



JOINT COMMITTEE ON TAXATION

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**TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION
BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS HEARING ON
THE PROPOSED TAX TREATY WITH BELGIUM AND THE PROPOSED TAX
PROTOCOLS WITH DENMARK, FINLAND, AND GERMANY¹**

JULY 17, 2007

My name is Thomas A. Barthold. I am Acting Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation today concerning the proposed income tax treaty with Belgium and the proposed income tax protocols with Denmark, Finland, and Germany.

Overview

As in the past, the Joint Committee staff has prepared pamphlets covering the proposed treaty and protocols. The pamphlets provide detailed descriptions of the proposed treaty and protocols, including comparisons with the United States Model Income Tax Convention of November 15, 2006 (“2006 U.S. model treaty”), which reflects preferred U.S. tax treaty policy, and with other recent U.S. tax treaties.² The pamphlets also provide detailed discussions of issues raised by the proposed treaty and protocols. We consulted with the Treasury Department and with the staff of your committee in analyzing the proposed treaty and protocols and in preparing the pamphlets.

¹ This document may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Tax Treaty with Belgium and the Proposed Tax Protocols with Denmark, Finland, and Germany* (JCX-51-07), July 17, 2007. This publication can also be found at www.house.gov/jct.

² Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Belgium* (JCX-45-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Denmark* (JCX-46-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany* (JCX-47-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Finland* (JCX-48-07), July 13, 2007.

The principal purposes of the treaty and protocols are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed treaty and protocols also are intended to promote close economic cooperation between the treaty countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the treaty countries. As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country.

The proposed treaty with Belgium would replace an existing treaty signed in 1970 and modified by a protocol signed in 1987. The proposed protocol with Denmark would amend an existing tax treaty that was signed in 1999. The proposed protocol with Finland would make several modifications to an existing treaty that was signed in 1989. The proposed protocol with Germany would update the existing treaty and protocol that were signed in 1989.

My testimony today will highlight some of the key features of the proposed treaty and protocols and certain issues that they raise.

U.S. model treaty

As a general matter, U.S. model tax treaties provide a framework for U.S. tax treaty policy and a starting point for tax treaty negotiations with our treaty partners. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on tax treaty matters. Periodically updating the U.S. model tax treaty to reflect changes, revisions, developments, and the viewpoints of Congress with regard to U.S. tax treaty policy ensures that the model treaties remain meaningful and relevant. In November 2006, the Treasury Department released a new model income tax treaty; the U.S. model income tax treaty had not been updated since 1996.³ As a general matter, the 2006 U.S. model treaty incorporates the key developments in U.S. income tax treaty policy that are reflected in recent U.S. income tax treaties. The proposed treaty and protocols that are the subject of this hearing are generally consistent with the provisions found in the 2006 U.S. model treaty. However, there are some key differences from the 2006 U.S. model treaty that I will discuss.

Limitation-on-benefits provisions

One area in which the proposed treaty and protocols are generally consistent with the 2006 U.S. model treaty is the inclusion in all four proposed instruments of a comprehensive limitation-on-benefits provision. The limitation-on-benefits provision of the 2006 U.S. model treaty reflects significant changes to the limitation-on-benefits provision of the United States Model Income Tax Convention of September 15, 1996. These changes generally are intended to make it more difficult for third country residents to benefit inappropriately from a treaty between two countries.

³ For a comparison of the 2006 U.S. model income tax treaty with its 1996 predecessor, see Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 15, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

When a resident of one country derives income from another country, the internal tax rules of the two countries may cause that income to be taxed in both countries. One purpose of a bilateral income tax treaty is to allocate taxing rights for cross-border income and thereby to prevent double taxation of residents of the treaty countries. Although a bilateral income tax treaty is intended to apply only to residents of the two treaty countries, residents of third countries may attempt to benefit from a treaty by engaging in treaty shopping. This treaty shopping may involve organizing in a treaty country a corporation that is entitled to the benefits of the treaty or engaging in income-stripping transactions with a treaty-country resident. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping.

The limitation-on-benefits provisions in the proposed treaty and protocols are generally similar to the limitation-on-benefits provisions in one another, in recent U.S. tax treaties, and in the 2006 U.S. model treaty. However, there are some differences. First, the public trading test in the limitation-on-benefits provision in the proposed protocol with Germany may be satisfied only if the principal class of a company's shares is primarily traded on a recognized stock exchange located in the company's country of residence. This rule is the same as the rule in the 2006 U.S. model treaty. The public trading tests in the proposed treaty with Belgium and in the proposed protocols with Denmark and Finland may be satisfied by trading on a stock exchange located in a company's country of residence or in one of various other countries that are considered to be part of the economic area that includes the applicable treaty country. Second, the proposed treaty and the three proposed protocols include so-called derivative benefits rules intended to grant treaty benefits to a treaty country resident if the resident's owners would have been entitled to the same benefits if the income had flowed directly to them. Third, the proposed treaty and the three proposed protocols include rules intended to foreclose eligibility for treaty benefits for certain triangular arrangements, arrangements in which income such as interest on a loan is lightly taxed because it is derived by a third-country permanent establishment of a treaty country resident. The 2006 U.S. model treaty does not include special derivative benefits rules or rules for triangular arrangements.

The proposed treaty with Belgium and the proposed protocols with Denmark and Germany have special limitation-on-benefits rules that are not included in the 2006 U.S. model treaty. The proposed treaty with Belgium includes rules intended to allow treaty benefits to certain treaty country residents that function as headquarters companies. Although the 2006 U.S. model treaty does not include special limitation-on-benefits rules for headquarters companies, similar rules have been included in U.S. income tax treaties with Australia and the Netherlands. The proposed protocol with Denmark includes rules intended to allow treaty benefits to certain Danish taxable nonstock corporations and to Danish companies owned by taxable nonstock corporations. Taxable nonstock corporations are entities designed to preserve control of certain Danish operating companies through control of the companies' voting stock. The proposed protocol with Germany includes special rules for determining whether certain German investment vehicles are entitled to treaty benefits.

“Zero-rate” dividend provisions

One significant difference between the 2006 U.S. model treaty and the proposed treaty and protocols is the “zero rate” of withholding tax on certain intercompany dividends provided

under all four of the proposed instruments. Until 2003, no U.S. income tax treaty provided for a complete exemption from dividend withholding tax, and the 2006 U.S. model treaty and the 2005 Model Convention on Income and Capital of the Organisation for Economic Co-operation and Development (“OECD”) do not provide an exemption. By contrast, many bilateral income tax treaties of other countries eliminate withholding taxes on direct dividends between treaty countries, and the European Union (“EU”) Parent-Subsidiary Directive repeals withholding taxes on intra-EU direct dividends. The Directive’s required ownership threshold for qualification for zero withholding is 15 percent in 2007. Recent U.S. income tax treaties and protocols with Australia, Japan, Mexico, the Netherlands, Sweden, and the United Kingdom include zero-rate provisions. The Senate ratified those treaties and protocols in 2003 (Australia, Mexico, United Kingdom), 2004 (Japan, Netherlands), and 2006 (Sweden). The zero-rate provisions in those treaties are similar to the provisions in the proposed treaty and protocols.

In general, the dividend articles of the proposed treaty and protocols provide a maximum source-country withholding tax rate of 15 percent and a reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. The proposed treaty and protocols generally provide a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. Eligibility for this zero rate is contingent on satisfaction of more stringent limitation-on-benefits requirements than the general limitation-on-benefits requirements of the proposed treaty and protocols. A zero rate also generally is available under the proposed treaty and protocols for dividends received by a pension fund. The treaty and protocols also include special rules for dividends received from U.S. regulated investment companies and real estate investment trusts. These special rules generally are similar to provisions included in other recent U.S. treaties and protocols.

The zero-rate provision in the proposed treaty with Belgium includes two unique features. First, the required ownership threshold for dividends paid by Belgian companies to U.S. companies is 10 percent rather than 80 percent. Second, the provision allows the United States to terminate the zero-rate provision for dividends paid by U.S. companies if Belgium fails to comply with certain obligations under the exchange-of-information and mutual agreement procedure provisions. The zero-rate for dividends paid by U.S.-resident companies will terminate for amounts paid or credited on or after January 1 of the sixth year following the year in which the proposed treaty enters into force unless by June 30 of the preceding year the U.S. Treasury Secretary, on the basis of a report of the IRS Commissioner, certifies to the U.S. Senate that Belgium has satisfactorily complied with its obligations under Article 25 (Exchange of Information and Administrative Assistance). The United States also may terminate the zero-rate provision for dividends paid by U.S. companies if the United States determines that Belgium’s actions under Article 24 (Mutual Agreement Procedure) and Article 25 (Exchange of Information and Administrative Assistance) have materially altered the balance of benefits of the proposed treaty. If the United States terminates the zero-rate provision, Belgium will not be required to comply with exchange-of-information rules specifically requiring the treaty countries to provide information held by banks and other financial institutions and by nominees and persons acting in agency or fiduciary capacities.

Notwithstanding the fact that zero-rate provisions are common in recent U.S. treaties, the 2006 U.S. model treaty does not include a zero-rate provision, nor do recent treaties with

Bangladesh and Sri Lanka nor the recent protocol with France. In previous testimony before the Committee, the Treasury Department has indicated that zero-rate provisions should be allowed only under treaties that have restrictive limitation-on-benefits rules and that provide comprehensive information exchange. Even in those treaties, according to previous Treasury Department statements, dividend withholding tax should be eliminated only based on an evaluation of the overall balance of benefits under the treaty. Looking beyond the four treaty relationships directly at issue, the Committee may wish to consider what overall balance considerations might prompt the Treasury Department not to seek a zero-rate provision in a treaty that has limitation-on-benefits and information-exchange provisions meeting the highest standards, such as those found in the 2006 U.S. model treaty.

Mandatory and binding arbitration provisions

One new feature of the proposed treaty with Belgium and the proposed protocol with Germany is the mandatory and binding arbitration provision. The provision does not appear in the 2006 U.S. model treaty or in any existing U.S. tax treaty. However, the use of mandatory and binding arbitration procedures in tax disputes between countries is not a completely novel concept. Earlier this year, the OECD Committee on Fiscal Affairs adopted proposed changes to its model treaty and commentary that incorporate a mandatory and binding arbitration procedure, some elements of which are generally similar to those of the proposed treaty and protocol. In addition, the EU has adopted certain mandatory and binding arbitration procedures that are applicable to transfer pricing disputes between 15 of the oldest members of the EU. There have been statements made by the European Commission that the EU mandatory arbitration procedure is not working as well as it is supposed to, for reasons that need to be further explored.

Judging from the actions taken by the OECD and the EU, unresolved competent authority proceedings appear to be a multinational occurrence. However, the information that would help clarify whether this phenomenon represents a problem for the U.S. competent authority program, as well as the information that would identify the extent of the problem and its root causes, is not publicly available. Consequently, if unresolved competent authority proceedings are a problem for the United States, it is difficult to determine whether mandatory and binding arbitration would solve it. The Committee may wish to assess the basis for the Treasury Department, or taxpayers, to believe that there is a problem with the current resolution of disputes through the competent authority process. Are problems that have been identified pervasive or idiosyncratic to specific countries or tax issues?

As a general matter, it is beneficial to resolve tax disputes effectively and efficiently. The new arbitration procedures are intended to ensure that the mutual agreement procedures proceed according to a schedule and that all cases will be resolved within a limited time period. There are many potential variations of the arbitration methodology, however, and the Committee may wish to consider the rationale for some of the choices made by the United States and its treaty partners and whether those chosen methodologies help to resolve the perceived problem. For example, the proposed arbitration procedures utilize the “last best offer” method. Under the “last best offer” method (also informally called “baseball arbitration” because it is similar to the arbitration method used to resolve major league baseball salary disputes), each of the treaty countries submits to the arbitration board (“board”) a proposed resolution describing its proposed disposition of the specific amounts of income, expense, or taxation at issue in the case (and a

supporting position paper), and the board is required to adopt one of the proposed resolutions submitted by the treaty countries. The determination of the board is binding upon the treaty countries in the case, but does not state a rationale and has no precedential value. The last best offer approach is intended to induce the competent authorities to moderate their positions, including before arbitration proceedings would commence, thus increasing the possibility of a negotiated settlement. The proposed arbitration procedures do not adopt the “independent opinion” approach, under which the board is presented with the facts and arguments of the parties based on applicable law and then reaches its own independent decision based upon a written, reasoned analysis of the facts involved and applicable legal sources. Other examples of choices made are the lack of provision for taxpayer involvement in the arbitration proceedings and the absence of feedback to the competent authorities regarding the rationale for the board’s determination.

The proposed mandatory and binding arbitration procedures are new to the United States’ treaty network. It will take time to ascertain if these procedures are effective or if unexpected problems arise. Meanwhile, the Treasury Department or other trading partners may seek to negotiate treaty provisions with current or future treaty partners that are similar, in whole or in part, to the arbitration procedures of the proposed treaty and protocol. The Committee may wish to better understand how the Treasury Department intends to monitor the competent authority function, as well as arbitration developments with respect to other countries, to determine the overall effects of the new arbitration procedures on the mutual agreement process. The Committee may wish to consider what types of information are needed to measure whether, regardless of whether they are availed of, the proposed arbitration procedures result in more efficient case resolution, both before and during arbitration, and whether they enhance the quality of the outcome of the competent authority cases. In addition, the Committee may wish to inquire as to whether and under what circumstances the Treasury Department intends to pursue similar provisions in other treaties.

Belgium

The proposed treaty replaces the existing treaty (signed in 1970) and protocol (signed in 1987). In addition to the inclusion of a comprehensive limitation-on-benefits provision, a zero-rate dividend provision, and a mandatory and binding arbitration provision, as previously discussed, the proposed treaty has several other key features.

The proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 7). Similarly, the proposed treaty contains certain exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14 and 16).

The proposed treaty provides that, subject to certain rules and exceptions, interest and royalties derived by a resident of either country from sources within the other country may be taxed only by the residence country (Articles 11 and 12).

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 22).

The proposed treaty contains the standard provision (the “saving clause”) included in U.S. tax treaties pursuant to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). This provision also allows the United States to tax certain former citizens and long-term residents regardless of whether the termination of citizenship or residency had as one of its principal purposes the avoidance of tax. The provision generally allows the United States to apply special tax rules under section 877 of the Code as amended in 1996 and 2004. In addition, the proposed treaty contains the standard provision providing that the treaty may not be applied to deny any taxpayer any benefits to which the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries (Article 1).

The proposed treaty adds to the present treaty certain provisions regarding cross-border contributions to, and benefit accruals of, pension plans (Article 17). These rules are intended to remove barriers to the flow of personal services between the two countries that could otherwise result from discontinuities under the laws of each country and are similar to provisions included in other recent U.S. treaties and protocols, including the 2006 U.S. model treaty.

The proposed treaty (Article 19) generally provides that students, teachers, business trainees, and researchers visiting the other treaty country are exempt from host country taxation on certain types of payments received.

The proposed treaty provides authority for the two countries to exchange information (Article 25) and assist in the collection of tax (Article 26) in order to carry out the provisions of the proposed treaty.

Denmark

The proposed protocol makes a few modifications to the 1999 treaty, in addition to the adoption of the comprehensive limitation-on-benefits provision and the zero-rate dividends provision previously discussed.

The proposed protocol expands the saving clause provision in Article 1 (Personal Scope) of the existing treaty to allow the United States to tax certain former citizens and long-term residents regardless of whether their termination of citizenship or residency has as one of its principal purposes the avoidance of tax. This provision generally allows the United States to apply special tax rules under section 877 of the Code as amended in 1996 and 2004.

The proposed protocol amends Article 19 (Government Service) of the existing treaty to correct a drafting error that inappropriately expands the scope of an exception to the general rule governing the taxation of certain government pensions.

Finland

The proposed protocol makes several modifications to the 1989 treaty, in addition to the adoption of the comprehensive limitation-on-benefits provision and the zero-rate dividends provision previously discussed.

The proposed protocol expands the saving clause provision in Article 1 (Personal Scope) of the existing treaty to allow the United States to tax certain former citizens and long-term residents regardless of whether the termination of citizenship or residency had as one of its principal purposes the avoidance of tax. This provision generally allows the United States to apply special tax rules under section 877 of the Code as amended in 1996 and 2004. The proposed protocol makes coordinating changes to Article 23 (Elimination of Double Taxation) with respect to foreign tax credits allowed for former U.S. citizens and long-term residents.

The proposed protocol also adds to Article 1 (Personal Scope) of the existing treaty rules included in recent U.S. treaties and the 2006 U.S. model treaty related to fiscally transparent entities.

The proposed protocol amends Article 4 (Residence) of the existing treaty to clarify which persons are residents of a treaty country and to more closely reflect the provisions included in the 2006 U.S. model treaty and recent U.S. income tax treaties.

The proposed protocol modifies Article 11 (Interest) and Article 12 (Royalties) of the existing treaty. It adds to Article 11 two new exceptions to the general prohibition on source-country taxation of interest income, one for contingent interest and the other for interest that is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit. It amends Article 12 by deleting a paragraph that permits source-country taxation of royalties that are beneficially owned by a resident of the other treaty country and that are received as consideration for the use of patents and trademarks or for information concerning industrial, commercial, or scientific experience.

The proposed protocol replaces Article 26 (Exchange of Information) of the existing treaty with new exchange-of-information rules that are largely similar to the exchange-of-information rules included in the 2006 U.S. model treaty.

The proposed protocol will enter into force upon the exchange of instruments of ratification. If the proposed protocol enters into force before December 31, 2007, the dividend withholding tax provisions will have effect for income derived on or after January 1, 2007.

Germany

The proposed protocol makes several modifications to the 1989 treaty and protocol, in addition to the adoption of the comprehensive limitation-on-benefits provision, the zero-rate dividends provision, and the mandatory and binding arbitration provision previously discussed.

The proposed protocol expands the saving clause provision in Article 1 (General Scope) of the existing treaty to allow the United States to tax certain former citizens and long-term residents regardless of whether the termination of citizenship or residency had as one of its

principal purposes the avoidance of tax. This provision generally allows the United States to apply special tax rules under section 877 of the Code as amended in 1996 and 2004. The proposed protocol also updates the existing treaty to include the rules in the 2006 U.S. model treaty related to fiscally transparent entities.

The proposed protocol amends Article 4 (Residence) of the existing treaty to clarify which persons are residents of a treaty country. The proposed protocol specifically addresses the residence of the two treaty countries (and subdivisions and local authorities thereof), U.S. citizens and aliens lawfully admitted for permanent residence in the United States, and certain investment funds.

The proposed protocol modifies Article 7 (Business Profits) in two important respects. First, the protocol modifies Article 7 to provide that income derived from independent personal services (i.e., income from the performance of professional services and of other activities of an independent character) is included within the meaning of the term “business profits.” Accordingly, the treatment of such income is governed by Article 7 rather than by present treaty Article 14 (Independent Personal Services), which the proposed protocol deletes. In addition, Paragraph 4 of Article XVI provides that the OECD Transfer Pricing Guidelines apply by analogy in determining the profits attributable to a permanent establishment under Article 7. These new rules are similar to provisions included in other recent U.S. treaties and protocols, including the 2006 U.S model treaty.

The proposed protocol adds to the present treaty Article 11 (Interest) two new exceptions to the general prohibition on source-country taxation of interest income, one for contingent interest and the other for interest that is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit.

The proposed protocol adds to the present treaty Article 18A (Pension Plans). Article 18A includes new rules related to cross-border pension contributions and benefit accruals. These rules are intended to remove barriers to the flow of personal services between the two countries that could otherwise result from discontinuities under the laws of each country regarding the deductibility of pension contributions and the taxation of a pension plan's earnings and accretions in value. These new rules are similar to provisions included in other recent U.S. treaties and protocols, including the 2006 U.S model treaty.

The proposed protocol replaces Article 19 (Government Service) of the existing treaty with a new article that more closely reflects the government service provisions included in the 2006 U.S. model treaty and recent U.S. income tax treaties.

The proposed protocol modifies Article 20 (Visiting Professors and Teachers; Students and Trainees) of the existing treaty to provide that professors or teachers who visit the other treaty country for a period that exceeds two years do not retroactively lose their exemption from host country income tax. The proposed protocol increases the amount of the exemption from host country tax for students and trainees who receive certain types of payments.

The proposed protocol replaces Article 23 (Relief From Double Taxation) of the present treaty with a new article providing updated rules for the relief of double taxation. Among other

changes, the new Article 23 provides special rules for the tax treatment in both treaty countries of certain types of income derived from U.S. sources by U.S. citizens who are resident in Germany.

The proposed protocol updates Article 17 (Artistes and Athletes) and Article 20 (Visiting Professors and Teachers; Students and Trainees) of the existing treaty to reflect Germany's use of the euro.

The proposed protocol provides for the entry into force of the proposed protocol. The provisions of the proposed protocol are generally effective on a prospective basis. However, the provisions of the proposed protocol with respect to withholding taxes are effective for amounts paid or credited on or after the first day of January of the year in which the proposed protocol enters into force.

Conclusion

These provisions and issues are all discussed in more detail in the Joint Committee staff pamphlets on the proposed treaty and protocols. I am happy to answer any questions that the Committee may have at this time or in the future.