



## **DEPARTMENT OF THE TREASURY**

### **OFFICE OF PUBLIC AFFAIRS**

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#### **TESTIMONY OF**

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#### **BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS**

#### **ON PENDING INCOME TAX AGREEMENTS**

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 two income 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.

This Administration is dedicated to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers to trade and investment are bilateral tax treaties. Tax treaties eliminate barriers by providing greater certainty to taxpayers regarding their potential liability to tax in the foreign jurisdiction; by allocating taxing rights between the two jurisdictions so that the taxpayer is not subject to double taxation; by reducing the risk of excessive taxation that may arise because of high gross-basis withholding taxes; and by ensuring that taxpayers will not be subject to discriminatory taxation in the foreign jurisdiction. 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.

Coupled with the goal of removing tax barriers that can discourage cross-border investment and distort investment structures and locations is the need to ensure that our tax treaties cannot be used inappropriately, as such inappropriate use also can distort investment choices. We continually monitor our existing network of tax treaties to make sure that each treaty continues to serve its intended purposes optimally and is not being exploited for unintended purposes. A tax treaty reflects a balance of benefits that is struck when the treaty is negotiated and that can be affected by future developments. In some cases, changes in law or policy in one or both of the

treaty partners may make it possible to increase the benefits provided by the treaty; in these cases, negotiation of a new or revised agreement may be very beneficial. In other cases, developments in one or both countries, or international developments more generally, may require a revisiting of the agreement to prevent exploitation and eliminate unintended and inappropriate consequences; in these cases, it may be necessary to modify or even terminate the agreement. Both in setting our overall negotiation priorities and in negotiating individual agreements, our focus is on ensuring that our tax treaty network fulfills its goals of facilitating cross border trade and investment and preventing fiscal evasion.

The Administration believes that these agreements with the Netherlands and Barbados will serve to further the goals of our tax treaty network. Both of these agreements substantially improve long-standing treaty relationships. We urge the Committee and the Senate to take prompt and favorable action on both 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**

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 and covers the vast majority of foreign trade and investment of U.S. businesses. 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.

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.

### **Focus on Limitation on Benefits Provisions**

The agreements before the Committee today both are modifications to existing tax treaty relationships. Both agreements are the product of our ongoing efforts to ensure that our tax treaties continue to serve optimally their intended purposes of facilitating cross-border investment and preventing fiscal evasion and that our tax treaties cannot be exploited to secure unintended and inappropriate results. The two existing treaties are different as they necessarily reflect differences in the tax systems and policies of the two treaty partners. The amendments now pending also are different as they reflect responses to particular developments affecting each of the tax treaty relationships. Before I discuss the specific provisions of each agreement, I would like to discuss a key element that is common to the two agreements: each agreement reflects significant developments with respect to the limitation on benefits provisions designed to ensure that the benefits of the treaties are appropriately directed.

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.

Anti-treaty-shopping approaches have taken different forms over the years. About twenty years ago, the United States settled on the limitation on benefits approach. This approach relies primarily on a series of objective tests rather than requiring an examination of motives. An entity resident in one of the treaty countries that does not meet one of the objective tests does not qualify for treaty benefits unless the competent authority of the source country determines that treaty benefits are appropriate in the particular case (e.g., unless the competent authority determines that the entity is not being used for treaty shopping). This is fundamentally different from the approach in earlier U.S. tax treaties, under which treaty benefits were applicable unless the tax administrator in the source country established that the entity had a "bad" motive that justified a denial of treaty benefits.

The limitation on benefits approach was a substantial step forward in terms of limiting treaty-shopping because of its use of objective rather than subjective tests. Of course, there is no one-size-fits-all objective test that covers all circumstances. Therefore, limitation on benefits provisions include a series of alternative tests, some of which are common across different treaties and others of which are tailored to the particular circumstances of the treaty partner. Moreover, these objective tests have been refined and modified over the years, as more experience has been gained in applying and administering the tests and as the cross-border business structures subject to the tests have evolved.

The agreements with the Netherlands and Barbados reflect revisions to the limitation on benefits articles in the two treaties to modernize those provisions, bringing them more in line with the provisions in more recent U.S. tax treaties. The agreements each also reflect the reworking of one of the objective tests that has become a standard feature of our limitation on benefits provisions: the "publicly-traded company test" under which certain public companies satisfy the applicable limitation on benefits provision and thus qualify for treaty benefits. The specific changes in the publicly-traded company test in each of the treaties are responses to particular developments in the cross-border activity between the United States and the treaty partner. In both cases, the changes represent a further refinement of this test to ensure that the underlying objectives of the limitation on benefits provision are achieved.

In its original form, the publicly-traded company test focused on companies that were regularly traded on the stock markets in their home country and reflected the view that such companies likely would not be used by residents of third countries for treaty shopping purposes. The parameters of the test evolved with changes in the global financial markets. With the growth of

regional markets, companies that are listed on a stock exchange in their home country nevertheless may have a substantial portion of their trading volume occur on another exchange in their region. Moreover, the international prominence of the U.S. stock exchanges means that many foreign companies are listed and substantially traded on U.S. exchanges. The fact that the publicly-traded company test has been structured to take into account both home-country trading and also U.S. and regional third-country trading reflects the realities of modern global financial markets. However, it has become clear that, in some circumstances, this test alone may not be sufficient to establish the nexus between the company and its country of residence that is the underlying objective of the limitations on benefits provision.

The proposed Protocol with Barbados was negotiated in order to prevent the potential for exploitation of the U.S.-Barbados treaty by U.S. corporations to facilitate inappropriate U.S. tax reductions. In recent years, a small number of U.S. corporations have engaged in corporate inversion transactions, which involve a complicated restructuring in which a new foreign corporation is interposed between the public shareholders and the existing U.S. parent corporation. This restructuring can be used to take advantage of U.S. tax rules to reduce U.S. tax on income from the corporate group's U.S. operations and also to reduce U.S. tax on income from any foreign operations of the corporate group. In some corporate inversion transactions, the new foreign "parent" corporation claimed to be a resident of Barbados so that the provisions of the U.S.-Barbados treaty could be used to reduce U.S. tax on payments from the existing U.S. corporate group to the new Barbados company. The use of the treaty in connection with this sort of corporate inversion transaction was neither intended nor appropriate. More generally, the treaty was not intended to be used by companies that while technically resident in Barbados do not have sufficient nexus with Barbados.

The proposed Protocol with Barbados prevents this inappropriate exploitation of the treaty through modifications to the limitation on benefits provision. In particular, the proposed Protocol tightens the publicly-traded company test to ensure that a company resident in Barbados must have a real nexus with Barbados in order to be eligible for treaty benefits. This nexus is established through the requirement that the company's stock not only be listed on the Barbados stock exchange but also be primarily traded on the Barbados stock exchange (or on the sister exchanges in Jamaica or Trinidad and Tobago). As a result of the proposed Protocol's changes to the limitation on benefits provision, a Barbados company that is largely traded on a U.S. stock exchange, which is true of the corporations that have undertaken corporate inversion transactions, will no longer qualify for treaty benefits.

The proposed Protocol with the Netherlands includes a more complete overhaul of the limitation on benefits provision in the current U.S.-Netherlands treaty. It is notable that the current U.S.-Netherlands treaty broke new ground in terms of comprehensive anti-treaty shopping rules and the inclusion of the provision in that treaty was crucial to our success in negotiating such provisions with other countries. The refinements included in the proposed Protocol reflect experience gained both through the administration of the provision in the current treaty and through the crafting of similar provisions in more recent treaties.

The proposed Protocol with the Netherlands also reflects a new approach for the publicly-traded company test designed to ensure the intended nexus between a publicly-traded company and its country of residence while recognizing the integration of the global financial markets. With this new approach, a public company that does not have sufficient nexus to its residence country

through trading on the stock exchanges in that country must establish nexus through primary management and control in its residence country in order to qualify for treaty benefits under the publicly-traded company test. Thus, for example, a Dutch company that has more trading on U.S. stock exchanges than on exchanges in the Netherlands and its economic region or that otherwise is overwhelmingly traded on exchanges outside the Netherlands will qualify for U.S. treaty benefits under this new test if the company's center of management and control is in the Netherlands (which establishes a real link between the company and the Netherlands). Given developments in trading patterns, the new publicly-traded company test better serves the intended purpose of limiting treaty shopping by third-country residents. Moreover, the revisions to the test were intended to be forward looking, to prevent any potential for the U.S.-Netherlands treaty to be exploited by what is really a U.S. company in some possible future evolution of corporate inversion type transactions.

In sum, the refinements to the limitation on benefits provisions generally, and the publicly-traded company test in particular, that are included in the two pending agreements reflect a common goal: to ensure that the limitation on benefits provision serves its underlying objective of limiting treaty benefits to bona fide residents of our treaty partners. The specific approaches used in the two agreements to achieve this common goal differ. As with many aspects of our limitation on benefits provisions, the differences are due to the differing economic and legal circumstances of the two treaty partners.

We intend to continue to scrutinize the limitation on benefits provisions in all our tax treaties. In addition to our ongoing efforts to incorporate such provisions in the few remaining U.S. treaties that do not yet include them, we also will continue to review our limitation on benefits provisions generally, and the publicly-traded company test in particular, to make sure that the rules work to establish the intended nexus in the particular circumstances. If we find inadequacies in any of our treaties, we will work to refine the provisions in those treaties. As in the case of these two agreements, the optimal approach may well vary from treaty to treaty depending on the particular circumstances; flexibility in approach will be needed in order to accomplish the underlying objective while recognizing the need for certainty and clear, administrable rules.

## **Discussion of Proposed New Treaties and Protocols**

I now would like to discuss the two 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 Netherlands

The proposed Protocol with the Netherlands was signed in Washington on March 8, 2004. The proposed Protocol modifies the current U.S.-Netherlands treaty, which entered into force in 1993, to take into account developments over the last decade, including changes in each country's tax laws and tax treaty policies.

The proposed Protocol includes significant changes with respect to the limitation on benefits rules. Although the current treaty includes a comprehensive limitation on benefits article, the



details of the rules differ from those in other U.S. tax treaties in some respects and the rules have proven somewhat cumbersome in application for both taxpayers and the governments. The proposed Protocol brings the limitation on benefits article into closer conformity with the provisions in more recent U.S. treaties, including most particularly the new treaty with the United Kingdom. At the same time, as discussed earlier, the proposed Protocol tightens the limitation on benefits rules applicable to publicly-traded companies to ensure real nexus between the company and its residence country, as evidenced either by trading in the company's stock on the stock exchanges of such country or by the company's being primarily managed and controlled there.

The proposed Protocol modifies the current treaty's provisions setting maximum rates for source-country withholding taxes on cross-border dividends by providing for exclusive residence-country tax on certain intercompany dividends. This provision of the proposed Protocol provides for the elimination of source-country withholding taxes on certain intercompany dividends where the dividend is received by a company that owns at least 80 percent of the voting stock of the company paying the dividend. In the case of other dividends, the proposed Protocol continues the current treaty's limits on source-country withholding taxes, with a maximum rate of 5 percent applicable to direct dividends (where the recipient of the dividends is a company that owns at least 10 percent of the company paying the dividends) and 15 percent otherwise. The dividend withholding tax provisions in the proposed Protocol closely follow the analogous provisions in the recent agreements with the United Kingdom, Australia and Mexico.

Treasury believes that this provision eliminating source-country withholding taxes on certain intercompany dividends is appropriate in light of our overall treaty policy of reducing tax barriers to cross-border investment and in the context of this important treaty relationship. As I have testified previously, the elimination of source-country taxation of dividends is something that is to be considered only on a case-by-case basis. It is not the U.S. model position because we do not believe that it is appropriate in every treaty. Consideration of such a provision in a treaty is appropriate only if the treaty contains anti-treaty-shopping rules and an information exchange provision that meet the highest standards. In addition to these prerequisites, the overall balance of the treaty must be considered.

These conditions and considerations all are met in the case of the proposed Protocol with the Netherlands. The proposed Protocol includes both comprehensive anti-treaty-shopping provisions and model exchange of information provisions. The United States and U.S. taxpayers benefit significantly from the dividend withholding tax provision. The elimination of source-country withholding taxes on intercompany dividends provides reciprocal benefits because the Netherlands and the United States both have dividend withholding taxes and there are substantial dividend flows going in both directions.

The proposed Protocol updates the provisions applicable to dividends paid by REITs (and comparable Dutch entities) to conform to current U.S. tax treaty policy. The proposed Protocol reflects the refinement of approach adopted in 1997, which is intended to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available while providing appropriate reductions in the case of portfolio investors in REITs.

The proposed Protocol includes provisions intended to coordinate the two countries' rules regarding earnings and accretions of pension plans and contributions to pension plans in cross-border situations. For example, the proposed Protocol provides that in the case of a U.S. citizen who contributes to a U.S. qualified pension plan while working in the United States and subsequently establishes residence in the Netherlands, the Netherlands will not impose tax on the earnings and accretions of the pension plan with respect to that individual until distributions are made from the plan. In addition, the proposed Protocol extends the reach of provisions regarding cross-border pension contributions that are included in the current treaty to cover situations where a U.S. citizen residing in the Netherlands makes contributions to a Dutch pension plan.

The proposed Protocol extends the provision in the current treaty which preserves the U.S. right to tax certain former citizens whose loss of citizenship had, as one of its principal purposes, the avoidance of tax to cover also certain former long-term residents whose loss of such status had, as one of its principal purposes, the avoidance of tax.

The proposed Protocol includes a provision, similar to that in the U.S. model treaty and other recent treaties, which is intended to coordinate each country's obligations in situations in which a taxation measure falls within both the nondiscrimination provisions of the treaty and the national treatment obligations of the General Agreement on Trade in Services. The proposed Protocol also includes several other administrative and technical modifications, including an update of the exchange of information provisions in the current treaty that fully reflects U.S. model standards in this area.

The Memorandum of Understanding accompanying the proposed Protocol provides additional explanations and guidance regarding the agreed interpretation of the current treaty and the proposed Protocol. The Memorandum of Understanding is an update of the understanding with respect to the current treaty and is intended to replace that document.

### Barbados

The proposed Protocol with Barbados was signed in Washington on July 14, 2004. The proposed Protocol was negotiated to ensure that the U.S.-Barbados tax treaty cannot be used inappropriately to secure tax reductions in circumstances where there is no risk of double taxation. The proposed Protocol also updates the current treaty to reflect changes in U.S. tax law and to bring the treaty into closer conformity with current U.S. tax treaty policy.

The most significant provision in the proposed Protocol is the modification of the current treaty's limitation on benefits article. As discussed earlier, the proposed Protocol revises the limitation on benefits article, with a particular focus on the publicly-traded company test, to ensure that the article operates effectively to limit treaty benefits to bona fide residents. Under the proposed Protocol, a company that is a resident of Barbados qualifies for treaty benefits under the publicly-traded company test only if the stock of the company is primarily traded on the Barbados stock exchange (or on one of the sister exchanges in Jamaica or Trinidad and Tobago).

The proposed Protocol adds a further restriction to the limitation on benefits article to address the treatment of entities that qualify for one of several special preferential tax regimes in Barbados. Under the proposed Protocol, the provisions of the treaty that provide for reductions in U.S. withholding taxes do not apply in the case of entities that are not subject to the generally

applicable Barbados tax system and that benefit instead from a preferential tax regime. An entity that is subject to no or very low taxation in Barbados under these preferential regimes does not have any real risk of the double taxation that these treaty provisions are intended to address.

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 expands this right to include taxation of former long-term residents whose loss of such status had, as one of its principal purposes, the avoidance of tax. The proposed Protocol also includes a clarification of the operation of the treaty's provisions relating to tax information exchange consistent with U.S. model standards in this area.

### **Treaty Program Priorities**

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

As I noted earlier, 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. Another continuing priority is entering into new tax treaties with the former Soviet republics that are still covered by the old U.S.S.R. treaty (which does not include an adequate exchange of information provision). We also are focused on continuing to expand our treaty network by entering into new tax treaty relationships with countries that have the potential to be important trading partners in the future.

Following up on our discussion earlier this year, we have begun work on an update to the U.S. model tax treaty to reflect our negotiating experiences since 1996. We look forward to working with the staffs of the Senate Foreign Relations Committee and Joint Committee on Taxation 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. Such action will further strengthen the U.S. tax treaty network by eliminating weaknesses and ensuring that our treaties continue to serve their intended purpose of facilitating real cross-border trade and investment.