

Joint Committee on Taxation
October 7, 1997
JCX-53-97

**TESTIMONY OF THE
STAFF OF THE JOINT COMMITTEE ON TAXATION
BEFORE THE
SENATE COMMITTEE ON FOREIGN RELATIONS
HEARING ON TAX TREATIES AND PROTOCOLS
WITH EIGHT COUNTRIES**

October 7, 1997

My name is Ken Kies. I am 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 ("Joint Committee staff") at this hearing concerning the proposed income tax treaties with Austria, Ireland, Luxembourg, South Africa, Switzerland, Thailand, and Turkey and the proposed protocol amending the existing income tax treaty with Canada.

Overview

As in the past, the Joint Committee staff has prepared pamphlets covering each of the proposed treaties and protocols. The pamphlets contain detailed descriptions of the provisions of the proposed treaties and protocols, including comparisons with the 1996 U.S. model treaty, which reflects preferred U.S. treaty policy, and with other recent U.S. tax treaties. The pamphlets also contain detailed discussions of issues raised by the proposed treaties and protocols. We consulted extensively with your Committee staff in analyzing the proposed treaties and protocols and preparing the pamphlets.

Five of the eight agreements at issue today would modify existing U.S. treaty relationships. The proposed protocol with Canada would make two modifications to the current treaty which was amended most recently in 1995. The proposed treaty with Austria would replace an existing treaty that has not been modified since 1956. The proposed treaty with Ireland would replace an existing treaty that has not been modified since 1949. The proposed treaty with Luxembourg would replace an existing treaty that has not been modified since 1962. The proposed treaty with Switzerland would replace an existing treaty that has not been modified since 1951. The other three treaties are with countries with which the United States does not currently have a treaty relationship. The proposed treaties with Thailand and Turkey would represent the entrance into tax treaty relationships where the United States has not previously had such a treaty. The final proposed treaty is with South Africa; the United States previously had a treaty with South Africa which was terminated in 1987, and no treaty currently is in force.

I will highlight some of the key features of these treaties and protocols and the issues they raise.

Common Issue

In connection with consideration of these treaties, an issue was raised regarding the U.S. treaty policy with respect to the treatment of dividends from U.S. Real Estate Investment Trusts ("REITs").

U.S. tax treaties generally limit the maximum rate of withholding tax that may be imposed by the source country on portfolio dividends paid by a corporation resident in one country to residents of the other country; most commonly, the maximum rate of withholding tax on dividends is 15 percent. Treaties negotiated by the United States after 1988 contain specific rules excluding REIT dividends from the reduced rates of withholding tax generally applicable to dividends. Accordingly, under such treaties, REIT dividends may be subject to U.S. withholding tax at the full statutory rate of 30 percent. The exclusion of REIT dividends from the reduced rates of withholding tax generally applicable to dividends reflects the view that REIT dividends should be treated in a manner that generally is comparable to the treatment of rental income earned on a direct investment in real property.

The REIT industry has expressed concern that the exclusion of REIT dividends from the reduced withholding tax rates applicable to other dividends may inappropriately discourage some foreign investment in REITs. The Treasury Department has worked extensively with your Committee staff, the Joint Committee staff, and representatives of the REIT industry in order to address this concern while maintaining a treaty policy that properly preserves the U.S. taxing jurisdiction over foreign direct investment in U.S. real property. As a result of significant cooperation among all parties to balance these competing considerations, the U.S. treaty policy with respect to the treatment of REIT dividends has been modified.

Under this policy, REIT dividends paid to a resident of a treaty country will be eligible for the reduced rate of withholding tax applicable to portfolio dividends (typically, 15 percent) in two cases. First, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 5 percent or less in each class of the REIT's stock and such dividends are paid with respect to a class of the REIT's stock that is publicly traded. Second, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 10 percent or less in the REIT and the REIT is diversified, regardless of whether the REIT's stock is publicly traded. In addition, the treaty policy with respect to the application of the reduced withholding tax rate to REIT dividends paid to individuals holding less than a specified interest in the REIT will remain unchanged.

For purposes of these rules, a REIT will be considered diversified if the value of no single interest in real property held by the REIT exceeds 10 percent of the value of the REIT's total interests in real property. An interest in real property will not include a mortgage, unless the mortgage has substantial equity components. An interest in real property also will not include foreclosure property. Accordingly, a REIT that holds exclusively mortgages will be considered to be diversified. The diversification rule will be applied by looking through a partnership interest held by a REIT to the underlying interests in real property held by the

partnership. Finally, the reduced withholding tax rate will apply to a REIT dividend if the REIT's trustees or directors make a good faith determination that the diversification requirement is satisfied as of the date the dividend is declared.

This new policy with respect to the treatment of REIT dividends will be incorporated into the U.S. model treaty. In addition, the Treasury Department will use its best efforts to negotiate protocols to amend the proposed treaties with Austria, Ireland, and Switzerland to incorporate this policy.

In the case of Luxembourg, it is recommended that this policy be implemented by means of a reservation to the proposed treaty presently under consideration. In addition, it is recommended that this reservation include a special rule for existing investment in REITs by Luxembourg residents. Under this special rule, in the case of any resident of Luxembourg who held an interest in a diversified REIT as of June 30, 1997, dividends paid to such resident with respect to that interest would be eligible for the reduced rate of withholding tax. However, this special rule would not apply to dividends paid after December 31, 1999, unless the stock of the REIT is publicly traded on December 31, 1999 and thereafter. The special rule would apply to existing investment in a REIT as of June 30, 1997 and to reinvestment in the REIT of both ordinary and capital dividends paid with respect to that investment. In addition, if a REIT in which there is a qualifying investment as of June 30, 1997 goes out of existence in a nonrecognition transaction, the special rule would continue to apply to the investment in the successor REIT if any.

Canada

The proposed protocol with Canada would modify the income tax treaty that was signed in 1980 and amended by protocols in 1983, 1984, and 1995.

The proposed protocol would replace the provision in the existing treaty that provides for exclusive source-country taxation of social security benefits with a provision that provides for exclusive residence-country taxation of social security benefits. Under the proposed protocol, U.S. social security benefits paid to Canadian residents would be subject to tax only in Canada, and Canadian social security benefits paid to U.S. residents would be subject to tax only in the United States. This represents a return to the approach that applied prior to the 1995 protocol. The amendment made by the proposed protocol would take effect for social security benefits paid after 1995, with a refund mechanism applying to taxes that have been paid with respect to post-1995 benefits.

The proposed protocol also would modify the provision in the existing treaty allowing situs-country taxation of gains from real property; under this provision, the country in which real property is situated may tax gains with respect to corporate stock if a sufficient portion of the corporation's assets consists of such real property. The protocol would limit this rule so that it applies only to stock of domestic corporations and not to stock of foreign corporations. Such a

limitation is consistent with U.S. internal law regarding the taxation of gains from stock of real property holding companies.

Austria

The proposed treaty with Austria is a comprehensive update of the 1956 treaty. The provisions of the proposed treaty generally comport with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provisions in the U.S. model treaty and other recent treaties. The proposed treaty also includes an anti-abuse rule covering certain "triangular cases," which involve payments from the United States to a branch of an Austrian company located in a third country. Under this rule, the United States generally may tax, in accordance with its internal law, interest and royalties paid to a low-taxed third-country branch of an Austrian company.

Under the proposed treaty, Austria may tax the disposition of stock of an Austrian company that was received upon the incorporation of a permanent establishment in Austria, if any inherent capital gains were not taxed at the time of the incorporation. This rule, which represents a unilateral concession by the United States, applies through the year 2010.

The proposed treaty expands the class of royalty payments that is subject to a 10-percent source-country tax. Under the existing treaty, only payments for the use of motion picture films are subject to source-country tax. Under the proposed treaty, source-country tax also applies to payments for the use of films, tapes or other means of reproduction used for radio or television broadcasting. The preferred U.S. treaty position is the elimination of source-country taxation of royalty income.

The OECD Commentary, which reflects agreed interpretations of the OECD model treaty, is to apply in interpreting any provision of the proposed treaty that corresponds to a provision of the OECD model treaty. This rule does not apply where either the United States or Austria has entered a reservation, or has included an observation, with respect to the OECD model treaty or its Commentary. In addition, this rule generally does not apply where a contrary interpretation is included in the Memorandum of Understanding with respect to the proposed treaty or in a published interpretation of the proposed treaty (e.g., the Treasury Department's Technical Explanation).

The exchange of information provisions of the proposed treaty are substantially more useful than those of the current treaty. Information generally may be exchanged to carry out the purposes of the proposed treaty or to carry out the domestic laws of the countries concerning taxes covered by the information exchange article of the proposed treaty. There are provisions in Austrian law that prohibit Austria from obtaining information from Austrian banks in non-penal investigations; however, bank information may be obtained for penal investigations. Accordingly, under the proposed treaty, bank information may be provided by Austria in

connection with U.S. penal investigations, including the commencement of a criminal investigation by the Internal Revenue Service.

Ireland

The proposed treaty with Ireland is a comprehensive update of the 1949 treaty. The provisions of the proposed treaty generally are consistent with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which includes most of the elements of the anti-treaty shopping-provisions found in the U.S. model treaty and other recent U.S. treaties. The proposed treaty includes a "derivative benefits" provision under which treaty benefits generally would be available to Irish companies that are owned by residents of countries that are members of the European Union ("EU") or parties to the North American Free Trade Agreement ("NAFTA"). Under this rule, the treaty benefits with respect to dividends, interest, and royalties would be available only if the countries in which such owners are resident have treaties with the United States providing for benefits that are at least as favorable as those provided under the proposed treaty; however, this restriction on the availability of treaty benefits would take effect no earlier than two years after the proposed treaty takes effect. The proposed treaty also includes an anti-abuse rule covering the so-called "triangular case." This rule generally permits the United States to impose a 15-percent tax on dividends, interest, and royalties paid to a low-taxed third-country branch of an Irish company and to tax other payments to such a branch in accordance with U.S. internal law.

The proposed treaty provides an exemption for Irish insurance companies from the U.S. excise tax on insurance and reinsurance premiums paid to foreign insurers with respect to U.S. risks. However, this exemption applies only to the extent that the U.S. risk is not reinsured by the Irish insurer with a person that is not entitled to the benefits of an income tax treaty that similarly provides an exemption from such tax. Moreover, the exemption does not apply if the premiums paid to the Irish insurance company are not subject to the generally applicable tax imposed on insurance corporations in Ireland.

The proposed treaty includes an arbitration provision similar to the provision that was included in the 1989 U.S.-Germany tax treaty. However, like the provisions in several other recent treaties and the proposed treaty with Switzerland, the arbitration provision in the proposed treaty will take effect only upon a future exchange of diplomatic notes. It is intended that this arbitration approach be evaluated further once there has been some experience arbitrating cases under the U.S.-Germany treaty.

The exchange of information article contained in the proposed treaty conforms in most respects to the corresponding articles of the U.S. and OECD model treaties. As is true under these model treaties, under the proposed treaty the countries are to exchange such information as is necessary for carrying out the provisions of the proposed treaty or the domestic tax laws of the countries. There is one significant respect in which the exchange of information article does not conform to the corresponding article of the U.S. model treaty. The proposed treaty includes the

standard provision that upon request a country shall obtain information to which the request relates in the same manner and to the same extent as if the tax of the requesting country were imposed by the requested country. However, this provision cannot be fully implemented with respect to requests by the United States. Because of restrictions in Irish internal law, the United States may obtain limited information from Ireland with respect to criminal offenses, but may not obtain information from Ireland with respect to civil offenses. Ireland may, however, obtain information from the United States generally with respect to both criminal and civil offenses.

Luxembourg

The proposed treaty with Luxembourg is a comprehensive update of the 1962 treaty. The provisions of the proposed treaty generally comport with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provisions in the U.S. model treaty and other recent treaties. The proposed treaty includes a "derivative benefits" provision under which treaty benefits generally would be available to Luxembourg companies that are owned by residents of countries that are members of the EU or parties to NAFTA. The proposed treaty also includes an anti-abuse rule covering the so-called "triangular case." This rule generally permits the United States to impose a 15-percent tax on dividends, interest, and royalties paid to a low-taxed third-country branch of a Luxembourg company and to tax other payments to such a branch in accordance with U.S. internal law.

The proposed treaty provides an exemption for Luxembourg insurance companies for the U.S. excise tax on insurance premiums paid to foreign insurers with respect to U.S. risks. This exemption applies only to the extent that the U.S. risk is not reinsured by the Luxembourg insurer with a person that is not entitled to the benefits of an income tax treaty that similarly provides an exemption from such tax. All existing U.S. tax treaties that provide exemptions from the U.S. excise tax on insurance premiums also provide exemptions from the U.S. excise tax on reinsurance premiums paid to foreign insurers. However, the proposed treaty does not provide an exemption from the excise tax on reinsurance premiums paid to Luxembourg reinsurers.

The exchange of information provisions of the proposed treaty are more useful than those of the current treaty. Information generally may be exchanged to carry out the purposes of the proposed treaty or to carry out the domestic laws of the countries concerning taxes covered by the information exchange article of the proposed treaty. There are provisions in Luxembourg law that generally prohibit Luxembourg from obtaining information from Luxembourg financial institutions either for their own purposes or for purposes of the proposed treaty. However, such bank information may be obtained under certain circumstances involving criminal tax matters pursuant to the proposed Mutual Legal Assistance Treaty with Luxembourg.

South Africa

The proposed treaty with South Africa generally is 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, with only a few deviations. For example, the proposed treaty allows broader source-country taxation of business activities of residents of the other country by expanding the definition of a permanent establishment to include cases in which an enterprise provides services through its employees in a country if the activities continue for more than 183 days.

In addition, like many other U.S. treaties, the proposed treaty includes in the anti-treaty-shopping provision an anti-abuse rule covering the so-called "triangular case." This rule generally permits the United States to impose a 15-percent tax on interest and royalties paid to a low-taxed third-country branch of a South African company and to tax other payments to such branch in accordance with U.S. internal law.

Switzerland

The proposed treaty with Switzerland is a comprehensive update of the 1951 treaty. The provisions of the proposed treaty generally are consistent with modern U.S. treaty policy.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provisions in the U.S. model treaty and other recent treaties. The proposed treaty includes a "derivative benefits" provision under which treaty benefits generally would be available to Swiss companies that are owned by residents of countries that are members of the EU or the European Economic Area or parties to NAFTA. The proposed treaty includes an anti-abuse rule covering the so-called "triangular case." This rule generally permits the United States to impose a 15-percent tax on dividends, interest, and royalties paid to a low-taxed third-country branch of a Swiss company and to tax other payments to such a branch in accordance with U.S. internal law.

The proposed treaty provides an exemption for Swiss insurance companies from the U.S. excise tax on insurance and reinsurance premiums paid to foreign insurers with respect to U.S. risks. However, this exemption applies only to the extent that the U.S. risk is not reinsured by the Swiss insurer with a foreign person that is not entitled to the benefits of an income tax treaty that similarly provides an exemption from such tax.

The proposed treaty includes an arbitration provision similar to the provision that was included in the 1989 U.S.-Germany tax treaty. However, like the provisions in several other recent treaties and the proposed treaty with Ireland, the arbitration provision in the proposed treaty will take effect only upon a future exchange of diplomatic notes. It is intended that this arbitration approach be evaluated further once there has been some experience arbitrating cases under the U.S.-Germany treaty.

The exchange of information provisions of the proposed treaty are somewhat more useful than those of the current treaty, but are nonetheless more restrictive than the comparable provisions in tax treaties with other countries. Information generally may be exchanged to carry out the purposes of the proposed treaty, but it may not be exchanged to carry out the domestic laws of the countries concerning taxes covered by the information exchange article of the proposed treaty. Information may also be exchanged to prevent tax fraud. For example, in cases of tax fraud, Swiss banking secrecy provisions do not hinder the gathering of documentary evidence from banks or its being provided to the United States pursuant to the proposed treaty.

Thailand

The proposed treaty with Thailand would represent a new tax treaty relationship for the United States.

Under the proposed treaty, Thailand would agree to reduce its taxes on income that U.S. residents earn from sources in Thailand and the United States would agree to reciprocal reductions of its tax on U.S. income of Thai residents.

The proposed treaty follows preferred U.S. treaty positions in many respects. However, it differs from preferred U.S. treaty positions in other respects, primarily by not reducing source-country taxation to the same extent as many U.S. tax treaties. In this regard, the proposed treaty is similar to other treaties that the United States has entered into with developing countries.

The proposed treaty would allow broader source-country taxation of business activities of residents of the other country. For example, the proposed treaty expands the definition of a permanent establishment to include cases in which an enterprise provides services through its employees in a country if the activities continue for more than 90 days.

The proposed treaty also would permit higher maximum rates of source-country tax on dividends, interest and royalties, and would permit the imposition of source-country tax on certain equipment rental income. These maximum rates of source-country tax generally range from 10 to 15 percent in the case of dividends, 10 to 15 percent in the case of interest, and 5 to 15 percent in the case of royalties. The proposed treaty would treat equipment rental income as royalties subject to a maximum 8 percent source-country tax.

In addition, the proposed treaty would allow Thailand to tax gains derived by U.S. residents from the alienation of property in accordance with its internal law. Although the proposed treaty would permit the United States to impose tax in the reverse situation, U.S. internal law generally does not tax such gains of foreign persons, other than gains with respect to a U.S. real property interest.

The exchange of information article contained in the proposed treaty conforms in most respects to the corresponding articles of the U.S. and OECD model treaties. As is true under these model treaties, under the proposed treaty the countries are to exchange such information as

is necessary for carrying out the provisions of the proposed treaty or the domestic tax laws of the countries. There is one significant respect in which the exchange of information article does not conform to the corresponding article of the U.S. model treaty. The proposed treaty includes the standard provision that upon request a country shall obtain information to which the request relates in the same manner and to the same extent as if the tax of the requesting country were imposed by the requested country. However, the proposed treaty also would suspend the application of this provision until the United States receives from Thailand a diplomatic note indicating that Thailand is prepared and able to implement this provision, which will require that Thailand enact enabling legislation. This means that neither country will obtain information for the other until this diplomatic note is provided.

The provision by Thailand of this diplomatic note also is an important element in the termination article of the proposed treaty. There are two ways in which the proposed treaty may terminate. The first is a voluntary mechanism under which either country may terminate the proposed treaty at any time after five years after it enters into force, provided that appropriate notification is given. The second, which is much more unusual, is a mandatory termination on January 1 of the sixth year following the year the proposed treaty enters into force, unless this diplomatic note with respect to Thailand's ability to implement the information exchange provision is received by the previous June 30th.

Turkey

The proposed treaty with Turkey would represent a new tax treaty relationship for the United States. Turkey is the only OECD member country with which the United States has no tax treaty in force.

Under the proposed treaty, Turkey would agree to reduce its taxes on the income that U.S. residents earn from sources in Turkey and the United States would agree to reciprocal reductions of its tax on U.S. income of Turkish residents. The United States and Turkey also would 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.

The proposed treaty follows preferred U.S. treaty positions in many respects. However, it differs from preferred U.S. treaty positions in other respects, primarily by not reducing source-country taxation to the same extent as many U.S. tax treaties. In this regard, the proposed treaty is similar to other treaties that the United States has entered into with developing countries.

The proposed treaty would allow broader source-country taxation of business activities of residents of the other country. It also would permit higher maximum rates of source-country tax on dividends, interest, and royalties, and would permit the imposition of source-country tax on certain equipment rental income. These maximum rates of source-country tax generally range from 15 to 20 percent in the case of dividends, 10 to 15 percent in the case of interest, and 5 to

10 percent in the case of royalties. The proposed treaty would treat equipment rental income as royalties subject to a maximum 5 percent source-country tax.

In addition, the proposed treaty would allow Turkey to tax gains derived by U.S. residents from shares and bonds of Turkish companies in certain cases. Although the proposed treaty would permit the United States to impose tax in the reverse situation, U.S. internal law does not tax such gains of foreign persons.

Conclusion

These issues are discussed in more detail in the Joint Committee staff pamphlets on the proposed treaties and protocols. I would be happy to answer any questions.