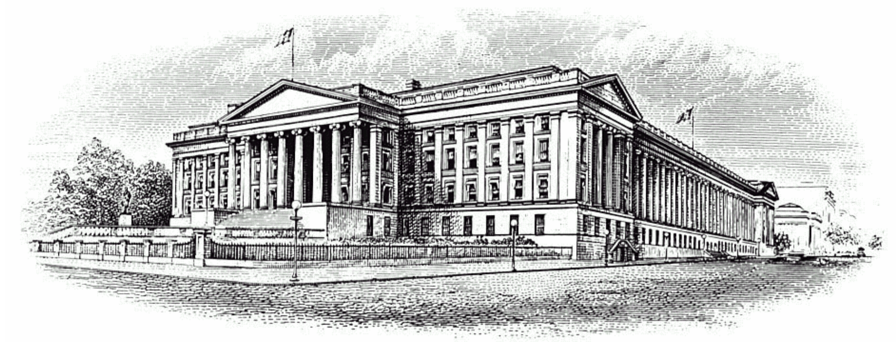

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

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TESTIMONY OF
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UNITED STATES DEPARTMENT OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS
ON PENDING INCOME TAX AGREEMENTS

FEBRUARY 25, 2004

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 treaties that are pending before this Committee. We appreciate the Committee's interest in these agreements 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.

The Administration believes that these agreements with Japan and Sri Lanka would provide significant benefits to the United States and to our treaty partners, as well as our respective business communities. The tax treaty with Japan is a critically important modernization of the economic relationship between the world's two largest economies. The agreement with Sri Lanka represents the first tax treaty between our two countries, and reflects our continuing commitment to extending our treaty network to emerging economies. 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. In the absence of a tax treaty, a U.S. company operating a branch or division or providing services in another country might be subject to income tax in both the United States and the other country on the income generated by such operations. Although the United States generally provides a credit against U.S. tax liability for foreign taxes paid, there remains potential for resulting double taxation that could make an otherwise attractive investment opportunity unprofitable, depriving both countries of the benefits of increased cross-border investment.

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 “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 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 having suffered “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.

Our 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.

Tax treaties also 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 employee stock options, Social Security benefits, and alimony and child support 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 subjects may not involve substantial tax revenue from the perspective of the two governments, rules providing clear and appropriate treatment can be very important to each of the individual taxpayers who are affected.

In addition, tax treaties 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 necessary 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. In fact, information exchange is a matter we raise with the other country before commencement of formal negotiations because it is one of a very few matters that we consider non-negotiable.

Tax Treaty Negotiating Priorities and Process

The United States has a network of 56 bilateral income tax treaties covering 64 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. It is, however, appreciably smaller than the tax treaty networks of some other countries. There are a number of reasons for this.

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 particularly the goal of meshing two different tax systems, make the negotiation process exacting and time-consuming.

A country's tax policy, as reflected in its domestic tax legislation as well as its tax treaty positions, reflects the sovereign choices made by that country. 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, the funds themselves, and distributions from the funds. A treaty negotiation must take into account all of these and many other aspects of the treaty partner's tax system in order to arrive at an agreement that accomplishes the United States' tax treaty objectives.

In any tax treaty negotiation, the two countries may come to the table with very different views of what a final treaty should provide. Each country will have its own list of positions that it considers non-negotiable. The United States, which insists on effective anti-treaty-shopping and exchange of information provisions, and which must accommodate the uniquely complex U.S. tax laws, probably has more non-negotiable positions than most countries. For example, the United States insists on inclusion of a special provision – the "saving clause" – which permits the United States to tax its citizens and residents as if the treaty had not come into effect, as well as special provisions that allow the United States to apply domestic tax rules covering former citizens and long-term residents. Other U.S. tax law provisions that can complicate negotiations include the branch profits tax and the branch level interest tax, rules regarding our specialized investment vehicles, such as real estate mortgage investment conduits, real estate investment trusts and regulated investment companies, and the Foreign Investors in Real Property Tax Act rules. As our international tax rules become more and more complicated, the number of special tax treaty rules that are required increases as well.

Obtaining the agreement of our treaty partners on provisions of importance to the United States sometimes requires other concessions on our part. Similarly, other countries sometimes must make concessions to obtain our agreement on matters that are critical to them. 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 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 U.S. commitment to including comprehensive 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 can exploit one of our treaties to secure reductions in U.S. tax, the benefits would flow only in one direction. Such use of treaties is not consistent with the balance of the deal negotiated. Moreover, preventing this exploitation of our 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.

Despite the protections provided by the limitation on benefits provisions, there may be countries with which a tax treaty is not 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, we generally do not conclude tax treaties with jurisdictions that do not impose significant income taxes, because there is little possibility of the double taxation of income in the cross-border context that tax treaties are designed to address; with such jurisdictions, an agreement focused on the exchange of tax information can be very valuable in furthering the goal of reducing U.S. tax evasion.

The situation is more complex when a country adopts a special preferential regime for certain parts of the economy that is different from the 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 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. Accordingly, in some cases we have tax treaty relationships that carve out certain categories of residents and activities from the benefits of the treaty. In other cases, we have determined that economic relations with the relevant country were such that the potential gains from a tax treaty were not sufficient to outweigh the risk of abuse, and have therefore decided against entering into a tax treaty relationship (or have terminated an existing relationship).

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 potential treaty partner is unable to do so. In other cases we may feel that a tax treaty is 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.

Lesser developed and newly emerging economies, for which capital and trade flows with the United States are often disproportionate or virtually one way, may be reluctant to agree to the reductions in source-country withholding taxes preferred by the United States because of concerns about the short-term effects on their tax revenues. These countries have two somewhat conflicting objectives. They need to reduce barriers to investment, which is the engine of development and growth, and reducing source-country withholding taxes reduces a significant barrier to inward investment. On the other hand, reductions in source-country withholding taxes may reduce tax revenues in the short-term. Because this necessarily involves the other country's judgment regarding the level of withholding taxes that will best balance these two objectives, our tax treaties with developing countries often provide for higher maximum rates of source-country tax than is the U.S. preferred position. Such a treaty nevertheless provides benefits to taxpayers by establishing a stable framework for taxation. Moreover, having an agreement in place makes it easier to agree to further reductions in source-country withholding taxes in the future. It is important to recognize that even where the current capital and trade flows between two treaty countries are disproportionate, conclusion of a tax treaty is not a zero-sum exercise. The goal of the tax treaty is to increase the amount and efficiency of economic activity, so that the situation of each party is improved.

For a country like the United States that has significant amounts of both inbound and outbound investment, treaty reductions in source-country withholding taxes do not have the same one-directional impact on tax revenues, even looking just at the short-term effects. Reductions in withholding tax imposed by the source country on payments made to foreign investors represent a short-term static reduction in source-country tax revenues. However, reductions in foreign withholding taxes borne by residents on payments received with respect to foreign investments represent an increase in tax revenues because of the corresponding reduction in the foreign tax credits that otherwise would offset the residents' domestic tax liabilities. Thus, the reciprocal reductions in source-country withholding taxes accomplished by treaty will have offsetting effects on tax revenues even in the short term.

More importantly, looking beyond any net short-term effect on tax liabilities, an income tax treaty is a negotiated agreement under which both countries expect to be better off in the long run. These long-term economic benefits far outweigh any net short-term static effects on tax liabilities. Securing the reduction or elimination of foreign withholding taxes imposed on U.S. investors abroad can reduce their costs and improve their competitiveness in connection with international business opportunities. Reduction or elimination of the U.S. withholding tax imposed on foreign investors in the United States may encourage inbound investment, and increased investment in the United States translates to more jobs, greater productivity and higher wage rates. The tax treaty as a whole creates greater certainty and provides a more stable environment for foreign investment. The agreed allocation of taxing rights between the two countries reduces cross-border impediments to the bilateral flow of capital, thereby allowing companies and individuals to more effectively locate their operations in such a way that their investments are as productive as possible. This increased productivity will benefit both countries' economies. The administrative provisions of the tax treaty provide for cooperation between the two countries, which will help reduce the costs of tax administration and improve tax compliance.

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.

Japan

The proposed Convention and Protocol with Japan was signed in Washington on November 6, 2003. The Convention and Protocol are accompanied by an exchange of diplomatic notes, also dated November 6, 2003. The Convention, Protocol and notes replace the existing U.S.-Japan tax treaty, which was signed in 1971.

Because the existing treaty dates back to 1971, it does not reflect the changes in economic relations between the two countries that have taken place over the last thirty years. Today, the trade and investment relationship between the United States and Japan, the world's two largest economies, is critical to creating economic growth throughout the world. The proposed new treaty significantly reduces existing tax-related barriers to trade and investment between Japan and the United States. Reducing these barriers will help to foster still-closer economic ties between the two countries, enhancing the competitiveness of both countries' businesses and creating new opportunities for trade and investment.

The existing treaty also is inconsistent in many respects with U.S. tax treaty policy. The proposed new treaty brings the treaty relationship into much closer conformity with U.S. policy and generally modernizes the agreement in a manner consistent with other recent treaties. At the same time, several key provisions of the new treaty represent "firsts" for Japan. The evolution embodied in this agreement may very well provide important precedents for many countries in the region that look to Japan for guidance and leadership in this regard.

Perhaps the most dramatic advances in the proposed new treaty are reflected in the reciprocal reductions in source-country withholding taxes on income from cross-border investments. The existing treaty sets maximum rates for withholding taxes on cross-border interest, royalty and dividend payments that are much higher than the rates reflected in the U.S. model tax treaty and provided in most U.S. tax treaties with developed countries. The new treaty substantially lowers these maximum withholding tax rates, bringing the limits in line with U.S. preferred tax treaty provisions. The maximum rates of source-country withholding tax provided in the new treaty are as low as, and in many cases significantly lower than, the rates provided for in any other tax treaty entered into by Japan. These important reductions in source-country withholding tax agreed in this new treaty reflect the commitment of both governments to facilitating cross-border investment.

In today's knowledge-driven economy, intangible property developed in the United States, such as trademarks, industrial processes or know-how, is used around the world. Given the importance of the cross-border use of intangibles between the United States and Japan, a primary objective from the U.S. perspective in negotiating a new tax treaty with Japan was to overhaul the existing rules for the treatment of cross-border income from intangible property. This goal is achieved in the proposed new treaty through the complete elimination of source-country withholding taxes on royalties. This is the first treaty in which Japan has agreed to eliminate source-country withholding taxes on royalties.

The proposed new treaty is a major change from the existing treaty, which allows the source country to impose a 10 percent withholding tax on cross-border royalties. The gross-basis taxation provided for under the existing treaty is particularly likely to lead to excessive taxation in the case of royalties because the developer of the licensed intangible who receives the royalty payments typically incurs substantial expenses, through research and development or marketing. The existing treaty's 10-percent withholding tax imposed on gross royalties can represent a very high effective rate of source-country tax on net income when the expenses associated with such income are considered. In addition, because withholding taxes can be imposed on cross-border payments where the taxpayer has no presence in the source country, the existing treaty's allowance of such taxes on royalties created a significant disparity in treatment between royalty income and services and other income. This has been particularly problematic as the line between the types of income is not always clear.

With the elimination of source-country royalty withholding taxes provided for in the proposed new treaty, royalties will be taxed exclusively by the country of residence on a net basis in the same manner as other business profits. This eliminates the excessive taxation that can occur under the existing treaty. Moreover, treating royalties in the same manner as business profits removes the disparity in treatment between royalty income and services and other income and therefore eliminates what has been a significant source of dispute and potential double taxation for U.S. taxpayers under the existing treaty. As a final note, this change in the U.S.-Japan treaty relationship may well have positive effects for other U.S. treaty negotiations. Japan's historic policy of retaining its right to impose withholding tax on royalties in its tax treaties has encouraged other countries to do the same. The change in this policy reflected in the new treaty may serve as an impetus to other countries to consider agreeing by treaty to greater reductions in source-country withholding taxes on royalties.

The proposed new treaty also reflects significant improvements in the rules regarding cross-border interest payments. The existing treaty provides for a maximum withholding tax rate of 10 percent for all interest payments other than a narrow class of interest paid to certain government entities. The new treaty includes provisions eliminating source-country withholding taxes for significant categories of interest. The most important of these is the elimination of source-country withholding tax for interest earned by financial institutions. Due to the highly-leveraged nature of financial institutions, imposition of a withholding tax on interest received by such enterprises could result in taxation that actually exceeds the net income from the transaction. The new treaty will eliminate this potential for excessive taxation, with cross-border interest earned by financial institutions taxed exclusively by the residence country on a net basis. The new treaty also provides for the elimination of source-country withholding taxes in the case of interest received by the two governments, interest received in connection with sales on credit, and interest earned by pension funds. This elimination of source-country withholding taxes on income earned by tax-exempt pension funds ensures that the assets expected to accumulate tax-free to fund retirement benefits are not reduced by foreign taxes; a withholding tax in this situation would be particularly burdensome because there is no practical mechanism for providing individual pension beneficiaries with a foreign tax credit for withholding taxes that were imposed on investment income years before the retiree receives pension distributions. These exemptions from source-country withholding tax for interest provided in the new treaty are broader than in any other Japanese tax treaty.

In addition, the proposed new treaty significantly reduces source-country withholding taxes with respect to all types of cross-border dividends. Under the existing treaty, direct investment dividends (that is, dividends paid to companies that own at least 10 percent of the stock of the paying company) generally may be taxed by the source country at a maximum rate of 10 percent and portfolio dividends may be taxed at a maximum rate of 15 percent. The new treaty reduces the maximum rates of source-country withholding tax to 5 percent for direct investment dividends and 10 percent for portfolio dividends. The new treaty also provides for the elimination of source-country withholding taxes on certain intercompany dividends where the dividend is received by a company that owns more than fifty percent of the voting stock of the company paying the dividend. This provision is similar to provisions included in the U.S. treaties with the United Kingdom, Australia, and Mexico. The elimination of withholding taxes on this category of intercompany dividends is substantially narrower than provisions in other Japanese treaties. In addition, the new treaty includes a provision that eliminates source-country withholding taxes on dividends paid to pension funds, which parallels the treatment of interest paid to pension funds.

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 to agree to such an exemption in every treaty. Consideration of such a provision in a treaty is appropriate only if the treaty contains anti-treaty-shopping rules that meet the highest standards and the information exchange provision of the treaty is sufficient to allow us to confirm that the requirements for entitlement to this benefit are satisfied. Strict protections against treaty shopping are particularly important when the elimination of withholding taxes on intercompany dividends is included in relatively few U.S. treaties. 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 new treaty with Japan. The new treaty includes the comprehensive anti-treaty-shopping provisions sought by the United States, provisions that are not contained in the existing treaty. The new treaty includes exchange of information provisions comparable to those in the U.S. model treaty. In this regard, Japan recently enacted domestic legislation to ensure that it can obtain and exchange information pursuant to a tax treaty even in cases where it does not need the particular information for its own tax purposes.

The United States and U.S. taxpayers benefit significantly both from this provision in the new agreement and from the treaty overall. The elimination of source-country withholding taxes on intercompany dividends provides reciprocal benefits because Japan and the United States both have dividend withholding taxes and there are substantial dividend flows going in both directions. U.S. companies that are in an excess foreign tax credit position will be able to keep every extra dollar they receive if the dividends they repatriate to the United States are free of Japanese withholding tax. The treaty as a whole reflects dramatic reductions in source-country withholding taxes relative to the existing treaty. The elimination of withholding taxes on royalties and certain interest was a key objective for the United States; while these provisions secured in this new treaty are consistent with U.S. tax treaty policy, they are an unprecedented departure from historic Japanese tax treaty policy.

Another important change reflected in the proposed new treaty is the addition of an article providing for the elimination of source-country withholding taxes on “other income”, which include types of financial services income that under the existing treaty could have been subject to gross-basis tax by the source country. In particular, the Protocol confirms that securities lending fees, guarantee fees, and commitment fees generally will not be subject to source-country withholding tax and rather will be taxable in the same manner as other business profits.

The proposed new treaty provides that the United States generally will not impose the excise tax on insurance policies issued by foreign insurers if the premiums on such policies are derived by a Japanese enterprise. This provision, however, is subject to the anti-abuse rule that denies the exemption if the Japanese insurance company were to enter into reinsurance arrangements with a foreign insurance company that is not itself eligible for such an exemption.

Another significant modernization reflected in the proposed new treaty is the inclusion of specific rules regarding the application of treaty provisions in the case of investments in one country made by residents of the other country through partnerships and other flow-through entities. These rules coordinate the domestic law rules of Japan and the United States in this area in order to provide for certainty in results for cross-border businesses operated in partnership form.

In the case of shipping income, the proposed new treaty provides for exclusive residence-country taxation of profits from the operation in international traffic of ships or aircraft. This elimination of source-country tax covers profits from the rental of ships and aircraft on a full basis; it also covers profits from rentals on a bareboat basis if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. In addition, the new treaty provides an exemption from source-country tax for all income from the use, maintenance or rental of containers used in international traffic.

The proposed new treaty generally provides for exclusive residence-country taxation of gains with narrow exceptions, which is generally consistent with U.S. tax treaty preferences but is a departure from the source-country taxation of gains that is provided for in recent Japanese treaties. The new treaty provides for source-country taxation of share gains in two circumstances. First, the new treaty includes a rule similar to that in U.S. domestic law under which gains from the sale of shares or other interests in an entity investing in real estate may be taxed by the country in which the real estate is located. Second, it contains a narrow rule dealing with gains on stock in restructured financial institutions that was included at the request of Japan. Under this rule, the source country may tax gains on stock of a financial institution if the financial institution had received substantial financial assistance from the government under rules relating to distressed financial institutions, the stock was purchased from the government, and the stock is sold within five years of such assistance. Under a very broad grandfather rule, this provision does not apply to any stock held by an investor who made an investment in such a financial institution prior to the entry into force of the new treaty including any additional stock in the financial institution that the investor acquires subsequently.

Like the existing treaty, the proposed new treaty provides that pensions and social security benefits may be taxed only by the residence country. The new treaty also provides rules regarding the allocation of taxing rights with respect to compensation earned in the form of employee stock options.

The proposed new treaty provides rules governing income earned by entertainers and sportsmen, corporate directors, government employees, and students that are consistent with the rules of the U.S. model treaty. The new treaty continues and improves a host-country exemption for income earned by teachers that is found in the existing treaty, although not in the U.S. model.

The proposed new treaty contains a comprehensive limitation on benefits article, which provides detailed rules designed to deny “treaty shoppers” the benefits of the treaty. These rules, which were not contained in the existing treaty and which have not been included in this form in other Japanese tax treaties, are comparable to the rules contained in recent U.S. treaties.

At the request of Japan, the proposed new treaty includes an additional limit on the availability of treaty benefits obtained in connection with certain back-to-back transactions involving dividends, interest, royalties or other income. This provision is substantially narrower than the “conduit arrangement” language found in the 2003 treaty with the United Kingdom. It is intended to address abusive transactions involving income that flows to a third-country resident. Japanese domestic law does not provide sufficient protection against these abusive transactions. The stricter protections against this type of abuse that are provided under U.S. domestic law will continue to apply.

The proposed new treaty provides relief from double taxation in a manner consistent with the U.S. model. The new treaty also includes a re-sourcing rule to ensure that a U.S. resident can obtain a U.S. foreign tax credit for Japanese taxes paid when the treaty assigns to Japan primary taxing rights over an item of gross income. A comparable rule applies for purposes of the Japanese foreign tax credit.

The proposed new treaty provides for non-discriminatory treatment (i.e., national treatment) by one country to residents and nationals of the other. Also included in the new treaty are rules necessary for administering the treaty, including rules for the resolution of disputes under the treaty. The information exchange provisions of the new treaty generally follow the U.S. model and make clear that Japan 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. Inclusion of this U.S. model provision was made possible by a recent change in Japanese law.

Sri Lanka

The United States does not currently have an income tax treaty with Sri Lanka. The proposed income tax Convention with Sri Lanka was signed in Colombo on March 14, 1985 but was not acted on by the Senate at that time because changes made to U.S. international tax rules by the Tax Reform Act of 1986 necessitated some modifications to the agreement. The proposed Protocol, which was signed on September 20, 2002, amends the 1985 Convention to reflect changes in domestic law since 1985 as well as developments in U.S. tax treaty policy and includes modifications that better reflect U.S. tax treaty preferences. We are requesting the Committee to report favorably on both the 1985 Convention and the 2002 Protocol.

The proposed new 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. Special rules consistent with those in the U.S. model treaty apply to certain dividends paid by a U.S. real estate investment trust. The proposed treaty provides a maximum source-country withholding tax rate on interest of 10 percent. This source-country tax is eliminated in the case of interest paid by one of the two governments or received by one of the two governments or one of the central banks.

Under the proposed treaty, royalties may be subject to source-country withholding taxes at a maximum rate of 10 percent. As in many treaties with developing countries, the royalties article also covers rents with respect to tangible personal property; in the case of such rents, however, the maximum withholding tax rate is 5 percent. These rules in the proposed treaty do not apply to rental income with respect to the lease of containers, ships or aircraft, which is instead covered by the specific rules in the shipping article.

The rules in the proposed treaty relating to income from shipping and air transport are complicated in terms of drafting, but produce results that in most cases are consistent with many recent U.S. tax treaties. First and simplest, under the proposed treaty income derived from the rental of containers used in international traffic is taxable only in the country of residence and not in the source country. Exclusive residence-country taxation of such income is the preferred U.S. position reflected in the U.S. model treaty. Second, the proposed treaty provides that income derived from the international operation of aircraft also is taxable only in the country of residence. This rule eliminating source-country tax covers income derived from aircraft leases on a full basis as well as profits from the rental of aircraft on a bareboat basis if the aircraft are operated in international traffic by the lessee or if the lease is incidental to other profits from the operation of aircraft. Third, the rules in the treaty provide for some source-country taxation of income from the operation and rental of ships, but not to exceed the source-country tax that may be imposed under any of Sri Lanka's other treaties. Sri Lanka has entered into two treaties that eliminate source-country tax on income from the operation of ships and has confirmed through diplomatic note that this exemption from source-country tax will apply in the case of the United States as well.

The proposed treaty provides the basic tax treaty rule that business profits of a resident of one of the treaty countries generally may be taxed in the other country only when such profits are attributable to a permanent establishment located in that other country. The rules in the proposed treaty permit broader host-country taxation than is provided for in the U.S. model treaty. In this regard, the definition of permanent establishment in the proposed treaty is somewhat broader than the definition in the U.S. model, which lowers the threshold level of activity required for imposition of host-country tax. This permanent establishment definition is consistent with other U.S. treaties with developing countries. In addition, the proposed treaty provides that certain profits that are not attributable to the permanent establishment may be taxed in the host state if they arise from business activities carried on in the host state that are similar to those carried on through the permanent establishment. These rules are quite similar to rules found in our tax treaties with other developing countries.

The proposed treaty's rules for taxation of income from personal services similarly are consistent with our recent treaties with developing countries. Under the proposed treaty, income earned through independent personal services may be taxed in the host country if they are performed through a fixed base or if the individual performing the services was in the host country for more than 183 days in any 12-month period. The proposed treaty provides rules governing income earned by entertainers and sportsmen, corporate directors and government employees that are broadly consistent with the rules of the U.S. model treaty. The proposed treaty also includes a limited exemption from source country taxation of students.

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 Sri Lanka will provide such relief through the foreign tax credit mechanism, including a deemed paid credit for indirect taxes paid by subsidiary companies.

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, Sri Lanka 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. Sri Lanka has confirmed through diplomatic note its ability to obtain and exchange key information relevant for tax purposes. The information that may be exchanged includes information held by financial institutions, nominees or persons acting in an agency or fiduciary capacity.

Treaty Program Priorities

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

With respect to future negotiations, we expect to begin discussions soon with Germany and Norway. Another key priority is updating the few remaining 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. Also a priority is entering into new 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.

Significant resources have been devoted in recent years to the negotiation of new tax treaties with Japan and the United Kingdom, two major trade and investment partners for the United States and two of our oldest tax treaties. With the completion of these important negotiations, we believe that it would be appropriate to update the U.S. model treaty to reflect our negotiating experiences since 1996. A new model will help facilitate the negotiations we expect to begin in the near future. 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 the time and attention to the review of these new agreements. We 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 help to reduce barriers to cross-border trade and investment by further strengthening our economic relations with a country that has been a significant economic and political partner for many years and by expanding our economic relations with an important trading partner in the developing world.

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