EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND SWEDEN

Scheduled for a Hearing

Before the

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

On February 2, 2006

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JOINT COMMITTEE ON TAXATION

January 26, 2006
JCX-1-06
INTRODUCTION

This pamphlet, prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the existing income tax treaty between the United States and Sweden (the “proposed protocol”). The proposed protocol was signed on September 30, 2005. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol for February 2, 2006.

Part I of the pamphlet provides a summary of the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of the Swedish tax laws. Part IV provides a discussion of investment and trade flows between the United States and Sweden. Part V contains an article-by-article explanation of the proposed protocol. Part VI contains a discussion of issues relating to the proposed protocol.

1 This pamphlet may be cited as follows: Joint Committee on Taxation, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Sweden (JCX-1-06), January 26, 2006. References to “the Code” are to the U.S. Internal Revenue Code of 1986, as amended.

2 The proposed protocol is accompanied by official understandings implemented by an exchange of diplomatic notes (the “notes,” collectively).

3 For a copy of the proposed protocol, see Senate Treaty Doc. 109-8.
I. SUMMARY

The principal purposes of the existing treaty between the United States and Sweden are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The existing treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

The proposed protocol modifies several provisions in the existing treaty (signed in 1994) to make it similar to more recent U.S. income tax treaties, the 1996 U.S. model income tax treaty (“U.S. model”), and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated (“OECD model”). However, the existing treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models.

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol would retain both the generally applicable maximum rate of withholding at source of 15 percent and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. However, like several other recent treaties and protocols, the proposed protocol would provide for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. A zero rate also generally would apply to dividends received by a pension fund. As in the current treaty, special rules would apply to dividends received from RICs and REITs, with some new modifications applicable to dividends from REITs, similar to provisions included in other recent treaties and protocols.

The proposed protocol replaces Article 17 (Limitation on Benefits) of the existing treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. model and more recent U.S. income tax treaties. Unlike the U.S. model, but like the recent protocol amending the Netherlands income tax treaty, the proposed protocol includes a requirement to determine whether a company’s public trading or management constitutes an adequate connection to its residence in a treaty country to prevent certain companies from qualifying for treaty benefits.

The proposed protocol amends Article 20 (Government Service) of the existing treaty to include a special new rule related to Swedish tax on a U.S. Government pension.

The proposed protocol expands the “saving clause” provision in Article 1 (Personal Scope) of the existing treaty to allow the United States to tax certain former citizens and long-term residents regardless of whether their termination of residency has as one of its principal purposes the avoidance of tax. This provision generally allows the United States to apply special

4 See Joint Committee on Taxation, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and the Netherlands (JCX-54-04), September 16, 2004.
tax rules under section 877 of the Code as amended in 1996 and 2004. The proposed protocol makes coordinating changes to Article 23 (Relief from Double Taxation) with respect to foreign tax credits allowed in such situations.

The proposed protocol updates Article 1 of the existing treaty to include the rules in recent U.S. treaties related to fiscally transparent entities, modifies outdated references in Article 2 (Taxes Covered), and brings Article 4 (Residence) of the existing treaty into conformity with the U.S. model and more recent U.S. income tax treaties.

Article VIII of the proposed protocol provides for the entry into force of the modifications made by the proposed protocol.
II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE 
AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and 
foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the 
general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules 
made by treaties.

A. U.S. Tax Rules

The United States taxes U.S. citizens, residents, and corporations on their worldwide 
income, whether derived in the United States or abroad. The United States generally taxes 
nonresident alien individuals and foreign corporations on all their income that is effectively 
connected with the conduct of a trade or business in the United States (sometimes referred to as 
“effectively connected income”). The United States also taxes nonresident alien individuals and 
foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. 
trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively 
connected with the conduct of a trade or business in the United States generally is subject to U.S. 
tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed 
to the extent that they are related to effectively connected income. A foreign corporation also is 
subject to a flat 30-percent branch profits tax on its “dividend equivalent amount,” which is a 
measure of the effectively connected earnings and profits of the corporation that are removed in 
any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is 
subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of 
interest that is deducted by the foreign corporation in computing its effectively connected income 
over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien 
individual or foreign corporation (including, for example, interest, dividends, rents, royalties, 
salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or 
business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance 
premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax 
at a rate of one or four percent of the premiums. These taxes generally are collected by means of 
withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For 
example, certain original issue discount and certain interest on deposits with banks or savings 
institutions are exempt from the 30-percent withholding tax. An exemption also is provided for 
certain interest paid on portfolio debt obligations. In addition, income of a foreign government 
or international organization from investments in U.S. securities is exempt from U.S. tax.
U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a “per-country” basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.
B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person’s contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term “resident” so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient’s country of residence or by reducing the rate of the source country’s withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either
country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the “IRS”), and the treaty partner’s tax authorities, also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a “competent authority” mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than the tax it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain an “anti-treaty-shopping” provision that is designed to limit treaty benefits to bona fide residents of the two countries.
III. OVERVIEW OF TAXATION IN SWEDEN

A. National Income Taxes

Overview

Sweden imposes an income tax on net income at the national and local levels upon net income from employment, investment, and business activities. The definition of income subject to tax within each enumerated category is, as in the United States, expansive, and generally includes capital gains. The tax is computed on an annual basis, and timing of income and deductions is generally determined by reference to commercial accounting rules. Sweden’s broad anti-avoidance statute may recharacterize for tax purposes any transaction in which a taxpayer has participated if the transaction produces, as its principal purpose, a substantial tax benefit in contravention of a policy of the tax law.

Individuals

Individuals resident in Sweden are taxed on their worldwide income. The rate of income tax imposed upon an item of income depends upon its characterization as employment, investment, or business income.

Employment income, including wages, salaries, pensions, directors’ fees, and most fringe benefits, is taxed at progressive national rates of 20 to 25 percent (approximately the first $37,500 of an individual’s employment income being wholly exempt from tax). The 20 percent tax rate is applied to individuals whose employment income is higher than $37,500 and 25 percent is applied to those whose income exceeds $57,000. National tax is also levied at a fixed amount of approximately $26 dollars on all individuals. In addition, varying municipal and county rates together averaging 31.6 percent are applied. Expenses bearing a very close relationship with the production of employment income, including business travel, are allowed as deductions from taxable employment income. A fixed personal deduction and a deduction for employee social security contributions are also allowed.

Investment income, including dividends, interest, rents, and gains from the sale of property not arising out of the conduct of a business, is subject to tax at a flat national rate of 30 percent. Two-thirds of the gain from the sale of a private residence is generally subject to tax as investment income, but, at the taxpayer’s election, may be deferred until the sale of a

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5 The information in this section relates to foreign law and is based on the Joint Committee staff’s review of publicly available secondary sources, including in large part “Taxes in Sweden,” a publication of an agency of the Swedish government, The Swedish Institute. The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition. Major law changes under the Swedish proposed budget for 2005, expected to apply from January 1, 2005, are noted.

6 U.S. dollar equivalents were calculated using an exchange rate of 7.7 Swedish kronor to one U.S. dollar and amounts are based on 2005 tax rates.
replacement residence purchased within one year. Net investment losses for a taxable year give rise to allowances against national tax at rates diminishing from 30 percent for losses below a threshold amount to 21 percent for larger losses.

Business income is aggregated with employment income for taxation at the same progressive rates. Private businesses may notionally deposit up to 25 percent of their income in a “profit equalization” account to defer taxation for not more than five years (and potentially avoid taxation at higher progressive rates).

An inflation-indexed exemption and certain pension contributions are allowed as deductions against taxable income.

**Corporations**

Companies resident in Sweden are generally subject to tax on their worldwide income at a rate of 28 percent. No local income taxes are imposed upon corporate profits. Capital gains are generally aggregated with all other income for taxation at progressive rates. Dividends paid by, and capital gains realized on sales of, shares in domestic companies held for business purposes are exempt from tax. Shares are considered to be held for business purposes if they are not treated as current assets under commercial accounting rules and if the shares are not publicly traded, represent 10 percent of the voting power in the issuing company, or are important in the organizational structure of the business of the holder or an affiliate. Dividends paid by foreign companies are exempt from tax if paid upon stock held for an aforementioned business purpose provided that the payor is subject to an income tax “similar” to the Swedish income tax: an income tax imposed at a rate of at least 15 percent with a similar base and timing rules. Normal corporate income taxes of foreign countries with which Sweden has concluded tax treaties are presumed similar to Swedish taxes. Companies may notionally deposit up to 20 percent of their income in a “profit equalization” account to defer taxation for not more than five years.
B. International Aspects of Taxation in Sweden

Individuals

Individuals resident in Sweden are generally taxed on their worldwide income. Individuals continually present in Sweden for a period of at least six months are generally considered residents for tax purposes. Nonresidents are subject to an income tax imposed at progressive rates upon income derived from employment in Sweden, including certain pensions; income derived from the conduct of a business through a permanent establishment in Sweden; and income and capital gains derived from real property located in Sweden. Nonresidents are further subject to a withholding tax of 30 percent on dividends paid by Swedish companies and a withholding tax of 30 percent on capital gains from the sale of shares in Swedish companies - the latter tax only being imposed upon nonresidents who have been residents of Sweden at some time within the past 10 years. Employment income received by Swedish residents for employment abroad (other than employment on Swedish ships or Swedish, Danish or Norwegian airplanes) is exempt from tax if the employment lasts at least six months, and the income is taxed in the country of employment; or if the employment lasts at least 12 months, and the income is exempt from tax in the country of employment. Employment income received by a nonresident for services performed in Sweden for a person other than the state or a municipality is exempt from tax if the recipient has been present in Sweden for fewer than 183 days within a 12-month period, the income is paid by a nonresident employer, and the income does not constitute an expense of a Swedish permanent establishment of the employer.

Corporations

Companies resident in Sweden are generally subject to tax on their worldwide income. Nonresident companies are generally subject to tax only on their income from sources within Sweden. Business income of a nonresident company is subject to taxation on a net basis at a rate of 28 percent, while dividend and royalty income of a nonresident company is subject, in the absence of a treaty, to withholding tax on a gross basis at a rate of 30 percent. (Sweden does not impose a withholding tax upon payments of interest.) However, dividends paid to nonresident companies owning at least 25 percent of the capital of the dividend-paying company are exempt from withholding tax. A Swedish resident company holding at least a 10 percent capital or voting interest in a “controlled foreign company” of which at least 50 percent of the capital or voting interest is held by Swedish residents will be taxed on its share of the foreign company’s profits if the foreign company is neither subject in its country of residence to an income tax considered similar to that of Sweden (and imposed at a rate of no less than 10 percent) nor a resident of a country, other than Australia, Cyprus, Malaysia, Spain, or Thailand, with which Sweden has concluded an income tax treaty. A company is considered to be resident in Sweden if it is incorporated under the laws of Sweden.

Relief from double taxation

In the absence of a treaty, Sweden generally provides double tax relief by way of a credit against Swedish tax. This foreign tax credit is generally commensurate with the amount of foreign taxes paid.
C. Other Taxes

Inheritance, gift and wealth taxes

The inheritance tax and gift tax were abolished in Sweden as of January 1, 2005. Wealth tax is imposed annually upon individuals, family trusts, and undivided estates of decedents resident in Sweden at a rate of 1.5 percent. Taxes are calculated based on the taxable wealth of an individual, which is determined based on various exemption thresholds.

Social security

Social security tax, which serves to finance pensions and various other social insurance programs, is imposed upon income of individuals earned within Sweden and not in excess of a threshold “normal” amount. Social security tax is collected through a 33 percent payroll tax imposed upon employers and a 31 percent self-employment tax imposed upon the self-employed.

Indirect taxes

Sweden imposes a value-added tax upon all increases in value throughout the Swedish production and distribution chains of goods and services. The generally applicable rate is 25 percent, but reduced rates are imposed upon certain goods and services. Goods and services for export outside the EU are wholly exempt from value-added tax. Excise duties are levied on certain consumer goods such as alcohol, tobacco, and petroleum products. A national real property tax is imposed at an annual rate of one percent of the assessed value of residential buildings within Sweden. Real estate values are assessed so as to equal approximately 75 percent of the fair market value of a particular piece of real property.
IV. THE UNITED STATES AND SWEDEN: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for business persons in one country who might aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who might aspire to own assets in the other country. Clarifying the application of the two nations’ income tax laws makes more certain the tax burden that will arise from different transactions, but may also increase or decrease that burden. Where there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment has the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed protocol it may be beneficial to examine the cross-border trade and investment between the United States and Sweden. When measuring by trade in goods or services or when measuring by direct and non-direct cross-border investment, the United States and Sweden engage in significant cross-border activity. The income from cross-border trade and investment generally is subject to income tax in either the United States or Sweden and in many cases the income is subject to withholding taxes.
B. Overview of International Transactions Between the United States and Sweden

Cross-border trade

The current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. While detail regarding the balance of payments between the United States and Sweden is not publicly available, one can document that the value of trade between the United States and Sweden is large. In 2004, the United States exported $3.3 billion of goods to Sweden and imported $12.7 billion in goods from Sweden. This made Sweden the United States’ 34th largest merchandise export destination and the 21st largest source of imported merchandise. In addition, in 2004, Swedish persons imported $3.6 billion of exported U.S. services, while U.S. persons imported $1.9 billion of services from Sweden.

Numerous disparate activities comprise trade in services. Among the sources of receipts from exported services are payments for transportation of goods, travel by persons and passenger fares, payments for professional services such as management consulting, architecture, engineering, and legal services, financial services, insurance services, computer and information services, and film and television tape rentals. Also included in receipts for services are the returns from investments in intangible assets in the form of royalties and license fees. In 2003, U.S. persons received approximately $460 million in royalty and license fees from Sweden. The majority of such receipts received were paid to U.S. parents from their affiliates in Sweden. In 2003, U.S. persons paid approximately $180 million in royalties and license fees to Swedish persons. The majority of such payments were from U.S. affiliates to their foreign parents.

Cross-border investment

Income from foreign assets is categorized as income from “direct investments” and income from “non-direct investments.” Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a


10 Ibid. Within Europe, Germany, Switzerland, the United Kingdom, the Netherlands, and France received more total payments of royalties and license fees from the United States in 2003.
single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as “portfolio investments,” and bank deposits and loans. Hence, the income from non-direct investments generally is interest or dividends.

The value of cross-border investment, U.S. investments in Sweden and Swedish investments in the United States is large. In 2004, U.S. persons held direct investments in Sweden valued at $36.4 billion on a historic cost basis and Swedish persons held direct investments in the United States valued at $23.9 billion. Figure 1, below, documents the value in U.S. direct investment in Sweden and Swedish direct investment in the United States on an historical cost basis at year-end for 2000 through 2004.

![Figure 1: Value of U.S. Direct Investments in Sweden and Swedish Direct Investments in The United States on an Historical Cost Basis, Year-End 2000-2004](chart)

Source: Bureau of Economic Analysis, U.S. Department of Commerce.

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U.S. direct investments in Sweden produced approximately $2.3 billion in income (net of withholding) to U.S. persons in 2004. Swedish direct investments in the United States produced approximately $2.2 billion in income (net of withholding) to Swedish persons in 2004. Figure 2, below, details income from U.S. direct investments in Sweden and Swedish direct investments in the United States (net of withholding taxes) for the period 2000-2004.

Figure 2.—Income From U.S. Direct Investments in Sweden and Swedish Direct Investments in the United States (net of withholding taxes), 2000-2004

Source: Bureau of Economic Analysis, U.S. Department of Commerce.


C. Income Taxes and Withholding Taxes on Cross-Border Income Flows

The data presented above show that U.S. persons own a substantial amount of direct investment in Sweden and Swedish persons own a substantial amount of direct investment in the United States. Data from tax returns reflect the substantial magnitudes of cross-border investment and trade and income flows reported above. In 2002, U.S. corporations with Swedish parent companies had $5.3 billion of income subject to tax and paid $1.3 billion in U.S. Federal income taxes. U.S. corporations, including U.S. parent companies of Swedish controlled foreign corporations, reported the receipt of $1.5 billion of dividends from Swedish corporations in 2000. Of the $1.5 billion in dividends reported, approximately $0.7 billion reflected the grossed up value of net dividends to account for deemed taxes paid to Sweden. U.S. corporations recognized about $1.3 billion in taxable income originating in Sweden, including the dividend amounts just cited. This income was subject to an average Swedish corporate income tax rate of approximately 52 percent (after allowing for apportionment and allocation of certain expenses incurred in the United States).

Data for withholding taxes from 2000 show that Sweden and the United States collected approximately the same amounts of receipts, with each country withholding under $100 million annually, by withholding tax on respective payments to each other.\textsuperscript{15} Data on withholding taxes may not be an accurate indicator of cross-border investment and income flows, because a taxpayer can often control the amount and timing of tax paid, and thus only pays withholding tax when dividends are repatriated to the home country.

D. Analyzing the Economic Effects of Protocols to Income Tax Treaties

Among other things, tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant economic effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources will result and economic growth in both countries will be enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation-on-benefits provision should reduce the potential for outright evasion of U.S. and Swedish income tax liabilities.

Generally, a treaty-based reduction in withholding rates will reduce directly U.S. tax collections in the near term on payments from the United States to Sweden, but will increase U.S. tax collections on payments from Sweden to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this initial dampening of collections on payments to Sweden and related decrease in foreign tax credits will begin to reverse. The protocol’s reductions in dividend withholding rates will reduce U.S. withholding tax collections on dividend payments from the United States to Sweden. Over the longer term, the withholding tax rate changes coupled with other changes in the protocol are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of a withholding change, or any other change in a treaty, would account for both tax and non-tax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.
V. EXPLANATION OF PROPOSED PROTOCOL

Article I. Personal Scope

Saving Clause

Like all U.S. income tax treaties and the U.S. model, the existing treaty includes a “saving clause,” which is set forth in Article 1 (Personal Scope). Under this clause, with specific exceptions, the treaty does not affect the taxation by the United States of its citizens or residents. Thus, the United States generally may continue to tax its citizens who are residents of Sweden as if the treaty were not in force.

Like other U.S. income tax treaties, the current treaty contains a provision under which the saving clause (and therefore U.S. taxing jurisdiction to the full extent of U.S. internal law in most respects) applies to a former U.S. citizen whose loss of citizenship status had as one of its principal purposes the avoidance of U.S. income tax. This provision was included to allow the United States to apply its special expatriation tax regime, set forth in section 877 of the Code.16

First enacted in 1966, this regime was designed to reduce opportunities for U.S. citizens to renounce their citizenship for the purpose of avoiding U.S. taxes. The regime has the main effect of expanding the scope of income that is subject to taxation by the United States, such that a former citizen or long-term resident to whom the rules apply is subject to U.S. tax on a somewhat broader basis than other nonresident aliens, but still on a narrower basis than a current U.S. citizen or resident. This special tax treatment applies for a period of 10 years, and thus the provision of the current treaty applies only for the 10-year period following the loss of U.S. citizenship.

Under the regime prior to its amendment in 1996, only former citizens were subject to these special tax rules, if they relinquished U.S. citizenship with a principal purpose of avoiding U.S. taxes. The Congress made several changes to the rules in 1996, including extending the special rules to certain former long-term residents of the United States who terminated U.S. residency with a principal purpose of avoiding U.S. taxes.

The proposed protocol would expand the application of the expatriation provision of the saving clause beyond former citizens, to include former long-term residents.17 This provision would update the treaty to reflect the amendments made to U.S. law in 1996.

Substantial changes to the special expatriation rules were included in the American Jobs Creation Act of 2004 (“AJCA”), which was signed into law on October 22, 2004 (nearly a year

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16 The Code also includes special expatriation-related rules for purposes of the estate and gift taxes. See Code secs. 2107 and 2501(a)(3).

17 Under the proposed protocol, the “tax” being avoided need not be the income tax, but could, for example, be the estate or gift tax. This would also be the case with respect to a former citizen.
before the proposed protocol was signed, on September 30, 2005). The proposed protocol reflects these recent changes.

AJCA eliminated prior law’s subjective determinations of tax-avoidance purpose and replaced them with objective rules for determining the applicability of the special tax regime for expatriates. Under the regime as amended by AJCA, a former citizen or former long-term resident is subject to the special income, estate, and gift tax rules for expatriates unless the individual: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth is less than $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all Federal tax obligations for the preceding five years and provides such evidence of compliance as the Treasury Secretary may require. Thus, as a result of AJCA, the application of the expatriation tax regime no longer turns on determinations of whether a person had a principal purpose of tax avoidance, as it often did prior to AJCA.

Fiscally transparent entities

The proposed protocol contains special rules for fiscally transparent entities. Under these rules, income derived through an entity that is fiscally transparent under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in that country as the income of a resident. For example, if a Swedish company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest income for U.S. tax purposes.

The Technical Explanation states that these rules for income derived through fiscally transparent entities apply regardless of where the entity is organized (i.e., in the United States, Sweden, or a third country). The Technical Explanation also states that these rules apply even if the entity is viewed differently under the tax laws of the other country. As an example, the Technical Explanation states that income from U.S. sources received by an entity organized under the laws of the United States, which is treated for Swedish tax purposes as a corporation and is owned by a Swedish shareholder who is a Swedish resident for Swedish tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent.

Article II. Taxes Covered

Article II of the proposed protocol modifies and updates outdated references to applicable Swedish taxes in Article 2 (Taxes Covered), paragraph 1(b) of the existing treaty. Under the proposed protocol, Swedish taxes to which the treaty applies are the national income tax, the withholding tax on dividends, the income tax on non-residents, the income tax on non-resident artistes and athletes, the national capital tax (for purposes of Article 2, paragraph 3 of the existing treaty), the excise tax imposed on insurance premiums paid to foreign insurers, and the municipal income tax.
Article III. Residence

Article III of the proposed protocol replaces the definition of the term “resident of a Contracting State” that appears in paragraph 1 of Article 4 (Residence) of the current treaty. Under paragraph 1, as modified by the proposed protocol, “resident of a Contracting State” means any person who, under the laws of that country, is subject to tax there by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature, and also includes that country and any political subdivision or local authority of that country. However, persons who are subject to tax in a treaty country only on income from sources in that country or on profits attributable to a permanent establishment in that country are not considered residents of that country under the proposed protocol. Thus, an alien of the United States who is considered to be a resident under the U.S. tax law (e.g., because he holds a “green card”) is a resident of the United States under the proposed protocol. In addition, certain entities that are nominally subject to tax but are rarely required to pay tax, such as regulated investment companies (“RICs”), real estate investment trusts (“REITs”), and real estate mortgage investment conduits (“REMICs”), are all residents of the United States under the proposed protocol.

Article III of the proposed protocol also provides that certain legal entities, such as pension funds and charitable organizations, that are organized under the laws of a treaty country, established and maintained in that country, and generally tax-exempt in that country are regarded as residents of that country. The provision applies to entities established and maintained in that country (1) exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, or (2) to provide pensions or other similar retirement benefits pursuant to a plan.

Article III of the proposed protocol does not change the other provisions of Article 4 of the current treaty.

Article IV. Dividends

Overview

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol would retain both the generally applicable maximum rate of withholding at source of 15 percent and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. However, like several other recent treaties and protocols, the proposed protocol would provide for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. A zero rate also generally would apply to dividends received by a pension fund. As in the current treaty, special rules would apply to dividends received from RICs and REITs, with some new modifications applicable to dividends from REITs, similar to provisions included in other recent treaties and protocols.

Internal taxation rules

United States. The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The
30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax on such dividends on a net basis at graduated rates in the same manner that a U.S. person would be taxed.

Under U.S. law, the term “dividend” generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A REIT is a corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. In order to qualify for the deduction for dividends paid, a REIT must distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. Because a REIT is taxable as a U.S. corporation, a distribution of its earnings is generally treated as a dividend rather than income of the same type as the underlying earnings. Such distributions are subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, the receipt of a distribution from a REIT is generally treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT.18

A REIT is generally organized to allow persons to diversify ownership in primarily passive real estate investments. As such, the principal income of a REIT often is rentals from real estate holdings. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have such rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law.

U.S. internal law also generally treats a RIC as both a corporation and a conduit for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio

18 There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Sec. 897(h)(1). Such distributions are treated as dividends under U.S. internal law.
of securities. Dividends paid by a RIC are generally treated as dividends received by the payee, and the RIC generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, before January 1, 2008, net short-term, capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has such net capital gains. Nonresident aliens and foreign corporations are generally not subject to tax on capital gains. Notwithstanding, a distribution made by a RIC to a nonresident alien or a foreign corporation before January 1, 2008 is treated as gain recognized by such person from the sale or exchange of a U.S. real property interest to the extent such gain is attributable to gain from sales or exchanges of U.S. real property interests.

Similarly, a RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")\(^\text{19}\) may generally designate a dividend it pays prior to January 1, 2008 as derived from such interest income, to the extent of such income. Nonresident aliens and foreign corporations are not subject to tax on such interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to such interest income.

Sweden.—Sweden generally imposes withholding tax at a rate of 30 percent on dividends paid to nonresidents. However, dividends paid to nonresident companies owning at least 25 percent of the capital of the dividend-paying company are exempt from withholding tax.

Proposed protocol limitations on internal law

In general.—Under the proposed protocol, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in such other country. Such dividends also may be taxed by the country in which the payor company is resident, but the rate of such tax is limited. Under the proposed protocol, source-country taxation of dividends (i.e., taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower rate of five percent applies if the beneficial owner of the dividend is a company that owns shares representing at least 10 percent of the voting power in the dividend-paying company.

The term “beneficial owner” is not defined in the current treaty or proposed protocol, and thus is defined under the internal law of the source country. The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the

\(^\text{19}\) Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.
dividend income is attributable for tax purposes under the laws of the source country. Further, companies holding shares through fiscally transparent entities, such as partnerships, are considered to hold their proportionate interest in the shares.

In addition, the proposed protocol provides a zero rate of withholding tax with respect to certain intercompany dividends in cases in which there is a sufficiently high (80-percent) level of ownership (often referred to as “direct dividends”). A zero rate also would apply with respect to dividends received by a tax-exempt pension fund, provided that such dividends are not derived from the carrying on of a business, directly or indirectly, by such fund or through an associated enterprise, and the fund does not sell or make a contract to sell the holdings from which such dividend is derived within two months of acquiring the holdings.

Zero rate for direct dividends.—Under the proposed protocol, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. Under the current treaty, these dividends may be taxed at a five-percent rate. The 80-percent ownership requirement under this provision may be satisfied by either direct or indirect ownership (through one or more residents of either contracting state).

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than normally would apply under the proposed protocol. Specifically, in order to qualify for the zero rate, the dividend-receiving company must either: (1) meet the public trading test of the limitation-on-benefits article; (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) meet the derivative benefits test of the limitation-on-benefits article; or (4) receive a favorable determination from the competent authority with respect to the zero-rate provision.

The Technical Explanation states that these additional restrictions are intended to prevent companies from reorganizing in order to become eligible for the zero rate. As an example, the Technical Explanation describes a situation in which a company resident in a third country that does not have a zero-rate treaty provision with the United States might contribute the stock of a wholly owned U.S. subsidiary to a wholly owned Swedish subsidiary in order to secure the benefit of the zero rate on a dividend from the U.S. subsidiary. In such a case, the Technical Explanation explains that treaty shopping could occur notwithstanding the Swedish company’s satisfaction of the active trade or business test with respect to the dividend. For this reason, the

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20 The IRS has ruled privately, in connection with a situation arising under the recently adopted U.S.-U.K. zero-rate provision, that entities disregarded under the U.S. entity classification regulations also are disregarded for purposes of determining whether certain ownership requirements of the zero-rate provision are satisfied. Thus, stock owned through a disregarded entity (established under the laws of a third country) was treated as owned directly for purposes of applying the holding period requirement of that provision (which, according to that treaty’s Technical Explanation, required direct ownership). See Priv. Ltr. Rul. 200522006.
The proposed protocol would not allow the benefits of the zero rate to be claimed by a company that meets only the active trade or business test of the limitation-on-benefits article.

The Technical Explanation notes that, in the case of a Swedish company receiving dividends from a U.S. subsidiary, the derivative benefits test might be satisfied if the Swedish company is wholly owned, for example, by a publicly traded company resident in an EU, EEA, or NAFTA country (or, potentially, Switzerland) with which the United States has a zero-rate treaty provision (a list that currently includes only the United Kingdom, Netherlands, and Mexico). In the case of a U.S. company receiving dividends from a Swedish subsidiary, the derivative benefits test could be satisfied if the U.S. company is wholly owned by a company resident in the European Union, because the EU Parent-Subsidiary Directive would exempt from withholding tax a dividend paid directly by the Swedish company to an EU parent company.

The proposed protocol also modifies the application of the derivative benefits test in the context of the zero-rate provision, in order to ensure that certain joint ventures may qualify for the zero rate. Specifically, in determining whether a shareholder of a dividend-receiving company is an equivalent beneficiary, each such shareholder is treated as owning shares in the dividend-paying company with the same percentage voting power as the shares held by the dividend-receiving company for purposes of determining entitlement to the zero rate. Thus, as the Technical Explanation describes, a Swedish company owned 49 percent by another Swedish company, and 51 percent by a company resident in another EU country that has an identical zero-rate provision with the United States, would be able to qualify via the derivative benefits test for the zero rate on a dividend received from a U.S. company, despite the fact that neither shareholder of the dividend-receiving company would meet the 80-percent ownership test individually.

The Technical Explanation also provides some guidance as to how the competent authority discretion to grant the benefits of the zero-rate provision is intended to be exercised. Specifically, the Technical Explanation states that the U.S. competent authority will consider the obligations imposed upon Sweden by its membership in the European Union in determining whether to grant U.S. tax benefits. The U.S. competent authority also will consider the differing internal tax systems, tax incentive regimes, and tax treaty practices of the relevant countries. Thus, if a Swedish company receives dividends from a U.S. subsidiary, the fact that the Swedish company is wholly owned by a company resident in another EU country would weigh in favor of a positive competent authority determination. However, the Technical Explanation notes, this positive factor could be outweighed by negative factors, such as third-country tax incentive regimes that eliminate any domestic taxation, among others.

Dividends paid by U.S. RICs and REITs.—The proposed protocol generally denies the five percent and zero rates of withholding tax to dividends paid by RICs and REITs in the United States.

The 15-percent rate of withholding generally is allowed for dividends paid by a RIC. The 15-percent rate of withholding is allowed for dividends paid by a REIT, provided one of four additional conditions is met: (1) the beneficial owner of the dividend is an individual or pension fund holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of shares that is publicly traded, and the beneficial owner of the dividend is a
person holding an interest of not more than five percent of any class of the REIT’s shares; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than five percent, and the REIT is “diversified” (i.e., the value of no single interest in real property held by the REIT exceeds 10 percent of the total interest of the REIT in real property).

The Technical Explanation indicates that the restrictions on availability of the lower rates are intended to prevent the use of RICs and REITs to gain unjustifiable U.S. tax benefits. For example, a company resident in Sweden could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 15 percent on dividends on those shares. Absent these restrictions, there is a concern that such a company instead might purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and thereby obtain a lower withholding tax rate by holding the portfolio through the RIC (transforming portfolio dividends generally taxable at 15 percent into direct investment dividends taxable under the treaty at zero or five percent).

Similarly, the Technical Explanation provides an example of a resident of Sweden directly holding real property and required to pay U.S. tax either at a 30-percent rate on gross income or at graduated rates on the net income. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the lower rates provided in the proposed protocol. The limitations on REIT dividend benefits are intended to protect against this result.

Definitions and special rules and limitations. The proposed protocol generally defines “dividends” as income from shares or other corporate participation rights that are not treated as debt, as well as other amounts that are subjected to the same tax treatment as income from shares by the source country (e.g., constructive dividends). The term “dividends” also includes income from arrangements, including debt obligations, carrying the right to participate in profits. In the case of the United States, contingent interest of a type that would not qualify as portfolio interest would be treated as a dividend under this definition.

The proposed protocol’s reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country, or performs in the source country independent personal services from a fixed base located in that country, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such cases, the dividends effectively connected to the permanent establishment or the fixed base are taxed as business profits (Article 7) or income from independent personal services (Article 14), as the case may be.

The proposed protocol prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country, unless such dividends are paid to a resident of the first country or are attributable to a permanent establishment or fixed base in such country.

The proposed protocol provides an exemption from U.S. excise taxes imposed with respect to private foundations in the case of a religious, scientific, literary, educational, or charitable organization that is resident in Sweden and that has received substantially all of its support from persons other than citizens or residents of the United States.
The proposed protocol also allows each treaty country to impose a branch profits tax on a company that has income attributable to a permanent establishment in such country, derives income from real property in such country that is taxed on a net basis under the treaty, or realizes gains taxable in such country under the treaty. In the case of the United States, the tax is limited to the “dividend equivalent amount,” consistent with the branch profits tax under U.S. internal law (Code section 884). In the case of Sweden, which currently does not impose a branch profits tax under its internal law, the tax would be limited to the portion of the aforementioned items that is comparable to the amount would be distributed as a dividend by a locally incorporated subsidiary. The rate of branch profits tax is generally limited to five percent, but a zero rate applies where limitation-on-benefits requirements parallel to those applicable to the zero-rate provision for dividends are satisfied.

The proposed protocol defines a “pension fund” as a person that is organized under the laws of Sweden or the United States, is established and maintained in such country primarily to administer or provide pensions or other similar remuneration, including social security payments, and is exempt from tax in such country.

Relation to other Articles

The Technical Explanation notes that the saving clause of paragraph 4 of Article 1 of the treaty (Basis of Taxation) permits the United States to tax dividends received by its residents and citizens as if the proposed protocol had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 17 of the treaty (Limitation on Benefits).

Article V. Limitation on Benefits

In general

The proposed protocol replaces Article 17 (Limitation on Benefits) of the present treaty with an article that better reflects the limitation on benefits provisions included in more recent U.S. income tax treaties. These provisions are intended to limit the benefits of the treaty to residents of the United States and Sweden who satisfy the requirements of the article and any other specified conditions in other articles for the obtaining of benefits.

The proposed protocol is intended to limit double taxation caused by the interaction of the tax systems of the United States and Sweden as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as “treaty shopping,” which refers to the situation where a person who is not a resident of either treaty country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the third-country resident may be able to secure these benefits indirectly by establishing a corporation or other entity in one of the treaty countries, which entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions either through relaxed tax provisions in the distributing country or by
passing the funds through other treaty countries until the funds can be repatriated under favorable terms.

Generally, a resident of either country qualifies for the benefits accorded by the proposed treaty if such resident is within one of the following categories (and satisfies any other specified conditions for obtaining benefits):

1. An individual;
2. One of the two countries or a political subdivision or local authority of one of the two countries;
3. A company that satisfies a public company test and certain subsidiaries of such companies;
4. An entity that is generally tax exempt in the country in which it is organized, that operates in that country to provide pensions pursuant to a plan, and that meets a beneficiary or sponsor test;
5. An organization operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes; or
6. An entity that satisfies an ownership test and a base erosion test.

Alternatively, a resident that does not fit into any of the above categories may claim treaty benefits with respect to certain items of income under the derivative benefits test or the active business test. Notwithstanding the preceding provisions, special anti-abuse rules govern certain items of insurance premiums, interest, or royalties derived from the United States in so-called “triangular cases.” Finally, a person that does not satisfy any of the above requirements may be entitled to the benefits of the proposed treaty if the source country’s competent authority so determines.

**Individuals**

Under the proposed protocol, individual residents of the United States and Sweden are entitled to all treaty benefits. However, if such an individual receives income as a nominee on behalf of a third country resident, and thus is not the beneficial owner of such income, benefits may be denied.

**Governmental entities**

The proposed protocol provides that the United States or Sweden, or any political subdivision or local authority of the two countries, is entitled to all treaty benefits.

**Publicly traded companies and subsidiaries**

A company that is a resident of Sweden or the United States is entitled to all treaty benefits if the principal class of its shares, and any disproportionate class of shares, is regularly
traded on one or more recognized stock exchanges, and one of two additional requirements are met. The two alternative requirements (a public trading connection test and a management and control test) incorporate and simplify the essential elements of the “substantial presence” test in the country of residence (that was contained in the recent protocol with the Netherlands) in order for a company to qualify for treaty benefits under the public company test. Unlike the limitation on benefits provision in the recent protocol with the Netherlands, and in recognition of European integration, the proposed protocol does not require that the shares be listed in a recognized stock exchange in a treaty country.

The first alternative requirement determines whether public trading constitutes an adequate connection to the geographic region in which the residence country is located. The requirement is met if the company’s principal class of shares is primarily traded (1) on a recognized stock exchange in the treaty country in which the company is resident, (2) in the case of a company resident in the United States, on a recognized stock exchange located in a third country that is a party to the North American Free Trade Agreement (“NAFTA”), and (3) in the case of a company resident in Sweden, on a recognized stock exchange located in the European Economic Area (“EEA”), the European Union (“EU”), or in Switzerland.

The term “recognized stock exchange” means the NASDAQ System owned by the National Association of Securities Dealers; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934, the Stockholm Stock Exchange, the Nordic Growth Market, and any other stock exchange subject to regulation by the Swedish Financial Supervisory Authority. The term also includes the Irish Stock Exchange and the stock exchanges of Amsterdam, Brussels, Copenhagen, Frankfurt, Hamburg, Helsinki, London, Madrid, Milan, Oslo, Paris, Reykjavik, Riga, Tallinn, Toronto, Vienna, Vilnius, Zurich, and any other stock exchange agreed upon by the competent authorities of the United States and Sweden.

The term “principal class of shares” means the ordinary or common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the “principal class of shares” means that class or any combination of classes of shares that represents, in the aggregate, a majority of the aggregate voting power and value of the company. The term “shares” includes depository receipts for shares.

The term “disproportionate class of shares” means an outstanding class of shares, of a company resident in a treaty country, which is subject to terms or other arrangements that entitle the holder to a larger portion of the company’s income, profit, or gain in the other country, when compared to its participation in overall assets or activities of the company, than that to which the holder would be entitled in the absence of such terms or arrangements. For example, a company resident in Sweden meets this test if it has outstanding a class of “tracking stock” (or preferred stock) that pays dividends based upon a formula that approximates the company’s return on its assets employed in the United States.

A class of shares is considered to be “regularly traded” on one or more recognized stock exchanges in a taxable year if the aggregate number of shares of that class traded during the
preceding taxable year is at least six percent of the average number of shares outstanding in that class during that preceding taxable year. According to the Technical Explanation, if a class of shares was not listed on a recognized stock exchange during the preceding taxable year, the class of shares will be treated as regularly traded only if that class meets the aggregate trading requirements for the taxable year in which the income arises. The Technical Explanation further states that the “regularly traded” requirement can be met by aggregating trading on one or more of the recognized stock exchanges.

The second alternative requirement determines whether the company’s primary place of management and control is in the treaty country where it is a resident. A company whose principal class of shares (and any disproportionate class of shares) is regularly traded on a recognized stock exchange but can not meet the public trading connection requirement may claim treaty benefits if its primary place of management and control is in the treaty country of which it is a resident. A company’s primary place of management is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in the residence country than in any other country, and the staffs conduct more of the day-to-day activities necessary for preparing and making those decisions in that country than in any other country.

The Technical Explanation notes that the management and control test should be distinguished from the “place of effective management” test which is used by many countries and in the OECD model to establish residence. The place of effective management test has often been interpreted to mean the place where the board of directors meets. Under the proposed protocol, however, the primary place of management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

In addition, a company does not itself pass the requirements above, for example, because its shares are not publicly traded, is entitled to treaty benefits if it is a resident of the United States or Sweden and at least 50 percent of the aggregate voting power and value of the company’s shares (and at least 50 percent of any disproportionate class of its shares) is owned (directly or indirectly) by five or fewer companies that satisfy the test previously described, provided that, in the case of indirect ownership, each intermediate owner used to satisfy the control requirement is a resident of the United States or Sweden. This rule allows certain subsidiaries of publicly traded companies to take advantage of all benefits under the treaty.

**Tax-exempt pensions**

Under the proposed protocol, a pension organization that is resident in a treaty county and generally exempt from tax there is entitled to all the benefits of the treaty if, as of the close of the end of the prior taxable year, more than 50 percent of the beneficiaries, members, or participants of the organization are individuals resident in either the United States or Sweden, or if the organization sponsoring the pension is entitled to the benefits of the treaty. According to the Technical Explanation, for purposes of this provision, the term “beneficiaries” should be understood to refer to the persons receiving benefits from the organization.
Other tax-exempt organizations

Under the proposed protocol, an organization (other than a pension) that is resident in a treaty country and generally exempt from tax there is entitled to treaty benefits if it is organized under the laws of the United States or Sweden and established and maintained exclusively for religious, charitable, educational, scientific, artistic, cultural, or educational purposes. There is no requirement that specified percentages of the beneficiaries of these organizations be residents of the United States or Sweden.

Ownership and base erosion tests

An entity that is a resident of one of the countries under the proposed protocol is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

Under the ownership test, on at least half the days of the taxable period, at least 50 percent of each class of shares or other beneficial interests must be owned (directly or indirectly) by residents of the same treaty country in which the entity is resident, and who are entitled to treaty benefits under this article as individuals, governmental entities, parent companies that meet the public company test, tax-exempt pensions, or tax-exempt organizations.

The base erosion test is satisfied only if less than 50 percent of the person’s gross income for the taxable year, as determined in the person’s country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person’s country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governmental entities, parent companies that meet the public company test, tax-exempt pensions, or tax-exempt organizations. However, these amounts do not include arm’s-length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank that is not related to the payor. According to the Technical Explanation, deductible payments also do not include (1) such payments to a bank that is a resident of a treaty country or that has a permanent establishment in either treaty country to which such payment is attributable, or (2) depreciation and amortization deductions.

In the case of Sweden, the notes to the proposed protocol provide that for these purposes, the amount of a person’s deductible payments and gross income is reduced by the amount of “group contributions” paid to a Swedish resident or Swedish permanent establishment. Group contributions are special payments between related Swedish companies that effect tax consolidation.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Residence), as amended by the proposed protocol, and they otherwise satisfy the ownership and base erosion tests.

Derivative benefits rule

The proposed protocol contains a derivative benefits rule that is potentially applicable to all treaty benefits of a company, although the test is applied to individual items of income. This rule effectively allows a Swedish company, for example, to receive “derivative benefits” in the sense that it derives its entitlement to U.S. tax reductions in part from the U.S. treaty benefits to
which its owners would be entitled if they earned the income directly. If the requirements of this rule are satisfied, a company that is resident in one of the treaty countries will be entitled to the benefits of the proposed protocol.

A company resident in one of the countries satisfies this rule if both ownership and base erosion requirements are met. Under the ownership requirement, shares representing at least 95 percent of the aggregate voting power and value of the shares of the company (and at least 50 percent of any disproportionate class of shares) must be owned, directly or indirectly, by seven or fewer persons that are “equivalent beneficiaries.”

For this purpose, an equivalent beneficiary means a resident of (1) a member state of the EU, (2) any other EEA country, (3) a party to NAFTA, or (4) Switzerland, but only if one of two sets of alternative conditions are satisfied. The first set of alternative conditions consists of two requirements. Under the first requirement, that resident must be entitled to all the benefits of a comprehensive tax treaty between its residence country and the country from which the benefits of the proposed treaty are being claimed, under provisions analogous to the rules of this article relating to individuals, governmental entities, parent companies that meet the public company test, tax-exempt pensions, or tax-exempt organizations. However, if such treaty does not contain a comprehensive limitation on benefits provision, then the person must be a person that would be entitled to the benefits under the rules of this article relating to individuals, governmental entities, parent companies that meet the public company test, tax-exempt pensions, or tax-exempt organizations, if such person were a resident of the United States or Sweden under the current treaty (as amended by the proposed protocol).

Under the second requirement, with respect to items of insurance premiums, dividends, interest, and royalties, the resident (i.e., the potential equivalent beneficiary which is a resident of an EU, EEA, or NAFTA member country, or of Switzerland) must be entitled under such treaty to a rate of withholding tax for that item that is at least as low as the rate applicable to such income under the U.S.-Sweden treaty, as modified by the proposed protocol. Under this test, the appropriate comparison is between (1) the favorable withholding rate imposed under the treaty, as modified by the proposed protocol, to items paid by the source treaty country to a resident of the other treaty country, and (2) the withholding rate that would be imposed if the payment was from the source country directly to a resident of the third state. The resident of the third state is an equivalent beneficiary if it is not obtaining a rate advantage by being resident in the third state rather than the other treaty country, and the first requirement is met.

The Technical Explanation sets forth the following example of this comparison. A U.S. company, USCo, is a wholly owned subsidiary of SCo, a company resident in Sweden. SCo is wholly owned by ICo, a corporation resident in Italy. Assuming SCo satisfies the requirements of paragraph 3 of Article 10 (Dividends), SCo would be eligible for a zero rate of withholding tax. The dividend withholding rate in the treaty between the United States and Italy is five percent. Thus, if ICo received the dividend directly from USCo, ICo would have been subject to a five percent rate of withholding tax on the dividend. Because ICo would not be entitled to a rate of withholding tax that is at least as low as the rate that would apply under the current treaty (as modified by the proposed protocol) to such income (i.e., zero), ICo is not an equivalent beneficiary.
The proposed protocol provides a special rule to take into account the fact that withholding taxes on many intercompany dividends, interest, and royalties are exempt within the EU by reason of various EU directives, rather than by tax treaty. If a U.S. company receives such payments from a Swedish company, and that U.S. company is owned by a company resident in an EU member state that would have qualified for an exemption from Swedish withholding tax pursuant to any directive of the EU if it had received the income directly, the EU parent company will be treated as an equivalent beneficiary. The Technical Explanation notes that this rule is necessary because many EU member countries have not re-negotiated their tax treaties to reflect the rates applicable under the directives.

Under the second set of alternative conditions for qualifying as an equivalent beneficiary, the person must be a resident of either the United States or Sweden, and must be entitled to the benefits of the U.S.-Sweden treaty, as modified by the proposed protocol, under the rules of this article relating to individuals, governmental entities, parent companies that meet the public company test, tax-exempt pensions, or tax-exempt organizations. Thus, an individual resident in Sweden will be an equivalent beneficiary without regard to whether it would have been entitled to the same benefits if it received the income directly.

The base erosion test for derivative benefits is similar to the “regular” base erosion test described above, with certain modifications. The base erosion test relating to derivative benefits is satisfied only if less than 50 percent of the person’s gross income for the taxable year, as determined in the person’s country of residence, is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries (as defined above) in the form of payments deductible in the company’s country of residence. Thus, the only difference between the base erosion test for derivative benefits and the “regular” base erosion test is that in the former case deductible payments made to equivalent beneficiaries, rather than amounts paid to residents of the United States or Sweden, are not counted against a company for purposes of determining whether the company exceeds the 50-percent limit.

Active business test

Under the proposed protocol, residents of one of the treaty countries are entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, and (2) the income from the other country is derived in connection with that trade or business or is incidental to that trade or business. The proposed protocol provides that the business of making or managing investments for the resident’s own account does not constitute an active trade or business unless these activities are banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer.

The term “trade or business” is not defined in the current treaty or proposed protocol. According to the Technical Explanation, pursuant to paragraph 2 of Article 3 (General Definitions) of the current treaty, when determining whether a resident of Sweden is entitled to the benefits of the treaty under the active business test with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the law of the United States. Accordingly, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term “trade or
business.” In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates upon the “in connection with” and “incidental” rules. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that “forms a part of” or is “complementary to” the trade or business conducted in the residence country by the income recipient.

According to the Technical Explanation, a business activity generally will be considered to form part of a business activity conducted in the country of source if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the country of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation also states that for two activities to be considered to be “complementary,” the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first out of earnings and profits of the treaty-benefited trade or business, and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

The Technical Explanation further states that an item of income derived from the country of source is “incidental to” the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

The proposed protocol provides that if a resident of a treaty country or any of its associated enterprises carries on a trade or business activity in the other country which gives rise to an item of income, the active business test applies only if the trade or business activity in the residence country is substantial in relation to the trade or business activity in the source country. The determination is made separately for each item of income derived from the source country.
The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (i.e., activities that have little economic cost or effect with respect to the company business as a whole). The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each country (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country. According to the Technical Explanation, in making each determination or comparison, due regard will be given to the relative sizes of the U.S. and Swedish economies.

The proposed protocol provides that, in determining whether a person is engaged in the active conduct of a trade or business in a treaty country, activities conducted by persons “connected” to such person are deemed to be conducted by such person. A person is “connected” to another if one possesses at least 50 percent of the beneficial interest in the other (in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company), or another person possesses, directly or indirectly, that requisite interest in each of the two entities. A person is also considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

The triangular case

The proposed protocol provides a special anti-abuse rule that addresses the use of the following structure to earn certain types of income from the United States. The resident of Sweden (who is otherwise qualified for benefits under this article) sets up a permanent establishment in a third country that imposes a relatively low rate of tax on the income of the permanent establishment. The permanent establishment is an integral part of the Swedish resident. The permanent establishment earns interest, royalties, or insurance premiums that would be entitled to exemption under this article (absent this provision). Under the current tax treaty between Sweden and the third country, Sweden does not tax the income earned by the permanent establishment. Consequently, the income is not taxed in Sweden or the United States, and is only lightly taxed, if at all, in the third country.

Under the proposed protocol, the United States may impose withholding tax on such payments if the tax actually paid with respect to the income in the third country is less than 60 percent of the tax that would have been payable to Sweden if the income were earned in Sweden and were not attributable to the permanent establishment in the third country. However, in such a case the U.S. withholding tax rate is limited to 15 percent with respect to interest and royalties, while insurance premiums are subject to full tax under the U.S. domestic tax law rules. According to the Technical Explanation, the principles of the subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The anti-abuse rule does not apply in the case of interest if the income from the United States is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of
making, managing, or simply holding investments for the enterprise’s own account, unless these activities are banking or securities activities carried on by a bank or a registered securities dealer). In the case of royalties, the anti-abuse rule does not apply if the royalties are received from the United States as compensation for the use of, or the right to use, intangible property that has been produced or developed by the permanent establishment itself.

Because the United States does not exempt the profits of a third-country permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty, the anti-abuse rule only applies with respect to U.S.-source insurance premiums, interest, or royalties that are attributable to a third-country permanent establishment of a Swedish resident.

Grant of treaty benefits by the competent authority

The proposed protocol provides that a resident of a treaty country that is not otherwise entitled to benefits under this article may still be granted treaty benefits if the competent authority of the other country determines that the establishment, acquisition, or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty. The competent authority may determine to grant all treaty benefits, may determine to grant benefits only with respect to a particular item of income, or may set time limits on the duration of any relief granted. This provision acts as a “safety-valve” for a person that has not established that it meets one of the objective tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty.

According to the notes to the proposed protocol, and the Technical Explanation, in applying this provision the competent authorities will consider the obligations of Sweden by virtue of its membership in the EU. In particular, the competent authorities will consider any legal requirements for the facilitation of the free movement of capital and persons, the differing internal tax systems, tax incentive regimes, and existing tax treaty policies among member states of the EU. Accordingly, where certain changes in circumstances might cause a person to cease to qualify for treaty benefits under the objective limitation on benefits provisions, such changes need not result in the denial of benefits under the treaty. The changes in circumstances contemplated by the Technical Explanation include, all under ordinary business conditions: (1) a change in the country of residence of a major shareholder of the company, (2) the sale of part of the stock of a Swedish company to a resident in another member state of the EU, (3) or an expansion of a company’s activities in other member states of the EU. If the competent authority is satisfied that these changed circumstances are not attributable to tax avoidance motives, this will also count as a factor weighing in favor of continued qualification for benefits under this provision.

The proposed protocol provides that the competent authority of the source country must consult with the competent authority of the residence country before refusing to grant benefits under this provision.
Article VI. Government Service

The proposed protocol modifies Article 20 (Government Service) by adding a new paragraph providing that Sweden may not impose tax on a pension paid by the U.S. government to Swedish citizens and residents (including those entitled to survivor benefits) who were hired prior to 1978 to work for the U.S. embassy in Stockholm or the U.S. consulate general in Gothenburg, if the individual was covered under the U.S. Civil Service retirement plan.

The proposed protocol has the effect of modifying the rule of the present treaty providing that a government pension paid by one treaty country to a resident of the other may be taxed only in the residence country. Prior to the present treaty, the previous treaty had provided a different rule: pensions paid by the government or a political subdivision of one treaty country to a resident of the other were specifically exempted from taxation in the residence country (Article 10 of the previous treaty).

The Technical Explanation notes that the U.S. government had reduced the salaries paid to Swedish residents and citizens working at the U.S. embassy in Stockholm or the U.S. consulate general in Gothenburg to take account of the fact that they were exempt from Swedish income tax under the terms of the 1939 treaty. As a result, their pensions, which were based on their salaries, were automatically reduced. Such employees and former employees were not exempted from the change permitting Sweden to tax government pensions when the present treaty was adopted in 1994. The Technical Explanation states that the proposed protocol adds a grandfather rule to prevent the unintended consequences resulting from the provision of the 1994 treaty.

Article VII. Relief from Double Taxation

The proposed protocol makes conforming changes to Article 23 (Relief from Double Taxation) to reflect the amendments made to the saving clause of paragraph 4 of Article 1 (Personal Scope) regarding former citizens and former long-term residents of the United States.

Article VIII. Entry into Force

Article VIII of the proposed protocol contains the rules for ratification, entry into force, and effective date of the provisions of the proposed protocol.

Paragraph 1 of the article provides that the proposed protocol is subject to the ratification procedures of each country. Each treaty country will notify the other when it has completed its required ratification procedures, through the diplomatic channel, accompanied by an instrument of ratification.

Paragraph 2 of the article provides that the proposed protocol will enter into force on the 30th day after the later of the notifications described in the immediately preceding paragraph. With respect to withholding taxes, the provisions of the proposed protocol will have effect for amounts paid or credited on or after the first day of the second month next following the date on which the proposed protocol enters into force. In respect of taxes on income covered by Article VI of the proposed protocol, relating to the taxation by Sweden of pensions of certain employees of the U.S. embassy in Stockholm or the U.S. consulate general in Gothenburg, the provisions
will have effect for income derived on or after January 1, 1996. With respect to other taxes, the provisions of the proposed protocol will have effect for taxable years beginning on or after the first day of January next following the date on which the proposed protocol enters into force.

Paragraph 3 of the article provides that the proposed protocol will remain in effect as long as the treaty remains in force.

**Exchange of Notes**

At the signing of the protocol, notes were exchanged dealing with the exchange of information (Article 26) under the treaty. The notes provide that the powers of each country’s competent authority to obtain information include the ability to obtain information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity. The notes clarify that this authority does not include the ability to obtain information that would reveal confidential communications between a client and an attorney, solicitor, or other legal representative, where the client seeks legal advice. The notes also provide that the competent authorities may obtain information relating to the ownership of legal persons (e.g., the identity of a beneficial owner of bearer shares). The notes confirm that each country’s competent authority is able to exchange such information in accordance with this article.
VI. ISSUES

A. Zero Rate of Withholding Tax on Dividends from 80-Percent-Owned Subsidiaries

In general

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

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

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

Description of provision

Under the proposed protocol, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. The 80-percent ownership requirement under this provision may be satisfied by either direct or indirect ownership (through one or more residents of either contracting state).

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than normally would apply under the proposed protocol. Specifically, in order to qualify for the zero rate, the dividend-receiving company must either: (1) meet the public trading test of the limitation-on-benefits article; (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) meet the derivative benefits test of the limitation-on-
benefits article; or (4) receive a favorable determination from the competent authority with respect to the zero-rate provision.

**Issues**

**In general**

The proposed protocol would make the Swedish treaty the sixth treaty in the U.S. network to provide for a zero rate of withholding tax on direct dividends. In view of the relative novelty of zero-rate dividend provisions in the U.S. network, the Committee may wish to devote particular attention to the benefits and costs of taking this step.

In addition, as it becomes clear that zero-rate provisions are a trend in U.S. tax treaty practice, the Committee may wish to consider the Treasury Department’s criteria for determining the circumstances under which a zero-rate provision may be appropriate. The Committee also may wish to examine some of the specific design features of the provisions, such as ownership thresholds, holding period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements, and assess the purposes served by these various features.

**Benefits and costs of adopting a zero rate with Sweden**

Tax treaties mitigate double taxation by resolving the potentially conflicting claims of a residence country and a source country to tax the same item of income. In the case of dividends, standard international practice is for the source country to yield mostly or entirely to the residence country. Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a relatively low rate (e.g., five percent) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist. To the extent that the residence country allows a foreign tax credit for the withholding tax, this remaining double taxation may be mitigated or eliminated, but then the priority of the residence country’s claim to tax the dividend income of its residents is not fully respected. Moreover, if a residence country imposes limitations on its foreign tax credit, withholding taxes may not be fully creditable as a practical matter, thus leaving some double taxation in place. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. The principal argument in favor of eliminating withholding taxes on certain direct dividends in the proposed protocol is that it would remove one such barrier.

Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee. Whether in the United States or in Sweden, the dividend-paying corporation generally faces full net-basis income taxation in the source country, and the dividend-receiving corporation generally is taxed in the residence country on the receipt of the dividend (subject to allowable tax credits). The committee may wish to consider the specific design features of the provisions, such as ownership thresholds, holding period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements, and assess the purposes served by these various features.

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21 See, e.g., Code sec. 904.
foreign tax credits or, in the case of Sweden, the participation exemption). If the dividend-paying corporation is at least 80-percent owned by the dividend-receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-receiving corporation as having a more remote investor-type interest warranting the imposition of a second-level source-country tax.

Since Sweden does not currently impose a withholding tax on these dividends under its internal law, the zero-rate provision would principally benefit direct investment in the United States by Swedish companies, as opposed to direct investment in Sweden by U.S. companies. In other words, the potential benefits of the provision would accrue mainly in situations in which the United States is importing capital, as opposed to exporting it.

However, it should be noted that, although Swedish internal law currently does not impose a withholding tax on dividends paid by Swedish subsidiaries to U.S. parent companies, there is no guarantee that this will always be the case. Thus, the inclusion of a zero-rate provision under the proposed protocol would give U.S.-based enterprises somewhat greater certainty as to the applicability of a zero rate in Sweden, which arguably would facilitate long-range business planning for U.S. companies in their capacities as capital exporters. Along the same lines, the provision would protect the U.S. fisc against increased foreign tax credit claims in the event that Sweden were to change its internal law in this regard.

Although the United States only recently first agreed to bilateral zero rates of withholding tax on direct dividends, many other countries have a longer history of including such provisions in one or more of their bilateral tax treaties. These countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its Parent-Subsidiary Directive. Finally, many countries have eliminated withholding taxes on dividends as a matter of internal law. Thus, although the zero-rate provision in the proposed protocol is a relatively recent development in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment.

**General direction of U.S. tax treaty policy**

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

The Committee also may wish to examine some of the specific design features of the provisions, such as ownership thresholds, holding period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements. With respect to ownership thresholds, the Committee may wish to ask the Treasury Department what factors support the usual choice of 80 percent as an ownership threshold for zero-rate provisions, and what factors might make it appropriate to employ a threshold lower than 80 percent (such as the 50-percent threshold that was used in the treaty with Japan). With respect to holding period requirements, the Committee may wish to ask the Treasury Department why a 12-month holding period strikes a proper balance between the competing considerations of preventing short-term shifting of ownership in order to claim the benefits of the provision on one hand, and allowing such benefits in connection with ordinary, non-abusive structures on the other hand.

With respect to direct and indirect ownership, the Committee may wish to ask whether the rule of the proposed protocol (and the U.S.-Japan treaty) allowing indirect ownership through a treaty-country resident reflects the likely resolution of this issue for future provisions. In addition, it is worth noting that the IRS has ruled privately, in connection with a situation arising under the recently adopted U.S.-U.K. zero-rate provision, that entities disregarded under the U.S. entity classification regulations also are disregarded for purposes of determining whether certain ownership requirements of the zero-rate provision are satisfied. Thus, stock owned through a disregarded entity (established under the laws of a third country) was treated as owned directly for purposes of applying the holding period requirement of that provision (which, according to that treaty’s Technical Explanation, required direct ownership).22 The Committee may wish to ask the Treasury Department whether the approach taken in this private ruling under the U.S.-U.K. treaty reflects a more general approach that the Treasury Department and the IRS are likely to take in applying these provisions to structures involving disregarded entities.

With respect to heightened limitation-on-benefits requirements, the Committee may wish to ask whether the provisions in the proposed protocol dealing with the active trade or business and ownership and base erosion tests are likely to be included in future treaties, and how these special limitation-on-benefits provisions might change as zero-rate provisions become more widespread in the U.S. network.

B. Treaty Shopping

The proposed protocol, like all recent U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed protocol generally is intended to benefit residents of Sweden and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to reduce the tax on interest on a loan to a U.S. person by lending money to the U.S. person indirectly through a country whose treaty with the United States provides for a lower rate of withholding tax on interest. The third-country investor may attempt to do this by establishing in that treaty country a subsidiary, trust, or other entity that then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty-shopping provision of the proposed protocol is similar to anti-treaty-shopping provisions in the Code (as interpreted by Treasury regulations) and in the U.S. model. The proposed protocol replaces the anti-treaty-shopping provision in the present treaty to update it for modifications included in the U.S. model and other more recent U.S. income tax treaties. The degree of detail included in these provisions is notable in itself. The amount of detail may reflect, in part, an intent to reduce the discretion afforded the IRS and the courts to resolve interpretive issues adversely to taxpayers. In contrast, the IRS generally is not limited under the proposed protocol in its discretion to allow treaty benefits under the anti-treaty-shopping rules. The detail in the proposed protocol does represent added guidance and certainty for taxpayers that may be absent under treaties that have somewhat simpler and more flexible provisions.

Although the provision in the proposed protocol is similar to the anti-treaty-shopping provisions in several recent U.S. income tax treaties, there are some key differences. A key element of the anti-treaty-shopping provisions in these recent U.S. treaties and protocols (i.e., United Kingdom, Australia, Japan, and the Netherlands) applicable only to public companies, is that, in order to pass the public company test, the company must be listed on a recognized stock exchange in one of the treaty countries, and must be regularly traded on one or more recognized stock exchanges. In addition, the proposed protocol includes a requirement, first introduced in the U.S.-Netherlands protocol, that tests for “substantial presence” in the residence country in order for a public company to qualify for treaty benefits under the public company test or ownership/base erosion test. The proposed protocol does not use the term “substantial presence,” but incorporates the essential elements of that test into its rubric.

Under the proposed protocol, the substantial presence requirement is met if one of two tests is passed. The first test determines whether public trading constitutes an adequate connection to the residence country, or to the economic region in which the residence country is located. The first test compares trading within the company’s primary economic zone with worldwide trading. For the United States, the primary economic zone includes all NAFTA countries, and for Sweden, the primary economic zone includes the EEA, the EU, and Switzerland. Thus, a Swedish company will pass this test only if more trading in its stock takes place on recognized stock exchanges in the EEA, EU, and Switzerland than everywhere else.
However, even if a company fails the first test of the substantial presence requirement, it can still establish substantial presence if it passes the second test. The second test determines whether the company’s primary place of management and control is in the country where it is a resident. This test should be distinguished from the “place of effective management” test that is used by many countries to establish residence and by the OECD model as a tiebreaker. The place of effective management test has beeninterpreted to mean the place where the board of directors meets. By contrast, the primary place of management and control test under the proposed protocol looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. A company’s primary place of management and control will be located in the country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries) in the residence country than in the other country or any third country, and the staffs that support the management in making those decisions are also based in the residence country.

The substantial presence test makes the public company test in the proposed protocol distinctly different from the U.S. model and most recent U.S. income tax treaties. The rules in the Netherlands protocol and the proposed protocol test for adequate connection to the residence country, while the U.S. model and other recent U.S. income tax treaties only require that a public company be listed in one of the two treaty countries and regularly traded on a recognized stock exchange, thereby allowing a company to qualify for treaty benefits if all the trading takes place in the other country or on a third-country exchange. The new rules tighten the public company test by requiring nexus in the residence country, and they address situations where a company may simply invert its corporate structure to change its residence status without changing the situs from which the business is carried on and where it is managed and controlled. The recently ratified U.S.-Barbados protocol contains similar rules, albeit tighter than the anti-treaty-shopping provisions in the proposed protocol. On the other hand, the U.S.-Japan income tax treaty, ratified in 2004, and the Australia protocol and UK income tax treaty, both ratified in 2003, do not include the substantial presence rules. The Committee may wish to inquire as to what circumstances warrant the tighter public trading tests like the ones found in the Netherlands and Barbados treaties and the proposed protocol, and what circumstances make the more traditional approach appropriate.

In addition, the public company test in the proposed protocol raises further questions. By and large, recent treaties and protocols (e.g., Australia, United Kingdom, Japan, the Netherlands, and Barbados) require a public company to be listed in a treaty country in order to pass the public company test. Although this requirement can be met in most cases by listing in the treaty country in which the company is not resident, the requirement does provide some additional assurance that the company has nexus specifically to a treaty country, and not merely to the economic region in which the residence country is located. The Committee may wish to ask the Treasury Department whether loosening the listing requirement of the most recent treaties shifts the public company test to a purely or more regional test, and whether such a shift is appropriate in the light of the anti-treaty-shopping purpose of this provision. This regional approach also raises two collateral questions: (1) whether the addition of Switzerland (which is a member of neither the EU nor the EEA) to the region changes the rationale for the approach from a grouping based on economic interest to one based primarily on geographic proximity, and (2) whether
provisions of a regional scope would remain viable if the political climate in Europe were to shift in favor of decreasing the scope of European integration.
C. Treatment of Certain Pensions With Respect to Government Service

The proposed protocol modifies Article 20 (Government Service) by adding a new paragraph providing that Sweden may not impose tax on a pension paid by the U.S. government to Swedish citizens and residents (including those entitled to survivor benefits) who were hired prior to 1978 to work for the U.S. embassy in Stockholm or the U.S. consulate general in Gothenberg, if the individual was covered under the U.S. Civil Service retirement plan. This provision differs from provisions relating to pensions for government service in other U.S treaties, the U.S. model, and the OECD model. Whether this provision is necessary and appropriate is an issue for the Committee’s consideration.

The U.S. model treaty provides rules eliminating double taxation of pensions in respect of an individual’s government service. Article 19 of the U.S. model provides generally that any pension paid from the public funds of one contracting state to an individual in respect of service rendered to that state is taxable only in that state. However, the pension is taxable only in the other contracting state if the individual is a resident and national of that state. The OECD model provides the same general rules with respect to individuals’ pensions for government service, as do recent treaties between the United States and other countries, such as the United Kingdom and Japan.

The present treaty between the United States and Sweden also includes similar rules with respect to individuals’ pensions for government service. Article 20 of the present treaty provides that a pension paid by a contracting state to an individual in respect of services rendered to that state is taxable only in that state. However, the pension is taxable only in the other contracting state if the individual is a resident of, and a citizen of, that state. Prior to the adoption of the present treaty in 1994, however, the prior treaty provided a different rule. Article 10 of the prior treaty (which had been adopted in 1939) provided that pensions (as well as wages, salaries and similar compensation) paid by one of the contracting states to individuals residing in the other contracting state were exempt from taxation in the other contracting state. Thus, under the 1939 treaty, Swedish residents receiving a pension from the United States Government would not have been subject to Swedish tax on the pension. In the 1994 treaty, this treaty rule was reversed, conforming generally to the U.S. and OECD model treaty provisions on this topic. Thus, Swedish residents receiving a pension from the U.S. government in respect of service to the U.S government would no longer be protected from Swedish tax on the pension, should Sweden impose such tax.

The Technical Explanation notes that the U.S. government had reduced the salaries paid to Swedish residents and citizens working at the U.S. embassy in Stockholm or the U.S. consulate general in Gothenberg to take account of the fact that they were exempt from Swedish income tax under the terms of the 1939 treaty. As a result, their pensions, which were based on their salaries, were automatically reduced. Such employees and former employees were not exempted from the change permitting Sweden to tax government pensions when the present treaty was adopted in 1994. Thus, the pensions of such employees and former employees became subject to Swedish tax at that time, although such pensions had been reduced because they were exempt from Swedish tax under the 1939 treaty.
The proposed protocol prevents Sweden from imposing tax on income received by its own residents, a result that could be viewed as not necessary to achieve through a treaty, as the legislature could achieve the same result. Furthermore, this provision of the proposed protocol could be questioned as targeted to a small group of individuals who receive different tax treatment under the treaty than other individuals receiving government pensions. On the other hand, the inclusion of this provision in the proposed protocol may be based on the fact that the group of individuals was not grandfathered when the rule relating to government pensions paid by one treaty country to residents of the other treaty country was reversed at the time the present treaty was adopted. Thus, it can be argued, this failure has led to the need to provide a treaty rule addressing these individuals’ tax treatment under Swedish law. The Committee may wish to satisfy itself of the necessity for inclusion of this provision in the proposed protocol.
D. U.S. Model Income Tax Treaty

It has been longstanding practice for the Treasury Department to maintain, and update as necessary, a model income tax treaty that reflects the current policies of the United States pertaining to income tax treaties. Some of the purposes of this model are explained by the Treasury Department in its Technical Explanation of the U.S. model:

[T]he Model is not intended to represent an ideal United States income tax treaty. Rather, a principal function of the Model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries. In this regard, the Model can be especially valuable with respect to the many countries that are conversant with the OECD Model. … Another purpose of the Model and the Technical Explanation is to provide a basic explanation of U.S. treaty policy for all interested parties, regardless of whether they are prospective treaty partners.23

U.S. model tax treaties provide a framework for U.S. treaty policy. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on often complicated treaty matters. In order to promote clarity, transparency, and meaningful Congressional oversight in this area, the U.S. model tax treaties should reflect the most current positions on U.S. treaty policy. Periodically updating the U.S. model tax treaties to reflect changes, revisions, developments, and the viewpoints of Congress with regard to U.S. treaty policy would ensure that the model treaties remain meaningful and relevant.24

With assistance from the staff of the Joint Committee on Taxation, the Committee on Foreign Relations reviews tax treaties negotiated and signed by the Treasury Department before ratification by the full Senate is considered. The U.S. model is an important part of this review process, because it helps the Senate determine the Administration’s most recent treaty policy and understand the reasons for diverging from the U.S. model in a particular tax treaty. To the extent that a particular tax treaty adheres to the U.S. model, transparency of the policies encompassed in the tax treaty is increased and the risk of technical flaws and unintended consequences resulting from the tax treaty is reduced.

It is recognized that tax treaties often diverge from the U.S. model due to, among other things, the unique characteristics of the legal and tax systems of treaty partners, the outcome of negotiations with treaty partners, and recent developments in U.S. treaty policy. However, even without taking into account the central features of tax treaties that predictably diverge from the U.S. model (e.g., withholding rates, limitation on benefits, exchange of information), the

23 Treasury Department, Technical Explanation of the United States Model Income Tax Convention, at 3 (September 20, 1996).

24 The staff of the Joint Committee on Taxation has recommended that the Treasury Department update and publish U.S. model tax treaties once per Congress. Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS-3-01), April 2001, vol. II, pp. 445-447.
technical provisions of recent U.S. tax treaties have diverged substantively from the U.S. model with increasing frequency. This development suggests that the U.S. model, which has not been updated since 1996, is becoming obsolete.

In testimony before the Committee in February 2004, the Treasury Department stated that it intended to update the U.S. model, and to work with the staffs of this Committee and the Joint Committee on Taxation in this regard.\(^{25}\) In testimony before the Committee in September 2004, the Treasury Department stated that it had begun work on an update to the U.S. model, and was looking forward to working with the staffs of this Committee and the Joint Committee on Taxation on this project.\(^{26}\) The Committee may wish to inquire of the Treasury Department as to the current status of this project.
