

Joint Committee on Taxation  
June 13, 1995  
JCX-25-95

**TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION  
BEFORE THE  
SENATE COMMITTEE ON FOREIGN RELATIONS  
HEARING ON TAX TREATIES AND PROTOCOLS WITH SEVEN COUNTRIES  
June 13, 1995**

Thank you, Mr. Chairman. My name is Kenneth J. Kies, and I am Chief of Staff of the Joint Committee on Taxation. I am accompanied today by Daniel M. Berman, a Legislation Counsel for the Joint Tax Committee, and Angela Yu, a Staff Accountant for the Joint Tax Committee. Mr. Dan Berman and Ms. Angela Yu work primarily on international tax issues. Dan and Angela have headed our effort concerning the treaties and protocols which are the subject of today's hearing.

**Overview**

As in the past, we have prepared pamphlets that describe each of the proposed treaties and protocols, and the issues raised by them. The description of the proposed treaties in the staff pamphlets includes comparisons with the former U.S. model treaty, as the most recent published description of preferred U.S. treaty policy, and with other recent U.S. tax treaties, which often reflect developments in that policy. The descriptions also compare the proposed treaties with the treaties currently in effect, if any, with the respective countries. We have also consulted extensively with your staff during the development of our analysis and the preparation of the pamphlets. In light of the previous testimony and the discussion that has already taken place, we would like to highlight for you some of the key features of these treaties and some of the issues they raise.

Of the agreements at issue today, those with 6 of the 7 countries would modify existing U.S. treaty relationships. The Canada protocol makes some significant modifications to the current treaty. The Mexico protocol makes only one modification to the treaty that was signed less than three years ago. The new treaty with France replaces an existing treaty that has been modified by a series of recent protocols. The new treaty with Sweden replaces an existing treaty that has not been amended since 1963. The new treaties with Ukraine and Kazakhstan replace, with respect to those countries, the application of the 1973 U.S. treaty with the Soviet Union. That détente-era agreement was never considered to be a full-fledged income tax treaty. The new treaty with Portugal, the seventh country, would lead to the entrance by the United States into a tax treaty relationship where no treaty is currently in force.

## Specific tax treaties and protocols

### Canada

In the case of Canada, the protocol before you would reduce source-country taxation of interest from 15 percent to 10 percent, reduce the source-country taxation of direct-investment dividends from 10 percent eventually to 5 percent, and expand the categories of royalties that are exempt from source-country taxation. Given the traditional U.S. effort to reduce these taxes to zero, the protocol would bring the Canada treaty more in line with existing U.S. policy. A comprehensive anti-treaty-shopping provision is adopted, which in many respects resembles the anti-treaty-shopping provisions of most recent U.S. tax treaties, but which also adds some unique elements. One unique element is that the anti-treaty-shopping provision operates only to restrict the availability of treaty benefits offered by the United States to residents of Canada; Canada prefers not to restrict the treaty benefits it offers to its treaty partners by means of anti-treaty-shopping rules.

The Canada protocol also presents a complex and unique provision that coordinates the estate tax laws of the United States with the feature of Canada's income tax that taxes unrealized capital gains at death. The United States does not impose income tax on gains at death, and Canada does not tax the value of a decedent's estate, but these two separate taxes overlap to a significant enough extent that it is appropriate to apply the traditional purpose of a tax treaty--to relieve double taxation. This unique provision is also the first U.S. treaty response to the significant amendments of the U.S. international estate tax rules that were enacted as part of the Technical and Miscellaneous Revenue Act of 1988. In fact, the death tax provisions of the Canada protocol are to be effective retroactively, back to 1988. Several other countries with which we have estate tax treaties in force may be interested in the approach taken by this provision.

### Mexico

The Mexico protocol amends the present treaty's information exchange provisions, which incorporate by reference the provisions of a prior Tax Information Exchange Agreement with Mexico, for the purpose of allowing information to be exchanged with respect to taxes imposed at the state and local level. The protocol is accompanied by a conforming protocol to the Tax Information Exchange Agreement, which is not subject to Senate advice and consent.

### France

The new treaty with France is a comprehensive update of a treaty that has already been modified by four protocols. As such, most provisions of the treaty already comport with modern U.S. treaty policy. The new treaty includes a comprehensive anti-treaty-shopping provision, which closely resembles the lengthy and detailed anti-treaty-shopping provision in the 1993 U.S.-Netherlands treaty. In the case of the "triangular problem" involving an exempt third-country branch of a controlled foreign corporation that is based in France, however, as has been discussed,

the Treasury Department has determined that it is appropriate to grant relief generally where it offers only case-by-case relief for controlled foreign corporations that are based in the Netherlands. In the case of France, the "triangular problem" anti-abuse rule will not apply with respect to payments of income from the United States that are taxable currently to the U.S. shareholders of the controlled foreign corporation.

The new treaty with France also expands the availability of refunds to U.S. persons of the French imputation credit, known as the "*avoir fiscal*."

Further, the new treaty attempts to restore reciprocity to the availability of on-site tax examinations between the United States and France. Unlike under present law, where France is permitted to conduct tax examinations in the United States while local French law prevents the Internal Revenue Service from conducting tax examinations in France, the new treaty will allow cross-border tax examinations only when the United States and France agree to allow them on a reciprocal basis. This rule may serve to encourage France to modify its internal laws so that both countries could more effectively enforce their tax laws.

#### Sweden

The new treaty with Sweden is fully consistent with other recent treaties that the United States has signed with developed countries. It is a straightforward reflection of current U.S. treaty policy. In particular, the new Sweden treaty closely resembles the 1989 U.S. tax treaty with Germany.

#### Ukraine and Kazakhstan

The new treaties with Ukraine and Kazakhstan, which are very similar, would reciprocally reduce source-country taxation of dividends from 30 percent to our normal treaty rates of 5 or 15 percent (depending on the relationship of the payor and payee); and would greatly expand the scope of the USSR treaty's exemption from withholding tax on interest. It reduces the U.S. branch profits tax on a Ukrainian or Kazakh corporation from 30 percent to 5 percent. In the case of a U.S.-owned business located in, and taxed by, Ukraine and Kazakhstan, the protocols ensure that Ukraine and Kazakhstan provide interest and wage deductions necessary to allow the Ukrainian and Kazakh taxes to qualify as creditable "income taxes" for U.S. purposes. On this basis, the Ukraine and Kazakhstan protocols specifically provide that their respective taxes do qualify for U.S. foreign tax credits. The tax treaties with Ukraine and Kazakhstan also bring the tax treaty relationships between those countries and the United States much more into the mainstream of U.S. tax treaties: for example, they introduce an anti-treaty-shopping provision, and update the provisions to prevent discrimination, for intergovernmental cooperation on tax collection, and for the exchange of tax-related information. An "other income" article is added in each treaty, although the corresponding articles in the two treaties differ fundamentally from each other. The article in the Ukraine treaty, like the more common U.S. treaty provision, reserves to the residence country exclusive tax jurisdiction over income not specifically covered in the treaty. The article in the Kazakhstan treaty on the other hand, like some existing U.S. tax treaties with

developing countries, allows source-country taxation of such income.

Most tax treaty partners of the United States have long-established tax systems. The states of the former Soviet Union generally have not yet had the opportunity to fully develop their economies and tax systems. It is less common for the United States to use a tax treaty as a device to stabilize the economy or tax system of a country undergoing development or transition. Where Ukraine and Kazakhstan have been making significant progress in bringing their respective tax systems into general conformity with international norms of taxation, it may be appropriate to use the proposed Ukraine and Kazakhstan tax treaties as such devices.

### Portugal

The new treaty with Portugal would lead to the entrance by the United States into a tax treaty relationship where no treaty is currently in force. Portugal is the only member country of the European Union with which the United States has no tax treaty in force. As a practical matter, Portugal would agree to reduce its taxes on the income that U.S. residents earn from sources in Portugal, and the United States would undertake reciprocal reductions of tax on U.S. income of Portuguese residents.

The United States and Portugal would also agree that their tax administrators will exchange tax information where necessary to carry out tax laws and will cooperate together to resolve problems in the coordination of the tax rules of the two countries that may arise in individual cases.

This first-time treaty follows the preferred U.S. negotiating position in some respects. For example, it takes into account the special U.S. concerns that cause the United States to refrain from releasing taxing jurisdiction over income from special pass-through entities like RICs, REITs, and REMICs. It differs from the preferred U.S. treaty position, however, in other respects, primarily by not reducing source country taxation as much as would the U.S. model.

Most notably, the treaty allows Portugal to impose an additional 5-percent tax on dividends paid by certain Portuguese companies to U.S. recipients, over and above the reciprocal dividend rate allowed under the treaty. The additional Portuguese tax is considered by Portugal to be a substitute for an inheritance or gift tax, and we understand that Portugal has not given up this tax in any of its tax treaties.

In addition, the reciprocal dividend withholding rates are intended to be lowered, to a level more consistent with preferred U.S. treaty policy, once Portugal is required to lower its withholding tax rates applicable to dividends paid within the European Union. The timing of this rate reduction under the treaty is based entirely on when the establishment of the European Union will require Portugal to eliminate its tax on intra-EU dividends. Thus, the United States has no involvement in negotiations that will have the effect of adjusting the withholding tax rates in the U.S.-Portugal treaty.

## Common treaty issues

These proposed treaties present a number of issues in common, of which we think two bear mentioning today.

First, since the last time this Committee considered tax treaties in 1993, the Uruguay Round trade negotiations have concluded. One agreement among the several concluded in the Uruguay Round is the General Agreement on Trade in Services, or "GATS," which has much broader implications for taxation than does the General Agreement on Tariffs and Trade, or "GATT." The GATS imposes national-treatment and most-favored-nation requirements, and provides for the resolution of disputes under the auspices of the World Trade Organization. However, the GATS also permits a tax treaty to apply exclusively to tax matters within the scope of the treaty, and also to provide that the determination of whether an issue lies within the scope of a tax treaty must be made under the dispute resolution procedures of the tax treaty.

This all means that a new tax treaty provision must be developed and included in all new treaties in order to ensure that the rules of the GATS and the procedures of the World Trade Organization will not preempt the tax principles and procedures established in a tax treaty. The proposed tax treaties with France, Sweden and Portugal, as well as the protocol with Canada, all include such a new provision. We believe that this new provision will be effective in protecting the jurisdiction of the tax treaties in which it appears, and that this language or similar language is necessary in all new tax treaties.

The proposed treaties with Ukraine and Kazakhstan do not include such GATS-override language, however. This occurred because those two treaties were negotiated and signed before the Uruguay Round was completed. The GATS also provides that treaties that were in force on January 1, 1995, when the GATS itself entered into force, automatically preclude preemption by the GATS, necessarily without the need for a specific provision within the treaty. Had these treaties been ratified in 1994, they then would have been treaties in force on January 1, 1995. Added complications arise from the facts that Ukraine and Kazakhstan are not yet members of the World Trade Organization or the GATS, and that those countries inherited coverage under the Jackson-Vanik Amendment from the Soviet Union. Because the treaties neither entered into force last year nor include GATS-override language, however, such language needs somehow to be added to the treaties. As Treasury has testified, the Administration has been endeavoring to add GATS-override language through diplomatic notes. We recommend that the Committee continue to work with the Treasury Department to determine the most effective way for the Ukraine and Kazakhstan treaties to be protected from preemption by the GATS.

Second, some of the proposed treaties seek to continue the trend toward international tax arbitration that began with the 1989 U.S.-Germany tax treaty. The proposed treaties with France, Canada, and Kazakhstan follow the German treaty's arbitration provisions, but like the recent treaties with Mexico and the Netherlands, delay the effect until a further exchange of diplomatic notes. In effect, the positive but cautious approach is reflective of the Committee's comments in 1990 on the German arbitration provision. Once there are some actual cases arbitrated under the

German treaty, the process of evaluation can finally begin. Until then, the arbitration provisions of several subsequent treaties will not be activated.

This concludes my testimony. We would be happy to answer any questions.