



JOINT COMMITTEE ON TAXATION

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**TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION
BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS HEARING ON
THE PROPOSED TAX PROTOCOLS WITH SWEDEN AND FRANCE AND THE
PROPOSED TAX TREATY WITH BANGLADESH¹**

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My name is Tom Barthold. I am the Acting Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee today concerning the proposed income tax protocol with Sweden, the proposed income and estate and gift tax protocols with France, and the proposed income tax treaty with Bangladesh.

Overview

As in the past, the Joint Committee staff has prepared pamphlets covering the proposed treaty and protocols. The pamphlets provide detailed descriptions of the proposed treaty and protocols, including comparisons with the 1996 U.S. model income tax treaty (the “U.S. model”), which generally reflects preferred U.S. tax treaty policy, and with other recent U.S. tax treaties. The pamphlets also provide detailed discussions of issues raised by the proposed treaty and protocols. We consulted with the Treasury Department and with the staff of your committee in analyzing the proposed treaty and protocols and in preparing the pamphlets.

The proposed income tax protocol with Sweden would amend an existing treaty signed in 1994. The proposed income tax protocol with France would amend an existing tax treaty that was signed in 1994. The proposed estate tax protocol with France would amend an existing treaty that was signed in 1978. The proposed income tax treaty with Bangladesh represents a new tax treaty relationship for the United States. A proposed treaty with Bangladesh was signed in 1980 but never went into force. My testimony today will highlight some of the key features of the proposed protocols and treaty and certain issues that they raise.

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Sweden

Updates to existing treaty

The proposed protocol modifies several provisions in the existing treaty to conform it to new U.S. domestic tax laws, and to make it similar to more recent U.S. income tax treaties and the U.S. model. For example, the proposed protocol expands the “saving clause” provision of the existing treaty to allow the United States to tax certain former citizens and long-term residents under the special expatriation tax regime of U.S. internal law, as amended in 1996 and 2004. The proposed protocol also updates the existing treaty to include the rules in recent U.S. treaties related to fiscally transparent entities.

New “zero-rate” dividend provision

The proposed protocol also would eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as “direct dividends”), provided that certain conditions are met. The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two countries.

Under the present treaty, these dividends may be taxed by the source country at a maximum rate of five percent, a tax that the United States, but not Sweden, imposes as a matter of internal law. Thus, the principal immediate effect of this provision would be to exempt dividends that U.S. subsidiaries pay to Swedish parent companies from U.S. withholding tax. With respect to dividends paid by Swedish subsidiaries to U.S. parent companies, the effect of this provision would be to provide greater certainty as to the continued availability of a zero rate of Swedish withholding tax, regardless of how Swedish domestic law might change in this regard.

Until 2003, no U.S. treaty provided for a complete exemption from withholding tax under these circumstances, and the U.S. and OECD models currently do not provide for such an exemption. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its “Parent-Subsidiary Directive.” Moreover, in 2003 and 2004, the Senate ratified U.S. treaties and protocols containing zero-rate provisions with the United Kingdom, Australia, Mexico, Japan, and the Netherlands. These provisions are similar to the provision in the proposed protocol, although the treaty with Japan allows a lower ownership threshold (i.e., more than 50 percent, as opposed to at least 80 percent) than do the other provisions, among other differences.

Because zero-rate provisions have become a trend in U.S. tax treaty practice, the Committee may wish to examine the Treasury Department’s criteria for determining the circumstances under which a zero-rate provision may be appropriate. In previous testimony before the Committee, the Treasury Department has indicated that zero-rate provisions should be limited to treaties that have the strongest limitation-on-benefits and information-exchange provisions, where appropriate in light of the overall balance of the treaty. The Committee may wish to ask what “overall balance” considerations might prompt the Treasury Department not to

seek a zero-rate provision in a treaty that has limitation-on-benefits and information-exchange provisions meeting the highest standards. The Committee also may wish to examine some of the specific design features of the provisions, such as ownership thresholds, holding period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements, as discussed in detail in our pamphlet.

It is also worth noting that a zero rate generally would apply with respect to dividends received by tax-exempt pension funds, similar to provisions in other recent treaties.

Anti-treaty-shopping provision

The proposed protocol replaces the limitation-on-benefits article of the current treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. model and most of the more recent U.S. income tax treaties. For example, the proposed protocol provides for tests for publicly traded companies, ownership and base erosion, derivative benefits, and active business.

The proposed protocol also provides a new, special anti-abuse rule to address the use of certain triangular branch structures to earn certain types of U.S. income. Under this rule, certain payments of interest, royalties, or insurance premiums from a U.S. payor to a permanent establishment of a Swedish resident in a third country may be subject to U.S. withholding tax if Sweden does not tax such income and the third country only taxes it lightly. The proposed protocol limits such U.S. withholding tax to 15 percent in the case of interest or royalties.

Unlike the U.S. model, but like the recent protocol amending the Netherlands income tax treaty, the publicly traded company test in the proposed protocol includes a set of requirements, referred to in the Netherlands protocol as the “substantial presence” test, to determine whether a company’s public trading or management is adequately connected to its residence in a treaty country. Under the proposed protocol, a company that is a resident of Sweden or the United States is entitled to all treaty benefits if the principal class of its shares, and any disproportionate class of shares, is regularly traded on one or more recognized stock exchanges, and, in addition, the company meets either a public trading connection test or a management and control test. The public trading connection test is met if the company’s principal class of shares is primarily traded (1) on a recognized stock exchange in the treaty country in which the company is resident, (2) in the case of a company resident in the United States, on a recognized stock exchange located in a third country that is a party to the North American Free Trade Agreement (“NAFTA”), or (3) in the case of a company resident in Sweden, on a recognized stock exchange located in the European Economic Area (“EEA”), the EU, or in Switzerland. The management and control test is met if the company’s primary place of management and control is in the treaty country where it is a resident.

The intent of this provision generally is to prevent certain companies from qualifying for treaty benefits if their nexus to their residence country is not sufficiently strong. The provision reflects a significant tightening of the public trading test in this regard. The Committee may wish to ask whether this tighter public trading test is likely to be included in future treaties, as opposed to the traditional, looser test.

It is also worth noting that, unlike most recent treaty instruments, including the Netherlands protocol, the proposed protocol does not require that the public company be listed in a treaty country. Consequently, the test under the proposed treaty is based primarily upon regional nexus. The Committee may wish to ask whether this regional focus is appropriate in the light of the anti-treaty-shopping purpose of this provision, and whether such a focus would remain viable if the political climate in Europe were to shift in favor of decreasing the scope of European integration.

Taxation of certain U.S. government pensions

The proposed protocol amends the existing treaty to include a special new rule related to Swedish tax on U.S. government pensions paid to certain Swedish citizens and residents. The provision bars Sweden from imposing tax on such pensions paid to former employees who were hired prior to 1978 to work for the U.S. Embassy in Stockholm or the U.S. consulate general in Gothenberg. These employees' salaries, and, therefore, their future pensions, were reduced because the U.S.-Sweden treaty in force at that time exempted their salaries from Swedish tax. When the treaty was renegotiated in 1994, Sweden was permitted to tax such pensions, which were not increased by the United States, notwithstanding the previous decrease. The Committee may wish to satisfy itself regarding the necessity of a treaty provision solely affecting the Swedish taxation of Swedish individuals.

France

Income Tax Protocol

The proposed income tax protocol with France would make several modifications and updates to the existing treaty. The proposed protocol would amend the dividends provision of the existing treaty by expanding the class of shareholders eligible for the treaty's 15-percent rate of U.S. withholding tax on dividends from real estate investment trusts ("REITs"). The provisions of the proposed protocol in this regard are similar to those included in other recent U.S. income tax treaties and protocols.

The proposed protocol replaces the pension rules of the current treaty and provides new rules for the taxation of pensions and social security benefits. The new pension rules are similar to those in recent U.S. tax treaties with both the United Kingdom and the Netherlands.

The proposed protocol amends the residence rules of the current treaty in a manner intended to address certain ambiguities in the tax treatment of cross-border investments through partnerships and similar entities. Ambiguities have arisen in particular circumstances in part because of the different rules governing the taxation of partnerships under French and U.S. internal law.

The proposed protocol expands the "saving clause" provision of the existing treaty to allow the United States to tax former long-term residents whose termination of residency has as one of its principal purposes the avoidance of tax. The existing treaty only applies to former citizens. The extension of this provision to long-term residents allows the United States to apply amendments made in 1996 to the special tax regime for expatriates under section 877 of the Code. The proposed protocol does not, however, update the saving clause provision to reflect

more recent changes made to the special expatriation rules by the American Jobs Creation Act of 2004 (“AJCA”). AJCA eliminated subjective determinations of tax-avoidance purpose and replaced them with objective rules for determining the applicability of the special tax regime for expatriates.

In three of the four treaty instruments before the Committee today (the two proposed French protocols and the proposed Bangladesh treaty), the saving clause uses the obsolete “principal purposes of tax avoidance” formulation in determining whether the special tax regime may apply to individuals who expatriate, even though the subjective determinations of tax-avoidance purpose under prior law were recently eliminated. Treasury Department technical explanations note that under these instruments, the determination of whether there was a principal purpose of tax avoidance is made under the laws of the United States. The technical explanations further state that this language would include “the irrebuttable presumptions based on average annual net income tax liability and net worth under section 877,” and that the new objective tests “represent the administrative means by which the United States determines whether a taxpayer has a tax avoidance purpose.” Thus, although the provisions employ the now-obsolete concept of a tax-avoidance purpose, the Treasury Department maintains that this language should be understood as fully preserving U.S. taxing jurisdiction under the expatriation tax rules in their current form. The Committee may wish to satisfy itself that the language included in the proposed protocol allows the United States to exercise its full taxing jurisdiction with respect to former citizens and long-term residents.

Estate Tax Protocol

The proposed estate, inheritance, and gift tax protocol with France would make several updates and other modifications to the existing treaty. The principal purpose of the treaty is to reduce or eliminate double taxation in connection with estate, inheritance, and gift taxes. One of the general principles of the treaty is that the country in which a donor or decedent was domiciled may tax the estate or gifts of that individual on a worldwide basis, but must credit tax paid to the other country with respect to certain types of property located in such other country.

Among other updates to the treaty, the proposed protocol would add a saving clause, which would protect the right of the United States to apply its estate and gift tax rules to U.S. citizens, as well as to certain former U.S. citizens and long-term residents. (As noted above, this saving clause was not updated to reflect changes made to the special expatriation tax regime under U.S. law in 2004.) The proposed protocol also would provide a pro rata unified credit to the estate of an individual domiciled in France (other than a U.S. citizen) for purposes of computing the U.S. estate tax due. An estate eligible for this provision would be entitled to a portion of the full, generally applicable credit, based on the ratio of the value of the estate’s U.S.-situated assets to the value of its worldwide assets.

In addition, the proposed protocol would provide a limited U.S. estate tax marital deduction in cases in which the surviving spouse is not a U.S. citizen. This provision would apply in the case of certain small estates. The proposed protocol also would add new limits to the situs-based taxation of certain interspousal transfers of noncommunity property. These changes are generally consistent with those made in other recent U.S. treaties in this area (e.g., in treaties with Canada and Germany).

Bangladesh

The proposed income tax treaty with Bangladesh represents a new treaty relationship for the United States. A proposed income tax treaty was signed in 1980 but never entered into force.

The proposed treaty with Bangladesh is similar to the U.S. model treaty in many ways, but it also includes certain departures from the U.S. model. In particular, the proposed treaty permits higher rates of source-country withholding tax on interest, royalties, and certain dividends than are provided for in the U.S. model. The proposed treaty also is broader than the U.S. model in its circumstances in which the activities of a resident of one treaty country give rise to a permanent establishment in the other country. In giving wider scope to permitted source-country taxation, the proposed treaty is similar to other treaties negotiated with developing countries. The Committee may wish to consider whether this concession is appropriate in the case of Bangladesh.

Updating the U.S. model treaty

As a general matter, U.S. model tax treaties provide a framework for U.S. tax treaty policy. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on tax treaty matters. Periodically updating the U.S. model tax treaties to reflect changes, revisions, developments, and the viewpoints of Congress with regard to U.S. tax treaty policy ensures that the model treaties remain meaningful and relevant. The current U.S. model income tax treaty was last updated in 1996. As we mentioned in the treaty hearings in 2003 and 2004, the Joint Committee staff believes that this model is becoming obsolete and is in need of an update. The Treasury Department stated at a hearing in 2004 that it was updating the model. The Committee may wish to inquire as to the current status of this project.

I would be happy to answer any questions that the Committee may have at this time or in the future.