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PREPARED STATEMENT OF  
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HEARING ON PROPOSED TAX TREATIES  
(BARBADOS, CHINA, CYPRUS, DENMARK, AND ITALY)  
BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS  
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INTRODUCTION

It is our pleasure to appear before you to provide staff assistance on the tax treaties and protocols that are currently under consideration by your Committee. Our staff has prepared pamphlets discussing each proposed treaty and protocol before you; these pamphlets give article-by-article descriptions of the treaties and protocols and generally indicate those provisions that differ significantly from those normally found in U.S. tax treaties. These pamphlets highlight the significant policy issues raised by each treaty.

In preparing for this hearing, we analyzed the treaties, and also spoke with a number of attorneys, accountants, and business people who are familiar with the treaties. In this process, we worked closely with staff of your Committee and with the Treasury Department.

In our testimony before the Committee in 1981, 1983, and 1984, in connection with proposed tax treaties and protocols then under consideration by the Committee, we discussed at some length the purpose, function, and overall desirability of tax treaties. We will not repeat that testimony today. (Our 1981 testimony appears in Tax Treaties: Hearings Before the Senate Committee on Foreign Relations on Various Tax Treaties, 97th Cong., 1st Sess., 39-53 & 77-99 (1981).) In general, tax treaties have two main purposes. They are intended to prevent tax avoidance and evasion and to reduce international double taxation. The former purpose generally is achieved in U.S. tax treaties by means of a mutual agreement procedure and a provision for the exchange of information. Tax treaties also perform the important function of removing impediments to international investment and to the free flow of capital generally.

Before you for consideration are proposed income tax treaties with Denmark and Italy (and proposed protocols to those treaties) that would replace the existing treaties with those countries. Also before you for consideration are proposed income tax treaties with Barbados, Cyprus, and China (and a proposed protocol to the latter treaty). The proposed treaties with Barbados, Cyprus, and China would be the first comprehensive U.S. income tax treaties with those countries.

In light of the materials already provided to you, we will not describe the features of each treaty in this presentation. Instead, we would like to focus our discussion today on the tax policy issues presented by various provisions in these treaties. General tax policy issues raised by two or more of the treaties are analyzed first below. Separate discussions of each treaty follow.

The credit provided in the proposed treaty with Denmark for the Danish hydrocarbon tax has generated some controversy. Otherwise, these treaties and protocols are, for the most part, noncontroversial. In the past, the Committee has recommended a reservation or an understanding on a particular provision of certain treaties and protocols. We recommend a reservation to prevent the treaty with Barbados from overriding a provision of the 1984 Tax Reform Act that prevents tax haven abuse and an understanding to prevent the Italian treaty from allowing double foreign tax credits. We believe that it would be appropriate to make it clear to all parties that the treaties with Barbados, China, Cyprus, and Italy do not override a provision of the 1984 Act that prevents the use of foreign corporations to inflate foreign tax credits artificially. Also, we recommend that the Committee indicate in its report accompanying the resolution approving ratification of the treaty with China that a reexamination of that treaty, which has a very limited anti-treaty shopping provision, will be necessary if treaty shopping abuses develop in the future. In addition, we believe that in certain other instances the Committee may want to consider stating in its reports accompanying the resolutions approving ratification that a particular provision is intended to be interpreted in a certain way or that the policy reflected in a particular provision is not viewed as precedent for future U.S. tax treaty negotiations.

We appreciate the schedule that the Committee is following this year. In recent years, Treasury has adopted the practice of furnishing its Technical Explanations of treaties to this Committee and to the public on the day of the treaty hearing. When markup followed the hearing by a matter of days, it was very difficult for the public to comment meaningfully on proposed treaties before Committee action. This year, this Committee is allowing ample time for the public to comment on the Technical Explanations as well



as the treaties.

## I. GENERAL ISSUES

### Treaty shopping--third country use of treaties

To prevent international double taxation, income tax treaties reduce taxes in some cases. Tax reductions in a treaty between two countries sometimes attract third-country investors. For example, an investor from Country A, which has no income tax treaty with the United States, may establish a corporation or other entity in Country B, which does have a tax treaty with the United States, to make investments in the United States. This is called "treaty shopping." Under current law, treaty shopping is sometimes successful; that is, the United States sometimes collects less tax because the foreign investor has put a treaty country corporation between himself and the United States.

The Treasury Department and the Internal Revenue Service have taken steps to reduce treaty shopping. Treasury has adopted a policy of denying treaty benefits to treaty shoppers in the new treaties it is negotiating. Congress has urged the Treasury to continue this policy, so as to limit treaty benefits to bona fide residents of the treaty country. (See House Comm. on Ways and Means, Supplemental Report on the Tax Reform Act of 1984, H. Rep. No. 432, part 2, 98th Cong., 2d Sess. 1343 (1984).) The Internal Revenue Service has issued rulings to limit some treaty benefits to real treaty country residents (Rev. Ruls. 84-152 and 84-153, 1984 C.B. 381).

In 1981, this Committee recommended that the Senate return two income tax treaties to the President because of potential treaty shopping problems (Senate Comm. on Foreign Relations, Report on Return of Two Tax Treaties, Exec. Rep. No. 43, 97th Cong., 1st Sess.). The Senate followed the Committee's recommendation (S. Exec. Res. 4, agreed to December 16, 1984). Treasury has renegotiated one of those treaties, with Cyprus. The revised treaty with Cyprus is before you today.

Each of the proposed treaties before the Committee today contains rules designed to prevent treaty shopping. The issue in each case is whether the proposed treaty's rules are adequate. The determination in each case will involve a number of factors, including the precise language of the treaty at issue, the treaty partner's current tax and nontax rules affecting foreign investors, and the likelihood that these rules would change in the future. In each case, the Committee faces a policy issue: whether the potential for inappropriate treaty shopping is great enough that the Senate should not approve the treaty as proposed.

## Resourcing rule of the Tax Reform Act of 1984

The foreign tax credit is one of the most important provisions of international tax law. Many countries, including the United States, provide a foreign tax credit to reduce international double taxation. The credit allows U.S. taxpayers to reduce U.S. tax liability dollar for dollar by foreign taxes paid. The Code limits the credit, though, so that it cannot offset U.S. tax on U.S. income. That is, the foreign tax credit can offset only U.S. tax on foreign income. This limitation sometimes gives taxpayers an incentive to treat income as foreign source income rather than U.S. source income.

Taxpayers can generally treat dividends and interest from foreign corporations as foreign income, which they can shelter from U.S. tax using foreign tax credits. Frequently, they can shelter this foreign income with foreign tax credits that are totally unrelated to the sheltered income. Before the Tax Reform Act of 1984, U.S. income was sometimes routed through a foreign corporation to take advantage of these rules. The income became foreign source when it was paid to the foreign corporation's U.S. owners and thus could be sheltered from U.S. tax with foreign tax credits. The foreign tax credit limitation was thereby effectively avoided. The 1984 Act added "look-through" rules that sometimes treat payments from a foreign corporation as U.S. income. These look-through rules examine the income that a U.S.-owned foreign corporation earns to determine whether it is foreign or U.S. source. The rules then treat dividends, interest and certain other income from those foreign corporations as foreign or U.S. source on the basis of the source of the foreign corporation's underlying income. The 1984 rules were intended to override any existing treaties with which they conflicted.

Four of the five treaties before the Committee could arguably prevent application of the look-through rule in cases where Congress intended it to apply. (Three of these four were signed before Congress passed the Tax Reform Act of 1984.) Each of these four treaties requires the United States to credit the income taxes of the treaty partner country, but in accordance with and/or subject to the limitations of U.S. law. In general, each treaty also effectively obligates the United States to treat as foreign income any income (1) that a U.S. resident earns and (2) that the treaty allows the other country to tax. Thus, if a U.S. taxpayer owns a corporation in a treaty country, and the treaty allows the other country to tax a dividend paid to the U.S. taxpayer, then arguably that dividend must be treated as foreign source (under the treaty) even though it may be treated as U.S. source under the rule of the 1984 Act. These provisions, therefore, present an issue of treaty interpretation: must the United States allow foreign tax



credits to reduce its tax on payments from a corporation that is resident in the treaty partner country, even if the paying corporation derived its income from the United States? The Treasury Department's view is that the treaties do not override the 1984 anti-abuse rule. Should the Committee decide to recommend approval of these treaties, we suggest that the Committee recommend that the Senate resolution of ratification make it clear to the other countries involved that these treaties do not prevent application of the 1984 Act's resourcing rule.

### Developing country concessions

Most existing United States tax treaties are with industrialized countries who are also members of the OECD, the Organization for Economic Cooperation and Development. These treaties generally give the country of residence of the taxpayer the primary right to tax income, with two exceptions: business income that is attributable to a permanent establishment in the other country; and income from real property.

Three of the treaties and protocols before you today, however, are with developing countries.

For a variety of reasons, including the potential revenue loss and the difficulties in administering an extra-territorial tax system, developing countries generally are opposed to yielding jurisdiction to tax income at its source. This philosophy is reflected in the model tax treaty developed by the United Nations for use between developed and developing countries, which provides fewer limitations on source basis taxation than are included in most U.S. income tax treaties, the U.S. model, or the OECD model.

Let us give you two examples of the lower limitations. First, treaties generally provide that a country can tax business profits only if they are attributable to a permanent establishment. A permanent establishment is defined in the most recent U.S. model to include a building site, construction or installation project, or the like, but only if it lasts more than 12 months. Under this definition, a construction project that lasts less than 12 months would not be a permanent establishment and the country of source would not be able to tax any of the profits generated. The U.N. model, however, provides that the construction site will be a permanent establishment if it exists for 183 days. Accordingly, a permanent establishment will arise sooner under the U.N. model, and the developing country will be able to tax those profits sooner. All of the developing-country treaties before you contain the six-month rule. The model treaties contain a listing of activities that will generate a permanent establishment. Developing countries seek to include in this list supervisory or consulting services. The

U.S. model does not provide for treating such activities as a permanent establishment and accordingly they are generally not taxed at source under the U.S. model. However, in deference to the developing country status of the proposed treaty partners, two of the treaties before the Committee today treat supervisory or construction services as a permanent establishment.

Developing countries also seek relatively high rates of tax at source on passive income while the United States generally seeks low withholding taxes at source. The U.S. model calls for five percent on direct investment dividends and 15 percent on portfolio investment dividends. The U.S. model takes the position that interest and royalties should be exempt from tax at source. Developing countries do not want to relinquish source basis taxation, and negotiate for higher rates. These treaties generally follow the pattern of U.S. treaties with developing countries by permitting withholding on dividends, interest, and royalties at rates in the range of 10 to 15 percent.

While there may be an argument for insisting on adherence to residence basis taxation, such a position would probably limit substantially our ability to negotiate treaties with developing countries. To the extent that treaties with developing countries are desirable, the concessions are probably necessary. The Committee may wish to determine whether guidelines are appropriate.

A significant advantage of treaties with developing countries is the ability of the parties to exchange tax-related information. An expanded treaty network could thus generally assist IRS enforcement efforts in the international area. In addition, of course, treaties with developing countries can be in the interest of the United States because they provide tax relief for U.S. investors and a framework within which the taxation of U.S. investors will take place; in general, uncertainty regarding the foreign taxation of U.S. investors has been a significant problem for U.S. investment abroad. An income tax treaty with a developing country may also be desirable for non-tax reasons, such as the possible contributions of increased U.S. investment to the economic development of the country.

#### Dividend credit and dividends paid deduction

Barbados, Cyprus, Denmark, and Italy all have imputation-type tax systems. An imputation system is intended to relieve the two tiers of taxation that apply when a corporation's profits are taxed both in the corporation's hands, at the time they are earned by the corporation, and again in the shareholder's hands, when those profits are distributed as a dividend. Double taxation is relieved under an imputation-type system by providing shareholders with a



tax credit when they receive a dividend from a corporation; the credit is meant to reflect all or a portion of the taxes that were paid by the corporation on the profits out of which the dividend is paid. Countries that have imputation-type systems rarely grant relief to nonresident shareholders unilaterally; that is to say, they will provide credit to nonresident shareholders only under income tax treaties with other countries. (Cyprus is an exception.) They view the granting of such a benefit under a treaty as a concession that should be met with some equivalent concession by the treaty partner.

One issue presented here is the extent to which it should be the tax treaty policy of the United States to seek dividend credits for U.S. shareholders of corporations in treaty-partner countries. Two of the four proposed treaties with dividend-credit countries (those with Cyprus and Denmark) require those countries to give some form of relief to U.S. shareholders; two (those with Barbados and Italy) do not. However, those treaties which do not grant dividend credits do lower the rate of withholding tax on dividends, thus arguably providing some relief from two-tiered taxation of corporate earnings to U.S. investors in those countries.

Another issue that is closely related to the imputation credit problem is raised with respect to all five of these treaties by one of the Administration's tax reform proposals. The Administration has proposed enactment of an alternative to the imputation credit to reduce the two-tiered taxation of corporations and shareholders. Under the Administration's proposal, corporations would be allowed a deduction equal to 10 percent of the amount of any dividend paid to their shareholders. The dividends paid deduction would extend to some dividends paid to foreign shareholders. However, the proposal would impose on such dividends a compensatory withholding tax designed to prevent elimination of all tax on 10 percent of corporate profits where shareholders are not U.S. taxpayers. Many U.S. tax treaties would prohibit U.S. imposition of this compensatory withholding tax, though. Although the Administration proposal would not initially impose a compensatory tax on dividends paid to protected treaty country recipients, it would delegate to the Secretary of the Treasury the authority to override treaties to impose a compensatory dividend withholding tax on a country-by-country basis. The purpose of this delegation is, in part, to seek elimination of discrimination against U.S. shareholders by treaty partner countries.

If the Senate ratified these treaties and Congress subsequently enacted a dividends paid deduction, a compensatory withholding tax on dividends paid to foreign shareholders would violate all five of these treaties (as well as all existing treaties). The Administration's response would be to provide that the compensatory

withholding tax generally would not be imposed on dividends paid to treaty country residents (and, thus, the dividends paid deduction would be fully extended to such residents who are shareholders in U.S. companies), while Treasury's authority to override treaties selectively would be used against countries whose imputation-type systems discriminate against U.S. shareholders. Arguably, some or all of the four countries with imputation-type systems at issue today discriminate against U.S. shareholders. Thus, Treasury might plan to override some of these treaties in an attempt to eliminate discrimination that is permitted by the treaties as they have been proposed.

The issue that this raises is whether it makes sense to present new treaties for ratification while simultaneously pursuing changes to domestic law that would require either the override or renegotiation of parts of those treaties. It may be that the Administration's proposal to permit selective overriding while pursuing renegotiation is an appropriate way to coordinate the two processes of treaty negotiation and tax reform, each of which is time-consuming and complex. Nevertheless, it appears as if Congress, and the Senate in particular, is being asked to take contradictory actions.

The Committee might address this issue in one of three ways. One possibility would be to consent to the treaty as proposed. Congress might not enact any dividend relief, or it might enact a credit mechanism for dividend relief like these countries use. In either of those events, there would be no treaty violation by the United States. (Even though the credit method and the deduction method proposed by the Administration achieve the same economic result (at least if the credit is refundable), the credit method does not violate treaties as the deduction method does.) However, if the Senate ratifies the treaties as proposed, and Congress enacts a dividends paid deduction as proposed by the Administration, the following two possibilities would arise. On the one hand, Congress could authorize the override of the recently-ratified treaties and the imposition of the compensatory withholding tax on dividends paid to treaty-country shareholders (as contemplated by the Administration proposal). However, treaty-country expectations would be frustrated in that case, and the United States could be accused of acting in an arbitrary manner. On the other hand, if Congress did not override the treaties, then the dividends paid deduction would have the effect of eliminating all U.S. tax on 10 percent of corporate profits paid out to treaty-country shareholders.

The second possible way to address this issue would be to seek a reservation allowing the United States to impose a compensatory withholding tax if it decides to do so. This course could present a condition that the treaty-country governments would find unacceptable, and thus could delay or



prevent the proposed treaty's taking effect. The third possibility would be to await legislative progress on the Administration proposals for tax reform to decide how to handle this issue. However, this course too would delay the treaty.

Another issue is raised by the proposed dividends paid deduction. The Administration's tax reform proposal would allow such a deduction to U.S. corporations, but would not allow the deduction to foreign corporations. Three of the proposed treaties (those with Barbados, China, and Italy) would extend "national treatment" to corporations as well as to individuals. In particular, these proposed treaties would generally obligate the United States to treat corporations that are organized in these countries like U.S. corporations "in the same circumstances." It is not clear whether these proposed treaties would obligate the United States to allow corporations organized in these countries a deduction for dividends paid. Arguably, a foreign corporation, which the United States does not tax on its worldwide income, is never in the same circumstances as a U.S. corporation. If so, however, it is not clear what effect the extension of national treatment to foreign corporations by treaty would have. It is possible that courts would interpret that extension to require the United States to give the dividends paid deduction to foreign corporations. (It is also possible that non-discrimination provisions applicable to permanent establishments could require allowance of the deduction.)

If these proposed treaties require the United States to allow corporations organized in these countries a dividends paid deduction, they conflict with the Administration's tax reform proposal. The Administration has not indicated whether it might seek to override treaties on this point, perhaps because it takes the view that the proposed treaties would not require the United States to allow any foreign corporations to deduct dividends paid.

#### Administration proposal to impose branch-level tax

In addition to prohibiting the imposition of the compensatory withholding tax included in the Administration's proposal for a dividends paid deduction, four of the five treaties before you today arguably would prohibit the imposition of the proposed new branch-level tax included in the Administration's tax reform package.

Under current law, in general, the United States seeks to tax foreign corporations that operate in the United States like U.S. corporations that operate here. This goal of symmetrical treatment extends to dividend and interest payments, that is, the United States seeks to tax the recipients of dividends and interest paid by foreign corporations that operate in the United States like it taxes

the recipients of dividends and interest paid by U.S. corporations that operate here. If the recipient of the dividends or interest is a U.S. person, the United States imposes tax on the dividends or interest at the regular graduated rates. If the recipient of the dividends or interest is a foreign person, however, symmetry is more difficult to enforce.

A U.S. corporation that pays dividends to a foreign person generally must withhold 30 percent of the payment as a tax. The United States imposes the tax at a flat 30-percent rate because it is generally not feasible to collect a graduated tax based on the net income of foreign persons who may have very limited contacts with the United States. Similarly, a 30-percent withholding tax applies to some interest paid to foreign persons, including interest paid to related parties and certain interest paid to banks. Some interest paid to foreign persons is exempt from U.S. tax, however. Also, some U.S. income tax treaties eliminate the tax on all interest and reduce the tax on dividends to as little as five percent.

Similarly, a foreign corporation that has enough U.S. activity and that pays dividends (or some kinds of interest) to a foreign person must withhold a portion of the payment as a tax. A foreign corporation becomes liable to withhold when more than half of its gross income for a three-year period is effectively connected with a U.S. trade or business. If it crosses that 50-percent threshold, the 30-percent (or lower treaty rate) tax applies to a fraction of the payment. That fraction is effectively connected income divided by worldwide income. One purpose of this withholding tax is to treat payments by foreign corporations with U.S. operations like payments by U.S. corporations.

The Administration proposal would repeal the withholding taxes on dividends and interest paid by foreign corporations with U.S. operations, and would replace the tax on dividends with a tax on branch profits. That is, the Administration proposal would impose a tax on the profits of a U.S. branch operation of a foreign corporation before those profits were distributed to shareholders as a dividend, because of the difficulty of taxing those shareholders on the dividend. For this purpose, branch profits would consist of distributable profits after allowing for reinvestments and for U.S. income taxes paid by the foreign corporation. The proposal also would replace the tax on interest with a tax on certain interest payments by foreign corporations to foreign persons that corresponds to the U.S. tax on interest payments by U.S. persons to foreign persons. The tax on interest payments would apply to certain interest allocable to the branch, and the allocable interest would be part of the base of the branch-level tax. Also, the proposal would fix the rate of these taxes at 30 percent, but if the recipient resides in a



treaty country, it would reduce the rate to the rate that applies to direct investment dividends under the treaty. When a treaty prevents U.S. imposition of the proposed tax, the proposal would have the Treasury Department seek to renegotiate the treaty.

Some argue that a branch-level tax would violate some of the treaties before the Committee today as well as some existing U.S. treaties. The treaties with China, Cyprus, Denmark, and Italy contain a standard nondiscrimination rule protecting permanent establishments that, it is argued, technically would be violated by a branch-level tax. Nonetheless, a branch-level tax would not actually discriminate against U.S. operations of foreign corporations. The United States attempts to tax corporate profits at two levels, the corporate level and the shareholder level. These treaties promise that the United States will not collect more corporate-level tax from a foreign branch than it collects from a similar U.S. corporation. In the case of a U.S. corporation, the United States collects a shareholder-level tax on its dividend payments. In the case of a foreign corporation with U.S. operations, the United States may not. The Administration proposal for a branch-level tax would compensate for the lack of a shareholder-level tax by adding to the corporate-level tax.

The issue is whether the sequence of actions that the Administration asks Congress in general and the Senate in particular to take makes sense. If the Senate agrees to these treaties and then Congress enacts a branch-level tax that the treaty protects a foreign corporation from paying, it is unclear why the treaty partner would agree to allow the United States to impose that tax. The treaty partner could unilaterally concede the issue, but the treaty partner could instead ask for a quid pro quo from the United States, or it could instead not yield on this point. Experience has shown that it is difficult to renegotiate treaties once ratified.

The Committee might address this issue in one of three ways. First, the Committee could follow the Administration's request and recommend that the Senate consent to the treaty notwithstanding this branch-level tax issue. It is not clear if or when Congress will enact a branch-level tax; if Congress does not do so, then there will have been no need for the Committee to take notice of this issue. Similarly, if Congress overrides treaties in enacting a branch-level tax, there is no need for current adverse Committee action. Overriding the treaty soon after approval could disappoint the treaty partner's legitimate expectations, however. To meet this eventuality, the Committee might wish to put the treaty-partner countries on notice that unilateral change may occur. Second, the Committee could seek a reservation allowing the United States to impose a branch-level tax if it decides to do so. This course, while it could allow the

United States to collect the tax (if enacted), could also present a condition that the treaty partner's government finds unacceptable. Therefore, this course could delay or prevent the benefits of the treaty. Third, the Committee could delay action on the treaty while it awaits legislative progress on the Administration proposals for tax reform.

### Complexity

One general concern that we do have with these, and other recent U.S. income tax treaties, is their complexity, specificity, and resulting length. It would be useful for the Committee to remind the negotiators that tax treaties have only two main purposes: the prevention of tax avoidance and evasion and the mitigation of international double taxation. It often appears that the fact that treaties are general efforts at minimizing double taxation rather than mini-internal revenue Codes is obscured. As our Internal Revenue Code has shown, attempting to deal in a very specific and highly technical way with every problem leads to greater and greater complexity. The increasing complexity and specificity of the Internal Revenue Code and of income tax treaties have increased the chances that a treaty provision, taken in combination with a statutory rule, would yield a literal result that does not reflect a policy choice. The more complex the rules become the easier it often is for taxpayers to manipulate them to avoid tax, which in turn leads to disrespect for the tax system generally. We are concerned that the fine tuning seen in recent treaties is an extension of that trend to treaties, and that attempts at meshing precisely two complex systems will lead not to the elimination of double taxation, but rather to elimination of international tax in both countries. This problem is assuming greater importance as the United States, income tax treaty network is steadily expanded.

While we do not recommend any specific action on these treaties with respect to the complexity issue, we believe this tendency toward complexity is something that should be avoided in the future.

## **II. INCOME TAX TREATY WITH BARBADOS**

The proposed income tax treaty with Barbados is generally consistent with other recent U.S. income tax treaties and with the U.S. and OECD models. A number of its provisions that are different from the U.S. model treaty are similar to provisions that have been included in other recent U.S. treaties with developing countries.

The proposed treaty is the first income tax treaty to be negotiated between the United States and Barbados. An extension to Barbados of the 1945 income tax treaty between



the United States and the United Kingdom, under the second protocol to that treaty (ratified in 1955), was terminated by the Treasury Department, effective January 1, 1984, along with extensions of that treaty to 14 other former colonies and territories of the United Kingdom. On November 3, 1984, the United States and Barbados signed an exchange of information agreement satisfying the criteria set forth in the Caribbean Basin Economic Recovery Act of 1983 (the Caribbean Basin Initiative).

In general, the treaty is noncontroversial. However, a conflict between the treaty rules relating to the United States' accumulated earnings tax and a 1984 Congressional amendment to that tax warrants Committee attention. In addition, the treaty contains a few other provisions worthy of note. These provisions, and the accumulated earnings tax issue, are discussed below.

#### Accumulated earnings tax--vote or value

The most significant issue raised by the proposed treaty relates to the U.S. accumulated earnings tax, which is an anti-abuse tax designed to prevent U.S. taxpayers from avoiding tax by accumulating income in a corporation. Because the treaty does not take into account a recent amendment to the tax, it could be read to override the tax in a manner that was not anticipated, and could invite abuse.

The accumulated earnings tax was amended in 1984 through the addition of Code section 535(d), which preserves the tax with respect to U.S. income received by a U.S.-owned foreign corporation. Section 535(d) applies if U.S. shareholders own a majority of the voting power or value of stock in a foreign corporation.

The proposed treaty provides that a company which is a resident of Barbados will be exempt from U.S. accumulated earnings tax if individuals (other than U.S. citizens) who are residents of Barbados control, directly or indirectly, throughout the last half of the taxable year, more than 50 percent of the entire voting power in that company. If this treaty rule were applied on the basis of voting power alone, section 535(d) would be overridden by the treaty in cases where Barbadian shareholders held a majority of the voting power of stock in a Barbadian corporation, even if U.S. shareholders held a majority of the value of the stock (and thus section 535(d) would otherwise apply). U.S. taxpayers could avoid the intended effect of section 535(d) by creating Barbadian corporations in which a small class of voting stock was primarily held by Barbadians, while the majority of the value of the company was represented by non-voting stock held by U.S. persons. We believe that the Committee should recommend a reservation on this issue clarifying that the 1984 amendment to the accumulated earnings tax rules will be

given effect under the treaty.

### Developing country concessions

The proposed treaty contains a number of concessions to Barbados' status as a developing country. In general, these concessions expand Barbados' right to tax Barbadian-source income by broadening the definition of permanent establishment and permitting relatively high withholding taxes on interest and royalties.

The proposed treaty defines a permanent establishment to include a construction or drilling project that continues for more than 183 days (rather than one year, as under the U.S. model) and a dredging project continuing more than 120 days (rather than one year). Also, under the proposed treaty, unlike the U.S. model, the performance of certain supervisory services in connection with construction activities or the performance of certain consulting and other services through personnel engaged by an enterprise for that purpose (even if the enterprise has no fixed place of business in the country of performance) can, by itself, create a permanent establishment if the period of performance exceeds certain time limits. The practical effect of these rules could be to allow more Barbadian taxation of U.S. mineral exploration activities, construction activities, and consulting services carried out in Barbados than would be permitted under the U.S. model's provisions.

In addition, a nominally independent agent of an enterprise may constitute a permanent establishment of that enterprise under the proposed treaty if the agent's activities are devoted substantially on behalf of that enterprise and the dealings between the agent and the enterprise are not at arms length.

Other developing country concessions in the proposed treaty include maximum rates of source country tax on interest and royalties (but not dividends) that are higher than those provided in the U.S. model treaty and some existing U.S. treaties; taxing jurisdiction on the part of the source country as well as the residence country with respect to income not otherwise specifically dealt with by the treaty; and source-country taxation rules for independent personal services income, dependent personal services income, directors' fees, and entertainers' income that are all broader than those contained in the U.S. model.

In addition to allowing relatively broad source basis taxation, the proposed treaty contains some other types of developing country concessions. For example, certain administrative assistance requirements contained in the U.S. model and many existing U.S. income treaties have been omitted from the proposed treaty. Also, as previously



discussed, the treaty prohibits the United States from imposing its accumulated earnings tax on Barbadian companies that are controlled by individual residents of Barbados (who are not U.S. citizens). It also prohibits imposition of the tax on manufacturing companies operating under Barbados' investment incentive regime.

### Anti-treaty shopping provisions

The provisions of the proposed treaty with Barbados that are intended to prevent treaty shopping differ from the provisions of the U.S. model treaty in some respects.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in the 1981 U.S. model and other U.S. treaties. The U.S. model allows benefits to be denied unless more than 75 percent of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like several newer treaties) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, this safe harbor is considerably easier to enter, under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty shopping article differs from the comparable rule of the U.S. model, but the effect of the change is less clear. The general test applied by the U.S. model to deny benefits is a broad one, looking to whether the acquisition, maintenance, or operation of an entity had "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) The practical difference between the two tests will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the active trade or business test could be interpreted to require a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could be stricter than a broad reading of the active

business test (i.e., would operate to deny benefits in potentially abusive situations more often).

However, the IRS may find it relatively difficult to sustain a narrow reading of the principal purpose test. (In litigation involving Code section 367, for example, which utilized a principal purpose test until 1984, courts have consistently refused to apply this test to transactions where taxpayers could claim any business purpose.) Given that possibility, it may well be that the test contained in the proposed treaty will prove stricter than that in the U.S. model treaty.

Finally, the proposed treaty's active trade or business exception does not apply to a person engaged in a banking or insurance business whose income is taxed in its country of residence at a rate substantially below the rate generally applicable to business income in that country. The comparable rule in the U.S. model treaty is not limited to banking and insurance businesses. It may be argued that this formulation of the rule is logical, since banking and insurance are the activities granted reduced rates of tax by Barbados that best lend themselves to treaty-shopping abuses. The reduced rate of tax afforded under certain industrial development incentives, by contrast, would probably not lend itself to treaty-shopping abuse, since those incentives require substantial business operations, while treaty shopping involves the movement of passive income through a conduit entity in a treaty country. On the other hand, Barbados could amend its laws in the future to provide reduced rates of tax for other types of foreign income (not covered by this provision) that could lend themselves to treaty shopping abuses (e.g., passive royalty income).

Although drafted to limit foreseeable cases of abuse, the anti-treaty shopping provision of the proposed treaty may not prevent all potential unintended uses of the treaty by third-country investors. Treaty shopping possibilities in Barbados at present appear relatively limited. In general, Barbadian taxes on foreign investors and foreign income are relatively high, with the exception of the incentive regimes that are specifically addressed by the proposed treaty's anti-treaty shopping rule. Interest and dividend payments to foreign enterprises are subject to withholding tax (although at reduced rates under several treaties). On the other hand, there is no guarantee that the present impediments to use of the proposed treaty by third-country investors will continue in the future. Changes in Barbadian law and administrative practice with respect to foreign investors could occur. Experience has shown that if abuses develop after a treaty is ratified it is very difficult to negotiate solutions. Thus, the Committee should be satisfied that the provision as proposed is an adequate deterrent of possible treaty shopping abuses in the future.



### Resourcing rule of the Tax Reform Act of 1984

In 1984, Congress amended the foreign tax credit limitation rules to prevent U.S. persons from circumventing that limitation by routing U.S. source income through a foreign corporation, thereby converting the income to foreign source income and enabling them to use up excess foreign tax credits against the income. One issue is whether the proposed treaty would allow the 1984 anti-abuse rules to operate in the case of U.S. income that might be earned in the future by U.S. persons through a Barbadian corporation. If the 1984 amendment is a provision of U.S. law limiting the foreign tax credit, the proposed treaty arguably would not prevent its operation, since the treaty provides that the treaty credit is to be granted only "in accordance with and subject to the limitations of U.S. law (as it may be amended from time to time without changing the general principle hereof)." A strong argument for this view is that the 1984 Act amended Code section 904, which deals only with the foreign tax credit limitation. However, if instead the 1984 change is read as a source rule amendment, the proposed treaty arguably would prevent operation of the change since the treaty has a source rule that requires foreign sourcing of certain income that would otherwise be treated as U.S. source income under the 1984 Act rule. The argument for this latter view is that that source rule, because it applies for purposes of the double taxation relief article of the treaty, would have little meaning if it did not obligate the United States to credit taxes on income that the rule treats as foreign source income. The Treasury Department interprets the proposed treaty not to override the 1984 resourcing amendment.

The proper operation of the resourcing provision may be particularly important in the case of Barbados. Barbados has sought to promote itself as a center for the insurance of non-Barbadian risks. One of the principal problems that the resourcing provision of the 1984 Act addressed was the insurance of U.S. risks by foreign corporations owned by U.S. persons. Before that Act, dividends from foreign insurers (and subpart F inclusions with respect to their income) were always foreign source. The Act sources those income inclusions by looking through to the risks insured.

It may be appropriate for the Committee to consider recommending approval of the treaty subject to either a reservation or understanding that, consistent with Treasury's technical explanation, the 1984 anti-abuse rule is not defeated by the treaty.

### Dividends paid deduction and imputation credit

Barbados provides an imputation credit to resident

shareholders only. The proposed treaty does not require that Barbados grant the credit to U.S. shareholders in Barbadian corporations. The issue presented is whether the United States should insist on greater relief for its shareholders in Barbadian companies. The reduction of the dividend withholding tax does provide some relief. However, the imputation credit may give shareholders a greater Barbadian tax reduction than the withholding tax reduction gives comparable U.S. shareholders.

The Administration's May 1985 tax reform proposal asks Congress to enact a 10-percent dividends paid deduction. Nonresident shareholders generally would be denied the benefit of the deduction through the imposition of a compensatory withholding tax on dividends paid to them by U.S. companies. The proposed treaty with Barbados, like all five treaties, would prohibit imposition of the compensatory withholding tax. The Administration proposal would resolve this conflict by allowing the treaty to override the compensatory withholding tax at the outset, but would grant Treasury the authority to apply the tax (notwithstanding the treaty) pending the outcome of renewed treaty negotiations concerning that tax and the imputation credit. This matter is discussed further in the general portion of our testimony.

### III. INCOME TAX TREATY (AND PROTOCOL) WITH CHINA

The proposed income tax treaty with China, as amended by the proposed protocol, is similar to a number of recent U.S. income tax treaties and to the U.S. and OECD models. In addition, a number of the proposed treaty's provisions are based on articles of the model treaty developed by the United Nations for use between developed and developing countries. The proposed treaty is the first comprehensive income tax treaty between the two countries.

In general, we are not aware of any substantial controversy concerning the proposed treaty and protocol. However, the anti-treaty shopping provision contained in the protocol would likely provide very limited protection against any treaty shopping abuses that might develop in the future in connection with the proposed treaty. A few other features of the proposed treaty and protocol also present issues worthy of special note. The anti-treaty shopping provision, these other features of the treaty and protocol, and the issues they raise, are discussed below.

#### Anti-treaty shopping provision

The anti-treaty shopping provision of the proposed treaty (added by the proposed protocol) is less strict (and much less detailed) than the anti-treaty shopping provision



found in most recent U.S. treaties. It would fail to prohibit the types of treaty shopping arrangements most commonly used in connection with existing U.S. income tax treaties.

The provision is also considerably less strict (and much less detailed) than the anti-treaty shopping provision of the current 1981 U.S. model, although the U.S. model provision is only one of several approaches that the Treasury Department considers satisfactory to prevent treaty shopping abuses.

First, under the proposed treaty provision, sanctions against treaty shopping may be imposed only if a company formed in a third country becomes a resident of one of the countries for the principal purpose of enjoying the proposed treaty's benefits. Under the U.S. model, sanctions may be imposed, in addition, if the conduct of a company's operations had as its principal purpose obtaining treaty benefits, whether the company was formed in a third country or in one of the treaty countries, and regardless of the original purpose of the company's becoming a resident of one of the treaty countries. Currently, little if any treaty shopping involves changing the residence of a company. Thus, the proposed treaty would fail to address the types of treaty shopping arrangements generally employed by third-country residents seeking the benefits of treaties now in force.

In addition, under the proposed treaty provision, only treaty benefits provided under the dividend, interest, and royalty articles (chiefly reduced source country withholding tax rates) may be denied. Under the U.S. model provision by contrast, all treaty benefits may be denied. The proposed treaty provision applies to companies only. The U.S. model treaty provision applies to all persons except individuals, that is, to all business organizations. The proposed treaty provides that the competent authorities of the two countries "may through consultation deny" treaty benefits. Some have argued that, under this language, if the Chinese competent authority, for example, fails to cooperate, the United States will be unable to prevent third-country residents from obtaining treaty reductions in U.S. tax through the use of an investing entity set up in China. (According to the Treasury Department, however, treaty benefits could be denied under the anti-treaty shopping rules without prior consultations by the competent authorities.) The U.S. model's anti-treaty shopping provision does not contain language referring to consultations by the competent authorities.

The U.S. model applies an additional "safe harbor" test to determine whether, when the requirements for the imposition of sanctions discussed above have been met, treaty benefits actually will be denied. Treaty benefits will be denied to a business organization in such a case unless it is owned 75 percent or more by individuals residing in the

country of which it is a resident, and its income is not used in substantial part to meet liabilities to persons residing in third countries who are not U.S. citizens. The proposed treaty does not apply such a safe harbor test; it provides no standard for denying treaty benefits other than the rule that they may be denied if a company becomes a resident for the principal purpose of obtaining them. The safe harbor test of the U.S. model has the advantage of providing both business organizations and the countries with relative certainty as to who will be denied treaty benefits.

Finally, unlike the U.S. model, the proposed treaty does not limit treaty benefits with respect to foreign source income of a country's residents that bears a significantly lower tax in the residents' home country, under its laws, than similar domestic source income. This treatment contrasts with that provided under a treaty that has in the past provided treaty shopping opportunities, the treaty with the Netherlands Antilles.<sup>1</sup> That treaty reduces U.S. withholding tax rates only if the Netherlands Antilles does not grant special benefits to the income.<sup>2</sup>

The limited anti-treaty shopping provision of the proposed treaty may weaken the Treasury Department's ability to negotiate comprehensive anti-treaty shopping provisions in future treaties. In addition, it might invite treaty shopping abuses in the future with respect to the proposed treaty. While China's present tax structure and non-tax restrictions on foreign investment make current treaty shopping possibilities there insignificant, experience has shown that if abuses develop after a treaty is ratified, it is very difficult to negotiate solutions. Changes in Chinese law and administrative practice with respect to foreign investors have been occurring at a rapid pace in recent years, and could continue to do so. The proposed treaty limits the U.S. withholding tax on dividends paid to any portfolio Chinese investing entities to 10 percent, the lowest rate of any U.S. treaty, matched only by the treaty with Romania.

China's announced intention to resume the exercise of sovereignty over Hong Kong in 1997 also may have some bearing on the treaty shopping issue. The proposed treaty does not address directly the question of whether it will cover Hong Kong once Chinese sovereignty is resumed. If Hong Kong were covered, treaty shopping possibilities using a Hong Kong conduit entity could be substantial: at present, Hong Kong

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<sup>1</sup> See Rev. Ruls. 84-152 and 84-153, 1984 C.B. 381.

<sup>2</sup> See Article I(1) of the 1964 protocol applicable to the Netherlands Antilles.



imposes low income taxes, exempts from income tax entirely overseas profits and dividends from Hong Kong companies, and has no exchange controls or other non-tax rules that would restrict the movement of capital or the repatriation of profits. However, China and Britain have concluded an agreement governing the resumption of Chinese control over Hong Kong and, based on the terms of that agreement as they relate to the treaty definition of "China", it appears that the proposed treaty will not apply to Hong Kong. The Treasury Department takes this position.

The Committee might consider recommending a delay of ratification pending negotiation of an anti-treaty provision that conforms more closely to that of the U.S. model treaty if it considers the potential for future treaty-shopping under the present provision serious. It must be recognized, of course, that insistence by the United States on such a provision might result in the refusal of China to accept the treaty. In the alternative, the Committee may wish to indicate in its report accompanying the resolution approving ratification of the treaty and protocol that the treaty is intended to benefit bona fide Chinese and U.S. residents only and that the United States will reexamine the treaty should treaty shopping abuses develop in the future as a result of changes in China's foreign investment or tax rules. We recommend the inclusion of such language. The Committee also may wish to state in its report its understanding that the treaty will not apply to Hong Kong.

#### Resourcing rule of the Tax Reform Act of 1984

In 1984, Congress amended the foreign tax credit limitation rules to prevent U.S. persons from circumventing the foreign tax credit limitation by routing U.S. source income through a foreign corporation and thereby converting the income to foreign source income. One issue is whether the proposed treaty would allow the 1984 anti-abuse rule to operate in the case of U.S. income that might be earned in the future by U.S. persons through a Chinese corporation. If the 1984 amendment is a provision of U.S. law limiting the foreign tax credit, the proposed treaty would not prevent its operation since the treaty provides that the treaty credit is to be granted only "in accordance with the provisions" of U.S. law. A strong argument for this view is that the 1984 Act amended a Code section (904) that deals only with the foreign tax credit limitation. However, if instead the 1984 change is read as a source rule amendment, the proposed treaty arguably would prevent operation of the change since the treaty has a source rule that requires foreign sourcing of certain income that would otherwise be treated as U.S. source income under the 1984 Act rule. The argument for this latter view is that that source rule, because it appears in the double taxation relief article of the treaty, would have little meaning if it did not obligate the United States to

credit taxes on income that it treats as foreign source income.

At present, Chinese rules governing foreign investment appear to preclude the use of a Chinese corporation to convert U.S. source income to foreign source income. However, Chinese restrictions on foreign investment have been eased considerably over the last several years and could be eased further in the future. The Treasury Department interprets the proposed treaty not to override the 1984 resourcing amendment. It may be appropriate for the Committee to consider recommending approval of the treaty subject to a reservation of understanding that, consistent with the Treasury Department's technical explanation, the 1984 anti-abuse rule is not defeated by the treaty.

#### Branch-level tax

The Administration's May 1985 tax reform proposal asks Congress to enact a branch-level tax. The proposed treaty does not expressly prohibit the United States from imposing a branch-level tax but contains a standard nondiscrimination rule protecting permanent establishments that many argue forbids the imposition of a branch-level-type tax on permanent establishments. After ratification of the treaty and enactment of the branch-level tax it has proposed, the Administration would seek to renegotiate the treaty to allow the United States to impose the tax. Discussed above in the general portion of our testimony is the issue of whether this sequence of actions that the Administration asks Congress in general and the Senate in particular to take makes sense.

#### Developing country concessions

A number of the provisions of the proposed treaty generally reflect U.S. concessions to China because it is a developing country.

Permanent establishment rules.--The treaty definition of permanent establishment is somewhat broader than that in the U.S. model and many existing U.S. treaties. For example, the proposed treaty defines a permanent establishment to include a drilling rig or ship used for the exploration or exploitation of natural resources in a country if it is so used for more than three months. Under the U.S. model, by contract, such a drilling rig or ship must be present for at least one year.

The three-month rule for oil drilling activities also contrasts with the proposed treaty's six-month rule for construction activities. In its 1984 report on the income tax treaty with Canada, the Committee expressed its view that the offshore activities of contract drillers are, as a general matter, closely analogous to construction activities.<sup>3</sup> The Committee indicated its strong belief that



the permanent establishment threshold for drilling contractors should be the same as that provided for enterprises engaged in construction activities.<sup>4</sup> The proposed treaty once again presents the issue whether unequal treatment for drilling activities and construction activities is appropriate. On the one hand, it might be argued that the United States should not make concessions of this kind, especially in light of the Committee's comments just over a year ago. On the other hand, the proposed treaty with China was signed before the Committee made the comments described above. Therefore, it may be argued, unequal treatment is appropriate in this isolated case. In addition, it might be argued that this treatment must be viewed in the context of an overall agreement that benefits a broad range of U.S. taxpayers and the United States.

The six-month permanent establishment rule for construction activities itself departs from the 12-month rule of the U.S. model. The permanent establishment provision of the proposed treaty also departs from that of the U.S. model in treating as a permanent establishment the performance of consulting and other services though personnel engaged by an enterprise for that purpose even if the enterprise has no fixed place of business in the country of performance (provided the activities continue for more than six months in a 12-month period), and the performance of supervisory services in connection with construction activities (provided the activities continue for more than six months). The practical effect of the above variations from the U.S. model could be greater Chinese taxation of U.S. mineral exploration activities, construction activities, and consulting services than would be the case if the U.S. model rules were used.

In addition, under the proposed treaty, an independent agent of an enterprise may constitute a permanent establishment of that enterprise if the agent's activities are devoted wholly or almost wholly on behalf of that enterprise and it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions.

Other developing country concessions.--Other concessions to China's status as a developing country include limitations on source country withholding taxes that are higher than those in the U.S. model. Under the proposed treaty, the tax on direct investment dividends is limited to 10 percent in contrast with the five-percent limit in the U.S. model. The

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<sup>3</sup> See Senate Comm. on Foreign Relations, Report on Treaty Docs. 98-7 and 98-22, S. Exec. Rep. No. 22, 98th Cong., 2d Sess. 7-8 (1984).

<sup>4</sup> See id.

tax at source on gross interest is limited to 10 percent rather than the zero rate in the U.S. model. Royalties may be taxed at seven percent of gross if paid for the rental of industrial, commercial, or scientific equipment and at 10 percent of gross otherwise. This contrasts with the zero rate for royalties in the U.S. model, which is rarely obtained. Independent personal service income may be taxed if the person is present in a country for more than 183 days, in contrast with the U.S. model rule under which a person must have a fixed base regularly available to him in a country. The treaty also allows broader source country taxation of directors' fees and entertainers' income than that allowed in the U.S. model.

In notes exchanged when the treaty was signed, the United States agreed to amend the treaty to provide a U.S. tax sparing credit should the United States agree to the provision of such a credit in a future treaty with any other country.

Finally, the proposed treaty would prevent the United States from imposing its so-called second withholding taxes on any dividends and interest paid by Chinese corporations that might in the future earn significant business profits in the United States.

#### Covered Chinese taxes

The treaty covers four Chinese taxes: the individual income tax, the income tax concerning joint ventures with Chinese and foreign investment, the income tax concerning foreign enterprises, and the local income tax. All of these taxes are new, adopted in 1980 or later. Staff understands that the latter three taxes are presently collected chiefly from foreigners. In drafting the covered taxes, the Chinese Government apparently sought to make them creditable under the internal creditability rules of the United States and certain other Chinese trading partners, i.e., in the absence of any special treaty credit rules. Although the matter is not entirely free from doubt, it appears that all of these taxes are creditable generally under Treasury Department regulations.

If so, then, even in the absence of the treaty, these taxes generally reduce on a dollar-for-dollar basis the U.S. tax otherwise due on the foreign income of a U.S. taxpayer who pays them. U.S. tax revenues are reduced accordingly. Thus, the structuring of the Chinese taxes to meet the creditability requirements of the United States and other Chinese trading partners, while understandable from China's point of view, may result in an effective transfer of tax revenue from the U.S. to the Chinese Treasury, even in the absence of special treaty credit rules.



Nonetheless, the United States could, if it thought it desirable, amend its internal creditability rules in a manner that might discourage foreign governments from establishing taxes collected chiefly from nonresidents that effectively transfer tax revenue from the U.S. Treasury to the foreign government's treasury. While Congress might be willing to override treaties to achieve this goal, the presence of treaty credit rules (in the proposed treaty and other U.S. income tax treaties) may complicate any future Congressional efforts to restrict the indirect transfer of U.S. tax revenues to foreign governments via the foreign tax credit mechanism. For example, the Treasury Department, China, and other affected U.S. treaty partners might object to a future statutory override of treaty rules.

#### IV. INCOME TAX TREATY WITH CYPRUS

The proposed income tax treaty with Cyprus is similar in substance to a number of recent U.S. income tax treaties and to the U.S. and OECD models. The proposed treaty amends and replaces a proposed treaty between the two countries, signed in 1980, which was returned to the Treasury Department in 1981 after the Department requested that consideration of the treaty be deferred pending the renegotiation of its anti-treaty shopping provisions.<sup>5</sup> In its request for deferred consideration, the Treasury Department indicated that Cyprus was a tax haven and that opportunities for use of the treaty by residents of third-countries to receive U.S. treaty benefits were too great for the Department to tolerate.<sup>6</sup>

The proposed treaty also replaces an earlier proposed treaty between the United States and Cyprus, signed in 1974, which was never transmitted to the Senate.

The proposed treaty contains a comprehensive set of anti-treaty shopping provisions. In general, the treaty is noncontroversial. However, one feature of the anti-treaty shopping provisions and a few other features of the proposed treaty are worthy of special note. These features of the treaty, the issues they raise, and the propriety of entering into an income tax treaty with a tax haven country, are discussed below.

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<sup>5</sup> See Senate Comm. on Foreign Relations, Report on Return of Two Tax Treaties, S. Exec. Rep. No. 43, 97th Cong., 1st Sess. (1981).

<sup>6</sup> See id.

### Treaties with tax haven countries

Cyprus substantially revised its tax laws in the 1970's to attract foreign investment. Among other things, it now imposes sharply reduced taxes on foreign source income of Cypriot companies registered as overseas companies. Cyprus has sought to promote itself as a center for financial activities for nonresidents and as a tax haven. The United States recently terminated a number of extensions of its treaties with the United Kingdom and Belgium to their former colonies and territories, some of which have tax haven characteristics. The issue is whether the benefits for the U.S. Government and U.S. persons of an income tax treaty with Cyprus outweigh the possible disadvantage of appearing to legitimize Cyprus' tax haven function.

At present, Cyprus does not have substantial business relations with the United States, so the reductions in Cypriot tax provided under the treaty would not appear to have much current significance for U.S. persons. The proposed treaty does contain exchange of information rules which generally aid the United States in reducing avoidance and evasion of U.S. tax. However, it seems doubtful that these rules would produce much useful tax information to the United States in the context of this treaty. On the other hand, one of Cyprus' purposes in seeking the proposed treaty is to increase legitimate U.S. business investment in Cyprus and the treaty would facilitate such investment by providing U.S. investors with greater certainty of tax treatment and, in many cases, reduced Cypriot tax liability.

### Anti-treaty shopping provisions

The anti-treaty shopping provisions of the treaty, as renegotiated, follow closely those of the current (1981) U.S. model. The proposed treaty provisions are stricter than those found in most U.S. income tax treaties now in force.

However, certain of the anti-treaty shopping provisions found in the proposed treaty (those in paragraphs 1 and 2 of Article 26), like the corresponding provisions of the U.S. model (paragraphs 1 and 2 of Article 16), do not apply to individuals resident in one of the treaty countries who claim treaty benefits. The treaty would not deny treaty benefits if, for example, a third-country investor lent money to U.S. persons pursuant to a "back-to-back" loan arrangement utilizing a Cypriot individual as the intermediary and the intermediary's U.S. income on the transaction were subject to full Cypriot tax. This raises the issue of whether coverage of individuals under all of the anti-treaty shopping provisions is needed to forestall effectively treaty shopping abuses.

As already indicated, the corresponding anti-treaty



shopping provisions of the U.S. model do not apply to individuals either. However, some potential for treaty shopping using an individual intermediary exists. That potential is of particular concern in the case of a tax haven country like Cyprus that encourages third-country residents to channel investment income through it by reducing its taxes on income derived from certain offshore investments and providing other tax and non-tax incentives to attract foreign investors. In contrast with those included in the proposed treaty with Cyprus, all of the anti-treaty shopping provisions included in the proposed treaty with Barbados, a country with some tax haven characteristics, apply to individuals.

It is important to note, however, that there are provisions of the treaty and Cypriot law that reduce considerably the treaty's vulnerability to treaty shopping using a Cypriot individual as an intermediary. At present, Cyprus generally imposes a 42.5-percent withholding tax on interest payments to nonresidents. (However, this tax is substantially reduced or eliminated under several Cypriot income tax treaties.) An important anti-treaty shopping provision contained in the treaty--the provision denying treaty benefits to income earned in one country by a resident of the other when the residence country substantially reduces the tax on such income as compared with similar domestic income--applies to individual residents. According to the Treasury Department, the reduced rates of source country tax provided by the treaty for dividends, interests, and royalties do not apply if the recipient is a nominee for a third-country resident. In addition, the principles of a recent IRS ruling, if extended to individuals, could limit treaty shopping possibilities using an individual intermediary.

However, there is no guarantee that existing impediments to the use of the proposed treaty by third-country investors will continue. Cyprus, for example, substantially revised its tax laws in the 1970's to attract foreign investment. The possibility that Cyprus may make further tax law changes in the future to remove impediments to foreign investment cannot be discounted.

Experience has shown that if abuses develop after a treaty is ratified, it is very difficult to negotiate solutions. If the Committee believes that the potential for third-country abuse of the treaty using individual residents as conduits is serious, it might consider recommending that the treaty be approved but with a reservation requiring that all of its anti-treaty shopping provisions be made applicable

to individuals. It must be recognized, of course, that such a reservation by the United States might result in the refusal of Cyprus to accept the treaty. In the alternative, the Committee might consider recommending approval without any reservation, but with a recommendation that the Treasury Department in the future insist on comprehensive individual coverage under the anti-treaty shopping provisions included in any treaties negotiated with countries that appear to possess substantial treaty shopping potential.

### Developing country concessions

A number of the provisions of the proposed treaty generally reflect U.S. concessions to Cyprus because it is a developing country. For example, the treaty definition of permanent establishment is somewhat broader than that in the U.S. model and many existing U.S. treaties. The principal way in which the proposed treaty definition departs from the U.S. model is in the inclusion as a permanent establishment of a building site, construction or installation project, or installation, drilling rig or ship lasting in a country for more than six months (rather than the model's 12 months).

In addition, the limitation on withholding taxes on interest is higher than that in the U.S. model. The tax at source on gross interest is limited to 10 percent rather than the model's zero rate. Independent personal service income may be taxed if the person is present in a country for more than 183 days, in contrast with the U.S. model rule under which a person must have a fixed base regularly available to him in a country. The treaty also allows broader source country taxation of personal service income, directors' fees, and entertainer's income than that allowed under the U.S. model. Further, taxing jurisdiction is granted to the source country as well as to the residence country with respect to income not otherwise specifically dealt with by the treaty. Under the U.S. model, only the residence country may tax such income.

In notes exchanged when the proposed treaty was signed, the United States gives assurances that, when circumstances permit, it will be prepared to resume discussions with a view to incorporating provisions in the treaty, consistent with U.S. income tax policies regarding other developing countries, that would minimize the interference of the U.S. tax system with investment incentives offered by the Cypriot Government. These assurances reflect the desire of Cyprus and other developing countries to have the United States adopt a tax sparing credit.

### Resourcing rule of the Tax Reform Act of 1984

In 1984, Congress amended the foreign tax credit limitation to prevent U.S. persons from circumventing the



foreign tax credit limitation by routing U.S. source income through a foreign corporation and thereby converting the income to foreign source income. One issue is whether the proposed treaty would allow the 1984 anti-abuse rule to operate in the case of U.S. income earned in by U.S. persons through a Cypriot corporation. If the 1984 amendment is a provision of U.S. law limiting the foreign tax credit, the proposed treaty would not prevent its operation since the treaty provides that the treaty credit is to be granted only "[i]n accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the principles hereof)." A strong argument for this view is that the 1984 Act amended a Code section (904) that deals only with the foreign tax credit limitation. However, if instead the 1984 change is read as a source rule amendment, the proposed treaty arguably would prevent operation of the change since the treaty has special source rules that require foreign sourcing of certain income that would otherwise be treated as U.S. source income under the 1984 Act rule. The argument for this latter view is that these source rules would have limited meaning if they did not obligate the United States to credit taxes on income that they treat as foreign source income.

The Treasury Department interprets the proposed treaty not to override the 1984 resourcing rule. It may be appropriate for the Committee to consider recommending approval of the treaty subject to either a reservation or understanding that, consistent with Treasury's technical explanation, the 1984 anti-abuse rule is not defeated by the treaty.

#### Dividend credit and dividends paid deduction

Under Cypriot law, Cypriot resident shareholders generally receive a tax credit with respect to dividends from Cypriot resident companies. The credit equals the Cypriot corporate tax deducted (paid) by the distributing company on the profits out of which the dividends are paid. The credit is applied against a Cypriot resident shareholder's income tax liability. If the credit exceeds that liability, the excess is refunded to the shareholder. Cyprus' integrated system is unusual in that nonresident shareholders also generally receive a credit for the corporate tax paid; however, in the absence of a treaty, a nonresident of Cyprus generally is taxed on Cypriot source dividends at the top Cypriot corporate rate of 42.5 percent rather than at the rate otherwise applicable to the nonresident under Cypriot law. Nonresidents may not receive a refund of any corporate tax paid with respect to a Cypriot source dividend.

Under the proposed treaty, Cypriot source dividends derived by U.S. shareholders generally may not be subjected

to Cypriot tax in excess of the Cypriot corporate tax imposed on the profits or earnings from which the dividends are paid. U.S. shareholders generally receive credit against their Cypriot tax liability for the amount of the Cypriot corporate tax paid on those profits or earnings.

The treaty also provides U.S. resident individuals with a refund of any Cypriot corporate tax imposed on the profits or earnings out of which a dividend is paid that exceeds the individuals' Cypriot personal income tax liability. Under the treaty, Cypriot source dividends of U.S. resident individuals generally are taxed at the same Cypriot personal income tax rates applicable to the income of Cypriot resident individuals. Unlike Cypriot resident individuals, however, U.S. resident individuals effectively are subject to a maximum Cypriot tax on such dividends (at current Cypriot rates) of 42.5 percent instead of the top personal income tax of 60 percent. Also, U.S. resident individuals have only their Cypriot source income counted in determining the applicable marginal rate. Thus, U.S. individual shareholders are generally treated more favorably under the treaty than they would be in its absence and are sometimes treated more favorably by virtue of the treaty than their Cypriot counterparts are. The issue of inferior dividend tax relief for individual U.S. shareholders does not arise under the proposed treaty with Cyprus, as it does under the proposed treaties with Denmark, Italy, and Barbados.

U.S. corporate shareholders are also treated more favorably under the proposed treaty than they would be in its absence: The treaty lowers the Cypriot tax rate applicable to their Cypriot source dividends from the top corporate rate of 42.5 percent, which is otherwise generally applicable, to the rate on the profits or earnings from which the dividends are paid. However, U.S. corporate shareholders apparently may be treated less favorably than their Cypriot counterparts are in some cases: As indicated above, Cypriot corporate shareholders are subject to tax on Cypriot source dividends at the rates otherwise applicable to them as Cypriot corporations rather than at the rates applicable to the profits or earnings out of which the dividends are paid. Since Cyprus subjects some foreign-owned corporations to lower tax rates than Cypriot-owned corporations, U.S. corporate shareholders in Cypriot resident companies might have been better off (in the aggregate) with the rule applicable to Cypriot corporate shareholders. However, this result is not certain. In any event, the dividend tax relief provided U.S. corporate shareholders under the treaty (as compared to Cypriot corporate shareholders) is probably superior to that provided such shareholders under any existing U.S. income tax treaty with a country having a partially integrated tax system. No country with such a system except the United Kingdom provides substantial U.S. corporate investors any portion of the credit provided its



own residents. The U.S. treaty with the United Kingdom provides substantial U.S. corporate investors with a credit equal to one-half of the credit that a U.K. resident would be entitled to were he the recipient of the dividend.

The Administration's May 1985 tax reform proposal asks Congress to enact a 10-percent dividends paid deduction. Nonresident shareholders generally would be denied the benefits of the deduction through the imposition of a compensatory withholding tax on dividends paid to them by U.S. companies. The proposed treaty with Cyprus, like all five proposed treaties, would prohibit imposition of the compensatory withholding tax. The Administration proposal would resolve this conflict by allowing the treaty to override the compensatory withholding tax at the outset, but would grant Treasury the authority to apply the tax (notwithstanding the treaty) pending the outcome of renewed treaty negotiations concerning that tax and the dividend credit. This matter is discussed further in the general portion of our testimony.

#### Branch-level tax

The Administration's May 1985 tax reform proposal also asks Congress to enact a branch-level tax. The proposed treaty does not expressly prohibit the United States from imposing a branch-level tax but contains a standard nondiscrimination rule protecting permanent establishments that many argue forbids the imposition of a branch-level-type tax on permanent establishments. After ratification of the treaty and enactment of the branch-level tax it has proposed, the Administration would seek to renegotiate the treaty to allow the United States to impose the tax. Discussed above in the general portion of our testimony is the issue of whether this sequence of actions that the Administration asks Congress in general and the Senate in particular to take makes sense.

### **V. INCOME TAX TREATY (AND PROTOCOL) WITH DENMARK**

The proposed new income tax treaty with Denmark, as amended by the proposed protocol, is similar to a number of recent U.S. income tax treaties and to the U.S. and OECD models. Last year, the Committee reported favorably on the proposed treaty (and protocol) without reservation and recommended that the Senate advise and consent to its ratification. However, the Senate did not consider the treaty further in 1984.

The income tax treaty and protocol with Denmark deal with a number of issues that have arisen over the years. The present treaty with Denmark is over 30 years old. It no

longer adequately addresses the economic relationship between Denmark and the United States.

The proposed treaty and protocol provide some benefits to U.S. taxpayers not found in the existing treaty. The protocol benefits U.S. oil companies, for example, by providing that the income tax imposed under the Danish Hydrocarbon Tax Act adopted by Denmark in 1982 will be a fully creditable tax for U.S. foreign tax credit purposes. In the absence of the treaty credit, the income tax specifically imposed under the Danish Hydrocarbon Tax Act (as opposed to the income tax imposed on U.S. oil companies under the general Danish income tax law) probably would not be a fully creditable tax under Treasury regulations governing the creditability of foreign taxes.

Since 1976, Danish law has reduced two-tier taxation of corporate earnings by granting Danish resident shareholders an imputation credit against Danish tax equal to a percentage of the amount of dividends received from Danish resident companies. The proposed treaty and protocol provide an imputation credit to U.S. investors in Danish resident companies. The credit and the Danish imputation system are discussed in more detail below. The general portion of our testimony analyzes the issues raised by the Administration's proposed dividends paid deduction rules as they relate to the imputation credit.

If the Committee again decides to recommend that the Senate advise and consent to the ratification of the proposed treaty and protocol, quick action would benefit many U.S. taxpayers. The imputation credit will be available for Danish-source dividends paid or credited on or after the first day of the second month following the date the treaty and protocol enter into force. Once the treaty and protocol enter into force, the treaty credit rules relating to the Danish hydrocarbon tax apply retroactively to taxable years beginning after 1982.

The treaty credit for Danish hydrocarbon taxes has generated some controversy. In addition, the treaty and protocol have a few other features worthy of special note. These features, the treaty credit, and the issues they raise, are discussed below.

#### Hydrocarbon Tax Act

The Danish Hydrocarbon Tax Act generally imposes a tax on income in connection with preliminary surveys, exploration, and extraction of hydrocarbons in Denmark. The tax is assessed separately from the regular Danish income and corporate taxes applicable to oil companies and amounts to 70 percent of the aggregate taxable income of fields showing profits. Regular Danish corporate and income taxes are



deducted in computing taxable hydrocarbon income. Other special deduction and allowance rules also apply.

The protocol treats the Danish hydrocarbon tax, and any substantially similar tax, as a creditable tax for U.S. foreign tax credit purposes. No determination has been made by the U.S. Treasury Department or Internal Revenue Service concerning the creditability of the Danish hydrocarbon tax. Questions such as whether the hydrocarbon tax is a creditable income tax under general Code concepts or whether it is a substantially similar tax to the creditable tax described in paragraph (1)(a) of Article I of the present treaty have not been resolved administratively or judicially. However, under the Treasury's new foreign tax creditability regulations, promulgated in October 1983, it would appear that income tax specifically imposed under the Danish Hydrocarbon Tax Act probably would not be fully creditable. Regular corporate income taxes applicable to U.S. oil companies operating in Denmark, which are currently imposed at a 40-percent rate, would be creditable in the absence of the special treaty credit.

The Danish hydrocarbon tax is creditable under the protocol, but subject to certain limitations. In addition to the general rules found in tax treaties, the protocol will permit Danish hydrocarbon taxes to offset U.S. taxes on Danish oil and gas extraction income only. Thus, a "per-country" limitation applies to the use of the credit for hydrocarbon tax. A limited carryback and carryforward of taxes not used in the current year is also provided. Under the Code, the credit for taxes on foreign oil and gas extraction income is subject to a separate limitation too but it applies on a worldwide basis only, not on a per-country basis.

Similar provisions making the United Kingdom's Petroleum Revenue Tax and Norway's Submarine Petroleum Resource Tax creditable are contained in the third protocol to the U.S.-United Kingdom income tax treaty and the protocol to the U.S.-Norway income tax treaty, respectively. In the case of the U.S.-United Kingdom treaty, there was a threatened reservation on the provision. In response, the per-country limitation was inserted in that protocol.

The issue is the extent to which treaties should be used to provide a credit for taxes that may not otherwise be fully creditable and, in cases where a treaty does provide creditability, to what extent the treaty should impose limitations not contained in the Code. In considering this issue, it is important to keep in mind that the tax credits allowed under the treaty for Danish taxes, because they will probably be somewhat larger than the credits otherwise allowed under Treasury regulations, may reduce somewhat the U.S. taxes collected from U.S. oil companies operating in the

Danish sector of the North Sea. However, because of the treaty's per-country limitation on the treaty credit and the creditability of the regular Danish income tax in the absence of the treaty, that reduction will be limited.

Another question raised is whether a controversial issue in U.S. tax policy such as the tax credits to be allowed U.S. oil companies on their foreign extraction operations should be resolved through the treaty process rather than the regular legislative process. Also at issue is whether Denmark should be denied a special treaty credit for taxes on oil and gas extraction income when Norway and the United Kingdom, its North Sea competitors, now receive a similar treaty credit under the U.S. income tax treaties with those countries currently in force. On the one hand, it would appear fair to treat Denmark like Norway and the United Kingdom. On the other hand, the United States should not view any particular treaty concession to one country as requiring identical or similar concessions to other countries. Moreover, Denmark enacted its hydrocarbon tax after the United States agreed in principle to credit such taxes by treaty; it may be inappropriate to grant a treaty credit for taxes not creditable in full under U.S. internal rules that might have been specifically established and structured with the treaty credit in mind. Finally, the Norwegian and United Kingdom treaties were ratified before U.S. internal creditability rules were modified to permit a portion of the extraction taxes imposed on oil companies taxes to be credited. Under current Treasury regulations, partial credit for the Norwegian, United Kingdom, and Danish extraction taxes would be available in the absence of a special treaty credit. It can be argued, therefore, there is less need to provide the treaty credit in the case of Denmark than there was to do so in the cases of Norway and the United Kingdom.

A related issue involves the imposition of the regular Danish corporate tax on U.S. oil drillers. The proposed treaty defines "Denmark" and the "United States" more broadly than the present treaty to include expressly the U.S. and Danish portions, respectively, of the continental shelf. Exploration and extraction of natural resources, the income from which is subject under Danish internal law to Danish tax, is presently concentrated along the Danish portion of the continental shelf in the North Sea. While the matter is not free from doubt, it is arguable that, under the present treaty's more restrictive definition of Denmark, U.S. oil drillers are not subject to Danish corporate tax in connection with their North Sea operations. This is because, under the more restrictive definition of Denmark, income from operations along the continental shelf arguably is not from Danish sources. This raises the issue whether the United States should agree to allow its oil drillers under the new Danish treaty to be subject to a tax from which they are



possibly exempt under the existing treaty.

#### Imputation credit and dividends paid deduction

Under the Danish imputation system, Danish resident shareholders subject to full tax liability in Denmark on dividends from Danish resident companies generally receive a tax credit equal to a percentage of the gross dividend. The credit was 15 percent of the gross dividend for years of assessment 1978/79 through 1981/82. It was increased by the Danish Parliament in the summer of 1981 to 25 percent for years of assessment beginning with 1982/83. The 15-percent credit in effect before 1982/83 offset approximately 25 percent of the Danish corporate tax paid on distributed profits.

Under Danish law, Danish parent companies do not include in taxable profits dividends received from Danish resident subsidiaries if the parent holds at least 25 percent of the share capital or cooperative share capital of the subsidiary during the whole of the taxable year in which the dividends are received. Because of this rule, no tax credit is attached to such dividends.

In the absence of a tax treaty, no imputation credit is allowed by Denmark with respect to dividends paid to nonresidents of Denmark. In addition, dividends from a Danish subsidiary are taxed by Denmark when paid to a nonresident parent company (as opposed to a resident parent company) owning at least 25 percent of the share capital of the subsidiary. Thus, a higher tax burden is imposed on dividends paid to nonresident shareholders than is imposed on dividends paid to Danish resident shareholders. The proposed treaty and protocol substantially reduce this disparity.

Under the proposed treaty's imputation credit rules, dividends paid by a Danish resident company to, and beneficially owned by, a U.S. direct investor (a U.S. company which holds directly at least 25 percent of the share capital of the company paying the dividends) are distinguished from dividends paid by a Danish resident company to a U.S. portfolio investor (a U.S. company owning less than a 25 percent share capital interest in the company paying the dividend or any noncorporate U.S. resident). A U.S. direct investor is entitled to a credit equal to five percent of the gross amount of dividends paid to it by a Danish resident company. Under the treaty, Denmark may charge a U.S. direct investor a tax on the aggregate amount of the dividends and the tax credit at a rate not exceeding five percent. A U.S. portfolio investor is entitled to a credit equal to 15 percent of the gross amount of dividends paid to it by a Danish resident company. Under the treaty, Denmark may charge a U.S. portfolio investor a tax on the aggregate amount of the dividends and the tax credit at a rate not

exceeding 15 percent.

As originally drafted, the proposed treaty set the imputation credit for U.S. direct investors equal to one-third of the credit to which a Danish resident individual would have been entitled. The proposed treaty set the credit for U.S. portfolio investors equal to the credit to which a Danish resident individual would have been entitled. At the time the proposed treaty was signed, Danish law provided for a 15 percent credit for Danish residents. As indicated above, the credit was increased to 25 percent for years of assessment beginning with 1982/83. By setting the credit for U.S. direct investors at five percent of gross dividends and for U.S. portfolio investors at 15 percent of gross dividends, the proposed protocol, therefore, cuts back the treaty credit available to U.S. investors, freezing it at the level that the proposed treaty would have provided for years of assessment before 1982/83. Under the proposed protocol, U.S. investors in Danish resident companies will be eligible for a smaller imputation credit than Danish shareholders in Danish resident companies. However, it is important to recognize that the agreement of Denmark to extend the imputation credit to U.S. shareholder, particularly to U.S. direct investors, is an important concession by Denmark. The proposed treaty represents only the fourth time that a country with a tax system which integrates corporate and shareholder taxation has agreed to extend its imputation credit to U.S. portfolio investors, and only the third time that such a country has agreed to extend its imputation credit to U.S. direct investors. The proposed income tax treaties with Italy and Barbados, for example, which, like Denmark, have imputation systems, do not extend imputation benefits to U.S. shareholders.

The Administration's May 1985 tax reform proposal asks Congress to enact a 10-percent dividends paid deduction. Nonresident shareholders generally would be denied the benefit of the deduction through the imposition of a compensatory withholding tax on dividends paid to them by U.S. companies. The proposed treaty with Denmark, like all five proposed treaties, would prohibit imposition of the compensatory withholding tax. The Administration proposal would resolve this conflict by allowing the treaty to override the compensatory withholding tax at the outset, but would grant Treasury the authority to apply the tax (notwithstanding the treaty) pending the outcome of renewed treaty negotiations concerning that tax and the imputation credit. This matter is discussed further in the general portion of our testimony above.

#### Branch-level tax

The Administration's May 1985 tax reform proposal also asks Congress to enact a branch-level tax. The proposed



treaty does not expressly prohibit the United States from imposing a branch-level tax but contains a standard nondiscrimination rule protecting permanent establishments that many argue forbids the imposition of a branch-level-type tax on permanent establishments. After ratification of the treaty and enactment of the branch-level tax it has proposed, the Administration would seek to renegotiate the treaty to allow the United States to impose the tax. Discussed above in the general portion of our testimony is the issue of whether this sequence of actions that the Administration asks Congress in general and the Senate in particular to take makes sense.

### Anti-treaty shopping provision

The anti-treaty shopping provision of the proposed treaty is less strict than the anti-treaty shopping provision found in some recent U.S. tax treaties, but more restrictive than the anti-treaty shopping provisions in older U.S. treaties.

This provision is also less strict than that of the current (1981) U.S. model, although the U.S. model provision is only one of several approaches that the Treasury Department considers satisfactory to prevent treaty shopping abuses. For example, the provision generally limits the use of the treaty not, as the U.S. model does, to corporations 75 percent of whose stock is owned by persons who are residents of the treaty partner in which the corporation is a resident, but to corporations in which 50-percent ownership is shared by either residents of the treaty partner or of which the corporation is a resident, residents of the other treaty partner, U.S. citizens, publicly traded companies that are residents of the two countries, the two countries themselves, or any combination of them. The recently enacted treaties with Australia and New Zealand maintain the U.S. model's 75-percent standard, but like the proposed treaty, they expand the class of qualified beneficial owners.

The liberalized anti-treaty shopping provision of the proposed treaty may create a potential for abuse. Treaty shopping potential in the case of Denmark may be more serious than in the case of some other U.S. treaty partners because of the absence of any Danish withholding tax on interest payments from a Danish conduit to third-country investors; Denmark is relatively unusual amount U.S. treaty partners in not imposing a withholding tax on interest derived by nonresidents. Experience has shown that if abuses develop after a treaty is ratified it is very difficult to negotiate solutions.

Last year, the Committee decided not to recommend a reservation on the anti-treaty shopping provision. In its report on the treaty, the Committee gave several reasons for

its decision. Among them was the Committee's recognition that the proposed treaty contains other provisions which are advantageous to the United States, in particular, the provision extending the Danish imputation credit for dividends to U.S. shareholders in Danish companies. Also, the Committee noted that Denmark is generally a high-tax country and has shown no interest in serving as an international finance center that would attract treaty shopping. However, the Committee stressed in its report that it would closely scrutinize anti-treaty shopping provisions included in treaties negotiated in the future for treaty shopping potential. The Committee stated that it expected our treaty negotiators, before agreeing to a proposed anti-treaty shopping provision, to continue to consider carefully possible interactions between the proposed provision and the other proposed provisions of the treaty at issue, as well as the domestic laws of the other country. It also stated that it expected the Treasury Department to interpret and apply the proposed treaty and other treaties in the manner most consistent with anti-treaty shopping goals.

#### Allowance of deductions to U.S. persons

The proposed treaty contains a provision that gives U.S. taxpayers a deduction not permitted under the Code. Under the proposed treaty, child support payments by a U.S. citizen or U.S. resident to a Danish resident under 18 years of age pursuant to a Danish court decree may be taxed by Denmark and the United States must allow a deduction for the payments. Under U.S. law, child support payments are not taxable income to the recipient and the payor may not deduct the payments. This is the first time that a deduction for child support payments has been provided by treaty.

The issue is whether treaties should be used to allow U.S. persons deductions to which they would not otherwise be entitled. As a general rule, treaties have not given U.S. persons such deductions. On the other hand, this is arguably an appropriate function of treaties in limited cases because it adjusts U.S. rules to take into account conflicting tax rules of the treaty partners and the particular tax relationship between the two countries. Four treaties allowing U.S. persons deductions to which they would not otherwise be entitled have been considered recently by the Committee--the proposed treaty, the income tax treaties with Canada and Jamaica, and the proposed income tax treaty with Israel. The treaty with Israel has been approved by the Senate.

The issue of the granting of deductions to U.S. persons by treaty has been brought to the attention of this Committee in the past. In September of 1981, the Chairman and ranking minority Member of the Ways and Means Committee and the Chairman of the Finance Committee submitted statements to



this Committee, as part of the record of the hearings on the proposed Canadian and Israeli treaties, in which they expressed serious reservations with granting deductions by treaty. This Committee, in reporting favorably the proposed treaty with Israel, indicated its concern with granting deductions to U.S. persons by treaty. In reporting favorably the treaty with Canada last year, the Committee reiterated its concern.

Last year, the Committee considered recommending a reservation on the child support provision. However, the Committee decided against it, noting in its report that the child support provision was included in the proposed treaty before the 1981 treaty hearings, when the deduction issue was brought generally to the Committee's attention and the Committee first indicated its general disapproval of the granting of U.S. tax deductions by treaty. In its report, the Committee made it clear that, in the future, proposed treaty provisions that would grant U.S. persons deductions not otherwise allowed under the Code would bear a substantial risk of Committee disapproval.

## VI. INCOME TAX TREATY (AND PROTOCOL) WITH ITALY

The proposed treaty with Italy, as modified by the proposed protocol, is similar to a number of recent U.S. income tax treaties and to the U.S. and OECD models. It would replace the present treaty with Italy, which is over 30 years old. The proposed treaty provides some benefits not found in the existing treaty. The proposed treaty also raises some concerns, however.

### Dual resident corporations

The proposed treaty presents the possibility of double U.S. foreign tax credits for taxes paid to Italy. Italy determines corporate residence on the basis of corporate activities, while the United States determines corporate residence on the basis of place of incorporation. Therefore, an Italian resident corporation under Italian law may be a U.S. resident corporation under U.S. law; such corporations are known as dual resident corporations. A U.S. corporation is entitled to foreign tax credits for the taxes it pays directly. It is entitled to those credits even if it is a dual resident corporation.

The problem arises if a dual resident corporation pays a dividend to a 10-percent U.S. corporate shareholder. On payment of a dividend from an Italian corporation to a 10-percent U.S. corporate shareholder, the proposed treaty allows the U.S. corporate shareholder to credit its share of the Italian taxes that the Italian resident corporation paid

to Italy. (The Code generally allows 10-percent U.S. corporate shareholders to credit their share of foreign taxes paid by a foreign corporation from which they receive dividends, but that treatment (the "deemed paid credit" or "indirect credit") does not apply to dividends from U.S. corporations.) The proposed treaty does not specifically indicate that the deemed paid credit is unavailable when the payor of the dividend is a dual resident corporation. If the deemed paid credit is available, the payor would credit the Italian taxes it paid, and the payee could credit those same Italian taxes, while excluding 100 percent or 85 percent of the dividend from income by virtue of the dividends received deduction.

The negotiators of the proposed treaty did not intend this combination of double foreign tax credits and dividends received deduction. The language of the proposed treaty, on its face, may not prohibit that result, however. One recent treaty, that between the United States and New Zealand, contains a deemed paid credit provision similar to that of the proposed treaty with Italy but with an exception: U.S. corporate shareholders cannot credit taxes paid by dual resident corporations. The existence of that exception in the New Zealand treaty might lead taxpayers or the courts to infer that double foreign tax credits would be available under the proposed Italian treaty. We understand that this part of the Italian treaty was negotiated before the development of the more modern language used in the New Zealand treaty.

A reservation requiring a change in the treaty would clearly achieve the result the Committee seeks. We do not recommend a reservation, however, if a reservation could somehow create an inference that similar language in earlier treaties allowed double foreign tax credits. That inference would be incorrect. We believe that, given the ambiguity of this treaty language, an understanding will be sufficient to prevent double foreign tax credits from being claimed.

### Social security

In 1983, Congress imposed a 30-percent withholding tax on one-half of the amount of social security benefit payments to nonresident aliens. The proposed treaty would prevent the United States from taxing U.S. social security payments made to U.S. citizens who are both citizens and residents of Italy. The United States has never before agreed to forego completely its right to tax income that arises in the United States and that is earned by a U.S. person (a term that includes U.S. citizens). The United States frequently waives tax on U.S. source income that is earned by foreigners. The United States sometimes waives tax on foreign source income that is earned by U.S. persons (typically, but not always, through the foreign tax credit). In at least one case, the



United States has foregone the primary right to tax some U.S. source income paid to U.S. citizens (in the 1984 French protocol), but the United States has always retained at least a residual right to tax U.S. income of U.S. citizens.

One might argue that the waiver of tax on social security payments in this instance is of minor importance, since the waiver would apply to a limited class of individuals. The precedential importance of this treaty provision could be significant, however. If the United States agrees to waive tax on social security payments for U.S. citizens who are both citizens and residents of Italy, it may be difficult to deny equivalent treatment to other countries. In addition, allowing this treatment for social security payments in this treaty could encourage demands for waiver of tax on other types of income by other countries in the future. If the United States once abandons the principle that it has at least a residual right to tax U.S. source income of U.S. persons who reside abroad, it may be difficult to defend that principle in the future, except on an ad hoc basis.

If the Committee feels that this issue is of sufficient importance, it could recommend a reservation. If the Committee agrees that this waiver of jurisdiction is of concern but does not wish to jeopardize the treaty, the Committee could instead express its view that it will not be likely to approve similar provisions in the future.

#### Resourcing rule of the Tax Reform Act of 1984

In 1984, Congress amended the foreign tax credit limitation rules to prevent U.S. persons from circumventing the foreign tax credit limitation by routing U.S. source income through a foreign corporation and thereby converting the income to foreign source income. One issue is whether the proposed treaty would allow the 1984 anti-abuse rule to operate in the case of U.S. income earned by U.S. persons through a Italian corporation. If the 1984 amendment is a provision of U.S. law limiting the foreign tax credit, the proposed treaty arguably would not prevent its operation since the treaty provides that the treaty credit is to be granted only "in accordance with and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)." A strong argument for this view is that the 1984 Act amended a Code section (904) that deals only with the foreign tax credit limitation. However, if instead the 1984 change is read as a source rule amendment, the proposed treaty arguably would prevent operation of the change since the treaty has a source rule that requires foreign sourcing of certain income that would otherwise be treated as U.S. source income under the 1984 Act rule. The argument for this latter view is that that source rule,

because it appears in and applies for purposes of the double taxation relief article of the treaty, would have little meaning if it did not obligate the United States to credit taxes on income that it treats as foreign source income.

The Treasury Department interprets the proposed treaty not to override the 1984 resourcing amendment. It may be appropriate for the Committee to consider recommending approval of the treaty subject to either a reservation or understanding that, consistent with Treasury's technical explanation, the 1984 anti-abuse rule is not defeated by the treaty.

### Branch-level tax

The Administration's May 1985 tax reform proposal asks Congress to enact a branch-level tax. The proposed treaty does not expressly prohibit the United States from imposing a branch-level tax but contains a standard nondiscrimination rule protecting permanent establishments that many argue forbids the imposition of a branch-level-type tax on permanent establishments. After ratification of the treaty and enactment of the branch-level tax it has proposed, the Administration would seek to renegotiate the treaty to allow the United States to impose the tax. Discussed above in the general section of our testimony is the issue of whether the sequence of actions that the Administration asks Congress in general and the Senate in particular to take makes sense.

### Treatment of drilling rigs as permanent establishments

The proposed treaty defines permanent establishment to include a drilling rig or ship used for the exploration or development of natural resources in a country if it remains there for more than 180 days in a 12-month period. This treatment contrasts with the general 12-month permanent establishment rule of the proposed treaty. In its 1984 report on the income tax treaty with Canada, the Committee expressed its view that the offshore activities of contract drillers are, as a general matter, closely analogous to construction activities.<sup>1</sup> The Committee indicated its strong belief that the permanent establishment threshold for drilling contractors should be the same as that<sup>2</sup> provided for enterprises engaged in construction activities. The proposed treaty once again presents the issue whether unequal treatment for drilling rigs and construction activities is

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See Senate Comm. on Foreign Relations, Report on Treaty Docs. 98-7 and 98-22, S. Exec. Rep. No. 22, 98th Cong., 2d Sess. 7-8 (1984).

See id.



appropriate. On the one hand, it might be argued that the United States should not make concessions to developed countries like Italy of the kind typically made to developing countries, especially in light of the Committee's comments just over a year ago. On the other hand, the proposed treaty with Italy was signed before the Committee made the comments described above. Therefore, it may be argued, unequal treatment is appropriate in this isolated case. In addition, it might be argued that this treatment must be viewed in the context of an overall agreement that benefits a broad range of U.S. taxpayers and the United States. Further, the proposed treaty may be an improvement from the existing treaty, which arguably provides no permanent establishment protection for drilling contractors.

#### Anti-treaty shopping provision

The anti-treaty shopping provision of the proposed protocol differs significantly from that of the U.S. model treaty. The anti-treaty shopping rule of the proposed protocol applies only to treaty benefits provided under the articles dealing with business profits, dividends, interest, royalties, capital gains, and other income. The model anti-treaty shopping article applies to all benefits under the model treaty, not just to specified benefits. The largest omission appears to be the omission of coverage of shipping and aircraft income. The staff is not aware of current tax plans wherein third country residents use Italy as a base for shipping operations, however. Moreover, most foreign shipping income is already exempt from U.S. tax under reciprocal exemptions contemplated by the Code (sec. 883).

The model contains a 75-percent ownership test, in contrast to the 50-percent ownership test of the proposed protocol and some recent treaties. In addition, the model contains a "base erosion" rule that denies treaty benefits to a person when a substantial part of that person's gross income is used (directly or indirectly) to meet liabilities (including liabilities for interest or royalties) to third-country residents. The proposed treaty omits this rule. This base erosion rule prevents use of a company whose owners met the ownership test to pay treaty-protected interest or royalties (or other amounts) to third-country residents. The omission of this base erosion rule is the most significant treaty shopping issue that the proposed Italian treaty presents. Italy is a developed country that generally imposes significant withholding taxes on interest. If Italy, like other European countries, repeals its withholding tax on interest, U.S. borrowers might seek to circumvent the restrictions that retain the U.S. tax on some interest payments to foreigners by routing interest payments through an Italian-owned Italian corporation. It is not clear that this avoidance plan would yield the result that taxpayers seek, however, in light of a recent ruling by the

Internal Revenue Service.<sup>10</sup>

While an argument might be made that a broader anti-treaty shopping provision is appropriate, Italy is a relatively high tax country with no history as a tax haven for conduit entities established by third-country investors. At present, it is doubtful that third-country investors would seek to use Italy as a base for treaty shopping. One concern, however, is that abuses could develop in the future. It has proved difficult to renegotiate treaties once abuses develop. Another concern is that this provision creates a precedent that may weaken the Treasury Department's ability to negotiate comprehensive anti-treaty shopping provisions in future treaties. While a reservation or understanding on this point does not appear necessary, the Committee might wish to indicate the circumstances when it believes that a base erosion test is not necessary.

#### Imputation credit and dividends paid deduction

Italy gives resident shareholders a tax credit when they receive dividends that reflects taxes that the corporation paid on the profits it is distributing in the form of dividends. Italy gives individual Italian resident shareholders a credit for one-third of corporate taxes paid, while it gives corporate Italian resident shareholders a credit for three-sevenths of corporate taxes paid. However, Italy, like most other countries, does not give this credit to foreign shareholders unilaterally. Thus, a higher tax burden is imposed on dividends paid to nonresident shareholders than is imposed on dividends paid to Italian resident shareholders. Some countries have given part of this credit to U.S. shareholders by treaty, but neither the existing treaty with Italy nor the proposed treaty does so. One issue is whether the United States should insist that the treaty give U.S. shareholders at least a partial credit.

The U.S. income tax treaties with the United Kingdom and France, which, like Italy, have imputation systems, provide U.S. portfolio investors with a credit equal to the credit a U.K. or French resident would have received. On the other hand, the U.S. income tax treaty with Canada, which also has an imputation system, does not allow U.S. shareholders in Canadian companies any portion of the imputation credit provided by Canadian statute to Canadian shareholders in Canadian companies. The proposed treaties with Denmark and Cyprus grant U.S. portfolio investors some relief, while the proposed treaty with Barbados does not. Under present U.S. income tax treaties, however, no imputation system country except the United Kingdom allows U.S. direct investors any



portion of the imputation credit provided its own residents. The U.S. treaty with the United Kingdom provides U.S. direct investors with a credit equal to one-half of the credit which an individual U.K. resident would be entitled to were he the recipient of the dividend. The proposed treaties with Denmark and Cyprus also grant U.S. direct investors some relief.

The Administration's May 1985 tax reform proposal asks Congress to enact a 10-percent dividends paid deduction. Nonresident shareholders generally would be denied the benefit of the deduction through the imposition of a compensatory withholding tax on dividends paid to them by U.S. companies. The proposed treaty with Italy, like all five proposed treaties, would prohibit imposition of the compensatory withholding tax. The Administration proposal would resolve this conflict by allowing the treaty to override the compensatory withholding tax at the outset, but would grant Treasury the authority to apply the tax (notwithstanding the treaty) pending the outcome of renewed treaty negotiations concerning that tax and the imputation credit. This matter is discussed further in the general portion of our testimony above.

#### Timing considerations

Taxpayers assert several reasons for quick Senate action on the proposed treaty. If the proposed treaty goes into effect during 1985, taxpayers will be able to choose between the existing treaty and the proposed treaty for transactions occurring in 1985. The proposed treaty contains a number of rules that are more favorable to U.S. taxpayers than those contained in the existing treaty. In particular, it prohibits source country taxation of capital gains (except real property gains). We understand that at least one U.S. taxpayer has sold Italian property at a substantial gain in 1985, and that Italy will forgive the tax on that gain only if the proposed treaty takes effect in 1985. While this taxpayer and others might benefit from early action, nothing compels Italy to take steps to make the treaty effective in 1985 even if the Senate agreed to the treaty immediately. However, we understand that the Italian Government is proceeding with its ratification procedures at this time. In addition, the potential benefit of quick action to this taxpayer (and similarly situated taxpayers) must be weighed against factors that might militate for delay. These factors include those discussed above in connection with the Administration proposal for tax reform, and the possible need for reservations or understandings to make the proposed treaty reflect sound U.S. tax policy.

## SUMMARY OF PREPARED STATEMENT

Mr. Chairman and members of the Committee:

It is an honor to appear before you today. A two-page handout outlines our statement.

We have studied the proposed treaties with Barbados, China, Cyprus, Denmark, and Italy extensively. We have prepared pamphlets discussing each of these treaties, and we are submitting a written statement for the record. In our efforts, we have consulted with your staff, the Treasury Department, the staffs of the tax-writing committees, and outside experts.

These treaties are generally consistent with the tax policy goals Congress has sought to achieve in the current tax Code. These treaties are generally similar to other recent tax treaties that this Committee and the Senate have approved. These five treaties do present some issues, however.

The task of a tax treaty is to make our tax system mesh with another country's tax system. Recent rapid changes in our complicated and changing tax system make this task difficult.



Tax legislation in this country has become a two-step process. Enactment of a major tax bill is only the first step. The second step is enactment of a technical corrections bill to make the original major bill do what Congress wanted it to do in the first place. This year, the Chairmen and ranking members of the tax-writing Committees have introduced identical bills to correct the Tax Reform Act of 1984. The technical corrections bill is 225 pages long.

Four of the five treaties before you were signed before the 1984 Act passed. It is not surprising that some parts of the proposed treaties do not mesh well with the 1984 Tax Act. Instead, it is surprising how well these treaties reflect recent legislation.

The apparent conflicts between these treaties and the 1984 Tax Act are technical. We do not believe that the other countries involved wanted these treaties to override the 1984 Act. We do not believe that those countries should object to U.S. action to clarify some technical points. Tax treaties are supposed to prevent double taxation so that both countries do not impose full tax on the same item of income. The danger is that technical problems could cause some income to escape tax in both countries.

As for the specific treaties themselves, the treaty with

Barbados would override a change that the 1984 Tax Reform Act made to the accumulated earnings tax. This result would be inadvertent. A reservation to the treaty with Barbados would be appropriate to prevent tax haven abuse.

An ambiguity in the treaty with Italy might be read to allow double foreign tax credits in some cases. That result was not intended. An understanding clarifying the Italian treaty would be appropriate.

Four of the treaties, those with Barbados, China, Cyprus, and Italy, fail to reflect a provision of the 1984 Act that pierces the veil of foreign corporations. That provision prevents the use of foreign corporations to inflate foreign tax credits artificially. Three of those four treaties were signed before Congress passed the 1984 Act. The interaction of these treaties and the 1984 Act is not totally clear. The Administration agrees that it would be unwise to adopt these four treaties without making it clear that they do not override the 1984 foreign tax credit changes. We believe that it would be appropriate to include language in any Senate resolution of ratification to make it clear to all concerned, including the other countries, that these treaties will not override the 1984 Act on this foreign tax credit point.

The treaty with Denmark would allow U.S. taxpayers to



take a foreign tax credit for the Danish oil tax. Taxpayers might not be able to credit all of that tax without this treaty. In general, we question the wisdom of allowing foreign tax credits by treaty. Earlier treaties with Norway and the United Kingdom allow a credit of the kind in the Danish treaty, however. In addition, last year this Committee approved this Danish treaty, although the full Senate did not consider it. In light of U.S. allowance of the credit to the United Kingdom and Norway, the Administration and this Committee decided that the United States should give the credit to Denmark. If the Committee again approves the Danish treaty with the tax credit provision, the Committee might wish to state that it does not view any concession we give to one country as requiring us to give a similar concession to another country.

The Administration proposed a treaty with Cyprus in 1981, but withdrew that treaty after informal discussions with Congressional staff. The problem with that treaty in 1981 was its lack of an adequate treaty shopping provision. We think that problem has been solved. The one concern that remains is whether it is appropriate for the United States to enter into a tax treaty with a tax haven. Our entering into a treaty with Cyprus could tend to increase investors' confidence in using Cyprus as a financial center for tax-avoidance transactions.

The treaty with China would not effectively prevent treaty shopping. Treaty shopping typically occurs when an investor in one country without a treaty goes into a country with a treaty and sets up a dummy corporation to take advantage of the treaty. In effect, this third country investor runs his U.S. investment through this dummy corporation in the treaty country. Today, China would not allow treaty shoppers to set up dummy corporations in China to make investments in the United States. If China changes its law, though, the treaty would do little or nothing to prohibit treaty shopping. The Chinese treaty allows the lowest U.S. tax rate on portfolio dividends paid from U.S. companies that we have ever allowed. We recommend that if the Committee approves the Chinese treaty, the Committee should indicate its view that a reexamination will be necessary if changes to Chinese law ever permit treaty shopping using that treaty to occur.

In May, the Administration proposed to Congress a major overhaul of this country's tax Code. In particular, the Administration's tax reform proposal would impose two new taxes on foreigners. Each of the five treaties before the Committee would prevent the United States from imposing at least one of these two new taxes. The Administration asks, first, that the Senate agree to these treaties; second, that Congress then impose the new taxes that these treaties prohibit; and third, that Treasury then renegotiate these



treaties to bring them in line with the legislation that overrode them. In some cases, if renegotiation is not possible, Treasury would unilaterally override these treaties. The question for this Committee is whether to approve these treaties when the situation is so uncertain.

