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PREPARED STATEMENT OF
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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 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. The summaries of each of these pamphlets highlight the provisions of the proposed treaties which present significant policy issues.

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 the Senate Committee on Foreign Relations and with the Treasury Department.

In our testimony before the Committee in 1981 and 1983 in connection with 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 Comm. 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 reduce double taxation and to avoid tax avoidance and evasion. The latter 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 secondary function of removing impediments to international investment and to the free flow of capital generally.

Before you for consideration are proposed new income tax treaties with Canada and Denmark (and proposed protocols to those treaties), a proposed protocol to the existing income tax treaty with France, and proposed estate and gift tax treaties with Sweden and Denmark. The latter would be the first U.S. estate and gift tax treaties with Sweden and Denmark.

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 relatively important tax policy issues presented by various provisions in these treaties.

The proposed treaties and protocols are, for the most part, noncontroversial. The treaties and protocols, however, raise several issues. The proposed income tax treaties with Canada and Denmark contain special foreign tax credit provisions that may allow U.S. residents to credit more foreign tax than would be allowed otherwise under the Internal Revenue Code. These two treaties, along with the proposed protocol to the French treaty, contain anti-treaty shopping provisions that are less comprehensive than those of the U.S. model treaty and some recent U.S. tax treaties. Because Denmark, under its internal law, does not impose a withholding tax on interest derived by nonresidents and, under the proposed treaty, taxes dividends paid by Danish companies to U.S. shareholders at a very low effective rate, treaty-shopping potential under the proposed Danish income tax treaty could be a significant concern. Treaty-shopping potential appears less of a concern under the proposed Canadian treaty and under the proposed protocol to the French treaty since both Canada and France are high-tax countries. In particular, both countries generally impose substantial withholding taxes on payments from domestic sources to foreign entities.

Another issue raised by the proposed income tax treaties with Canada and Denmark is whether treaties should allow U.S. persons U.S. tax deductions to which they would not otherwise be entitled under the Internal Revenue Code. The Canadian treaty would permit a deduction for contributions to certain Canadian charitable organizations and the Danish treaty a deduction for certain child support payments to Danish children. The granting of deductions by treaty was criticized by the Chairmen of both the Ways and Means and Finance Committees in statements submitted to this Committee in connection with its consideration of treaties in 1981. While there are special considerations in the case of Canada, the Danish provision breaks new ground and raises serious questions.

The proposed income tax treaties with Canada and Denmark also define the countries more broadly than the present treaties to include expressly their respective portions of the continental shelf. This makes it clear that income earned by U.S. residents from natural resource extraction, principally of oil, along the Canadian and Danish portions of the continental shelf will be from Canadian and Danish sources, respectively, and therefore generally will be taxable by those countries under the new treaties. Under the present treaties with Canada and Denmark, such income of U.S. residents arguably would not be taxable by Canada or Denmark.

Both Canada and Denmark have imputation tax systems. In general, these systems partially relieve the double taxation of corporate earnings by providing resident shareholders with a tax credit for dividends received from resident companies. The question whether countries with imputation systems should extend relief to nonresident shareholders in income tax treaties, therefore, arises. The proposed treaty with Denmark, like the existing treaties with the United Kingdom and France, would grant a limited imputation credit to U.S. shareholders for dividends received from Danish companies. The proposed treaty with Canada would not extend imputation relief to U.S. shareholders. However, the proposed treaty would reduce the present treaty rate of withholding tax on dividends, thus arguably providing some relief from double taxation of corporate earnings to U.S. investors in Canadian companies.

The proposed treaty with Canada allows the United States to impose its tax on Canadians who dispose of U.S. real property interests, but allows continuation of the present treaty exemption through at least 1985, and allows Canadian investors a stepped-up basis that prevents U.S. tax on appreciation that occurs prior to the end of the year in which the treaty enters into force. In addition, it prevents the United States from imposing its tax on social security benefit payments to Canadian residents who are not U.S. citizens.

The estate tax treaty with Sweden is not controversial, but the estate tax treaty with Denmark raises a serious issue. That treaty effectively requires the United States to allow a 100-percent marital deduction for transfers by Danes or Danish decedents, while Denmark will be able to tax transfers by Americans and American decedents. This lack of reciprocity is a serious concern. These and other issues are discussed in greater detail below.

In the past, the Committee has recommended a reservation or an understanding on a particular provision of certain treaties and protocols. However, in most cases the provisions of the treaties and protocols before you today are not sufficiently troublesome or controversial that recommendation of a reservation or understanding with respect to any particular treaty provision need be seriously considered. The one provision on which we recommend a reservation is the lack of a reciprocal marital provision in the Danish estate tax treaty. Also, we believe in certain instances the Committee may want to consider stating in its report accompanying the resolution 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. Indeed, in some of these areas the Committee may want to recommend that, subsequent to ratification of these treaties, the policies embodied in certain provisions be reexamined by the Treasury Department, both in the context of legislative changes and in the context of the U.S. treaty negotiating position.

One concern that we do have with these, and other recent U.S. income tax treaties, is their complexity, specificity and resulting length. Both the Canadian and Danish income tax treaties are examples, although Canada, because of the level of investment and population flows, is unique. It would be useful for the Committee to remind the negotiators that, as indicated above, tax treaties have two, and only two main purposes: the mitigation of double taxation, and the prevention of tax avoidance and evasion. 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 more complex the rules become the easier it 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 tax in both countries.

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.

I. INCOME TAX TREATY (AND PROPOSED PROTOCOLS) WITH CANADA

The proposed income tax treaty with Canada, as amended by two proposed protocols, is generally consistent with other U.S. income tax treaties and with the U.S. model income tax treaty. However, it differs in a number of respects from other U.S. treaties and from the U.S. model.

The proposed treaty, without the two protocols, was the subject of hearings before this committee in 1981. At that time, our staff and others raised a number of issues.[1] The Chairmen of the tax-writing committees of Congress expressed particular concern about the taxation of Canadian investors in U.S. real property. The two protocols have made some significant changes in the proposed treaty since this Committee held hearings on the proposed treaty in 1981. Some of those changes protect the United States' tax base. Most significantly, the treaty now conforms more closely than it did to the U.S. tax rules that apply to foreign investors in U.S. real property (although it does not conform totally). The rules that still do not conform are transition rules. Some changes, however, reduce the United States' tax base, such as the obligation not to tax U.S. social security payments made to Canadian residents. In addition, the treaty provision that makes Canadian taxes creditable is now retroactive to taxable years beginning in 1981 and thereafter. These taxes may have been creditable even without the treaty, though.

Importance of ratification

The proposed treaty with Canada deals with many issues that have arisen over a number of years. The present treaty, as amended, is over 40 years old and does not adequately address the current economic relationships between Canada and the United States. Canada is our most important trading and investment partner. Also, its physical proximity and the similarity between the two countries in language and in background make the personal relationships between the two countries among our closest. The proposed treaty contains a number of provisions that reflect these close personal and economic contacts. For example, it solves some problems of concern to persons who move between the two countries, and permits a deduction to residents of the one country for charitable contributions to universities in the other country which they or their family attended. It contains rules that may help to settle disputes as to the taxation of persons who move from one country to the other for short periods of time.

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1 For the convenience of the Committee, our prepared statement contains relevant portions of our 1981 testimony.

It provides and coordinates rules relating to taxation of capital gains. It solves some problems involving corporate reorganizations, and it improves the administrative provisions in the present treaty.

Among the most significant benefits provided to United States taxpayers under the pending treaty is a reduction in dividend withholding rates from the present 15 percent to 10 percent if the recipient owns 10 percent of the voting stock of the paying corporation. Furthermore, when compared to the existing treaty, the proposed treaty contains significantly expanded protection for United States taxpayers against discrimination by Canada.

In some cases, a particular taxpayer or industry receives better treatment under the present treaty than under the proposed treaty. Since the treaty is essentially a compromise between the conflicting interests of the two countries which have changed in a variety of respects since the present treaty was entered into, that result is not unexpected. The central issue is whether the final agreement represents a bargain which is sufficiently favorable overall to the United States that it should be ratified.

The proposed treaty was under negotiation for approximately nine years. We have talked with a number of former Treasury officials involved in the negotiation process. They generally believe that the treaty is the most favorable result they could expect on a number of the important points such as nondiscrimination and the withholding rate on dividends. In general, they believe the treaty to be a good one and a vast improvement over the present treaty.

For a number of reasons, the pressure from Canadian business groups to agree to a new treaty may be less substantial than for the United States. One is that there is more U.S. investment in Canada than Canadian investment in the United States. Accordingly, the larger share of the benefits of the reduction in source taxation of direct investment dividends accrues to the United States taxpayers. Thus the reduction in the withholding tax on direct investment dividends from the present 15 percent to 10 percent in the proposed treaty is a significant concession by Canada.

Even for those Canadian businesses investing in the United States, the proposed reduction in the U.S. tax on dividends paid by U.S. subsidiaries to Canadian parent companies apparently is not that significant because much of that investment is routed through the Netherlands. This is due to a form of treaty-shopping by which many Canadian direct investors may be able to receive dividends from the United States at the 5-percent tax rate provided for in the treaty between the United States and the Netherlands. This result is possible because under the Dutch-Canadian treaty there is no Dutch withholding tax on certain dividends paid from Dutch companies to their Canadian shareholders.

Discussed below are the significant issues that were brought to our attention in the course of our analysis of the treaty and discussions with outside persons, other staff and staff from the Treasury.

Nondiscrimination

The United States generally insists that its tax treaties contain a broad nondiscrimination provision that would prohibit the treaty partner from discriminating against United States investors. At the insistence of Canada, the nondiscrimination provision in the proposed treaty is not as comprehensive as that sought by the United States or as that contained in the United States or the OECD Model treaties or the United Nations Model. It is much broader than that contained in the present Canadian treaty which only applies to individual United States citizens resident in Canada. We understand that the provision is the broadest agreed to by Canada in any of its treaties. We also understand that a number of United States negotiators generally believe that Canada simply would not agree to a broader provision.

The area of concern is the treatment of Canadian corporations owned by U.S. shareholders. The U.S. model would prohibit Canada from taxing that Canadian corporation any less favorably than a similarly situated Canadian corporation owned by Canadian shareholders. In contrast, the proposed treaty only prohibits Canada from taxing a Canadian corporation owned by United States interests less favorably than a Canadian company owned by residents of any third country. For example, a Canadian company owned by United States residents cannot be taxed in a more burdensome manner than a Canadian company owned, for example, by a Swiss resident is required to be treated under the Swiss-Canadian income tax treaty. However, a Canadian subsidiary of a United States company can be taxed in a more burdensome manner than a Canadian company owned by Canadians. In effect, the United States is given most favored nation status. The present treaty does not provide for such most favored nation treatment.

The effect of this article on U.S. and Canadian investors is not reciprocal. The United States has obligated itself to treat foreign-owned U.S. corporations as well as U.S. corporations. Granting most-favored nation status to Canada obligates the United States to treat Canadian-owned U.S. corporations as well as U.S.-owned corporations. Canada does not promise, however, to treat U.S.-owned Canadian corporations as well as Canadian-owned Canadian corporations.

There is an argument, however, that the duty of nondiscrimination that the treaty imposes on the United States does not represent a substantial concession by the United States, because the United States does not discriminate against foreign-owned corporations.

Staff understands that the Canadian tax system contains other features that discriminate against foreign-owned Canadian companies. One particular area is that Canada may require a higher ratio of equity to debt of foreign-owned corporations than of locally owned corporations. However, this requirement would appear to be an appropriate anti-avoidance requirement and, as such, consistent with the overall purpose of the treaty.

Some might question the wisdom of entering into a treaty with a developed country that permits a broad form of discrimination. Such a provision might be viewed as precedent for future negotiations particularly with developing countries that tend to want to discriminate to encourage local ownership of resources. Furthermore, it has been the long-standing policy of the United States not to agree to discriminatory treatment. The discriminatory treatment permitted here is prohibited by the OECD model convention. See Article 24(b). Canada reserved its position on the entire article. Commentary on the Articles of the OECD Model Convention, Article 24, paragraph 61, pg. 174.

However, our discussions have given us little reason to doubt that Canada is unlikely to grant nondiscrimination protection to United States controlled Canadian companies.

On balance, we do not believe that the nondiscrimination article presents a serious enough problem to warrant action. Rejection of the treaty (or a reservation that Canada rejects) will not by itself end the discrimination by Canadians against United States-owned Canadian companies.

If the Committee feels that the nondiscrimination issue is of special importance, it may wish to include a statement in its recommendations emphasizing its concern and urging the Treasury to resist strenuously similar provisions in future treaties. It may, however, wish to distinguish between developed and developing countries for this purpose.

Natural resource income

The present treaty contains an overall 15-percent limit on the rate of tax that either country can impose on investment income paid to residents of the other country. The proposed treaty, consistent with the U.S. model and general tax treaty standards, removes this overall limitation but replaces it with limitations on the level of source-basis taxation of various types of investment income. However, mineral rents and royalties are income from real property which under the real property article (Article VI) may be taxed without limit by the country of source. Accordingly, the Canadian tax on mineral royalties will be increased to the Canadian statutory rate (25 percent of the gross royalty). The United States rate will increase to the statutory 30-percent rate. The proposed treaty contains a transition rule that will keep the lower 15 percent rate for one additional year only.

The provision will primarily affect United States persons who receive royalty income from natural resource operations in Canada. There are, however, Canadian royalty interests in United States resources and the United States Treasury will increase its revenues in those cases.

The exclusion of mineral royalties from any treaty limitation on the level of withholding taxes is consistent with present United States treaty policy and the OECD model convention. It is consistent with most current United States tax treaties.

In connection with the 1981 hearings on this treaty, affected United States taxpayers argued that investments were made taking into account the 15-percent limit in the current treaty, and raising the tax on the royalties from that investment could make them noneconomic. Also, some expressed concern that once the present treaty is approved Canada will increase its tax on royalties, perhaps significantly. However, in an Exchange of Notes dated June 14, 1983, the United States and Canada have agreed to resume negotiations promptly if either country increases the statutory tax rate that now applies to natural resource royalties paid to nonresidents.

It would be difficult to recommend strong action with respect to a provision that reflects current United States and international standards. However, we are not starting from scratch, and thus certain alternatives might have been considered. One would be to grandfather existing mineral interests by giving them the current 15-percent rate. Another would be to have a longer transitional period followed by a phase out of the limitation. This would give investors time to adjust. An alternative would be to provide a much higher limit, for example 25 or 30 percent, which would permit Canada to increase the tax burden on United States mineral resource investors, but would give some comfort, beyond that of the Exchange of Notes, to United States investors against greatly increased Canadian taxation. These approaches were apparently rejected, and we believe that the Exchange of Notes reflects the best resolution of any problems.

<u>Benefits under Canadian integrated tax system</u>

In 1972, Canada introduced a new system of taxing income from corporations that partially combines or integrates the tax paid by the corporation on its earnings with any tax paid by the shareholder with respect to distributions from the corporation.

Under the Canadian system, a Canadian corporation pays tax at the normal rates whether or not the earnings are distributed. At the shareholder level, shareholders who are Canadian residents include the dividend in their income and also "gross-up" the dividend by an amount equal to 50 percent of the dividend. That is, the shareholder reports as income the dividend plus an amount equal to 50 percent of the dividend. The shareholder may then credit an amount approximately equal to the gross-up against his tax otherwise due. The credit offsets both Canadian and provincial tax to reach this result. Unlike some other systems, like that of Denmark, no cash refund is made if the credit exceeds the taxpayer's total Canadian tax liability.

The intent of this system is to partially relieve double taxation of distributed corporate profits. At times, the effect can be the total elimination of Canadian tax on dividends. Nonresident shareholders do not get the imputation credit. Accordingly, nonresident shareholders may be subject to a higher combined corporate and personal tax than a Canadian would be.

Relief is granted to United States shareholders by United States treaties with France and the United Kingdom, both of whom also have partially integrated corporate tax systems. In those two treaties, the relief takes the form of a refund to the U.S. shareholder of the appropriate amount of tax paid at the corporate level. As discussed below, relief, in the form of an imputation credit, would also be granted to United States shareholders under the proposed new United States treaty with Denmark. In the proposed Canadian treaty, no refund to U.S. shareholders is provided. However, at least partial relief is granted by the limitation on dividend withholding taxes. It should also be noted that under Canadian law, a nonresident shareholder does not "gross-up" his dividend from a Canadian corporation by the amount of the imputation credit. Accordingly, the amount of the U.S. shareholder's taxable dividend is lower than that of a Canadian shareholder.

The Canadian situation is distinguishable in certain respects from that with the United Kingdom and France. The French relief is limited in that it applies only to portfolio investment. Both France and the United Kingdom have generally extended relief to investors from other countries comparable to that extended U.S. investors. The policies of the United Kingdom and Canada are different. The United

Kingdom has traditionally welcomed United States investors and the granting of imputation relief is consistent with that philosophy.

By contrast, the Canadians have refused to extend the imputation credit in their treaties. The Canadians are not seeking United States investors in their industries. Also, Canadians have made what they consider to be a significant concession to the United States in lowering the dividend withholding rate at source to 10 percent from the present 15 percent.

Some concern has been expressed that the treaty without specific relief for U.S. shareholders will be precedent for negotiations with other countries, particularly Germany.

If the Committee considered relief for United States shareholders under imputation systems important, it could urge the Treasury not to agree to future treaties without such relief, at least with certain countries. However, this could tie Treasury's hands and preclude future treaties that on balance may be in the United States' national interest.

<u>Canadian investment in United States real property</u>

The proposed treaty also contains certain provisions that would limit the United States taxation of Canadian investment in United States real estate provided for in the Foreign Investment in United States Real Property Tax Act that was enacted at the end of 1980. However, the proposed first protocol has brought the proposed treaty into closer conformity with the U.S. tax rules taxing foreign investors in U.S. real property than when this Committee held its hearing on the treaty in September 1981.

The Act generally applies to tax the gain on sales made after June 18, 1980. The legislation specifically overrode real estate rules in existing treaties if those rules conflicted with its provisions. However, the legislation did not apply in those cases until January 1, 1985.

The present treaty contains a reciprocal exemption from tax for gains from the disposition of real estate. Accordingly, under the present treaty, Canadian and United States residents could continue to sell property located in the other country free of source country tax.

Under the legislation a foreign investor is taxed on his entire gain realized on the sale of United States real estate regardless of when purchased. Congress decided not to give a step-up in basis (or fresh start) to fair market value as of the effective date of the legislation. Under the proposed treaty, however, gain would in effect be taxable only to the extent it occurred after the treaty goes into force.

Taxpayers can show the actual amount of appreciation or use a monthly proration rule. The fresh-start basis provided in the treaty will principally be of benefit to Canadian investors in U.S. real estate because the Canadian capital gains tax has a general fresh start as of 1975.

In addition, the proposed treaty contains a special effective date rule that allows taxpayers to benefit from the rules of the current treaty that are more favorable than those of the proposed treaty through the first taxable year that begins on or after January 1 of the year of ratification. The effect of this rule, for Canadian investors in U.S. real property, is to allow treaty exemption for U.S. real estate gains of Canadian investors through the first taxable year that begins on or after January 1 of the year of ratification, even in cases where the step-up in basis is not available. If ratification occurs in 1984, then U.S. real estate gains of Canadian investors will generally be exempt through at least all of 1985. In the case of some fiscal year taxpayers, gains will be exempt through November 30, 1986. Treaty exemption for non-Canadian investors will end at the end of 1984.

This delayed effective date may allow Canadian investors additional time to plan and to arrange their affairs to avoid virtually all U.S. and Canadian tax on the appreciation of the U.S. real property prior to the delayed date. For example, if a Candian corporation owns all the shares of a U.S. corporation whose principal asset is U.S. real property that it uses in a U.S. business, and if the U.S. corporation liquidates into the Canadian corporation, the liquidation is free of Canadian tax. Moreover, the Canadian corporation takes a stepped-up basis for Canadian tax purposes in the U.S. real property. The present treaty, as extended through at least 1985, exempts the transaction from U.S. tax as well. The Canadian corporation takes a carryover basis for U.S. tax purposes, but if it sells the property before the delayed effective date, the sale may well be free of U.S. tax. The sale will bear Canadian tax only to the extent of the appreciation between the liquidation and the sale. Thus, the transfer during this period avoids any significant U.S. or Canadian tax on appreciation that occurs before the delayed effective date of the proposed treaty, even for property not eligible for the treaty's step-up rule. A proper purpose of income tax treaties is to prevent double taxation, but it is questionable policy to extend current rules that eliminate U.S. tax on income that is not subject to tax in any other country.

Notwithstanding the arguments against the extension of current treaty rules for an additional year, the extension benefits some U.S. owners of Canadian real estate and U.S. recipients of Canadian resource royalties.

Exempt organizations

Unlike other United States tax treaties generally, the proposed treaty would exempt charitable organizations of either country from tax imposed by the other to the extent they are exempt in their home country. In addition, Canadian private foundations which receive substantially all their support from non-United States persons would be exempt from the 4-percent United States excise tax on income of private foundations. An exemption is also provided for pension funds but the exemption is limited to interest and dividends received from sources within the other country. Accordingly, Canadian pension funds could invest in debt obligations of United States persons and stock of United States corporations free of tax.

It is our understanding that this provision represents a concession primarily to Canadian charities and pension funds. The Committee should be aware that in recent years bills have been introduced that would grant an even broader exemption to foreign pension plans. These bills have not been reported out of Committee. United Kingdom and Dutch pension plans have expressed an interest in the exemption. It can be anticipated that approval of this provision in this treaty will encourage them to seek similar relief.

Foreign tax credit

The proposed treaty specifically provides that taxes paid under Canada's general corporate income tax system are creditable income taxes under the treaty. The proposed treaty also contains a provision generally found in United States income tax treaties to the effect that it will apply to substantially similar taxes that either country may subsequently impose. It also contains a provision that it will apply to taxes on capital that either country may later impose.

In general, for most taxpayers there appears to be little doubt that the taxes described as creditable under the treaty are creditable in any event. The only significant question as to the creditability under the Code rules of any of the Canadian taxes covered by the treaty appears to be confined to the Canadian corporate tax as it is imposed on income from the exploitation of natural resources. Natural resource companies are subject to certain special rules that deny them certain deductions in computing their Canadian general corporate tax. The denial of these deductions creates some uncertainty as to whether the general corporate tax as imposed on such income qualifies for a foreign tax credit under the Code.

The proposed treaty makes creditable the general Canadian corporate tax even though Canada has enacted a low flat-rate tax on natural resource revenues that is not deductible in computing income under the general rules of Part I of the Canadian Income Tax Act. The original Treasury technical explanation indicated that an 8-percent tax on oil and gas production revenues would be not affect the creditability of the general corporate tax. Canada has now imposed a flat rate tax on natural resource income with an effective 12-percent rate. Treasury now indicates that the general corporate tax will be creditable under the treaty notwithstanding imposition of the nondeductible resource tax at this higher rate. While the proposed treaty would resolve the doubt as to creditability of the Canadian corporate tax as presently imposed on natural resource income, that treaty credit only applies if Canada does not make substantial changes in the tax. It is unclear whether or how much Canada could raise this tax without affecting the creditability of the general Canadian income tax as applied to natural resource income.

The Internal Revenue Service has ruled that the general corporate tax was creditable before Canada imposed the full effective 12-percent non-deductible tax that now applies, but has not ruled on the tax as in effect currently. It is not clear that the Service would rule that the current tax is creditable. In this particular case, however, it can be argued that the economic substance of the tax is sufficiently comparable to United States notions of what constitutes an income tax even with a higher gross receipts tax that it does not require a major departure from applicable tax policy principles to treat the Canadian tax as a creditable tax. Thus, the treaty in this case can be viewed as merely overcoming any possible technical obstacles to the creditability of the Canadian tax under the Code rules.

Another issue is whether Canadian taxes that are creditable only by virtue of the treaty should be permitted to offset U.S. tax on income from other foreign countries. Before amendment by the proposed protocol, the proposed treaty would not have allowed that result. Treasury regulations issued between the signing of the proposed treaty and the proposed first protocol that define foreign taxes that are creditable may make these taxes creditable without regard to the treaty. After amendment by the proposed protocol, the proposed treaty allows any taxes that are creditable only by virtue of the treaty to offset U.S. tax on income from other foreign countries. If the treaty allows taxpayers to credit otherwise noncreditable Canadian taxes that are high, U.S. taxpayers who pay such taxes may have an incentive to invest in low tax foreign countries rather than in the United States. However, any Canadian taxes on extraction income that the treaty makes creditable can be used only to offset U.S. tax on low-taxed foreign extraction income.

Allowance of deductions to United States persons

The proposed treaty contains two provisions that give United States taxpayers deductions not permitted under the Code. This represents an expansion of general treaty policy, although one of the provisions, the allowance (on a reciprocal basis) of charitable deductions for contributions to Canadian charities, is in the present treaty.

The proposed treaty contains a provision that would permit United States persons to deduct expenses incurred in attending business conventions in Canada. At the time this provision was negotiated, deductions for conventions held in all foreign countries, including Canada, were subject to substantial restrictions pursuant to amendments to the Code made by the 1976 Act. However, the Code was amended in 1980 to permit deductions for conventions in Canada and Mexico on the same basis as those held in the United States and its possessions. Accordingly, the treaty provision would no longer have any impact on United States taxpayers attending Canadian conventions. In 1983, Congress passed the Caribbean Basin Initiative, which permits deductions for conventions in certain Caribbean Basin countries that agree to exchange tax information with the United States on the same basis as U.S. conventions.

Unless a contrary intention is expressed by the Senate, however, the inclusion of this provision in the treaty could be taken as precedent for other negotiations. It should be noted that Canada also has statutory provisions denying Canadian taxpayers deductions for attending foreign business conventions, so the principal impact of the provision is to allow Canadians deductions for Canadian tax purposes for attending business conventions in the United States.

The proposed treaty also permits United States persons a deduction for contributions to Canadian charities and Canadian persons a contribution to United States charities. The present treaty (like the proposed treaty with Israel) contains a similar provision.

It has been argued that treaties should not be used to grant deductions to United States persons because they are not necessary to limit double taxation. On the other hand, the special relationship between the United States and Canada may warrant special rules in this case.

Anti-treaty shopping provisions

Most recent U.S. treaties (and the U.S. model) contain provisions that limit the use of the treaty by corporations and other legal entities to those that are controlled by persons who are residents of the treaty partner. The United States has recently terminated a number of treaties that afforded treaty shopping opportunities. The proposed treaty contains only limited anti-treaty shopping provisions. These provisions deny treaty benefits only to certain trusts and to Canadian nonresident owned investment companies.

While an argument might be made that a broader anti-treaty shopping provision is appropriate, Canada is a high tax country that imposes taxes on resident entities at rates comparable to U.S. rates. Canada also imposes significant withholding taxes on payments from Canadian entities to foreign investors. Also, Canada has a history of concern about tax avoidance and evasion, and has recently repealed the rules that allow creation of nonresident owned investment companies (although existing nonresident owned investment companies can continue to exist). The one concern would be that abuse possibilities could develop in the future, and it has proved difficult to renegotiate treaties once abuses develop.

<u>Exemption for social security payments to Canadian residents</u>

The proposed treaty would eliminate the United States tax on social security benefit payments to Canadian residents (unless they are U.S. citizens). This tax was part of a comprehensive legislative solution to social security problems. The tax on nonresident aliens goes into the Social Security Trust Fund. The treaty's prohibition on U.S. tax on Canadian residents would reduce the Fund's receipts by about $10 million each year.

In imposing the tax on social security benefit payments to nonresident aliens in 1983, Congress indicated that it did not intend to override treaties in force at the time of the enactment of the legislation, such as those with Japan and the United Kingdom, that prevent U.S. taxation of social security payments made to residents of the treaty partner (unless they are U.S. citizens). It can be argued that this tax, although recently enacted, should not be subject to special scrutiny. In enacting the tax on foreign investors in U.S. real property, by contrast, Congress overrode treaties, and sought to limit the extent to which future treaties could override that legislation. However, it can be argued that failure to override should not be construed as indicating a willingness to waive jurisdiction to impose the tax in the future.

<u>Denial of Canadian tax deductions for advertising carried by U.S. broadcasters</u>

Since 1976, Canadian tax law has denied deductions, for purposes of computing Canadian taxable income, for an advertisement directed primarily to a market in Canada and broadcast by a foreign television or radio station. Canadian law contains a similar provision for print media. The purpose of this provision was to strengthen the market position of Canadian broadcasters along the U.S.-Canadian border.

At the time Canada adopted this provision, the United States and Canada were renegotiating the income tax treaty between the two countries. The Treasury Department negotiators raised U.S. concerns with the Canadians, but the Canadian negotiators refused to discuss this provision.

At one time it was suggested that the treaty should address this point. Recently, however, the Senate Committee on Finance reported legislation that would deny deductions or expenses of advertising primarily directed to U.S. markets and carried by a foreign broadcaster, if the broadcaster were located in a country that denied its taxpayers a deduction for advertising directed to its markets and carried by a U.S. broadcaster. Although the bill does not mention Canada by name, Canada is the only known country to which the bill would apply. This legislation would not violate the proposed treaty, and it requires only an Act of Congress, and not the consent of Canada.

Canadian legislation interpreting treaties

The Canadian Government has introduced legislation (the proposed "Income Tax Conventions Interpretation Act") in Parliament that would provide that, absent an indication to the contrary, undefined treaty terms are to have the meaning that they have under internal law as it changes from time to time. This legislation would overrule The Queen v. Melford Developments, Inc., 82 Dominion Tax Cases 6281 (1982), decided by the Supreme Court of Canada, which held that such treaty terms have the meaning they had under internal law at the time of the making of the treaty. The view that treaty terms change with internal law as it changes from time to time generally comports with the U.S. view of the meaning of treaty terms.

That proposed Canadian legislation, as originally introduced, would have applied retroactively. It would have specified that, notwithstanding any tax treaty, Canada includes and has always included the Canadian Continental Shelf. Therefore, Canada would have the right to tax income arising on its Continental Shelf. The retroactive application of the legislation's proposed definition of Canada was of particular concern to U.S. drilling contractors that operated on the Canadian Continental Shelf. The Canadian Government has reintroduced the proposed Income Tax Conventions Interpretations Act, but has made it prospective for taxable years ending after June 23, 1983. In addition, a January 26, 1984, competent authority agreement has substantially restricted the ability of Canada to impose tax on U.S. drilling contractors that operate on the Canadian

Continental Shelf. This restriction applies retroactively as well as prospectively.

In addition, the proposed Income Tax Interpretations Act prevents non-Canadian taxpayers from using treaties to lower their Canadian taxes below the taxes that comparable Canadian taxpayers would pay. The current U.S.-Canada treaty allows the deduction of all expenses reasonably allocable to a Canadian permanent establishment of a U.S. resident. By statute, however, Canada does not allow taxpayers (whether or not Canadian residents) to deduct certain expenses, including the petroleum and gas revenue tax or provincial income or mining taxes or resource royalties. Canada, by statute, allows a "resource allowance" deduction; this deduction is at least in part in lieu of a deduction for these actual expenses incurred in the petroleum business. Some U.S. taxpayers with Canadian permanent establishments contend that they may deduct, for Canadian purposes, (1) both the statutory resource allowance and (2) the actual expenses that Canada's statute makes nondeductible. The proposed Canadian legislation makes it clear that nonresidents of Canada that do business in Canada through Canadian permanent establishments may deduct only the amounts deductible by a comparably situated Canadian resident. This legislative provision, too, will apply only to taxable years ending after June 23, 1983.

II. 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.

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. In 1976, the Danish corporate and individual income taxes were partially integrated to reduce the double taxation of corporate earnings. Double taxation of these earnings is reduced under Danish law 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 effective rate of Danish tax on Danish-source dividends paid to certain U.S. corporate investors is reduced to one-quarter of one percent as a result of the Danish imputation credit, coupled with the reduction of the Danish withholding tax rate applicable to Danish-source dividends paid to these investors that is carried over from the existing treaty. The effective rate of Danish tax on Danish-source dividends paid to other U.S. investors is reduced to 2.25 percent as a result of the imputation credit, coupled with the reduction of the Danish withholding tax rate carried over from the existing treaty. The imputation credit and the Danish imputation system are discussed in more detail below.

The proposed protocol benefits U.S. oil companies by providing that the income tax imposed under the Danish Hydrocarbon Tax Act adopted by Denmark in 1982 will be creditable for U.S. foreign tax credit purposes. In the absence of this provision, income tax imposed under the Danish Hydrocarbon Tax Act probably would not be creditable under Treasury regulations governing the creditability of foreign taxes. This provision, too, is discussed in more detail below.

If the Committee 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 proposed treaty and protocol enter into force, the credit against U.S. tax for Danish hydrocarbon taxes paid by a U.S. taxpayer will be available retroactively for taxable years beginning after 1982.

In general, we are not aware of any substantial controversy concerning the proposed treaty and protocol. The protocol and treaty do, however, contain a few provisions worthy of special note, two of which have already been mentioned briefly. These provisions, and the issues they raise, are discussed below.

Imputation credit

As indicated above, the treaty contains an important, new provision under which U.S. residents generally receive a credit against Danish tax with respect to dividends received from Danish resident companies. Subject to some exceptions, the effect of this credit, coupled with the reduced rates of withholding tax on dividends also provided in the treaty, is to reduce to nearly zero the effective Danish rate of tax on dividends paid by Danish resident companies to U.S. investors.

The inclusion of this provision reflects Denmark's introduction in 1976 of a credit (or imputation) system for Danish resident shareholders and Danish resident companies which integrates in part the corporate income tax with the individual income tax. The intent of this system is to partially relieve double taxation of distributed corporate profits.

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.

The legislation introducing the imputation system did not change the prior rule of Danish law that 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.

Under Danish law, the imputation credit either is applied against a resident shareholder's Danish income tax liability or, if the credit exceeds such liability, is refunded to the shareholder. Shareholders who have no Danish tax liability obtain a refund on demand. The dividend subject to tax is "grossed up" by the amount of the credit; that is, a Danish shareholder is required to include in taxable income the amount credited or refunded to him as well as the amount of the cash dividend.

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, but do not eliminate, 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 U.S. resident individual). 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.

The aggregate amount of the dividend and the credit will be treated as a dividend to the U.S. resident for purposes of the U.S. foreign tax credit. Thus, the U.S. resident's foreign-source income for purposes of the foreign tax credit limitation will be increased by the amount of the credit as well as by the amount of the dividend. The creditable tax will be five percent or 15 percent, as the case may be, of the aggregate amount of the dividend and the credit.

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. As a result, U.S. shareholders may be subject to higher Danish corporate and personal income taxes in connection with dividends received from Danish resident companies than Danish shareholders are. The issue is whether the United States should insist on the same tax relief for U.S. investors in Danish resident companies as Danish shareholders receive under Danish law.

In considering this issue, it is important to recognize that the agreement of Denmark to extend the imputation credit to U.S. shareholders, particularly to U.S. direct investors, is an important concession by Denmark. The proposed treaty represents only the third 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 second time that such a country has agreed to extend its imputation credit to U.S. direct investors. The proposed income tax treaty with Canada, for example, which, like Denmark, has an imputation system, does not extend the Canadian imputation credit to U.S. shareholders. The granting of the imputation credit to U.S. shareholders under the proposed treaty with Denmark will significantly reduce the amount of Danish tax paid by U.S. investors with respect to dividends received from Danish resident companies.

The two countries that presently, by treaty, grant U.S. portfolio investors an imputation credit with respect to foreign-source dividends are France and the United Kingdom. The U.S. treaties with these countries provide U.S. portfolio investors (defined more narrowly than under the proposed Danish treaty) with an imputation credit equal to the credit a French or U.K. resident would have received. By contrast, the proposed protocol would effectively provide U.S. portfolio investors with an imputation credit equal to 3/5ths (15%/25%) of the credit a Danish resident would receive currently under Danish law.

The only country that presently grants U.S. direct investors an imputation credit with respect to foreign-source dividends is the United Kingdom. The U.S.-U.K. treaty provides U.S. direct investors (defined more broadly than under the proposed treaty) with a credit equal to one-half of the credit an individual U.K. resident would be entitled to were he the recipient of the dividend. By contrast, the proposed protocol would effectively provide U.S. direct investors with a credit equal to one-fifth (5%/25%) of the credit an individual Danish resident currently would be entitled to under Danish law, were he to receive the dividend.

Some concern has been expressed that permitting U.S. shareholders in Danish resident companies a smaller imputation credit with respect to dividends than Danish shareholders in such companies receive may be harmful precedent for negotiations in the future with countries having imputation systems, particularly Germany.

If the Committee considered equal relief for U.S. shareholders under imputation systems important, it could urge the Treasury not to agree to future treaties without such equal relief, at least with certain countries. However, this could tie Treasury's hands and preclude future treaties that on balance may be in the United States' national interest.

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 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 Internal Revenue 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 creditable.

The Danish hydrocarbon tax is creditable under the protocol, 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 Internal Revenue 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 treaty and the protocol to the U.S.-Norway 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 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 Danish treaty credit for the Danish hydrocarbon tax, because it will probably be larger than any credit otherwise allowed under Treasury regulations, may reduce the U.S. taxes collected from U.S. oil companies operating in the Danish sector of the North Sea.

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.

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. Thus, the proposed treaty may subject U.S. oil drillers operating along the Danish portion of the continental shelf to Danish corporate tax for the first time. 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.

U.S. insurance excise tax

Among the U.S. taxes covered by the proposed treaty is the Federal excise tax imposed on insurance premiums paid to foreign insurers. This tax is covered to the extent that a foreign insurer does not reinsure the insurance risks in question with a person not entitled to relief from the tax under the proposed treaty or another U.S. treaty. Covering the U.S. insurance excise tax under the treaty means that, under the "business profits" and "other income" articles of the treaty, any income of a Danish insurer from the insurance of U.S. risks would not be subject to the insurance excise tax, except in situations where the risk is reinsured with a company not entitled to the exemption, if that insurance income is not attributable to a U.S. permanent establishment maintained by the Danish insurer. This treatment is a departure from the existing tax treaty with Denmark and other older U.S. tax treaties, although it appears in some more recent treaties such as the present treaties with France and Hungary. Staff is not aware, however, of any Danish insurers currently insuring U.S. risks.

The U.S. excise tax on premiums paid to foreign insurers is a covered tax under the U.S. model tax treaty.

Anti-treaty shopping provision

Most recent U.S. treaties contain a provision that limits the use of the treaty to corporations controlled by persons who are residents of the treaty partner. These provisions are intended to prevent third country residents from establishing a company in a treaty partner in order to take advantage of reduced withholding rates. They also function to deter residents of one treaty partner from attempting to take advantage of reduced withholding rates by establishing a company in the other to borrow from residents of a third country without a treaty with the United States or with a treaty that does not provide for reduced withholding tax on interest. These practices are known as "treaty-shopping."

The anti-treaty shopping provision of the 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 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.

As another example, under the proposed treaty, a business organization is generally denied treaty benefits if more than 50 percent of its gross income is used to make interest payments to persons other than those just named. By contrast, under the 1981 U.S. model treaty, a business organization is denied treaty benefits if its income is used in substantial part to meet liabilities to third-country residents who are not U.S. citizens. Because the income-use rule of the proposed Danish anti-treaty shopping provision refers to using income "to make payments" rather than "to meet liabilities," third-country investors might arguably meet the test by lending through an investing entity that is a resident of Denmark (and that satisfies the 50-percent ownership test discussed above) on a zero coupon (original issue discount) basis. In that case, the Danish investing entity might not "make payments" to the third-country investor until the zero coupon obligation matures. Before that time, the income-use rule may not be violated and, consequently, interest received by the Danish investing entity from the U.S. borrowers may be eligible for the treaty exemption from U.S. tax. On the other hand, the Treasury Department's technical explanation of the proposed treaty and protocol indicates that payments will be considered to be made under the treaty's income-use rule with respect to a zero coupon obligation when interest accrues for Danish tax deduction purposes.

Also, the recent treaties with Australia and New Zealand, it should be noted, have no protective income-use rule of any kind.

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 among 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. The Committee might consider recommending a delay of ratification pending negotiation of an anti-treaty shopping provision that conforms more closely to that of the U.S. model treaty if it considers this potential serious. It must be recognized, of course, that insistence by the United States on such a provision might result in the refusal of Denmark to accept the treaty. In the alternative, the Committee may wish to include in its resolution of ratification of the proposed treaty and protocol an understanding consistent with the Treasury Department's interpretation of the "make payments" language of the income-use rule.

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.

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. Three treaties allowing U.S. persons deductions to which they would not otherwise be entitled have been considered recently by the Committee--the proposed income tax treaties with Canada, and Israel and the treaty with Jamaica. 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. The Report stated that the Committee might recommend a reservation in the future.

Normally, with this history, we would urge that the Committee seriously consider a reservation on the deduction provision. This case, however, deserves special consideration because the deduction provision was in the proposed Danish treaty as negotiated before the September 1981 hearings, when the deduction issue was brought generally to the Committee's attention. The Committee still may wish to recommend a reservation. In the alternative, the Committee might consider strong language in its Report suggesting that deductions should not be granted by treaty in the future.

III. PROTOCOL TO INCOME TAX TREATY WITH FRANCE

The proposed protocol to the existing income tax treaty with France was negotiated at the request of the United States after France's introduction of a wealth tax, effective January 1, 1982. The protocol would amend the treaty to cover this tax and would generally provide U.S. citizens residing in France with a five-calendar year exemption from the tax for their assets situated outside France. If the Committee decides to recommend that the Senate advise and consent to the ratification of the proposed protocol, quick action would benefit U.S. citizens residing in France, since the five-year exemption and other wealth tax provisions of the protocol will apply retroactively to the date of inception of the wealth tax.

The proposed protocol also makes a number of other noncontroversial changes to the existing treaty. Some of these changes deal with specific problems that have arisen in the administration of the treaty since it entered into force in 1968 or since the two earlier protocols to the treaty entered into force in 1972 and 1979. Other changes generally modernize the existing treaty, bringing it into closer conformity with the U.S. model treaty. Some of the more significant of these changes, along with the changes relating to the French wealth tax, are discussed below.

French wealth tax

Effective January 1, 1982, France introduced a tax on large net wealth (l'impot sur les grandes fortunes). The tax applies to certain assets, wherever situated, of French resident individuals, including U.S. citizens, and certain assets situated in France of nonresident individuals, if the value of the individual's assets exceeds certain thresholds. The protocol would amend the existing treaty to treat the new French wealth tax as a covered tax and would provide reciprocal rules for the imposition of capital taxes generally. Because the United States does not currently impose a Federal wealth tax, these reciprocal provisions would have current effect only with respect to the French wealth tax.

The proposed protocol would provide a five-calendar-year exemption from the French wealth tax for assets situated outside France belonging to certain U.S. citizens residing in France. This exemption is intended to benefit U.S. citizens who live in France for relatively short periods of time such as employees of multinational corporations transferred abroad on temporary assignment. Some U.S. citizens residing in France requested a wealth-tax exemption for their non-French assets lasting for their entire periods of French residency, whatever the duration. Such an exemption is somewhat difficult to rationalize and was not vigorously sought by our negotiators.

Under the protocol, assets situated outside France that U.S. citizens residing in France who are not French nationals own on January 1st of each of the five years following the calendar year in which they become French residents are excluded from the wealth tax base of assessment for each of those five years. Thus, for example, if a qualifying U.S. citizen became a resident of France on December 31, 1983, the five-year period would run through December 31, 1988; the non-French assets which the U.S. citizen owned on January 1 of the calendar years 1984, 1985, 1986, 1987, and 1988 would be exempt from the French wealth tax. If the U.S. citizen became a resident of France on January 2, 1984, the exemption period would, in effect, be almost six years long: the U.S. citizen would not be subject to French wealth tax in 1984 on his non-French assets because he was not a French resident on January 1, 1984; in addition, the five-year treaty exemption would run from January 1, 1985 through December 31, 1989.

The five-year exemption may be available more than once. If a U.S. citizen ceases to be a French resident for at least three years, then becomes a French resident again, another five-year exemption period will begin on January 1 of the year following the calendar year in which the individual again becomes a French resident.

The five-year exemption from the French wealth tax does not apply to assets situated in France. Thus, U.S. citizens who reside in France only temporarily may nonetheless be subject to the wealth tax with respect to certain French-situs assets to the extent the value of such assets exceeds the threshold exemptions provided under French law. Also, U.S. citizens not resident in France may be subject to the wealth tax with respect to French-situs assets.

Interest

The proposed protocol would amend the treaty to provide a general exemption from tax at source for interest. This reflects the U.S. position on source country taxation of interest, as expressed in the U.S. model. Under the existing treaty, the rate of source country tax on interest is generally limited to 10 percent, with a full exemption granted only for interest on bank loans.

Anti-treaty shopping provision

The proposed protocol would add an anti-treaty shopping provision to the existing treaty which, like some other older U.S. income tax treaties, does not contain such a provision. The anti-treaty shopping provision of the protocol generally would limit the use of the treaty by corporations to corporations controlled by U.S. residents, U.S. citizens, French residents, companies whose shares are publicly traded in France or the United States, or the two countries themselves. The proposed anti-treaty shopping provision is similar to those included in the U.S. income tax treaties with New Zealand and Australia, ratified in 1983. It is somewhat less strict than the anti-treaty shopping provision of the U.S. model treaty.

While an argument might be made that a stricter anti-treaty shopping provision is appropriate--particularly because of the protocol exemption from source-country withholding tax for interest--potential for abuse under the proposed anti-treaty shopping provision does not appear serious. France is a high tax country. Experience under the existing treaty indicates that French internal tax rules and French tax treaties with third countries make France relatively unattractive to third-country residents seeking to obtain benefits under the U.S.-France treaty. In particular, France generally imposes significant withholding taxes on payments from French residents to persons outside France. In addition, it is our understanding that the anti-treaty shopping provision of the U.S. model is only one of several approaches that the Treasury Department considers satisfactory to prevent anti-treaty shopping abuses.

The one concern would be that abuse possibilities could develop in the future. It has proved difficult to renegotiate treaties once abuses develop.

Other changes

Other significant changes to the existing treaty that would be made by the proposed protocol include the following: The protocol would replace the present treaty rule that income not dealt with elsewhere in the treaty is taxable by the source country with the current U.S. model treaty rule that items of income not dealt with elsewhere in the treaty that are derived by a resident of either country are taxable by the country of residence only. The proposed protocol would amend in several respects the provisions of the treaty which deal with the avoidance of double taxation. The protocol would adopt, with one significant variation, the U.S. model treaty regime for taxing artistes and athletes. Finally, the proposed protocol would specifically allow refunds to be made regardless of the statute of limitations or other procedural limitations of the countries.

IV. ESTATE AND GIFT TAX TREATIES WITH DENMARK AND SWEDEN

The proposed estate and gift tax treaties with Denmark and Sweden are intended to limit double taxation of estate and gifts of domiciliaries. The treaties are similar to each other and similar in concept to the gift and estate tax treaties with France and the United Kingdom ratified in 1980 and 1979, respectively. The treaties generally follow the U.S. model estate and gift tax treaty. The treaties are explained in separate pamphlets which have been made available to the Committee and its staff. With the exception of one provision of the proposed Danish treaty, the treaties do not contain any special provisions which warrant the attention of the Committee.

Under the "Reductions" Article of the proposed Danish treaty (Article 9), in general, each country obligates itself to impose no more tax on transfers from a spouse domiciled in the other country than it would impose on transfers from a spouse domiciled locally. While this approach appears neutral on its face, it is not neutral in practice. The United States allows a 100 percent marital deduction for both estate and gift tax purposes, while Denmark does not. Thus, under the proposed treaty, the United States will give Danish residents a 100 percent marital deduction for both estate and gift tax purposes, while Denmark will not fully reciprocate. A transfer by a U.S. resident to his or her spouse of property located in Denmark (either during life or at death) will generally incur Danish tax even under the proposed treaty. A similar transfer by a Danish resident (of property located in the United States to his or her spouse) would not incur U.S. tax under the proposed treaty. Denmark may grant some relief for certain transfers between spouses, but generally does not exempt them from tax.

During the negotiation of this provision, U.S. law on transfers between spouses was generally similar to Danish law. In general, one-half of the amount of a transfer from a U.S. citizen or resident to his or her spouse (above a floor) was generally subject to U.S. tax. Now U.S. law has become more generous than Danish law. In 1981, in the Economic Recovery Tax Act amended the law then in effect to allow a 100-percent marital deduction for estate and gift tax purposes. The Committee may wish to reserve on the treaty to conform the Danish treatment of interspousal transfers to the U.S. treatment. The Committee may believe that the United States should not grant a full marital deduction by treaty unless the treaty partner reciprocates. The Committee may wish to approve the treaty on condition that Denmark fully exempt transfers by a U.S. citizen or resident (or his or her estate) to his or her spouse from its gratuitous transfer taxes.