S. HRG. 106–356

# BILATERAL TAX TREATIES AND PROTOCOL: ESTONIA—TREATY DOC. 105–55; LATVIA—TREATY DOC. 105–57; VENEZUELA—TREATY DOC. 106–3; DENMARK—TREATY DOC. 106–12; LITHUANIA—TREATY DOC. 105–56; SLOVENIA—TREATY DOC. 106–9; ITALY—TREATY DOC. 106–11; GERMANY—TREATY DOC. 106–13

## HEARING

BEFORE THE

## COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

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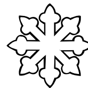

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# BILATERAL TAX TREATIES AND PROTOCOL: ESTONIA—TREATY DOC. 105–55; LATVIA—TREATY DOC. 105–57; VENEZUELA—TREATY DOC. 106–3; DENMARK—TREATY DOC. 106–12; LITHUANIA—TREATY DOC. 105–56; SLOVENIA—TREATY DOC. 106–9; ITALY—TREATY DOC. 106–11; GERMANY—TREATY DOC. 106–13

**WEDNESDAY, OCTOBER 27, 1999**

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
*Washington, DC.*

The committee met, pursuant to notice, at 3:05 p.m. in room SD–419, Dirksen Senate Office Building, Hon. Chuck Hagel presiding.

Present: Senators Hagel and Sarbanes.

Senator HAGEL. Good afternoon.

The committee meets today to consider bilateral income tax treaties between the United States and Estonia, Latvia, Lithuania, Venezuela, Denmark, Italy, and Slovenia as well as an estate tax protocol with Germany.[1]

The United States has tax treaties with 59 countries. This global network of treaties is designed to protect U.S. taxpayers from double taxation and to provide the IRS with information and data to prevent tax evasion and avoidance.

The treaties prevent international double taxation by setting down rules to determine what country will have the primary right to tax income and at what rates. These bilateral international tax treaties are important for America's economic growth.

As we move into the next millennium, today's global economy will be even more interconnected and more interdependent on international tax treaties. The treaties pending before this committee represent new treaty relationships between the United States and Estonia, Latvia, Lithuania, Venezuela and Slovenia.

The treaties with Denmark and Italy would modernize existing treaty relationships. These treaties generally track with the U.S. tax treaty model, although some deviate to various degrees from the U.S. model.

Additionally, some of the provisions in these treaties are being seen by this committee for the first time. The treaties with Italy and Slovenia contain main purpose tests that are not usually con-

[1] The Department of the Treasury technical explanations for these tax treaties and protocol are available via the World Wide Web. See appendix, page 101, for the Website addresses.

tained in U.S. treaties. These provisions would permit the denial of benefits under a treaty if one of the main purposes of a transaction was to take improper advantage of the treaty.

I hope our Treasury witness today will be able to expand on those provisions and explain the intent and practicality of including these provisions in the treaties.

A variety of other issues has been raised by the Joint Committee on Taxation. I know our witnesses are fully aware of these issues and will be prepared to discuss them. As usual, the Joint Committee staff has prepared careful analysis of each of the treaties.

We are pleased today to have with us three distinguished panels of witnesses. The first panel consists of Senator Byron Dorgan from North Dakota. Senator Dorgan has been a leader on many important issues in the U.S. Senate, including agriculture, trade, taxes, and telecommunications.

Senator Dorgan became the youngest constitutional officer in North Dakota's history when he was appointed State Tax Commissioner at the age of 26. He was later elected to that office twice. Senator Dorgan served a total of 11 years as Tax Commissioner for North Dakota, so I suspect he knows a little bit about this issue.

And I hope he is very impressed that I know so much about that.

The second panel includes Mr. Philip West, International Tax Counsel for the U.S. Department of the Treasury, and Ms. Lindy L. Paull, chief of staff of the Joint Committee on Taxation.

Mr. West has served as International Tax Counsel for the Treasury Department for nearly 2 years. Prior to becoming Tax Counsel, Mr. West served as the Deputy International Tax Counsel.

Ms. Paull has served as the chief of staff of the Joint Committee on Taxation since February, 1998. Prior to her work at the Joint Committee, she was staff director and chief counsel for the U.S. Senate's Finance Committee.

On the third panel, we will hear from Mr. Fred Murray, vice president for tax policy of the National Foreign Trade Council. Prior to his work at the National Foreign Trade Council, Mr. Murray was special counsel for legislation in the office of the Chief Counsel at the Internal Revenue Service from 1992 to 1996.

My friend and counterpart on the subcommittee, Mr. Sarbanes, will be here momentarily. I understand he has requested that we proceed.

So, with that, Senator Dorgan we welcome you and are pleased to have you.

**STATEMENT OF HON. BYRON L. DORGAN, U.S. SENATOR FROM NORTH DAKOTA**

Senator DORGAN. Mr. Chairman, thank you very much. I also, in addition to serving as State Tax Commissioner, served 10 years in the House Ways and Means Committee when I was in the U.S. House. So I have an acquaintance with the tax issue.

I am here today because we are dealing with tax treaties which spark very little public interest, and yet there are significant considerations that must be weighed in my judgment as we deal with these treaties. I hope that the representatives from the Treasury Department and the Joint Tax Committee will also weigh in on

some of these issues. I don't know that they will, but I hope they will.

My concern deals with what is traditionally article 9 and article 7 of these treaties, dealing with associated enterprises and business profits. They deal with transactions between intracorporate operations, that is, a corporation that owns another corporation and sells to itself, or buys from itself.

To tell you a little about that, let me ask you to think about a toothbrush that is priced at $171. My expectation is that you have not purchased one of those lately. But that toothbrush is an intracompany transaction, designed by one part of a company wholly owned by the other to move income in one direction or another. Or if not $171 for a toothbrush, think of $38 for a pair of pantyhose, or a missile rocket launcher for $13, or how about a radial tire for $5. All of these are examples of transfer pricing.

There is, in my estimation, a substantial amount of lost income from transfer pricing. The Internal Revenue Service has done some studies and they predict that it is somewhere in the $2 billion to $3 billion range. The studies done by Professors Pak and Zdanowicz in Florida suggest that it is between $30 billion and $40 billion a year. The right number is perhaps somewhere in between.

These treaties that we negotiate include an article 7 and an article 9. These treaties are, in my judgment, going to cause us more and more difficulty with respect to court decisions that have been rendered recently about them. I wanted to mention that to the committee and ask that you consider taking some action.

First, let me say something about massive tax avoidance by some of the largest, especially foreign-based firms, but generally speaking large corporations that buy and sell to and from themselves in wholly owned subsidiaries. Thirty percent of the largest foreign based firms with at least $250 million in assets in the U.S. and business receipts of at least $50 million in a recent year paid no Federal income tax at all—zero, none—to this country. This is despite doing over $300 billion of business in America. That information comes from a GAO study.

Now is this something that is reasonable? Would you expect that to be the case? If you had a kind of main street mentality, where you do business, make a profit, and have to pay a tax, would you expect that companies doing $300 billion worth of business in this country would actually be able to tell the IRS that they suffered only losses—and, therefore, should exercise opportunities in our marketplace but should not exercise the opportunity to pay taxes on profits?

This is where the $171 for a toothbrush comes in. It is the device by which profit is moved away from the United States tax collecting service.

Now what has happened is this. The Treasury Department and the IRS use an antiquated system, called the arms length pricing approach, for dealing with intracompany transactions. It is like taking two plates of spaghetti and deciding to try to attach the ends of the spaghetti together. It is, of course, patently absurd and unworkable in today's practice. The Internal Revenue Service is literally drowning in complexity and is totally and completely unable to deal with it.

They won't admit that, but I will help them do so in the absence of their admission. I might also say that the way to do this, as opposed to the current standard that is an antiquated one, is to use formulary apportionment, which most large enterprises do not want. This is an approach which, incidentally, the current U.S. Treasury Secretary previously embraced until he came to the Treasury Department. Using formulary apportionment makes a lot of sense.

But I cannot force our Government to do that. I can, however, come to you and say that when a judge interprets tax treaties and articles 7 and 9 as absolutely prohibiting formulary apportionment, when our country believes it is the only approach by which we can accurately measure income, then this committee and the Congress had better get serious about evaluating what articles 9 and 7 mean.

We have for many years felt that it is a harmless enough provision. And yet, recent court decisions show us this is not the case. A judge in the U.S. Court of Federal Claims in the case of National Westminster Bank ruled that an existing Treasury regulation was overridden by language in the U.S.-U.K. tax treaty. The language he refers to is exactly this language that exists in all of these treaties.

I testified against the language previously when the Congress had moved these treaties out, and I come today again to say that we are running flat into trouble on these issues.

This case alone will likely amount to $180 million in lost tax revenue to the Federal Government. But multiply that many fold, incidentally, if this case stands.

I come here today to ask that the committee do two things. First, I want the committee to declare unequivocally that our tax treaties do not prohibit the United States from using reasonable formula methods to deal with tax avoidance.

Second, the committee should make whatever changes it needs to these pending income tax treaties to stop the kind of absurd result that has recently been approved by a couple of Federal court cases, one of which I have just mentioned.

So, Mr. Chairman, you have a number of expert witnesses. I know you are anxious to hear them. I have a lot more that I could say about this, but I think in my prepared testimony I have set out a more complete story.

I thank you for your patience and courtesy in allowing me to stop by and present testimony today.

[The prepared statement of Senator Dorgan follows:]

PREPARED STATEMENT OF SENATOR BYRON L. DORGAN

Mr. Chairman and members of the Senate Foreign Relations Committee, I appreciate the opportunity to testify about an urgent matter involving most of our bilateral income tax treaties including several of those being reviewed by the Committee this afternoon.

Here are some facts that many Americans do not know. Sixty-seven percent of the foreign multinational firms operating in this country paid not one penny in federal income taxes despite having hundreds of billions of dollars of sales here in 1995, which is the latest year the IRS has statistics available. For many of the preceding years, this percentage was even higher!

These facts, are of course, outrageous. This is an absolute affront to our families, individuals and Main Street business owners who diligently pay the taxes they owe,

on time, every April 15th. It's equally galling that several foreign firms have snookered some of our federal courts into believing that tax treaties we have with other countries prohibit the United States from doing much to put a stop to this massive tax avoidance.

That's why I'm here to urge you to do two things as the Committee considers the income tax treaties before it today. First, the Committee should declare unequivocally that our tax treaties do not prohibit the United States from using reasonable formula methods to deal with this enormous tax avoidance. Second, the Committee should make whatever changes it needs to these pending income tax treaties to stop the kind of absurd results that have recently been approved by our federal courts.

When I last testified before your Committee about the transfer pricing problem and how our income tax treaties impact it, I shared with you a growing body of evidence that multinational firms are continuing to use a sophisticated tax scheme called "transfer pricing" to avoid paying their fair share of U.S. income taxes. This bookkeeping practice allows enormously profitable multinational firms to shift their profits out of one taxing jurisdiction into another more favorable taxing jurisdiction—or even nowhere at all—by the simple stroke of a pen.

Since that time, we've made little progress in stopping the hemorrhaging of revenues caused by transfer pricing that some experts say is now draining our Treasury coffers by more than $30 billion annually. To make matters worse, the Treasury Department is continuing to negotiate language in our income tax treaties that the tax practitioners of large, sophisticated multinational firms are using to sidestep what may be our country's best tools for enforcing our tax laws in the fast-changing global marketplace. In theory, our income tax treaties are intended to prevent treaty countries from "double" taxing the profits of multinational firms that operate around the globe, while also allowing such countries to take steps to ensure that multinational firms pay the taxes they rightfully owe. Unfortunately, several troubling federal court rulings show that a handful of well-represented multinational, companies can convince our courts that somehow the language in our tax treaties overrides reasonable U.S. efforts to enforce our international tax laws.

But let me first step back and describe the nature of the tax avoidance by many large multinational conglomerates and how our income tax treaties impact it.

Many of today's globe-trotting businesses are involved in a campaign of massive global tax avoidance. Far from being overtaxed, these large multinational companies have devised an aggressive accounting scam that allows them to avoid paying U.S. taxes with virtual immunity. Under this scheme called "transfer pricing," multinational companies can move U.S. profits out of this country by simply manipulating the price they charge themselves for goods and services they move between related parts of their business.

This ruse, for example, allows foreign-based corporations to purchase goods and services from U.S. affiliates at artificially low prices and to sell their foreign-produced goods and services to U.S. affiliates at artificially high prices. *With transfer pricing, some foreign-based firms claimed their U.S.-based operations in 1998 purchased toothbrushes for $171 each and pantyhose for $38 a pair, and sold missile and rocket launchers for $13 each and radial tires for $5 each. This is absurd.*

It should, therefore, come as no surprise that the vast majority of foreign-based corporations are doing hundreds of billions of dollars of business in the United States without paying *any* U.S. income taxes, according to General Accounting Office (GAO) studies. This virtual tax holiday for many profitable multinational firms is not an aberration or limited, perhaps, to start-up firms or small businesses. In fact, the GAO's most recent review of IRS tax data shows that about 30-percent of the largest foreign-based firms with at least $250 million in U.S. assets or total U.S. business receipts of at least $50 million in 1995 paid no federal income taxes that year, despite doing over $300 billion of business here. The results for large U.S.-based firms were no better.

No one seriously disputes the dismal record that our tax enforcement officials have had in transfer pricing adjustment cases of international firms under audit. Even the Treasury Department understands that the potential for abuse in this area makes it one of, if not the most, important international tax issue we have to deal with.

Now the income tax treaties being reviewed by your Committee today may pose a significant threat to both our current and possible future efforts to put a stop to transfer pricing abuses.

Let me explain. Tucked away in the pending income tax treaties with Estonia, Slovenia, Latvia, Lithuania and Venezuela are the so-called "Associated Enterprises" and "Business Profits" articles which deal with transactions between related companies—whether intercompany transactions between a parent company and its subsidiaries or intra-corporate transactions between business branches. These provi-

sions, which are frequently found in Article 9 and Article 7, respectively, are common to most bilateral income tax treaties that exist between the United States and other countries. The actual language in Articles 9 and 7 appears harmless enough. But in practice, it is being used to undermine our ability to enforce our tax laws regarding the major multinational firms that do business between these countries.

For years, U.S. tax officials have wrestled with the problem of how to divide the overall income of a firm doing business in many different jurisdictions. At first glance, the problem seems simple. If corporation *X* has operations in Idaho, and North Dakota, and Mexico, just audit the books of each.

Unfortunately, though, the problem is not that simple. Corporations have multitudes of ways of shifting income around from one subsidiary or another, or one branch to another, by arranging artificial "transactions" between them. There are literally thousands of paper transitions between these entities. Untangling them is a bureaucracy intensive and ultimately futile exercise. Frequently, the income disappears into the black holes of the company's multinational balance sheets and is reported to no jurisdiction at all.

In the beginning, state tax officials tried to deal with the problem on what is called a "separate accounting" basis. They would pretend that the subsidiaries of a multistate corporation really were separate businesses, and tried to adjust the transactions between them one by one, to what they would be if the subsidiaries really were dealing at "arm's length."

But for companies doing business between the states, the proliferation of commerce simply overwhelmed this system. One by one, the states shifted to using a formula method, which drops the arcane tax accounting and allocates the corporation's overall income through a simple, 3-factor formula instead.

This formula method is now the norm between the states. And the United States Supreme Court has repeatedly held that the formula method as used by the states is reasonable and fair.

Stubbornly, however, the Treasury Department has persisted with—and the IRS has been burdened with—trying to enforce our international tax laws under the rubric of the antiquated, bureaucracy-intensive "arms-length" or "separate-entity" accounting method that is embraced in current Treasury regulations and our income tax treaties. Yet the Treasury Department understands that traditional "comparable pricing" methods used by IRS examiners are often unworkable and therefore they have issued regulations using formula approaches to apportion profits of an international business in many cases.

Many parties affected by our income tax treaties are now interpreting Articles 9 and 7 as prohibiting the use of *any* formulary methods to apportion income or expenses at the federal tax level. Although there is nothing in the language of our treaties, or past Committee reports interpreting our treaties, that sensibly supports this interpretation, some well-financed—and well-represented—multinational firms are successfully convincing many of our federal court judges otherwise. For example, this past July, a judge on the U.S. Court of Federal Claims in the case of National Westminster Bank, PLC (NatWest) ruled that an existing Treasury regulation—Section 1.882-5—was overridden by language in our U.S.-U.K. tax treaty merely because it used a formula to determine a reasonable apportionment of NatWest's true interest expense to its U.S. banking business.

Unfortunately the judge's decision in NatWest is not an isolated case. This ruling, and others like it, have potentially exposed the Treasury Department to billions of dollars of new refund claims solely on a company's claim that *any* formula approach—however reasonable and fair—is in violation of our bilateral income tax treaties.

Quite simply it is a mistake for companies, our treaty partners and our courts to read this restriction on formulary methods into our existing income tax treaties and those pending before the Committee today. This is certainly not the result this Committee intended to sanction.

The Senate Foreign Relation Committee's view on this issue has remained basically unchanged for decades. This Committee's report language describing comparable language in the U.S.-United Kingdom treaty in 1977 went to great lengths to ensure that countries may "apply apportionment formulas . . . as a method to achieve an arm's length price for a transaction between related parties or to apportion income between related entities if it is established the entities are not dealing on an arm's-length basis." The Committee report expressed this view despite the existence of unique treaty language that attempted to limit the use of formula methods. This point was re-emphasized in a 1993 colloquy between Senator Mitchell and Foreign Relations Committee Chairman Pell on the Senate floor during the consideration of income tax treaties. Senator Pell reiterated the Senate's longstanding position that our income tax treaties do not prevent the appropriate use of a formula

method by the United States or our treaty partners to apportion overall income among associated enterprises.

I urge this Committee to take steps to ensure that these pending treaties do not lock this nation into a tax enforcement system that does not work and cannot work. Again, this costs us billions of dollars in revenue that we cannot afford to lose. And frankly, it just makes no sense for the federal government to sit idly by as high-powered foreign-based multinational companies use our tax treaties or any other international agreements as a tool to prevent this country from enforcing its existing tax laws—or future alternatives—to end abusive tax avoidance practices such as transfer pricing. I happen to believe that our best chance to curtail this massive avoidance is for this country to replace its current transfer pricing enforcement provisions with the kind of formulary apportionment that the states have used to divide business profits successfully for decades. But I'm not here asking to impose this today.

However, the Committee should take positive, formal steps to declare that the use of a reasonable and fair formula to reach the best possible result in a given circumstance would be contemplated by these treaties and any future treaties. Consequently, if a formula method to apportion income among related parties, or among units of a single party, renders a reasonable and fair result, then multinational companies must no longer be allowed to use our tax treaties to circumvent that result in order to avoid paying their fair share of U.S. income taxes. Such a declaration has always been appropriate. However, it's needed now more than ever to put a stop to the kind of absurd results that have recently been sanctioned by our federal courts.

Once again, I appreciate your extending me the opportunity to testify before this Committee on this important issue. I urge you to consider taking the steps needed to ensure that this nation's tax enforcement laws can keep pace with the changing world of global economics and international business operations.

Senator HAGEL. Senator, thank you.

May I ask just a general question? I will pursue your points in questions with our witnesses from Treasury and the Joint Committee on Taxation, and this committee will take a look. But you know this business about as well as anybody around here.

What is your suggestion as to how we then would proceed if we took your suggestions? We have tax treaties with 59 countries. How do you start unravelling this?

Senator DORGAN. Well, you start by not moving a treaty that includes language in article 7 and article 9 that is now being misinterpreted by the courts and make more explicit exactly what these mean. But, in fact our representatives from the Treasury Department overseas in the OECD and elsewhere are representing this portion of a tax treaty absolutely prohibit formulary apportionment, than that is wrong. This is a bad interpretation and it is not consistent with what this committee and the Congress have said previously.

So we have the Treasury Department misinterpreting it in the OECD. We have the court misinterpreting it now. And to the extent that the committee has a willingness to make certain it is not misinterpreted in the future, perhaps we need some more explicit language to say that nothing in these articles shall prohibit our taxing authorities, when they believe it is necessary and appropriate to find an accurate method of measuring income apportionment, from using a formulary approach. We perhaps need to be more explicit in doing that.

Senator HAGEL. Do you believe that would require going back and renegotiating all of the tax treaties?

Senator DORGAN. I do not believe that is the case.

There are several methods of doing that. One is a reservation. There are other approaches that can also be used. All I am doing

today is asking the committee to evaluate especially what our obligation is in light of the recent U.S. Court of Federal Claims case. I don't think we ought to ignore this. I hope Treasury will not ignore it in its testimony, and I hope you will ask the Joint Taxation Committee people about it as well.

This moves down the road a good, long way in furthering tax avoidance on a massive scale.

Look, if I were running a multinational corporation, the last thing I would want is formulary apportionment because you are able, under the current circumstance, to create a great deal of "nowhere income" and, therefore, avoid the tax consequences of earning income in certain areas.

But good corporations—and there are plenty of them—do not mind at all. They don't want to be overtaxed or double taxed, and I agree with that. Formulary apportionment will prevent double taxation and do so in a way that protect corporations while, at the same time, making sure that our country is able to collect a reasonable income tax on profits made in this country—just as we do from domestic corporations and from other taxpayers.

Senator HAGEL. Senator, thank you. I know you have other obligations. But I would say that you are welcome through any part of this hearing today to come up here, sit next to me, and ask questions or participate in any way you want. That invitation is open at any point to you.

Senator DORGAN. Well, I will not wear out my welcome. But thank you for the courtesy of allowing me to come today.

Senator HAGEL. Thank you.

Now we would ask the second panel to come forward. We have Mr. West and Ms. Paull.

In the interest of full disclosure, I should tell you that this morning at our hearing on China—I don't know if it had anything to do with this subject matter—about halfway through the hearing all of the glasses with ice were immediately retrieved. The reason for that, after I asked Cheryl why this was done, is because there was glass in the ice. Again, in the interest of full disclosure and what is good for your health, I would tell you that I presume we have no glass in the ice today.

So there you are. If you prefer something else, we will get you whatever else you need.

Now, after I have given a sampling of your glittering backgrounds and resumes, let me ask you to proceed.

Mr. West, we will begin with you. I thank you both for coming.

**STATEMENT OF PHILIP R. WEST, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY**

Mr. WEST. Thank you, Mr. Chairman. My name is Philip West and I am the Treasury Department's International Tax Counsel.

I am pleased today to appear before the committee to recommend favorable action on eight bilateral tax treaties and protocols that the President has transmitted to the Senate and that are the subject of this hearing.

These agreements would provide significant benefits to the United States, particularly our multinational businesses doing business around the world as well as benefits to our treaty part-

ners. The Treasury appreciates the committee's interest in these agreements and requests the committee and the Senate take prompt and favorable action on all of these agreements.

Mr. Chairman, the United States can be proud of our efforts in the tax treaty area. As you pointed out, we have a broad treaty network, including treaties with all 28 of our fellow members of the OECD. Our treaties cover the vast majority of trade and investment by U.S. companies abroad, and we meet regularly with members of the U.S. business community regarding their priorities and the practical problems they face with respect to particular countries.

We are expanding our treaty network and we are focused on renegotiating our older treaties. Since the beginning of 1993, we have replaced our oldest treaties with Sweden, The Netherlands, Ireland and Switzerland, and the Denmark treaty, which you have before you today, will replace what is currently the oldest of our income tax treaties still in force.

The treaties and the protocol before the committee today represent a cross section of our tax treaty program, as you have observed. We have treaties with developing countries in Latin America, Eastern Europe and the former Yugoslavia, as well as treaties with the developed world.

These treaties, like all of our treaties, allocate taxing rights between the United States and our treaty partners when both might claim jurisdiction to tax the same item of income.

As such, they remove impediments to international trade and investment by reducing the threat of double taxation. Although the domestic tax legislation of the United States furthers these same general objectives, a treaty goes beyond what domestic legislation can achieve. A treaty can address the unique aspects of other countries' laws and the way they interact with ours. A treaty can also modify the domestic law of each country as it applies to income flowing between the treaty partners.

I would like to give you a few examples of how the treaties can operate to provide these benefits. All of the treaties contain mechanisms for resolving double tax problems, not otherwise resolved on the face of our treaties. The transfer pricing disputes that Senator Dorgan referred to are capable of resolution under our competent authority mechanisms in our treaties.

The proposed treaty with Italy, as a specific example, is of great importance to the U.S. business community. It addresses the creditability of a new Italian regional tax and it generally lowers the withholding tax rates imposed by each country.

Our proposed treaty with Venezuela also contains important benefits. Among these are establishing and clarifying minimum taxing threasholds, limiting the taxation of payments for technical services, and insuring the deductibility of payments by Venezuelan subsidiaries to their U.S. parents.

The proposed treaty with Venezuela is of special importance because it represents a crucial step toward achieving our goal of expanding our tax treaty network in Latin America.

I know that the committee has been alerted to a pending change in Venezuela's income tax law through which Venezuela will move to the U.S. standards for taxing international income and begin

taxing all of the worldwide income earned by its residents, rather than only income determined under broad sourcing rules to be connected with Venezuela.

The possibility that Venezuela would adopt this worldwide approach was anticipated throughout our treaty negotiations and we planned for it in drafting the treaty. After reading, analyzing, and discussing drafts of the new law, we have determined that the treaty will be at least as appropriate under the new law as the old law.

The increased possibilities for double taxation that are the natural result of this change in Venezuela's law will make the treaty even more important than it would have been previously.

Accordingly, we recommend that the committee approve the treaty despite this change in Venezuela's law.

Our proposed treaty with Denmark also provides significant benefits to taxpayers, for example, by providing certainty with respect to the creditability of Denmark's hydrocarbons tax and by reducing the threshold that taxpayers must meet in order to qualify for a lower withholding tax on dividend payments.

Also in the Denmark treaty, we furthered our effort to curb abuse of the treaty by adding important new treaty shopping rules. The treaty shopping rules play a significant role in our efforts to prevent tax avoidance and evasion and to insure that treaty benefits flow only to the intended recipients.

Treasury shares the concerns expressed by this committee and the Congress regarding treaty shopping, and we have taken a leading role in developing anti-treaty shopping provisions and encouraging other countries to adopt these provisions in their treaties as well.

As we have pursued our goal of eliminating treaty shopping, however, we have seen an increasing number of other transactions that seek to use treaties to achieve inappropriate results. Therefore, we have decided to include in two of the treaties before you today, the most recently negotiated of all the treaties before you, anti-abuse rules in addition to the limitation on benefits provisions. These rules are found in our proposed treaties with Italy and Slovenia, again, the most recently negotiated.

Mr. Chairman, we can all agree on the need to curb abuse. Therefore, any debate on the subject should center on what measures are appropriate to that end. Although we understand the concerns that have been raised regarding the measures proposed here today, we believe that they represent an appropriate step to curb abuse.

In this regard, it is important to keep in mind that our tax treaties contain only benefits for taxpayers. They contain no provisions that increase tax burdens and, as such, it is appropriate to impose reasonable limits on those benefits to curb abusive transactions that may be developed in the future.

These rules are being proposed as a result of several concurrent developments in the international tax law. First, although the overwhelming majority of taxpayers who avail themselves of treaty benefits are entitled to those benefits and are not engaged in abusive transactions, aggressive abuse of treaties has increased.

Congress has twice in recent years taken the unusual step of legislating against treaty abuse. Most recently, Congress enacted sec-

tion 894(c) to deny benefits in certain transactions structured not only to eliminate double taxation, a legitimate goal, but, if possible, to eliminate all taxation.

Several years earlier, Congress enacted section 7701(l), providing Treasury with regulatory authority to curb treaty abuse. This authority has been exercised to adopt a standard very similar to that under consideration by the committee today under which taxpayers have been operating for some years now, apparently without significant difficulty.

The increase in treaty abuse has unfortunate results for both Treasury and our taxpayers. It requires Treasury to devote resources that otherwise could be spent expanding our treaty benefits to curbing abuse.

The anti-abuse rules before you will address the abuse problem while, at the same time, freeing up Treasury resources to negotiate greater treaty benefits for our taxpayers.

We believe that the proposed rules will be more effective than a narrower rule and we decided against a broader, more subjective, anti-abuse rule both because it provides a less certain standard against which taxpayers can evaluate their transaction and because it is less consistent with international norms.

We decided on these particular rules in our treaties because, when we were considering what measures were appropriate to curb treaty abuse, we observed that virtually all of the other countries with which we were negotiating at the time either had treaty anti-abuse precedents generally consistent with the rules you have before you today, in the case of the United Kingdom, Chile, and Korea, or, in the case of Canada, it had already included in its treaty with the United States an explicit recognition of the right to apply a similar anti-abuse rules that was in force under its domestic law.

In addition, other countries, such as Ireland and Mexico, have agreed to a similar provision with each other, and the rule has been included in more than 50 treaties, representing approximately 40 different countries, including 10 OECD members.

Therefore, because the proposed rule appears in a significant number of treaties and promises to appear in more, it will likely be the subject of more interpretive law than the other standards and likely will provide greater certainty over time than some of the alternatives.

We take additional comfort from the fact that the Internal Revenue Code contains at least 2 dozen separate provisions that use a very similar standard, whether one of the principal purposes of a transaction is the avoidance of tax. Development of the law under these code sections may also help provide greater certainty regarding the rules proposed here today.

Finally, our competent authority process provides an additional measure of comfort to U.S. businesses if these provisions, which are included in treaties intended to last for decades, are misused by our treaty partners. The long-lasting nature of our treaties effectively prevents us from relying on amendments to the treaties to eliminate abuses that will arise in the future.

Moreover, relying on amendments to domestic law will invite charges that our treaties are being over-ridden, such as were made when section 894(c) was enacted.

For these reasons, the treaties should contain their own mechanisms to combat abuse, such as the provision in the treaties before you today.

Mr. Chairman, I would like to close by addressing Senator Dorgan's comments. I want to address Senator Dorgan's comments and clarify the Treasury position on these matters, as well as some of the developments to which he has referred.

First of all, the NatWest case, to which he referred, actually represents a favorable trend in the law compared to the prior case that he was referring to, the NorthWest Life case.

In the earlier case, there was a decision with which we disagreed at the Treasury Department that had some broad language that indicated that perhaps these sorts of formulas that we include in our legislation and regulations on occasion were inappropriate and improper under our treaties.

We believe a close reading of the more recent precedent, the NatWest case, is narrower and would not lead to that conclusion, and we are encouraged by the narrower scope of that opinion.

We would also note that both opinions relied on commentaries to the OECD model treaty. Those commentaries are not, as Senator Dorgan suggested—that interpretation of those commentaries is not something the Treasury Department supports. The Treasury Department is working in this international forum to modify those commentaries in an effort to achieve what we believe is a more appropriate result under our treaties.

Finally, I would like to clarify that, in the Treasury Department's view, nothing in our treaties would prohibit the sort of formulas to which Senator Dorgan alluded. We do not favor that approach currently and do not intend to pursue it, but would like to make clear that, in our view, our treaties do not prohibit those approaches.

In closing, Mr. Chairman, I would like to reiterate our recommendation for favorable action on these agreements. I respectfully request that my written statement be included in the record and I would be glad to answer any questions that you may have.

[The prepared statement of Mr. West follows:]

PREPARED STATEMENT OF PHILIP R. WEST

Mr. Chairman and members of the Committee, I am pleased today to recommend, on behalf of the Administration, favorable action on eight bilateral tax treaties and protocols that the President has transmitted to the Senate and that are the subject of this hearing. These agreements would provide significant benefits to the United States, as well as to our treaty partners. Treasury appreciates the Committee's interest in these agreements as demonstrated by the scheduling of this hearing, and requests that the Committee and the Senate take prompt and favorable action on all of these agreements.

The treaties and protocols before the Committee today represent a cross-section of the United States tax treaty program. There are new agreements with three of our oldest treaty partners—new income tax treaties with Denmark and Italy and a protocol to our estate tax treaty with Germany—and five agreements—with Estonia, Latvia, Lithuania, Slovenia and Venezuela—expand our treaty network in Latin America, Eastern Europe, and the former Yugoslavia.

An active treaty program is important to the overall international economic policy of the United States, and tax treaties have a substantial positive impact on the after-tax profitability of United States businesses that enter a treaty partners marketplace. This is an obvious incentive to expand our treaty network to new treaty

partners. However, it also requires us to update our existing treaties. When President Clinton took office, many important U.S. tax treaties were nearly half a century old. Since the beginning of 1993, we have replaced our tax treaties with Sweden, which dated from 1939, with The Netherlands, which dated from 1948, with Ireland, which dated from 1949, and with Switzerland, which dated from 1951. The Denmark treaty, which you are considering today, will replace the oldest of our income tax treaties still in force, which was signed in 1948.

For these reasons, negotiating new treaties and updating existing treaties take up a large amount of my staff's time. We believe, however, that the investment of our resources is worthwhile because of the benefits a modern treaty network brings both to taxpayers and to the government. I'd like to speak now about these benefits.

BENEFITS TO TAXPAYERS

An income tax treaty removes impediments to international trade and investment by reducing the threat of "double taxation" that can occur when both countries impose tax on the same income. Four different aspects of this general goal illustrate the point. First, an income tax treaty generally increases the extent to which exporters can engage in trading activity in the other country without triggering tax. Second, when taxpayers do engage in a sufficient amount of activity for tax to be imposed, the treaty establishes rules that assign to one country or the other the primary right of taxation with respect to an item of income, that help ensure the allowance of appropriate deductions and that reduce withholding tax on payments of income to the treaty beneficiary. Third, the treaty provides a dispute resolution mechanism to prevent double taxation that sometimes can arise in spite of the treaty. Finally, the treaty helps to create stability of tax rules that the private sector needs if its member are to be confident in their projections of an investment's return.

Although the domestic tax legislation of the United States and other countries in many ways is intended to further the same general objectives as our treaty program, a treaty goes beyond what domestic legislation can achieve. Legislation cannot easily take into account differences among other countries' rules for the taxation of particular classes of income and how those rules interact with United States law. Legislation also cannot reflect variations in the United States' bilateral relations with our treaty partners. A treaty, on the other hand, can make useful distinctions, and alter in an appropriate manner the domestic statutory law of both countries as it applies to income flowing between the treaty partners. Examples in the treaties before you include reductions in statutory withholding tax rates and the creditability of the Italian tax known as the IRAP.

One of the principal ways in which double taxation is eliminated is by assigning primary taxing jurisdiction in particular factual settings to one treaty partner or the other. In the absence of a treaty, a United States company operating a branch or division or providing services in another country might be subject to income tax in both countries on the income generated by such operations. The resulting double taxation can impose an oppressive financial burden on the operation and might well make it economically non-viable.

For example, lesser developed countries frequently assert much broader taxing jurisdiction than the United States does. In the absence of a treaty, they might well tax a foreign corporation on income from business activities even if the activities conducted in the other country are relatively negligible or, in some cases, if the payor of the income is a resident of the developing country without regard to whether any activities take place within its territory. In many cases, the country will not allow the foreign corporation to deduct business expenses relating to such income. Finally, the foreign corporation may not be able to plan its activities in such a way as to avoid the tax because the rules that establish the taxation threshold under the country's domestic laws may not be clear. If the economic activities that give rise to the income take place in the United States, we would view the income as being from U.S. sources. In cases where a foreign corporation taxes income that we view as U.S.-source, the effect of the U.S. tax rules may be to deny a foreign tax credit in whole or in part (depending on the U.S. corporation's overall foreign tax credit situation).

Tax treaties help to resolve these situations by establishing the minimum level of economic activity that a resident of one country must engage in within the other before the latter country may tax the resulting business profits. The tax treaty lays out ground rules providing that one country or the other, but not both, will have primary taxing jurisdiction over branch operations and individuals performing services in the other country. In general terms, the treaty provides that if the branch operations have sufficient substance and continuity and, accordingly, sufficient economic penetration, the country where the activities occur will have primary (but not

exclusive) jurisdiction to tax. In other cases, where the operations are relatively minor, the home country retains the sole jurisdiction to tax.

Under these treaty rules, United States manufacturers may test a market by establishing a foreign presence through which products are sold without subjecting themselves to foreign tax, including compliance, rules. Generally, if the market proves promising, the company will establish a more substantial operation which would become subject to tax in the other country. Similarly, United States residents generally may live and work abroad for short periods without becoming subject to the other country's taxing jurisdiction; if they stay longer, however, they would become subject to tax on the income derived in the other country or, ultimately, might even become subject to taxation as residents. These rules, the permanent establishment and business profits rules and analogous provisions for individuals, not only eliminate in many cases the difficult task of allocating income and tax between countries but also serve to encourage desirable trade activities by eliminating or reducing what can often be complex tax compliance requirements.

High withholding taxes at source can be an impediment to international economic activity. Under United States domestic law, all payments to non-United States persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Inasmuch as this tax is imposed on a gross rather than net amount, it imposes a high cost on investors receiving such payments. Indeed, in many cases the cost of such taxes can be prohibitive as a 30 percent tax on gross income often can exceed 100 percent of the net income. Most of our trading partners impose similar levels of withholding tax on these types of income. Tax treaties alleviate this burden by reducing the levels of withholding tax that the treaty partners may impose on these types of income. In general, United States policy is to reduce the rate of withholding taxation on interest and royalties to zero. Dividends normally are subject to tax at one of two rates, 15 percent on portfolio investors and 5 percent on direct corporate investors. The extent to which we realize our policy of reducing withholding rates depends on a number of factors. Although generalizations often are difficult to make in the context of complex negotiations, it is fair to say that we are more successful in reducing these rates with countries that are relatively developed and where there are substantial reciprocal income flows. We also achieve lesser but still significant reductions with countries where the flows tend to be disproportionately in favor of the United States.

The benefits of tax treaties are not limited to business profits earned by companies. Treaties remove tax impediments to desirable scientific, educational, cultural and athletic interchanges, facilitating our ability to benefit from the skills and talents of foreigners including world-renowned rock stars, symphony orchestras, astrophysicists and Olympic athletes. In fact, treaty benefits are not limited to profit-making enterprises but extend to pension plans, Social Security benefits, charitable organizations, researchers and alimony and child support recipients.

The rules provided in the treaty frequently do not explicitly address every future development. This may be because the international community has not yet reached a consensus on the appropriate standard for taxation. For example, the international community may take some time to reach a consensus on the appropriate taxation standard with respect to the area of communications technology. This is an area in which international cooperation is vitally important. To address these issues, our proposed treaties with Estonia, Latvia and Lithuania, require the parties to consult within five years after the treaties enter into force concerning the taxation of income from new technologies. This period was chosen because of the possibility that an international standard might emerge within that time that both Contracting States would want to consider adopting. In fact, the Organization for Economic Cooperation and Development ("OECD"), recognized as the leading international forum to consider developments such as these, is considering these issues today. Until resolution is reached, the treaties with the Baltic countries provide that income of a resident of one country from transmission by satellite, cable, optic fiber and similar technologies will not be taxable in the other country unless the resident has a permanent establishment in the other country. We rejected an approach that would have taxed this income like a royalty, subject to withholding.

Even with constant monitoring, there will be cases in which double taxation occurs in spite of the treaty. In such cases, the treaty provides mechanisms enabling the tax authorities of the two governments—known as the "competent authorities" in tax treaty parlance—to consult and reach an agreement under which the taxpayer's income is allocated between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation. The U.S. competent authority under our tax treaties is the Secretary of the Treasury. Currently, that function is dele-

gated to the Assistant Commissioner (International) of the Internal Revenue Service.

One of the most common situations in which this type of agreement may be necessary is in the area of "transfer pricing." If a multinational manipulates the prices charged in transactions between its affiliates in different countries, the income reported for tax purposes in one country may be artificially depressed, and the tax administration of that country will collect less tax from the enterprise than it should. In theory, the multinational would plan its transactions to ensure that its income is reported in the jurisdiction with the lowest effective tax rate. It is this possibility that makes transfer pricing one of the most important international tax issues.

If this potential tax avoidance (and the potential for double taxation) is to be avoided, it is necessary to have a benchmark by which to evaluate the prices charged. The benchmark adopted by the United States and all our major trading partners is the arm's-length standard. Under the arm's-length standard, the price charged should be the same as it would have been had the parties to the transaction been unrelated to one another—in other words, the same as if they had bargained at "arm's-length." This requires an analysis of the functions performed, resources employed and risks assumed by each party, to make sure each party is adequately compensated for those functions, resources and risks in light of the contractual terms and other relevant economic circumstances of the transaction. If taxpayers and tax administrators can find similar transactions that took place between unrelated parties, they begin the inquiry by analyzing those transactions to see whether the functions, resources and risks of each party are comparable to those in the related party transaction.

In more and more cases, it is difficult or impossible to find a uniquely comparable transaction. This may be because the transactions between related parties are highly specialized or involve unique intangibles, or, as in the case of certain kinds of global securities trading, the functions are so highly integrated that there is a single profit center and no transactions are ever booked between the separate entities. In those cases, it will not be possible to apply "traditional transactional methods." Instead, taxpayers and tax administrators will have to perform the functional analysis required by the arm's-length approach, but will use transactional profits methods, such as the comparable profits method or the profit-split method, in order to compensate the entities for the functions performed, resources employed and risks assumed. The Internal Revenue Service developed transactional profits methods in the 1980's because it saw that it would not always be possible to use traditional transactional methods. These methods, including the use of multi-factor formulas in appropriate cases, were found by the OECD to be an acceptable application of the arm's length standard, at least as a method of last resort, in the Transfer Pricing Guidelines issued in 1995 and its report on Global Trading of Financial Instruments in 1998. We have seen, and expect to continue to see, increasing acceptance of these profits-based approaches in the coming years, speeded by the increase in globally-integrated businesses that will become possible as a result of improvements in telecommunications technology.

Perhaps because of globalization, there has also been an increased focus in recent years on the taxation of branches (known as "permanent establishments"). Treaties use the same arm's length standard to determine the profits attributable to a permanent establishment. Many of the legal developments that have occurred in the context of the taxation of separate legal entities, however, have not yet been extrapolated to the branch situation. Because the commentaries to the relevant parts of the OECD model tax treaty have not yet been revised to reflect current thinking regarding profit splits, taxpayers have taken inconsistent approaches in the context of permanent establishments. One recent court case suggests that it is not possible to use profits-based methods in determining the business profits attributable to a permanent establishment, and that the tax administrator is required to respect the income shown on the books of the branch, except in "exceptional circumstances," a much higher standard than applies when adjusting the income of separate legal entities. A more recent case would allow the administrators to adjust the branch books to reflect an arm's length result, but does not provide any guidance on how that is to be accomplished.

We believe that an international consensus eventually will develop around the proposition that *any* of the methods that are acceptable for transfer pricing between related entities will also be acceptable in the context of allocating income between branches of a single entity. The United States has already adopted this approach in the context of global dealing of financial instruments, both in advance pricing agreements and by regulation, as has the OECD in its report on Global Trading in Financial Instruments. It has done so by sanctioning the use of multi-factor for-

mulas to allocate income from global trading activity under one common trading model—the “functionally fully-integrated” model.

PREVENTION OF TAX AVOIDANCE AND EVASION

The foregoing aspects of our tax treaties involve benefits to taxpayers. While providing these benefits certainly is a major purpose of any tax treaty, it is not the only purpose. The second major objective of our income tax treaty program is to prevent tax avoidance and evasion and to ensure that treaty benefits flow only to the intended recipients. Tax treaties achieve this objective in several ways. They provide for exchange of information between the tax authorities. They contain provisions designed to ensure that treaty benefits are limited to *bona fide* residents of the other treaty country and not to “treaty shoppers.” And two of the treaties before you reflect one version of an anti-abuse rule that set limits on aggressive tax avoidance transactions using treaties.

Under the tax treaties, the competent authorities are authorized to exchange information, including confidential taxpayer information, as may be necessary for the proper administration of the countries’ tax laws. This aspect of our tax treaty program is one of the most important features of a tax treaty from the standpoint of the United States. The information that is exchanged may be used for a variety of purposes. For instance, the information may be used to identify unreported income or to investigate a transfer pricing case. In recent years information exchange has become a priority for the United States in its tax treaty program. If a country has bank secrecy rules that prevent or seriously inhibit the exchange of information under the tax treaty, we will not conclude a treaty with it. In fact, we generally do not even negotiate with such countries. Information exchange is one of the handful of issues that we discuss with the other country before beginning formal negotiations because it is one of a very few issues that we consider non-negotiable. This has, of course, prevented us from entering into treaties with some countries with which we have significant economic ties, but we believe that it is the right policy.

Recent technological developments which facilitate international, and anonymous, communications and commercial and financial activities can also encourage illegal activities. Over the past several years we have experienced a marked and important sea change as many of the industrialized nations have recognized the increasing importance of tax information exchange; the absence thereof serves to encourage not only tax avoidance and evasion, but also criminal tax fraud, money laundering, illegal drug trafficking, and other criminal activity. Treasury is proud of the role it has played in moving these issues forward not only in our bilateral treaty negotiations but also in other fora such as the OECD.

A second aspect of U.S. tax treaty policy to deal with avoidance and evasion is to include in all treaties comprehensive provisions designed to prevent “treaty shopping.” This abuse of the treaty can take a number of forms, but it generally involves a resident of a third state that has either no treaty with the United States or a relatively unfavorable one establishing an entity in a treaty partner that has a relatively favorable treaty with the United States. This entity is used to hold title to the person’s United States investments, which could range from portfolio stock investments to major direct investments or other treaty-favored assets in the United States. By placing the investment in the treaty partner, the third-country person is able to withdraw the returns from the United States investment subject to the favorable rates provided in the tax treaty, rather than the higher rates that would be imposed if the person had invested directly into the United States. Of course, the tax imposed by the treaty partner on the intermediate entity must be relatively low, or the structure will not produce tax savings that justify the added transaction costs.

This Committee and the Congress have expressed strong concerns about treaty shopping, and the Treasury Department shares those concerns. Our treaty program is designed to give benefits to residents and, if applicable, nationals of our treaty partner. Treaty shopping represents an abusive attempt to siphon benefits to others. Moreover, if treaty shopping is allowed to occur, then there is less incentive for the third country with which the United States has no treaty to negotiate a treaty with the United States. The third country can maintain inappropriate barriers to United States investment and trade, and yet its companies can obtain the benefits of lower U.S. tax by organizing their United States transactions so that they flow through a country with a favorable United States tax treaty.

For these reasons, the United States has taken a leading role in developing anti-treaty-shopping provisions and encouraging other countries to adopt the provisions in their treaties. The Department of the Treasury has included in all its recent tax treaties comprehensive “limitation on benefits” provisions that limit the benefits of

the treaty to *bona fide* residents of the treaty partner. These provisions are not uniform, as each country has its own characteristics that make it more or less inviting to treaty shopping in particular ways. Consequently, each provision must to some extent be tailored to fit the facts and circumstances of the treaty partners' internal laws and practices. Moreover, the provisions need to strike a balance that avoids interfering with legitimate and desirable economic activity.

As we have pursued our goal of updating our existing treaties to eliminate treaty-shopping abuses, however, we have seen an increasing number of other types of transactions that seek to use treaties to achieve inappropriate results. Therefore, we have decided to include in our treaties relatively modest anti-abuse rules in addition to the limitation on benefits provision. In the treaties before you, these rules are found only in the treaties with Italy and Slovenia, because the others were substantially negotiated before this change in our policy.

As described above, anti-treaty shopping rules are now firmly entrenched in our treaty policy, in part as a result of concerns raised by the Committee. The anti-abuse rules before you are complementary to these anti-treaty shopping rules. Anti-treaty shopping rules take the broad approach of denying all treaty benefits to persons who are not bona fide residents of the treaty country. Anti-abuse rules such as those before you are more targeted in the sense that they are not blanket exclusions from all treaty benefits; they deny specific treaty benefits in abuse cases.

These rules have been included in our treaties because of several concurrent developments in international tax law. First, although the overwhelming majority of taxpayers who avail themselves of treaty benefits are entitled to those benefits and are not engaged in abusive transactions, aggressive abuse of treaties has increased. As evidence of this trend one need only observe that Congress has twice in recent years taken the unusual step of legislating against treaty abuse. Most recently, Congress enacted section 894(c) to deny benefits to certain taxpayers that are not excluded from our treaties under limitation on benefits provisions. Congress also enacted section 7701(l), providing the Treasury with a broad grant of regulatory authority to curb treaty abuse. This authority has been exercised to adopt a standard very similar to that under consideration by you today, under which taxpayers have been operating for some years now, apparently without significant difficulty. (The commentary to Article 1 of the OECD model tax treaty and the OECD Report on Harmful Tax Competition make clear that countries can impose their domestic anti-abuse rules to claims for treaty benefits.)

A second development contributed to the decision to include these rules in our treaties. We observed that Italy had just concluded a treaty containing a broader but more subjective anti-abuse rule. We then observed that virtually all of the other countries with which we were negotiating at the time either had treaty anti-abuse precedents generally consistent with the rule you have before you (the United Kingdom, Chile and Korea) or, in the case of Canada, had already included in its treaty with the United States an explicit recognition of the right to apply a similar anti-abuse rule that was in force under its domestic law. In addition, other countries such as Ireland and Mexico had agreed to a similar provision with each other and other countries such as Israel were consistently seeking even broader provisions. The rule has been included in more than 50 treaties, representing approximately 40 different countries (including 10 OECD members). In fact, concerns about the adequacy of current treaty rules to prevent abuses have stimulated work in the OECD on this subject. As one of the more common approaches to achieving such an objective, rules such as those before you today are obviously part of that work.

The increase in treaty abuse has unfortunate results for both Treasury and our taxpayers: it requires Treasury to divert resources to fighting abuse that it might otherwise devote to improving our treaty network. The emergence internationally of anti-abuse rules such as those before you provides a win-win solution. They help address the abuse problem, while at the same time freeing up Treasury resources to provide greater benefits for U.S. taxpayers. As such, the question became not whether an anti-abuse rule was appropriate, but which anti-abuse rule was appropriate. Treasury rejected a narrower anti-abuse rule because of its ineffectiveness. Treasury also rejected a broader more subjective anti-abuse rule for several reasons. First, it provided a less certain standard against which a taxpayer could meaningfully evaluate its transaction. Second, since the narrower rule before you appears in a significant number of treaties around the world, and promises to appear in more, it is more consistent with international norms and will likely be the subject of more interpretive law than the other standards.

As such, the proposed rule should provide greater certainty over time than some of the alternatives. Nevertheless, we are aware of concerns that the proposed anti-abuse rules will provide uncertainty for taxpayers. The test incorporated in the rule does require taxpayers and their advisors to make some judgements. This standard

creates no more uncertainty, however, than other U.S. tax doctrines that may also apply to the transaction under consideration, such as the business purpose and step transaction doctrines. And, as the commentary to the OECD model treaty makes clear, even if our treaties are silent regarding abuse, other countries may apply their own internal anti-abuse doctrines to U.S. taxpayers' claims for treaty benefits, whether we have explicitly agreed to those standards or not.

Our treaties are intended to last decades before re-negotiation. Therefore, relying on treaty amendments to eliminate abuses that arise in the future will invariably prove inadequate. Moreover, relying on amendments to domestic law will invite charges that the treaty is being overridden, as were made when section 894(c) was enacted. For these reasons, the treaties should contain their own mechanisms to combat abuse, such as the provisions in the treaties before you today. In this regard, it is important to keep in mind that our tax treaties contain only benefits for taxpayers, and no provisions that increase tax burdens. As such, it is appropriate to impose reasonable limits on those benefits to curb abusive transactions that may be developed in the future.

TREATY PROGRAM AND NEGOTIATION PRIORITIES

Given all of these benefits to taxpayers and the government, an obvious question is why we do not have a tax treaty with every country. The answer is slightly different for each potential treaty partner, but there are some general themes. In establishing priorities, we keep in mind the two principal objectives of tax treaties—to prevent both double taxation and tax avoidance and evasion.

The United States has a network of 50 bilateral income tax treaties, the first of which was negotiated in 1939. Although that number is somewhat lower than the number of treaties that some other countries have, it is important to note that the network includes all 28 of our fellow members of the OECD and covers the vast majority of trade and investment by U.S. companies abroad. For the past decade, the Treasury Department has given priority to renegotiating older treaties to ensure that they reflect current United States treaty policy, particularly with respect to anti-abuse provisions and information exchange.

As demonstrated by the mix of treaties being considered today, the progress we have made at updating old conventions has given us the opportunity to focus on expanding our treaty network. In this, our primary concern is to conclude treaties or protocols that are likely to provide the greatest benefits to United States taxpayers, such as when economic relations are hindered by substantial tax obstacles. We meet regularly with members of the U.S. business community regarding their priorities and the practical problems they face with respect to particular countries. We are proud of our efforts in the treaty area, and believe that our record of accomplishment here is as strong as that of any other administration in recent memory.

Even when business identifies problems that could be resolved by treaty, however, a treaty may not be appropriate for a variety of reasons. Despite the protections of the limitation on benefits provisions and anti-abuse rules, there may be countries with which we choose not to have a tax treaty because of the possibility of abuse. Other countries may not present us with sufficient tax problems that are best resolved by treaty. For example, we generally do not conclude tax treaties with jurisdictions that do not impose significant income taxes, because there is little danger of double taxation of income in such a case. In such cases, particularly with Caribbean Basin countries, we have offered to enter into an agreement limited to the exchange of tax information, which furthers the goal of reducing tax avoidance and evasion without creating other opportunities for abuse.

However, the situation can become more complex when a country adopts a special regime for certain parts of the economy while the rest of its residents are subject to substantial taxation. It might be considered inappropriate to grant treaty benefits to companies taking advantage of such regimes, while a treaty relationship might be useful and appropriate in order to avoid double taxation in the case of the residents who are subject to substantial taxation. Accordingly, in some cases we have devised treaties that carve out from the benefits of the treaties certain residents and activities. The anti-treaty shopping provisions in our treaty network prevent investors from enjoying the benefits of a tax-haven regime or preferential tax regime in their home country and, at the same time, the benefits of a treaty between the United States and another country. The recent OECD report on Harmful Tax Competition recommends that member countries adopt similar policies, and not enter into tax treaties with tax havens. The report also directed the group within the Committee on Fiscal Affairs that is responsible for the OECD Model treaty to consider various additions to the Model that are intended to prevent abuse of tax treaties.

Prospective treaty partners also have to indicate that they understand their obligations under the treaty, including with respect to information exchange, and demonstrate that they are able to comply with those obligations. Sometimes they are unable to do so. In other cases we may feel that a treaty is inappropriate because a treaty partner may be unwilling to deal with the tax problems that have been identified by business. Lesser developed and newly emerging economies, where capital and trade flows are often disproportionate or virtually one-way, may not be willing to reduce withholding taxes to a level that will eliminate double taxation because they feel that they cannot give up scarce tax revenues. None of the new treaties that we have asked you to consider today are in that class. All are with countries that showed a willingness to reduce or eliminate withholding taxes or other impediments to investment.

Most of the emerging economies with which we have had successful treaty discussions—including those whose treaties we present today—have been active participants in the training and outreach programs run by the Treasury Department, the Internal Revenue Service and the OECD. These programs are a wise investment as they help to ensure that all parties understand the international norms that are represented by these agreements. We have every reason to believe that these programs will continue to increase the number of countries—particularly in Eastern Europe and Latin America—that are ready to enter into mutually advantageous treaties with us. In many cases, the existence of a treaty that lowers taxation of trade and investment will help to establish economic ties that will contribute to the country's stability and independence, as well as improve its political relationships with the United States.

The primary constraint on the size of our treaty network, however, may be the complexity of the negotiations themselves. The various functions performed by tax treaties, and particularly the goal of meshing two different tax systems, makes the process of negotiation quite time-consuming.

A nation's tax policy, as reflected in its domestic tax legislation as well as its tax treaty positions, reflects the sovereign choices made by that country in the exercise of one of its most important governmental functions, that of funding the government. Numerous features of the treaty partner's unique tax legislation and its interaction with United States legislation must be considered in negotiating an appropriate treaty. Examples include whether the country eliminates double taxation through an exemption or a credit system, whether the country has bank secrecy legislation that needs to be modified by treaty, the treatment of partnerships and other transparent entities, and how the country taxes contributions to pension funds, the funds themselves and distributions from the funds. A negotiated treaty needs to take into account all of these and many other aspects of the treaty partner's tax system in order to arrive at an acceptable treaty from the perspective of the United States. Accordingly, a simple side-by-side comparison of two actual treaties, or of a proposed treaty against a model treaty, will not enable meaningful conclusions to be drawn as to whether a proposed treaty reflects an appropriate balancing of interests. In many cases the differences are of little substantive importance, reflecting language problems, cultural obstacles or other impediments to the use of particular U.S. or OECD language.

In addition to keeping in mind that each treaty must be adapted to the individual facts and circumstances of each treaty partner, it also is important to remember that each treaty is the result of a negotiated bargain between two countries that often have conflicting objectives. Each country has certain issues that it considers non-negotiable. The United States, which insists on effective anti-abuse and exchange-of-information provisions, and which must accommodate its uniquely complex internal laws, probably has more non-negotiable issues than most countries. For example, each of the full treaties before the Committee today allows the United States to impose our branch profits tax and branch-level interest tax at the rates applicable to direct dividends and interest, respectively, paid to related parties. All of them also reflect our new policy with respect to dividend distributions from real estate investment trusts, except for the treaties with Estonia, Latvia and Lithuania, which were fully negotiated before the change in policy. They also include the "saving clause," which permits the United States to tax its citizens and residents as if the treaty had not come into effect, and allow the United States to apply its rules dealing with former citizens and long-term residents and with investments in U.S. real property interests.

Obtaining the agreement of our treaty partners on these issues sometimes requires other concessions on our part. Similarly, other countries sometimes must make concessions to obtain our agreement on issues that are critical to them. Eventually, the process of give-and-take produces a document that is the best treaty that is possible with that other country. In many cases, the process ends there, as the

Administration decides that the treaty does not further the interests of the United States enough to justify the necessary compromises. These treaties never make it to this Committee. Accordingly, each treaty that we present here represents not only the best deal that we believe we can achieve with the particular country at this time, but also constitutes an agreement that we believe is in the best interests of the United States. The technical explanations which accompany our treaty, the discussions with the staffs of this Committee and its members, and the staffs of the tax-writing Committees, and most importantly, hearings such as this, will provide the Senate with the assurance that a particular treaty is, overall, in the best interests of the United States.

DISCUSSION OF TREATIES AND PROTOCOLS

Each of the treaties before you today reflects the basic principles of current United States treaty policy. The provisions in each treaty borrow heavily from recent treaties approved by the Senate and the U.S. model and are generally consistent with the 1992 OECD Model Income Tax Convention, as subsequently amended. The United States was and continues to be an active participant in the development of the OECD Model, and we are generally able to use most of its provisions as a basis for negotiations.

The U.S. model was published in September 1996. A model treaty is a useful device if used properly and kept current. In the course of the negotiation of these treaties, we discovered that certain provisions of our model treaty could be improved upon, and we did so in these agreements. Many of these improvements have become part of the document that we use to begin negotiations and we expect that they will be reflected in a new version of the U.S. model that will be published in the future.

There are no major inconsistencies between the U.S. and OECD models, but rather the U.S. model elaborates on issues in which the United States may have a greater interest or which result from particular aspects of United States law and policy. For example, our limitation of benefits provisions are generally not found in typical tax treaties of other OECD countries. We have also found it useful to expand on treaty coverage and treatment of pass-through entities such as our limited liability companies. Despite the importance we attach to the OECD model and our continuing efforts with our colleagues to improve it and keep it current, most countries cannot accede to all of the provisions of that model, nor do we expect that all of our prospective treaty partners will agree with all of the provisions of our model. The primary benefit of the U.S. Model is that it enables all interested parties, including this Committee and the Congress and its staffs, the American business community, and our prospective treaty partners, to know and understand our treaty positions. We do not anticipate that the United States will ever sign a tax convention identical to the model; there are too many variables.

Nevertheless, there are some basic provisions that are found in all of the treaties. These include provisions designed to improve the administration both of the treaty and of the underlying tax systems, including rules concerning exchange of information, mutual administrative assistance, dispute resolution and nondiscrimination. Each treaty permits the General Accounting Office and the tax-writing committees of Congress to obtain access to certain tax information exchanged under treaty for use in their oversight of the administration of United States tax laws and treaties. Each treaty also contains a now-standard provision ensuring that tax discrimination disputes between the two nations generally will be resolved within the ambit of the tax treaty, and not under any other dispute resolution mechanisms, including the World Trade Organization (WTO).

Finally, some treaties will have special provisions not found in other agreements. These provisions account for unique or unusual aspects of the treaty partner's internal laws or circumstances. For example, many well-known Danish multinational companies are owned in part by "taxable non-stock corporations." If the treaty had not included special rules for taxable non-stock corporations, the multinationals might not have qualified for full treaty benefits, even though they clearly are not treaty-shopping. These rules had to be tailored to the Danish law and the specific manner in which the taxable non-stock corporations operate, without violating any of the basic principles underlying our limitation on benefits provisions. The flexibility we bring to the table should be regarded as a strength rather than a weakness of the tax treaty program, since it is these differences in the treaties which enable us to reach agreement and thereby reduce taxation at source, prevent double taxation and increase tax cooperation.

I would like to discuss the importance and purposes of each agreement that you have been asked to consider. We have submitted Technical Explanations of each agreement that contain detailed discussions of each treaty and protocol. These Tech-

nical Explanations serve as an official guide to each agreement. We have furnished our treaty partners with a copy of the relevant technical explanation and offered them the opportunity to submit their comments and suggestions.

*The Baltic Treaties—Estonia, Latvia and Lithuania*

I would now like to turn to the three treaties colloquially known as the "Baltic Treaties." Since gaining independence from the Soviet Union at the beginning of this decade, the three Baltic States—Estonia, Latvia and Lithuania—have actively pursued reforms aimed at economic stabilization and market strengthening. These reforms have placed Estonia in the first wave of Central and East European applicants to the European Union, while Latvia and Lithuania are currently under consideration by the EU for promotion to this first wave. Economic performance in all three countries over the past several years has been among the best in the region.

Entering into these treaties is an important element in our current tax treaty program and is a high priority with the U.S. business community. Without the current treaty, U.S. businesses are at a competitive disadvantage in the Baltics, since many of their competitors are from countries that have concluded a tax treaty with them. Under the proposed Conventions, the Baltic States taxation of U.S. operations would decrease on direct investment dividends, copyright royalties (including software), royalties on the right to use equipment, and interest paid on loans guaranteed by the U.S. Export-Import Bank. In addition, the proposed Convention would provide U.S. business a greater degree of certainty, protection against discriminatory tax practices and the ability to resolve potential double taxation cases and other disputes.

Although these Conventions were largely negotiated at joint sessions, these are, of course, three separate treaties with three separate, sovereign nations. I will, therefore, deal with each of the three separately. In general, however, it should be noted that none of the three deviates substantially from any of our more recent treaties.

*Estonia*

Let me first deal with Estonia. The treaty does differ from other recent U.S. treaties in a number of respects. I will now highlight some of these differences as well as other important provisions of the treaty.

First, in respect of the taxation of investment income. The withholding rates under the treaty are in some respects higher than those in the U.S. Model and in many recent U.S. treaties with OECD countries. The rates are the same as in many Estonian treaties. Under the treaty dividends are subject to taxation at source in the same manner as under the U.S. Model. Direct investment dividends are subject to withholding tax at source at a maximum 5 percent rate, and portfolio dividends are taxable at a maximum 15 percent rate. The treaty requires a 10 percent ownership threshold for application of the 5 percent tax rate.

The treaty provides for a maximum 10 percent rate of tax at source on most interest payments. Interest earned on trade credits, and on government debt, including debt guaranteed by government agencies (e.g., the U.S. Export-Import Bank) is exempt from tax at source.

Royalties for the use of industrial, commercial or scientific equipment are subject to a 5 percent tax at source. All other royalties (including payments for the use of software, other than off-the-shelf software) are taxed at a maximum rate of 10 percent.

In relation to the taxation of business income, consistent with the U.S. and OECD Models, the treaty provides generally for the taxation by one State of the business profits of a resident of the other only when such profits are attributable to a permanent establishment located in that other State. The treaty, however, includes an anti-abuse rule that would allow the source state to tax sales or activities performed by the enterprise outside the United States as if they were performed by a permanent establishment if it is ascertained that such activities were structured with the intention to avoid taxation in the State where the permanent establishment is situated.

The treaty, consistent with current U.S. treaty policy, provides for exclusive residence-country taxation of profits from international carriage by aircraft and ships. This reciprocal exemption also extends to income from the rental of aircraft, ships and containers if the rental activity is incidental to the operation of aircraft and ships by the lessor in international traffic. However, income from the international rental of ships and aircraft that is non-incidental to operation of ships and aircrafts is taxed at a 5 percent rate as a royalty paid for the rental of equipment.

Income from the use or rental of containers that is non-incidental to the operation of ships or aircraft in international traffic is treated as other income. Therefore,

non-incidental leasing of containers by U.S. businesses is taxable only in the United States.

With regard to the taxation of personal services income, the taxation of income from the performance of personal services under the treaty is generally similar to that under the U.S. Model, but, like some U.S. treaties with developing countries, it grants a taxing right to the host country with respect to certain categories of personal services income that is somewhat broader than in the OECD or U.S. Model.

The limitation on benefits provisions are similar to those found in the U.S. Model and in all recent U.S. treaties.

The exchange of information provisions generally follow the U.S. Model and make clear that Estonia is obligated to provide U.S. tax officials such information as is necessary to carry out the provisions of the treaty.

The treaty provides a U.S. foreign tax credit for the Estonian income taxes covered by the treaty, and a Estonian foreign tax credit for the U.S. income taxes covered by the treaty.

The treaty will enter into force after each State has notified the other that it has completed its ratification requirements. It will have effect, with respect to taxes withheld at the source, for amounts paid or credited on or after the first day of January of the calendar year next following the year in which the treaty enters into force. In other cases the treaty will have effect with respect to taxable years beginning on or after the first day of January of the calendar year next following the year in which the treaty enters into force. The treaty will remain in force indefinitely unless terminated by one of the Contracting States. Either State will be able to terminate the treaty at the end of any calendar year by giving written notice at least six months before the end of that calendar year.

Unique to the treaty and the treaties with Latvia and Lithuania is an agreement that there will be a five-year period within which the appropriate authorities of the two States will meet to discuss the application of the treaty to income derived from new technologies (such as payments received for transmission by satellite, cable, optic fibre or similar technology). The meeting may result in a protocol that specifically addresses the treaty's application to income from new technologies.

*Latvia*

Next I will turn to Latvia. This treaty also differs in some respects from other recent U.S. tax treaties. I will again highlight some of these differences as well as other important provisions of the treaty.

In respect of the taxation of investment income, the withholding rates under the treaty are, again, in some respects higher than those in the U.S. Model and in many recent U.S. treaties with OECD countries. The proposed rates are the same as in many Latvian treaties.

Under the treaty dividends are subject to taxation at source in the same manner as under the U.S. Model. Direct investment dividends are subject to withholding tax at source at a maximum 5 percent rate, and portfolio dividends are taxable at a maximum 15 percent rate. The treaty requires a 10 percent ownership threshold for application of the 5 percent tax rate.

The treaty provides for a maximum 10 percent rate of tax at source on most interest payments. Interest earned on trade credits, and on government debt, including debt guaranteed by government agencies (e.g., the U.S. Export-Import Bank) is exempt from tax at source.

Royalties for the use of industrial, commercial or scientific equipment are subject to a 5 percent tax at source. All other royalties (including payments for the use of software, other than off-the-shelf software) are taxed at a maximum rate of 10 percent.

In relation to the taxation of business income, consistent with the U.S. and OECD Models, the treaty provides generally for the taxation by one State of the business profits of a resident of the other only when such profits are attributable to a permanent establishment located in that other State. The treaty, however, includes an anti-abuse rule that would allow the source state to tax sales or activities performed by the enterprise outside the United States as if they were performed by a permanent establishment if it is ascertained that such activities were structured with the intention to avoid taxation in the State where the permanent establishment is situated.

The treaty, consistent with current U.S. treaty policy, provides for exclusive residence-country taxation of profits from international carriage by aircraft and ships. This reciprocal exemption also extends to income from the rental of aircraft, ships and containers if the rental activity is incidental to the operation of aircraft and ships by the lessor in international traffic. However, income from the international

rental of ships and aircraft that is non-incidental to operation of ships and aircrafts is taxed at a 5 percent rate as a royalty paid for the rental of equipment.

Income from the use or rental of containers that is non-incidental to the operation of ships or aircraft in international traffic is treated as other income. Therefore, non-incidental leasing of containers by U.S. businesses is taxable only in the United States.

With regard to the taxation of offshore activities, the treaty contains a reciprocal agreement, found in several U.S. treaties, particularly those with our North Sea partners, that the income from the exploration or exploitation of the seabed and sub-soil is taxable by the source State if the activities are carried on for more than 30 days in any twelve month period. Wages, salaries and similar remuneration paid to those whose employment is derived from such activities can be taxed in the state where the offshore activities occur if such activities exceed the 30 day threshold. However, that same remuneration can be taxed only in the non-source State if the period of activity does not exceed 30 days and the employer is not a resident of the source State. If the wages, salaries or other remuneration are derived from the transportation of supplies or from other activities (such as tugboats) auxiliary to the exploration and exploitation then that remuneration can be taxed only in the country of which the employer is resident.

The taxation of income from the performance of personal services under the treaty is generally similar to that under the U.S. Model, but, like some U.S. treaties with developing countries, it grants a taxing right to the host country with respect to certain categories of personal services income that is somewhat broader than in the OECD or U.S. Model.

The limitation on benefits rules of the treaty are similar to those found in the U.S. Model and in all recent U.S. treaties.

The exchange of information provisions generally follow the U.S. Model and make clear that Latvia is obligated to provide U.S. tax officials such information as is necessary to carry out the provisions of the treaty.

The treaty provides a U.S. foreign tax credit for the Latvian income taxes covered by the treaty, and a Latvian foreign tax credit for the U.S. income taxes covered by the treaty.

The treaty will enter into force after each State has notified the other that it has completed its ratification requirements. It will have effect, with respect to taxes withheld at the source, for amounts paid or credited on or after the first day of January of the calendar year next following the year in which the treaty enters into force. In other cases the treaty will have effect with respect to taxable years beginning on or after the first day of January of the calendar year next following the year in which the treaty enters into force.

The treaty will remain in force indefinitely unless terminated by one of the Contracting States. Either State will be able to terminate the treaty at the end of any calendar year by giving written notice at least six months before the end of that calendar year.

Unique to the treaty and the treaties with Estonia and Lithuania is an agreement that there will be a five-year period within which the appropriate authorities of the two States will meet to discuss the application of the treaty to income derived from new technologies (such as payments received for transmission by satellite, cable, optic fibre or similar technology). The meeting may result in a protocol that specifically addresses the treaty's application to income from new technologies.

*Lithuania*

Finally, let me turn to Lithuania. As with the other two Baltic treaties, this treaty differs in some respects from other recent U.S. tax treaties. I will again highlight some of these differences as well as other important provisions of the treaty.

Once again, the withholding rates under the treaty are, in some respects higher than those in the U.S. Model and in many recent U.S. treaties with OECD countries. The proposed rates are the same as in many Lithuanian treaties.

Under the treaty, dividends are subject to taxation at source in the same manner as under the U.S. Model. Direct investment dividends are subject to withholding tax at source at a maximum 5 percent rate, and portfolio dividends are taxable at a maximum 15 percent rate. The treaty requires a 10 percent ownership threshold for application of the 5 percent tax rate.

The treaty provides for a maximum 10 percent rate of tax at source on most interest payments. Interest earned on trade credits, and on government debt, including debt guaranteed by government agencies (e.g., the U.S. Export-Import Bank) is exempt from tax at source.

Royalties for the use of industrial, commercial or scientific equipment are subject to a 5 percent tax at source. All other royalties (including payments for the use of

software, other than off-the-shelf software) are taxed at a maximum rate of 10 percent.

Consistent with the U.S. and OECD Models, the treaty provides generally for the taxation by one State of the business profits of a resident of the other only when such profits are attributable to a permanent establishment located in that other State. The treaty, however, includes an anti-abuse rule that would allow the source state to tax sales or activities performed by the enterprise outside the United States as if they were performed by a permanent establishment if it is ascertained that such activities were structured with the intention to avoid taxation in the State where the permanent establishment is situated.

The treaty, consistent with current U.S. treaty policy, provides for exclusive residence-country taxation of profits from international carriage by aircraft and ships. This reciprocal exemption also extends to income from the rental of aircraft, ships and containers if the rental activity is incidental to the operation of aircraft and ships by the lessor in international traffic. However, income from the international rental of ships and aircraft that are non-incidental to operation of ships and aircrafts is taxed at a 5 percent rate as a royalty paid for the rental of equipment.

Income from the use or rental of containers that is non-incidental to the operation of ships or aircraft in international traffic is treated as other income. Therefore, non-incidental leasing of containers by U.S. businesses is taxable only in the United States.

The treaty contains a reciprocal agreement, found in several U.S. treaties, particularly those with our North Sea partners, that the income from the exploration or exploitation of the seabed and sub-soil is taxable by the source State if the activities are carried on for more than 30 days in any twelve month period. Wages, salaries and similar remuneration paid to those whose employment is derived from such activities can be taxed in the state where the offshore activities occur if such activities exceed the 30 day threshold. However, that same remuneration can be taxed only in the non-source State if the period of activity does not exceed 30 days and the employer is not a resident of the source State. If the wages, salaries or other remuneration are derived from the transportation of supplies or from other activities (such as tugboats) auxiliary to the exploration and exploitation then that remuneration can be taxed only in the country of which the employer is resident.

The taxation of income from the performance of personal services under the treaty is generally similar to that under the U.S. Model, but, like some U.S. treaties with developing countries, it grants a taxing right to the host country with respect to certain categories of personal services income that is somewhat broader than in the OECD or U.S. Model.

The limitation on benefits rules of the treaty are similar to those found in the U.S. Model and in all recent U.S. treaties.

The information exchange provisions generally follow the U.S. Model and make clear that Lithuania is obligated to provide U.S. tax officials such information as is necessary to carry out the provisions of the treaty.

The treaty provides a U.S. foreign tax credit for the Lithuanian income taxes covered by the treaty, and a Lithuanian foreign tax credit for the U.S. income taxes covered by the treaty.

The treaty will enter into force after each State has notified the other that it has completed its ratification requirements. It will have effect, with respect to taxes withheld at the source, for amounts paid or credited on or after the first day of January of the calendar year next following the year in which the treaty enters into force. In other cases the treaty will have effect with respect to taxable years beginning on or after the first day of January of the calendar year next following the year in which the treaty enters into force.

The treaty will remain in force indefinitely unless terminated by one of the Contracting States. Either State will be able to terminate the treaty at the end of any calendar year by giving written notice at least six months before the end of that calendar year.

Unique to this treaty and the treaties with Estonia and Latvia is an agreement that there will be a five-year period within which the appropriate authorities of the two States will meet to discuss the application of the treaty to income derived from new technologies (such as payments received for transmission by satellite, cable, optic fibre or similar technology). The meeting may result in a protocol that specifically addresses the treaty's application to income from new technologies.

This concludes my remarks on the three Baltic treaties.

*Venezuela*

Next, I would like to tell you about the proposed treaty with Venezuela. This treaty is of special importance because it represents a crucial step towards achieving

our goal of expanding our tax treaty network in Latin America. If ratified, this agreement would be the United States' only tax treaty in force with a South American nation.

The proposed treaty with Venezuela generally follows the pattern of the 1996 U.S. Model, while incorporating some provisions found in recent U.S. treaties with other developing countries and in the OECD Model. The treaty's rules on the taxation of investment income are an example. Although the withholding rates under the proposed treaty are generally higher than those in the U.S. Model, the rates are comparable to those found in other U.S. tax treaties with developing countries and those in other tax treaties of Venezuela. Also, the withholding rates reflect Venezuela's territorial system of taxation and the policy objective of establishing an adequate single level of tax on cross-border investment income.

Under the proposed treaty, as in the U.S. Model, direct investment dividends are taxable at source at a 5 percent rate, and portfolio dividends are taxable at source at a 15 percent rate. The proposed treaty requires a 10 percent ownership threshold for application of the 5 percent direct investment tax rate. Also similar to the U.S. Model, dividends paid to a Contracting State or a governmental entity constituted and operated exclusively to administer or provide pension benefits, are exempt from withholding in the source State.

The proposed treaty provides for a 10 percent rate of tax at source on most interest payments. Interest that is received by a financial institution (including an insurance company) is subject to a lower 4.95 percent rate of tax. Interest earned on government debt, including debt guaranteed by government agencies (e.g., the U.S. Export-Import Bank, the Federal Reserve Banks and the Overseas Private Investment Corporation) is exempt from tax at source. These provisions are, in effect, a melding of the U.S. and OECD Models.

Royalties for the right to use copyrights, patents or trademarks are subject to a 10 percent tax at source. Royalties for the right to use industrial, commercial or scientific equipment are subject to a lower 5 percent rate of tax at source. Under the proposed treaty, fees for the provision of technical services and fees for technical assistance are considered business profits or personal services income, and are taxed as such, rather than as royalty payments. These latter important provisions thereby mitigate double taxation and generally limit any taxation to net rather than gross income, and then only to when a permanent establishment is created.

The taxation of capital gains under the proposed treaty follows the format of the U.S. Model. Gains and income derived from the sale of real property and from real property interests may be taxed by the State in which the property is located. Likewise, gains or income from the sale of personal property, if attributable to a fixed base or permanent establishment situated in a Contracting State, may be taxed in that State. All other gains, including gains from the sale of ships, aircraft and containers, and gains from the sale of stock in a corporation, are taxable only in the State of residence of the seller.

Regarding the taxation of business income, as with the U.S. and OECD Models, the proposed treaty provides generally for the taxation by one State of the business profits of a resident of the other only when such profits are attributable to a permanent establishment located in that other State. Under the proposed treaty, the taxation of income from the operation of ships and aircraft in international traffic and from the use, maintenance or rental of containers used in international traffic is fully consistent with the U.S. Model.

The taxation of income from the performance of personal services under the proposed treaty is similar to that under some U.S. treaties with developing countries, but grants a taxing right to the host country with respect to such income that is broader than in the OECD or U.S. Model.

The limitation on benefits provisions of the proposed treaty are similar to those found in the U.S. Model and in all recent U.S. treaties, with minor modifications necessary because of Venezuela's territorial tax system.

The information exchange provisions generally follow the U.S. Model and make clear that Venezuela is obligated to provide U.S. tax officials such information as is necessary to carry out the provisions of the treaty.

The proposed treaty provides a U.S. foreign tax credit for Venezuelan income taxes subject to the limitations imposed by U.S. internal law on the granting of foreign tax credits. Similarly, Venezuela shall, under the proposed Convention, provide relief against double taxation to Venezuelan taxpayers who are also subject to U.S. income tax, subject to the limitations imposed by Venezuelan law.

The proposed treaty will enter into force when each Contracting State has notified the other that the domestic requirements needed for entry into force have been completed. It will have effect, with respect to taxes withheld at source, for amounts paid or credited on or after January 1 of the year following the date on which the treaty

enters into force. In other cases the treaty will have effect with respect to taxable periods beginning on or after January 1 of the year following the date on which the treaty enters into force.

I know that the Committee has been alerted to a pending change in Venezuela's income tax law, through which Venezuela will begin taxing all of the income received by its residents, rather than only that income that was determined, under broad "sourcing" rules, to be connected to Venezuela. The possibility that Venezuela would adopt this "worldwide" system was present throughout our treaty negotiations, and we planned for it in drafting the treaty. And while more time with the new law may provide us with more opportunity to analyze its provisions, we belIeve that the analysis we have performed is adequate to allow us to determine that the treaty is at least as appropriate under the new law as it would have been under the old law, and likely more so. We believe that the treaty works appropriately, in large part because this change from "territorial" to "worldwide" taxation brings Venezuela's domestic laws into closer conformity with international norms. The increased possibilities for double taxation that are the natural result of this change make the treaty that much more important than it was when Venezuela had a territorial system. And the vestiges of Venezuela's territorial system are also addressed by special provisions in the treaty included to deal with that system. On balance, we believe we can recommend that the Committee approve the treaty despite this change in Venezuela's law.

*Slovenia*

The United States does not currently have an income tax treaty with Slovenia. Slovenia will be the first country in the area of the former Yugoslavia with which we will have concluded a tax treaty. It is the most economically advanced country in the former Yugoslavia and is in the first wave of applicants to the European Union from Central and Eastern Europe. We expect that the conclusion of the tax treaty will be an important element in expanding trade and investment between the United States and Slovenia.

The proposed income tax treaty with the Republic of Slovenia generally follows the pattern of the U.S. Model, while incorporating some provisions found in the OECD Model. The proposed treaty establishes maximum rates of source country tax on cross-border payments of dividends, interest, and royalties. The withholding rates on investment income in the proposed treaty are generally consistent with those found in U.S. treaties with OECD member countries.

Dividends may be subject to tax at source at a maximum rate of 15 percent, except when paid to a corporation in the other country that owns at least 25 percent of the paying corporation, in which case the maximum rate is 5 percent.

The maximum rate of withholding tax at source on interest under the proposed treaty is 5 percent. However, interest received, guaranteed, or insured by the Government of either Contracting State or the central bank of either Contracting State and interest with respect to a deferred payment for personal property or services is exempt from withholding at source.

Royalties are generally subject to tax at source at a rate not to exceed 5 percent.

The taxation of capital gains under the proposed treaty follows the format of the U.S. Model. Gains and income derived from the sale of real property and from real property interests may be taxed in the State in which the property is located. Likewise, gains or income from the sale of personal property, if attributable to a fixed base or permanent establishment situated in a Contracting State, may be taxed in that State. All other gains, including gains from the sale of ships, aircraft and containers, and stock in a corporation, are taxable only in the State of residence of the seller.

As with the U.S. and OECD Models, the proposed treaty provides generally for the taxation by one State of the business profits of a resident of the other only when such profits are attributable to a permanent establishment located in that other State. Under the proposed treaty, the taxation of income from the operation of ships and aircraft in international traffic and from the use, maintenance or rental of containers used in international traffic is fully consistent with the U.S. Model.

The taxation of income from the performance of personal services under the proposed treaty generally follows standard U.S. treaty policy. The taxation of income from dependent personal services or of income derived by corporate directors, by athletes, or by entertainers is essentially the same as in other recent U.S. treaties. The dollar threshold for the taxation of athletes and entertainers is slightly lower than in the U.S. Model to reflect the lower average income level in Slovenia.

The treaty provides for host-country exemption for students for up to five years with respect to certain types of income. These exempted categories of income include support payments from abroad, grants and awards, and up to $5,000 of annual in-

come from personal services in the host state. Business trainees temporarily present in the host State are exempted from tax for up to 12 months with respect to income from personal services not exceeding $8,000. Visiting professors and researchers at recognized educational or research institutions are exempt from host-country taxation for a period not exceeding two years from the date of first arrival.

The proposed treaty contains comprehensive rules in its "Limitation on Benefits" article, designed to deny "treaty-shoppers" the benefits of the treaty. In addition, the treaty contains new provisions aimed at preventing abuse with respect to specific transactions. Under these provisions, a person otherwise entitled to treaty benefits will be denied those benefits if the main purpose, or one of the main purposes, of the creation or assignment of the rights giving rise to the income was to take advantage of the treaty. These provisions apply with respect to the Articles regarding Dividends, Interest, Royalties, and Other Income. It is expected that the United States will incorporate these new anti-abuse provisions into its Model.

The information exchange provisions generally follow the U.S. Model and make clear that each State is obligated to provide tax officials of the other State such information as is necessary to carry out the provisions of the treaty. Slovenia has confirmed to us that it has no bank secrecy or other rules that would prevent such exchange from taking place.

The proposed treaty provides a U.S. foreign tax credit for Slovenian income taxes subject to the limitations imposed by U.S. internal law on the granting of foreign tax credits. Similarly, Slovenia shall, under the proposed treaty, provide relief against double taxation to Slovenian taxpayers who are also subject to U.S. income tax, subject to the limitations imposed by Slovenian law.

Also included in the proposed treaty are rules necessary for administering the treaty, including rules for the resolution of disputes under the treaty.

The proposed treaty will enter into force upon the exchange of instruments of ratification. It will have effect with respect to taxes withheld at source for payments made or credited on or after the first day of the third month next following the date the treaty enters into force, and with respect to other taxes, for taxable years beginning on or after the first day of January next following the date of entry into force.

*Denmark*

I'd like to turn now to the proposed treaty and protocol with Denmark. This proposed treaty would replace the existing convention, our oldest income tax treaty, which was signed in 1948. The new treaty generally follows the pattern of the OECD Model and of recent U.S. treaties with other developed countries.

First, with regard to the taxation of investment income, the withholding tax rates under the proposed treaty are the same as those in the U.S. Model. Direct investment dividends are subject to withholding tax at source at a maximum 5 percent rate and portfolio dividends are taxable at a maximum 15 percent rate. The proposed treaty requires a 10 percent ownership threshold for application of the 5 percent tax rate. This ownership threshold is reduced from the 95 percent threshold required under the existing treaty. As under the existing treaty, interest and royalty payments are generally exempt from tax in the source country under the proposed treaty. These limitations on taxation by the source country do not apply if the beneficial owner of the income is a resident of a Contracting State that carries on business in the other Contracting State in which the income arises and, in the case of business profits, the income is attributable to a permanent establishment or, in the case of independent personal services, to a fixed base in that other State.

The taxation of capital gains under the proposed treaty generally follows the format of the U.S. Model. Gains from the sale of real property and from real property interests may be taxed by the country in which the property is located. Likewise, gains from the sale of personal property forming part of a fixed base or permanent establishment situated in a contracting State may be taxed in that State. All other gains, including gains from the alienation of ships, boats, aircraft and containers used in international traffic and gains from the sale of corporate stock are taxable only in the seller's residence State. As a variation from the rules under the current treaty and the U.S. Model, gains of an enterprise of one Contracting State from the deemed alienation of an installation, drilling rig or ship used in the other State for the exploration or exploitation of oil and gas resources may be taxed in that other State in accordance with its law, but only to the extent of any depreciation taken in that other State. In order to minimize possible double taxation that could otherwise arise, the treaty allows adjustments to the timing of the taxation of capital gains.

As with the existing treaty, recent U.S. treaties and the OECD Model, the proposed treaty provides generally for the taxation by one State of the business profits

of a resident of the other only when such profits are attributable to a permanent establishment located in that other State.

In addition, the proposed treaty preserves the U.S. right to impose its branch tax on U.S. branches of Danish corporations. This tax is not imposed under the existing treaty.

Consistent with the U.S. Model, the proposed treaty permits only the country of residence to tax profits from the international operation of ships or aircraft and income from the use, maintenance or rental of containers used in international traffic. This reciprocal exemption extends to income from the rental on a full basis of ships and aircraft and, if the ships or aircraft are operated in international traffic by the lessee or the income is incidental to income from the operation of ships or aircraft in international traffic, to income from the rental on a bareboat basis of ships and aircraft. The exemption under the proposed treaty is broader in scope than under the existing treaty.

The proposed treaty clarifies the treatment of the profits of the Scandinavian Airlines System (SAS) by treating it as a consortium that is eligible for the exemption from taxation in the source State to the extent of the participation of the Danish member of SAS, SAS Danmark A/S.

The taxation of income from the performance of personal services under the proposed treaty generally follows U.S. standard treaty policy. The rules for the taxation of pension income vary from the rules found in the existing treaty and the U.S. Model by providing for taxation only in the source State, subject to an exception for persons currently receiving pensions, who will continue to be taxed only in the country of residence.

The limitation on benefits provisions of the proposed treaty are similar to those found in the U.S. Model and recent U.S. treaties, with modifications to take account of certain types of entities found only in Denmark.

The proposed treaty provides a foreign tax credit for certain taxes imposed under the Danish Hydrocarbon Tax Act, subject to the same type of limitation that is found in other tax treaties with countries on the North Sea.

Also included in the proposed treaty are the rules necessary for administering the treaty, including rules for the resolution of disputes under the treaty and the exchange of information. The exchange of information provisions of the proposed treaty generally follow the U.S. Model. Our experience on exchange of information with Denmark is positive. As under the existing treaty, the proposed treaty contains a provision for assistance in the collection of taxes.

The proposed treaty will enter into force when the Governments notify each other that their requirements for entry into force have been met. It will have effect, with respect to taxes withheld at source, for amounts paid or credited on or after the first day of the second month next following the date on which the treaty enters into force; with respect to other taxes, the treaty will take effect for taxable periods beginning on or after the first day of January next following the date on which the treaty enters into force. Where the existing treaty would have provided greater relief from tax than the proposed treaty, the existing treaty will continue to have affect for an additional year at the election of any person that was entitled to benefits under the current treaty. The proposed treaty will remain in force indefinitely unless terminated by one of the Contracting States by giving prior notice through diplomatic channels.

*Italy*

The proposed new treaty and protocol with Italy would replace the existing treaty, which was signed in 1984. The proposed treaty generally follows the pattern of the OECD Model and other recent United States treaties with developed countries. The proposed treaty is of great importance to the U.S. business community because it addresses a new Italian regional tax on productive activities and generally lowers the withholding rates imposed by each country on passive investment income.

The proposed treaty addresses the replacement of the Italian local income tax by the new Italian regional tax on productive activities (IRAP). Because IRAP is calculated without an allowance for labor costs and, for certain taxpayers, without an allowance for interest costs, it raises the issue of potential double taxation. By providing a U.S. tax credit for a portion of IRAP, the proposed treaty resolves this issue. A formula is provided in the proposed treaty for calculating the creditable portion. Only the creditable portion of IRAP is considered to be a covered tax under the proposed treaty.

The proposed treaty establishes maximum rates of source country tax on cross-border payments of dividends, interest, and royalties that are generally lower than those in the existing treaty.

Under the proposed treaty, dividends may be subject to tax at source at a maximum rate of 15 percent, except when paid to a corporation in the other country that owns at least 25 percent of the paying corporation, in which case the maximum rate is 5 percent. Under the existing treaty, the 5 percent rate is available only if the receiving corporation owns more than 50 percent of the stock or capital of the paying corporation, while a 10 percent rate applies if the receiving corporation owns between 10 and 50 percent of the paying corporation, and a 15 percent maximum rate applies in all other cases. While the maximum rate applicable to those corporate taxpayers owning at least 10 percent and less than 25 percent of the paying corporation will increase from 10 percent to 15 percent under the proposed treaty, the maximum rate for those owning between 25 percent and 50 percent of the paying corporation, including the significant group of taxpayers who own exactly 50 percent, will decrease from 10 percent to 5 percent.

The proposed treaty lowers the maximum rate of withholding tax at source on interest to 10 percent from the 15 percent rate in the existing treaty. As in the existing treaty, the proposed treaty provides an exemption from withholding at source for interest received, guaranteed, or insured by the Government of either Contracting State (although, in order for interest received by a qualified governmental entity to be eligible for this exemption, the qualified governmental entity must hold less than 25 percent of the capital of the person paying the interest). The proposed treaty also exempts from withholding at source interest with respect to credit sales between enterprises and credit sales of industrial, commercial, or scientific equipment.

The proposed treaty lowers the maximum rates of withholding tax at source for royalty payments compared to the rates in the existing treaty. Under the proposed treaty, royalties for literary copyrights are exempt from tax at source. The maximum rate for royalties for the use of computer software or for the rental of industrial, commercial, or scientific equipment is 5 percent, and the maximum rate for all other royalties is 8 percent. In contrast, under the existing treaty the maximum rate for royalties for literary copyrights is 5 percent, the maximum rate for royalties for the rental of tangible personal property is 7 percent, the maximum rate for royalties for motion pictures and films is 8 percent, and the maximum rate for all other royalties is 10 percent. Thus, although the proposed treaty does not reflect the U.S. Model position of exemption at source for software and rentals of tangible personal property, the proposed treaty reduces the rates of withholding as compared to the existing treaty.

The taxation of capital gains under the proposed treaty follows the format of the existing treaty. Gains and income derived from the sale of real property and from real property interests may be taxed in the State in which the property is located. Likewise, gains or income from the sale of personal property, if attributable to a fixed base or permanent establishment situated in a Contracting State, may be taxed in that State. As in the existing treaty, but unlike the U.S. Model, non-incidental gains from the alienation of ships and aircraft rented on a bareboat basis and attributable to a permanent establishment situated in a Contracting State may be taxed in that State. All other gains, including gains from the alienation of containers, gains from the alienation of ships and aircraft rented on a full basis, incidental gains from the alienation of ships and aircraft rented on a bareboat basis, and gains from the sale of stock in a corporation, are taxable only in the State of residence of the seller.

As with the U.S. and OECD Models, the proposed treaty provides generally for the taxation by one State of the business profits of a resident of the other only when such profits are attributable to a permanent establishment located in that other State.

As under the U.S. Model, all income from the use, maintenance or rental of containers used in international traffic is exempt from source-country taxation under the proposed treaty. Also, the proposed treaty provides for exclusive residence-country taxation of profits from the international operation of ships or aircraft, including the rental of ships and aircraft on a full basis and, when the rental is incidental to the operation of ships or aircraft by the lessor, rentals of ships and aircraft on a bareboat basis. Like the existing treaty, but unlike the U.S. Model, income from the rental of ships and aircraft on a bareboat basis that is not incidental to the operation of ships or aircraft by the lessor and that is attributable to a permanent establishment situated in a Contracting State may be taxed in that State.

Unlike the existing treaty, the taxation of income from the performance of personal services under the proposed treaty generally follows standard U.S. treaty policy. Consistent with the U.S. Model, the proposed treaty eliminates a provision of the existing treaty that allows the source State to tax an individual performing independent personal services if that individual has been present in that State for

more than 183 days during the year, even if that person does not have a fixed base regularly available to him.

The limitation on benefits provisions of the proposed treaty are similar to those found in the U.S. Model and in all recent U.S. treaties, and are more comprehensive than those found in the existing treaty.

In addition, the treaty contains new provisions aimed at preventing abuse with respect to specific transactions. Under these provisions, a person otherwise entitled to treaty benefits will be denied those benefits if the main purpose, or one of the main purposes, of the creation or assignment of the rights giving rise to the income was to take advantage of the treaty. These provisions apply with respect to the Articles regarding Dividends, Interest, Royalties, and Other Income. It is expected that the United States will incorporate these new anti-abuse provisions into its Model.

The information exchange provisions are similar to those in the existing treaty and make clear that each State is obligated to provide tax officials of the other State such information as is necessary to carry out the provisions of the treaty. Italy has confirmed to us that it has no bank secrecy or other rules that would prevent such exchange from taking place.

Finally, the proposed treaty includes modernized rules necessary for administering the treaty, including rules for the resolution of disputes under the treaty. These provisions now conform to the OECD Model, which should improve the functioning of the mutual agreement process. They include the use of arbitration to resolve disputes that may arise between the Contracting States. However, the arbitration process may be implemented under the treaty only after the two Contracting State have agreed to do so through an exchange of diplomatic notes. Once implemented, a particular case may be assigned to an arbitration panel only with the consent of all the parties to the case.

The proposed treaty will enter into force upon the exchange of instruments of ratification. It will have effect with respect to taxes withheld at source for payments made or credited on or after the first day of the second month next following the date the treaty enters into force, and with respect to other taxes, for taxable years beginning on or after the first day of January next following the date of entry into force. In the event that a person would have been entitled to greater relief under the existing treaty, that person may elect to continue to apply the existing treaty for a twelve-month period from the date on which the proposed treaty would otherwise have effect. The proposed treaty will remain in force indefinitely unless terminated by one of the Contracting States. Either State may terminate the proposed treaty at any time after 5 years from the date on which the proposed treaty enters into force by giving at least six months prior notice through diplomatic channels.

*Estate Tax Protocol with Germany*

The proposed protocol amends the estate, inheritance and gift tax treaty between the United States and Germany, which was signed in 1980 and entered into force in 1986. In 1988, the United States amended its estate tax law in a way that increased estate taxes in the case of deceased U.S. citizens who were married to noncitizens.

Although the U.S. rejected claims by estate tax treaty partners that the 1988 change violated treaty nondiscrimination clauses, we indicated our willingness to amend our estate tax treaties with certain treaty partners to provide relief to surviving noncitizen spouses in appropriate cases. In particular, the proposed protocol eases the impact of the 1988 provisions upon certain estates of limited value. The United States, in a 1995 protocol to the U.S.-Canada income tax treaty, provided similar relief to certain estates of limited value involving Canadians. The United States' willingness to enter into the proposed protocol was a significant factor in Germany's ratification of the current U.S.-Germany income tax treaty, which was signed in 1989.

The proposed protocol also provides a pro rata unified credit to the estate of a German domiciliary for purposes of computing the U.S. estate tax. Under this provision, a German domiciliary is allowed a credit against U.S. estate tax ranging from the amount ordinarily allowed to the estate of a nonresident under the Code ($13,000) to the amount of credit allowed to the estate of a U.S. citizen under the Code ($202,050 in 1998), based on the extent to which the assets of the estate are situated in the United States. Congress anticipated the negotiation of such pro rata unified credits in Internal Revenue Code section 2102(c)(3)(A), and a similar credit was included in the 1995 U.S.-Canada income tax protocol.

The proposed protocol also makes other changes to the Convention to reflect more closely current U.S. treaty policy. For example, the proposed protocol extends the period of time during which a citizen of one country can be domiciled in the other country without becoming subject to the primary taxing jurisdiction of the other

country. Such a provision is increasingly important to peripatetic business executives. The proposed protocol also extends the United States' ability to tax former citizens and long-term residents to conform with 1996 legislative changes to the Internal Revenue Code.

### AGREEMENTS DEALING WITH TAXATION OF DIVIDENDS FROM REITS

In 1997, the Senate approved three treaties, with Austria, Ireland and Switzerland, subject to the understanding that the Treasury Department would use its best efforts to negotiate agreements that would modify those treaties' treatment of dividends paid by Real Estate Investment Trusts. The agreements with Austria and Switzerland are in an advanced stage of negotiation, but have not yet been completed. However, the agreement with Ireland was signed on September 24, 1999. Although it is not yet pending before the Committee, we hope that, if the President transmits it to the Senate in time, the Committee will consider it at the same time as the rest of the treaties as the agreement does nothing other than respond to the Senate's 1997 understanding.

### TREATIES UNDER NEGOTIATION

We continue to maintain an active calendar of tax treaty negotiations. We are in active negotiations with Canada, Korea, the United Kingdom and Chile. We expect to announce the start of negotiations with several other countries soon. In accordance with the treaty program priorities noted earlier, we continue to seek appropriate opportunities for tax treaty discussions and negotiations with several countries in Latin America and in the developing world generally.

### CONCLUSION

Let me conclude by again thanking the Committee for its continuing interest in the tax treaty program, and for devoting the time of Members and staff to undertake a meaningful review of the agreements that are pending before you. We appreciate your efforts this year and in past years to bring the treaties before this Committee and then to the full Senate for its advice and consent to ratification. We also appreciate the assistance and cooperation of the staffs of this Committee and of the Joint Committee on Taxation in the tax treaty process. With your and their help, we have, since the beginning of 1993, brought into force 22 new treaties and protocols, not counting the eight agreements presently being considered.

We urge the Committee to take prompt and favorable action on all of the Conventions and Protocols before you today. Such action will send an important message to our trading partners and our business community. It will demonstrate our desire to expand the United States treaty network with income tax treaties formulated to enhance the worldwide competitiveness of United States companies. It will strengthen and expand our economic relations with countries that have seen significant economic and political changes in recent years. It will make clear our intention to deal bilaterally in a forceful and realistic way with treaty abuse. Finally, it will enable us to improve the administration of our tax laws both domestically and internationally.

I will be glad to answer any questions you might have.

Senator HAGEL. Mr. West, thank you.

Ms. Paull.

## STATEMENT OF LINDY L. PAULL, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Ms. PAULL. Thank you, Mr. Chairman. It is a pleasure to be here.

Our staff has worked closely with the staff of this committee over the years on tax treaties, and we appreciate the opportunity to testify today before you.

I, too, have submitted written testimony for the record and I would just like to highlight some of the issues that we have raised for which there is a lot more detail in our pamphlets with respect to the eight treaties and protocol that are before you today.

With respect to the Baltic countries—Estonia, Latvia, and Lithuania—the proposed treaties are consistent with our treaties with

developing countries. I would just highlight one issue which is that these treaties do not reduce withholding taxes on real estate investment trust dividends, which is contrary to a policy that was instituted in 1997.

With respect to the Denmark proposed treaty, this is a major update of a 1948 treaty. Again, the proposed treaty is generally consistent with the U.S. model treaty. I would mention one issue here that Mr. West touched on and that is that the treaty provides, as is present with a few other treaties we have with North Sea countries, that a foreign tax credit may be claimed under the U.S. law for the Danish hydrocarbon tax. Also, there is a limitation that is placed on it which is consistent with at least one other treaty.

With respect to the new protocol, the proposed protocol for Germany, that modifies a 1980 treaty dealing with estate, gift, and inheritance taxes. We are not aware of any particular problems. We would just kind of note that this is somewhat of a small modification, important to German residents. They are principally directed at easing U.S. taxes on German heirs.

Again, we are unaware of any major issues involved in that protocol.

With respect to the proposed treaty with the Italian Republic, this is, again, an update of a treaty, an existing treaty, that was in force since 1984. I would call to your attention four items in that treaty.

The first item would be that there is a tax in that this proposed treaty would allow a portion of the so-called IRAP tax, the Italian Regional Tax on Productive Activities, to be eligible for a U.S. foreign tax credit. It is a little bit of an unusual provision in the sense that there is a hypothetical computation that is made to try to replicate or turn this tax into a proxy for an income tax. I think this is an unusual provision.

However, because there is some history here that the IRAP tax replaces a previously creditable tax under the existing treaty and the Treasury Department worked closely with Congress on this, we think it is an appropriate provision.

The proposed treaty also provides a limited exception for Italian insurance companies who are insuring U.S. risks. This has to do with, basically, a limited exception from the U.S. excise taxes on insurance premiums and reinsurance premiums.

It is our understanding—and I don't think the prior testimony covered this—that there have been assurances that there is appropriate Italian tax being collected on any of that type of income that would be generated from U.S. risks.

The proposed treaty also omits the U.S. model treaty language addressing bank secrecy laws. It is our understanding that there has been an exchange of letters on this subject so that there would be adequate exchange of information under the treaties between the two countries.

Finally, the fourth item is the major item, which Mr. West discussed in his testimony. This is the new main purpose test, so to speak, that exists in the articles dealing with dividends, interest, royalty and other incomes, which reduces withholding rates on those items. The main purpose test would operate to deny the benefits of the treaty provisions, those articles, in the case of somebody

who has created or assigned shares, debt claims rights, various things depending on the type of income that is generated.

I highlight this for the committee because this is a new policy for the United States. It was not something of which I think the staff who worked on this diligently throughout the years with the Treasury Department was aware, that there was going to be this new policy in these two recent treaties for which the negotiations were just finished.

The Treasury's testimony today indicates that this new policy would be included, possibly in a revision to the U.S. model treaty in the near future.

I would note that there is a little, I guess, anxiety on the part of the staffs who work on treaties diligently with the Treasury Department to say that there was no consultation with respect to this change. Also, this change is very vague. It is very unclear what this means, we would have to note to the committee, especially the language that talks about one of the main purposes.

One of the concerns certainly that we would have is that treaties are supposed to provide certainty and to facilitate investment between the two countries. I think our concern is that this will add quite a bit of uncertainty to investments between the two countries.

Let me just give a simple example of what I mean. For example, a company is looking to make an investment in a region and, when looking at that region, may want to make that investment in a country that, if all things are equal, has a treaty with the United States. So, yes, one of the main purposes of making that investment in that country might be to make sure that they get some of the treaty benefits which would be a lower withholding rate on their interests, dividends, or royalties generated by that investment.

What happens to that transaction under this language? We don't know the answer to that. But it seems like a fairly common transaction and it seems like something that the committee ought to be concerned about when you are trying to have a free flow of investment between two countries.

I think we have other concerns about this particular language because it is inserted in some parts of the treaty and not throughout the treaty. What does that mean in terms of anti-abuse, the so-called anti-abuse provision? What does that mean for the rest of the treaties?

Often courts will look to one provision and say well, you knew how to negotiate over an anti-abuse rule in that area, so you must not have been concerned or nothing applies there. We have a question as to what is the inference as to our domestic laws.

Mr. West indicated we have a lot of domestic laws specifically targeting transactions that could be abusive. What is the inference here with respect to our domestic laws? Does the fact that these treaties have some test at some point in these treaties and then our domestic law—we just don't know how they interact with them and whether or not they would be elevated to a higher level than our domestic law, or whether or not the standard used here is at a higher level than our domestic law.

Our domestic law would really look at an abusive transaction, look at such factors as is there a business purpose for the investment, or is there an economic substance to it—things like that. But this does not seem to incorporate any of those notions.

These are some of the concerns that we would raise about these provisions.

We, on balance, recognize there have been abusive transactions to abuse treaties like there are abusive transactions to abuse our current Tax Code. Congress has reacted to them in the past and can in the future. The question is whether or not that is such a significant concern that you would put a cloud on your investments under these treaties. That would be our concern there.

The Slovenia treaty also has just two of the issues that I highlighted for the Italian Republic treaty, and that is that the main purpose test that I was just discussing is also included in the dividends, interests, royalties and other income articles. Also, that treaty does not include the U.S. model treaty language addressing bank secrecy laws.

Finally, we have the treaty with Venezuela. This is a new treaty that was sought out by the United States at a time when the country had a territorial tax system. So it is a little bit unusual to be seeking out a treaty with a country like that. The country is in the process of moving to a worldwide tax system which makes a treaty to alleviate double taxation much more relevant, as Mr. West said.

We have been informed that the worldwide tax system law was enacted yesterday in this country. We have not seen the final language of that law. We have consulted with representatives of Venezuela and have been told that the new law is generally consistent with our style of a worldwide tax system.

We would just mention to the committee that the new law should be reviewed to make sure that the treaty provisions are not in need of some sort of modification. We have a concern with respect to the title that deals with the branch profits tax, that the language used in that title seems to be directed toward the United States branch profits tax as there was none in Venezuela at the time the treaty was negotiated. There is likely to be one in this new law. So we believe that that article should be looked at.

Finally, on the Venezuela treaty, this is a country that is undergoing profound political changes. Right now, it could be perceived—we are not experts in this by any means, not even close—but it could be perceived that there are somewhat dueling bodies responsible, having overlapping responsibilities in Venezuela right now.

They have a National Constituent Assembly, which is drafting a new constitution. I think it is imminent that a new constitution is going to be put before the people of Venezuela, which would also trigger some new elections. So that is just a question for the committee to consider, as to whether or not there is sufficient political stability in that country to insure that Venezuela will live up to its treaty obligations.

This ends my brief highlights of the issues presented by the proposed treaties. As I said, the issues are discussed in a lot more detail in our pamphlets which were submitted to the committee. I would be happy to answer any questions you may have now or as you consider the treaties.

[The prepared statement of Ms. Paull follows:]

PREPARED STATEMENT OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION

My name is Lindy Paull. I am chief of staff of the Joint Committee on Taxation. It is my pleasure to present testimony of the staff of the Joint Committee on Taxation ("Joint Committee staff") today concerning the proposed income tax treaties with Denmark, Estonia, Italy, Latvia, Lithuania, Slovenia, and Venezuela, and the proposed estate and gift tax protocol with Germany.

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 the staff of your Committee in analyzing the proposed treaties and protocols and preparing the pamphlets.

Five of the eight agreements at issue today represent new tax treaty relationships for the United States. The new agreements are with Estonia, Latvia, Lithuania, Slovenia, and Venezuela. The remaining three agreements modify existing treaty relationships. The proposed treaty with Denmark would replace an existing treaty signed in 1948. The proposed protocol with Germany would make several modifications to the existing estate, gift, and inheritance tax treaty signed in 1980. The proposed treaty with Italy would replace an existing treaty signed in 1984.

My testimony will highlight some of the key features of these treaties and protocols and certain issues they raise.

BALTIC COUNTRIES (ESTONIA, LATVIA, AND LITHUANIA)

The proposed treaties with the three Baltic countries of Estonia, Latvia, and Lithuania represent new tax treaty relationships for the United States. The terms of the three proposed Baltic treaties are substantially similar to each other.

Under the proposed treaties, each Baltic country agrees to reduce its taxes on the income that U.S. residents earn from sources in that country and the United States agrees to reciprocal reductions of its tax on U.S. income of Baltic country residents. The United States and each Baltic country also agree that their tax administrators will exchange tax information to carry out the provisions of the proposed treaties and each country's tax laws, and will cooperate together to resolve problems in the coordination of the tax rules of the countries that may arise in individual cases.

The proposed treaties with Estonia, Latvia, and Lithuania follow the U.S. model treaty in many respects. However, they differ from the U.S. model treaty in certain respects, primarily by not reducing source-country taxation to the same extent as many U.S. tax treaties. In this regard, the proposed treaties are similar to other treaties that the United States has entered into with developing countries.

The proposed treaties allow broader source-country taxation of business activities of residents of the other country than the U.S. model treaty. They also permit higher maximum rates of source-country tax on royalties, and permit the imposition of source-country tax on certain equipment rental income. The maximum rate of source-country tax on royalties generally is 10 percent. The proposed treaties treat equipment rental income as royalties subject to a maximum 5-percent source-country tax.

Under the proposed treaties, as under certain other U.S. tax treaties, the reduced rates of U.S. withholding tax applicable to dividends generally would not apply to dividends from U.S. Real Estate Investment Trusts ("REITs"). Thus, REIT dividends may be subject to U.S. withholding tax at the full statutory rate of 30 percent. In 1997, the Treasury Department modified its policy with respect to the exclusion of REIT dividends from the reduced withholding tax rates applicable to other dividends under the treaties. 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 certain cases. The proposed treaties do not incorporate this new policy with respect to the treatment of REIT dividends (i.e., the 30-percent U.S. withholding tax for REIT dividends generally would not be reduced under the proposed treaties).

### DENMARK

The proposed treaty with Denmark is a comprehensive update of the 1948 treaty. The provisions of the proposed treaty generally are consistent with the U.S. model treaty.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provisions of 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 Danish companies owned by residents of countries that are members of the European Union or the European Economic Area, or are parties to the North American Free Trade Agreement.

The proposed treaty provides certainty to U.S. taxpayers that taxes imposed under the Danish Hydrocarbon Tax Act are creditable income taxes for purposes of the U.S. foreign tax credit. It is not entirely clear whether such taxes would be creditable under U.S. law. The proposed treaty subjects each tax imposed under the Danish Hydrocarbon Tax Act to separate "per-country" limitations. Such limitations do not otherwise exist under U.S. law. A prior proposed U.S. income tax treaty with Denmark contained a similar provision providing for the creditability of taxes imposed under the Danish Hydrocarbon Tax Act. This Committee reported favorably the prior proposed treaty (and its protocol) in 1984 and 1985. During Senate consideration of the proposed treaty in 1985, objections were raised regarding the creditability under the treaty of the Danish hydrocarbon tax. The Senate has not given its advice and consent to ratification of that treaty.

### GERMANY

The proposed protocol with Germany modifies in several respects the estate, gift, and inheritance tax treaty between the United States and Germany that was signed in 1980.

First, the proposed protocol modifies certain tiebreaker rules in the existing treaty that determine which country has the right to tax on a worldwide basis when a decedent or donor is domiciled in both the United States and Germany at the time of death or at the time of making a gift. In this regard, the proposed protocol extends from five to ten years the period of time during which a citizen of one country can be domiciled in the other country without being subject to the primary taxing jurisdiction of the other country.

Second, the proposed protocol modifies certain exemptions granted when property is transferred between spouses. The existing treaty provides that interspousal transfers of property are granted a 50-percent exemption. The proposed protocol permits the United States to deny this exemption if the decedent or donor was a U.S. citizen, or was a former U.S. citizen or longterm resident who lost such status principally to avoid tax.

Third, the proposed protocol provides a pro-rata unified credit to an individual domiciled in Germany, who is not a U.S. citizen, for purposes of computing the U.S. estate tax. Under this provision, such an individual domiciled in Germany would be entitled to a credit against U.S. estate tax with respect to assets of the estate that are located in the United States.

Fourth, the proposed protocol provides a limited U.S. estate tax marital deduction when the surviving spouse is not a U.S. citizen.

Finally, the proposed protocol expands the saving clause of the treaty to cover two additional classes of individuals over which the United States would retain the right to tax under U.S. law. These are individuals who, at the time of the transfer of property, were either domiciled in the United States, or were former long-term residents of the United States who lost such status principally to avoid tax.

### ITALY

The proposed treaty with Italy would replace the 1984 treaty. The proposed treaty generally follows the U.S. model treaty. However, the proposed treaty differs from the U.S. model treaty in certain respects, as described below.

The proposed treaty contains certain "main purpose" tests that do not appear in any other U.S. treaties or the U.S. model treaty. The main purpose tests operate to deny the benefits of the dividends, interest, royalties, and other income articles of the proposed treaty if the main purpose or one of the main purposes of a person is to take advantage of the benefits of the respective article through a creation or assignment of shares, debt claims, or rights that would give rise to income to which the respective article would otherwise apply. In addition, the proposed treaty provides that the competent authorities of the treaty countries can agree as to when the conditions of the main purpose tests have been met. While the main purpose

tests are intended to prevent inappropriate benefits under the treaty, such tests inject considerable uncertainty into the treaty provisions because such tests are subjective and vague. This uncertainty can create difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty.

The proposed treaty provides certainty to U.S. taxpayers that a portion of taxes imposed with respect to the Italian regional tax on productive activities (referred to as the "IRAP") are creditable income taxes for purposes of the U.S. foreign tax credit. Effective January 1, 1998, the IRAP replaced Italy's local income tax (referred to as the "ILOR"), which was a creditable tax under the present U.S.-Italy treaty. Unlike the ILOR, the IRAP is calculated without a deduction for labor costs and, for certain taxpayers, without a deduction for interest costs. Absent the proposed treaty, the IRAP is unlikely to be a creditable tax under U.S. law. The proposed treaty provides a formula to calculate a portion of the IRAP that is intended to approximate an income tax under U.S. tax principles. Creditability is provided for only that portion of the IRAP.

The proposed treaty provides an exemption for Italian insurance companies from the U.S. excise tax on insurance and reinsurance 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 Italian insurer with a foreign person that is not entitled to the benefits of a U.S. treaty providing a similar exemption from such tax.

The proposed treaty includes an arbitration provision that is similar to the provision that was included in the 1989 U.S.-Germany treaty. However, like the provisions in several other recent U.S. treaties, such as the treaties with Ireland and 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 by taking into account 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, the proposed treaty requires the countries to exchange such information as is necessary for carrying out the provisions of the proposed treaty and 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 omits the provision in the U.S. model treaty that requires information to be provided to the requesting country notwithstanding that such disclosure may be precluded under bank secrecy laws or similar legislation.

### SLOVENIA

The proposed treaty with Slovenia is a new tax treaty relationship for the United States. The provisions of the proposed treaty generally comport with the U.S. model treaty. Under the proposed treaty, Slovenia agrees to reduce its taxes on the income that U.S. residents earn from sources in Slovenia and the United States agrees to a reciprocal reduction of its tax on U.S. income of Slovenian residents.

Like the proposed treaty with Italy, the proposed treaty with Slovenia contains certain "main purpose" tests that do not appear in any other U.S. treaties or the U.S. model treaty. The main purpose tests operate to deny the benefits of the dividends, interest, royalties, and other income articles of the proposed treaty if the main purpose or one of the main purposes of a person is to take advantage of the benefits of the respective article through a creation or assignment of shares, debt claims, or rights that would give rise to income to which the respective article would otherwise apply. In addition, the proposed treaty provides that the competent authorities of the treaty countries can agree as to when the conditions of the main purpose tests have been met. While the main purpose tests are intended to prevent inappropriate benefits under the treaty, such tests inject considerable uncertainty into the treaty provisions because such tests are subjective and vague. This uncertainty can create difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty.

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country notwithstanding that such disclosure may be precluded under bank secrecy laws or similar legislation.

VENEZUELA

The proposed treaty with Venezuela represents a new tax treaty relationship for the United States.

The proposed treaty raises unique issues because Venezuela currently has a territorial tax system. Under this system, Venezuela taxes income of residents or nonresidents only with respect to income from Venezuelan sources; accordingly, foreign-source income is not taxed by Venezuela. This is unlike the U.S. tax system, which taxes U.S. residents on worldwide income and generally taxes nonresidents only on certain income from U.S. sources. The inconsistencies between the two tax systems could result, in certain cases, in Venezuelan residents obtaining a complete exemption from both U.S. and Venezuelan taxes under the proposed treaty with respect to certain U.S. source income. In addition, under the proposed treaty, the reduced rates of U.S. withholding tax on certain payments to Venezuelan persons (such as for dividends, interest, and royalties) would provide additional relief for such persons from taxation by both countries.

The Committee should be aware that Venezuela is in the process of moving from a territorial tax system to a worldwide tax system. On April 26, 1999, an enabling law authorized the President to take "extraordinary economic and financial measures," including reforming Venezuela's income tax laws. Among other things, the enabling law specifically authorizes the President to amend Venezuela's tax laws to adopt a worldwide tax system (in lieu of Venezuela's current territorial tax system) with a credit system to provide relief from international double taxation. The enabling law authorizes the President to publish a decree within six months of the authorization (i.e., no later than October 26, 1999) which contains these and other changes to Venezuelan tax laws. In September 1999, the Council of Ministers, with the President presiding, approved a draft of a new income tax law which includes provisions adopting a worldwide tax system.[1])

In general, the new worldwide tax system is similar to the U.S. system. Under the new worldwide tax system, Venezuelan residents and domiciled entities would be taxable on worldwide income while nonresidents and non-domiciled entities would be taxable only on certain income from Venezuelan sources. Taxpayers generally would be permitted to claim a credit against their Venezuelan tax liability for foreign taxes paid on their foreign source income.

The draft new tax law has not yet been published in Venezuela's *Official Gazette.*[2] For such law to take effect as provided by the enabling law, this action must take place no later than October 26, 1999. Once officially published, the new tax law generally would take effect for taxable years beginning after the law is published. However, the new worldwide tax system would take effect for taxable years beginning on or after January 1, 2001.

The proposed treaty differs from the U.S. model treaty in certain respects. First, the proposed treaty does not reduce source-country taxation to the same extent as many U.S. treaties. In this regard, the proposed treaty is similar to other treaties that the United States has entered into with developing countries.

Second, the proposed treaty would allow broader source-country taxation of business activities of residents of the other country than the U.S. model treaty. 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 183 days.

Third, the proposed treaty permits higher maximum rates of source-country tax on royalties, and permits the imposition of source-country tax on certain equipment rental income. The maximum rate of source-country tax on royalties generally is 10 percent. The proposed treaty treats equipment rental income as royalties subject to a maximum 5-percent source-country tax.

Venezuela currently is in a period of constitutional and institutional change. In the past ten months, the Venezuelan people have elected a new President, Hugo Chavez. In April, a new National Constituent Assembly was formed to draft a new constitution. Among other things, conflicts have developed between the new Na-

[1] The draft new tax law also provides for several fundamental changes in Venezuela's tax laws beyond the adoption of a worldwide tax system, including the imposition of taxes on dividends, the adoption of rules on transfer pricing, as well as general anti-abuse rules to allow the tax authorities to disregard transactions entered into with a principal purpose to evade, avoid, or otherwise reduce income taxes.

[2] In general, laws are enacted in Venezuela by means of publication in Venezuela's *Official Gazette.*

tional Constituent Assembly and established political institutions, such as the Venezuelan Congress. The Committee should consider the implications of ongoing political changes in Venezuela as they relate to the proposed treaty. For example, if there are competing claims as to who is authorized to exercise legislative, executive, or judicial functions, it may be difficult to identify the responsible competent authority with respect to the proposed treaty. These uncertainties may make it difficult to administer the treaty.

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 the Committee may have at this time and in the future.

Senator HAGEL. Ms. Paull, thank you, and Mr. West, thank you.

You each know the drill around here. As a matter of fact, I recall that not too long ago, Ms. Paull, you were on the other side developing the questions.

What I would like to do is this. Let's just back through your testimony, Ms. Paull, because you raise some questions that I know Mr. West would like to engage in. I know he would like to clarify some of those points.

So, if I might, let's just take your testimony and proceed right along our merry way and stay on Venezuela.

Mr. West, you heard some of the concerns and the questions raised by Ms. Paull. Let's start with the current government.

Obviously, that was factored into the equation as you all thought through this and negotiated. It is an unknown. We appreciate that. But why don't you start there and work your way through some of the questions that Ms. Paull raised.

Thank you.

Mr. WEST. I would be happy to, Mr. Chairman.

Starting with the last issue, which is the political turmoil there, we have consulted closely with the State Department and, as Ms. Paull said, this is not something that the tax experts profess to be expert in. But what we understand from the State Department is that the changes that are going on in Venezuela—and there are changes—are in the nature of healthy changes that are fully consistent with democratic principles.

Again, this is our understanding from the State Department. They are not seeing developments there inconsistent with a popularly elected government and popular democracy being exercised.

So, while any further questions on that subject I would be happy to take back to the State Department so as to provide you with additional answers, we have not heard anything to indicate that there is any reason not to go forward. In fact, the one tax related concern in that area would be whether or not a treaty makes sense even if you assumed great instability. In our view, a tax treaty is perhaps even more important in an unstable environment than it is in a stable environment, because it will give U.S. taxpayers a measure of predictability and certainty when they do business in Venezuela, even if there is some change going on down there.

But, again, we have not heard anything to indicate that there is any change that would affect the ability of Venezuela to bring the treaty into force, that would affect, would adversely affect, any of the provisions of the treaty.

Senator HAGEL. Of course, that all depends on whether a new government would enforce that treaty.

Mr. WEST. We have asked that question. What we understand is this. The legislature has approved this treaty already. The question would then have to be whether any new government would actually invalidate a prior action of the legislature. We hear nothing to indicate that that is at all on the radar screen for what is happening in Venezuela.

Senator HAGEL. Have you had a chance to look at what was done yesterday with the passage of the language that Ms. Paull referenced? They have not had a chance to look at it. Is there anything that you know of that would be of concern to this committee?

Mr. WEST. We have been working long and hard to make sure that everything we can find out about this new legislation we are learning, studying, discussing, and analyzing. As I said earlier, we are now comfortable with what we have seen so far that the treaty is an appropriate measure.

Now that leaves the question of whether or not what ultimately is reflected in the final legislative language is consistent with what we know so far. And we have not seen that final legislative language. I do not believe it is available yet.

But we understand that it will be available at any time.

What we intend is, when that language is made available—and, again, it ought to be at any time now—we want to make sure that the final legislative language is consistent with our understanding of what the drafts have said to date. I think that is important.

We need to do that and intend to do that before the treaty is brought into force, to make sure that what is finally enacted is consistent with what our understanding is.

Senator HAGEL. Of course, you both know what we will do. Some of the areas that we do not cover today we will submit to you in writing for you to deal with.

Are there other areas, Mr. West, that Ms. Paull brought up to which you want to respond regarding Venezuela?

Mr. WEST. I would only reiterate, again, that the new tax system seems to us to be a move in a direction that makes the treaty make more sense even than it did before. We think that is a logical development and that our businesses will be all the more benefited by ratification of the treaty.

Ms. PAULL. And we agree with that.

Senator HAGEL. Before we leave our neighbors to the south, is there anything that you want to add, Ms. Paull, regarding Venezuela?

Ms. PAULL. No, but I would just agree with the last statement Mr. West made.

Senator HAGEL. OK. Thank you.

We will submit some questions to further clarify some of these issues.

Let's talk a little bit about Italy. There is an area that Ms. Paull raised in questions, and maybe a good place to start, one of the general areas we could work from is this. Maybe there was some lack of complete consultation between Treasury and Joint Tax Committee. I don't know that, but I pay attention occasionally.

If I was listening to this correctly, I sensed that from Ms. Paull's testimony.

Maybe you would like to reflect on that.

Mr. WEST. I would, Mr. Chairman.

Undoubtedly, we did not consult on this issue as much as we might have, as much as we could have. I will say that there are differing views as to the extent of the consultation that was engaged in. But I don't think that is something that is necessarily productive to go into.

But I will say that we could have done more and I would like to undertake that in the future in areas like this we will do more.

Senator HAGEL. Ms. Paull brought out a couple of specific areas. I think she talked about the anti-abuse provision where there is some concern.

Would you like to put her fears to rest?

Mr. WEST. I would.

Senator HAGEL. And you are fortunate that Senator Sarbanes is now here as well. He brings a calmness and sereneness to the effort, and a much needed dignity, I might add.

Is that good enough, Paul?

Senator SARBANES. I thought that was just fine, yes.

Mr. WEST. Let me address some of the concerns that Ms. Paull raised.

First, let me address the negative inference concern regarding what this means for our other treaties and the other parts of this treaty that do not contain this rule.

Our technical explanation, which serves as the first stop after the committee reports and the congressional reports regarding interpretation of this agreement, make clear that no inference is intended; that our domestic law anti-abuse rules that otherwise would apply will no longer apply after this rule is in place.

So it is not the intent of the negotiators that otherwise applicable rules will cease to apply after this rule comes into force.

Senator HAGEL. Are there any other areas on the Italy treaty that Ms. Paull raised to which you want to respond?

Mr. WEST. Yes. Let me address the vagueness problem which I know is a concern.

I tried to highlight in my testimony some of the reasons why this standard was chosen over other standards. Again, let me reiterate that there are broader standards—such as the one Italy agreed to in its immediately preceding treaty—broader standards, what we might call more subjective standards, that Italy had recently agreed to. We reviewed those standards and we rejected those. We thought that this produced a measure of uncertainty with which we were not comfortable.

But we needed an effective standard, and we think this standard will be an effective standard. Again, we took comfort from the fact that it is contained in some 50 treaties around the world, 40 treaty countries, 10 OECD members. We have identified, as I said, over 2 dozen provisions of the Internal Revenue Code that contain a very, very similar provision—one of the main purposes is tax avoidance. The Internal Revenue Code in many places refers to one of the principal purposes being tax avoidance.

We discussed the differences in those words with some of our treaty partners, and they viewed them as not being different. They thought that there was greater certainty going with the language that was already contained in many treaties around the world.

So we agreed that that would actually enhance the certainty of our rule. So we decided on that provision.

Senator HAGEL. Does your reference to a standard mean that you had prepared a comprehensive analysis of these main purpose tests?

When you say standard, what do you mean? Let me put it another way. Was there a comprehensive analysis done?

Mr. WEST. Mr. Chairman, we can always do more. This is no doubt another example of a situation in which we could have done more in identifying the exact contours of what the ramifications of a rule like this would be.

There is relatively little, we will acknowledge, relatively little interpretive authority on standards like this. The case law is sparse on standards like this. We acknowledge that.

But, again, what we do believe is that, over time, the case law will develop and the interpretive authorities will develop in a way that will provide adequate certainty to our taxpayers.

Senator HAGEL. One of the questions, and I think it is a valid point, is the uncertainty issue—more uncertainty/less uncertainty. Of course, as you know, investment depends, to some extent, on certainty. Realizing that we cannot all be certain, do you think that this treaty makes it better in that area or not?

Mr. WEST. Well, it does not make it better, Mr. Chairman. But, again, I would like to keep in mind that these treaties only provide benefits. They do not restrict taxpayer benefits in any way.

Because of this, we view it as reasonable to impose reasonable limits.

Now in some situations, like our limitation on benefits provisions, it is relatively easy to identify with bright line standards when a person, an entity, a company is a bona fide resident of a jurisdiction and when that company is not a bona fide resident of that jurisdiction.

In the area of avoidance of tax, generalized tax avoidance, that does not lend itself as easily to those kinds of bright line standards. Again, we think the Internal Revenue Code reflects that because, again, in over 2 dozen places there is a very similar standard. It has been incorporated as recently as a provision relating to active financing income for our financial services businesses, which is included in the extenders bill that is under consideration by the Congress now.

Even this provision contains language very similar—whether one of the principal purposes is the avoidance of tax.

We have seen it elsewhere. It does not increase certainty. But our view, again, is that it is a reasonable measure in these circumstances where tax avoidance through treaty abuse is increasing.

Senator HAGEL. Thank you, Mr. West.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman. I appreciate your calling this hearing. I am not going to be able to stay. But I do have some questions that I want to ask.

I am very much concerned by the fact that these tax treaties come before us and then, all of a sudden, we are confronted with

new provisions that we have not dealt with before. It is difficult to ascertain the rationale for this.

The main purpose test that you have just been talking about, it seems to me, is one clear example of that. Has it been incorporated in other U.S. tax treaties, the Italian and Slovenian main purposes tests?

Mr. WEST. No other U.S. tax treaties, no.

Senator SARBANES. This is the first time, right?

Mr. WEST. Yes, it is.

Senator SARBANES. Is it in the U.S. model treaty?

Mr. WEST. No, it is not.

Senator SARBANES. Is it in the OECD model treaty?

Mr. WEST. No, it is not.

Senator SARBANES. I understand that the countries insisting on such language internationally are the U.K., Ukraine, Kazakhstan, Canada, Mexico, and Uzbekistan. Is that correct?

Mr. WEST. I would not say that was correct for the following reason. These provisions, as I am sure you know, Senator, the negotiations are frequently not a matter of one country insisting on a provision. We have a few nonnegotiable provisions we insist on. But many of these treaties are agreed on by both parties to the negotiation because they believe they are in the mutual interests of both parties.

The countries you mentioned do have this as part of their policy. There are other countries that also have it as part of their policy.

Senator SARBANES. With respect to the countries I listed, does the U.S. have bilateral tax treaties with those countries?

Mr. WEST. The U.S. has a tax treaty with the United Kingdom, Senator. We have a tax treaty with the Ukraine that has been signed and approved by the Senate but not yet brought into force.

Senator SARBANES. And Kazakhstan?

Mr. WEST. We have a tax treaty with Kazakhstan, yes.

Senator SARBANES. Canada?

Mr. WEST. We have a tax treaty with Canada, yes.

Senator SARBANES. Mexico?

Mr. WEST. We do, yes.

Senator SARBANES. Uzbekistan?

Mr. WEST. Our treaty with the former Soviet Union continues to apply.

Senator SARBANES. Would they contain main purpose language?

Mr. WEST. Our treaty with Canada includes a provision that allows Canada to apply a similar rule under its domestic law to U.S. taxpayers. It is not the identical rule.

Senator SARBANES. Why wouldn't applying U.S. domestic law cover whatever problem you are concerned with?

Mr. WEST. We have actually reviewed U.S. domestic law on that point. Actually, the standards are quite low.

The most recent significant authority in that regard is a case called Northern Indiana Public Service Company. We look at that case and see that the kind of tax treaty, what we view as tax treaty abuse, that is allowed to go on under the standards as articulated by some of the courts beyond that which we think is appropriate.

Senator SARBANES. Has Slovenia incorporated such language in its previous tax treaties?

Mr. WEST. Not to my knowledge, Senator.

Senator SARBANES. So it's the first time for Slovenia?

Mr. WEST. I believe so.

Senator SARBANES. How about Italy?

Mr. WEST. Italy has broader language in some of its prior treaties—more subjective, less certain standards in some of its provisions.

Senator SARBANES. In how many of its treaties?

Mr. WEST. I do not have a count for you, but I would be happy to provide you with that number.

I am informed that it is in seven.

Senator SARBANES. I am told that in five instances out of 70 tax treaties, Italy has language that approximates this main purpose language. Would that be correct?

Mr. WEST. I am advised the number is seven, and I don't know if it is the most recent seven.

Senator SARBANES. Seven out of what?

Mr. WEST. Senator, it could be the most recent seven. It could be all seven of its most recently negotiated treaties. I do not have those numbers, though. I would be happy to get those to you.

Senator SARBANES. You don't know that it's seven out of how many?

Mr. WEST. No, I don't know how many bilateral treaties Italy has, Senator.

Senator SARBANES. It's probably a fairly large number, wouldn't you think?

Mr. WEST. We can surmise.

Senator SARBANES. Where did this impetus come from to put in this language?

Mr. WEST. Originally from looking at the Italian precedent in its treaty with Israel, Senator. We looked at that precedent and saw that some very broad anti-abuse rules were being incorporated in treaties around the world. We considered the broader Italian precedent when we sat down at the table with Italy but decided against it. We decided it would not provide enough certainty to our taxpayers.

Senator SARBANES. Is it now our policy to request or support such language? Is it your intention to amend or change the U.S. model treaty?

Mr. WEST. The Treasury Department believes it is appropriate policy, Senator. Whether it is our policy will, of course, depend on the views of this committee and our consultations and work with you.

Senator SARBANES. I don't quite follow that answer.

Mr. WEST. It is the Treasury Department's view that it is appropriate policy. Whether it goes in our future treaties will, of course, be dependent on the views of this committee.

Senator SARBANES. Well, ultimately that is quite true because a treaty cannot go through if this committee and the Senate do not accede to it. But what is the Treasury's position?

Mr. WEST. As I said, Senator, the Treasury's view is that this is appropriate treaty policy, yes.

Senator SARBANES. So you intend to put this in all succeeding tax treaties?

Ms. PAULL. Let me show you your testimony.

Mr. WEST. Let me quote from my written testimony. "It is expected that the United States will incorporate these new anti-abuse rules into its model."

Senator SARBANES. Is that your statement?

Mr. WEST. That is my written testimony.

Senator SARBANES. Well, I had not gone through your written testimony. But I am glad Ms. Paull helped us out. That seemed to be a lot clearer than what you have been telling me in the last few minutes.

Mr. WEST. Let me explain the ambiguity.

What is or is not our model position at any time is this. We have a published model. But, again, what our model is for our next negotiation is, in part, a function of developments between the publication of our last model and that negotiation. I hope that explains some of the ambiguity.

Senator SARBANES. Now does this treaty with Italy waive the excise tax on insurance premiums?

Mr. WEST. It does, Senator.

Senator SARBANES. The Senate on numerous occasions has specifically expressed its opposition to such a waiver, has it not?

Mr. WEST. The Senate has expressed its opposition I believe in cases in which there have been no assurance that there would be adequate taxation to protect the domestic insurance industry from unfair competition by foreign insurers who might compete for U.S. risk business.

In the case of Italy, the Treasury Department is comfortable that Italian law does provide for a substantial level of taxation so that there would be no such unfair competition with our domestic insurance industry.

Senator SARBANES. So you're telling our people that you can assure them that they will not be placed at a competitive disadvantage?

Mr. WEST. No, I would not make so broad a statement.

Senator SARBANES. Why shouldn't you be able to make that statement?

Mr. WEST. It's a personal reticence about personal advantage and disadvantage and my ability to assess what competitive advantage and disadvantage is.

What I would say, Senator, is that we are comfortable that Italy imposes a substantial domestic tax on the Italian companies competing with U.S. businesses.

Senator SARBANES. Do you have a view on that, Ms. Paull?

Ms. PAULL. Well, I certainly have been in the throes of this provision in my former capacity at the Senate Finance Committee. I flagged that for the committee because of that. We had inquired of the Treasury Department and they assured us that there would be an adequate level of tax imposed by Italy on the insurance companies who are insuring U.S. risks over here.

If that is not the case, then certainly that would be an issue that the committee would want to visit. We do not have any independent way of judging.

Senator SARBANES. Nor do we, I assume.

Ms. PAULL. Yes.

Senator SARBANES. I mean, if that happens, it will happen after the fact, correct—after the treaty goes into effect?

Ms. PAULL. This is one of those things that certainly we are under an obligation, the Treasury Department is under an obligation, I would believe, to monitor very carefully.

Senator SARBANES. What would happen if you found out that the Italians were not doing this?

Ms. PAULL. Well, what happened in the past, of course, though there were a lot different circumstances, is the Congress overrode the treaty provision ultimately. That is not a great position for the Senate to be in.

Senator SARBANES. That's right. Everyone comes and tells us we should not do that because we won't be able to negotiate any treaties.

What happens if, in effect, your assurances turn out to be empty?

Mr. WEST. Well, Senator, we can go and seek renegotiation of that point and attempt to reach agreement on a protocol with the Italians if the facts change in such a dramatic manner.

Senator SARBANES. Let me ask about bank secrecy.

The model treaty contains a provision on bank secrecy authorizing a country to obtain and provide information held by financial institutions, notwithstanding any laws or practices of the requested country that would otherwise preclude such exchange of information. Both the Italian and the Slovenian treaties are missing this provision, although both technical explanations state that the omission of this section does not relieve those countries of the obligation to provide this information.

Why was the standard bank secrecy provision omitted from these two treaties?

Mr. WEST. Senator, that language has proven problematic for us not for any substantive reasons in a number of cases but, really, for reasons that I will term diplomatic.

What the language does, in effect, is require our treaty partner to declare in a rather open way that this treaty will override provisions of its domestic law potentially if that is the case; or, if it is not the case, they view this language as unnecessary because their domestic law already provides for full exchange of bank information.

Let me assure you that in the case of Italy and Slovenia, we have obtained assurances in writing from both countries that they can obtain such information and that the absence of that language from our treaties does not in any way affect or alter our ability to obtain the information from financial institutions that is appropriate under our exchange of information provisions.

Senator SARBANES. That is not a very good precedent to be setting, is it, in terms of negotiating treaties with other countries that come along?

Mr. WEST. Senator, we are coming to believe that the bad precedent is the language in our model treaty, and we are reconsidering that language, not in any way to step back from our full commitment to complete an open exchange of information regarding financial institutions, but because the language itself, the words, seem problematic to many of our treaty partners.

Senator SARBANES. What does that mean, "problematic to our treaty partners"? They don't want to supply the information?

Mr. WEST. Well, as I said, either it is unnecessary because they provide this information or it is, again, what I can best term diplomatically objectionable because it is an open declaration that laws that might otherwise be on the books would be overridden, or both, perhaps.

Senator SARBANES. Then how do you handle that situation?

Mr. WEST. Well, what we do, again, Senator, is assure ourselves.

Senator SARBANES. Let's say a country has the laws on the books that would not enable this information to be exchanged. I think your phrase was "it is diplomatically problematical" to have language in the treaty that would provide for the exchange of information. So where are we, then?

Mr. WEST. Senator, that is not a treaty we would enter into. In the facts you described, there is no ability to get the information. But they find the language objectionable.

Senator SARBANES. Presumably, the ability to get the information is on a continuum. At one end of the continuum is: you can't get anything; at the other end of the continuum is: what we can get by the provision in the model treaty. So you range across that landscape.

Mr. WEST. Senator, there is no continuum for us. It is full and open exchange of information held by financial institutions or we will not enter into a new treaty relationship.

Senator SARBANES. But it should be in the treaty, then.

In how many treaties is such a provision found?

Mr. WEST. It is not a majority of our treaties. I will see if I can get that information. If I cannot answer it now, I will provide it to you.

Senator SARBANES. Has it been in all the treaties since we became increasingly concerned about this issue?

Mr. WEST. It is not in all the treaties, Senator Sarbanes. We have 8 treaties that have been approved by the Senate since 1996 when our model treaty language appeared that do not have this language.

Senator SARBANES. And how many do?

Mr. WEST. Four do and most of the treaties before you today do. But several of them do not.

Senator SARBANES. Mr. Chairman, you have been very generous. I have just a couple of more questions and then will have to depart, which I regret.

Senator HAGEL. Why don't you continue, then.

Senator SARBANES. Thank you.

You stated earlier at the table that there were benefits in all of these treaties for U.S. taxpayers, is that correct?

Mr. WEST. I believe so. Yes, sir.

Senator SARBANES. And that it was just a question of limiting them. What are the benefits in the German protocol?

Mr. WEST. One benefit in the German protocol is our ability to apply our recent expanded expatriation rules in that protocol, Senator.

Senator SARBANES. In my reading and in the reading we have done it seems to indicate that it works to the benefit of German residents with assets in the United States.

Mr. WEST. There are a couple of things about that.

Senator SARBANES. But, also, there are no reciprocal benefits to U.S. residents with property in Germany.

Mr. WEST. Well, first of all, German internal law provides many of those same benefits. So there was no need to obtain them through a reciprocal agreement.

Senator SARBANES. What happens if they change German internal law?

Mr. WEST. We would, again, consider seeking renegotiation if this agreement became nonreciprocal.

Senator SARBANES. On what basis would we do that?

Mr. WEST. A change in the circumstances. We are in discussions with Germany all the time.

Senator SARBANES. What would happen if we changed U.S. internal law to the disadvantage of German residents?

Ms. PAULL. That did happen.

Mr. WEST. That is what happened, which engendered this negotiation.

Senator SARBANES. What?

Mr. WEST. That is what happened. In 1988, our domestic law was amended. It adversely affected German decedents with noncitizen spouses, and Germany sought negotiation of this protocol to our estate and gift tax convention.

They also sought it, Senator, in the context of our income tax treaty that was agreed to in the early 1990's. The way the Treasury Department has viewed this agreement is hand-in-glove with the benefits and agreements that were provided under our income tax treaty with Germany. Again, that was concluded after the 1988 changes in law that adversely affected the Germans, but prior to the conclusion of this estate and gift tax provision.

Senator SARBANES. Are you telling me that the reach of this protocol is only to the extent of altering our earlier treaty with Germany to encompass the changes in U.S. domestic tax law?

Mr. WEST. The two main things it does is it addresses the 1988 change in law that adversely affected German decedents with noncitizen spouses and also implements a congressional directive to negotiate with treaty partners to provide a pro rata unified credit to them more appropriate than the one provided to them under prior law.

Senator SARBANES. Ms. Paull, do you have any observations on any of these issues that I covered with Mr. West?

Ms. PAULL. Yes, I have a few observations. I could start with this last one.

I think we were on notice that the issues rising from our 1988 change in our law, Germany was on notice, and I believe their testimony indicates that we made some modifications for Canada as well.

The process of negotiating an income tax treaty with Germany was near its final stages when we changed the law. So I think there were commitments made that we would revisit the Estate, Gift, and Inheritance Tax Treaty, and that is what this is. I think

we have been aware of that all along, that it was an obligation of the United States to go back and revisit that.

That is why it looks a little bit unusual, in the sense that it is principally a one-sided modification of the 1980 treaty, which deals only with estate, gift, and inheritance taxes.

With respect to the bank secrecy provisions of the U.S. model treaty, I would have to say that our staff would have concerns about the Treasury Department deleting that language from the model treaty.

Certainly, some of the treaties that were concluded in the last 5 years only have some partial exchanges of information, and I imagine that this committee believed that that was a step in the right direction considering the countries that were involved.

One would hope that we would hold that standard as a high standard so that we could, with all of our treaty partners, get a full and adequate exchange of information. I think you know the countries we are talking about here. So I would just simply comment on that.

On the main purpose test, I would, again, say to the committee that this test is very vague, very vague, and we have serious concerns about it. There is nothing of the test that appears in the treaties in their various articles that deals with tax avoidance, to which Mr. West was pointing—a variety of, a kind of similar, a principal purpose, or a main purpose type motivation—to avoid taxes as in our anti-abuse rules.

I go back to my situation, a fairly straight-forward situation, where, all things being equal, a company, a U.S. company is going to make an investment in a region. They might want to pick Slovenia, but they might not want to under this treaty to get the benefits of the treaty, the lower withholding on the income that is generated by their investment.

It puts a major cloud on investments that has nothing to do with what is stated in the articles and in the test that there is tax avoidance involved. Certainly, the technical explanation goes into that. But, you know, courts tend to look right at the language of the provision they are having to interpret first.

So it is troublesome language. I don't think we have a clue what it really means, to be perfectly frank with the committee.

Senator SARBANES. Thank you very much, Ms. Paull.

Thank you, Mr. Chairman.

Senator HAGEL. Senator Sarbanes, thank you.

Let me move along to a couple of other areas that we have not had an opportunity to talk about.

First is the Baltic states. In reading the general dynamics of what you have here, it is my understanding that the treaties with the Baltics, as well as the Venezuela treaty, all contain developing country concessions. You know what that means regarding permitting higher withholding rates, different source rules, and so on.

I guess I have two general questions. One is what was the criteria used to determine if a country is entitled to developing country concessions? That is my first question.

Mr. WEST. Mr. Chairman, what we do in cases like these, in consultation with the State Department, is make a determination of whether in the administration's view it is in the overall interest of

the United States to embark on treaty negotiations with a country that we'll call a developing country.

Once we make a decision to do that and sit down at the table with them, the extent to which we make concessions from the positions we take with developed countries is a dynamic, and it is a function of factors that I would venture to say are not subject to precise delineation of how a negotiating dynamic proceeds.

We take into account the overall benefits to the United States and we negotiate the best agreement that we can under the circumstances. That is certainly true with these treaties. They reflect long negotiations, detailed negotiations. They go on for a number of rounds, over weeks and years from beginning to end, and we make a judgment as to whether the overall package is the best that could be obtained.

It is our view that these agreements before you are the best agreements that could be obtained with these countries.

Senator HAGEL. Who makes the final decision on this?

Mr. WEST. The final decision is made by the Senate in determining passage.

Senator HAGEL. No, no. You know what I mean.

Mr. WEST. In the Treasury Department?

Senator HAGEL. That's where you're from.

Mr. WEST. Typically, the Assistant Secretary for Tax Policy is involved in reviewing these agreements and is apprised of the terms of the agreements, sometimes has a role in negotiating the agreements, and all of these negotiations are subject to his judgment as to whether they are appropriate. They are, of course, reviewed and transmitted by the Secretary of the Treasury. They are reviewed by his office to make a determination as to whether the Office of Tax Policy has acted appropriately. But the Assistant Secretary for Tax Policy is generally the official that I would say is responsible for those judgments.

Senator HAGEL. Thank you.

Do you believe or can you quantify if there are any effects, impacts on investment in the countries that were given these kinds of concessions?

Mr. WEST. Those are very hard to quantify, Mr. Chairman. I would not even venture a guess as to what the effects are. We do not negotiate these agreements with an eye toward a short-term boost to investments. These are agreements that we enter into because they are in the overall interests of the United States, in our overall economic interests.

Senator HAGEL. Are you familiar with a letter that Senators Helms, Biden, and I recently wrote to the Secretary of the Treasury regarding the U.S.-Japan Tax Treaty?

Mr. WEST. I am.

Senator HAGEL. So you know that the question we posed to the Secretary was about these same kinds of concessions with Japan?

Mr. WEST. As I read the letter, Mr. Chairman, it was a request, or an expression of the view of the signing Senators that the Treasury Department should do what it can to open formal negotiations to renegotiate the Japanese treaty.

Senator HAGEL. Does that treaty have similar developing country provisions in it?

Mr. WEST. I would say this, that certain of the positions held by the Japanese consistently in all their treaty relationships, relatively few but certain of them are inconsistent with international norms for developed countries. There is really one in particular and that is their withholding tax rate on royalties.

One of the other provisions that I know is of interest to the U.S. business community is the withholding tax rate on interest. In that case, the United States position is actually lower than the international norm in that area. So, saying what a developed country versus developing country standard is can get a bit tricky because in some cases the United States standard is actually more favorable to our business community than the international norm. That is the case with the interest withholding tax rate in the Japanese treaty.

But their royalties tax withholding rate is inconsistent with the international norm.

Senator HAGEL. Are we renegotiating that part of the treaty?

Mr. WEST. Mr. Chairman, I am doing everything in my power to open negotiations in a manner that would lead to a treaty that would be acceptable to this committee, to our business community, and to the Japanese, as well. We want very much to renegotiate the existing agreement to arrive at something that would be acceptable to all three of those constituencies at this time.

I am doing everything in my power to work toward opening those negotiations.

Senator HAGEL. Does it not occur to you—and I suspect it has—that we are dealing here with the second largest economy in the world, that of Japan, but yet it has developing country provisions in it? Are we not talking about a charade here and wouldn't that subject all further treaties to an erosion of any confidence or any standards?

Mr. WEST. I would only comment, Mr. Chairman, not by way of justification but by way of context, that two of our three largest trading partners—that is, Canada and Japan—both hold that same position regarding interest withholding tax rates.

Senator HAGEL. The Secretary probably will be getting another letter.

I want you to know that there are a number of us on this committee who would be very happy to work with you on this, Mr. West, if you feel you are not getting the kind of support and impetus you need. We would look forward to working with you on this.

Mr. WEST. I very much appreciate that.

Senator HAGEL. Ms. Paull, is there anything you would like to add to what Mr. West has said in any of these areas, these general areas—anything we have talked about this afternoon?

Ms. PAULL. No. I think I probably have outstayed my welcome.

Senator HAGEL. Oh, you have been most helpful, as always.

We could spend the rest of the day with some of the more specific areas that we have not gotten into. But, suffice it to say we will submit in writing some questions for details of some of the more specific areas we want to get into.

This committee has a business meeting on November 3. Obviously, as is always the case, the more timely the response, the more likely that we could turn some of this around.

As always, we are grateful that you could come up today, Mr. West. We appreciate it very much.

Ms. Paull, it is always nice seeing you. Thank you very much.

Are there any last comments?

Mr. WEST. I would just say, again, that we request all of these treaties be favorably acted on. Thank you for your time.

Senator HAGEL. Thank you.

Mr. Murray, are you still awake?

Please come forward to the table. We will give you some coffee or water, whatever you need.

Mr. Murray, thank you. We are grateful that you are here today and look forward to your testimony. Please proceed.

**STATEMENT OF FRED F. MURRAY, VICE PRESIDENT FOR TAX POLICY, NATIONAL FOREIGN TRADE COUNCIL, WASHINGTON, DC**

Mr. MURRAY. Thank you, Mr. Chairman. I am very happy to be here. As you have noted, my name is Fred Murray. I am vice president for tax policy of the National Foreign Trade Council.

The NFTC is an association of businesses with some 500-plus members founded in 1914. It is the oldest and largest U.S. association of businesses devoted to international trade matters.

Most of the largest U.S. manufacturing companies and most of the 50 largest U.S. banks are members. They account for approximately 70 percent of all U.S. nonagricultural exports and 70 percent of U.S. private foreign investment.

We are here today to recommend ratification of these treaties and protocols under consideration by the committee. We appreciate the chairman's and the committee's actions in scheduling this hearing and agreeing to receive both our testimony and our written statement for the record.

Expanding U.S. foreign trade and investment and incorporating the United States into an increasingly integrated world economy is an evermore important concern. Foreign trade is fundamental to our economic growth and our future standard of living. Although the U.S. economy is still the largest economy in the world, its growth rate represents a mature market for many of our companies.

As such, U.S. employers must export in order to expand the U.S. economy by taking full advantage of the opportunities in overseas markets.

Today, some 96 percent of U.S. firms' potential customers are outside the United States. In the 1990's, some 86 percent of the gains in worldwide economic activity occurred outside the United States.

In recent years, exports have accounted for as much as one-third of total U.S. economic growth.

As global competition grows ever more intense, it is vital to the health of the U.S. economy and to our enterprises that they be free from excessive foreign taxes or double taxation that can serve as a barrier to full participation in the international marketplace.

Tax treaties are a crucial component of the framework that is necessary to allow such balanced competition. The NFTC has long

supported the expansion and strengthening of the U.S. tax treaty network.

As you noted, the United States has in force approximately 59 income tax treaties, depending on how you count certain of the agreements with the former Soviet Union. It has taken more than 60 years to negotiate, sign, and approve these treaties that form the current network. And, although there has been significant progress in recent years in expanding the treaty network, the U.S. treaty network still covers considerably less of the developing world compared to coverage by the networks of Japan and leading European nations and is still considerably smaller than some of our major trading partners.

This discrepancy has persisted for many years, even though the United States relies on the developing world to buy a far larger share of its exports than does Europe.

Five of the eight agreements before the committee today represent new tax treaty relationships with the United States. The remaining three agreements modify existing relationships. Virtually all treaty relationships depend upon difficult, and sometimes delicate, negotiations aimed at resolving conflicts between the tax laws and policies of the negotiating countries.

The resulting compromises always reflect a series of concessions by both countries from their preferred positions.

With one exception that I will later note, we believe that the treaties and protocols presently under consideration represent a good compromise and that they will contribute significantly both to the economic competitiveness of U.S. companies and to the proper administration of U.S. tax laws.

Though all of the treaties before the committee today are important and serve to expand the tax treaty network of the United States, two of the treaties before the committee are especially important to U.S. business interests.

First, let me address the treaty with Venezuela. Venezuela is a major destination for U.S. based foreign investment, and the U.S. is a major recipient of Venezuelan foreign investment. Venezuela is the second largest importer and exporter to the U.S. in the Western Hemisphere outside of those countries in NAFTA. Only Brazil exceeds Venezuela.

The U.S. is Venezuela's most important trading partner, and many U.S. based companies have a significant stake in Venezuela. In fact, I have been told that as many as 1,000 companies are members of the "AMCHAM" in Venezuela.

If the treaty is ratified and comes into force and effect, U.S. companies will be put on the same competitive footing that companies from other nations currently have in their relationships with Venezuela. There are 12 other countries with whom Venezuela currently has double taxation treaties.

The United States currently has no tax treaties in force and effect with countries on the continent of South America. This remark bears special emphasis.

South American countries, including Venezuela, consistently rank at or near the top of NFTC surveys in their importance to U.S. based companies. This treaty is extremely important, as noted

above, because of its importance to U.S. based companies and their interests in Venezuela.

It is perhaps even more critically important because its ratification would tend to encourage more cooperation between the new Government of Venezuela and that of the United States. Conversely, failure to ratify the treaty may have important negative implications to that relationship.

It is difficult to overstate the importance of gaining a foothold in our treaty network with South American countries, particularly in light of some of the tensions that have previously existed with some of our neighbors and friends to the south.

We are concerned, or, we have been made aware of some of the concerns that the committee has become aware of in regard to the situation there. I must say that my members report to me that they are cautiously optimistic about the situation in Venezuela and support the treaty. They hope that the committee will look upon it favorably.

In fact, the NFTC congratulates the Treasury for its efforts to persevere through some difficult negotiations of this treaty, and through the change in government, to make this landmark treaty.

I would also note that I am informed by some of my colleagues that the new law that has been the subject of some discussion this afternoon is to be published in the "Official Gazette" this afternoon, as we speak.

The Treasury Department is also to be commended for modernizing tax treaties with our major trading partners and, specifically, members of the European Union.

The new tax treaty with Italy updates the existing treaty to reflect current tax policies in the United States and Italy. In addition to its other important contributions, the new treaty addresses the replacement of the ILOR, the local income tax, by the new Italian regional tax on productive activities, the IRAP. This provision is very important to our companies and, in spite of the inclusion of the other provision that has been the subject of much discussion this afternoon and which has caused a lot of concerns not only within our membership but certainly within the committee as we have discussed or heard discussed, it is very important that the treaty, with or without the offending provision, be ratified so that the provision governing the creditability of the ILOR come into force and effect.

Our economic relationship with the Italian Republic is one of our most important and the changes made by the treaty are beneficial and important to our companies and workers.

Ratification of the treaties and protocols before the committee today continues the momentum that is needed to bring other nations into the U.S. treaty network. It sends a continuing signal that the U.S. wishes to reduce and eventually eliminate existing impediments to global business.

Again, the Council is grateful to the chairman and to the members of the committee for the opportunity to speak before the committee. We respectfully urge the committee to proceed with ratification of these treaties and protocols as expeditiously as the committee finds it appropriate.

I would like, given the discussion this afternoon, to make one additional comment before I close, Mr. Chairman. The two agreements that have been mentioned in a number of the comments and questions, those with Italy and Slovenia, contain this main purpose test that has been much discussed. Although the NFTC does not support inappropriate use of such treaties, the wording of these tests is vague and unclear. The tests must be applied in a subjective way under treaty language that may be difficult to change if they do not work as intended.

The questions and answers have elicited a number of comments about these types of subjective rules. We have found in other circumstances where the principal purpose test has been used, or tests like the business purpose test, that there is a good deal of uncertainty and quite a bit of litigation. It gives rise to some concern in respect of the inclusion of these rules in this particular context.

The rules may cause considerable uncertainty to taxpayers in the application of the otherwise available provisions of the treaties. In that respect, we certainly adopt Ms. Paull's concerns.

That concludes my oral remarks this afternoon. I would be pleased to answer your questions.

[The prepared statement of Mr. Murray follows:]

PREPARED STATEMENT OF FRED F. MURRAY

Mr. Chairman, and Members of the Committee:

The National Foreign Trade Council, Inc. (the "NFTC" or the "Council") is pleased to present its views on ratification of the various income tax treaties and protocols before the Committee today.[1] We are here today to recommend ratification of the treaties and protocols under consideration by the Committee. We appreciate the Chairman's and the Committee's actions in scheduling this hearing and agreeing to receive our testimony and written statement. We strongly urge this Committee to reaffirm the United States' historic opposition to double taxation by giving your full support to the pending treaties.

The NFTC is an association of businesses with some 550 members, originally founded in 1914 with the support of President Woodrow Wilson and 341 business leaders from across the U.S. It is the oldest and largest U.S. association of businesses devoted to international trade matters. Its membership now consists primarily of U.S. firms engaged in all aspects of international business, trade, and investment. Most of the largest U.S. manufacturing companies and most of the 50

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[1] Convention Between the Government of the United States of America and the Government of the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income Signed at Washington, D.C., on the 9th Day of August, 1999, Together with a Protocol Signed at the Same Time and Place; Convention Between the United States of America and the Republic of Estonia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Signed at Washington, D.C., on the 15th Day of January, 1998; Protocol Signed at Washington, D.C., on the 14th Day of December, 1998, Amending the Convention Between the United States of America and Federal Republic of Germany For the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts, Signed at Bonn on December 3, 1980; Convention Between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation With Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, Signed at Washington, D.C., on the 25th Day of August, 1999, Together with a Protocol Signed at the Same Time and Place; Convention Between the United States of America and the Republic of Latvia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Signed at Washington, D.C., on the 5th Day of January, 1998; Convention Between the Government of the United States of America and the Government of the Republic of Lithuania for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington, D.C., on the 15th Day of January, 1998; Convention Between the United States of America and the Republic of Slovenia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Signed at Ljubljana, on the 21st Day of June, 1999; And, Convention Between the Government of the United States of America and The Government of the Republic of Venezuela for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Signed at Caracas on the 25th Day of January, 1999, Together with a Protocol Signed at the Same Time and Place.

largest U.S. banks are Council members. Council members account for at least 70% of all U.S. nonagricultural exports and 70% of U.S. private foreign investment. A significant NFTC emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities and anomalies.

The founding of the Council was in recognition of the growing importance of foreign trade and investment to the health of the national economy. Since that time, expanding U.S. foreign trade and investment, and incorporating the United States into an increasingly integrated world economy, has become an even more vital concern of our nation's leaders. The share of U.S. corporate earnings attributable to foreign operations among many of our largest corporations now exceeds 50 percent of their total earnings. Even this fact in and of itself does not convey the full importance of exports to our economy and to American-based jobs, because it does not address the additional fact that many of our smaller and medium-sized businesses do not consider themselves to be exporters although much of their product is supplied as inventory or components to other U.S.-based companies who do export.

Foreign trade is fundamental to our economic growth and our future standard of living.[2] Although the U.S. economy is still the largest economy in the world, its growth rate represents a mature market for many of our companies. As such, U.S. employers must export in order to expand the U.S. economy by taking full advantage of the opportunities in overseas markets. Today, some 96% of U.S. firms' potential customers are outside the United States, and in the 1990's 86% of the gains in worldwide economic activity occurred outside the United States. In recent years, exports have accounted for as much as one-third of total U.S. economic growth.[3]

TAX TREATIES AND THEIR IMPORTANCE TO THE UNITED STATES OF AMERICA

Given the importance of the international economy to the United States, the Council is grateful to the Committee for giving international economic relations a prominent place on its agenda.

As noted, our membership is actively engaged in a broad spectrum of industrial, commercial, financial, and service activities. The NFTC therefore seeks to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad. As global competition grows ever more intense, it is vital to the health of U.S. enterprises, and to their continuing ability to contribute to the U.S. economy, that they be free from excessive foreign taxes or double taxation that can serve as a barrier to full participation in the international marketplace. Tax treaties are a crucial component of the framework that is necessary to allow such balanced competition. The NFTC has long supported the expansion and strengthening of the U.S. tax treaty network.

Tax treaties are bilateral agreements between the United States and foreign countries that serve to harmonize the tax systems of the two countries. In the absence of tax treaties, income from international transactions or investment may be subject to "double taxation:" once by the country where the income arises and again by the country of the income recipient's residence. Tax treaties eliminate this double taxation by allocating taxing jurisdiction between the two treaty countries.

[2] "Continued robust exports by U.S. firms in a wide variety of manufactures and especially advanced technological products—such as sophisticated computing and electronic products and cutting-edge pharmaceuticals—are critical for maintaining satisfactory rates of GDP growth and the international competitiveness of the U.S. economy. Indeed, it is widely acknowledged that strong export performance ranks among the primary forces behind the economic well-being that U.S. workers and their families enjoy today, and expect to continue to enjoy in the years ahead." Gary Hufbauer (Reginald Jones Senior Fellow, Institute for International Economics) and Dean DeRosa (Principal Economist, ADR International, Ltd.), "Costs and Benefits of the Export Source Rule, 1998–2002," A Report Prepared for the Export Source Coalition, February 19, 1997. For an extensive discussion of the importance of foreign operations and cross-border trade and investment to the United States and the effects of globalization of the world economy, see Ch. 5, "The NFTC Foreign Income Project: International Tax Policy for the 21st Century; Part One: A Reconsideration of Subpart F," National Foreign Trade Council, Inc., Washington, D.C., March 25, 1999.

[3] See, Fourth Annual Report of the Trade Promotion Coordinating Committee (TPCC) on the National Export Strategy: "Toward the Next Century: A U.S. Strategic Response to Foreign Competitive Practices," October 1996, U.S. Department of Commerce, ISBN 0–16–048825–7; J. David Richardson and Karin Rindal, "Why Exports Matter: More!," Institute for International Economics and the Manufacturing Institute, Washington, D.C., February 1996.

In addition, the tax systems of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners. These taxes can be reduced only by treaty. If U.S. enterprises earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they may suffer double taxation and be unable to compete with business ventures from other countries that do have such benefits. Thus, tax treaties serve to prevent this barrier to U.S. participation in international commerce.

Tax treaties also provide other features which are vital to the competitive position of U.S. businesses. For example, by prescribing internationally agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring foreign tax laws to be applied in a nondiscriminatory manner to U.S. enterprises, treaties offer a significant measure of certainty to potential investors. Another extremely important benefit, that is available exclusively under tax treaties, is the mutual agreement procedure, a bilateral administrative mechanism for avoiding double taxation.

The United States has in force some forty-nine[4] Conventions for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income ("income tax treaties") with various jurisdictions, not including other agreements affecting income taxes and tax administration (e.g., Exchange of Tax Information Agreements or Treaties of Friendship and Navigation that may include provisions that deal with tax matters). It has taken more than sixty years to negotiate, sign, and approve the treaties that form the current network.[5] A number of new agreements are being negotiated by the Treasury Department. Nevertheless, the U.S. treaty network has never been as extensive as the treaty networks of our principal competitors. The U.S. treaty network still covers considerably less of the developing world, compared to coverage by the networks of Japan and leading European nations. This discrepancy has persisted for many years, even though the United States relies on the developing world to buy a far larger share of its exports than does Europe.

As noted above, the typical income tax treaty provides for the elimination or at least mitigation of double taxation in a number of ways: modification of sourcing rules, clarification of rules affecting computation of foreign tax credits, specification of certain taxes that may be considered income taxes for the purposes of the foreign tax credit, rules allocating income to permanent establishments or establishing transfer prices, rules establishing the competent authority mechanism, and other rules in which jurisdiction to tax is relinquished. The reciprocal reduction of withholding taxes imposed by the respective contracting states on dividends, interest, royalties, and certain other types of cross-border flows is the most important form of mutually agreed relinquishment of jurisdiction to tax. The treaties also provide a number of "administrative" mechanisms for resolution of disputes as to state of residence, exchange of tax information between tax authorities of the two contracting states, nondiscrimination against nationals or other parties of one contracting state by the other contracting state, and the like.

The principal function of an income tax treaty is to facilitate international trade, investment, and commerce by removing or preventing tax barriers to the free flow or exchange of goods and services and the free movement of capital and persons. In making such an agreement, a contracting state acts in two capacities.

First, as a country of residence, the contracting state imposes tax on the income derived by resident individuals and legal entities (and, in countries like the United States that tax their citizens on a world-wide basis, its non-resident citizens and those legal entities organized under its laws or otherwise subject to its jurisdiction). In this capacity, the contracting state seeks to minimize the source-based taxes imposed on these taxpayers by the other contracting state, its treaty partner. If, like the United States, its system of world-wide taxation is relieved by a foreign tax credit mechanism, it will have a revenue interest in this result, but even in other circumstances, it will have an interest in the reduction of source-based taxes as a

[4] The count is somewhat imprecise—e.g., the effects of the treaty with the former Union of Soviet Socialist Republics and its effects on the former members of that Union are not considered (the count may be increased by up to nine depending upon how such effects are determined). Some treaties have been terminated in part, and there are a number under active negotiation or renegotiation, or that have been signed but not ratified.

[5] The current international consensus favoring income tax treaties is derived from sixty years of evolution, starting with the model income tax treaty drafted by the League of Nations in 1927, culminating in its "London Model" treaty in 1946, and carried on later by the United Nations, and the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development ("OECD"). The U.S. first signed a bilateral tax treaty in 1932 with France, which treaty never went into force. The first effective treaty, also with France, was signed July 25, 1939, and came into force on January 1, 1945.

means of assuring fair treatment of its taxpayers and promoting their foreign trade and commerce.

Second, the country of source may impose a tax on income derived by individuals and entities resident in its treaty partner. In this role, the contracting states have multiple and sometimes incongruent interests. The source country may be interested in protecting its revenues from unwarranted erosion. However, it is also concerned with providing a hospitable environment for desirable inbound foreign investment. As these bilateral treaties are reciprocal agreements, contracting states must be willing to make concessions with respect to taxing authority to gain similar reciprocal concessions from its treaty partner.

The loss of revenue from withholding taxes, or other reductions of source-based taxation has now, after these six decades, become generally accepted as the price for obtaining for its taxpayers the benefits of neutral tax treatment with respect to their international trade, investment, and commerce. In fact, there has developed a remarkably broad, general consensus among national governments, even those who agree on few other principles, that it is in their interest to enter into income tax treaties, and almost as broad consensus as to the form of the mechanisms adopted.

Income tax treaties enable U.S. firms to compete in foreign countries, and foreign firms to establish plants in the United States and invest in U.S. securities. Without the tax treaty network and complementary national legislation, double taxation would create an enormous barrier to the international movement of capital and technology. Likewise, a crippling of our treaty network could cause world trade to shrink because so much of it depends upon cross-border investment and open channels for movement of capital and technology.

A study, conducted under the auspices of the NFTC, illustrates the possible consequences of abandoning all existing U.S. tax treaties, and, in selective ways, changing U.S. tax laws to extract more revenue from inward foreign investment:

- Broadly speaking, the average foreign tax burden on income flowing to the United States, which is predominantly from direct investment and therefore subject to foreign corporate tax as well as withholding taxes, would rise from about 16.0 percent (with a treaty network) to about 23.4 percent (without a treaty network). The average U.S. tax burden on income flowing to foreign investors would similarly rise from about 9.1 percent to about 14.1 percent.
- In relative terms, the tax burdens on U.S. investment abroad and foreign investment in the United States would thus escalate by about the same amount. However, the absolute tax level is lower on foreign investments in the United States because that investment is concentrated in bank deposits and portfolio securities, which are not immediately subject to the U.S. corporate income tax.
- As a consequence of higher tax rates, international investment could implode. Using a conservative estimating procedure, it was calculated that the stocks of U.S. investment abroad and foreign investment in the United States would each shrink by about $340 billion annually, without a treaty network.
- Reduced foreign investment in the United States would curb competition in the U.S. marketplace and raise U.S. interest rates. U.S. consumers would have to pay higher prices for a smaller variety of goods, investment would be squeezed and, ultimately, growth rates would be lower. In addition, the smaller role of multinational firms would curtail U.S. exports by some $21 billion annually, which would reduce the domestic employment of those firms and their suppliers by an estimated 340,000 jobs.
- In order for the U.S. Treasury to realize any revenue gain from the non-treaty world, the Congress would need to impose a new withholding tax on interest paid to foreign investors on their U.S. bank deposits and Treasury securities. At a rate of 5 percent, the new tax would raise significant revenue, about $6.4 billion annually. However, the larger tax revenues would be more than offset by the inevitable rise in U.S. Treasury interest payments (net of associated tax reflows) on Treasury debt held by the public in this country and abroad. Higher interest payments to the public (net of tax reflows) were estimated by the model at $7.1 billion.
- If the level of international investment imploded by twice as much as the conservative estimating procedure might suggest, the U.S. Treasury would lose $0.8 billion on U.S. income payments to foreigners, and $3.2 billion on U.S. income receipts from foreign sources In other words, the Treasury could lose up to $40 billion from a policy that abandoned the U.S. tax treaty network.
- In any event, U.S. multinational enterpnses would be substantially worse off. Their income flows before foreign tax would contract from $279 billion to $240 billion. Their combined tax burden, counting payments both to foreign governments and the U.S. Treasury (after allowing for the U.S. foreign tax credit),

would rise by $9.4 billion. The loss of income coupled with a rising tax burden would significantly impair the competitive strength of U.S. multinational enterpnses relative to rival firms based in Japan and Europe.

—G. Hufbauer, "Tax Treaties and American Interests—A Report to the National Foreign Trade Council, Inc." (1988).

While the preceding analysis is now somewhat out of date, world-wide expansion of business enterprises and the increasing importance of foreign investment flows and exports have served to increase the importance of our treaty network. These conclusions nevertheless serve to illustrate the importance of maintaining and expanding the treaty network of which the United States is a member, and in a world in which U.S. multinational enterprises must compete. Absent a "level playing field" environment, taxes of all types on the income and capital flows of U.S. multinational enterprises can easily escalate in proportion to the economic activity involved. Particularly where more than two junsdictions are involved, they can exceed one hundred percent.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the U.S. Treasury by providing for the exchange of information between tax authorities. Treaties have also provided a framework for the resolution of disputes with respect to overlapping claims by the respective governments. In particular, the practices of the Competent Authorities under the treaties have led to agreements, known as "Advance Pricing Agreements" or "APAs" within which tax authorities of the United States and other countries, have been able to avoid costly and unproductive disputes over appropriate transfer prices for the trade in goods and services between related entities. APAs, which are agreements jointly entered into between one or more countries and particular taxpayers, have become common and increasingly popular procedures for countries and taxpayers to settle their transfer pricing issues in advance of dispute. The clear trend is that treaties are becoming an increasingly important tool used by tax authorities and taxpayers alike in striving for fairer and more efficient application of the tax laws.

TREATIES BEFORE THE COMMITTEE TODAY

Five of the eight agreements before the Committee today represent new tax treaty relationships for the United States: Estonia, Latvia, Lithuania, Slovenia, and Venezuela. The remaining three agreements modify existing relationships.

Virtually all treaty relationships depend upon difficult and sometimes delicate negotiations aimed at resolving conflicts between the tax laws and policies of the negotiating countries. The resulting compromises always reflect a series of concessions by both countries from their preferred positions. Recognizing this, but also cognizant of the vital role tax treaties play in creating a level playing field for enterprises engaged in international commerce, the NFTC believes that treaties should be evaluated on the basis of their overall effects in encouraging international flows of trade and investment between the United States each of its treaty partners, in providing the guidance enterprises need to plan for the future, in providing nondiscriminatory treatment for U.S. traders and investors as compared to those of other countries, and in meeting a minimum level of acceptability in comparison with the preferred U.S. position and expressed goals of the business community. Comparisons of a particular treaty's provisions with the U.S. Model or with treaties with other countries may not in some cases provide an appropriate basis for analyzing a treaty's value.

The treaties and protocols presently under consideration represent a good illustration of the contribution of such agreements to the economic competitiveness of U.S. companies and to the proper administration of U.S. tax laws. Each of these treaties also includes important advantages for the administration of U.S. tax laws. They offer the possibility of administrative assistance between the relevant tax authorities. The treaties also include modern safeguards against treaty-shopping in accordance with established U.S. policy.

Moreover, each of the new treaties contains two very significant provisions of great importance. First, each treaty contains a nondiscrimination article which ensures even-handed treatment of taxpayers by both contracting states. Second, they contain a mutual agreement article which ensures that each country lives up to its treaty obligations to avoid double taxation.

Likewise, these treaties set international norms for the conduct of administrative audits of transactions between affiliates and provides a mechanism to resolve tax disputes. Without these, U.S. companies could not be assured of protections against arbitrary tax assessments. These tax treaties help create the environment for predictable tax treatment of cross-border business transactions so necessary to successful global business enterprises. Transactions in tangible goods, intangible goods in-

cluding computer software, information and services are more viable if the tax rules applied are consistent and avoid double taxation. It is vital that these treaties be ratified so that U.S.-based business can be better prepared to compete in an global marketplace.

Though all of the treaties before the Committee today are important and serve to expand the tax treaty network of the United States, two of the treaties before the Committee are especially important to U.S. business interests.

### REPUBLIC OF VENEZUELA

According to data received by NFTC, Venezuela is a major destination for U.S.-based foreign investment, and the U.S. is a major recipient of Venezuelan foreign investment. In fact, Venezuelan companies and individuals have invested more than one-hundred billion dollars in the United States. Venezuela exported more than $9.3 billion in trade to the U.S. in 1998, and imported more that $6.5 billion that year. Venezuela is the second largest importer and exporter to the U.S. in the Western Hemisphere outside of those countries in the North American Free Trade Agreement (Brazil is first).

*The United States currently has no tax treaties in force and effect with countries on the continent of South America.* This remark bears emphasis. South American countries, including Venezuela, consistently rank at or near the top of NFTC surveys in their importance to U.S.-based companies. The U.S. is Venezuela's most important trading partner, and many U.S.-based companies have a significant stake in Venezuela, its economy and its people. If the treaty is ratified and comes into force and effect, U.S.-Venezuela business will be put onto the same competitive footing that companies from other nations currently have in their relationships in Venezuela. There are twelve other countries with whom Venezuela currently has double taxation treaties.[6]

This treaty is extremely important, as noted above, because of its importance to U.S.-based companies and their interests in Venezuela. It is perhaps even more critically important because its ratification would tend to encourage more cooperation between the government of Venezuela and that of the United States. Conversely, failure to ratify the treaty may have important negative implications to that relationship. It is difficult to overstate the importance of gaining a foothold in our treaty network with South American countries, particularly in light of some of the tensions that have sometimes existed between the U.S. and its neighbors and friends to the south.

The NFTC congratulates the Treasury for its efforts to persevere through difficult negotiations and changes in governments in Venezuela to make this landmark treaty.

### ITALIAN REPUBLIC

The Treasury Department is to be commended for modernizing tax treaties with our major trading partners and specifically members of the European Union.

The new treaty with Italy updates the existing treaty to reflect current tax policies in the United States and Italy. The new treaty addresses the replacement of the Italian local income tax (l'imposta locale sul redditi or "ILOR") by the new Italian regional tax on productive activities (l'imposta regionale sulle attivat . . . produttive or "IRAP"), revises the withholding rates for passive investment income for residents of each country, and strengthens the administrative provisions. Our economic relationship with the Italian Republic is one of our most important, and the changes made by the treaty are beneficial and important to our companies and workers.

Ratification of the treaties and protocols before the Committee today continues the momentum that is needed to bring other nations into the U.S. treaty network. It sends a continuing signal that the U.S. wishes to reduce and eventually eliminate existing impediments to global business. The larger business community hopes that side issues do not get in the way of a treaty process that is working. We are extremely pleased that both the Executive Branch and the Congress have given the tax treaties very high priority.

### GENERAL COMMENTS ON TAX TREATY POLICY

The NFTC also wishes to emphasize how important treaties are in creating, preserving, and implementing an international consensus on the desirability of avoid-

[6] Belgium, Czech Republic, France, Germany, Italy, Norway, Portugal, Sweden, Switzerland, The Netherlands, Trinidad & Tobago, and the United Kingdom. (A treaty with Mexico ratified by Venezuela is pending ratification by Mexico.)

ing double taxation, particularly with respect to transactions between related entities. The United States, together with many of its treaty partners, has worked long and hard to promote acceptance of the arm's length standard for pricing transactions between related parties. The worldwide acceptance of this standard, which is reflected in the intricate treaty network covering the United States and dozens of other countries, is a tribute to our government's commitment to prevent conflicting income measurements from leading to double taxation and the resulting distortions and barriers for healthy international trade. Treaties are a crucial element in achieving this goal, because they express both government's commitment to the arm's length standard and provide the only available bilateral mechanism, the competent authority procedure, to resolve overlapping claims.

The NFTC recognizes that determination of the appropriate arm's length transfer price for the exchange of goods and services between related entities is sometimes a complex task which can lead to good faith disagreements between well-intentioned parties. Nevertheless, the points of international agreement on the governing principles far outnumber any points of disagreement. Indeed, after decades of close examination, governments around the world agree that the arm's length principle is the best available standard for determining the appropriate transfer price, because of both its economic neutrality and its ability to be applied by taxpayers and revenue authorities alike by reference to verifiable data.

The NFTC strongly supports the efforts of the Internal Revenue Service and Treasury to promote continuing international consensus on the appropriate transfer pricing standards. We applaud the continuing growth of the Advance Pricing Agreement ("APA") program, which is designed to achieve agreement between taxpayers and revenue authorities on the proper pricing methodology to be used, before disputes arise. We commend the Internal Revenue Services' efforts to refine and improve the competent authority process under treaties, to make it a more efficient and reliable means to avoid double taxation.

The NFTC supported the arbitration option in earlier treaties with Germany, Mexico, and The Netherlands, and we urge that it be readily available in those unusual cases where competent authority negotiations prove unsuccessful.

These developments emphasize the international consensus behind the arms-length standard. We cannot overemphasize the potential damage we believe could result from any movement away from that consensus.

In fact, a recurring theme of our testimony is the importance of considering the United States as a member of the world community of nations, and the importance to United States business interests of providing harmony between the tax system of the United States and that of other nations where United States companies must conduct their business. The same is true as well for foreign investors who invest capital in the United States.

The NFTC also wishes to reaffirm its support for the existing procedure by which Treasury consults on a regular basis with this Committee, the tax-writing Committees, and the appropriate Congressional Staffs concerning treaty issues and negotiations and the interaction between treaties and developing tax legislation. We encourage all participants in such consultations to give them a high priority. We also respectfully encourage this Committee to schedule tax treaty hearings, if possible at least once a year, to enable improvements in the treaty network to enter into effect as quickly as possible.

The NFTC also wishes to reaffirm its view, frequently voiced in the past, that Congress should avoid occasions of overriding by subsequent domestic legislation the U.S. treaty commitments that are approved by this Committee. We believe that consultation, negotiation, and mutual agreement upon changes, rather than unilateral legislative abrogation of treaty commitments, better supports the mutual goals of treaty partners.

Two of the agreements before the Committee today, those with Italy and Slovenia, have provisions that contain "main purpose" tests that do not appear in any other U.S. treaties or the U.S. Model Treaty. Although NFTC does not support inappropriate use of such treaties, the wording of these tests are vague and unclear. The tests must be applied in a subjective way under treaty language that may be difficult to change if they do not work as intended. The rules may cause considerable uncertainty to taxpayers in the application of otherwise available provisions of the treaties. The NFTC would hope that the Treasury would not use its franchise to negotiate treaties as a way to achieve new authority under new and untested general anti-avoidance rules, particularly where the need for such rules has not been vetted in the public discourse or has been refused by the Congress in other contexts. NFTC strongly supports the immediate ratification of both treaties, but finds the inclusion of these test provisions to be troubling.

IN CONCLUSION

Again, the Council is grateful to the Chairman and the Members of the Committee for giving international economic relations prominence in the Committee's agenda. The NFTC appreciates the opportunity to submit written comments on the treaties and protocols pending before the Committee. We respectfully urge the Committee to proceed with ratification of these treaties and the protocol as expeditiously as possible.

Senator HAGEL. Mr. Murray, thank you. We appreciate very much what you have said and also what your organization does for our country.

Mr. MURRAY. Thank you, Mr. Chairman.

Senator HAGEL. You have been very important to this country in our exports and our interests in the world. We recognize that and appreciate it very much.

Mr. MURRAY. Thank you, Mr. Chairman.

Senator HAGEL. Let me begin with your last comment. I think you said regarding the main purpose test, the uncertainty, and your paraphrasing of what Ms. Paull and Mr. West said, that you tend to agree with Ms. Paull's concerns. Is that fair and accurate?

Mr. MURRAY. Yes, Mr. Chairman, I believe it is.

Senator HAGEL. What does that mean?

Mr. MURRAY. That is probably the hardest question you have asked this afternoon in many respects.

As I noted in my testimony and as others have noted, all of the treaties reflect a balancing of various concessions made by both parties, and there are certainly provisions, as I mentioned, in the Italy treaty that are very important to us. So I have to preface my remark by consideration that my membership really does want the Italian treaty, at least those provisions that apply to the difficult transition issue that I mentioned, to come into force and effect.

But I think it is also important to look at the policy underlying some of the concerns that both Mr. West and Ms. Paull have discussed this afternoon.

These provisions are new. We have not yet had a chance to really parse through how they would work. The wording is fairly vague.

I might also note, in addition to the other concerns that have been expressed, that there is a general concern, I think, in our jurisprudence about the use of general anti-avoidance rules. Some of the countries mentioned this afternoon make more prevalent use of such rules in their jurisprudence. But your colleagues on the tax writing committees have been very reluctant to make use of those rules in the past. In fact, as Mr. West noted, there are only two other instances of which I am aware that such a rule has been incorporated into our Internal Revenue Code.

So I guess the bottom line, so to speak, is that we are uncertain exactly what to make of these rules. But we are troubled by them.

Senator HAGEL. You noted that your members had given you some sense of what they think is going on in Venezuela. I believe your term was that they are cautiously optimistic.

Would you develop a little more what your members tell you about what is going on and how this might have a consequence and effect on the treaty and business?

Mr. MURRAY. I think probably the best place to start, Mr. Chairman, in answer to that question is to sort of echo what Mr. West

said about what he had heard from the State Department in this respect. I think it echoes to some degree what I have heard from our member companies who are on the ground in Venezuela.

I also had the occasion to have breakfast with Ambassador Toro Hardy last week from Venezuela and to hear his view of how some of these things were developing. I guess the proper way to sum it up would be to say that, although I think there is a good deal of transition—perhaps that is the best way to say it—that is going on in Venezuela now, at least those on the ground that have had discussion with me have indicated that, so far, things seem to be proceeding in a direction that would tend to support the thought that they are moving toward greater development of their democracy and not the other way around. Commercial interests seem to be, as I have said, cautiously optimistic that things will continue to develop in that direction.

It is certainly a situation that bears watching and there have been enough developments this year that have probably caused not only those who are citizens of Venezuela but also those who have to do business in Venezuela to carefully watch the situation.

Senator HAGEL. So it is your analysis, your judgment, your conclusion, based on the input you receive from members and others, that the best thing we could do is to ratify this treaty and move on, that that would be the most positive and, hopefully, potentially beneficial for future trade with Venezuela?

Mr. MURRAY. Mr. Chairman, while we certainly understand the concerns that the committee has expressed, that members of the committee have expressed, at least in some of our conversations in recent weeks, I think our members believe that that is the best course of action at this time.

Senator HAGEL. Thank you.

Let's talk about the Baltic states treaties now. Give this committee, if you would, your sense of how important that is. Are we looking at a rather dramatic breakthrough or not? Does it matter?

What do you think?

Mr. MURRAY. That is a hard question, also.

Senator HAGEL. Oh, Senator Sarbanes asks all of the hard questions.

Mr. MURRAY. You should be entitled also.

Senator HAGEL. I'll tell him that.

Mr. MURRAY. I think, Mr. Chairman, those treaties are important, not only because of the commercial relationships that exist between the United States and those republics but also because they represent an extension of our tax treaty network. It is difficult for me to assess the commercial importance of those treaties because they perhaps involve relationships that are somewhat newer than the more established relationships that we have in places like Italy and Venezuela, where our companies have been present for many years.

Senator HAGEL. What do your members say about it? Are they excited about these treaties? Will they jump on the next plane and go to the Baltics? What do your members think?

Mr. MURRAY. To be honest, I have not heard a great deal of discussion from my members with respect to those particular treaties. But I think I have found in previous discussions that one of the

reasons, in fact, why we spend so much time and energy supporting the Treasury Department's extension of the tax treaty network is because our members find that tax treaties play an integral role in expanding investment in these types of countries and help very much for our companies to, as you say, develop the certainty they need to make those kinds of investments.

So I would hope that it would lead to greater commercial exports and investment.

Senator HAGEL. I personally believe it will. I was in Lithuania in December and I think there is great potential there. The more of the uncertainty that we have talked about this afternoon that we can remove from investment decisions, obviously the better off we are. I do think the Baltic piece of this is an important piece.

You heard the give and take regarding Japan. Would you care to comment on the treaty with the Japanese, Third World concessions, and some of the other areas that we got into here today?

Mr. MURRAY. Mr. Chairman, we agree to the utmost with the comments and questions that you raised in regard to the treaty. We think that particular treaty relationship is out of kilter with the rest of our network.

As you noted, the provisions of the treaty are almost ancient by comparison to some of our other treaties. They are approximately 30 years old now and they do not work very well in the context of not only U.S. business operating in Japan, but some of our members who are Japanese companies have also expressed to us—in fact, I got a letter this morning from a major Japanese company—an interest in our work in trying to find a way to get that treaty renegotiated.

We understand Mr. West's concerns about some of the negotiations. But, at the same time, we feel that if our executive branch and the Congress make enough of an issue with this, the Japanese will come to the table and, hopefully, will be able to negotiate an arrangement that is satisfactory to both governments.

Senator HAGEL. Have you or your organization talked to Mr. West or any of his colleagues about this particular renegotiation?

Mr. MURRAY. Yes, Mr. Chairman. We had a dialog with the Treasury actually over several years, going back a number of years now, about this particular treaty. Most recently, six CEO's of our companies went in with me to talk to Secretary Summers about this particular treaty. It was our impression from the meeting that the Secretary was interested in renewing some of the internal discussions about how best to proceed forward with the negotiations.

He seemed to be supportive and that was encouraging to us, as well.

Senator HAGEL. Well, you heard what I said about it. I would be very happy to help, as I suspect some of my colleagues would, as well. Maybe we could revisit that, all of us together.

Mr. MURRAY. Thank you, Mr. Chairman. In doing our surveys and some of our internal analysis of the treaty network, we have found that that particular treaty is of concern to a great number of our companies. In fact, there are over 60 companies that presently are in our working group that are looking at ways to try to advance this negotiation. The flows that are involved in investment—for example, in some of our companies the remittances from

their Japanese subsidiaries account for as much as 25 percent of their worldwide gross receipts.

Some of our companies, despite the popular press about a U.S. presence in Japan, have significant presence in the Japanese markets, and this treaty is very necessary to enable those companies to effectively compete with their Japanese counterparts.

Senator HAGEL. Would this be one of the high priority, most important next venues for Treasury to negotiate?

Mr. MURRAY. I would say in conducting our surveys, at least since I have been the counsel, that the regions of East Asia and Latin America are the two most prevalent regions in which our companies express an interest in treaties. Within those two regions, the Japanese treaty and the treaty with Brazil as well as with Venezuela, come at the top of the list.

Senator HAGEL. Thank you.

I was in Asia, Southeast Asia, in August, and one of the countries I visited was Vietnam. Tell me a little bit about where your members are on the Vietnam issue.

Mr. MURRAY. A number of our members are very interested in Vietnam. In fact, some years ago, our council had a working group on Vietnam, looking at the investment treaty with Vietnam and some of the issues that were involved. Although I was not personally involved in that effort, I know there is a considerable interest within the membership in trying to expand our commercial relations with Vietnam.

Senator HAGEL. As you know, we are engaged up here on normal trade relations, and I suspect that is not going to happen before we lock the doors around here—who knows when? But, nevertheless, I happen to believe as well that this is an area we should pursue.

Have you talked to Treasury about it?

Mr. MURRAY. That is one particular area we have not really had a real dialog about, although it is certainly something we would want to discuss.

Senator HAGEL. Is there an area here that we have not talked about this afternoon that you would like to get on record about?

Mr. MURRAY. No, Mr. Chairman. I think we have covered most of the points that our membership has expressed some concern about.

Again, I would ask that the committee give its prompt consideration, as I believe you have indicated you will, to the movement of the treaties within the remaining time of the session.

I guess I would close by saying that we hope the committee and also the Senate will give advice and consent to the effect that these treaties should be ratified.

Senator HAGEL. Mr. Murray, thank you.

Let me do just one piece of business here.

I understand that Delegate Underwood of Guam has asked that his statement be included in the record. He wishes to note that he is concerned that Guam and other U.S. territories are not included in the treaty definition, of “United States.” I have done that. His statement will be recorded.

[The statement referred to follows:]

PREPARED STATEMENT OF HON. ROBERT A. UNDERWOOD, U.S. DELEGATE FROM GUAM

Mr. Chairman, I would like to express my concern over the manner in which tax treaties like the ones being considered today by the Senate Foreign Relations Committee are negotiated by the United States with other countries. This hearing focuses on tax treaties which the United States negotiated with the countries of Estonia, Latvia, Venezuela, Denmark, Lithuania, Slovenia, Italy, and Germany.

What will not be brought up today is the fact that under these tax treaties and many other tax treaties which the United States has negotiated with other countries over the years, the definition of the term "United States" generally excludes Guam and the other U.S territories. The most commonly employed definition of the term "United States" excludes Guam and the other territories by name like the treaties with Estonia, Latvia, Venezuela, Lithuania, Italy, and Germany. Some tax treaties explicitly includes the 50 states and the District of Columbia in the definition of the term "United States" like the treaty with Slovenia. Some tax treaties employ the antiquated definition of the term "United States" to mean "only States, the Territories of Alaska and Hawaii, and the District of Columbia" like the tax treaty with Denmark.

The point I wish to make, Mr. Chairman, is that if one of the goals of tax treaties between the United States and other countries is to provide for better foreign investment tax rates between the affected countries, then I believe the current practice by U.S. negotiators has been discriminatory against Guam and other U.S. territories because we are unable to offer foreign investors the same tax treatment as the fifty states. There also appears to be no justifiable reason why Guam should not be included in tax treaties.

As background, under the U.S. tax code, there is a 30% withholding tax rate on dividends, interest, and other forms of passive income remitted to foreign investors. Since Guam's tax law "mirror's" the rate established under the U.S. tax code, the standard rate for foreign investors on Guam is 30%. As a result, only large and profitable projects can absorb such high costs in Guam.

Lower withholding tax rates as negotiated under tax treaties provides for a better foreign investment climate in the fifty states, which often leads to the creation of new jobs and the stimulation of the economy. These are goals which the people of Guam want just as much as any other U.S. jurisdiction. Seventy-five percent of Guam's commercial development is funded by foreign investors. Being excluded from the definition of the term "United States" under tax treaties makes Guam the single most expensive place under any state or territorial jurisdiction in the United States for foreign investors.

To show how discriminatory the tax treaties being considered today are toward Guam, the following chart shows the difference in tax rates which the tax treaties would provide to the fifty states and the District of Columbia, as compared to what would be available to foreign investors in Guam.

Withholding Tax Rate Under Treaties

| Country | In Percent | |
|---|---|---|
| | Dividends | Interest |
| Estonia [1] | 15 | 0 |
| Denmark [2] | 5, 15 | 0 |
| Latvia [1] | 10, 25 | 0 |
| Venezuela [1] | 5, 15 | 4.95, 10 |
| Lithuania [1] | 0 | 20 |
| Slovenia [1] | 15 | 0 |
| Germany [2] | 5, 10, 15 | 0 |
| Italy [2] | 5, 15 | 15 |
| Withholding Tax Rate Under Guam Law (Based on U.S. Code) | | |
| Guam | 30 | 30 |

[1] Rates as quoted are from the general tax statutes of each country.
[2] Rates as quoted are from the double tax treaties of each country.
Source: Deloitte & Touche LLP.

In looking at Guam's situation, one might wonder why Guam just doesn't fix the problem by changing local law. Under current law, Guam has no authority to change the withholding tax rate for foreign investors. This is an issue that the federal government must resolve, which is why the policy of U.S. negotiators for var-

ious treaties in excluding Guam is so frustrating. Clearly, Guam cannot negotiate its own treaties with other countries. So the easiest solution for Guam would be for U.S. negotiators to include Guam in the definition of the term "United States" for all tax treaties.

In the interim, however, I believe that there is no justification for Guam's unfair treatment, which is why I have sought a legislative solution under Guam's Organic Act. On July 1, 1999, I introduced H.R. 2462, legislation which includes the Guam Foreign Direct Investment Equity Act. My bill seeks to amend Guam's Organic Act and allow Guam's tax law to withhold taxes under foreign income provisions of the U.S. tax code at the same rates available to states under U.S. tax treaties. This does not create any tax advantage for Guam when compared to the fifty states or any other U.S. territory. It simply levels the playing field and provides for a more favorable foreign investment environment on Guam by extending the same benefits foreign investors receive in the fifty states to Guam.

Mr. Chairman, the underlying federal policy toward the U.S. territories has always been to promote political and economic development so that we can become more self-sufficient. There is no reason why the federal government should impede Guam's efforts to promote foreign investment in Guam. This is a benefit extended to all fifty states and has been remedied for all other U.S. territories. Guam is the only U.S. jurisdiction which is stymied with a 30% withholding tax rate. It is bad for economic development for Guam and it is bad for the United States.

I ask that the members of the Senate Foreign Relations Committee consider reminding U.S. negotiators for future tax treaties with other countries to do what is right for the people of Guam on foreign investment opportunities by including Guam in the definition of the term "United States" or by supporting my legislation, the Guam Foreign Direct Investment Equity Act.

Senator HAGEL. Is there any other business we need to do?

[Pause]

Senator HAGEL. We will keep the record open for 3 days for further comments and statements. That probably does not apply to you, Mr. Murray, as much as it does to others. But I would note that we still have representatives here from Treasury and the Joint Tax Committee. You know how that works, anyway, all of you.

Unless you have anything to add, Mr. Murray, again, I thank you and your organization for your leadership.

Mr. MURRAY. Thank you, Mr. Chairman.

[Whereupon, at 4:58 p.m., the committee adjourned.]

# APPENDIX

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QUESTIONS FROM SENATOR HAGEL FOR PHIL WEST, TREASURY INTERNATIONAL TAX COUNSEL, REGARDING PENDING TAX TREATIES—OCTOBER 27, 1999

*Main Purpose Tests contained in the Italy and Slovenia Treaties*

*Question 1.* Do the anti-abuse principles under current U.S. law, such as the Business Purpose Doctrine, currently apply in the treaty context?

*Question 2.* Are these "main purpose" tests intended to clarify current domestic U.S. law or do they go beyond present U.S. law? If so, how?

*Question 3.* How will you assure that the tests will not be used by treaty partners to deny treaty benefits for legitimate business transactions?

*Question 4.* During the hearing you indicated that the Treasury Department has not prepared a comprehensive analysis of these "main purpose" tests? Will you undertake such an analysis and provide it to the Committee?

[NOTE. See Memorandum for Senator Hagel that follows for responses to above questions.]

*Other Issues*

*Question 1.* Please provide the Committee with a response to all issues raised in the Joint Committee pamphlets. (See page 75 for response.)

*Question 2.* Please provide a response to Senator Dorgan's testimony, including your view on whether the treaties allow for application of the formulary apportionment method in lieu of the arm's length test if the United States were to change its policy. (See page 91 for response.)

*Question 3.* Please provide a response to Congressman Underwood's testimony regarding the U.S. Treasury treaty policy excluding Guam and other U.S. territories from the definition of the "United States." (See page 92 for response.)

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MEMORANDUM FOR SENATOR HAGEL

Re: Responses to Additional Issues Raised by Senator Hagel Regarding Pending Tax Treaties, October 27, 1999

This memorandum provides responses to additional issues raised by Senator Hagel in connection with the Senate Foreign Relations Committee hearing on seven income tax treaties and an estate tax protocol held on October 27, 1999. It also provides a response to the issues raised in the pamphlets prepared by the Joint Committee on Taxation regarding the "main purpose" anti-abuse rules found in the treaties with Italy and Slovenia.

"MAIN PURPOSE" TEST

*Issue Raised by the JCT Pamphlet:* The issue raised by the JCT pamphlet is whether the benefits of the anti-abuse rule outweigh the uncertainties created for business.

*Response:* Because of the importance of preventing the abuse of our tax treaties, we believe that the benefits of the anti-abuse provisions outweigh any potential uncertainty.

The standard in the anti-abuse rule is substantively the same as one found in several places in our tax code (including legislation passed by the Senate this week), our tax regulations and our tax treaties. Also, it is a developing international standard. Thus, adopting this standard increases the likelihood that taxpayers will be subject to one anti-abuse standard wherever they conduct their business. These reasons for adopting the rules are discussed in greater detail below.

*Benefits of the Anti-Abuse Rules*

The literature regarding anti-abuse rules and the place they hold in U.S. tax jurisprudence, not to mention international tax jurisprudence, is vast. Thoughtful commentators acknowledge that there is a problem created by the self-assessment system, which creates an incentive to play the "audit lottery." Furthermore, the adversarial system, which frequently results in settlements, rather than litigation, may be seen as rewarding taxpayers who have taken aggressive positions based on the words of a statute. The "business purpose," "sham transaction" and "substance-over-form" doctrines alluded to in the question from Senator Hagel are themselves responses to this problem. The Commentary to Article 1 of the OECD Model and the OECD Report on Harmful Tax Competition make clear that countries can impose their domestic anti-abuse rules to claims for treaty benefits.

Accordingly, these important common-law principles are incorporated into our tax treaties, as confirmed by statements in the section of the Technical Explanation to each treaty dealing with Limitation on Benefits. The statements (found on page 94 of the Technical Explanation to the treaty with Italy and pages 64–65 of the Technical Explanation to the treaty with Slovenia) describe the interaction of the proposed anti-abuse rules, domestic law and the limitation on benefits provisions of our tax treaties. As stated in those paragraphs, the limitation on benefits provisions of our treaties and the anti-abuse provisions of domestic law complement each other, as the limitation on benefits provisions effectively determine whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (e.g., business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source State may be applied to identify the beneficial owner of an item of income, and the limitation on benefits provisions then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.

The previous inclusion in treaties of an anti-abuse rule—the limitation on benefits provision—was not seen as replacing domestic-law anti-abuse rules. The treaties, of course, include a number of anti-abuse rules, such as the "star-company" rule in the Artistes and Sportsmen provision. This rule deals with the same types of abuses as were present in *United States v. Johansson,* 336 F.2d 809 (5th Cir. 1964), where the court found that strictly applying the provisions of the treaty to the "star company" would have produced a result not in accordance with the rationale behind those provisions. No one has suggested, however, that these rules, addressing abuses of particular provisions, prevent us from applying our domestic anti-abuse rules.

Unfortunately, the domestic-law anti-abuse provisions have not been working adequately to prevent treaty abuses. The main purpose tests of the proposed treaty supplement these common-law doctrines to ensure that treaties are not utilized for abusive purposes. The common-law doctrines, such as economic substance, substance-over-form, and step-transaction, focus on whether, in addition to the abusive purpose, the transaction at issue has some colorable non-abusive purpose. In contrast, the "main purpose" test focuses on whether a principal purpose of the transaction is tax avoidance. This focus is justified because of the increasing trend toward aggressive abuse of tax treaties to obtain benefits that were not intended, such as the elimination of *all* taxation (in contrast to the intended goal of eliminating *double* taxation).

For example, in *Northern Indiana Public Service Co. v. Commissioner,* 115 F.3d 506 (7th Cir. 1997), the taxpayer funneled financing through a corporation established in a treaty country solely for the purpose of obtaining the treaty's exemption from interest tax withholding. The court conceded that it was "undisputed" that the structure was set up for this tax-avoidance motive. Nonetheless, the court permitted this abuse of the treaty because the IRS was unable to prove that the corporation engaged "in absolutely no business activity." This court case bolstered the confidence of aggressive taxpayers who had read very narrowly the seminal "conduit" case *Aiken Industries v. Commissioner of Internal Revenue,* 56 T.C. 925 (1971). In essence, many practitioners read a substantial business purpose test out of *Aiken Industries,* and interpreted the case as holding that treaty benefits could be denied only if the two legs of the conduit transaction exactly matched in terms of principal, interest rates and maturity dates.

Fortunately, by the time *Northern Indiana* was decided, Congress had passed section 7701(1), providing Treasury with regulatory authority to curb certain multi-party financing abuses, including certain treaty abuses. This authority has been exercised to adopt a "one of the principal purposes" standard very similar to that reflected in the proposed anti-abuse rules, under which taxpayers have been operating

for some years now, apparently without significant difficulty. Application of this test, rather than the "business purpose" test, would reverse the result of *Northern Indiana.*

In addition to legislating on conduit transactions, Congress has also as recently as 1997 legislated against another abuse of tax treaties by enacting section 894(c) of the Code. The history of this provision demonstrates the fact that taxpayers are relatively indifferent as to whether they are engaged in the type of classic "treaty-shopping" addressed by the limitation on benefits provisions or whether they participate in other transactions that produce the same result. Until 1993, Canadian companies with U.S. subsidiaries frequently used a financing structure that involved a Dutch corporation with a Swiss branch. In 1993, a limitation on benefits provision was added to the Netherlands tax treaty and the Canadian-U.S. groups adopted U.S. limited liability company structures. These were closed down in 1997 by the enactment of section 894(c). The companies then explored moving the financing structures to Ireland for the three years that remained before the limitation on benefits provision in that treaty became fully effective, and settled on a structure in other countries whose treaties with the United States do not have a limitation on benefits provision. We intend to re-negotiate those treaties in order to add a limitation on benefits provision, but we expect that the Canadian companies will develop new structures established with a main purpose to obtain treaty benefits.

The use of treaty amendments to eliminate specific abuses will always be inadequate. Because our treaties are intended to last decades before re-negotiation, and because of the difficulty involved with negotiating a bilateral international treaty, it is not realistic to update a treaty each time a new abusive transaction is discovered. Moreover, such an approach would only encourage the search for new techniques or unexplored opportunities under old treaties. For these reasons, and because it is difficult to anticipate how various tax, corporate and regulatory regimes will interact over long periods of time, we should decide whether such anti-abuse provisions should be included in our treaties not on the basis of any current abuses but rather on the basis of patterns of abuses that we know tend to recur. Similarly, the rifle-shot legislative approach to specific abuses is not fully effective. Moreover, these post-ratification unilateral legislative fixes have led to claims that our subsequently enacted domestic anti-abuse rules constitute an override of our tax treaty obligations. Adding an explicit provision to the treaty would lay such arguments to rest in the future, and appropriate legislative history would help to ensure that there is no negative inference regarding existing treaties. Such a statement is included in the Treasury's Technical Explanation to the proposed treaty.

These types of abusive transactions have become more prevalent as more U.S. treaties have included effective limitation on benefits provisions. Our treaty partners, which have even weaker anti-abuse rules than we do, and who do not include limitation on benefits provisions in their tax treaties, realized the necessity of these rules before we did. In the case of Italy, for example, we understand that this provision is necessary in order to combat the simplest of the conduit cases that we address under section 7701(l). Other transactions that would be addressed by this rule are more complicated. For example, several years ago, U.S. taxpayers with U.K. subsidiaries developed a scheme to inappropriately secure "refunds" of the advance corporation tax from the U.K. government by engaging in transactions that, under U.S. law, would be viewed as circular cash flows without economic substance. However, U.K. law did not allow that country to reach the U.S. result of ignoring the transaction entirely, and the current U.S.-U.K. treaty did not permit the U.K. from denying these refunds because it does not include the anti-abuse rules. These transactions became very expensive for the United Kingdom and may have contributed to the United Kingdom's decision effectively to eliminate these payments to *all* U.S. taxpayers, whether they were abusing the system or not, through changes in their domestic integration system.

It is therefore important to consider whether our treaty partner (or potential treaty partner) believes it is in its interest to have such rules in the treaty, in the same way that we consider the other peculiar aspects of that country's law when drafting other provisions of the treaty. Many countries do not have effective domestic anti-abuse rules. This could be a function of the legal system or the fact that their experience with sophisticated financial transactions is limited. These countries increasingly rely on explicit anti-abuse provisions in the treaty. It is difficult for the United States to tell such a developing country that it will be required to provide benefits to all U.S. taxpayers, without regard to whether they are participating in abusive transactions, but that the United States will be able to apply its panoply of anti-abuse rules in order to prevent many such abuses.

Slovenian tax authorities have informed us that Slovenia currently has no domestic anti-abuse provisions. Although they are contemplating the introduction of spe-

cific anti-abuse provisions with respect to certain of the most basic types of abuses, these provisions would not be broad enough to prevent the more sophisticated abuses that can occur with treaties. Thus, the anti-abuse provisions would be necessary in order for these tax authorities to effectively stop abuses of the proposed treaties. Similarly, according to Italian tax authorities, Italy currently does not have effective domestic anti-abuse doctrines that could be used to deny treaty benefits in the case of abusive transactions. As a result, Italy has increasingly included anti-abuse provisions in its more recent treaties. For example, Italy's 1995 treaty with Israel has the following anti-abuse rule:

> The competent authorities of the Contracting States, upon their mutual agreement, may deny the benefits of this Convention to any person, or with respect to any transaction, if in their opinion the receipt of those benefits, under the circumstances, would constitute an abuse of the Convention according to its purposes.

*Concerns about Uncertainty Interfering with Legitimate Business Transaction Planning*

As noted before, the drafting of any anti-abuse provision involves the question of how to prevent the abuse without hindering legitimate business transactions. Treasury rejected the broader, more subjective anti-abuse rule found in the Italy-Israel treaty for several reasons. First, it provided a less certain standard against which a taxpayer could meaningfully evaluate its transaction. Second, since the narrower rule before you appears in a significant number of treaties around the world, and promises to appear in more, it is more consistent with international norms and will likely be the subject of more interpretive law than the other standards. Treasury rejected a narrower anti-abuse rule because of its ineffectiveness.

In analyzing different approaches that have been taken over time, we had the benefit of participating in work on anti-abuse rules undertaken by Working Party 1 of the OECD's Committee on Fiscal Affairs in response to a recommendation in the OECD's Report on Harmful Tax Competition. The recommendation directs the Working Party to consider different ways in which the entitlement to treaty benefits should be restricted to prevent the abuse of tax treaties. As a result of that process, we have a significant catalog of approaches taken by different countries, and an idea of their views regarding how the law in this area should develop. Needless to say, that process has informed our thinking about the best ways to prevent treaty abuses.

We gravitated toward the "main purpose" standard of our proposed rule because it corresponds to the U.S. "a principal purpose" standard which is applied in a number of our statutory provisions and regulations. (A partial list of the relevant sections is attached.) In fact, it is embedded in section 954(h) of the Code, which was enacted in 1998 and passed by the Senate this week.

Judge Posner's ruling in *Santa Fe Pacific Corporation v. Central States, Southeast and Southwest Areas Pension Fund,* 22 F.3d 725 (1994) provides insight into the meaning of "a principal purpose." This standard is different from "the principal purpose." A purpose can be "a principal purpose" if it is a major purpose for a transaction. The standard is not met if a purpose was a minor, subordinate purpose. In determining whether a purpose is major or minor, the question is whether it "weighed heavily in the [relevant party's] thinking." Other synonyms provided by Judge Posner include "major, weighty, salient, and important." The court acknowledges that, because the determination of purpose involves inferring state of mind, the process of determining whether the standard has been met may require the examination of the relevant evidence.

Taxpayers, of course, are in the best position to know what "weighed heavily" on their minds when considering entering into a transaction. Taxpayers are required to make subjective judgments under all of the Code provisions in the attached list, and they can also look to the principles developed under these statutes and regulations for guidance. In essence, what the taxpayer is required to do is ask whether it is entering into a transaction with a principal purpose of tax avoidance. We think that requiring taxpayers to engage in this basic analysis neither is overly burdensome nor introduces an unacceptable level of uncertainty, but it does preserve our ability to ensure that tax treaties do not become the tools of tax avoiders.

Moreover, the underlying policies of the provision provide important guidance to taxpayers and limit its application. One underlying policy is the concept that, as a general matter, a treaty provision should not be exploited in a way that creates the opportunity to avoid tax in both countries. This type of abuse was present in the transactions that section 894(c) was intended to curb.

A second underlying policy is that treaty benefits are intended only for certain persons (i.e., residents of the treaty countries and, in certain circumstances, only particular residents of the treaty countries). Although limitation on benefits provisions generally prevent residents of third countries from obtaining treaty benefits, Treasury's Technical Explanation to the proposed Italy and Slovenia treaties contain examples of an abusive situation (i.e., "dividend washing") where residents of third countries might nonetheless obtain treaty benefits in the absence of an anti-abuse provision. The two Technical Explanations also contain examples of abusive situations where a resident of a treaty country might inappropriately obtain benefits that are only intended for a narrow class of residents (i.e., dividend benefits that depend upon a specific ownership threshold).

The Technical Explanations to our treaties generally provide rationales for the provisions found therein, and the Commentaries to the OECD Model provide more. Taxpayers therefore should not have great difficulty determining whether they were *supposed* to be entitled to certain benefits.

Another benefit to taxpayers of adopting this standard is that the rule appears to be broadly acceptable to other countries. The rule has been included in more than 50 treaties, representing approximately 40 different countries (including 10 OECD members). Therefore, because the proposed rule appears in a significant number of treaties around the world, and promises to appear in more, it will likely be the subject of more interpretive law than the other standards and likely will provide greater certainty over time than some of the alternatives.

*Concerns regarding Application*

The JCT pamphlet also raises concerns regarding the application of the proposed anti-abuse provisions, in particular the concern that the provisions could be used by treaty partners to deny treaty benefits for legitimate business transactions. As noted above, countries currently can apply their own domestic anti-abuse rules to treaties. As a result, a potential risk currently exists that a treaty partner could deny treaty benefits to legitimate business transactions under domestic anti-abuse rules (if any).

The explicit inclusion of "main purpose" tests in tax treaties will bring a more uniform standard to this area. As noted above, similar rules have been included in more than 50 treaties, representing approximately 40 different countries (including 10 OECD members). The expanding adoption and application of this standard will help ensure that it will be applied in a reasonable and consistent way. While a treaty partner's domestic anti-abuse rules (if any) could continue to apply, it is anticipated that in practice treaty partners will look primarily to the explicit standard in the treaty when they believe that an abusive transaction has occurred.

As in other circumstances involving interpretation of the treaty, a U.S. taxpayer who believes that the treaty partner has applied this provision incorrectly may invoke the Mutual Agreement Procedure of Article 25. Under that mechanism, the U.S. competent authority, if it believes that the taxpayer's position is justified, will consult directly with the treaty partner's competent authority in order to resolve the issue. Article 25 explicitly authorizes the competent authorities to reach agreement to avoid taxation that is not in accordance with the treaty, and to resolve any doubts regarding the interpretation or application of the convention. Arguably, it will be easier for competent authorities' to reach a common understanding with respect to the "main purpose" standard, which is explicitly included in the treaty, than it would be to reach agreement with respect to an anti-abuse provision of one country's domestic law. Of course, a taxpayer who believes that the treaty partner has applied this provision incorrectly could also invoke any other remedies available under the domestic law of the treaty partner, such as judicial review.

As a practical matter, we believe that treaty partners will not invoke this provision to deny treaty benefits for legitimate business transactions. We have consulted with the tax authorities of the United Kingdom, which has included a similar standard in more than 20 of its tax treaties. According to those authorities, the United Kingdom has not received any complaints from its taxpayers regarding the treaty partner's inappropriate use of the provision. Furthermore, one of the principal reasons that countries enter into tax treaties is to facilitate legitimate business transactions, so it would be unlikely that a treaty partner would invoke the main purpose provisions to challenge such transactions.

We are also aware of concerns regarding the provision that allows the competent authorities to agree that certain types of transactions that are entered into by a broad number of taxpayers violate the anti-abuse provisions. We believe that this provision is necessary to effectively prevent the potentially widespread abuses that can occur when a promoter develops and "sells" a treaty-abuse scheme to a number of taxpayers. These schemes are not aimed at furthering the specific business objec-

tives of the "purchasing" taxpayers, but instead are aimed merely at taking advantage of the treaty to avoid tax liability. It is contemplated that the competent authorities will provide the public with notice regarding such abusive schemes. The published competent authority agreements would be subject to judicial review.

*Lack of Conformity with other U.S. Tax Treaties*

The JCT pamphlet raises a slightly different issue regarding the fact that these provisions are not included in other U.S. tax treaties. In fact, a precursor to this provision can be found in the U.S. treaty with Canada, which explicitly recognizes each country's right to apply domestic anti-abuse rules, including Canada's right to apply a similar anti-abuse rule that is in force under its domestic law.

We too were concerned about the possibility that our treaties would not be uniform with respect to this provision, although the context was slightly different. The countries other than Canada (whose position is described above) with which we are currently negotiating (the United Kingdom, Chile and Korea) include this provision in their standard negotiating document. Because this rule is important to them, we were considering adopting it in those treaties. Since the substantive analysis described above suggested that it would be appropriate to adopt it in those treaties, it also seemed that it would be appropriate to adopt it in the treaties that were still under negotiation. This decision was made rather late in the negotiating process, immediately before the last round of negotiations with each of Italy and Slovenia, which took place in late November and early December, 1998. At those rounds, it was agreed to include the provision. Because it was an unusual provision, in accordance with our usual procedure, we described the rule and its purpose at a briefing with the Senate Foreign Relations Committee and the staffs of the Joint Committee on Taxation and the tax-writing committees which took place on December 16, 1998. The treaty with Slovenia was signed on June 21, 1999 and the treaty with Italy was signed on August 25, 1999.

Code provisions using "**a/one of the principal purposes**" anti-abuse language

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| §170(f)(9) | Denial of "charitable deductions" with **a principal purpose** of making non-deductible lobbying contribution. |
| §197(f)(9)(F) | Denial of amortization for intangibles acquired where **one of the principal purposes** was to avoid the churning or grandfather rule. |
| §302(c)(2)(B)(ii) | Exception to attribution where **one of the principal purposes** is tax avoidance. |
| §306(b)(4)(B) | Section 306 does not apply if it is established to the satification of the Secretary that tax avoidance is not **one of the principal purposes** of the transaction. |
| §336(d)(2)(B)(i)(II) | Plan to recognize loss through contribution/liquidation has **a principal purpose** of tax avoidance. |
| §355(a)(1)(D)(ii) | Retention of stock in controlling corporation can't be in pursuance of plan with tax avoidance as **one of its principal purposes.** |
| §382(l)(1)(A) | Capital contributions made with **a principal purpose** of avoiding/extending NOL limitations are ignored. |
| §453(e)(7) | Related person second distribution rules waived if it is established to the satisfaction of the Secretary that tax avoidance is not **one of the principal purposes** behind the distributions. |
| §467(b)(4)(B) | "Disqualified leaseback" must have **a principal tax avoidance purpose.** |
| §614(e)(1) | Aggregation of non-operating mining interests allowable so long as **a principal purpose** is not tax avoidance. |
| §643(f)(2) | Two or more trusts may be treated as one if **a principal purpose** of such trusts is the avoidance of tax. |
| §751(b)(3)(B) | Property contributed to PRS with **a principal purpose** of avoiding 120% "substantial appreciation" test is ignored. |
| §860K(e)(2) | FASITS supporting pass-thru interests received differing treatment if a tax avoidance is **a principal purpose** of the transaction. 1996. |
| §877(a)(2) | Expatriation tax (**a principal purpose** but with objective unsafe harbor). Test is referenced by §§2107, 2501(a)(3). |
| §953(e)(7)(C) | CFC insurance companies change of reserve methods where **a principal purpose** of the change is to claim benefits under §953(f) or §954(f) is disregarded. 1998. |
| §954(h)(7)(A),(D) | If a **one of the principal purposes** of a transaction is to take advantage of this subsection, that transaction is disregared. 1997. |
| §1031(f)(2)(C) | Like-kind exchanges between related persons may still qualify for nonrecognition where it is established to the satisfaction of the Secretary that **one of the principal purposes** is not tax avoidance. 1984. |
| §1272(a)(2)(E)(ii) | Loans between natural persons with an IP of less than $10,000 may still be subject to OID by overzealous auditors if **one of the principal purposes** of the transaction is tax avoidance. 1984. |
| §1298(d)(3)(B) | Exception to leasing rules for PFIC status if **a principal purpose** of leasing property was to avoid PFIC status. 1993. |

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|---|---|
| §1298(e)(2)(B)(ii) ... | Similar exception to intangible regime where **a principal purpose** of the license was to avoid PFIC ststus. 1993. |
| §7872(c)(1)(D) ........ | Below market loan provision applies to any below market loan **one of the principal purposes** of which is tax avoidance. 1984. |
| §9722 ..................... | Transactions with **a principal purpose** of tax avoidance are ignored. |

RECAPPING RESPONSES TO WRITTEN QUESTIONS FROM SENATOR HAGEL

*1. Do the anti-abuse principles under current U.S. law, such as the Business Purpose Doctrine, currently apply in the treaty context?*

—As noted above, such doctrines do apply in the treaty context.

*2. Are these "main purpose" tests intended to clarify current domestic U.S. law or do they go beyond present U.S. law? If so, how?*

—This question is discussed above under "Benefits of the Anti-Abuse Rules."

*3. How will you assure that the tests will not be used by treaty partners to deny treaty benefits for legitimate business transactions?*

—This issue is discussed above under "Concerns about Application."

*4. During the hearing you indicated that the Treasury Department has not prepared a comprehensive analysis of these "main purpose" tests? Will you undertake such an analysis and provide it to the Committee?*

—The requested analysis is provided above.

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MEMORANDUM FOR SENATOR HAGEL

Re: Responses to Issues Raised in JCT Pamphlets on Pending Tax Treaties

This memorandum provides responses to issues raised by the Joint Committee on Taxation in its pamphlets on the seven tax treaties currently pending before the Senate Committee on Foreign Relations. No issues were raised by the Joint Committee with respect to the pending estate tax protocol with Germany. The other written questions submitted after the hearing and the anti-abuse rules found in the treaties with Italy and Slovenia will be discussed in a separate memorandum to follow shortly. We apologize for this approach, as we would prefer to answer all of the questions at the same time, but were asked by the Joint Committee to provide these answers as quickly as possible in order to facilitate its work on the Senate Foreign Relations Committee Reports.

PROPOSED CONVENTION WITH DENMARK

*Creditability of Danish Hydrocarbon Tax*

*Issue:* The issue raised by the JCT pamphlet is the extent to which treaties should be used to provide a credit for taxes that may not otherwise be fully creditable and, in cases where a treaty does provide creditability, to what extent the treaty should impose limitations not contained in the Internal Revenue Code.

*Response:* The proposed Convention contains a limited credit with respect to taxes on oil and gas extraction income and oil-related income paid under Denmark's Hydrocarbon Tax Act. Various considerations led to the decision to include such a credit provision in this particular treaty.

First, taxpayers face uncertainty under our domestic laws regarding the creditability of the taxes covered by this provision under domestic law. In a 1995 decision interpreting temporary regulations under section 901, the Tax Court determined that the Norwegian taxes on offshore extraction activities was a fully creditable tax for U.S. foreign tax credit purposes. The 1995 decision may be distinguishable, however, and was not reviewed on appeal. A case is pending in the Tax Court that will address the creditability of the U.K. Petroleum Revenue Tax.

Second, our treaties with other North Sea countries provide that similar taxes in those countries are creditable. Although those taxes may be distinguishable from the Danish Hydrocarbons Tax, not providing for the creditability of that tax here would raise questions regarding the extent to which similarly-situated U.S. taxpayers are treated similarly.

Third, we considered the treatment of Danish hydrocarbon taxes in the context of the treaty as a whole. For Denmark, obtaining certainty regarding the creditability of its hydrocarbon taxes similar to that found in U.S. tax treaties with its North Sea petroleum competitors was an important issue which we conceded in order to promptly conclude a new treaty with an effective anti-treaty-shopping provision.

The pamphlet also questions the extent to which a tax treaty should impose limitations not otherwise contained in the Code. If the Danish tax were deemed to be noncreditable in the absence of a treaty, taxpayers would obtain a higher foreign tax credit under the treaty than they otherwise would. To limit the extent to which the treaty might have this effect, the Treasury chose to incorporate, within the treaty, an additional "per-country" limitation and restriction on the use of carryovers that is similar in effect to the limitations imposed by the other treaties in which this type of provision appears. Thus, the treaty imposes restrictions that prevent that tax from offsetting U.S. taxes on income earned in other countries or on Danish income that falls within a different foreign tax credit basket. Of course, since the treaty cannot put taxpayers in a worse position than domestic law, if it were determined that the tax were fully creditable under domestic law, these additional limitations would not apply. The Treasury Department believes that the limitation on the use of credits is a fair condition for the grant of the credit under the treaty.

*Treaty Shopping*

*Issue:* The issue raised by the JCT pamphlet is whether the limitation on benefits provision of the proposed treaty is an adequate tool for preventing possible treaty-shopping abuses in the future. The pamphlet directs particular attention to the "bright line rules" under the active business test and to the so-called "derivative benefits" rule.

*Response:* The United States is the international leader with respect to treaty provisions to prevent treaty-shopping. Unlike the existing treaty, the proposed treaty with Denmark contains a comprehensive anti-treaty-shopping provision. We made every effort in negotiating the proposed treaty with Denmark to ensure that the limitation on benefits provisions adequately distinguished between persons that legitimately should qualify for treaty benefits and persons that may have a treaty shopping motive.

The provisions in this treaty do differ in some respects from those in the U.S. Model and in other U.S. treaties, but this is not unusual. Like our treaty with Ireland, there is more detail in the limitation on benefits provision than is found in the U.S. Model. There is somewhat less detail than in our treaties with Switzerland and The Netherlands. Denmark wanted the added provisions in order to provide a measure of certainty to taxpayers as to whether they would be entitled to treaty benefits, but did not want the added complexity of the Swiss and Netherlands treaties.

In addition, negotiation of these provisions requires that the specific circumstances of the treaty partner be taken into account. As a consequence, no two treaties have identical limitation on benefits provisions. In Denmark's case, the provisions needed to accommodate the fact that Denmark is a country with close economic ties to the rest of Europe and the substantial foreign participation in its business sector. The provisions do this without compromising their fundamental objective.

The provision covering income from the operation of ships and aircraft in international traffic essentially confirms the benefits already provided by U.S. law under section 883 of the Code and reciprocally requires Denmark to extend those benefits to U.S. residents. As noted in the pamphlet, this provision was also included in the conventions with The Netherlands and Ireland, which were reviewed by the Committee in 1993 and 1997, respectively. Other rules were added to address the treatment of taxable nonstock corporations, whose ownership of some important Danish multinationals might have disqualified those corporations from treaty benefits under an unmodified limitation on benefits provision.

As noted in the JCT pamphlet, a company that satisfies the derivative benefits provision will be entitled to all the benefits of the treaty, just as in the U.S. treaties with France and Switzerland. The derivative benefits provision of the proposed Convention was crafted bearing in mind the openness of the Danish and U.S. economies and their close integration with their European and North American trading partners. Although the provision requires no Danish or U.S. ownership of a company in order for it to be entitled to benefits, at least 95 percent of the shares in the company must be owned by residents of countries in the European Union, European Economic Area or NAFTA. In addition, any third-country owners must be entitled to benefits under a comprehensive income tax treaty between their country of resi-

dence and the treaty partner (the United States or Denmark) from which the benefits of the proposed treaty are sought. And, in order to obtain the reduced withholding rates for an item of dividend, interest or royalty income, the treaty with the third country must provide a withholding rate on that item of income that is at least as low as the rate provided in the proposed treaty. The requirement that the third-country treaty provide at least equivalent withholding rates means that this provision is unlikely to be exploited for treaty shopping purposes, because the principal benefits of the treaty could be obtained directly by the third-country resident. Finally, a base erosion test ensures that treaty benefitted income is not being diverted to another country through deductible payments.

PROPOSED CONVENTION WITH ESTONIA

*Treatment of REIT Dividends*

*Issue:* The issue raised by the JCT pamphlet is whether the treatment of REIT dividends in the proposed treaty is appropriate.

*Response:* REITs are not generally subject to entity-level tax and their predominant income is typically real estate rental income, which is statutorily subject to a 30% rate of withholding tax that is not generally reduced by treaties. Therefore, the JCT, the Senate Foreign Relations Committee, and Treasury had, from 1988 to 1997, taken the position that REIT dividends generally should be treated under U.S. tax treaties as conduit distributions of real estate rental income and, thus, as subject to 30% withholding tax except in very limited circumstances. This is the policy currently embodied in the pending treaty with Estonia.

In 1997, we re-considered that position in light of economic changes since 1988. As a result of that re-consideration, we revised our treatment of REIT dividends under our tax treaties. At that time, we agreed to add the new rule in all "future negotiations." However, this treaty, like the treaties with Latvia and Lithuania, were fully negotiated at the time that the new treatment of income from REITs was developed. It would not have been appropriate to re-open negotiations with the Baltic countries at that stage. We spoke to the REIT industry at the time and they understood our position. As part of any future revision of the Estonian treaty, we would seek to update the REIT rule.

*Developing Country Concessions*

*Issue:* The issue raised in the JCT pamphlet is whether the developing country concessions represent appropriate U.S. treaty policy and, if they do, whether Estonia is an appropriate recipient of these concessions.

*Response:* Regarding whether Estonia is an appropriate recipient of developing country concessions, it should be noted that for 1997, Estonia's gross domestic product (GDP) was $9.3 billion and its per capita GDP was $6,450. By contrast, the United States' 1997 GDP was $8,100 billion and its per capita GDP $30,200.

With respect to the question of whether making developing country concessions is appropriate, we believe that when a treaty is in the interests of the United States we can agree to make such concessions when the treaty partner believes that it is in its interest. The issue is one of balancing the overall potential costs and benefits in the treaty and the potential costs of moving away from our preferred position against the potential benefits of having a treaty at all. With respect to Estonia, we believe that the potential benefits outweigh the potential costs.

For example, it generally is U.S. policy to reduce the rate of withholding taxation on interest and royalties to zero, and to reduce dividend withholding rates to 5 percent for direct investment dividends and to 15 percent for portfolio dividends. The extent to which this policy is realized depends on a number of factors. Although generalizations often are difficult to make in the context of complex negotiations, it is fair to say that we are more successful in reducing these rates with countries that are relatively developed and where there are substantial reciprocal income flows. We also achieve lesser but still significant reductions with countries where the flows tend to be disproportionately in favor of the United States. Lesser developed and newly emerging economies, where capital and trade flows are often disparate or sometimes one-way, create obstacles to achieving our desired level of withholding. These countries frequently find themselves on the horns of a dilemma. They know that reducing their high levels of taxation may help to attract foreign capital but, at the same time, they are unwilling to give up scarce revenues. Such prospective treaty partners may perceive that, by reducing withholding tax rates, they would be making a tangible current concession in favor of the United States while receiving at most a possible future benefit. In some such cases, we will look at the overall level of tax and avoid agreements which may have a significant adverse impact on the fisc of the less developed partner. For this reason and others, the treaty with-

holding rates will vary Estonia agreed to accept U.S. policy with respect to dividend withholding, but not interest and royalty withholding.

Businesses reinforce our view that frequently the treaty relationship itself is more important than any one or more specific benefits. For example, even if a treaty does not serve to reduce tax rates to the levels that we prefer, it provides limitations, certainty, and dispute resolution mechanisms that are important to business decision-makers. We think the concessions are appropriate, both because of the economic position of Estonia as a newly emerging economy and because of the overall package of benefits that will accrue to the United States under the treaty.

With respect to particular developing country concessions in the proposed Estonian treaty, the JCT pamphlet identified the following:

- the definition of "permanent establishment";
- the taxation of business profits;
- the taxation of certain equipment leasing; and
- other taxation by the source country.

These are discussed below seriatim.

*Permanent Establishment Definition*

The Estonian treaty provides that the term "permanent establishment" includes building sites, etc. and rigs, ships and installations used for the exploration of natural resources when the site or activity continues for more than six months. The U.S. Model provides that these activities will constitute a "permanent establishment" only when the site or activity continues for 12 months. The lower threshold rule in the treaty reflects the fact that, as a newly emerging economy, Estonia is more dependent upon tax revenues from construction projects and similar activities than developed countries whose physical and business infrastructure are more established. This rule in the Estonian treaty is consistent both with other Estonian treaties and with many other U.S. treaties with developing countries.

*Taxation of Business Profits*

The proposed treaty provides that if an enterprise has a permanent establishment in a country, that country may tax the portion of the enterprise's business profits that is attributable to the permanent establishment. As the JCT pamphlet points out, the proposed treaty further provides that, under certain circumstances, the country in which the permanent establishment exists may also tax income of the enterprise attributable to sales in that country of goods or merchandise of the same kind as those sold through the permanent establishment or to other business transactions carried on in that country that are of the same or similar kind as those effected through the permanent establishment. These rules are of a type known as "limited force of attraction" rules. Such rules are found in the U.N. Model, and are included in many treaties with developing countries.

Estonia requested that a limited force of attraction rule be included in the proposed treaty. The United States agreed, but negotiated a limited force of attraction rule that is narrower than the rule found in the U.N. Model. The force of attraction rule in the proposed treaty operates as an anti-abuse rule. Its application is limited to situations in which it can be shown that the transaction giving rise to the income was carried on outside the permanent establishment and a principal purpose of the transaction is to avoid taxation in the country in which the permanent establishment is situated. We therefore concluded that the rule did not improperly expand the taxation of business income.

*Taxation of Certain Equipment Leasing*

Under the U.S. Model Treaty, income from the rental of tangible personal property is treated as business profits. Under the proposed Estonian treaty, payments for the use of, or the right to use, industrial, commercial, or scientific equipment will be treated as royalties. Treatment of such income as royalties is consistent with the position taken by many developing countries and with the former OECD Model Treaty. It also represents the treaty policy of Estonia. Through negotiation, we were able to reduce the withholding rate on this class of royalties to 5 percent (from the general rate of 10 percent). As with all royalty income, if the income from rentals of tangible personal property are attributable to a permanent establishment or fixed base in the source country, such income is taxed on a net basis under Articles 7 or 14. As discussed below with respect to ships and aircraft, there are exemptions from even the 5 percent withholding tax in the case of income from the rental of containers, and from the rental of ships and aircraft when such income is incidental to the operation of the ships and aircraft in international traffic.

*Other Taxation by Source Country*

The JCT pamphlet also noted other areas in which the proposed treaty provides for greater taxation by the source country than would be permitted under the corresponding provisions of the U.S. Model. It notes the fact that the withholding rate at source on royalties is generally 10 percent, with a 5 percent rate on rentals of tangible personal property, rather than the zero rate at source in the U.S. Model. As noted above, developing countries are frequently unwilling to lower their withholding rates to the levels in the U.S. Model, largely because of their concerns over the potential loss of revenue. We were able to get Estonia to agree to relatively low rates, similar to those found in a number of other U.S. treaties with developing countries.

The JCT pamphlet also noted the fact that under the Estonia treaty a fixed base is deemed to exist, thus allowing the host country to tax income from independent personal services, when the visitor is present in that country for 183 days in a 12-month period. This rule is not in the U.S. Model. Estonia was concerned that, without this rule, a U.S. resident would be able to spend longer than 183 days in Estonia performing independent personal services, but would be able to do so without using a fixed base (e.g., moving among clients' offices) and would avoid Estonian tax. The addition of this rule will prevent this result. This is standard Estonian treaty policy. A similar rule is found in a number of other U.S. treaties with developing countries, some (e.g., Thailand) with lower time thresholds.

It is pointed out in the JCT pamphlet that the "Other Income" provision in the Estonian treaty differs from the U.S. Model in that if "other income" is sourced in a Contracting State, that State is allowed to tax the income. Under the U.S. Model all "other income," regardless of source, may be taxed only in the State of residence of the beneficial owner. The Estonian position is reflected in all of its treaties, and is found in a number of U.S. treaties with developing countries, as well as with several OECD partners. It is another aspect of U.S. treaty policy that often is adjusted to reflect the economic position of our treaty partners.

*Royalty Source Rules*

*Issue:* The issue raised by the JCT pamphlet is whether it is appropriate to have royalty source rules in the treaty that are different from the Internal Revenue Code rules regarding the source of royalties.

*Response:* Under the proposed treaty, royalties are generally sourced according to the residence of the payor or the location of the permanent establishment or fixed base that incurs and bears the royalty. That rule is consistent with the U.N. Model rule but is different from the rule of U.S. internal law, which sources royalties according to the place where the property is used. Estonia requested the U.N. Model rule. The U.S. agreed, on the condition that the rule be modified to provide that if the general rule, stated above, did not source the royalty to either the United States or Estonia, the royalty would be sourced according to the place of use of the property, which is the general U.S. rule. A similar provision has been included in some other U.S. treaties (e.g., the 1995 U.S.-Canada protocol and 1997 treaties with Thailand and Turkey). As noted in the JCT pamphlet, a conflict between U.S. law and the rule under the proposed U.S.-Estonia treaty would arise only in the circumstances where an Estonian resident that does not have a permanent establishment or fixed base in the United States pays a royalty to a U.S. resident for the right to use property exclusively in the United States. The proposed royalty source rule would treat such royalty as Estonian source (and therefore potentially taxable in Estonia). However, U.S. internal law would treat such royalty as U.S. source income. As noted in the JCT pamphlet, the JCT staff recognizes that this situation would arise in relatively few cases (as opposed to the more common situation in which an Estonian resident using property in the United States would also have a permanent establishment or fixed base in the United States to which the royalty would be attributed, in which case it would be U.S. source). As a consequence of a similar recognition by the Treasury staff, we believe that this provision was an acceptable concession in the context of the overall U.S.-Estonian tax treaty negotiation. A further exception to the general source rule was included, at the insistence of the United States, that sources royalties that are payments for the use of containers as arising in neither Contracting State, and thus taxable, as "Other Income," only in the State of residence of the income recipient. The result of this rule is consistent with the rule in the U.S. Model, which, under Article 8, gives exclusive taxation rights for such income to the State of residence of the beneficial owner of the income.

*Income from the Rental of Ships and Aircraft*

*Issue:* The issue presented in the JCT pamphlet is whether the proposed treaty's rules treating profits from certain rental of ships and aircraft less favorably than profits from the operation of ships and aircraft and the rental of containers are appropriate.

*Response:* The treatment of income from the rental of ships and aircraft, where the rental is not incidental to the operation of ships and aircraft in international traffic, was a difficult issue in the negotiations. Although it is U.S. policy to include such income within the scope of the source exemption in Article 8, Estonia was unwilling to do so, although they were willing to exempt incidental rentals from source country tax. The treaty permits Estonia to impose tax at source on non-incidental ship and aircraft rentals, but at a rate limited to 5 percent of the gross rental. This is a common result in Estonian treaties, and is also found in several other U.S. treaties.

*Treaty Shopping*

*Issue:* The issue raised by the JCT pamphlet is whether the limitation on benefits provision of the proposed treaty is an adequate tool for preventing possible treaty-shopping abuses in the future.

*Response:* The limitation on benefits provisions of the proposed treaty adhere closely to those of the U.S. Model. We therefore believe that they are adequate.

PROPOSED CONVENTION WITH ITALY

*"Main Purpose" Anti-Abuse Test*

As noted above, this issue will be addressed in a separate memorandum.

*Creditability of Italian IRAP Tax*

*Issue:* The issue raised by the JCT pamphlet is the extent to which treaties should be used to provide a foreign tax credit for taxes that may not otherwise be fully creditable.

*Response:* One of the principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. One of the common ways in which this is accomplished is through a foreign tax credit, whereby the taxpayer's country of residence or citizenship, which taxes the worldwide income of the taxpayer, allows a credit for taxes paid to the other country on income that the other country is allowed to tax under the treaty. This mechanism is provided for under internal U.S. law, and is also a common feature of U.S. tax treaties.

The proposed treaty provides for this mechanism, allowing U.S. residents or citizens a credit against U.S. income tax for the appropriate amount of income tax paid to Italy. The proposed treaty lists the specific Italian taxes that are considered creditable income taxes, and, like other U.S. treaties, provides that any identical or substantially similar taxes that are imposed by Italy after the date of signature will be considered creditable income taxes.

The proposed treaty also addresses the creditability of the Italian regional tax on productive activities ("IRAP"). This tax, which became effective January 1, 1998, was enacted by Italy to replace the local income tax ("ILOR"), as well as certain other taxes. This enactment was part of a fundamental revision of the Italian system for financing its regions and localities. In calculating the IRAP tax base, taxpayers are allowed to deduct certain expenses, such as depreciation and rental payments, but are not allowed to deduct labor expense or, in the case of non-financial institutions, interest expense.

The Italian legislation implementing IRAP provides that IRAP is to be considered substantially similar to ILOR for purposes of Italy's international agreements ILOR, which was an income tax under U.S. law, is explicitly listed as a creditable income tax in the existing treaty. Accordingly, Italian tax authorities took the position that IRAP is creditable in full under the existing treaty. In contrast, the Treasury Department believes that IRAP is not substantially similar to ILOR for purposes of the existing treaty. In particular, by disallowing deductions for labor and interest expense, IRAP is not likely to reach net gain in the normal circumstances in which it applies and, accordingly, it does not satisfy one of the requirements for being an income tax under U.S. law.

Because IRAP replaced a tax explicitly addressed by the existing treaty, and because of the disagreement over the proper interpretation of the existing treaty, the Treasury Department agreed to address the creditability of IRAP in the context of a comprehensive renegotiation of the existing treaty. The Treasury Department be-

lieved that such a renegotiation would allow the existing treaty, which was signed in 1984, to be updated to more closely reflect current U.S. treaty policy.

In its economic effect, IRAP constitutes a tax not only on the net income of a taxpayer, but also on labor and, in the case of non-financial institutions, interest. Accordingly, U.S. negotiators refused to permit a tax credit for the full amount of IRAP. However, because one of the principal purposes of the treaty is to eliminate double taxation of income, the negotiators believed it was appropriate to allow limited relief for that portion of IRAP that was equivalent to a tax on the net income of a U.S. taxpayer. Thus, the proposed treaty provides a formula for determining the portion of IRAP that is equivalent to an income tax for purposes of the foreign tax credit.

It is important to note that the portion of IRAP that is equivalent to an income tax under the proposed treaty is subject to the same limitations on creditability as the other Italian income taxes listed in the treaty. In particular, in accordance with U.S. treaty policy, the proposed treaty provides that an income tax is creditable only in accordance with, and subject to the limitations of, U.S. law. Thus, for example, the credit with respect to the relevant portion of IRAP is subject to U.S. law rules governing “basket limitations,” currency translation, and carryover periods.

As it has in the past, Treasury intends in its future negotiations to continue its practice of reviewing its treaty partner’s taxes carefully to determine wehther their creditability should be provided for in our treaty.

In summary, the proposed treaty’s allowance of a foreign tax credit for a portion of IRAP represents an appropriate response to a particular set of circumstances arising in the context of an existing treaty relationship. Moreover, the approach is narrowly tailored to allow a credit only for that portion of IRAP that is equivalent to a tax on the U.S. taxpayer’s net income, thereby furthering the treaty policy of eliminating double taxation on income. Under such circumstances, the provision of a foreign tax credit by treaty is appropriate.

*Insurance Excise Tax*

*Issue:* The issue raised by the JCT pamphlet is whether it is appropriate to provide an exemption from the federal excise tax on insurance premiums paid to foreign insurers in the proposed treaty with Italy.

*Response:* The existing treaty, which was signed in 1984, provides an exemption from the federal excise tax on insurance premiums paid to Italian insurers, as long as certain requirements are satisfied. The proposed treaty retains the existing treaty’s coverage of this tax.

Treasury recognizes the policy concerns about the competitiveness of U.S. insurance companies that serve as the basis for the imposition of the excise tax on foreign insurers insuring U.S. risks. Consistent with these policy concerns, the Treasury Department will only agree to cover this excise tax in an income tax convention, and thereby grant an exemption from the tax, if Treasury is satisfied that an insurer that is a resident of the treaty partner and is insuring U.S. risks would face a level of taxation that is substantial relative to the level of taxation faced by U.S. insurers.

During the course of negotiations, Treasury conducted a thorough review of Italian law and information on Italian insurance company operations. This review demonstrated that insurance companies that are resident in Italy are subject to a substantial level of tax in Italy. Accordingly, it was determined that U.S. insurance companies would not be placed at a competitive disadvantage by the retention of coverage of the excise tax in the proposed treaty.

As further protection, the proposed treaty includes the “anti-conduit” clause also found in the existing treaty. This provision ensures that the excise, tax will apply if an Italian insurer reinsures a policy it has written on a U.S. risk with a foreign insurer that is not entitled to a similar exemption under this or a different tax treaty.

*Shipping and Aircraft Income*

*Issue:* The issue raised by the JCT pamphlet is whether the proposed treaty’s rules with respect to income derived from the rental of ships and aircraft, and gains from the sale of ships and aircraft, are appropriate.

*Response:* The proposed treaty, with one favorable exception, retains the existing treaty’s treatment of income from the rental of ships and aircraft, and gains from their sale. As in the existing treaty, and consistent with U.S. policy, the proposed treaty provides an exemption from source-country taxation for rental income (and gains) from ships and aircraft rented on a full basis, as well as rental income (and gains) from containers used in international traffic. As in the existing treaty, the proposed treaty provides that income (and gains) from ships and aircraft rented on a bareboat basis will be exempt from source-country taxation only if the rentals are

incidental to the lessor's profits from the operation of ships or aircraft in international traffic.

Although it is the preferred U.S. policy to extend the source-country exemption to include non-incidental income from the bareboat rental of ships and aircraft (and gains from the disposition of such ships and aircraft), Italy was unwilling to change the existing treaty on this point because of its strong treaty policy against such exemptions. Indeed, the inclusion of a source-country exemption for rental income (and gains) from containers used in international traffic represents a significant departure for Italy from its normal treaty policy.

Nonetheless, the proposed treaty does represent an improvement over the existing treaty's treatment of rental income from the non-incidental rental of ships and aircraft on a bareboat basis. Whereas the existing treaty allows the source country to impose a 7 percent tax rate on the gross amount of such rentals that are not attributable to a permanent establishment in the source country, the proposed treaty lowers that rate to 5 percent.

*Treaty Shopping*

*Issue:* The issue raised by the JCT pamphlet is whether the limitation on benefits provision of the proposed treaty is an adequate tool for preventing possible treaty-shopping abuses in the future.

*Response:* The limitation on benefits provision of the proposed treaty is identical in all substantive respects to the provision contemplated by the U.S. Model We therefore believe that it is adequate.

*Arbitration of Competent Authority Issues*

*Issue:* The issue raised by the JCT pamphlet is whether the provision allowing for the competent authorities to agree to arbitration, with the consent of the affected taxpayer, is appropriate.

*Response:* Treasury recognizes that there has been little practical experience with arbitration of tax treaty disputes and this creates some uncertainty about how well arbitration would work. For this reason, Treasury does not advocate the inclusion of arbitration provisions in new treaties. However, if the treaty partner is strongly interested in an arbitration provision, we are willing to include such a provision in a new treaty with the proviso that it cannot be implemented until the treaty partners have exchanged diplomatic notes to that effect. This provides the opportunity to wait until more experience has been gained with arbitration and with the treaty partner before deciding whether the implementation of such a provision is desirable. For the foregoing reasons, and because Italy was strongly interested in the provision, it was included in the proposed treaty.

*Exchange of Information*

*Issue:* The issues raised by the JCT pamphlet are (1) whether the information exchange provision, which does not include a sentence regarding the ability to obtain information from financial institutions, is sufficient and (2) whether a statement that the omission of the provision regarding financial institutions does not lessen the commitment of the United States to pursue broader exchanges of information in future treaty negotiations would be beneficial.

*Response:* Adequate exchange of information with our treaty partners is one of the key objectives of our tax treaty policy. The Treasury Department remains strongly committed to this objective, including the ability to exchange third-party information obtained from banks and other financial institutions.

The Treasury Department believes that the exchange of information provisions in the proposed treaty will enable the United States to obtain this third-party information, and that the omission of paragraph 3 of Article 26 of the U.S. Model will have no adverse effect on this ability. Treasury has received written assurances from the Italian Ministry of Finance regarding Italy's ability to obtain bank information under its internal laws in order to comply with the information exchange provisions contained in the proposed treaty. Moreover, Italy has been at the forefront of international efforts to increase information exchange in order to prevent tax avoidance and evasion. Indeed, Italy recently hosted a high-level OECD meeting between tax and bank regulatory officials and the private sector in order to discuss the problem of bank secrecy and explore the subject of greater access to bank information for tax administration purposes.

It is important to note that the inclusion in a treaty of the first sentence of paragraph 3 of Article 26 of the U.S. Model, which purports to override a country's internal laws regarding bank secrecy, does not guarantee that the United States will, in practice, actually receive third-party bank information. For example, a country's internal laws might not allow the exchange of such information notwithstanding the purported override in the treaty. Accordingly, the most effective way of protecting

the United States' interest in this area is through due diligence during negotiations to ensure that internal laws will, in fact, enable the exchange.

In addition, some countries have viewed the request for this provision as a diplomatic slight. This is particularly of concern to those countries that have been affected by the United States' "later-in-time" principle, which permits a subsequently enacted U.S. domestic law to take precedence over the provisions of a previously ratified treaty.

For these reasons, the Treasury Department plans to substantially revise or eliminate this sentence in the U.S. Model. Of course, any change in the sentence would not lessen the Treasury Department's commitment to adequate information exchange, including third-party bank information.

As to the second issue, as noted above, we believe that the effect of the information exchange provision of this treaty is as broad as in any of our tax treaties, and we do not believe that it would be beneficial to suggest otherwise. However, we always welcome strong statements from the Committee regarding the importance of information exchange. Therefore, we believe that a statement from the Committee that the omission of this statement in this treaty does not reflect any lessening of our commitment to receiving information from banks and other financial institutions *would* be beneficial.

PROPOSED CONVENTION WITH LATVIA

*Treatment of REIT Dividends*

*Issue:* The issue raised by the JCT pamphlet is whether the treatment of REIT dividends in the proposed treaty is appropriate.

*Response:* As noted with respect to Estonia above, this treaty was fully negotiated at the time we decided to change our policy at the end of 1997. It was not appropriate to re-open negotiations, in particular because Latvia is not a significant source of investment in U.S. real estate.

*Developing Country Concessions*

*Issue:* The issue raised in the JCT pamphlet is whether the developing country concessions represent appropriate U.S. treaty policy and, if they do, whether Latvia is an appropriate recipient of these concessions.

*Response:* As noted above, developing country concessions may be necessary in order to enter into treaties with developing countries. Tax treaties with developing countries are in the interest of the United States because they provide reductions in the taxation by such countries of U.S. investors and a clearer framework for the taxation of U.S. investors. Such treaties also provide dispute resolution and non-discrimination rules that benefit U.S. investors and exchange of information procedures that benefit the tax authorities.

Regarding whether Estonia is an appropriate recipient of developing country concessions, it should be noted that for 1997, the GDP of Latvia was $10.4 billion (as compared to the U.S. GDP of $8,100 billion) and the per capita GDP was $4,260 (as compared to $30,200 per capita GDP in the United States).

The Treasury Department believes that the developing country concessions in the proposed treaty are in line with the concessions granted by the United States to other developing countries and compare favorably with developing country concessions granted to Latvia by other OECD countries. These provisions are addressed individually below.

With respect to particular developing country concessions in the proposed Latvian treaty, the JCT pamphlet identified the following:

- the definition of "permanent establishment";
- the taxation of business profits;
- the taxation of certain equipment leasing; and
- other taxation by the source country.

These are discussed below seriatim.

*Permanent Establishment Definition*

The Latvian treaty provides that the term "permanent establishment" includes building sites, etc. when the site or activity continues for more than six months. A special article provides that "offshore activities" relating to the exploration for natural resources will be taxed as a permanent establishment if such activities continue for more than 30 days in any twelve-month period. The U.S. Model provides that both building and oil exploration activities will constitute a "permanent establishment" only when the site or activity continues for 12 months. The lower threshold for building activities in the treaty reflects the fact that, as a newly emerging economy, Latvia is more dependent upon tax revenues from construction projects

and similar activities than developed countries whose physical and business infrastructure are more established. This rule in the Latvian treaty is consistent both with other Latvian treaties and with many other U.S. treaties with developing countries. With respect to the offshore activities rules, Latvia takes the same view as a number of North Sea countries (and other countries whose tax laws have been influenced by the North Sea countries) that the oil in their territorial waters is part of their patrimony. They therefore want to make sure that they have primary taxing jurisdiction with respect to all revenues generated from the oil. The rule in the treaty is the same as that in our treaties with Ireland, The Netherlands, Norway and the United Kingdom.

*Taxation of Business Profits*

The proposed treaty provides that if an enterprise has a permanent establishment in a country, that country may tax the portion of the enterprise's business profits that is attributable to the permanent establishment. As in the treaty with Estonia, the treaty with Latvia includes a "limited force of attraction" rule. The rule in the treaty is narrower than the rule found in the U.N. Model and operates as an anti-abuse rule. We therefore concluded that the rule did not improperly expand the taxation of business income.

*Taxation of Certain Equipment Leasing*

Under the U.S. Model Treaty, income from the rental of tangible personal property is treated as business profits. Under the proposed Latvian treaty, payments for the use of or the right to use, industrial, commercial, or scientific equipment will be treated as royalties. Treatment of such income as royalties is consistent with the position taken by many developing countries and with the former OECD Model Treaty. It also represents the treaty policy of Latvia. Through negotiation, we were able to reduce the withholding rate on this class of royalties to 5 percent (from the general rate of 10 percent). As with all royalty income, if the income from rentals of tangible personal property are attributable to a permanent establishment or fixed base in the source country, such income is taxed on a net basis under Articles 7 or 14. As discussed below with respect to ships and aircraft, there are exemptions from even the 5 percent withholding tax in the case of income from the rental of containers used in international traffic, and from the rental of ships and aircraft used in international traffic on a full (time or voyage) basis, and on a bareboat basis when such income is incidental to the operation of the ships and aircraft in international traffic.

*Other Taxation by Source Country*

The JCT pamphlet also noted other areas in which the proposed treaty provides for greater taxation by the source country than would be permitted under the corresponding provisions of the U.S. Model. It notes the fact that the withholding rate at source on royalties is generally 10 percent, with a 5 percent rate on rentals of tangible personal property, rather than the zero rate at source in the U.S. Model. As noted above, developing countries are frequently unwilling to lower their withholding rates to the levels in the U.S. Model, largely because of their concerns over the potential loss of revenue. We were able to get Latvia to agree to relatively low rates, similar to those found in a number of other U.S. treaties with developing countries.

The JCT pamphlet also noted the fact that under the Latvia treaty a fixed base is deemed to exist, thus allowing the host country to tax income from independent personal services, when the visitor is present in that country for 183 days in a 12-month period. This rule is not in the U.S. Model. Latvia was concerned that, without this rule, a U.S. resident would be able to spend longer than 183 days in Latvia performing independent personal services, but would be able to do so without using a fixed base (e.g., moving among clients' offices) and would avoid Latvian tax.

The addition of this rule will prevent this result. This is standard Latvian treaty policy. A similar rule is found in a number of other U.S. treaties with developing countries, some (e.g., Thailand) with lower time thresholds.

*Royalty Source Rules*

*Issue:* The issue raised by the JCT pamphlet is whether it is appropriate to have royalty source rules in the treaty that are different from the Internal Revenue Code rules regarding the source of royalties.

*Response:* Under the proposed treaty, royalties are generally sourced according to the residence of the payor or the location of the permanent establishment or fixed base that incurs and bears the royalty. That rule is consistent with the U.N. Model rule but is different from the rule of U.S. internal law, which sources royalties according to the place where the property is used. Latvia requested the U.N. Model

rule. The U.S. agreed, on the condition that the rule be modified to provide that if the general rule, stated above, did not source the royalty to either the United States or Latvia, the royalty would be sourced according to the place of use of the property, which is the general U.S. rule. This source provision has been included in some other U.S. treaties (e.g., the 1995 U.S.-Canada protocol and 1997 treaties with Thailand and Turkey). As noted in the JCT pamphlet, a conflict between U.S. law and the rule under the proposed U.S.-Latvia treaty would arise only in the circumstances where a Latvian resident that does not have a permanent establishment or fixed base in the United States pays a royalty to a U.S. resident for the right to use property exclusively in the United States. The proposed royalty source rule would treat such royalty as Latvian source (and therefore potentially taxable in Latvia) However, U.S. internal law would treat such royalty as U.S. source income. As noted in the JCT pamphlet, the JCT staff recognizes that this situation would arise in relatively few cases (as opposed to the more common situation in which a Latvian resident using property in the United States would also have a permanent establishment or fixed base in the United States to which the royalty would be attributed, in which case it would be U.S. source). As a consequence of a similar recognition by the Treasury staff, we believe that this provision was an acceptable concession in the context of the overall U.S.-Latvian tax treaty negotiation. A further exception to the general source rule was included, at the insistence of the United States, that sources royalties that are payments for the use of containers as arising in neither Contracting State, and thus taxable, as "Other Income," only in the State of residence of the income recipient. The result of this rule is consistent with the rule in the U.S. Model, which, under Article 8, gives exclusive taxation rights for such income to the State of residence of the beneficial owner of the income.

*Income from the Rental of Ships and Aircraft*

*Issue:* The issue presented in the JCT pamphlet is whether the proposed treaty's rules treating profits from certain rental of ships and aircraft less favorably than profits from the operation of ships and aircraft and the rental of containers are appropriate.

*Response:* The treatment of income from the bareboat rental of ships and aircraft, where the rental is not incidental to the operation of ships and aircraft in international traffic, was a difficult issue in the negotiations. Although it is U.S. policy to include such income within the scope of the source exemption in Article 8, Latvia was unwilling to do so, although they were willing to exempt incidental rentals from source country tax. The treaty permits Latvia to impose tax at source on non-incidental bareboat ship and aircraft rentals, but at a rate limited to 5 percent of the gross rental. This is a common result in Latvian treaties, and is also found in several other U.S. treaties.

*Treaty Shopping*

*Issue:* The issue raised by the JCT pamphlet is whether the limitation on benefits provision of the proposed treaty is an adequate tool for preventing possible treaty-shopping abuses in the future.

*Response:* The limitation on benefits provisions of the proposed treaty adhere closely to those of the U.S. Model. We therefore believe that they are adequate.

PROPOSED CONVENTION WITH LITHUANIA

*Treatment of REIT Dividends*

*Issue:* The issue raised by the JCT pamphlet is whether the treatment of REIT dividends in the proposed treaty is appropriate.

*Response:* As noted with respect to Estonia and Latvia above, this treaty was fully negotiated at the time we decided to change our policy at the end of 1997. It was not appropriate to re-open negotiations, in particular because Lithuania is not a significant source of investment in U.S. real estate.

*Developing Country Concessions*

*Issue:* The issue raised in the JCT pamphlet is whether the developing country concessions represent appropriate U.S. treaty policy and, if they do, whether Lithuania is an appropriate recipient of these concessions.

*Response:* As noted above, developing country concessions may be necessary in order to enter into treaties with developing countries. Tax treaties with developing countries are in the interest of the United States because they provide reductions in the taxation by such countries of U.S. investors and a clearer framework for the taxation of U.S. investors. Such treaties also provide dispute resolution and non-discrimination rules that benefit U.S. investors and exchange of information procedures that benefit the tax authorities.

Regarding whether Lithuania is an appropriate recipient of developing country concessions, it should be noted that for 1997, the GDP of Lithuania was $15.4 billion (as compared to the U.S. GDP of $8,100 billion) and the per capita GDP was $4,230 (as compared to $30,200 per capita GDP in the United States).

The Treasury Department believes that the developing country concessions in the proposed treaty are in line with the concessions granted by the United States to other developing countries and compare favorably with developing country concessions granted to Lithuania by other OECD countries. With respect to particular developing country concessions in the proposed Lithuanian treaty, the JCT pamphlet identified the following:

- the definition of "permanent establishment";
- the taxation of business profits;
- the taxation of certain equipment leasing; and
- other taxation by the source country.

These are discussed below seriatim.

*Permanent Establishment Definition*

The Lithuanian treaty provides, that the term "permanent establishment" includes building sites, etc. when the site or activity continues for more than six months. A special article provides that "offshore activities" relating to the exploration for natural resources will be taxed as a permanent establishment if such, activities continue for more than 30 days in any twelve-month period. The U.S. Model provides that both building and oil exploration activities will constitute a "permanent establishment" only when the site or activity continues for 12 months. The lower threshold for building activities in the treaty reflects the fact that, as a newly emerging economy, Lithuania is more dependent upon tax revenues from construction projects and similar activities than developed countries whose physical and business infrastructure are more established. This rule in the Lithuanian treaty is consistent both with other Lithuanian treaties and with many other U.S. treaties with developing countries. With respect to the offshore activities rules, Lithuania takes the same view as a number of North Sea countries (and other countries whose tax laws have been influenced by the North Sea countries) that the oil in their territorial waters is part of their patrimony. They therefore want to make sure that they have primary taxing jurisdiction with respect to all revenues generated from the oil. The rule in the treaty is the same as that in our treaties with Ireland, The Netherlands, Norway and the United Kingdom.

*Taxation of Business Profits*

The proposed treaty provides that if an enterprise has a permanent establishment in a country, that country may tax the portion of the enterprise's business profits that is attributable to the permanent establishment. As in the treaties with Estonia and Latvia, the treaty with Lithuania includes a "limited force of attraction" rule. The rule in the treaty is narrower than the rule found in the U.N. Model and operates as an anti-abuse rule. We therefore concluded that the rule did not improperly expand the taxation of business income.

*Taxation of Certain Equipment Leasing*

Under the U.S. Model Treaty, income from the rental of tangible personal property is treated as business profits. Under the proposed Lithuanian treaty, payments for the use of, or the right to use, industrial, commercial, or scientific equipment will be treated as royalties. Treatment of such income as royalties is consistent with the position taken by many developing countries and with the former OECD Model Treaty. It also represents the treaty policy of Lithuania. Through negotiation, we were able to reduce the withholding rate on this class of royalties to 5 percent (from the general rate of 10 percent). As with all royalty income, if the income from rentals of tangible personal property are attributable to a permanent establishment or fixed base in the source country, such income is taxed on a net basis under Article 7. As discussed below with respect to ships and aircraft, there are exemptions from even the 5 percent withholding tax in the case of income from the rental of containers used in international traffic, and from the rental of ships and aircraft used in international traffic on a full (time or voyage) basis, and on a bareboat basis when such income is incidental to the operation of the ships and aircraft in international traffic.

*Other Taxation by Source Country*

The JCT pamphlet also noted other areas in which the proposed treaty provides for greater taxation by the source country than would be permitted under the corresponding provisions of the U.S. Model. It notes the fact that the withholding rate

at source on royalties is generally 10 percent, with a 5 percent rate on rentals of tangible personal property, rather than the zero rate at source in the U.S. Model. As noted above, developing countries are frequently unwilling to lower their withholding rates to the levels in the U.S. Model, largely because of their concerns over the potential loss of revenue. We were able to get Lithuania to agree to relatively low rates, similar to those found in a number of other U.S. treaties with developing countries.

The JCT pamphlet also noted the fact that under the Lithuania treaty a fixed base is deemed to exist, thus allowing the host country to tax income from independent personal services, when the visitor is present in that country for 183 days in a 12-month period. This rule is not in the U.S. Model. Lithuania was concerned that, without this rule, a U.S. resident would be able to spend longer than 183 days in Estonia performing independent personal services, but would be able to do so without using a fixed base (e.g., moving among clients' offices) and would avoid Lithuanian tax. The addition of this rule will prevent this result. This is standard Lithuanian treaty policy. A similar rule is found in a number of other U.S. treaties with developing countries, some (e.g., Thailand) with lower time thresholds.

*Royalty Source Rules*

*Issue:* The issue raised by the JCT pamphlet is whether it is appropriate to have royalty source rules in the treaty that are different from the Internal Revenue Code rules regarding the source of royalties.

*Response:* Under the proposed treaty, royalties are generally sourced according to the residence of the payor or the location of the permanent establishment or fixed base that incurs and bears the royalty. That rule is consistent with the U.N. Model rule but is different from the rule of U.S. internal law, which sources royalties according to the place where the property is used. Lithuania requested the U.N. Model rule. The U.S. agreed, on the condition that the rule be modified to provide that if the general rule, stated above, did not source the royalty to either the United States or Lithuania, the royalty would be sourced according to the place of use of the property, which is the general U.S. rule. This source provision has been included in some other U.S. treaties (e.g., the 1995 U.S.-Canada protocol and 1997 treaties with Thailand and Turkey). As noted in the JCT pamphlet, a conflict between U.S. law and the rule under the proposed U.S.-Lithuania treaty would arise only in the circumstances where a Lithuanian resident that does not have a permanent establishment or fixed base in the United States pays a royalty to a U.S. resident for the right to use property exclusively in the United States. The proposed royalty source rule would treat such royalty as Lithuanian source (and therefore potentially taxable in Lithuania). However, U.S. internal law would treat such royalty as U.S. source income. As noted in the JCT pamphlet, the JCT staff recognizes that this situation would arise in relatively few cases (as opposed to the more common situation in which a Lithuanian resident using property in the United States would also have a permanent establishment or fixed base in the United States to which the royalty would be attributed, in which case it would be U.S. source). As a consequence of a similar recognition by the Treasury staff, we believe that this provision was an acceptable concession in the context of the overall U.S.-Lithuanian tax treaty negotiation. A further exception to the general source rule was included, at the insistence of the United States, that sources royalties that are payments for the use of containers as arising in neither Contracting State, and thus taxable, as "Other Income," only in the State of residence of the income recipient. The result of this rule is consistent with the rule in the U.S. Model, which, under Article 8, gives exclusive taxation rights for such income to the State of residence of the beneficial owner of the income.

*Income from the Rental of Ships and Aircraft*

*Issue:* The issue presented in the JCT pamphlet is whether the proposed treaty's rules treating profits from certain rental of ships and aircraft less favorably than profits from the operation of ships and aircraft and the rental of containers are appropriate.

*Response:* The treatment of income from the bareboat rental of ships and aircraft, where the rental is not incidental to the operation of ships and aircraft in international traffic, was a difficult issue in the negotiations. Although it is U.S. policy to include such income within the scope of the source exemption in Article 8, Latvia was unwilling to do so, although they were willing to exempt incidental rentals from source country tax. The treaty permits Latvia to impose tax af source on non-incidental bareboat ship and aircraft rentals, but at a rate limited to 5 percent of the gross rental. This is a common result in Latvian treaties, and is also found in several other U.S. treaties.

*Treaty Shopping*

*Issue:* The issue raised by the JCT pamphlet is whether the limitation on benefits provision of the proposed treaty is an adequate tool for preventing possible treaty-shopping abuses in the future.

*Response:* The limitation on benefits provisions of the proposed treaty adhere closely to those of the U.S. Model. We therefore believe that they are adequate.

PROPOSED CONVENTION WITH SLOVENIA

*"Main Purpose" Anti-Abuse Test*

As noted above, this issue will be addressed in a separate memorandum.

*Exchange of Information*

*Issue:* The issues raised by the JCT pamphlet are (1) whether the information exchange provision, which does not include a sentence regarding the ability to obtain information from financial institutions, is sufficient and (2) whether a statement that the omission of the provision regarding financial institutions does not lessen the commitment of the United States to pursue broader exchanges of information in future treaty negotiations would be beneficial.

*Response:* Adequate exchange of information with our treaty partners is one of the key objectives of our tax treaty policy. The Treasury Department remains strongly committed to this objective, including the ability to exchange third-party information obtained from banks and other financial institutions.

The Treasury Department believes that the exchange of information provisions in the proposed treaty will enable the United States to obtain this third-party information, and that the omission of the first sentence of paragraph 3 of Article 26 of the U.S. Model will have no adverse effect on this ability. Treasury has received written assurances from the Slovenian Ministry of Finance regarding Slovenia's ability to obtain bank information under its internal laws in order to comply with the information exchange provisions contained in the proposed treaty. Moreover, the Slovenian Ministry of Finance has confirmed that penalties exist under its internal law in order to ensure that banks and other financial institutions comply with requests for information.

It is important to note that the inclusion in a treaty of the first sentence of paragraph 3 of Article 26 of the U.S. Model, which purports to override a country s internal laws regarding bank secrecy, does not guarantee that the United States will, in practice, actually receive third-party bank information. For example, a country's internal laws might not allow the exchange of such information notwithstanding the purported override in the treaty. Accordingly, the most effective way of protecting the United States' interest in this area is through due diligence during negotiations to ensure that internal laws will, in fact, enable the exchange.

In addition, some countries have viewed the request for this provision as a diplomatic slight. This is particularly of concern to those countries that have been affected by the United States' "later-in-time" principle, which permits a subsequently enacted U.S. domestic law to take precedence over the provisions of a previously ratified treaty.

For these reasons, the Treasury Department plans to substantially revise or eliminate this sentence in the U.S. Model. Of course, any change in the sentence would not lessen the Treasury Department's commitment to adequate information exchange, including third-party bank information.

As to the second issue, as noted above, we believe that the effect of the information exchange provision of this treaty is as broad as in any of our tax treaties, and we do not believe that it would be beneficial to suggest otherwise. However, we always welcome strong statements from the Committee regarding the importance of information exchange. Therefore, we believe that a statement from the Committee that the omission of this statement in this treaty does not reflect any lessening of our commitment to receiving information from banks and other financial institutions *would* be beneficial.

*Treaty Shopping*

*Issue:* The issue raised by the JCT pamphlet is whether the limitation on benefits provision of the proposed treaty is an adequate tool for preventing possible treaty-shopping abuses in the future.

*Response:* The limitation on benefits provisions of the proposed treaty adhere closely to those of the U.S. Model. We therefore believe that they are adequate.

PROPOSED CONVENTION WITH VENEZUELA

*Developing Country Concessions*

*Issue:* The issue raised in the JCT pamphlet is whether the developing country concessions represent appropriate U.S. treaty policy and, if they do, whether Venezuela is an appropriate recipient of these concessions.

*Response:* Regarding whether Venezuela is an appropriate recipient of developing country concessions, it should be noted that for 1997, Venezuela's gross domestic product (GDP) was $185 billion and its per capita GDP was $8,300. By contrast, the United States' 1997 GDP was $8.1 trillion and its per capita GDP $30,200.

With respect to particular developing country concessions in the proposed Venezuela treaty, the JCT pamphlet identified the following:

- the definition of "permanent establishment";
- the taxation of certain equipment leasing;
- other taxation by source country.

These are discussed below seriatim.

*The Definition of Permanent Establishment*

The Venezuela treaty provides that the term "permanent establishment" encompasses building sites and drilling rigs and ships used for the exploration for natural resources when the site or activity continues for periods aggregating more than 183 days within any 12-month period. Under the U.S. Model, the site or activity would have to last for more than 12 months. The Venezuela treaty also includes a rule under which an enterprise that provides services in the other country would be treated as having a permanent establishment if its employees are in the other country and the activities continue for a period or periods aggregating more than 183 days within a 12-month period. The U.S. Model contains no provision treating the furnishing of services as a permanent establishment.

The building-site rule reflects the recognition that Venezuela is a developing nation and more dependent upon tax revenue from construction projects than developed nations whose physical and business infrastructure are more established. The building-site provision is consistent with other income tax treaties of Venezuela. The rules regarding the threshold for oil exploration were quite important to Venezuela because of the importance of the oil sector to Venezuela's economy. We also took into account the fact that the proximity of Venezuela to the United States would make it easier for owners of drilling rigs to move the rigs back and forth between the two countries than would be the case with respect to other areas in which oil exploration takes place. The rule in the treaty is the same as in our treaty with Mexico and significantly longer than in our treaty with Canada, which has a 3-month threshold.

Venezuela also requested the 183-day/12-month-period permanent establishment rule with respect to the furnishing of services. As a developing nation, Venezuela must import consultancy and other services to a greater degree than developed nations and did not want to surrender its right to tax such services. A similar rule is found in a number of other U.S. treaties with developing countries, some (e.g., Thailand) with lower time thresholds.

*Taxation of Certain Equipment Leasing*

Under the U.S. Model Treaty, income from the rental of tangible personal is treated as business profits. Under the proposed Venezuela treaty, payments for the use of, or the right to use, industrial, commercial, or scientific equipment will be treated as royalties. Treatment of such income as royalties is consistent with the position taken by many developing countries and with the former OECD Model Treaty. It also represents the treaty policy of Venezuela. Through negotiation, we were able to reduce the withholding rate on this class of royalties to 5 percent (from the general rate of 10 percent), and to carve out of the definition of "royalties" ship, aircraft and container leasing income, whether or not such income is incidental to the operation of such ships, aircraft or containers in international traffic by the recipient of the income. Of course, payments for the use of, or the right to use, industrial, commercial, or scientific equipment that are attributable to a permanent establishment will be taxed as business profits on a net, as opposed to a gross, basis.

*Other Taxation by Source Country*

The U.S. Model provides for an exemption from source-country taxation for royalty payments. The Venezuela treaty provides that royalties will be subject to withholding tax of 5 percent (in the case of equipment leasing, as described above) or 10 percent with respect to all other payments covered by the article. The Venezuela treaty also provides that the source country may impose tax on "other income", under the U.S. Model, income falling under the "other income" article is taxable only

by the country of residence of the beneficial owner. As with interest, source country taxation was preserved in the treaty for both royalties and other income to help ensure that under Venezuela's territorial system, U.S.-source income paid to Venezuela would be subject to a gross withholding tax that would approximate the results if the income were actually subject to a net income tax in Venezuela. We did not press for lower rates for these types of payments and do not view the rates in this treaty as developing country concessions. Of course, they are also in line with what Venezuela viewed as appropriate withholding rates under this treaty.

The proposed treaty generally permits source country taxation of artistes and sportsmen if the gross receipts derived by the individual in the source country exceed $6,000 for the taxable year concerned. The OECD and U.N. Models provide for taxation by the country of performance of the remuneration of entertainers or sportsmen with no dollar or time threshold. The United States introduces the dollar threshold test in its treaties to distinguish between two groups of entertainers and athletes—those who are paid very large sums of money for very short periods of service, and who would, therefore, normally be exempt from host country tax under the standard personal services income rules, and those who earn relatively modest amounts and are, therefore, not easily distinguishable from those who earn other types of personal service income. The United States has entered a reservation to the OECD Model on this point. Although the U.S. Model threshold is $20,000, we frequently adopt a lower limit to reflect economic conditions in the other country.

*Treaty Shopping*

*Issue:* The issue raised by the JCT pamphlet is whether the limitation on benefits provision of the proposed treaty is an adequate tool for preventing possible treaty-shopping abuses in the future.

*Response:* The limitation on benefits provisions of the proposed treaty adhere closely to those of the U.S. Model. We therefore believe that they are adequate.

*Venezuelan Territorial Tax System*

*Issue:* The issue raised by the JCT pamphlet is whether entering into a treaty with a country that has a territorial system like that of Venezuela is appropriate as a matter of U.S. treaty policy.

*Response:* As discussed extensively at the hearing, Venezuela is in the process of changing its income tax law. Under the new system, Venezuela will begin taxing all of the income received by its residents, rather than only that income that was determined, under broad "sourcing" rules, to be connected to Venezuela. The possibility that Venezuela would adopt this "worldwide" system was present throughout our treaty negotiations, and we planned for it in drafting the treaty. After reading, analyzing and discussing drafts of the new law, we have determined that the treaty will be at least as appropriate under the new law as the old law. The increased possibilities for double taxation that are the natural result of this change in law will make the treaty even more important than under Venezuela's territorial system. We believe that the treaty works appropriately, in large part because this change from "territorial" to "worldwide" taxation brings Venezuela's domestic laws into closer conformity with international norms. Moreover, there are vestiges of Venezuela's territorial system that are also addressed by special provisions in the treaty included to deal with that system.

Although the pending change in Venezuela's law makes this issue largely moot, we note that, in evaluating any tax treaty, it is important to consider the benefits of the treaty to taxpayers and the governments and weigh those benefits against any potential abuse that might arise. Other countries with which we already have treaties have certain aspects of territoriality in their tax codes, but we have entered into treaties with them because the treaty was in our overall interest. As with any prospective treaty partner, we analyzed Venezuela's system to determine where double taxation could arise and whether there were opportunities for double non-taxation and addressed both problems. In most cases, the solutions arrived at in the Venezuela treaty were based on principles established in other treaty contexts. We believe that the treaty with Venezuela would have been appropriate even without the change in law.

*Stability of Venezuelan Law*

*Issue:* The issues raised in the JCT pamphlet are whether the constitutional and institutional changes in Venezuela will create difficulties in administering the treaty, and whether the confidentiality of taxpayer information exchanged under the treaty will continue to be respected by any possible changes in local law.

*Response:* Potential constitutional and institutional changes in Venezuela make the certainty and stability that the treaty would provide especially important. The pamphlet suggests that there may be uncertainty regarding the substantive law of

Venezuela. The major potential change in substantive tax law is the likely change in Venezuela's system from territorial to worldwide taxation. Although this issue is framed by a discussion of recent political developments, the possibility that the law would change in this way existed during the course of the negotiations and affected the negotiation of many of the provisions of the treaty. The goal was to draft a treaty that would protect taxpayers and the government whether Venezuela had a territorial or a worldwide system. The treaty would benefit taxpayers by providing general principles regarding the threshold for taxation, the right to deductions for business expenses and non-discrimination.

With respect to tax administration, the provisions of the treaty would eliminate ambiguity with respect to the identity of the competent authority. The treaty clearly states that the Integrated National Service of Tax Administration (SENIAT) is the competent authority at this time, but Venezuela's Ministry of Finance also retains the discretion to re-designate the competent authority, just as, in the case of the United States, the Secretary of the Treasury retains the discretion to name the competent authority for purposes of the treaty. Maintaining the flexibility to change the designation of this authority is a standard practice of tax treaties.

The Internal Revenue Service and the Treasury Department are committed to ensuring that information exchanged under tax treaties is used only for permitted purposes. The treaty provides that any information exchanged in accordance with its provisions shall be used exclusively for tax purposes. In the context of our review of Venezuela, we consulted other government agencies, including agencies experienced in exchanging information with many Latin American countries. In this consultation we were not advised to anticipate abuses of exchanged information on the part of Venezuela. It should also be noted that moreover, we also understand that the new draft constitution being written by the National Constituent Assembly contains strong protections for civil and individual rights.

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## RESPONSE TO SENATOR DORGAN'S TESTIMONY

The written questions from Senator Hagel request a response to Senator Dorgan's testimony regarding the use of formulary apportionment to allocate and apportion income between related business entities. In particular, Senator Dorgan is concerned that certain provisions contained in all seven of the double taxation treaties (but not the German Estate Tax Protocol) pending before the Senate Foreign Relations Committee would restrict the use of formulary apportionment based on the interpretation of other U.S. treaties in two recent court cases.

Senator Dorgan's testimony raised concerns about the current approach by the United States to allocating income between related parties when those entities conduct business with one another. The problem arises because related entities can adjust the prices at which goods and services are purchased between each other without any non-tax economic consequences to the group, as both entities involved are owned or controlled by the same interests. Accordingly, other concerns such as taxation may effectively control how prices are determined for these related party transactions. For example, a multinational business can manipulate the prices charged in transactions between its affiliates in different countries, with the result that the income reported for tax purposes in one country may be artificially depressed, and the tax administration of that country collecting less tax from the enterprise than it should. In theory, the multinational would plan its transactions to ensure that its income is reported in the jurisdiction with the lowest effective tax rate. It is this possibility that makes transfer pricing one of the most important international tax issues.

If this potential tax avoidance (and the potential for double taxation) is to be ameliorated, it is necessary to have a benchmark by which to evaluate the prices charged. The benchmark adopted by the United States and all our major trading partners is the arm's-length standard. Under the arm's-length standard, the price charged should be the same as it would have been had the parties to the transaction been unrelated to one another—in other words, the same as if they had bargained at "arm's-length." This requires an analysis of the functions performed and risks assumed by each party to the transaction, to make sure each party is adequately compensated for those functions and risks. If taxpayers and tax administrators can find similar transactions that took place between unrelated parties, they begin the inquiry by analyzing those transactions to see whether the functions and risks performed by each party are comparable to those in the related party transaction.

This approach has been reflected in all of our treaties to date, including all seven treaties pending before the Committee. These treaties also apply an analogous ap-

proach for allocating income to a business conducted by a foreign corporation in the United States through a branch. Two recent court decisions have addressed the taxation of branch operations under a tax treaty and are the source of Senator Dorgan's concern. The first case suggests that it is not possible to use profits-based methods in determining the business profits attributable to a permanent establishment, and that the tax administrator is required to respect the income shown on the books of the branch, except in "exceptional circumstances," a much higher standard than applies when adjusting the income of separate legal entities. A more recent case provides that the tax administrators may adjust the branch's books to reflect an arm's length. Thus, the trend of the cases is in the right direction.

Moreover, the courts that decided these cases relied heavily on the existing Commentary to Article 7 (Business Profits) of the OECD Model Tax Convention. Without addressing the issue of whether the courts used that Commentary in an appropriate manner, we can say that we believe the Commentary itself needs to be changed in order to reflect recent changes that have occurred with respect to transfer pricing between related parties. These changes include the acceptance of transactional profits methods, at least as a method of last resort, in the Transfer Pricing Guidelines issued in 1995. In the OECD's report on Global Trading of Financial Instruments in 1998, there is extensive discussion of profit split methods, including the use of multi-factor formulas in appropriate cases. We have seen, and expect to continue to see, increasing acceptance of these profits-based approaches in the coming years, speeded by the increase in globally-integrated businesses that will become possible as a result of improvements in telecommunications technology. If the Commentary to Article 7 had reflected these changes, which have already taken place in the context of the treaty provision dealing with related separate entities (as opposed to branches and their home offices), the results in these cases might well have been different.

Accordingly, in response to Senator Dorgan's specific concerns regarding these cases, we do not believe that these recent cases limit the United States ability to apply formulary apportionment under the seven treaties before the Committee, or treaties currently in force. There is an international consensus that the provisions of Article 9 require the application of the arm's length standard. For that reason, the Treasury Department has testified in the past that "unilateral" adoption of a formulary apportionment system by the United States would constitute an override of such provisions, and we have not advocated, and do not advocate, that approach. However, if the major participants in international trade were to reach a new consensus that formulaiy methods are consistent with Article 9, adoption of such methods would be acceptable within the scope of the current treaty provisions.

In the case of allocating income to the operations of a foreign corporation's U.S. branch, we believe that an international consensus eventually will develop around the proposition that *any* of the methods that are acceptable for transfer pricing between related entities will also be acceptable in the context of allocating income between branches of a single entity. The United States has already adopted this approach in the context of global dealing of financial instruments, both in advance pricing agreements and by regulation, as has the OECD in its report on Global Trading in Financial Instruments. It has done so by sanctioning the use of multifactor formulas to allocate income from global trading activity under one common trading model—the "functionally fully-integrated" model.

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## RESPONSES TO CONGRESSMAN UNDERWOOD'S TESTIMONY

The question Senator Hagel raised, in connection with Congressman Underwood's testimony, is whether it is Treasury's policy to exclude Guam and other U.S. territories from treaty coverage. Although the State Department has concluded that the territories do not have the constitutional authority to negotiate treaties with foreign governments, the allocation of powers under the constitution is not violated by the United States' signing a tax treaty that covers the possessions of the United States. Thus, there is no legal bar to extending treaty coverage to U.S. territories. Regarding the Treasury Department's tax treaty policy with respect to the coverage of Guam and other U.S. territories, the Treasury Department is willing to discuss with Guamanian officials, or the officials of any other U.S. possession, the implications of such coverage and the mechanisms available to achieve appropriate tax results. We note that one implication of treaty coverage may be a reduction in the possessions tax collections. This and other implications must be carefully considered by the appropriate parties before such coverage is extended.

D'EMPAIRE REYNA BERMÚDEZ & ASOCIADOS
CARACAS, VENEZUELA, *October 11, 1999.*

The Honorable JESSE HELMS
*Chairman, Senate Committee on Foreign Relations,*
*U.S. Senate,*
*Washington, DC.*

DEAR MR. CHAIRMAN: On behalf of d'Empaire Reyna Bermúdez & Asociados, a law firm in Caracas, Venezuela which renders services to a number of multinational corporations of the United States of America, we submit the following statement, for its inclusion in the record of your committee hearings on the proposed Treaty for the Avoidance of Double Taxation Between Venezuela and The United States.

We thank you for this opportunity to express our views to you and to your Committee.

Very truly yours,

JOSÉ RAFAEL BERMÚDEZ,
ALBERTO I. BENSHIMOL,
*d'Empaire Reyna Bermudez & Asociados.*

STATEMENT TO THE SENATE COMMITTEE ON FOREIGN RELATIONS—OCTOBER 13, 1999

On behalf of the Law Office of d'Empaire Reyna Bermúdez & Asociados we wish to express our support to the ratification of the Treaty for the Avoidance of Double Taxation Between Venezuela and The United States (the "Treaty").

If the Treaty comes into effect next year,[1] business with United States, Venezuela's most important trading partner, will be put onto the same competitive footing that Venezuela already has with the other countries with whom it has bilateral comprehensive tax treaties based on the OECD Model Tax Convention on Income and on Capital.[2]

In line with the United States Model Income Tax Convention of September 20, 1996 and the OECD Model Tax Convention, the Treaty determines how each country will limit its taxing powers and jurisdictions, so that double taxation is eliminated or mitigated.

The Treaty also has provisions aimed at preventing discriminatory taxation (so that nationals of one state are not subject to a heavier tax burden in the source state than that applicable to nationals of the source state). Also, of particular importance to both the Internal Revenue Service and the Venezuelan Tax Administration are standard provisions aimed at providing cooperation between both contracting States to combat tax evasion. These include the exchange of information relevant to the collection of domestic taxes in each country, which may come from sources other than the taxpayer (e.g. financial institutions, agents and trustees).

Domestic tax laws change frequently, but tax treaties tend to have a permanence which affords a higher level of security to taxpayers. The Treaty will provide potential investors in each country with a level of certainty about the maximum levels of taxation of their activities, which is not currently available to them. It is this certainty that makes investment, financing, trade and technology transfers between both countries more attractive.

Some examples of how businesses operating in Venezuela can benefit from the Treaty are:

*Gains from the sale of shares.* Currently, U.S. residents must pay up to 34 percent income tax on the gains from the sale of their shares in Venezuelan companies. But when shares of listed companies are sold through a Venezuelan stock exchange, a flat income tax of one percent of the total price is withheld. Once the Treaty comes into effect, U.S. resident shareholders will not be subject to any income tax on the sale of shares of Venezuelan companies.

*Dividends.* Because dividends are not taxed under Venezuela's existing tax law, the IRS presently gets the full benefit of taxing all dividends distributed by companies in Venezuela to U.S. residents. However, since Venezuela's new income tax law would probably begin to tax dividends at a flat tax of 34 percent, the Treaty will protect U.S. investors from double taxation by limiting Venezuela's taxation of dividends to a maximum of 15 percent. Furthermore, if the beneficial owner of the divi-

[1] Venezuela's Congress approved the Treaty last July 15.

[2] Belgium, Czech Republic, France, Germany, Italy, Norway, Portugal, Switzerland, The Netherlands, Trinidad & Tobago and the United Kingdom. The Venezuelan Congress has also approved tax treaties with Barbados, Denmark, Indonesia, Mexico and Sweden, which are not yet in effect.

dend owns at least 10 percent of the company's voting stock, the limit falls to 5 percent.

*Interest.* Interest payments currently made by Venezuelan entities to U.S. creditors which are not financial institutions are subject up to a 34 percent income tax withholding in Venezuela. Under the Treaty this withholding will fall to 10 percent. Additionally, the 4.95 percent withholding applicable to payments to financial institutions is guaranteed not to increase.

*Capital goods and technology.* Income earned by U.S. residents on the leasing of equipment is currently subject to regular income tax in Venezuela and the U.S. Under the Treaty, taxation of this income by Venezuelan tax Administration is limited to five percent of the gross amount of the lease payments. In addition, the current income tax law levies a 10.2 percent withholding on technical assistance provided for use in Venezuela by U.S companies without a permanent establishment in Venezuela. Technical assistance provided on such a basis from the U.S. will not be subject to income taxation in Venezuela once the Treaty comes into effect. As a result, capital goods and technology sourced out of the U.S. will be more attractive to Venezuelan businesses, as the current general practice is to gross-up payments made to the foreign supplier to take account of taxation.

There are many more areas covered by the Treaty than those mentioned above. The Treaty will work to protect not only businesses from double taxation, allowing corporations and individuals to plan their taxes and the financial aspects of their projects with greater certainty, but it will also benefit other cross border activities that take place between the U.S. and Venezuela. For example, sportsmen and women, government, diplomatic and consular officers, entertainers, as well of overseas recipients of payments such as students, or recipients of pensions and social security payments, will all benefit from the Treaty.

The Treaty will facilitate access to the U.S. financial markets for Venezuelan companies, aid the use of leased capital goods and the contracting of U.S. technology and services. Moreover, the Treaty goes much further than simply protecting taxpayers from overlapping taxation by the two contracting States. The treaty can be seen as a guaranty of certainty to U.S. investors relating to the impact of the Venezuelan income tax on their investment in Venezuela.

For the aforementioned reasons we express our support to the ratification of the Treaty for the Avoidance of Double Taxation Between Venezuela and The United States.

We thank you again for this opportunity to express our views to you on this matter.

Very truly yours,

JOSÉ RAFAEL BERMÚDEZ,
ALBERTO I. BENSHIMOL,
*d'Empaire Reyna Bermudez & Asociados.*

ADDITIONAL STATEMENT TO THE SENATE COMMITTEE ON FOREIGN RELATIONS

On behalf of the Law Office of d'Empaire Reyna Bermúdez & Asociados and further to our statement dated October 13, 1999, in which expressed our support to the ratification of the Treaty for the Avoidance of Double Taxation Between Venezuela and The United State (the "Treaty"), we wish to highlight the following issues:

At the request of the Venezuelan Executive Branch of Government, the Venezuelan Congress issued on April 26, 1999 a special law authorizing the President to pass and amend economic and financial legislation (the "Enabling Law").[1] Among other reforms, the Enabling Law expressly authorized the President to amend the Venezuelan income tax law ("ITL") to introduce (i) a worldwide system of taxation with a credit system to relieve international double taxation; (ii) legal provisions authorizing the Tax Administration to disregard the abuse of corporate forms in tax-oriented transactions; and (iii) the taxation of dividends.

Pursuant to the Enabling Law, a proposed draft of amendments to the ITL (the "Amended ITL") was discussed by the President and his Council of Ministers. The Amended ITL adapts the worldwide income system of taxation applicable to Venezuelan resident individuals and legal entities and permanent establishments of foreign entities. Note that taxpayers would be generally allowed to credit against their Venezuelan income tax liability income tax paid in other jurisdictions, up to the amount resulting from applying the Amended ITL's rate to foreign source income.

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[1] *Ley Organica que Autoriza al Presidente de la República para Dictar Medidas Extraordinarias en Materia Economica y Financiera Requeridas por el Inetres Publico,* published in the Official Gazette number 36.687, dated April 26, 1999.

Pursuant to the Enabling Law, the Amended ITL, and all other economic and financial legislation passed thereunder, must be enacted no later than October 26, 1999.

Generally, laws are enacted in Venezuela by publication in Venezuela's Official Gazette. We were informed, that the Amended ITL will be enacted shortly by the President or the Ministry of the Interior, who is currently acting as President of the Republic, while the President is on an official trip to Asia. The Amended ITL will be enforceable immediately after its enactment.

Under the Constitution of the Republic of Venezuela any amendment to the current tax legislation may not be effective retroactively (article 226). Therefore, the provisions of the Amended ITL would generally be applicable to fiscal years beginning after their enactment. Because the Tax Administration needs to prepare to administer the Venezuela's new worldwide income system, the specific provisions governing the system will be effective for tax years beginning after December 31st, 2000.

We express our support to the ratification of the Treaty for the Avoidance of Double Taxation Between Venezuela and the United States and we thank you again for this opportunity to express our views on this matter.

Very truly yours,

JOSÉ RAFAEL BERMÚDEZ,
ALBERTO I. BENSHIMOL,
*d'Empaire Reyna Bermudez & Asociados.*

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HOET, PELÁEZ, CASTILLO & DUQUE,
CARACAS, VENEZUELA, *October 11, 1999.*

The Honorable JESSE HELMS
*Chairman, Senate Committee on Foreign Relations,*
*U.S. Senate,*
*Washington DC.*

DEAR MR. CHAIRMAN: On behalf of Hoet Peláez Castillo & Duque, an international law firm located in Caracas, Venezuela, we submit the following statement for inclusion in the record of your committee hearings on the proposed Treaty For The Avoidance Of Double Taxation Between Venezuela and The United States.

We thank you for this opportunity to express our views to you and to your Committee.

Very truly yours,

FRANCISCO M. CASTILLO, *Senior Partner.*

STATEMENT TO THE SENATE COMMITTEE ON FOREIGN RELATIONS—OCTOBER 13, 1999

The law offices of Hoet, Peláez, Castillo & Duque wishes to express our support for the ratification of the Treaty for the Avoidance of Double Taxation between Venezuela and the United States.

Hoet, Pelaez, Castillo & Duque has an extensive reputation and experience in joint-venture negotiations, international financing, including project financing of major projects, acting as Venezuelan Counsel for major U.S. Corporations doing business in Venezuela. We believe that a treaty to avoid double taxation between Venezuela and the United States is of extreme necessity, in order to create a crucial link between the tax systems of both nations. The treaty will allocate the taxing authority between the U.S. and Venezuela and bring certainty to the taxation of cross border transactions.

The absence of a tax treaty between the U.S. and Venezuela will represent a disadvantage for U.S. investors, as Venezuela has already entered into double taxation treaties with most European developed nations, such as France, United Kingdom, Italy, Germany, Portugal, The Netherlands and Switzerland, among others.

A double taxation treaty will never create or impose any tax, but it will allocate taxing authority on an exclusive basis to one contracting State or limit the taxing authority of one of the two contracting States, in order to avoid double taxation with its negative effects.

The need for such a treaty is nowadays even more urgent due to the recent reform of the Venezuelan Income Tax.

The Venezuelan Congress enabled President Hugo Chávez to take extraordinary economic and financial measures, including a reform of the Income Tax Law. The

President and the Cabinet have approved this reform in the month of September, although the final text has not yet been available to the general public, the main aspects of this reform have been widely disclosed.

Following the world trend, Venezuela has shifted from a territorial income tax to taxing global income.

According to the draft law which we have reviewed, all income earned by natural persons or legal entities, who are residents or domiciled in Venezuela, shall be subject to income tax, whether or not said income is earned within Venezuela or abroad. In addition, as in the present law, the income of natural persons or legal entities, who are non-residents and not domiciled in Venezuela, shall be subject to income tax, even though they do not have a permanent establishment or fixed base within the country, when the source of said income is in or occurs within the country.

Natural persons or legal entities domiciled or resident abroad and who have a permanent establishment or fixed base in the country, shall be subject to income tax exclusively on the income earned within Venezuela or abroad which is attributable to their permanent establishment or fixed base.

The law provides for a "tax credit" allowing deductions to be made against the Venezuelan Income Tax, for income tax paid abroad for income earned from extraterritorial sources. The draft law includes definitions with respect to what is considered "income tax" and, in case of any doubts, the Venezuelan Tax Administration should determine the nature of the tax credit. In addition, the tax credit may not exceed the income tax resulting from application of the provisions of the Venezuelan Income Tax Law which would have been required to be paid for said income.

On the other hand, to determine the income earned from a foreign source, the norms of the Venezuelan law will be applicable as far as income, costs and deductions of the income earned from an extraterritorial source. That is, in order to establish the net income the Venezuelan norms will be applied and not that of the country of origin, so that theoretically, at least, some deductions could be objected which in accordance to the Venezuelan law are not admissible, although in the country of origin of the income they are admissible.

The new law includes an international tax transparency regime applicable to all investment in low taxation jurisdiction.

Of particular importance are the rules on transfer pricing which may be applicable to transactions bctween related parties and which are included for the first time in Venezuelan tax legislation. These rules may allow the Tax Authorities to disregard for tax purposes the prices contained in import or export agreements if found different from those they determine by one of the methods included in the law.

When the treaty was negotiated, Venezuela imposed no tax on dividends under its internal laws. The new law will impose a withholding tax on dividends, for the net income which exceeds the taxable income, that is, those dividends which correspond to profits that were not subject to income tax in Venezuela shall be subject to the Dividend Tax.

The dividends will be subject to a proportional 34% tax, with the exception of those dividends arising from companies dedicated to mining activities, in which case the proportional dividend tax will be 60% or for those dividends coming from companies dedicated to the exploitation of hydrocarbons, the proportional dividend tax will be 67.7%.

Article 10 of the Treaty which limits tax on dividends will be a clear advantage to U.S. business particularly in the field of hydrocarbons.

Licensing of intellectual property is one of the most important business relationship between U.S. and Venezuela. In the absence of the Treaty, royalties would be subject to important withholding tax in both countries. The concept of royalties in the Treaty is important to limit the scope of the internal Venezuelan Income Tax Law that otherwise would impose a higher tax than that provided in the Treaty.

As in the case of royalties, in the absence of the Treaty, Venezuela would impose a higher withholding tax on interests paid to lenders that are not financial institutions. The treatment in the Treaty would assist such lenders taxing interests paid at a reviewed rate of 10%, whereas financial institutions would be taxed under the Venezuela internal laws at a 4.95% rate.

The Treaty would harmonize the taxation rules of both countries, avoiding that the new rules may result in an adverse effect to U.S. businesses investing in Venezuela.

The treaty closely follows recent U.S. income tax treaties and the Model income tax treaty of the Organization for the Economic Cooperation and Development.

Article 24 provides the rules for relief from double taxation. In the case of Venezuela, it will be either an exemption or a tax credit. As mentioned above, the new

Venezuelan income tax law provides for a tax credit. The U.S. will provide a direct or indirect credit for Venezuelan taxes effectively paid.

The Government of President Hugo Chavez initiated the most comprehensive legal reform of the Venezuelan democratic era, including a new Constitution that should be approved this year.

The Venezuelan Congress has already ratified the Treaty in an unprecedented decision confirming the Government's commitment to make Venezuela more competitive and compatible with the global economy. Ratification of the treaty with the U.S. is a key tool in giving U.S. investors confidence in the stability of the Tax Regime in Venezuela.

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VENAMCHAM,
VENEZUELAN AMERICAN CHAMBER OF COMMERCE AND INDUSTRY,
CARACAS, VENEZUELA, *October 26, 1999.*

The Honorable JESSE HELMS
*Chairman, Senate Committee on Foreign Relations,*
*United States Senate,*
*Washington DC.*

DEAR MR. CHAIRMAN: On behalf of the Venezuelan American Chamber of Commerce and industry (VenAmCham), we submit the following written statement for inclusion in the record of your Committee Hearings on the proposed Treaty for the Avoidance of Double Taxation Between Venezuela and The United States of America.

We thank you for this opportunity to express our views to you and to your Committee.

Yours very truly,

JORGE REDMOND, *President.*
ANTONIO A. HERRERA-VAILLANT,
*Vice President and General Manager.*

## WRITTEN STATEMENT OF THE VENEZUELAN AMERICAN CHAMBER OF COMMERCE AND INDUSTRY—OCTOBER 27, 1999

The following is submitted as a written statement of the views of the Venezuelan American Chamber of Commerce and Industry (VenAmCham) in reference to the proposed Treaty For The Avoidance of Double Taxation Between Venezuela and The United States of America.

### I. REASONS FOR THE NEED OF A PROMPT RATIFICATION OF THE TAX TREATY

VenAmCham submits that the ratification of this treaty will be most beneficial to both countries for the following three main reasons which, not at the exclusion of others are:

First: The proposed treaty reduces or eliminates double taxation of income earned by residents of either country from sources from the other country in addition to preventing avoidance or evasion of the taxes of the two countries and increasing transparency.

Second: The proposed treaty is also intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

Third: The absence of a treaty between Venezuela and the U.S. is a disadvantage for both Venezuelan and U.S. investors in either country, because Venezuela has already in effect double taxation treaties with most developed nations such as France, the United Kingdom, The Netherlands, Germany, Italy, Portugal and Switzerland. The new treaty will place on an equal competitive footing U.S. investments in Venezuela "vis-a-vis" those of the above mentioned countries.

### II. WHO WE ARE AND WHAT WE DO

VenAmCham, founded in 1950, is one of the largest overseas U.S. Chambers of Commerce in the world with over 1,040 corporate and 6,000 individual members. Our membership includes all major U.S. corporations and all U.S. oil companies doing business in Venezuela. We are a private, non-government, non-profit institution. Our mission is to foster, and improve business between the United States and Venezuela, to promote and defend private enterprise, free trade and free markets

where member companies operating in Venezuela can prosper, support and protect the general legitimate interests of our members.

VenAmCham has an active presence throughout Venezuela, as well as in the capital city of Caracas. Accordingly, we have offices in the cities of Maracaibo, Maturin, Barquisimeto and Valencia where we conduct similar activities as in Caracas.

VenAmCham is represented in Washington DC by Ulrico A. Reale, in order to maintain close contacts with the United States Congress, with all departments of the U.S. Federal Government and its agencies in addition with international lending institutions such as the IMF, the World Bank and the IDB.

VenAmCham is associated with the U.S. Chamber of Commerce and with the Association of the American Chambers of Commerce of which we are a founding member. In 1998 VenAmCham became the contractual representative in Venezuela of "Enterprise Florida," an organization jointly operated by business and the State of Florida, a state which is Venezuela's top trading partner with the United States.

Among our U.S. related activities, VenAmCham hosted during the last two years the chairmen of the Senate Energy Committee and of the House Ways and Means Committee, who made working visits to Venezuela with several members of their committees. On the U.S. Administration side, VenAmCham has also recently hosted the President of the United States of America, as well as the Secretaries of State, Commerce and Energy, in addition to the Special Presidential Envoy to Latin America.

### III. FACTS ABOUT VENEZUELA

Venezuela has had a new government since February of 1999. As a presidential candidate, President Chavez chose to enter the Venezuelan established process by running for president according to the standing rules of 1998. He was freely elected by a decisive majority of the Venezuelan people in an election process monitored by international observers, such as the OAS and by U.S. Government representatives.

There has been no disruption of the Constitutional order in the process leading to the establishment of the Constituent Assembly, this opinion is shared by the majority of the standing Supreme Court and most international observers. The Government has an overwhelming majority in the Assembly. Dissent and minority opinions have been expressed at all times and there has been no curtailment whatsoever of personal freedoms.

The Assembly is completing its process of drafting a new Constitution and the recent proposed drafts of the Constitution respect and encourage private property and enterprise, granting, as a general rule, equal treatment to national and foreign investments.

President Chavez has offered public and private assurances in Venezuela and to foreign governments—including the United States and international organizations such as the United Nations and the OAS—that Venezuela will remain a democracy, intends to pursue a democratic course of action, and a market oriented economy.

### IV. CONCLUSION

For the above reasons, although not to the exclusion of others, VenAmCham strongly supports and endorses without reservations the prompt ratification of the proposed Treaty for the Avoidance of Double Taxation between Venezuela and The United States of America.

VenAmCham thanks the members of the Senate Foreign Relations Committee for this opportunity to present its views and to be heard.

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TORRES, PLAZ & ARAUJO,
CARACAS, VENEZUELA, *October 11, 1999.*

The Honorable JESSE HELMS
*Chairman, Senate Committee on Foreign Relations,*
*U.S. Senate,*
*Washington, DC.*

DEAR MR. CHAIRMAN: On behaif of Torres, Plaz & Araujo, an Venezuelan firm active in international law areas, with its offices in Caracas, Venezuela, which specializes in international taxation, we submit the following statement, for inclusion in the record of your committee hearings on the proposed Treaty For The Avoidance of Double Taxation Between Venezuela and The United States.

We thank you for this opportunity to express our views to you and to your Committee.

Very truly yours,

FEDERICO ARAUJO MEDINA, *Senior Partner.*

STATEMENT TO THE SENATE COMMITTEE ON FOREIGN RELATIONS—OCTOBER 13, 1999

The Law Offices of Torres, Plaz & Araujo wishes to express our support for the ratification of the Treaty For The Avoidance of Double Taxation Between Venezuela and The United States.

Our firm has been acting as legal counsel on corporate tax matters for both U.S. and Venezuelan corporations engaged in trade and investments in the most significant economical sectors of our Country, namely petroleum, petrochemical, food sector, banking, among others, for more than 25 years. Along said period of time we have realized and event felt the need for the existence of a tax treaty between our countries, settling grounds for certainty and thus with enhancing the flow of business amount in our countries. We believe that in order to compete fairly with other countries that have already agreed with Venezuela Treaties in the Income Tax, we find that American investors could be in an incompetitive position compared to investors from other O.E.C.D. countries, which have concluded treaties previously with Venezuela.

The approval of the Treaty and its entering into force becomes critical in a moment when Venezuela has announced, through its Executive Branch, a major amendment of the income tax regime—by shifting from our traditional territorial tax principle, to the worldwide system of taxation (i.e. adding domiciled/resident taxation to source taxation) and by—furthermore—providing for taxation of dividends, tax-free since 1991.

In addition, what we envisage as a need for certainty—through a Tax Treaty—is enhanced since both taxpayer and Tax Administration will be confronted with a whole new concept in tax law (from the Venezuelan standpoint of view), having little or no experience in dealing with such complex issues as (i) piercing corporate veil through; the application of subtance over form rules; (ii) providing for a black-listing or "look-through" scenario for investments in law tax juridiction; (iii) including tax legislation (copies party from OECD directives rules) on transfer pricing for international trade among related parties; all of which even though bringing Venezuela's tax system close to systems in place in the USA and other OECD countries, is liable to end up in controversy between taxpayers and the Tax Aministration, which may result in costly litigation and uncertainty, in a moment when the latter cannot be afforded, at least for investments in our Country, which, could—and perhaps will be likely to—affect United States of American's individual and corporate citizens investing in Venezuela (being the U.S.A. the most important importing Country to Venezuela, of both investment and goods), as a drawback via a vis investors from other OECD countries with treaties already in force with Venezuela.

We sincerely believe that in view above mentioned of the facts and under the current Treaty drafting (e.g. rules for avoidance of tax treaty-shopping "LOB" provisions) ratification of the treaty could not result in the creation of a tax treaty protected shelter, but rather its approval would protect American investors in our country from the income tax point of view further and would provide the same with leverage in front of third country investors.

DRAFT

The Committee should be aware that Venezuela may be moving from a territorial tax system to a worldwide system. On April 26, 1999, the Venezuela Congress authorized President Chavez under an enabling law to take extraordinary economic and financial measures, including a reform of Venezuela's income tax law. The enabling law specifically provide that the changes must include the adoption of a worldwide tax system in lieu of Venezuela's current territorial tax system as well as dividend taxation, tax heaven's investments blacklisting a (look through) and elaborate transfer pricing provisions, inter alia. Under the worldwide tax system, similar to the U.S. system, Venezuelan residents and domiciled entities are taxable on worldwide income while nonresident and nondomiciled entities are taxable on certain income from Venezuela sources. The enabling law authorized the President to publish a decree within six months of the authorization (i.e., by October 26, 1999) which contain these and other changes to Venezuelan tax laws. In September 1999, the Cabinet approved a new income tax, which, among other things, included provisions adopting a worldwide tax system. The new tax law has not yet been signed by the President or published in the Official Gazette. The Joint Committee staff has been

told that these actions are expected to be imminent. Once officially published, the new laws generally will take effect for fiscal years beginning after the law is published (with the law generally not being effective later than January 1, 2000), even though a one (1) fiscal year tax postponement on worldwide income and dividend taxation is expected to be included in said income tax law transitional provisions.

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WILLIAMS,
1627 EYE STREET, NW., SUITE 900,
WASHINGTON, DC, *October 13, 1999.*

STATEMENT OF THE WILLIAMS COMPANIES IN SUPPORT OF THE U.S.-LITHUANIAN BILATERAL TAX TREATY—OCTOBER 13, 1999

On behalf of The Williams Companies, I want to express our strong support for the bilateral tax treaty between the United States and the Government of Lithuania now pending before the Committee and urge its ratification prior to adjournment of this session of Congress.

Williams is an $18 billion energy and communications company headquartered in Tulsa, Oklahoma. Williams is active in most areas of the oil and natural gas industry. Williams owns two refineries in the United States, natural gas gathering and processing facilities, five interstate natural gas pipeline systems, a large petroleum products pipeline network, petroleum products terminals throughout the Midwest and Southeast, and a large energy marketing and trading business. In addition, we have numerous international investments through our Williams International subsidiary. We also are leaders in the wholesale transmission of voice, data and video communications.

The Government of Lithuania has selected Williams International to be the strategic investor in the country's refining, transportation and oil export industry. This selection has been confirmed by the Parliament. While the terms of arrangement are still being discussed, Williams is prepared to invest $150 million in the businesses and manage a modernization program involving approximately $700 million. Once completed, the refinery and related facilities, known as Mazeikiu Nafta, will meet world class standards, including the more stringent fuel quality standards that will apply in Europe after the year 2000.

Assuming our agreements with the Lithuanian Government are concluded successfully, Williams will be the largest U.S. investor in Lithuania by a large margin.

As a result of our investment, Williams will maintain considerable staff in Lithuania. In addition to our direct investment, Williams will operate the refinery and related facilities pursuant to a management services agreement.

Ratification of the tax treaty is important for several reasons. It will allow for the elimination of Lithuanian withholding tax at the source on certain payments to U.S. legal entities, whose activities do not rise to the level of a permanent establishment. Further, it will reduce the withholding tax rates on payments of interest, dividends and other types of income, which is paid from Lithuanian sources to U.S. residents. This treaty will also benefit the competitive standing of United States businesses operating in Lithuania. Currently, U.S. businesses are at a severe disadvantage to businesses from countries which have ratified double tax treaties with Lithuania.

In addition to the above tax savings, the treaty will provide important relief from the double taxation of U.S. citizens and residents in Lithuania, who may otherwise be subject to double taxation of their income in both the United States and Lithuania.

In summary, we urge the Committee and the Senate to approve this important treaty this year. If our agreement with the Lithuanian Government is successfully concluded, we will begin making major investments in the oil sector immediately. Williams to date has expended considerable funds in studying the refinery and its operations and has provided considerable assistance in the completion of the Butinge oil export terminal on the Baltic. Any delay in ratifying the treaty will have a negative impact on our investments to date and cloud our future activities in the country.

We appreciate the Committee's desire to move this treaty forward and urge its ratification by the full Senate.

Submitted by:

JOHN C. BUMGAMER, JR.,
*President, Williams International.*

## WEBSITE ADDRESSES FOR THE TREASURY DEPARTMENT TECHNICAL EXPLANATIONS

Estonia:
http://www.ustreas.gov/taxpolicy/documents.html#Estonia

Latvia:
http://www.ustreas.gov/taxpolicy/documents.html#Latvia

Lithuania:
http://www.ustreas.gov/taxpolicy/documents.html#Lithuania

Venezuela:
http://www.ustreas.gov/taxpolicy/documents.html#Venezuela

Denmark:
http://www.ustreas.gov/taxpolicy/documents.html#Denmark

Italy:
http://www.ustreas.gov/taxpolicy/documents.html#Italy

Slovenia:
http://www.ustreas.gov/taxpolicy/documents.html#Slovenia

Germany:
http://www.ustreas.gov/taxpolicy/documents.html#Germany