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TAX TREATIES

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TAX TREATIES

Thursday, February 2, 2006

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

The committee met, pursuant to notice, at 9:30 a.m. in Room SD-419, Dirksen Senate Office Building, Hon. Richard G. Lugar, chairman of the committee, presiding.

Present: Senator Lugar.

OPENING STATEMENT OF HON. RICHARD G. LUGAR, U.S. SENATOR FROM INDIANA

The CHAIRMAN. This hearing of the Senate Foreign Relations Committee is called to order.

It's a pleasure to welcome our witnesses and our distinguished guests to the Foreign Relations Committee hearing on a tax treaty with Bangladesh, protocols amending the existing tax treaties with France, and a protocol amending the existing tax treaty with Sweden.

As chairman of the Senate Foreign Relations Committee, I'm committed to moving tax treaties as expeditiously as possible. I would point out, during the last Congress, the Committee and the full Senate approved tax agreements with Mexico, Australia, the United Kingdom, Japan, Sri Lanka, the Netherlands, and Barbados. I encourage the administration to continue its successful pursuit of treaties that strengthen the American economy by helping our businesses access foreign markets and by providing incentives for foreign companies to create more jobs in the United States.

The agreements before us today will bolster the economic relationships between the United States and countries that are already close trade and investment partners. As the United States considers how to create jobs and to maintain economic growth, it's important that we try to eliminate impediments that prevent our companies from fully accessing international markets. These impediments may come in the form of regulatory barriers, taxes, tariffs, and unfair treatment. In the case of taxes, we should work to ensure that companies pay their fair share without being unfairly taxed twice on the same revenue. Tax treaties are intended to prevent double taxation so that companies are not inhibited from doing business overseas. As the United States moves to keep the economy growing and to increase United States employment, international tax policies that promote foreign direct investment in the United States are critically important.

Our first agreement is a new tax treaty with Bangladesh, which was signed on September 26th, 2004. The investment banking firm Goldman Sachs recently cited Bangladesh in its list of developing countries that have the greatest potential to achieve long-term economic success. The United States is currently the largest source of foreign investment in Bangladesh, with $1.4 billion in fixed direct investment. American companies export about $290 million of products to Bangladesh each year.

Our next agreements are protocols with France. One protocol amends provisions of the existing income-tax treaty signed in 1994. The other protocol amends provisions of the existing estate-tax treaty signed in 1978. The United States is France's largest trading partner outside the European Union. France is one of our longest standing tax-treaty partners. We have had such treaties in place with the French for more than 65 years. The protocols before us contain provisions regarding treatment of pensions, application of estate taxes, marital-tax exclusions and deductions. These tax provisions are important to the numerous American nationals living and working in France, as well as French nationals living and working here. A key provision in the income-tax protocol clarifies taxation of partnerships.

Our final agreement is a protocol amending the existing treaty with Sweden. The original treaty was signed in 1994, and this protocol was finalized last September. The total amount of Swedish investment in the United States has quadrupled over the last decade, to $28.5 billion at the end of 2004. This is about 15 percent of Sweden's direct investments abroad. With $34 billion invested in Sweden, the United States is the largest source of foreign direct investment in that country. The most important aspect of the protocol before us deals with the taxation of cross-border dividend payments. This protocol is one of a few recent U.S. tax agreements to provide an elimination of withholding tax on dividends arising from certain direct investments. It will reduce tax-related barriers to trade and investment flows between the United States and Sweden, promoting even stronger economic ties between our nations.

We are joined today by a distinguished panel of witnesses who will help us evaluate the treaties and protocols before us. From the Treasury Department, we welcome Ms. Patricia Brown, the Deputy International Tax Counsel and the lead negotiator of the treaties. We also welcome Mr. Tom Barthold, Acting Chief of Staff of the Joint Committee on Taxation. Finally, we welcome Mr. Bill Reinsch, the President of the National Foreign Trade Council. The committee looks forward to the insights and analysis of our expert witnesses.

I will ask you to testify in the order that I introduced you—namely, Ms. Brown, then Mr. Barthold and Mr. Reinsch.

Let me say, at the outset, that your prepared statements will be placed in the record in full, so you need not ask for permission that that happen; it will occur.

You may proceed in any way that you wish, by reading the full statement, or by summarizing. We are not in a hurry. We've come to hear you today and to gain your insights. And then I will raise questions, and if other members of the committee join me, they may have questions, likewise, in due course.

It's a pleasure to have you before us. And would you please proceed, Ms. Brown?

STATEMENT OF PATRICIA BROWN, DEPUTY INTERNATIONAL TAX COUNSEL, OFFICE OF THE INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Ms. BROWN. Thank you, Mr. Chairman. I appreciate the opportunity to appear here today to recommend, on behalf of the administration, favorable action on the four tax agreements that you have described and that are pending before the committee.

We appreciate the committee's interest in these agreements, as demonstrated by the scheduling of this hearing and of the other hearings that you mentioned over the past few years.

In 2004, Mr. Chairman, you wrote that "Tax treaties are part of the basic infrastructure of the global marketplace." It is hard to imagine how that marketplace would operate without the international network of 2,000 bilateral tax treaties. They have established a stable framework for international trade and investment to flourish. The success of this framework is evidenced by the fact that countless cross-border transactions take place every year, with only a relatively few disputes regarding the allocation of tax revenues between governments. Many of these transactions involve individuals who benefit particularly from the rules regarding income from employment, the tax treatment of cross-border pension contributions and distributions, and, of course, estate-tax treaties.

Just like our physical infrastructure, our tax-treaty network requires constant attention. Countries introduce new preferential taxing regimes or tighter anti-abuse rules. They may introduce bank secrecy, or abolish it, or they may enter into an agreement with another country that is more advantageous than the agreement they have with the United States. Any of these situations may create an opportunity or a risk that needs to be addressed by a new or revised agreement.

To take advantage of these opportunities, we must be creative, flexible, and efficient. More and more, we are concluding short protocols in order to update an agreement without calling into question every one of its provisions. Of course, this committee's willingness to consider these agreements quickly has been crucial. It can change the entire tone and pace of a treaty negotiation when the other side discovers that an advantageous change can be approved and implemented within the course of a year, or if they realize that some other country will do it if they don't.

Three of the four agreements that are before you today are updates of this sort. The fourth, the full treaty with Bangladesh, is an updated version of a 1980 treaty that was approved by the Senate but never entered into force. The administration believes that these agreements with Bangladesh, France, and Sweden will serve to further the goals of our tax-treaty network, and we urge the committee and the Senate to take prompt and favorable action on all of these agreements.

In establishing our negotiating priorities, our primary objective is the conclusion of tax treaties or protocols that will provide the greatest economic benefit to the United States and to U.S. taxpayers. We communicate regularly with the U.S. business community, seeking input regarding the areas in which treaty network expansion and improvement efforts should be focused and information regarding practical problems encountered by U.S. business.

Our treaty network of 57 bilateral income-tax treaties covers the vast majority of U.S. foreign trade and investment. Because the coverage of our treaty network is already quite comprehensive, it frequently will make more sense, as an economic matter, for the United States to negotiate an update to an existing agreement rather than to negotiate a full treaty with a new treaty partner. Such a full agreement will require the potential treaty partner to grapple with many of the complexities of U.S. domestic and international tax rules and how it interacts with its own domestic law and policies. In some situations, the right result may be no tax treaty at all, or may be a substantially curtailed form of tax agreement. With some countries, a tax treaty may not be appropriate, because of the possibility of abuse. With other countries, there simply may not be the type of cross-border tax issues that are best resolved by treaty.

In all cases, the treaty that we present to the Senate represent not only the best deal that we believe we can achieve with the particular country, but also constitute an agreement that we believe is in the best interest of the United States.

In that context, I would like to provide a short update on the Treasury Department's position with respect to withholding taxes on intercompany dividends.

In earlier testimony before this committee, Treasury Department representatives have discussed the decision, first made in connection with the negotiation of the U.K. treaty in 2001, to eliminate this withholding tax. The position of the Treasury Department has been, and continues to be, that the decision is made independently with respect to every treaty negotiation. We agree to the provision only if the agreement includes limitation on benefits and information-exchange provisions that meet the highest standards, and if the overall balance of the agreement is appropriate.

Since we first adopted this new policy, a number of treaty relationships have changed for the better. Suddenly there was some leverage to achieve goals that had seemed out of reach. Thus, even though the policy is only 5 years old, we have been able, in one or more treaties, to strengthen our position on treaty shopping, to improve information exchange provisions, to reduce withholding taxes on interest on royalties, and to eliminate withholding taxes and dividends paid to pension funds. The reductions we have achieved in our own treaties are influencing the negotiation of agreements between other countries. In fact, just this morning a new U.K./Japan tax treaty was signed in London that adopts many of the provisions that were in the U.S./Japan treaty that was approved by this committee a few years ago. We believe that these significant achievements demonstrate that the current policy is having very positive effects on U.S. businesses and their subsidiaries, and will continue to do so in the foreseeable future.

I now would like to discuss the four agreements that are pending before the Senate. We have submitted technical explanations of each agreement that contain detailed discussions of the provisions of each treaty and protocol.

The proposed protocol with Sweden amends the income-tax treaty that was signed in 1994. As you said, the most significant provision is the elimination of the source-country withholding tax on most intercompany dividends and on dividends paid to pension funds. The provision dealing with intercompany dividends was very important to Sweden, because it had unilaterally eliminated its withholding tax on such dividends in the 1990s, after the United States insisted that it could not do so bilaterally. If we had failed to provide a reciprocal benefit for Swedish companies now that U.S. treaty policy has changed, it would have jeopardized the current exemption from Swedish withholding taxes that benefits U.S. companies now.

We also took this opportunity to add anti-inversion provisions to the limitation on benefits provisions of the treaty. Including the provision in a mainstream agreement such as this establishes a precedent that will be very useful in other treaty negotiations, and, in fact, has already helped us to secure similar provisions in protocols we're negotiating today.

The protocol also provides an effective grandfathering rule for Swedish employees of the U.S. Embassy in Stockholm and Consulate in Gothenburg who were inadvertently disadvantaged by changes made in the 1994 treaty.

The proposed income-tax protocol with France amends the 1994 income-tax treaty. The primary impetus for the negotiation of this protocol was to deal with the treatment of investments through partnerships located in the United States, France, or third countries. The United States and France have very different provisions dealing with partnerships. And so, the result of this protocol is to allow France to tax its own partnerships, but to give benefits to U.S. investors who invest through partnerships in the U.S. or third countries.

It also modifies the provisions of the treaty dealing with pensions and pension contributions in order to reflect the fact that we have very different systems in the two countries and to achieve parity, given those two fundamentally different pension systems. The French pension system relies almost entirely on the state social security system. Since the 1994 treaty provided disparate treatment for private pensions and social security distributions, there were significant differences in taxing rights between the two countries.

The proposed protocol provides for taxation in the country of source with respect to both, and also provides for consistent treatment for cross-border contributions to French social security and U.S. private pension plans.

The proposed estate-tax protocol amends the estate- and gift-tax treaty between the United States and France to take into account the changes that were made in U.S. domestic estate-tax rules in 1988. France, along with several other countries, objected to this change. Although we did not agree that the 1988 change was discriminatory, we did agree to enter into protocols with certain treaty partners to provide some limited relief with respect to non-citizen spouses of U.S. citizens. The United States' willingness to enter into the proposed protocol was a significant factor in France's ratification of the current U.S./France income-tax treaty, which was signed in 1994.

The proposed treaty with Bangladesh would be the first agreement between the United States and Bangladesh. The proposed treaty is consistent with other U.S. treaties with developing countries. The maximum rates of source-country withholding taxes on investment income are generally equal to, or lower than, the maximum rates provided in other U.S. treaties with developing countries.

The rules regarding taxation of business profits are generally consistent with the provisions of the U.S. model, as modified in our treaties with other developing countries. In particular, we were able to get Bangladesh to agree to U.S. model rules with respect to the treatment of income from shipping and aircraft and containers. And this was an issue that was raised by the Senate in connection with the earlier treaty that was not approved.

Turning now to the future, we continue to maintain a very active calendar of tax-treaty negotiations. We are in ongoing negotiations with Canada, Chile, Germany, Hungary, Iceland, Korea, and Norway. We also have substantially completed work on agreements with Denmark and Finland, and look forward to their conclusion. In addition, we are beginning negotiations with Bulgaria.

We, of course, will continue work on updating the few remaining U.S. treaties that provide opportunities for treaty shopping. We have also had informal exploratory discussions with several countries in Asia, and we hope these will lead to productive negotiations in the near future.

With respect to the U.S. model, we expect to forward a draft text to the staffs of the Senate Foreign Relations Committee and Joint Committee on Taxation within the next month. We look forward to working with them on this project.

Let me conclude by again thanking the committee for its continuing interest in the treaty program, and the members and the staff for devoting time and attention to the review of these new agreements. We greatly appreciate the assistance and cooperation of the staffs of this committee and of the joint committee in the tax-treaty process. We urge the committee to take prompt and favorable action on the agreements before you today.

I will, of course, be happy to answer any questions.

[The prepared statement of Ms. Brown follows:]

PREPARED STATEMENT OF PATRICIA A. BROWN

Mr. Chairman and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing to recommend, on behalf of the Administration, favorable action on four tax agreements that are pending before this Committee. We appreciate the Committee's interest in these agreements and in the U.S. tax treaty network, as demonstrated by the scheduling of this hearing.

As you expressed so well, Mr. Chairman, tax treaties are "part of the basic infrastructure of the global marketplace". The international network of over 2000 bilateral tax treaties has established a stable framework that allows international trade and investment to flourish. The success of this framework is evidenced by the fact that countless cross-border transactions, from investments in a few shares of a foreign company by an individual to multi-billion dollar purchases of operating companies in a foreign country, take place each year, with only a relatively few disputes regarding the allocation of tax revenues between governments. Individuals, too, benefit from the rules regarding allocation of investment income, but also from the rules regarding income from employment, the tax treatment of cross-border pension contributions and distributions, and, of course, the estate tax rules.

Just like our physical infrastructure, our tax treaty network requires constant attention. Countries introduce new preferential taxing regimes, or tighter anti-abuse rules; they may introduce bank secrecy or abolish it; or they may enter into an agreement with another country that is more advantageous than the agreement they have with the United States. Any of these situations may create an opportunity or a risk that needs to be addressed by a new or revised agreement. We must be creative and flexible in how we approach issues to find solutions to particular problems that are consistent with our overall goals. We are also becoming more efficient, concluding short protocols in order to update an agreement without calling into question every one of its provisions. Of course, this committee's willingness to consider these agreements quickly has been a tremendous help in this regard. It can change the entire tone (and pace) of a treaty negotiation when the other side discovers that an advantageous change can be approved and implemented within the space of a year.

Three of the four agreements that are before you now are updates to relatively recent agreements. The fourth, the full treaty with Bangladesh, is an updated version of a 1980 treaty that never entered into force because of Senate concerns about several provisions. The Administration believes that these agreements with Bangladesh, France and Sweden will serve to further the goals of our tax treaty network. We urge the committee and the Senate to take prompt and favorable action on all of these agreements.

PURPOSES AND BENEFITS OF TAX TREATIES

Tax treaties provide benefits to both taxpayers and governments by setting out clear ground rules that will govern tax matters relating to trade and investment between the two countries. A tax treaty is intended to mesh the tax systems of the two countries in such a way that there is little potential for dispute regarding the amount of tax that should be paid to each country. The goal is to ensure that taxpayers do not end up caught in the middle between two governments, each of which claims taxing jurisdiction over the same income. A treaty with clear rules addressing the most likely areas of disagreement minimizes the time the two governments (and taxpayers) spend in resolving individual disputes.

One of the primary functions of tax treaties is to provide certainty to taxpayers regarding the threshold question with respect to international taxation: whether the taxpayer's cross-border activities will subject it to taxation by two or more countries. Treaties answer this question by establishing the minimum level of economic activity that must be engaged in within a country by a resident of the other country before the first country may tax any resulting business profits. In general terms, tax treaties provide that if the branch operations in a foreign country have sufficient substance and continuity, the country where those activities occur will have primary (but not exclusive) jurisdiction to tax. In other cases, where the operations in the foreign country are relatively minor, the home country retains the sole jurisdiction to tax its residents.

Tax treaties protect taxpayers from potential double taxation through the allocation of taxing rights between the two countries. This allocation takes several forms. First, the treaty has a mechanism for resolving the issue of residence in the case of a taxpayer that otherwise would be considered to be a resident of both countries. Second, with respect to each category of income, the treaty assigns the "primary" right to tax to one country, usually (but not always) the country in which the income arises (the "source" country), and the "residual" right to tax to the other country, usually (but not always) the country of residence of the taxpayer. Third, the treaty provides rules for determining which country will be treated as the source country for each category of income. Finally, the treaty provides rules limiting the amount of tax that the source country can impose on each category of income and establishes the obligation of the residence country to eliminate double taxation that otherwise would arise from the exercise of concurrent taxing jurisdiction by the two countries.

As a complement to these substantive rules regarding allocation of taxing rights, tax treaties provide a mechanism for dealing with disputes or questions of application that arise after the treaty enters into force. In such cases, designated tax authorities of the two governments—known as the "competent authorities" in tax treaty parlance—are 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 that might otherwise result. The U.S. competent authority under our tax treaties is the Secretary of the Treasury. That function has been delegated to the Director, International (LMSB) of the Internal Revenue Service.

In addition to reducing potential double taxation, treaties also reduce potential "excessive" taxation by reducing withholding taxes that are imposed at source. Under U.S. domestic law, payments to non-U.S. 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. Most of our trading partners impose similar levels of withholding tax on these types of income. This tax is imposed on a gross, rather than net, amount. Because the withholding tax does not take into account expenses incurred in generating the income, the taxpayer that bears the burden of withholding tax frequently will be subject to an effective rate of tax that is significantly higher than the tax rate that would be applicable to net income in either the source or residence country. The taxpayer may be viewed, therefore, as suffering "excessive" taxation. Tax treaties alleviate this burden by setting maximum levels for the withholding tax that the treaty partners may impose on these types of income or by providing for exclusive residence-country taxation of such income through the elimination of source-country withholding tax. Because of the excessive taxation that withholding taxes can represent, the United States seeks to include in tax treaties provisions that substantially reduce or eliminate source-country withholding taxes.

Tax treaties also include provisions intended to ensure that cross-border investors do not suffer discrimination in the application of the tax laws of the other country. This is similar to a basic investor protection provided in other types of agreements, but the non-discrimination provisions of tax treaties are specifically tailored to tax matters and therefore are the most effective means of addressing potential discrimination in the tax context. The relevant tax treaty provisions provide guidance about what "national treatment" means in the tax context by explicitly prohibiting types of discriminatory measures that once were common in some tax systems. At the same time, tax treaties clarify the manner in which possible discrimination is to be tested in the tax context. Particular rules are needed here, for example, to reflect the fact that foreign persons that are subject to tax in the host country only on certain income may not be in the same position as domestic taxpayers that may be subject to tax in such country on all their income.

In addition to these core provisions, tax treaties include provisions dealing with more specialized situations, such as rules coordinating the pension rules of the tax systems of the two countries or addressing the treatment of Social Security benefits and alimony and child support payments in the cross-border context. These provisions are becoming increasingly important as the number of individuals who move between countries or otherwise are engaged in cross-border activities increases. While these matters may not involve substantial tax revenue from the perspective of the two governments, rules providing clear and appropriate treatment are very important to the individual taxpayers who are affected.

Tax treaties also include provisions related to tax administration. A key element of U.S. tax treaties is the provision addressing the exchange of information between the tax authorities. Under tax treaties, the competent authority of one country may request from the other competent authority such information as may be relevant for the proper administration of the country's tax laws; the requested information will be provided subject to strict protections on the confidentiality of taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank secrecy rules that would operate to prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not conclude a treaty with that country. Indeed, the need for appropriate information exchange provisions is one of the treaty matters that we consider non-negotiable.

TAX TREATY NEGOTIATING PRIORITIES AND PROCESS

In establishing our negotiating priorities, our primary objective is the conclusion of tax treaties or protocols that will provide the greatest economic benefit to the United States and to U.S. taxpayers. We communicate regularly with the U.S. business community, seeking input regarding the areas in which treaty network expansion and improvement efforts should be focused and information regarding practical problems encountered by U.S. businesses with respect to the application of particular treaties and the application of the tax regimes of particular countries.

The United States has a network of 57 bilateral income tax treaties covering 65 countries. This network includes all 29 of our fellow members of the OECD. It also covers the vast majority of foreign trade and investment of U.S. businesses. Because the coverage of our treaty network is already quite comprehensive, it frequently will make more sense, as an economic matter, for the United States to negotiate an update to an existing agreement, rather than to negotiate a full treaty with a new treaty partner. Such a full agreement will require the potential treaty partner to grapple with many of the complexities of U.S. domestic and international tax rules and U.S. tax treaty policy, and how it interacts with its own domestic law and policies. Thus, the primary constraint on the size of our tax treaty network may be the complexity of the negotiations themselves. The various functions performed by tax treaties and most particularly the need to mesh the particular tax systems of the two treaty partners, make the negotiation process exacting and time-consuming.

A country's tax policy reflects the sovereign choices made by that country. Numerous features of the treaty partner's particular tax legislation and its interaction with U.S. domestic tax rules must be considered in negotiating an appropriate treaty. Examples include whether the country eliminates double taxation through an exemption system or a credit system, the country's treatment of partnerships and other transparent entities, and how the country taxes contributions to pension funds, earnings of the funds, and distributions from the funds. A treaty negotiation must take into account all of these and many other aspects of the particular treaty partner's tax system in order to arrive at an agreement that accomplishes the United States' tax treaty objectives.

A country's fundamental tax policy choices are reflected not only in its tax legislation but also in its tax treaty positions. The choices in this regard can and do differ significantly from country to country, with substantial variation even across countries that seem to have quite similar economic profiles. A treaty negotiation also must reconcile differences between the particular treaty partner's preferred treaty positions and those of the United States.

Obtaining the agreement of our treaty partners on provisions of importance to the United States sometimes requires other concessions on our part. Similarly, the other country sometimes must make concessions to obtain our agreement on matters that are critical to it. In most cases, the process of give-and-take produces a document that is the best tax treaty that is possible with that other country. In other cases, we may reach a point where it is clear that it will not be possible to reach an acceptable agreement. In those cases, we simply stop negotiating with the understanding that negotiations might restart if circumstances change. Each treaty that we present to the Senate represents not only the best deal that we believe we can achieve with the particular country, but also constitutes an agreement that we believe is in the best interests of the United States.

In some situations, the right result may be no tax treaty at all or may be a substantially curtailed form of tax agreement. With some countries a tax treaty may not be appropriate because of the possibility of abuse. With other countries there simply may not be the type of cross-border tax issues that are best resolved by treaty. For example, with a country that does not impose significant income taxes, where there is little possibility of the double taxation of income in the cross-border context that tax treaties are designed to address, an agreement that is focused on the exchange of tax information may be most valuable. Alternatively, a bifurcated approach may be appropriate in situations where a country has a special preferential tax regime for certain parts of the economy that is different from the tax rules generally applicable to the country's residents. In those cases, the residents benefiting from the preferential regime do not face potential double taxation and so should not be entitled to the reductions in U.S. withholding taxes accorded by a tax treaty, while a full treaty relationship might be useful and appropriate in order to avoid double taxation in the case of the residents who do not receive the benefit of the preferential regime.

Prospective treaty partners must evidence a clear understanding of what their obligations would be under the treaty, including those with respect to information exchange, and must demonstrate that they would be able to fulfill those obligations. Sometimes a tax treaty may not be appropriate because a potential treaty partner is unable to do so. In other cases, a tax treaty may be inappropriate because the potential treaty partner is not willing to agree to particular treaty provisions that are needed in order to address real tax problems that have been identified by U.S. businesses operating there.

The U.S. commitment to including comprehensive limitation of benefits provisions designed to prevent "treaty shopping" in all of our tax treaties is one of the keys to improving our overall treaty network. Our tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes agreed to in a particular treaty mean that U.S. persons pay less tax to that country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents are able to exploit one of our tax treaties to secure reductions in U.S. tax, the benefits would flow only in one direction as third-country residents would enjoy U.S. tax reductions for their U.S. investments but U.S. residents would not enjoy reciprocal tax reductions for their investments in that third country. Moreover, such third-country residents may be securing benefits that are not appropriate in the context of the interaction between their home country's tax systems and policies and those of the United States. This use of tax treaties is not consistent with the balance of the deal negotiated. Preventing this exploitation of our tax treaties is critical to ensuring that the third country will sit down at the table with us to negotiate on a reciprocal basis, so that we can secure for U.S. persons the benefits of reductions in source-country tax on their investments in that country.

UPDATE ON THE TREASURY DEPARTMENT'S POSITION ON INTER-COMPANY DIVIDENDS

In earlier testimony before this committee, Treasury Department representatives have discussed the decision, first made in connection with the negotiation of the treaty with the United Kingdom in 2001, to eliminate the source-country withholding tax on certain inter-company dividends. The position of the Treasury Department has been, and continues to be, that this decision is made independently with respect to every treaty negotiation. The United States will agree to the provision only if the agreement includes limitation on benefits and information exchange provisions that meet the highest standards, and if the overall balance of the agreement is appropriate.

Since we first expressed our willingness to eliminate the source-country withholding tax on inter-company dividends, a number of treaty relationships that had been at best stagnant and at worst problematic have changed for the better. Suddenly, there was some leverage to achieve goals that had seemed out of reach for one reason or another. Thus, although the new policy has been in place for only about five years, it has enabled us to achieve the following goals in one or more treaties:

- Strengthening our provisions to prevent treaty shopping, including the introduction of rules that prevent the use of tax treaties after a corporate inversion transaction;
- Significantly improving information exchange provisions, allowing access to information even when the treaty partner does not need the information for its own tax purposes;
- Reducing withholding taxes on interest and royalties to levels lower than those to which those treaty partners had ever previously agreed;
- Eliminating withholding taxes on dividends paid to pension funds, a tax that otherwise would inevitably lead to double taxation; and
- Protecting U.S. companies against the retaliatory re-imposition of withholding taxes on inter-company dividends.

The reductions we have achieved in our own treaties also are influencing the negotiation of agreements between other countries. U.S. companies benefit from those agreements as well, as many of them have subsidiaries that may benefit if similar reductions in rates are adopted under a new U.K.-Japan treaty, for example.

We believe that these significant achievements demonstrate that the current policy is having very positive effects and will continue to do so in the foreseeable future.

DISCUSSION OF PROPOSED NEW TREATIES AND PROTOCOLS

I now would like to discuss the four agreements that have been transmitted for the Senate's consideration. We have submitted Technical Explanations of each agreement that contain detailed discussions of the provisions of each treaty and protocol. These Technical Explanations serve as an official guide to each agreement.

The proposed Protocol amends the income tax treaty between the United States and Sweden that was signed in 1994. The most significant provisions in the Protocol relate to the treatment of dividends and limitation on benefits. The Protocol also rectifies a mistake that was made in the 1994 treaty that caused a great deal of hardship for a number of former employees of the U.S. government. It also makes a number of necessary updates to the treaty.

Like a number of recent agreements, the Protocol will eliminate the source-country withholding tax on most inter-company dividends and on dividends paid to pension funds. The provision dealing with inter-company dividends was very important to Sweden, because it had unilaterally eliminated its withholding tax on inter-company dividends. The legislative history to that domestic law change makes it clear that the main beneficiaries of that change were expected to be U.S. companies. In fact, it refers specifically to assurances given to the Swedish negotiators that the United States would not agree to eliminate the withholding tax on inter-company dividends in any bilateral agreement with any country. Now that U.S. policy has changed, failure to provide a reciprocal benefit for Swedish companies would have jeopardized the exemption from Swedish withholding tax that currently benefits U.S. companies. We believe that securing that protection, as well as eliminating the withholding tax on dividends paid to pension funds, is a sufficient quid pro quo.

Nevertheless, we also took this opportunity to add anti-inversion provisions to the limitation on benefits provisions of the treaty. The new provision represents a somewhat simplified version of a similar provision introduced in the recent protocol with the Netherlands. Although we have no reason to believe that Sweden would be an attractive destination for an inverted U.S. corporation, including the provision in a mainstream agreement such as this helps to establish a precedent that will be extremely useful in other treaty negotiations.

The Protocol also resolves a long-standing problem regarding the taxation of local employees of the Embassy in Stockholm and consulate in Gothenburg. The Protocol provides a grandfather rule to eliminate the unintended consequences resulting from a change made by the 1994 U.S.-Sweden income tax treaty regarding the taxation of local employees (or former employees) of the Embassy in Stockholm and consulate in Gothenburg. To rectify this problem, the Protocol provides that Sweden may not tax a pension under the U.S. Civil Service Retirement Pension Plan paid by the United States to employees of the U.S. embassy in Stockholm or the U.S. consulate general in Gothenburg if the individual was hired prior to 1978.

Other provisions in the Protocol reflect changes in U.S. domestic law or are intended to bring it into closer conformity with current U.S. treaty practice. For example, the current treaty preserves the U.S. right to tax former citizens whose loss of citizenship had, as one of its principal purposes, the avoidance of tax. The proposed Protocol updates this provision to reflect legislative changes since 1994. In order to reflect 1996 changes to the Internal Revenue Code, the Protocol provides that a former citizen or long-term resident of the United States may, for the period of ten years following the loss of such status, be taxed in accordance with the laws of the United States.

United States and Sweden will notify each other through the diplomatic channel, accompanied by an instrument of ratification, when their respective requirements for entry into force have been completed. The proposed Protocol will enter into force on the thirtieth day after the later of the notifications. It will have effect, with respect to taxes withheld at source, on or after the first day of the second month next following the date upon which the Protocol enters into force. With respect to other taxes, it will have effect for taxable years beginning on or after the first day of January next following the date upon which the Protocol enters into force.

FRENCH INCOME TAX PROTOCOL

The proposed income tax protocol amends the 1994 income tax treaty between the United States and France, which entered into force in 1995.

The primary impetus for the negotiation of the income tax Protocol was to clarify the treatment of investments made in France by U.S. investors through partnerships located in the United States, France, or third countries. Because France taxes French partnerships on their worldwide income, and does not treat them as fiscally transparent, the Protocol confirms that France maintains taxing rights with respect to French partnerships. However, the Protocol provides that French treaty benefits will apply to U.S. residents who invest through U.S. partnerships or partnerships located in certain third countries. These partnership provisions will eliminate uncertainty and provide significant benefits to U.S. investors.

The income tax Protocol also reforms the treatment of certain French investment vehicles, which would have been entitled to U.S. treaty benefits under the 1994 treaty. Under the revised provision, a "fonds commun de placement" will not itself qualify for U.S. treaty benefits, but holders of interests in such an investment vehicle may qualify for treaty benefits if they are residents of France or of a third country that has an appropriate tax treaty with the United States.

The income tax Protocol modifies the provisions of the treaty dealing with pensions and pension contributions in order to achieve parity given the two countries' fundamentally different pension systems. The French pension system relies almost entirely on the state social security system with much more limited use of private pension arrangements such as employer plans and individual plans. The provisions in the 1994 treaty that treated private pension payments and social security payments differently are replaced in the proposed Protocol with provisions that treat the two systems the same. Under the proposed Protocol, the country of source is assigned taxing rights with respect to both state social security payments and private pension payments. The proposed Protocol also includes a provision that allows U.S. persons to deduct voluntary contributions to the French social security system to the same extent that contributions to a U.S. plan would be deductible, which is comparable to the provision in the 1994 treaty that allows French residents deductions for contributions to U.S. private pension plans.

The proposed Protocol makes other changes to the 1994 treaty to reflect more closely current U.S. treaty policy. The proposed Protocol updates the treatment of dividends paid by U.S. REITs to reflect a change in approach adopted in 1997, which is intended to prevent the use of structures designed to avoid U.S. withholding taxes on outbound dividends while providing appropriate benefits to portfolio investors in REITs. The proposed Protocol also extends the provision in the 1994 treaty preserving U.S. taxing rights with respect to certain former citizens to cover certain former long-term residents in order to reflect 1996 changes to the Internal Revenue Code.

Each state will notify the other when it has completed the necessary steps to bring the proposed Protocol into force. The Protocol will enter into force upon the receipt of the later of those two notices. In general, it will have effect, with respect to taxes withheld at source, for amounts paid or credited on or after the first day of the second month following the date on which the Protocol enters into force and, with respect to other taxes, for taxable periods beginning on or after the first day of January following entry into force. However, because the rules benefiting U.S. residents investing through partnerships are intended to ensure that the treaty provides results that are consistent with the intent of the negotiators of the 1995 treaty, those changes will be applicable as of the effective dates of the 1994 treaty.

FRENCH ESTATE TAX PROTOCOL

The proposed estate tax Protocol amends the estate and gift tax treaty between the United States and France, which was signed in 1978 and entered into force in 1980.

In 1988, U.S. estate tax law was changed to tax currently transfers of property to non-citizen surviving spouses. France, along with several other countries with which the United States has estate tax treaties, objected to this change.

Although the U.S. rejected claims by estate tax treaty partners that the 1988 change violated treaty nondiscrimination clauses, we indicated our willingness to amend our estate tax treaties with certain treaty partners to provide relief to surviving non-citizen spouses in appropriate cases. Accordingly, the proposed Protocol eases the impact of the 1988 provisions upon certain estates of limited value. Pursuant to the Protocol, transfers of non-community property from a French domiciliary to a spouse who is not a United States citizen that may be taxed by the United States solely on the basis of situs under the treaty can be included in the tax base only to the extent that the value of the property, after applicable deductions, exceeds 50 percent of the value of all property that may be taxed by the United States.

In addition to the allowance of the marital exclusion, the Protocol also provides for a limited elective estate tax marital deduction which, if elected, waives the right to any available marital deduction that would be allowed under United States domestic law. The election is available only where the spouses satisfy certain domiciliary and citizenship requirements and only to “qualifying property” (generally, property that passes to the surviving spouse and that would have qualified for the marital deduction if the surviving spouse had been a United States citizen). The amount of the deduction is equal to the lesser of the value of the qualifying property or the “applicable exclusion amount” (generally, the amount which the unified credit shelters from estate tax) for the year of the decedent’s death.

The United States, in a 1995 protocol to the U.S.-Canada income tax treaty and a 1998 protocol to the U.S.-Germany estate tax treaty, provided similar relief to certain estates of limited value involving Canadians and Germans. The United States’ willingness to enter into the proposed Protocol was a significant factor in France’s ratification of the current U.S.-France income tax treaty, which was signed in 1994.

The proposed Protocol also provides a pro rata unified credit to the estate of a French domiciliary for purposes of computing the U.S. estate tax. Under this provision, a French domiciliary is allowed a credit against U.S. estate tax ranging from the amount ordinarily allowed to the estate of a nonresident under the Code ($13,000) to the amount of credit allowed to the estate of a U.S. citizen under the Code ($555,800 in 2004 and 2005), based on the extent to which the assets of the estate are situated in the United States (with either amount reduced to the extent of any credit previously allowed with respect to lifetime gifts). Congress anticipated the negotiation of such pro rata unified credits in Internal Revenue Code section 2102(c)(3)(A), and a similar credit was included in the 1995 U.S.-Canada income tax protocol and the 1998 German estate tax treaty protocol.

The proposed Protocol also modernizes the provisions dealing with the elimination of double taxation. In determining the French tax, if the transferor was a French domiciliary at the time of the transfer, France may tax any property which may also be taxed by the United States, but must allow a deduction from that tax in an amount equal to the United States tax paid upon such transfer.

If the transferor is a domiciliary or citizen of the United States and a transfer of property is subject to situs taxation by France, the United States must allow a credit equal to the amount of tax imposed by France with respect to such property. If the transferor is a United States citizen (or former citizen or long-term resident who lost such status with a principal purpose of tax avoidance) but a French domiciliary, the United States must allow a credit for the amount of tax imposed by France (after allowance for the deduction from French tax referred to in the first paragraph) with respect to such property. All of the credits allowed under the Protocol are limited to the tax imposed (and actually paid) on the property for which the credit is claimed.

The proposed estate tax Protocol also makes other changes to the Convention to reflect more closely current U.S. treaty policy. For example, the proposed Protocol extends the United States' ability to tax former citizens and long-term residents to conform with 1996 legislative changes to the Internal Revenue Code. The proposed Protocol also defines the term "real property" in a manner consistent with the definition provided in Treas. Reg. § 1.897–1(b) and our income tax treaties. The proposed Protocol adds a rule that allows source state taxation of stock in real property holding companies.

Each state will notify the other when it has completed the necessary steps to bring the proposed estate tax Protocol into force. The Protocol will enter into force upon the receipt of the later of those two notices. Although the proposed Protocol generally will be effective with respect to gifts made and deaths occurring after the exchange of instruments of ratification, the relief provided with respect to surviving non-citizen spouses and the pro rata unified credit will be effective with respect to gifts made and deaths occurring after November 10, 1988 (the effective date of the 1988 legislative changes). Claims for refund asserting the benefits of the proposed Protocol that otherwise would be barred by the statute of limitations must be made within one year of entry of the Protocol, however, and all claims for retroactive relief are subject to the rules regarding the United States' ability to tax former citizens and long-term residents.

The negotiators believed that retrospective relief was not inappropriate, given the fact that the 1988 legislative changes were the impetus for negotiation of the proposed Protocol and negotiations commenced soon after the enactment of those changes. The United States agreed to similar retrospective relief in the 1995 U.S.-Canada income tax treaty protocol and the 1998 U.S.-Germany estate tax treaty protocol.

BANGLADESH

The United States does not currently have an income tax treaty with Bangladesh. The proposed income tax treaty with Bangladesh was signed in Dhaka September 26, 2004.

The proposed treaty generally follows the pattern of the U.S. model treaty, while incorporating some provisions found in other U.S. treaties with developing countries. The maximum rates of source-country withholding taxes on investment income provided in the proposed treaty are generally equal to or lower than the maximum rates provided in other U.S. treaties with developing countries (and some developed countries).

The proposed treaty generally provides a maximum source-country withholding tax rate on dividends of 15 percent. Direct investment dividends are subject to taxation at source at a 10-percent rate. The proposed treaty requires a 10-percent ownership threshold for application of the 10-percent tax rate.

The proposed treaty provides for a 10 percent rate of tax at source on most interest payments. However, interest received by any financial institution (including an insurance company) and interest earned on trade credits are subject to a 5 percent rate of tax at source. In addition, interest derived by the Governments of the Contracting States and instrumentalities of those Governments, as well as debt guaranteed by government agencies (e.g., the U.S. Export-Import Bank) is exempt from tax at source.

The proposed treaty provides that royalties are subject to a 10 percent tax at source. Consistent with the U.S. and OECD Model treaties, income from the rental of tangible personal property is not treated as a royalty, but as business profits, thus eliminating any withholding tax at source.

The standard U.S. anti-abuse rules are provided for certain classes of investment income. For example, dividends paid by non-taxable conduit entities, such as U.S. RICs and REITs, are subject to special rules to prevent the use of these entities to transform what is otherwise high-taxed income into lower-taxed income.

The proposed treaty follows the standard rules for taxation by the source country of the business profits of a resident of the other country. The source country's right to tax such profits is generally limited to cases in which the profits are attributable to a permanent establishment located in that country. The proposed treaty, however, defines a "permanent establishment" in a way that grants rights to tax business profits that are somewhat broader than those found in the U.S. and OECD Models. However, these rules are quite similar to rules found in our tax treaties with other developing countries.

In the case of shipping and aircraft, the proposed Convention, consistent with current U.S. treaty policy, provides for exclusive residence-country taxation of profits from the international operation of ships or aircraft. Like the U.S. model, only the country of residence may tax profits from the rental or maintenance of containers used in international traffic.

The proposed treaty provides rules that are similar to the U.S. model with respect to the taxation of income from the performance of personal services. However, like some other U.S. treaties with developing countries, the proposed treaty grants a taxing right to the host country with respect to some classes of personal services income that is broader in a few respects than in the OECD or U.S. model.

The proposed treaty contains a comprehensive limitation on benefits article, which provides detailed rules designed to deny "treaty shoppers" the benefits of the treaty. These rules are comparable to the rules contained in the U.S. model and recent U.S. treaties.

The proposed treaty also sets out the manner in which each country will relieve double taxation. Both the United States and Bangladesh will provide such relief through the foreign tax credit mechanism. The proposed Convention does not include a "tax sparing credit," since such credits are contrary to U.S. treaty policy. At Bangladesh's request, the exchange of notes provides that, if the United States alters its policy regarding the granting of tax sparing credits or provides for such credits in another treaty, negotiations will be reopened with a view to concluding a protocol that would offer similar benefits to Bangladesh.

The proposed treaty provides for non-discriminatory treatment (i.e., national treatment) by one country to residents and nationals of the other. Also included in the proposed treaty are rules necessary for administering the treaty, including rules for the resolution of disputes under the treaty.

The proposed treaty includes an exchange of information provision that generally follows the U.S. model. Under these provisions, Bangladesh will provide U.S. tax officials such information as is relevant to carry out the provisions of the treaty and the domestic tax laws of the United States.

The proposed Convention is subject to ratification. It will enter into force upon the exchange of instruments of ratification. It will have effect, with respect to taxes withheld at the source, for amounts paid or credited on or after the first day of the second month following entry into force. In other cases the Convention will have effect with respect to taxable periods beginning on or after the first day of January following the date on which the Convention enters into force.

TREATY PROGRAM PRIORITIES

We continue to maintain a very active calendar of tax treaty negotiations. We currently are in ongoing negotiations with Canada, Chile, Germany, Hungary, Iceland, Korea and Norway. In addition, we are beginning negotiations with Bulgaria. We also have substantially completed work on agreements with Denmark and Finland and look forward to their conclusion.

A key continuing priority is updating the few remaining U.S. tax treaties that provide for low withholding tax rates but do not include the limitation on benefits provisions needed to protect against the possibility of treaty shopping. We have also had informal exploratory discussions with several countries in Asia; we hope that those discussions will lead to productive negotiations later in 2006 or in 2007.

Work on the U.S. model was well advanced last year but was delayed due to other commitments. However, we expect to forward a draft text to the staffs of the Senate

Foreign Relations Committee and Joint Committee on Taxation within the next month. We look forward to working with them on this project.

CONCLUSION

Let me conclude by again thanking the committee for its continuing interest in the tax treaty program, and the members and staff for devoting time and attention to the review of these new agreements. We greatly appreciate the assistance and cooperation of the staffs of this committee and of the Joint Committee on Taxation in the tax treaty process.

We urge the committee to take prompt and favorable action on the agreements before you today.

The CHAIRMAN. Well, thank you very much, Ms. Brown. We appreciate your testimony; and likewise, your mention of the close cooperation between you and your staff and the staff on both sides of the aisle of this committee and the promise of more work to come. The Department of the Treasury has an active agenda in this vital endeavor. We appreciate your testimony.

I'd like to call now upon Mr. Barthold for his testimony.

STATEMENT OF THOMAS A. BARTHOLD, ACTING CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, WASHINGTON, D.C.

Mr. BARTHOLD. Thank you, Mr. Chairman.

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-tax protocols with France, and the proposed income-tax treaty with Bangladesh. As in the past, the joint committee staff has prepared background pamphlets covering the proposed treaty and protocols, providing detailed descriptions of their provisions and including comparisons with the 1996 U.S. model income-tax treaty, which generally reflects U.S. tax-treaty policy. Also, we make comparisons with other recent U.S. treaties which have come before the committee, and provide some detailed discussion of issues raised by the proposed treaty and the protocols. In this endeavor, we have consulted with the Treasury Department and the staff of your committee in analyzing the proposed treaty and protocols in preparation of this background material.

As Ms. Brown noted, the proposed income-tax protocol with Sweden is an amendment to an existing treaty signed in 1994. Likewise, the proposed protocols with France update the existing agreements, while the proposed income-tax treaty with Bangladesh represents a new treaty relationship for the United States. I will try to highlight some of the key features of the protocols and the treaty, and certain issues that they may raise.

Let me start with Sweden. The proposed protocol modifies several provisions of 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 amended again in 2004. The proposed protocol also updates the existing treaty to include rules in recent U.S. tax treaties related to fiscally transparent entities.

As Ms. Brown noted, perhaps the Swedish protocol is most noteworthy, because it would eliminate the withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock in the dividend-paying corporation, often referred to as “direct dividends,” provided that certain conditions are met. The elimination of the withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between Sweden and the United States. Under the present treaty, these dividends may be taxed by the source country at a maximum rate of 5 percent in the United States, but not Sweden, as Ms. Brown noted. We impose this tax as a matter of internal law. Thus, the principal and immediate effect of this provision would be to exempt dividends from U.S. subsidiaries paid to Swedish parent companies from U.S. withholding tax.

Now, also as Ms. Brown noted, until 2003 no U.S. treaty provided for complete exemption from withholding tax under these circumstances. And neither the U.S. nor OECD model treaties currently provides for such an exemption. However, it is not uncommon to see zero withholding rates on dividends among the tax treaties of other developed Western economies. And, as you well know, 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.

Because the zero rate provisions have become a trend in recent tax-treaty practice, and apparently Treasury Department policy, the committee may wish to inquire of the Treasury Department if it believes that a zero rate is generally beneficial. In previous testimony, and again today, the Treasury Department has indicated that zero-rate provisions should be limited to treaties with the strongest limitation on benefits and information exchange provisions. In light of the Treasury Department’s intention to update the model treaty, the committee may wish to inquire whether it might be appropriate to include a zero-withholding rate on dividends, coupled with strong provisions on limitation on benefits and information exchange, as part of a revised U.S. model treaty and as a guide of future treaty policy of the United States.

The Treasury Department has also indicated that the package of zero rate withholding, limitation on benefits and information exchange must be assessed in light of the overall balance of the treaty. The committee may wish to inquire what considerations on the overall balance would lead to a departure from the package of a zero rate, limitation on benefits, and information exchange.

If such a package of provisions does represent the current preferred Treasury Department policy, the committee may also wish to inquire whether such a package was considered as a part of the negotiations with France in the just-concluded income-tax protocol.

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

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.

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 which were 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 company. This provision demands nexus between the taxpayer and the residence country. Under the proposed protocol, a company that is resident in 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 within the economic area of the company. 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 resident.

The intent of this provision 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 on a regional nexus. The committee may wish to ask whether this regional focus is appropriate in light of the anti-treaty-shopping purpose of the basic 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.

The last provision in the proposed protocol with Sweden that I would like to note is somewhat anomalous for a tax treaty. 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 Gothenburg. These employee salaries and, therefore, their future benefits, were reduced because the U.S./Sweden in force at the time exempted their salaries from Swedish tax. As Ms. Brown noted, 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 in the value of their benefits. The committee may wish to satisfy itself regarding the necessity of a treaty provision solely affecting Swedish taxation of Swedish individuals.

With respect to France, there is both a proposed income-tax protocol and an estate- and gift-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, referred to as REITs. The provision of the proposed protocol in this regard is 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. These 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 its former long-term residents whose termination of residency had, 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 that were made to internal law in 1996 to the special tax regime for expatriates under section 877 of the Internal Revenue Code. The proposed protocol, however, does not update the saving-clause provision to reflect the more recent changes made to the special expatriation rules of the American Jobs Creation Act of 2004. The American Jobs Creation Act eliminated subjective determinations of tax-avoidance purpose and replaced them with objective rules for determining the applicability of the special tax regime for expatriates.

Thus, in three of the four treaty instruments before the committee today, the two French protocols and the proposed Bangladesh treaty, the saving clause uses the obsolete "principal purposes of tax-avoidance" formulation in determining whether this special tax regime may apply to individuals who expatriate, even though the subjective determinations of tax-avoidance purpose under prior law were recently eliminated by the American Jobs Creation Act.

The Treasury Department technical explanations note that under these instruments the determination of whether there is 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 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 tax-avoidance purpose, the Treasury Department maintains that this language should be understood, under these proposed protocols and treaties, as fully preserving U.S. taxing jurisdiction under the expatriation tax rules in their current form, as amended by the American Jobs Creation Act. 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.

The proposed estate, inheritance, and gift-tax protocol with France would make several updates and other modifications to the existing treaty, primarily to reflect changes in U.S. law made in 1988. Among the other updates to the treaties, 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. The present treaty does not have a such a provision. And, as I just noted above, this saving clause was not updated to reflect the changes made to the special expatriation tax regime by the American Jobs Creation Act.

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 proportion of the full, generally applicable credit based on a 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 citizen. This provision would apply in the case of certain small estates.

The proposed protocol also would apply new limits to the situs-based taxation of certain interspousal transfers of noncommunity property. These changes are generally consistent with changes made in other U.S. treaties in this area, such as the treaties with Canada and Germany.

Lastly, the proposed income-tax treaty with Bangladesh, as Ms. Brown noted, represents a brand new treaty relationship for the United States. The proposed treaty with Bangladesh is similar to the U.S. model 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 circumstances in which the activities of a resident of one country give rise to a permanent establishment in the other country. Thus, in giving a wider scope to permitted source-country taxation, the proposed treaty is similar to other treaties negotiated with developing countries, but the committee may wish to consider whether these concessions are appropriate in the case of Bangladesh.

Lastly, let me note that, as your committee is fully aware, the Joint Committee staff over the past several years has emphasized what we have perceived as a need to update the Treasury's model tax treaty. And so, we're extremely grateful and excited that Treasury says that they will be forwarding a draft within a month. We look forward to working with your staff and Ms. Brown and her colleagues on a new model, which we see as important in providing guidance to your committee and the Senate in analyzing the course of U.S. treaty policy.

I am happy to answer any questions that you or other committee members may have. And this concludes my formal testimony.

[The prepared statement of Mr. Barthold follows:]

PREPARED STATEMENT OF THOMAS A. BARTHOLD

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.[1]

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.

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

[1] This document may be cited as follows: Joint Committee on Taxation, 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 Bangladesh (JCX-08-06), February 2, 2006.

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 non-community 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.

The CHAIRMAN. Well, thank you very much, Mr. Barthold, for your very careful analysis of each of the provisions. And that testimony is tremendously valuable for everyone to consider. We'll get into it further with questions and maybe comments from the panel members.

STATEMENT OF HON. WILLIAM A. REINSCH, PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, WASHINGTON, DC

But first I want to call upon Mr. Reinsch. It's good to have you again before us this morning. Will you please proceed with your testimony?

Mr. REINSCH. Thank you, Mr. Chairman. It's a pleasure to be back.

I'm here on behalf of the National Foreign Trade Council to recommend ratification of the treaty and protocols that are before the committee today. The committee has graciously taken our advice, at least on tax matters, in the past, and we hope that you'll do so again this time.

If U.S. businesses are going to maintain a competitive position around the world, we need a treaty policy that protects them from multiple or excessive levels of foreign tax on cross-border investments, particularly if their competitors already enjoy that advantage. The United States has lagged behind other developed countries in eliminating this withholding tax and leveling the playing field for cross-border investment. The European Union eliminated the tax on intra-EU parent-subsidiary dividends over a decade ago, and dozens of bilateral treaties between foreign countries have followed that route. The majority of OECD countries now have bilateral treaties in place that provide for zero rate on parent-subsidiary dividends, so we're particularly pleased to note the additional progress on the treaty and protocols that are before you today.

Tax treaties also provide other features that are vital to the competitive position of U.S. businesses. For example, by prescribing internationally-agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring foreign tax laws to be applied in a nondiscriminatory manner to U.S. enterprises, treaties offer a significant measure of certainty to potential investors.

Another extremely important benefit, which is available exclusively under tax treaties, is the mutual-agreement procedure. This bilateral administrative mechanism provides another opportunity for the avoidance of double taxation on cross-border transactions.

The Swedish protocol that is before the committee today updates an existing agreement between Sweden and the United States signed over a decade ago. The protocol improves a convention that has stimulated increased investment, greater transparency, and a stronger economic relationship between our two countries. The NFTC commends Treasury for its determination to facilitate increased trade and investment through this protocol and the other agreements under consideration.

We have for years urged adjustment of U.S. treaty policies to allow for a zero withholding rate on related-entity dividends, and we commend the Treasury for making further progress in its protocol with Sweden. This agreement continues the important contribution toward improving the economic competitiveness of U.S. companies achieved in prior agreements with the Netherlands, Japan, the United Kingdom, Australia, and Mexico. We thank the committee for its prior support of this evolution in U.S. tax-treaty policy, and we strongly urge you to continue that support by approving the Swedish protocol.

The existence of a withholding tax on cross-border parent-subsidiary dividends, even at the 5 percent rate previously typical in U.S. treaties, has served as a tariff-like impediment to cross-border investment flows. Without a zero rate, the combination of the underlying corporate tax and the withholding tax on the dividend will often leave parent companies with an excess of foreign tax credits. Because these excesses are unusable, the result is a lower return from a cross-border investment than a comparable domestic investment. Tax treaties are designed to prevent this distortion in the investment decision making process by reducing multiple taxation of profits within a corporate group, and they serve to prevent the hurdle to U.S. participation in international commerce. Eliminating the withholding tax on cross-border dividends means that U.S. companies with stakes in Swedish companies will now be able to meet their foreign competitors on a level playing field.

Another notable inclusion is the zero-withholding rate on dividends paid to pension funds, which should attract investment from those funds into U.S. stocks. Also reflected is modern U.S. tax-treaty policy regarding when U.S. withholding rates will apply to dividends paid by regulated investment companies and real estate investment trusts, as well as recent U.S. law changes aimed at preserving taxing jurisdiction over certain individuals who terminate their long-term residence within the United States.

The French protocols that are before the committee today represent updates and improvements to existing agreements. These protocols will enhance an already flourishing economic relationship between our two countries. Included in the updated agreements are current U.S. tax-treaty policies regarding hybrid entities and the application of reduced withholding tax rates for dividends paid by RICs and REITs.

Another notable inclusion in the French protocols recognizes reciprocal pension and retirement benefits for individuals of either country, eliminating double taxation on contribution of payments paid by, or for, an individual to a pension or retirement plan, reducing the burden on individuals working for foreign subsidiaries of companies in either country.

The tax treaty with Bangladesh represents a new tax-treaty relationship for the United States. The agreement is a significant step forward in the U.S. economic relationship with Bangladesh. As a modernizing nation, Bangladesh is in a developmental phase which gives rise to opportunities for American business because of the projects and the economic development that an expanding infrastructure will allow. Without a similar tax arrangement, U.S. companies that are interested in investing in, or trading with, Bangladesh are at a competitive disadvantage.

While the Bangladesh treaty does not go as far as other agreements—for example, in eliminating withholding taxes for dividends, interest, and royalties—it represents an important starting point in a growing economic relationship with Bangladesh. The treaty reflects current U.S. tax-treaty policy for agreements with developing nations, and it includes appropriate measures to prevent treaty shopping. The NFT strongly supports action to create the competitive balance afforded to U.S. enterprises by this tax treaty.

While we are not aware of any opposition to the treaties under consideration, the NFTC, as it has done in the past as a general cautionary note, urges the committee to reject opposition to the agreements based on the presence or absence of a single provision. No process that is as laden with competing considerations as the negotiation of a full-scale tax treaty between sovereign states will be able to produce an agreement that will completely satisfy every possible constituency. And no such result should be expected. Agreements should be judged on whether they encourage international flows of trade and investment between the United States and the other country. An agreement that meets this standard will provide the guidance enterprises need in planning for the future, provide nondiscriminatory treatment for U.S. traders and investors, as compared to those of other countries, and meet a minimum level of acceptability in comparison with the preferred U.S. position and expressed goals of the business community.

The NFTC strongly supports the efforts of the Internal Revenue Service and the Treasury to promote continuing international consensus on the appropriate transfer pricing standards, as well as innovative procedures for implementing that consensus. We applaud the continuing growth of the advance pricing agreement program, which is designed to achieve agreement between taxpayers and revenue authorities on the proper pricing methodology to be used before disputes arise. We commend the ongoing efforts of the IRS to refine and improve the operation of the competent authority process under treaties to make it a more efficient and reliable means of avoiding double taxation.

We also want to reiterate our support for the existing procedure by which Treasury consults on a regular basis with this committee, the tax-writing committees, and the appropriate congressional staffs concerning tax-treaty issues and negotiations, and the interaction between treaties and developing tax legislation. We encourage all participants in such consultations to give them a high priority.

We particularly commend this committee, and you, personally, Mr. Chairman, for scheduling tax-treaty hearings quickly after receiving the agreements from the executive branch. Doing so enables improvements in the treaty network to enter into effect as quickly as possible, and it's much appreciated by our members.

We would also like to reaffirm our view, frequently voiced in the past—this is a message more for the Finance Committee than the Foreign Relations Committee, but, nevertheless—that Congress should avoid occasions of overriding, in subsequent domestic legislation, the U.S. tax-treaty commitments approved by your committee. We believe that consultation, negotiation, and mutual agreement upon changes, rather than unilateral legislative abrogation of treaty commitments, better supports the mutual goals of treaty partners.

Finally, Mr. Chairman, the NFTC is grateful to you and to the members of the committee for your continuing commitment to give international economic relations prominence in the committee's agenda, particularly when the demands upon your time are so pressing.

We would also like to express our appreciation for the efforts of both majority and minority staff in arranging for this hearing to be scheduled and held at this time.

Thank you very much.

[The prepared statement of Mr. Reinsch follows:]

PREPARED STATEMENT OF HON. WILLIAM A. REINSCH

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE: The National Foreign Trade Council (NFTC) is pleased to recommend ratification of the treaties and protocols under consideration by the committee today. We appreciate the Chairman's actions in scheduling this hearing so early in the year, and we strongly urge the committee to reaffirm the United States' historic opposition to double taxation by giving its full support to the pending Bangladesh Tax Treaty and the Protocols with Sweden and France.

The NFTC, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and the NFTC therefore 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. 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 they be free from excessive foreign taxes or double taxation and impediments to the flow of capital that can serve as barriers to full participation in the international marketplace. Foreign trade is fundamental to the economic growth of U.S. companies. Tax treaties are a crucial component of the framework that is necessary to allow that growth and to balanced competition.

This is why the NFTC has long supported the expansion and strengthening of the U.S. tax treaty network and why we are here today to recommend ratification of the Tax Treaty with Bangladesh and the Protocols with Sweden and France.

TAX TREATIES AND THEIR IMPORTANCE TO THE UNITED STATES

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

In addition, the tax systems of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners, and treaties are the mechanism by which these taxes are lowered on a bilateral basis. If U.S. enterprises earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they are liable to suffer excessive and noncreditable levels of foreign tax and to be at a competitive disadvantage relative to traders and investors from other countries that do have such benefits. Tax treaties serve to prevent this barrier to U.S. participation in international commerce.

If U.S. businesses are going to maintain a competitive position around the world, we need a treaty policy that protects them from multiple or excessive levels of foreign tax on cross border investments, particularly if their competitors already enjoy that advantage. The United States has lagged behind other developed countries in eliminating this withholding tax and leveling the playing field for cross-border investment. The European Union (EU) eliminated the tax on intra-EU, parent-subsidiary dividends over a decade ago and dozens of bilateral treaties between foreign countries have also followed that route. The majority of OECD countries now have bilateral treaties in place that provide for a zero rate on parent-subsidiary dividends.

Tax treaties also provide other features that are vital to the competitive position of U.S. businesses. For example, by prescribing internationally agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring foreign tax laws to be applied in a nondiscriminatory manner to U.S. enterprises, treaties offer a significant measure of certainty to potential investors. Another extremely important benefit which is available exclusively under tax treaties is the mutual agreement procedure. This bilateral administrative mechanism provides another opportunity for the avoidance of double taxation on cross-border transactions.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the United States by providing for the administration of U.S. tax laws and the implementation of U.S. treaty policy. The article that provides for the exchange of information between tax authorities is an excellent example of the benefits that result from an expanded tax treaty network. Treaties also offer the possibility of administrative assistance in the collection of taxes between the relevant tax authorities.

A framework for the resolution of disputes with respect to overlapping claims by the respective governments is also provided for in tax treaties. In particular, the practices of the Competent Authorities under the treaties have led to agreements, known as "Advance Pricing Agreements" or "APAs," through which tax authorities of the United States and other countries have been able to avoid costly and unproductive proceedings over appropriate transfer prices for the trade in goods and services between related entities. APAs, which are agreements jointly entered into between one or more countries and particular taxpayers, have become common and increasingly popular procedures for countries and taxpayers to settle their transfer pricing issues in advance of dispute. The clear trend is that treaties are becoming an increasingly important tool used by tax authorities and taxpayers alike in striving for fairer and more efficient application of the tax laws.

AGREEMENTS BEFORE THE COMMITTEE

The Swedish Protocol that is before the committee today updates an existing agreement between Sweden and the United States signed over a decade ago. The protocol improves a convention that has stimulated increased investment, greater transparency, and a stronger economic relationship between our two countries. The NFTC commends Treasury for its determination to facilitate increased trade and investment through this protocol and the other agreements under consideration.

The NFTC has for years urged adjustment of U.S. treaty policies to allow for a zero withholding rate on related-entity dividends, and we praise the Treasury for making further progress in this protocol with Sweden. This agreement continues the important contribution toward improving the economic competitiveness of U.S. companies achieved in prior agreements with the Netherlands, Japan, the United Kingdom, Australia, and Mexico. We thank the committee for its prior support of this evolution in U.S. tax treaty policy and we strongly urge you to continue that support by approving the Swedish Protocol.

The existence of a withholding tax on cross-border, parent-subsidiary dividends, even at the five percent rate previously typical in U.S. treaties, has served as a tariff-like impediment to cross-border investment flows. Without a zero rate, the combination of the underlying corporate tax and the withholding tax on the dividend will often leave parent companies with an excess of foreign tax credits. Because these excesses are unusable, the result is a lower return from a cross-border investment than a comparable domestic investment. Tax treaties are designed to prevent this distortion in the investment decision-making process by reducing multiple taxation of profits within a corporate group, and they serve to prevent the hurdle to U.S. participation in international commerce. Eliminating the withholding tax on cross-border dividends means that U.S. companies with stakes in Swedish companies will now be able to meet their foreign competitors on a level playing field.

Another notable inclusion is a zero withholding rate on dividends paid to pension funds which should attract investment from those funds into U.S. stocks. Also reflected is modern U.S. tax treaty policy regarding when reduced U.S. withholding rates will apply to dividends paid by Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs), as well as recent U.S. law changes aimed at preserving taxing jurisdiction over certain individuals who terminate their long-term residence within the United States.

Additionally, important safeguards are included in the Swedish Protocol to prevent treaty shopping. For example, in order to qualify for the lowered rates specified by the agreement, companies must meet certain requirements so that foreigners whose governments have not negotiated a tax treaty with Sweden or the U.S. cannot free-ride on this treaty. Provisions in the protocol are intended to ensure that its benefits accrue only to those for which they are intended.

The French Protocols that are before the committee today represent updates and improvements to existing agreements. These protocols will enhance an already flourishing economic relationship between our two countries. Included in the updated agreements are current U.S. tax treaty policies regarding hybrid entities and the application of reduced withholding tax rates for dividends paid by RICs and REITs. Another notable inclusion in the French Protocols recognizes reciprocal pension and retirement benefits for individuals of either country eliminating double taxation on contributions and payments paid by or for an individual to a pension or retirement plan, reducing the burden on individuals working for foreign subsidiaries of companies in either country.

Including REITs in the French Convention will stimulate foreign direct investment into the U.S. and provide greater incentives for French foreign nationals to keep that income in the U.S. Such measures are integral to fostering an atmosphere conducive to the investment needs of both foreign nationals and U.S. businesses, specifically in the financial services industry.

The tax treaty with Bangladesh represents a new tax treaty relationship for the United States. The agreement is a significant step forward in the U.S. economic relationship with Bangladesh. As a modernizing nation, Bangladesh is in a developmental phase, which gives rise to opportunities for American business because of the projects and the economic development that an expanding infrastructure will allow. Without a similar tax arrangement, U.S. companies that are interested in investing in or trading with Bangladesh are at a competitive disadvantage.

While the Bangladesh Treaty does not go as far as other agreements (e.g., in eliminating withholding taxes for dividends, interest, and royalties), it represents an important starting point in a growing economic relationship with Bangladesh. The Bangladesh Treaty reflects current U.S. tax treaty policy for agreements with developing nations, and it includes appropriate measures to prevent treaty shopping. The NFTC strongly supports action to create the competitive balance afforded to U.S. enterprises by this tax treaty.

GENERAL COMMENTS ON TAX TREATY POLICY

While we are not aware of any opposition to the treaties under consideration, the NFTC as it has done in the past as a general cautionary note, urges the committee to reject opposition to the agreements based on the presence or absence of a single provision. No process that is as laden with competing considerations as the negotiation of a full-scale tax treaty between sovereign states will be able to produce an agreement that will completely satisfy every possible constituency, and no such result should be expected. Virtually all treaty relationships arise from difficult and sometimes delicate negotiations aimed at resolving conflicts between the tax laws and policies of the negotiating countries. The resulting compromises always reflect a series of concessions by both countries from their preferred positions. Recognizing this, but also cognizant of the vital role tax treaties play in creating a level playing field for enterprises engaged in international commerce, the NFTC believes that treaties should be evaluated on the basis of their overall effect. In other words, agreements should be judged on whether they encourage international flows of trade and investment between the United States and the other country. An agreement that meets this standard will provide the guidance enterprises need in planning for the future, provide nondiscriminatory treatment for U.S. traders and investors as compared to those of other countries, and meet a minimum level of acceptability in comparison with the preferred U.S. position and expressed goals of the business community.

Mechanical comparisons of a particular treaty's provisions with the U.S. model or with treaties with other countries do not provide an appropriate basis for analyzing a treaty's value. U.S. negotiators are to be applauded for achieving agreements that reflect current U.S. tax treaty policy and the views expressed by the U.S. business community.

The NFTC also wishes to emphasize how important treaties are in creating, implementing, and preserving an international consensus on the desirability of avoiding double taxation, particularly with respect to transactions between related entities. The United States, together with many of its treaty partners, has worked long and hard through the OECD and other fora to promote acceptance of the arm's length standard for pricing transactions between related parties. The worldwide acceptance of this standard, which is reflected in the intricate treaty network covering the United States and dozens of other countries, is a tribute to governments' commitment to prevent conflicting income measurements from leading to double taxation and resulting distortions and barriers for international trade. Treaties are a crucial element in achieving this goal because they contain an expression of both governments' commitment to the arm's length standard and provide the only available bilateral mechanism, the competent authority procedure, to resolve any disputes about the application of the standard in practice.

We recognize that determination of the appropriate arm's length transfer price for the exchange of goods and services between related entities is sometimes a complex task that can lead to good faith disagreements between well-intentioned parties. Nevertheless, the points of international agreement on the governing principles far outnumber any points of disagreement. Indeed, after decades of close examination, governments around the world agree that the arm's length principle is the best available standard for determining the appropriate transfer price because of both its economic neutrality and its ability to be applied by taxpayers and revenue authorities alike by reference to verifiable data.

The NFTC strongly supports the efforts of the Internal Revenue Service and the Treasury to promote continuing international consensus on the appropriate transfer pricing standards, as well as innovative procedures for implementing that consensus. We applaud the continued growth of the APA program, which is designed to achieve agreement between taxpayers and revenue authorities on the proper pricing methodology to be used, before disputes arise. We commend the ongoing efforts of the IRS to refine and improve the operation of the competent authority process under treaties to make it a more efficient and reliable means of avoiding double taxation.

The NFTC also wishes to reiterate its support for the existing procedure by which Treasury consults on a regular basis with this committee, the tax-writing committees, and the appropriate congressional staffs concerning tax treaty issues and negotiations and the interaction between treaties and developing tax legislation. We encourage all participants in such consultations to give them a high priority. We also commend this committee for scheduling tax treaty hearings quickly after receiving the agreements from the executive branch. Doing so enables improvements in the treaty network to enter into effect as quickly as possible.

We would also like to reaffirm our view, frequently voiced in the past, that Congress should avoid occasions of overriding in subsequent domestic legislation the U.S. tax treaty commitments approved by this committee. We believe that consultation, negotiation, and mutual agreement upon changes, rather than unilateral legislative abrogation of treaty commitments, better supports the mutual goals of treaty partners.

IN CONCLUSION

Finally, the NFTC is grateful to the Chairman and the members of the committee for their continuing commitment to giving international economic relations prominence in the committee's agenda, particularly when the demands upon the committee's time are so pressing. We would also like to express our appreciation for the efforts of both majority and minority staff in arranging for this hearing to be scheduled and held at this time.

We commend the committee for its commitment to proceed with ratification of these important agreements as expeditiously as possible.

The CHAIRMAN. Thank you very much, Mr. Reinsch. We appreciate the compliments to our staff for their work on this. I take it as a point of pride that this committee and its subcommittees held more meetings than any other committee in the Senate last year, and it's largely because our country has a very active foreign policy. We have conflicts in many areas. We're seeking peace in many areas. But the considerations before us today are extremely important, as are many functions that the committee performs. And this means that our staffs have to work especially diligently to prepare for the hearings, to do a responsible job, as they will do once again with this hearing today. So, I thank you for your thoughts.

Now, let me begin the questioning with you, Ms. Brown. I'm excited, by the fact that you mentioned the new U.S. model treaty. And Mr. Barthold has commented on his enthusiasm about that, too. I want to ask both you about that treaty. Can you give us any preview of what is likely to be included, what we might anticipate? I know that, obviously, it's still under consideration. You may not wish to reveal everything that is going to occur, but can you give us some format for the future?

Ms. BROWN. Yes, of course, Mr. Chairman.

I'm afraid it's not going to be nearly as exciting as Mr. Barthold is anticipating.

The CHAIRMAN. Oh, that's too bad.

Ms. BROWN. I think that we should see the model treaty as really an evolution. We—because, in 1996—well, it was done in 1996, and, since then, we have done a number of treaties where we've refined the language; we've made some mistakes, and we've figured out how to fix them; and we've had some changes in policies, such as the rules on RICs and REITs. And so, what we're really trying to do is have a document that reflects all those changes in policy, which you've seen, and gets the drafting right, to have the best drafting that we've developed over the course of the last 10 years.

We would not expect to have the zero-withholding rate on dividends as part of that treaty, because it's not a provision that we think we could have with every country. In fact, I think probably only a handful of countries are really going to adopt that, going forward. So, we don't think that that is appropriate. We will have updated limitation-on-benefits provisions.

And an issue that the Joint Committee has raised, and the Senate Foreign Relations Committee has raised, is our treatment of students and teachers in a number of treaties. I have to say that that issue, we've been a little haphazard in the past. There are a couple of provisions. As long as the other country asks for something we've done before, we've agreed to it without really thinking about creating differences between different categories. And so, that's an issue that is particularly a Foreign Relations issue. It's the question of how to encourage cross-border cultural exchange. And we'd like to have the views of the committee staffs and the committee on that issue.

The CHAIRMAN. Well, I'm pleased that the student and scholar issue is going to be a part of your consideration. We look forward, obviously, to progress on that, because, you're correct, this has been the subject in many forums—more recently, immigration and visas and all the problems of homeland defense and so forth. And the table that you occupy has been filled with scholars from our universities, as well as officials from our government. We're making headway there, and the tax implications are often important, and have been long before 9/11 and the crisis that occurred then.

You and Mr. Barthold have touched upon the zero-withholding-rate treaties and the criteria that may be involved there. I suppose, as you enter the model treaty, there may be even further explication of the reasons why certain tax regimes in certain countries are worthy of that kind of consideration, as opposed to others. Can you make any further comment about that?

Ms. BROWN. We have applied the zero rate in a number of different circumstances. Sometimes the treaty partner has a foreign tax-credit system, sometimes it has a dividend-exemption system. And so, it's not the particular taxing regime, as long as we think that the other country has a robust regime. Certainly if there's a country that does not impose much tax at all, we may not enter into a treaty at all with that country, but certainly they would not be a candidate for a zero-withholding rate on dividends.

What we're interested in is protecting that provision. Mr. Barthold asks whether we would be interested in having zero across-the-board with all countries, and I think the answer is that in an ideal world, we would. The U.S. receives more in the way of dividends than it pays. And so, just as with respect to interest, that would probably be the preferred approach. The question really is, How do we get from where we are now, which is having it in a handful of treaties, to that ideal situation? And so, we think that we're going to have to continue to have limitations in order to prevent residents of third countries from getting the benefit of that provision without giving the same benefit to our companies. Because the point really is, as Mr. Reinsch will say, to make sure that our companies benefit from the zero-withholding rate, and not just the residents of third countries.

The CHAIRMAN. I thank you for that comment. And I know that will probably arise again as we take a look at the model tax treaty and the provisions that you make that pertain to this.

You discussed in your testimony that tax treaties provide settlement mechanisms. Just for the record, can you give us an example of a recent dispute that was resolved, and how the existence of a treaty, any one of those that you have recently formulated, led to a resolution of that dispute?

Ms. BROWN. Mr. Chairman, we always like to resolve things before they get to the level of a dispute, so maybe I'll mention a few areas.

Of course, most of the disputes that we're talking about relate to specific taxpayer matters. They're transfer pricing matters where the competent authority may resolve dozens, maybe hundreds, of those cases every year. Mostly transfer pricing. Sometimes something as simple as whether an individual is a resident of the United States or the United Kingdom, which has ramifications throughout the treaty for that individual.

We also have the ability to reach agreements on matters of general application. And so, in the past few years, recently, we reached an agreement on the definition of what an "investment bank" is, since there's an—with Japan—there's an exemption in that treaty for withholding—for interest withholding on payments received by banks and investment banks. And reaching an agreement with Japan on that was very important for our financial-services industry. We have also reached general agreements on what pension funds and insurance companies that do pension business in the United Kingdom will qualify for the exemption from withholding taxes on dividends paid to pension funds. And so, we deal with the small issues and the big issues.

But one of the things that our competent authority tells us is that with respect to truly large cases—and there are some that are in the paper—even our best treaty relationships can be improved. And so, we are looking at ways to improve the dispute settlement resolution mechanism, and you may hear more about that in the future.

The CHAIRMAN. Well, I thank you for that explanation. You know, obviously one of the purposes of your work, and our hearing, is to bring greater fairness to American taxpayers; likewise, reciprocally, taxpayers of other countries. But frequently when the Congress or the Treasury Department or others meet, why, taxpayers may fear that their lives are jeopardy, that there are consequences. We're attempting to bring some fairness to the process as advocates for American taxpayers, whether they be individuals or businesses, vis-a-vis other countries that might, at least in our judgment, have unfair burdens. And through the mechanisms of treaties, the ways in which the nations deal with each other can mitigate the severity of those situations. So, we appreciate your explanation—I think it's a good one—that sometimes you have hundreds of cases. Only a very few may arise, sometimes with questions of status, of the residence, of who is where and what legal standing they have in countries involved.

Now, let me ask, on the Swedish situation—you've touched upon this, and Mr. Barthold has, some more—that there was unintended taxation of local employees of the United States Embassy and the Consulate in Sweden. As Mr. Barthold has pointed out, this pertains primarily to Swedish individuals, citizens of Sweden. Can you offer further background on the equities of this, why we became involved in it—and what the resolution has been?

Ms. BROWN. Thank you, Mr. Chairman. Yes, it is an unusual situation. The issue was brought to our attention by the ambassador, our ambassador to Sweden.

The CHAIRMAN. How long ago did that occur?

Ms. BROWN. About 2002—actually, maybe as early as 2001.

The CHAIRMAN. But pertaining to people who had histories way back from——

Ms. BROWN. That is——

The CHAIRMAN (continuing). ——we've learned.

Ms. BROWN. That is exactly right. It took some time for the issue to really become clear to the embassy staff. And they felt very strongly that this was an issue where people who had spent their entire careers working for the U.S. Government were really being treated unfairly, and, in some cases, losing houses because they couldn't afford to pay them, because of the reduced pension. And this was clearly not what was intended in 1995. So, it was a case where we really needed to find a solution.

We did talk to the State Department about potentially increasing the pensions. They said that was impossible. We talked, for several years, with the Swedish Government about making an exception. Their view was that if they made an exception for these people, they would be asked to make exceptions for numbers of classes of people. And so, the view was that since this was a problem that was created by the treaty, it should be resolved through the treaty. And it is a little unusual, although one of the few articles that actually does deal with the taxation by the other government, of residents of that country, is the government-services article. So, it's not that unusual in the context of that provision.

The CHAIRMAN. Well, I thank you for that additional explanation, and I would estimate that all of this may pertain to a relatively small number of individuals in the population of Sweden; still, it would be good news to Swedes that there is sensitivity on the part of their government, and our government, to the situation of these employees, who have been helpful to American interests, but, likewise, reciprocally, to Swedish interests over the course of time.

Let me ask about the treaty with Sri Lanka, which we passed in the last Congress. Bangladesh is sometimes also considered, as countries are described, as a developing country. Can you point out any key differences between the Sri Lanka treaty that we passed last year and the Bangladesh treaty before us today? And are there likely to be current negotiations with other developing countries? Is that a trend, at least in the work in your shop?

Ms. BROWN. Thank you, Mr. Chairman.

The Sri Lanka treaty and the Bangladesh treaty are actually fairly similar, not surprisingly. We began negotiating them about the same time, quite a long time ago. I would say that the Bangladesh treaty has slightly lower rates on investment income. This is something that developing countries really have to decide for themselves. They have a dilemma. They want to attract investment, so they want the rates to be low enough to attract investment, but if they make them too low, then their own population may say, "Why are you treating the foreign companies better than our companies?" And so, we can reach appropriate resolutions at different rates with different countries. But I would say that the Bangladesh treaty is a little more favorable to businesses than the Sri Lanka treaty, but not in a significant way. They're both fairly mainstream developing-country treaties.

With respect to other developing countries, we have had some informal talks, and I think the one that perhaps I'm most hopeful about is Vietnam. But those are very preliminary talks, and—but if things to go well, we may be talking to them later, in 2006 or 2007.

The CHAIRMAN. Maybe a forecast of another hearing down the road.

Now, finally, on a practical level, how will the new protocols with France affect citizens currently living—that is, U.S. citizens—currently living and working in France? And, likewise, how will they affect French nationals working here? In terms of day-to-day examples or the rudimentary situations for these persons, how will they be affected?

Ms. BROWN. Well, I think for—the easier case, perhaps, is the French nationals who are living here. And that's partly because of these disparities that I described earlier. Since 1995, U.S. citizens who are working in France have been given a deduction by France for contributions that they make to their U.S. pension funds, or that their employer makes——

The CHAIRMAN. So, that's been very clear to them there.

Ms. BROWN (continuing). ——And so, they've had that advantage, going back 10 years. Whereas, French persons living in the United States who don't have private pension plans have not gotten the same benefit with respect to voluntary contributions that they make into the French social-security system. Such people would make those contributions to ensure that the benefits that they eventually get are maintained at a high level. And so, really what this does is achieve parity for the benefit we've been getting for the last 10 years.

I think the other significant benefit for U.S. people living in France would be that, if they are married to a French citizen, they won't see their estate disappear quite as quickly under the new estate-tax protocol, that the French spouse will be able to inherit some property without being subject to U.S. estate tax on that. And so, I think that's a peace-of-mind benefit for those people, that will be important.

The CHAIRMAN. Just a point of curiosity. Are French estate taxes comparable to ours? How would they be measured?

Ms. BROWN. I think they're actually higher.

The CHAIRMAN. Higher.

Ms. BROWN. And they provide fewer exemptions, overall. The French did agree, in this protocol, to provide for U.S. persons the same exemptions that they provide to French nationals. And so, there is parity there, but the exemptions are generally less generous than in the United States. And, of course, in France you can provide artwork to pay your estate taxes——

The CHAIRMAN. I see. Well, that's an interesting footnote for the record.

Let me ask Mr. Barthold the same initial question I asked Ms. Brown. The Joint Committee has taken a look at this model treaty drafting coming along. Are there specific provisions that you would suggest in the new model? We've touched a little bit upon this zero-withholding-rate business as something that may be considered, one way or another. But can you explore that a little bit, in terms of some forecasts of what might occur, or a wish list of what you wish would occur?

Mr. BARTHOLD. Well, Mr. Chairman, I can't offer a forecast. The model is for the Treasury to develop. And, as I said, I know we've been accused by some of harping on the model, but we view it as an important guidepost for your committee in assessing how we're developing our treaty relationships. But also, at a technical level, of course, it provides recommended treaty language, and puts it out there so that people can comment on it, so that people can explore whether it helps achieve the results that we are trying to achieve in these treaty relationships. And so, the points that Ms. Brown raised about updating to reflect the RIC/REIT changes, coverage of the issue that we raised today about the disparate treatment in the three proposed protocols and proposed treaty before you today with respect to the expatriation of citizens and long-term residents. So, putting out common language is very helpful, in terms of updating.

Now, the broader issue that we did raise, and of which you have inquired, the zero rate, is if we view this as U.S. policy, going forward, we might want to lay that out, in part, for your committee's guidance and for people to understand. And the context in which we raised the issue, is that, as part of the zero-rate provisions that the Treasury has negotiated over the last 5 years, as Ms. Brown noted, they have seen, as an important component of this, very strong or increased strength of limitation-on-benefit provisions and exchange-of-information provisions. If that is Treasury's policy, going forward, we think that there would be some benefit to your committee and to the public at large, to lay that out. We understand, of course, that in negotiations you do not expect to see everything in the U.S. model adopted as the result of a negotiation and brought before the committee and the Senate for ratification. But it does tell us a direction that we'd like to go, and also provides some guidance to investors and the business community. Looking ahead, it gives them a sense of, "How might the U.S. Government be trying to update treaties with a country in which I plan to make an investment? And what might this mean for my investment?" That is why we think the model, and updating the model, is an important thing to consider. I do reiterate our enthusiasm in working with your committee staff and the Treasury Department in an update of the model.

The CHAIRMAN. Well, I think that is a good explanation. And this model does offer Senators and staff a criteria that obviously is important to American businesses, and taxpayers have some idea of—in the best of circumstances. Now, I think, Ms. Brown, you used the term "some countries have a robust tax regime," others have a lot of missing pieces. So, if you have a model out there, you, I suppose, have to make some measurement of the reciprocity or some comparability of circumstances, and that is, I think, what you have said, what I perceive to be the situation. But it's very useful to have the model there that, in the event that other countries reciprocally take seriously the drafting of tax legislation, the collection of taxes, and so forth, as we do, then we offer comparable regimes.

Just let me ask, for sake of curiosity, Mr. Barthold, are there any specific provisions in the agreements before us today, albeit a limited number, which you think ought to be consistently included, or, for that matter, excluded from treaties with similarly situated countries? Are there any new features or things that you would like to highlight further in the treaties we're discussing today?

Mr. BARTHOLD. Thank you, Mr. Chairman.

We did highlight in our written materials and in my testimony, changes in provisions that we think are potentially very important for the committee: strengthened—as I noted a couple of times, strengthened limitation on benefit provisions, a new look at public trading, substantial presence, and tightening the notion of nexus between the taxpayer and the residence country. I think it is fair to say our staff viewed those all as very positive moves, adding more clarity, and, at least conceptually—of course, they have not been tested in practice yet, but at least conceptually—adding more strength to the result that the Treasury Department is trying to achieve.

Those would be some main things I would highlight.

The CHAIRMAN. As I listened to your testimony, I jotted down the substantial-presence situation, which is certainly logical, this nexus of the taxpayer with the country. And clearly that is emphasized in what we're considering today. These are principles that have application that I presume will reemerge in the model treaty, but might be worthy underlining today.

Many recent tax treaties matters strengthen the so-called "anti-treaty-shopping provisions." Do you believe the anti-treaty-shopping provisions, for example, as in the Swedish protocol we're talking about today, are effective in preventing companies or persons not intended to receive these treaty benefits from taking unfair advantage of the situation?

Mr. BARTHOLD. Well, Mr. Chairman, we should note the provisions in the Swedish protocol before us today are quite similar also to those provisions of the Netherlands protocol of a year ago. And so, we might want to think of those two as sort of a package reflecting some new attempts to lay out these limitations and anti-treaty-shopping provisions. So, since it is brand new, we clearly cannot assess the effectiveness, but I think it is certainly clear to say that by placing this emphasis on nexus, and some of the increased exchange of information that goes along with it, that conceptually a stronger provision has been included in these two instances. But, as with everything new, it is too soon to tell.

The CHAIRMAN. Yes. But these are two significant treaties. The Netherlands, as we all observed last year, was a very large treaty. Our investments and trade with the Netherlands are very significant. And Sweden, likewise. We've illustrated today the amount of investment and trade we currently have.

Mr. Barthold, you've noted in your testimony and your discussion that the tax-avoidance test in the past maybe has been supplanted by a new test, which appears in the American Jobs Creation Act. The Treasury Department has explained that the language for the old test can be interpreted to be consistent with the new test. But I gather from your testimony you're not totally satisfied with that explanation. Can you illuminate considerations that we ought to have as we proceed down that trail?

Mr. BARTHOLD. Well, the Joint Committee staff's degree of dissatisfaction expressed is relative only because we like perfection in everything, even if we are not always able to achieve it. We agree with the Treasury—that the Treasury's interpretation in the language of the proposed French income-tax protocol, the French estate-, gift-, and inheritance-tax protocol, and the proposed Bangladesh treaty, is a reasonable interpretation. However, I think we do have to say that in the Swedish protocol, Treasury has provided better and more precise language in the sense that it more clearly adapts or fits with the direction that the Congress took in the expatriation provisions of section 877 in the American Jobs Creation Act. So, in that sense, for future treaties—and we would hope that your committee agrees—I am sure the intent of the Treasury would be to follow language such as that developed in the Swedish protocol.

The CHAIRMAN. Ms. Brown, is that likely to be your intent, or that of your cohorts at Treasury?

Ms. BROWN. Thank you, Mr. Chairman.

Yes, certainly we intend to do that in future treaties. And we would have done it in these other three agreements. Bangladesh was actually signed before the legislation was changed. The French protocols were signed after, but had gone through all the approval processes, and to go back at that point to try to change it, I think, would have slowed things down. They had been in the works for some time.

No doubt that, hopefully, we'll be talking to the French about other improvements, and in that context, we may bring this up again.

The CHAIRMAN. Very well.

Let me begin to question Mr. Reinsch by observing his comment that I think each of the other panelists reflects. Even if a person or a business has some objection to some specific provision of the work we're looking at today, it would be unwise to reject the whole affair on the basis of that. As Mr. Barthold said, we're seeking perfection, and may not have quite achieved that in each provision, but, on the whole, as we take a look at these instruments, they appear to be substantial advances. And I want to ask you, Mr. Reinsch, for the record, can you, having taken a look at these specific agreements today, cite any benefits that you can see to American business and investment in the respective jurisdictions we're talking about?

Mr. REINSCH. Thank you, Mr. Chairman.

We believe, with respect to these particular treaties and protocols, the benefits, while there are some specific ones—and I'll mention one or two—the largest benefit is the continued harmonization, if you will, of tax systems, and, in particular, the continued march, as we see it, toward a zero-withholding status in a number of other countries. While the practical applications of that, in the Swedish case, are not great, because the Swedes have already done that unilaterally, we think adding that principle to this treaty will facilitate our ability to do that with respect to some other countries, particularly in the EU, where we've not yet achieved that goal. So, it's building blocks, if you will, for a stronger foundation.

With respect to the French, we particularly noted a number of the pension provisions which we think will produce the kind of parity, if you will, amongst their nationals here, and ours there, that Ms. Brown alluded to. We think this is important because our companies see this as an issue we—you and I have discussed in other fora, I believe, Mr. Chairman—the increasing movement of personnel all over the world. It's a topic in the Dohar Round of multilateral trade negotiations. It's a subject of congressional debate right now. We would like to see that movement facilitated.

We view the movement of personnel as a little bit like movement of capital, an opportunity for companies to deploy their resources most efficiently. To the extent that people would, for example, lose pension benefits or be in an adverse tax position if they moved, we would like to see those differences eliminated. And to the extent this treaty does that with respect to France, we think that's a good thing. I don't think it's a measurable benefit in the short term, but we think, in the long term, it will facilitate the movement of people, particularly senior people, around the world. And that's good.

With respect to the Bangladesh treaty, I would simply say that we applaud the Treasury entering into tax treaties with developing countries. It encourages them to develop robust tax systems, which is in all of our interest.

The CHAIRMAN. Well, thank you very much for those specific thoughts about these treaties, as well as their potential general application.

Let me just ask you the same question I've asked the other panelists. As we move toward the model treaty, what additional advice and counsel do you have, for the public record, of what we ought to be hoping for?

Mr. REINSCH. Well, first let me say—Ms. Brown can speak for her side—we feel we have a very good relationship with the Treasury Department right now, and we have not hesitated to supply that kind of advice frequently in the past, and we will continue to do so.

I think the issue that I would touch on is the same one that you have raised in your prior questions to the other witnesses, Mr. Chairman, and that's the zero-withholding issue. As a matter of principle, we support the expansion of that concept globally, and would like to see it in all the treaties. That said, we, nonetheless, support the Bangladesh treaty, even though it doesn't get there. And we certainly sympathize with Ms. Brown's and the Treasury Department's situation in not wanting to do that in certain situations, depending, among other things, on how robust the other party's tax system is. So, we don't fall on our sword on this issue, but if the question is, What would we like to see in the model treaty?—yes, we would like to see that in the model treaty.

The CHAIRMAN. You have mentioned the communication you have with Treasury. You're able to communicate on behalf of American business and individual taxpayers. Please share your own experience of how robust those tax systems are, or your findings, as practical businesspeople.

Mr. REINSCH. We are, Mr. Chairman. In particular, we've been very pleased with our relationship with Ms. Brown and with the Treasury. With respect to how to focus the negotiations, going forward, every year we survey our tax committee members, asking them what countries they're particularly interested in, and, with respect to those countries, what issues they're particularly interested in. And we regularly supply that information to the Treasury. We are pleased that the Treasury makes a good-faith effort to pursue our recommendations. They don't always succeed. Canada has been at the top of our list for a long time, and they're not there yet, but we appreciate the effort, nonetheless, and we would like to reinforce that. And we intend to keep on providing that kind of advice. And I think there's been a healthy dialogue. The Treasury has not been shy about telling us when they don't agree with us, and I think we've had a good exchange of views. We learn from them, just as I hope they learn from us.

The CHAIRMAN. In addition to Canadian friends, what other countries would you recommend as worthy of special attention, presently?

Mr. REINSCH. Well, the other big one for us is Brazil, but we're not having a lot of luck in that respect.

The CHAIRMAN. I see. What seems to be the dilemma?

Mr. REINSCH. I have to defer to Ms. Brown on the dilemma.

The CHAIRMAN. Oh, I see.

Mr. REINSCH. I think the dilemma's at their end, not at our end.

The CHAIRMAN. But, anyway, you're recommending Brazil, and that was really the gist of my question, as you try to take a look at additional trading partners with which we might make significant headway. And so, that may require some negotiation with Brazilians so that their system is as "robust," to use that expression, as should be required.

Mr. Reinsch, what particular concerns would your members like to raise? We've talked about the new tax treaty and the zero-withholding situation, so obviously that is something that's important. Please comment, generally, on effective or ineffective provisions as they pertain to treaties that you have looked at or advice that you're presently giving to Treasury.

Mr. REINSCH. I think with respect to tax treaties, Mr. Chairman, we really rest on the zero-withholding issue. That's the single-most important thing to us, and we've already discussed that in detail here. So, I won't harp on it.

Many of the provisions, of course, have to do with enforcement and adjudication issues, and we welcome what the Treasury is doing. We believe in strong enforcement. We don't really take positions on that.

Otherwise, in general, to the extent that you can, in specific cases, as in the French case, address pension issues where there is no parity, we support that, but I think that's hard to articulate as a general principle, because it really is specific to whatever country we're negotiating with at the time.

The CHAIRMAN. Let me just ask any of the three of you, or all, as the case may be. The tax treaties and protocols we're discussing today are important, in terms of equity for individuals and businesses, but, at least from the standpoint of our committee, they are also important in terms of our overall public diplomacy. Public diplomacy is often mentioned in other contexts, but it appears to me that we have an example, as a practical effect, because of the tens of thousands, maybe even more, who are affected, really, in their everyday lives and in their business transactions. And the impression that other countries, I hope, gain from this discussion, as well as from the practical work which you're describing, is that our country does work for fairness and for equity with every country all over the world that has similar objectives.

I'm just curious whether you see what you're doing in that context and would even offer more illumination as to how America's role in the world, and the perceptions of our country, are enhanced by these treaties.

Ms. Brown, would you make a comment on that?

Ms. BROWN. Thank you, Mr. Chairman.

It is an interesting question. We—and one of the things that we haven't talked about here, because we're looking at bilateral treaties, is some of the multilateral efforts we do. And the United States actually has a fairly small tax-treaty network. And, in part, that's because our tax system is so complex that negotiating these agreements takes a lot of time. But we participate, through the Organization for Economic Cooperation and Development and also the U.N., in outreach to developing countries through a global forum the OECD holds each year on tax treaties, developing tax-treaty policy, and also I participate in the U.N.'s group on international cooperation. And I think that those efforts, in particular, help to demonstrate this fairness. And we are open to developing countries negotiating treaties with us when they're ready. And I think we make that clear.

So, I think it is an important aspect of our tax treaty—of American diplomacy that we do these agreements. Not every country is going to be able to do one. Sometimes systems are just very different, and it's not going to be possible to reach a conclusion. That's certainly true with Brazil. Brazil has, certainly, a robust tax system. There's no question. It's maybe a little too robust. They're not willing to give up—make some concessions that we would like. And so, that's really the problem there. But we would like to increase our ties with Latin America. We think this is an important aspect of that. We'd like to increase our ties with Asian countries. And so, it is part, a big part, of our international diplomacy.

The CHAIRMAN. Do either of you have a comment on that question? Mr. Barthold?

Mr. BARTHOLD. Mr. Chairman, I personally am not a significant world traveler, and so in terms of public diplomacy, it is more likely that your committee members and staff would hear the feedback, because you are constantly dealing with representatives of foreign governments and with our embassy personnel reporting on our relations. And so, you and your staff would actually have a much better sense of that than I. Ms. Brown, of course, engages in these negotiations; and so, gets some direct feedback in the NFTC. Their members are on the ground abroad; and so, they would also have a sense. But my committee staff do not really get that direct sense——

The CHAIRMAN. Well, the Joint Committee, in other words, is really examining more of the quality of the documents and its consistency with American law and practice.

Mr. BARTHOLD (continuing). ——That's a fair assessment.

The CHAIRMAN. Mr. Reinsch, do you have any thoughts about this?

Mr. REINSCH. Only, Mr. Chairman, that these things don't make the front page, as some of our other public-diplomacy efforts do, as you well know. But, from our perspective, they're very important. Most large companies, which are our members, devote a substantial amount of their internal resources to tax issues and tax policy, both, trying to, as you might imagine, minimize taxation in every jurisdiction. And taxes are an important consideration when one goes into or expands or contracts one's enterprise somewhere else. So, how these things work out are very important to our companies and also to their employees in other countries.

You haven't asked about relative benefit. And I think the answer to the unasked question is, these things are not supposed to produce enormous benefit to us, and not to the other party; they're designed to create parity and to equalize the situation. But I think it's clear, in the case of these treaties, as well as some of the others that I've testified on, that there are very clear benefits for some of the foreign corporations, in doing business here. And I can tell you, from my conversations with them—some of whom, by the way, have American subsidiaries that are our members—that the willingness of the United States to undertake these kinds of negotiations and eliminate these inequities is very much appreciated. As I said, it's not a front-page issue, and it doesn't make the TV news, but, in corporate circles, these documents and agreements are very important, and the network that we are creating is a much appreciated one.

The CHAIRMAN. Well, I appreciate that testimony. I would just say, anecdotally, I had an experience the other evening at the beginning of the Cezanne in Provence exhibition, which is a remarkable exhibition in our National Gallery. The French Ambassador was present, but so were tens of citizens of Aix en Provence, where the exhibit will be going, and other persons from France who were really instrumental in this being the opening of something which is a centennial for Cezanne's birth and that great body of artwork. But the sponsor of the situation, the leading sponsor, was DaimlerChrysler. This reflects the numbers of persons who were there who travel regularly, almost commute to Germany and back to various parts of the United States where Americans are employed. This illustrates how complex business is, and how important that it be expedited well, and with fairness. The volume of contacts, just business-wise, that assembled in that room to begin the exhibition indicated how small the world is, in one respect, and how intertwined we are in all the complexities that we're talking about today. That probably undergirded the investments in that exhibit, the actual acquisition of all the artwork. Some thoughts that have been given about artwork as it enters into taxation and so forth. So, as I say, this simply was an anecdotal experience, but it struck home, again, a part of what we're discussing today, and its illustrated importance.

Now, let me just, indicate that Americans want to make certain that our tax code is fair. You've mentioned, Ms. Brown, that it also is complex. One of the problems that you face—and you've just touched upon this today—as you visit with other countries and they're confronted—usually not the first time; they have experts who are aware of what Americans are doing, our tax debates—but this is not easy to get your arms around to see what reciprocally might be of advantage or what things might be worked out. It may seem such a daunting task that, for a while, you may not make great headway. But I admire your ability to explain this to others. We may or may not simplify the tax code, ever, as the Congress moves. And the criticism is that we have added additional pages, usually, in most sessions, which is of discomfiture to some persons everywhere. We're talking about something here that is complex, and yet has to be made relatively simple so there is a perception on the part of Americans that special advantage is not being given to foreign nationals. On the other hand, as Mr. Reinsch has expressed, we're not talking, today, about the United States coming out well ahead of almost everybody we have negotiated with. Rather, it has been a question of how we can balance—whether it's the robust quality or the fairness or the coverage or the comprehensive nature—these instruments to bring about something which is important.

I would just observe that usually our hearings—and this is no exception—on these subjects are covered by a few stalwarts of the press, but not by many. The number of stories arising from the Japanese and the Netherlands treaties and others that were considered in recent times have been relatively small, in terms of American comprehension, except for a few professionals and a number of companies that have been involved. But I would say that's not always the case abroad as people from our staffs collect the stories that will occur from this hearing. I suspect, in Sweden and in France and in Bangladesh, we would be surprised with the interest. This is why I discussed the public-diplomacy aspect. This may seem dry as dust to most American observers and readers, but not so with situations where the United States of America, its Treasury Department, the Joint Committee, its businesses are all involved in an open discussion of things which are very important to the growth of those economies and their intersection with ours.

So, I appreciate the fact that you have taken time and care. The testimony you've offered, I think, is excellent. And you've been so forthcoming in your responses to our questions. If any of you have further testimony, why, proceed.

And, otherwise, we will bring the hearing to an adjournment. Are there any further questions or answers?

[No response.]

The CHAIRMAN. Well, we thank you all, and the hearing is adjourned.

[Whereupon, at 11:05 a.m., the hearing was adjourned.]

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