JOINT COMMITTEE ON TAXATION
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TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS HEARING ON THE PROPOSED TAX TREATIES WITH JAPAN AND SRI LANKA

FEBRUARY 25, 2004[1]

My name is George Yin. I am Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation today concerning the proposed income tax treaties with Japan and Sri Lanka.

Overview

As in the past, the Joint Committee staff has prepared pamphlets covering the proposed treaties. The pamphlets provide detailed descriptions of the proposed treaties, including comparisons with the 1996 U.S. model income tax treaty, which 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 treaties. We consulted with the Department of the Treasury and with the staff of your committee in analyzing the proposed treaties and in preparing the pamphlets.

The proposed treaty with Japan would replace an existing tax treaty signed in 1971. The proposed treaty with Sri Lanka represents a new tax treaty relationship for the United States. The proposed treaty with Sri Lanka was signed in 1985, but it never entered into force, and a protocol updating the proposed treaty was signed in 2002. My testimony today will highlight some of the key features of the proposed treaties and certain issues that they raise.

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Japan

The proposed treaty with Japan is a comprehensive update of the 1971 treaty. The provisions of the proposed treaty are generally consistent with the U.S. model treaty; however, there are some exceptions.

"Zero-rate" dividend provision

One such exception is the relatively novel "zero rate" of withholding tax on certain intercompany dividends. The provision would eliminate source-country tax on cross-border dividends paid by one corporation to another corporation that owns more than 50 percent of the stock of the dividend-paying corporation, provided that certain conditions are met. Under the current treaty with Japan, these dividends may be subject to withholding tax in the source country at a rate of 10 percent. The proposed elimination of the withholding tax is intended to further reduce tax barriers to direct investment.

Let me illustrate the significance of this change by directing your attention to the figure in Appendix A. This figure shows a common arrangement for U.S. investment in Japan, where a U.S. company wholly owns a Japanese subsidiary operating in Japan. In this case, Japan would be considered the "source" country and the United States would be considered the "residence" country. Under both the current and proposed treaties, the income of the Japanese subsidiary would generally be taxed by the source country–Japan–at the Japanese corporate tax rate of 30 percent. Further, the proposed treaty would not change the taxation by the residence country–the United States–of any dividends received by the U.S. parent from the Japanese subsidiary. The only change made by the proposed treaty would be to eliminate any additional taxation of the dividend income by the source country, Japan, in the form of a withholding tax. The reduction in Japanese tax would, in turn, reduce the amount of U.S. foreign tax credits that may be claimed by the U.S. parent.

The figure in Appendix B illustrates the opposite situation of Japanese investment in the United States through a wholly owned U.S. operating subsidiary. Once again, the proposed treaty would not affect either the U.S. tax on the U.S. subsidiary's operating income or the Japanese tax on any dividends received by the Japanese parent from the U.S. subsidiary. The only change would be to eliminate the additional source country tax currently collected by the United States upon the distribution of a dividend to the Japanese parent, and the amount of Japanese foreign tax credits the parent may claim against its Japanese tax liability.

These examples illustrate that the effect of a zero-rate provision is generally to reduce the taxing jurisdiction of the source country and increase the taxing jurisdiction of the residence country. In this regard, the provision serves the common objective of tax treaties to resolve the competing tax claims of the source and residence country, and thereby reduce or eliminate double taxation. Under the current treaty, which provides for a positive rate of withholding tax on dividends, double taxation may be eliminated through the foreign tax credit. However, both the United States and Japan limit the amount of foreign tax credits that may be claimed by taxpayers. Consequently, the current treaty may result in some degree of double taxation, and a zero-rate provision may lead to an overall reduction for some taxpayers of this double taxation.

This provision does not appear in the U.S. or OECD model treaties. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes in similar circumstances. The European Union has also eliminated withholding taxes in similar circumstances under its "Parent Subsidiary Directive." In 2003, the Senate approved adding zero-rate provisions to the U.S. treaties with the United Kingdom, Australia, and Mexico. Those provisions are similar to the provision in the proposed treaty, although the proposed treaty allows a lower ownership threshold than the provisions in the United Kingdom, Australia, and Mexico treaties (i.e., it allows the zero rate to apply in the case of parent corporations owning more than 50 percent of a subsidiary, as opposed to at least 80 percent). Thus, the proposed treaty would be the fourth U.S. tax treaty to provide a complete exemption from withholding tax on direct dividends, and generally would define the category of exempt dividends more broadly than the previous three treaties.

The Committee may wish to determine whether the inclusion of the zero-rate provision in the proposed treaty signals a broader shift in U.S. tax treaty policy. In addition, the Committee may wish to consider whether and under what circumstances the Department of the Treasury intends to pursue similar provisions in other treaties and whether the U.S. model will be updated to reflect these developments.

Other issues

I will mention very briefly several other issues. These and other issues are described in greater detail in the Joint Committee staff pamphlets.

Anti-conduit rules.–The proposed treaty contains anti-conduit rules that can operate to deny the benefits of several articles of the proposed treaty. These rules are similar to, but significantly narrower and more precise than the "main purpose" rules that the Senate rejected in 1999 in connection with its consideration of the U.S.-Italy and U.S.-Slovenia treaties. These rules were included in the proposed treaty at the request of Japan. The rules are largely unnecessary for U.S. purposes because U.S. domestic law provides generally stronger anti-conduit rules. The potential confusion between the proposed treaty provision and U.S. domestic law raises the question whether application of the treaty provision should have been limited to Japanese law purposes.

Insurance excise tax.–The proposed treaty also provides an exemption for Japanese insurance companies from the U.S. excise tax on insurance and reinsurance premiums paid to foreign insurers with respect to U.S. risks. The waiver may place U.S. insurers at a competitive disadvantage with respect to Japanese competitors in U.S. markets, depending upon the level of Japanese taxation of such competitors. The Committee may wish to satisfy itself that the tax imposed on insurance income by Japan is significant enough that no such disadvantage arises.

Gains on shares in restructured financial institutions.–The proposed treaty contains a unique provision that would permit Japan to tax certain gains of U.S. investors on shares in Japanese financial institutions that have received substantial Japanese financial assistance. (The proposed treaty provision is reciprocal, but it has no current relevance in the United States.) The U.S. investor may be able to claim a U.S. foreign tax credit for the Japanese tax paid, in which

case U.S. tax collections would be reduced. The Committee may wish to consider whether this special provision is warranted.

Non-arm's length payments and contingent interest.–With respect to non-arm's length payments of interest and royalties (as well as certain other income) between related parties, the proposed treaty provides that these amounts are taxable in the source country at five percent of the amount of the excess of the payment over the arm's-length amount. The U.S. model and most of our tax treaties do not contain any such limitation, and provide that non-arm's length amounts are taxable according to the laws of each country, taking into account the other provisions of the treaty.

In addition, the U.S. model and most of our tax treaties provide a special rule with regard to payments of contingent interest, where the yield on the debt instrument tracks one or more variables such as the profits of the debtor. Under the U.S. model, such contingent interest generally may be taxed in the source country in accordance with its laws, up to the maximum withholding rate prescribed for portfolio dividends under the treaty if the recipient of the contingent interest is a resident of the other treaty country. In contrast, the proposed treaty provides that contingent interest remains subject to the interest provisions of the proposed treaty. The Committee may wish to inquire why the U.S. model position was not followed in these two cases.

Gains on sale of U.S. real property holding corporations.–The proposed treaty largely preserves U.S. taxing jurisdiction under the Foreign Investment in Real Property Tax Act ("FIRPTA") over the gain derived by a resident of Japan from the alienation of direct or indirect interests in U.S. real property. However, the proposed treaty generally waives some U.S. taxing jurisdiction with respect to these gains by relaxing certain definitional requirements. The Committee may wish to inquire why the United States has waived this jurisdiction, which is inconsistent with the U.S. model.

Updating the U.S. model income tax 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 would ensure that the model treaties remain meaningful and relevant. The current U.S. model income tax treaty was last updated in 1996. The staff of the Joint Committee believes that it is becoming obsolete and is in need of an update.

Sri Lanka

Let me now mention a few issues relating to the proposed tax treaty with Sri Lanka.

The proposed treaty differs from the U.S. model by not reducing source country taxation as much as the model. In this regard, the proposed treaty is similar to other treaties that the United States has entered into with developing countries. The Committee may wish to consider whether these concessions are appropriate in the case of Sri Lanka.

In several places, the proposed treaty appears not to reflect recent changes in Sri Lankan tax law.

Finally, Sri Lanka is currently experiencing a domestic political crisis. The Committee may wish to consider the impact of this political instability on the proposed treaty.

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