, IBM's Manager of Government Affairs.

As global competition grows ever more intense, it is vital to the health of the United States enterprises and to their continuing ability to contribute to the United States economy that the companies be free from excessive foreign taxes or double taxation that can serve as a barrier to the full participation of American companies in the international marketplace. Bilateral tax treaties are a crucial component of the framework necessary to allow such balanced competition.

It is for this reason that both the National Foreign Trade Council and the United States United States Council on International Business have long supported the expansion and strengthening of the U.S. tax treaty network, and that we are here today to recommend ratification of these treaties under consideration by this committee. We appreciate the committee's action in scheduling this hearing and agreeing to receiving our testimony.

The treaties up for ratification should be ratified without delay. For example, the revised treaty with Austria modernizes an existing 40-year-old treaty, and eliminates a major impediment to U.S. business restructuring in the European Union. Austria joined the European Trading Union in 1995, and it is essential that barriers be removed for U.S. business to operate and restructure as required by the growing tendency toward globalization. Businesses can no longer focus solely on geographic borders, and many companies have increasingly integrated their regional business activities. This is true in Europe, and modernized tax treaties with Austria, Ireland, Luxembourg, and Switzerland are essential.

We also strongly support and urge the prompt ratification of the protocol with Canada and the new treaties with South Africa, Thailand and Turkey.

The new treaty with Thailand advances U.S. business needs for fairness and certainty in the Asian community. We commend the Treasury Department for its efforts to include more developing countries and Asian nations in our treaty network, as this area is so vitally important to U.S. interests in the global business arena. We trust that this committee will, Mr. Chairman, support their endeavors to bring further treaties with Asian and other developing countries for ratification to your committee.

American global business enterprises, in the next century, will be built around information networks, flexible work forces and webs of strategic alliances. Without a refreshed and expanding tax treaty network, IBM and other American-owned businesses would find untenable barriers to the necessary free flow of technology and investment which supports expanding export jobs in the United States.

The emergence of a new set of technologically skilled nations, which Thailand represents, necessitates that the U.S. clarify the international rules applying to commerce with these nations. These nations are linked to the U.S. by telecommunications and information technologies, and will be engaged in the conduct of electronic commerce. We would have preferred that the Thai and the Turkish treaties totally eliminated withholding taxes on the movement of technology products, such as computer software. However, these treaties are a realistic beginning in the right direction, and we support their ratification.

While in the past business value-add was determined by tangible goods, manufactured in plants located where comparative advantage dictated, in the next century, know-how, ideas and concepts—intangible goods—will drive economic value and the competitive strength of American-owned business. Recent trade agreements have brought down tariff barriers on high technology tangible goods exports from the United States. However, barriers on intangibles requires tax treaties which eliminate withholding taxes on royalties, dividends and interest flows.

These treaties set international norms for the conduct of administrative audits of transactions between affiliates, and provide a mechanism to resolve tax disputes. Otherwise, American companies could not be assured of protection against arbitrary tax assessments.

Tax treaties help create the environment for predictable tax treatment of cross-border business transactions so necessary to a successful global business. Ratification of these treaties continues the momentum which is needed to bring other nations into the U.S. treaty network. It sends a continuing signal that the U.S. desires a lessening, and eventual elimination, of the existing impediments to global business.

Again, thank you for your patience by listening to my statement today on this very important hearing to America's global businesses. I would be happy to answer any questions you might wish to ask.

[The prepared statement of Mr. Mattson follows:]

PREPARED STATEMENT OF MR. MATTSON

Mr. Chairman, Members of the Committee:

My name is Bob Mattson and I am Chief Tax Officer and Assistant Treasurer of the IBM Corporation. I appreciate the opportunity to appear today before this Committee on behalf of the United States Council for International Business, as vice chairman of its tax committee, and the National Foreign Trade Council, as its former tax committee chairman, which together represent the international business community and the United States largest exporters. These trade associations work to enhance the competitiveness of U.S.-owned business by promoting sound and appropriate international tax policy and agreements.

The National Foreign Trade Council, Inc. (NFTC) is an association of over 500 U.S. business enterprises engaged in all aspects of international trade and investment. The NFTC seeks to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad.

The United States Council for International Business (USCIB) is the American affiliate of the International Chamber of Commerce and the Business and Industry Advisory Committee to the OECD. The USCIB formulates its positions in committees composed of corporate and other experts drawn from its membership of 300 multinational corporations, service companies, law firms, and business associations. It advocates these positions to the United States Government and to such intergovernmental organizations as the OECD, the WTO, and other bodies of the United Nations system with which its international affiliates have official consultative status on behalf of world business.

As global competition grows ever more intense, it is vital to the health of U.S. enterprises and to their continuing ability to contribute to the U.S. economy that the companies be free from excessive foreign taxes or double taxation that can serve as a barrier to full participation in the international marketplace. Bilateral tax treaties are a crucial component of the framework necessary to allow such balanced competition.

It is for this reason that both the NFTC and USCIB have long supported the expansion and strengthening of the U.S. tax treaty network and that we are here today to recommend ratification of the treaties under consideration by this Committee. We appreciate the Committee's action in scheduling this hearing and agreeing to receive our testimony.

Tax treaties are bilateral agreements between the United States and foreign countries that serve to harmonize the tax systems of the two countries in respect of persons involved in cross-border investment and trade. In the absence of tax treaties, income from international transactions or investment may be subject to double taxation: once by the country where the income arises and again by the country of the income recipient's residence. Tax treaties eliminate this exposure to double taxation.

The treaties up for ratification should be ratified without delay. In particular, the revised treaty with Austria modernizing the existing 40-year old treaty eliminates a major impediment to U.S. business restructuring in the European Union. Austria joined the European trading union in 1995 and it is essential that barriers be removed for U.S. business to operate and restructure as required by the growing tendency toward globalization. Businesses can no longer focus solely on geographic borders and many companies have increasingly integrated their regional business activities, This is true in Europe and modernized tax treaties with Austria, Ireland, Luxembourg, and Switzerland are essential. We also strongly support and urge the prompt ratification of the protocol with Canada and the new treaties with South Africa, Thailand and Turkey.

The new treaty with Thailand advances U.S. business needs for fairness and certainty in the Asian community. We commend the Treasury Department for its efforts to include more developing countries and Asian nations in our treaty network as this area is so vitally important to U.S. interests in the global business arena. We trust that this committee will, Mr. Chairman, support their endeavors, to bring further treaties with Asian and other developing countries for ratification to this forum.

America's global business enterprises in the next century will be built around information networks, flexible work forces and webs of strategic alliances. Without a refreshed and expanding tax treaty network, IBM and other American-owned businesses would find untenable barriers to the necessary free flow of technology and investment which supports expanding export jobs in the United States. The emergence of a new set of technologically skilled nations which Thailand represents, necessitates that the U.S. clarify the international rules applying to commerce with these nations. These nations are linked to the U.S. by telecommunications and information technologies and will be engaged in the conduct of electronic commerce. We would have preferred that the Thai and Turkey treaties totally eliminated withholding taxes on the movement of technology products such as computer software, however, these treaties are a realistic beginning in the right direction and we support their ratification.

While in the past, business value-add was determined by tangible goods manufactured in plants located where comparative advantage dictated (such as our plants in North Carolina which export nearly 1-1/2 billion dollars a year), in the next Century, know-how, ideas and concepts - intangible goods - will drive economic value and the competitive strength of American-owned business. Recent trade agreements have brought down tariff barriers on high technology tangible good exports from the United States. However, barriers on intangibles require tax treaties which eliminate withholding taxes on royalty, dividend and interest flows.

American business interests will be greatly served by the recognition in these treaties that we now conduct a great portion of our worldwide business in joint ventures and alliances with other companies to gain greater access to foreign markets and technology. These treaties contain substantial reductions in ownership thresholds in qualifying for lower foreign withholding taxes on dividend repatriations to the United States.

Likewise, these treaties set international norms for the conduct of administrative audits of transactions between affiliates and provide a mechanism to resolve tax disputes. Otherwise, American companies could not be assured of protection against arbitrary tax assessments. Tax treaties help create the environment for predictable tax treatment of cross-border business transactions so necessary to a successful global business. Transactions in intangible goods including computer software, information and services are more viable if the tax rules applied are consistent and avoid double taxation. It is vital that these treaties be ratified to assist in that certainty so that American-owned business can be better prepared to compete in a global marketplace.

Ratification of these treaties continues the momentum which is needed to bring other nations into the U.S. treaty network. It sends a continuing signal that the U.S. desires a lessening and eventual elimination of the existing impediments to global business. The larger business community hopes that side issues do not get in the way of a treaty process that is working. We are extremely pleased that tax treaties, these days, are negotiated and submitted to this Committee promptly for your consideration.

Again, thank you for your patience by listening to my statement today on this very important hearing to America's global businesses. I would be happy to answer any questions you might wish to ask.

Senator HAGEL. Mr. Mattson, thank you.

You mentioned in your statement that the Council supports the ratification of these treaties that the committee will deal with. Could you give me some examples of how these treaties will in fact make a difference—add to productivity—not only in your company, but other companies that you represent through the Council, improved growth, more jobs here in the United States?

Mr. MATTSON. In one of your colleague's States, North Carolina, we export some——

Senator HAGEL. He is not just a colleague, he is the chairman now.

Mr. MATTSON. I understand that.

As well as Maryland, we export out of North Carolina over $1.5 billion, and a number of those countries that are under this treaty take that export.

You cannot export high technology good today without also having agreements with regard to intangibles, as I mentioned. Software, along with the personal computer exports out of our North Carolina plants, are useless without the software that accompanies them. These treaties help lower the foreign taxes on those software products that move into those jurisdictions.

In the same way, other companies—drug companies, many of our very highest technology companies and service companies—would be in great competitive disadvantage if these treaties did not lower the barriers on intangible products. For IBM, for example, we would be in massive excessive foreign tax credit situations. We would be paying very high foreign taxes without the tax treaty network. We could not sustain our global business posture without them, Senator.

Senator HAGEL. As you know, the Treasury is continuing negotiations on additional treaties—my understanding is especially in Latin America and Southeast Asia. Are there other areas, Mr. Mattson, that we should be looking at, or specific areas within those two regions that Treasury is currently negotiating treaties in?

Mr. MATTSON. Well, again, I would say we ought to strengthen our ties with Asia. That is very, very important. We now, as we heard, have finally completed the ring of the OECD countries, bringing in Turkey.

Latin America, it is vitally important to us that the Latin American countries get the message. I note that Treasury has been working with a number of them to bring them into the treaty network. The problem is often on their side.

My colleagues remind me that Brazil is a difficult country and very important to American business. The Japanese treaty needs refreshing very extensively. It is one of our older treaties, and you can understand the amount of trade and impediments that the Japanese treaty throws up. Japan has the highest withholding tax on intangibles in the entire OECD network, and it is time that the U.S. Treasury begin to engage the Japanese Government.

Senator HAGEL. Thank you.

In reflecting on your members here and their feeling and sense of this, are you generally pleased with the consultation role of U.S. business with the Treasury Department on these treaties?

Mr. MATTSON. If it was not for the competent authority of the Treasury Department, in the first instance, a number of countries would take greater liberties than they would otherwise in dealing with U.S. companies. Unfortunately, some tax audit issues are zero-sum games. The U.S. becomes very difficult with the foreign companies, and the foreign governments then take on the U.S. companies to recover the same am. If there were not these treaties in place, there could be much more abuse in this area. We are very thankful that we can go to the U.S. Government for assistance if we find these problems.

Senator HAGEL. Thank you.

Senator Sarbanes.

Senator SARBANES. Well, I had a question, really, that just follows along with what the chairman just asked. That is, what more can be done on our side to help develop a system of tax treaties? Or do you think everything is being done that can be done?

Mr. MATTSON. No, everything is not being done. It would be hard for me right now to go through the various issues. But I think the one thing I would say is that what happened with this set of treaties should be replicated time and time again. That is that this committee has brought before it the treaties for ratification for consideration in a very prompt manner. We all are very appreciative of that.

So, first and foremost is having a forum that treaties do not just linger and sit after they have been signed, but can come forth and be heard by this committee and examined, as you have today. We are very appreciative of that factor. I think that is a very important point that I would like to make.

Senator SARBANES. Do you have any consultations with Treasury about what countries should be given higher priority in terms of either updating an existing tax treaty or negotiating a tax treaty where none has heretofore existed? How is the priority list set? How much involvement do you have in helping to set that?

Mr. MATTSON. Let me talk about the National Foreign Trade Council, for example, which has over 500 U.S. business enterprises engaged in all aspects of international trade and investment. There is a tax committee, which many of these members sit on. Once a year the National Foreign Trade Council goes out and circularizes with its members what are their needs, both new treaties, refreshed treaties or issues that are pending.

We then accumulate that information, and the Treasury Department has an annual meeting with the National Foreign Trade Council and we submit this information to them. They have been very receptive and very willing to work on these issues that we bring before them. So, in that sense, business and government has a very good relationship in the United States with regard to the tax treaty network.

Senator SARBANES. And to what extent, in your perception, are the treaties worked out without cross-cutting of political or security considerations? Or do you find situations in which the United States is giving concessions to some country on a tax treaty because it is working on a different track with respect to some political or security matter with that country?

Mr. MATTSON. It is hard for me to respond to that, because while we do meet with Treasury and tell them our interests and concerns, once they go into a treaty negotiation, that is between the two countries. We do not have somebody sitting at the table. So we hear about it after the fact.

And so all I can say is they know our interest; they have generally accepted the importance of those issues, but once they begin their own negotiations on government to government, I think that you would have to ask the Assistant Secretary or the Deputy Secretary those questions, sir.

Senator SARBANES. OK. Well, thank you very much, sir, for your testimony.

Senator HAGEL. Mr. Mattson, once again, thank you. Thank also your colleagues at the Council for not just helping prepare the testimony today, but what you do every day to work with us on these important issues. Thank you.

Mr. MATTSON. Thank you, sir.

Senator HAGEL. Thank you.

[Whereupon, at 5:20 p.m., the committee adjourned, to reconvene subject to the call of the Chair.]

APPENDIX

RESPONSES OF MR. GUTTENTAG TO QUESTIONS ASKED BY SENATOR HELMS

Question 1. I understand that the South African Government has introduced legislation which will abrogate patent rights. Is there any provision for protection of intellectual property in the South Africa tax treaty?

Answer. The South African Parliament has just passed legislation which is intended to reform South Africa's's health care system. The stated object of the legislation is to make medicine more affordable. One specific provision of the legislation invests in the Minister of Health power which could severely restrict pharmaceutical patent owners rights.

The United States Government has been actively discussing its concerns about this legislation with the South African Government. Our Embassy has been in frequent contact with the Ministry of Health, the Department of Trade and Industry, and members of the Parliamentary Portfolio Committee on Health. In Washington, USG officials have also explained our views to South Africa's Ambassador, Franklin Sonn.

The U.S.-South Africa tax treaty provides for, among other things, reduced tax rates on royalties received by U.S. pharmaceutical companies from the exploitation of patents in South Africa. Because intellectual property night protection does not fall under the purview of bilateral tax treaties, the South African tax treaty does not provide for the protection of intellectual property.

Question 2. South Africa has Joined the WTO and should therefore abide by its intellectual property right protections. Is Treasury concerned by South Africa's attempt to single out the U.S. pharmaceutical industry for harsh treatment? Do you believe that Senate action on this treaty will be construed as a green light for the South African legislation?

Answer. The United States Government has reserved the right to consider WTO action with respect to the legislation. Various interested agencies currently are reviewing the legislation and considering a course of action. The view of South African Government officials is that the legislation is consistent with the South Africans' WTO obligations.

It is unlikely that South Africa will single out the U.S. pharmaceutical industry. All pharmaceutical patent holders in South Africa, regardless of country of origin, could be affected by the provision in the legislation regarding suspension of patents. As a result, the European Union and several European countries have also relayed their concerns to the South African Government.

Treasury does not believe the Senate action on the tax treaty will be construed. as a green light for the South African legislation. The South African Government is well aware of the views of the United States Government on the legislation. Both Governments believe it is in their interests for the tax treaty to be approved.

RESPONSES OF MR. GUTTENTAG TO QUESTIONS ASKED BY SENATOR SARBANES

APPLICATION OF THE TURKISH CONVENTION TO NORTHERN CYPRUS

Question 1. Under the proposed U.S.-Turkey income tax convention, would Turkish settlers on Cyprus be eligible for benefits?

Answer. The United States would not consider Turkish settlers on Cyprus as residents of Turkey eligible for treaty benefits.

Question 2. Could Turkey unilaterally change its laws in such a way as to make Turkish Cypriots eligible for benefits under the treaty?

Answer. The United States negotiated its tax treaty with Turkey on the understanding that only those persons resident in Turkey (as defined in the treaty, which does not include Cyprus) were residents of Turkey for purposes of the tax treaty. Turkey could, theoretically, try to make unilateral changes to its tax laws that would attempt to make Turkish settlers in Cyprus eligible for benefits under the U.S.-Turkish tax treaty. The United States would oppose any attempts by Turkey to gain benefits under the tax treaty which had the effect of changing the premise on which the treaty was negotiated or of undermining United States policy toward Cyprus. If Turkey persisted with such changes, Treasury would expect to take appropriate steps, possibly including consultations or negotiations so as to specifically exclude benefits for Cypriots, or termination of the treaty.

Question 3. Under the proposed treaty, could a resident of Turkey avoid income taxes on an investment in the U.S. by routing that investment through a branch in northern Cyprus?

Answer. A resident of Turkey cannot avoid income taxes on an investment in the U.S. by routing that investment through a branch in northern Cyprus. Under U.S. law, a resident of Turkey who made an investment in the U.S - through a branch in Cyprus, or any other jurisdiction, would be taxed under U.S. law and the U.S.-Turkey Convention, as if the investment had been made directly from Turkey. Furthermore, Turkey taxes the world-wide income of its residents as does the United States so income earned in Cyprus by a branch of a Turkish company would be subject to full Turkish tax.

Question 4. Would any treaty benefits accrue to a Turkish or U.S. resident with a permanent establishment in northern Cyprus?

Answer. The location of a permanent establishment of a U.S. or Turkish resident would be irrelevant for treaty purposes. Both Turkey and the United States tax residents on their worldwide income. Accordingly, both countries provide benefits to residents of the other regardless of the existence or location of a permanent establishment of the resident. Some countries provide special benefits for permanent establishments and our treaties with those countries provide appropriate limitation of benefits.

Question 5. If Turkey were to annex northern Cyprus, would any of the above answers change?

Answer. We cannot speculate now about a hypothetical annexation because we do not know what the circumstances would be. However, assuming that the annexation were not recognized by the United States, we would not expect the answers to change.

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