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THE JAPANESE TAX TREATY (T. DOC. 108–14) AND THE SRI LANKA TAX PROTOCOL (T. DOC. 108–9)

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WEDNESDAY, FEBRUARY 25, 2004

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

The committee met, pursuant to notice, at 9:32 a.m. in room SD–419, Dirksen Senate Office Building, Hon. Richard G. Lugar (chairman of the committee), presiding.

Present: Senator Lugar.

OPENING STATEMENT OF HON. RICHARD G. LUGAR, CHAIRMAN

The CHAIRMAN. This hearing of the Senate Foreign Relations Committee is called to order. It is my pleasure to welcome our distinguished witnesses and our guests to this hearing on the Japan Tax Treaty and the Sri Lanka Tax Protocol.

As the United States considers how to create jobs and maintain economic growth, we must strengthen the ability of American business to operate successfully in foreign markets. To this end, the U.S. Government has attempted to facilitate exports through a number of strategies, including bilateral and regional free trade agreements, favorable outcomes in the World Trade Organization, and, under the purview of this committee, bilateral investment treaties and tax treaties such as the ones we have before us this morning.

It is important that we try to eliminate impediments that prevent our companies from fully accessing international markets. These impediments may come in the form of regulatory barriers, taxes, tariffs, or unfair treatment. In the case of taxes, we should work to ensure that companies pay their fair share while not being unfairly taxed twice on the same revenue. Tax treaties are intended to prevent double taxation so that companies are not inhibited from doing business overseas.

As chairman of the Senate Foreign Relations Committee, I am committed to moving tax treaties as expeditiously as possible. Last year this committee and the full Senate approved three tax treaties. I encourage the Bush administration to continue the successful pursuit of tax treaties that strengthen the American economy and benefit workers, investors, and businesses.

The Japan Tax Treaty is particularly significant due to our expansive trade and investment relationship with Japan. The United States and Japan are the two largest economies in the world and

account for approximately 40 percent of the world's gross domestic product. Japan is the fourth largest source of imports to the United States and the third largest export market for United States goods.

The treaty, signed on November 6, 2003 by Treasury Secretary Snow and Japanese Ambassador Kato will improve the ability of U.S. businesses to expand and to prosper in Japan. It also will continue to encourage Japanese investment in the United States that contributes to the growth of our economy.

The original Japan Tax Treaty was signed in March 1971 and went into force in January 1973. Since then, both the United States and Japanese domestic laws have changed dramatically. Until now the 1971 treaty has not been amended to reflect those changes or the monumental expansion of United States-Japanese commercial relationships. American companies doing business with Japan are eager for this update of the bilateral tax treaty. It will guarantee more equitable treatment for United States corporate investors and relief from double taxation. It will strengthen dispute resolution mechanisms related to tax issues between our countries. It will eliminate withholding taxes on all royalty income, certain interest income, and dividend income paid to parent companies.

The overall benefit of the treaty is that our companies will become more competitive in the Japanese market. Japan is currently a party to tax agreements with several other nations that reduce double taxation for companies from those nations doing business in Japan. Consequently, without this treaty, United States businesses will continue to face a competitive disadvantage in the area of taxation.

Since transmittal to the Senate this past December, the committee has been engaged in a thorough review and analysis of the treaty. Officials in the Department of the Treasury have briefed the committee extensively on the impact of the treaty on business relations between the United States and Japan.

The committee also has consulted with numerous commercial entities with operations in Japan. These entities all have indicated that the treaty will make them more competitive in a market where they are already successful.

In addition, the committee has had meetings with commercial officers from the Japanese Embassy to discuss ratification and implementation of the treaty. I understand that the timing of enactment of the Japan Treaty is critical. Therefore, I have prioritized it on the committee's agenda, and I will seek to move forward expeditiously on the Senate's advise and consent procedure in cooperation with the Senate leadership.

I also have written to the Japanese Finance Minister and leaders of the Diet to inform them that we intend to take action on the treaty quickly. I am hopeful that the entire Senate will join this committee in promptly considering this agreement.

In addition to the Japan Tax Treaty, today we will be considering the protocol amending the 1985 Tax Treaty with Sri Lanka. The United States is Sri Lanka's largest export market. Almost 40 percent of Sri Lanka's exports are destined for the United States, while American businesses sell significant amounts of wheat, electrical machinery, textiles, medical instruments, and other products in Sri Lanka. About 90 United States companies have more than

$500 million invested in that country. These companies would reap benefits from the protocol's prevention of double taxation on revenue earned.

Sri Lanka was one of the first nations in the South Asian region to open up to foreign investment. It currently has a projected economic growth rate of more than 5 percent. Its developed port facilities and demonstrated desire to form positive trading relationships give it significant potential as a United States foreign investment destination.

Strong commercial relationships also can help improve internal stability in Sri Lanka, which has suffered from two decades of ethnic insurgency in the northeast part of the country.

During the last Congress, I sponsored, and the Senate passed, a resolution which recognized the positive relationship between the United States and Sri Lanka. This resolution denounced the ongoing violence, called for the observance of human rights, and suggested that the efforts of the international community could be useful in promoting a peaceful resolution to that conflict.

I am pleased to welcome our distinguished witnesses. On our first panel we will hear from Ms. Barbara Angus, the international tax counsel from the Department of the Treasury and the chief negotiator of the tax treaties before us. Also on our first panel is Mr. George Yin, chief of staff of the Joint Committee on Taxation. The Joint Committee is responsible for providing a comprehensive evaluation and scoring of the treaties.

On our second panel we will hear from witnesses representing companies doing business in Japan. Mr. Bill Reinsch is the president of the National Foreign Trade Council. Mr. Jim Fatheree is the president of the United States-Japan Business Council. Both organizations have been supportive of the Japan Tax Treaty and its prompt ratification. The committee looks forward to the insights and analysis of our expert witnesses. Indeed, we do welcome you and I look forward to your testimony, first of all Ms. Angus and then Mr. Yin.

STATEMENT OF BARBARA M. ANGUS, INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Ms. ANGUS. Thank you, Mr. Chairman. I appreciate the opportunity to appear today at this hearing to recommend on behalf of the administration favorable action on the income tax treaties with Japan and Sri Lanka. We appreciate the committee's interest in these agreements, as demonstrated by the scheduling of this hearing.

We are committed to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers are bilateral tax treaties. Tax treaties provide benefits to both taxpayers and governments by setting out clear ground rules that will govern tax matters relating to trade and investment between the two countries. A tax treaty is intended to mesh the tax systems of the two countries in such a way that there is little potential for dispute regarding the amount of tax that should be paid to each country. The goal is to ensure that taxpayers do not end up caught in the middle between two governments that are both trying to tax the same income.

We believe these agreements with Japan and Sri Lanka would provide significant benefits to the U.S. and to our treaty partners as well as our respective business communities. The tax treaty with Japan is a critically important modernization of the economic relationship between the world's two largest economies. The agreement with Sri Lanka represents the first tax treaty between our two countries and reflects our continuing commitment to expand our network to emerging economies.

These treaties, like our other tax treaties, employ a range of mechanisms to accomplish the objectives of reducing the instances where taxes stand as a barrier to economic activity cross-border. These agreements provide certainty to taxpayers regarding the threshold question of when the taxpayer's cross-border activities will subject it to taxation in the other country. They protect taxpayers from potential double taxation through the allocation of taxing rights between the countries. They also prevent potential excessive taxation by reducing withholding taxes that are imposed at source on gross income rather than net income.

Let me turn to highlights of each of these agreements. The proposed treaty with Japan replaces the existing treaty and generally follows the pattern of other U.S. treaties and the U.S. model treaty.

Because the existing treaty dates back to 1971, it does not reflect the changes in economic relations between the two countries that have taken place over the last 30 years. The proposed new treaty significantly reduces existing tax-related barriers to trade and investment between Japan and the U.S. Reducing these barriers will help to foster still closer economic ties between the two countries, enhancing the competitiveness of both countries' businesses and creating new opportunities for trade and investment.

The new treaty modernizes the agreement and brings the treaty relationship into much closer conformity with U.S. policy. At the same time, several key provisions of the treaty represent "firsts" for Japan.

The most dramatic advances in the new treaty are reflected in the reciprocal reductions in source country withholding taxes on income from cross-border investments. The existing treaty allows maximum rates for withholding taxes on cross-border interest, royalty, and dividend payments that are much higher than those in U.S. treaties with other developed countries. The new treaty substantially lowers these maximum withholding tax rates. The rates in the new treaty are as low as and in many cases significantly lower than the rates in any other treaty entered into by Japan.

Given the importance of the cross-border use of intangibles between the United States and Japan, a primary U.S. objective in negotiating a new Japanese treaty was to overhaul the existing rules for the treatment of income from intangible property. That objective was achieved with a provision completely eliminating source country withholding taxes on royalties. This is the first treaty in which Japan has agreed to such a provision.

Eliminating the existing treaty's 10 percent tax on gross royalties eliminates what can be excessive taxation when intangible development expenses are considered. It also removes the disparity in treatment between royalty income and services and other income and therefore eliminates what has been a significant source of dis-

pute and potential double taxation for U.S. taxpayers under the existing treaty.

The new treaty also eliminates withholding taxes for significant categories of interest income. Most importantly, the treaty eliminates withholding taxes on interest earned by financial institutions. Due to the high leverage typical of financial institutions, a withholding tax on interest received could result in taxation that actually exceeds the net income from the transaction. The new treaty eliminates this potential for excessive taxation, with cross-border interest earned by financial institutions subject only to net income tax at home. The new treaty's exemptions from withholding tax on interest also are broader than in any other Japanese tax treaty.

In addition, the new treaty significantly reduces source-country withholding taxes on all types of cross-border dividends. The maximum rates of withholding tax are reduced to 5 percent for direct investment dividends and 10 percent for portfolio dividends. The new treaty also provides for the elimination of withholding taxes on dividends received by a company that controls the dividend-paying company. In addition, the treaty eliminates withholding taxes on dividends and interest paid to pension funds, which ensures that assets accumulated to fund retirement benefits are not reduced by foreign taxes.

The provision eliminating withholding taxes on certain inter-company dividends is similar to the provisions included in our treaties with the U.K., Australia, and Mexico that were considered by the Senate last year. We believe this provision is appropriate in light of our overall treaty policy of reducing tax barriers to cross-border investment and in the context of this important treaty relationship.

As I testified last year, the elimination of source-country taxation of dividends is something that is to be considered on a case-by-case basis. Inclusion of such a provision in a treaty is appropriate only if the treaty contains anti-treaty shopping provisions and information exchange provisions that meet the highest standards. This treaty meets both these prerequisites.

The United States and U.S. taxpayers benefit significantly, both from this provision in the new agreement and from the treaty overall. The elimination of withholding taxes on inter-company dividends provides reciprocal benefits, because Japan and the United States both have dividends withholding taxes and there are substantial dividend flows going in both directions. U.S. companies that are in an excess foreign tax credit position will be able to keep every dollar they receive if the dividends they repatriate to the United States are free of Japanese withholding tax. Looking at the treaty as a whole, the provisions eliminating withholding taxes on royalties and certain interest were a major objective for the United States and U.S. businesses, but represent an unprecedented departure from historic Japanese policy.

Another significant modernization is the inclusion of specific rules on the application of treaty provisions in the case of investments in one country by a resident of the other country through partnerships or other flow-through entities. The new treaty provides for exclusive residence country taxation of gains with narrow

exceptions, which is generally consistent with U.S. treaty preferences, but is a departure from the source-country taxation of gains provided for in recent Japanese treaties.

The new treaty contains important provisions affecting individuals. For the increasing number of individuals who spent part of their careers working in the United States and part working in Japan, the treaty includes rules addressing the taxation of compensation earned in the form of employee stock options. The new treaty also improves the rule in the existing treaty to ease the tax burdens on teachers who participate in exchange programs.

Turning just briefly to Sri Lanka, the United States doesn't have an income tax treaty with Sri Lanka. The treaty—a treaty was signed in 1985, but was not acted on by the Senate at that time because changes made to the U.S. tax rules by the Tax Reform Act of 1986 made some modifications to that agreement necessary. The protocol amends the 1985 convention to reflect changes in domestic law since 1985 and developments in U.S. tax treaty policy, and includes modifications that better reflect U.S. tax treaty preferences.

The proposed treaty generally follows the pattern of the U.S. model treaty while incorporating some provisions found in other U.S. treaties with developing countries. The maximum rate for source-country withholding taxes on investment income provided in the treaty are generally equal to or lower than the maximum rates provided in other U.S. treaties with developing countries, and even with some developed countries.

The proposed treaty generally provides the maximum withholding tax rate on dividends of 15 percent. The maximum rate on interest is 10 percent. Similarly, the maximum withholding tax rate on royalties is 10 percent and the maximum withholding tax rate on rentals generally is 5 percent.

The treatment of shipping income under the proposed treaty is generally consistent with many recent U.S. treaties. Income from the rental of containers used in international traffic is taxable only in the country of residence. Income from the international operation of aircraft, including most aircraft rentals, is taxable only in the residence country. Income from the international operation of ships and from leases of ships on a full basis also is taxable only in the residence country. The treaty provides for very limited source-country taxation of income from leases of ships on a bare boat basis.

The proposed treaty provides the basic rule that business profits of a resident of one of the country generally may be taxed in the other country only when such profits are attributable to a permanent establishment in that country. Like many treaties with developing countries, the treaty permits modestly broader host-country taxation than is the U.S. preference. The rules for taxation of income from personal services are similar.

The proposed treaty contains a comprehensive limitation on benefits article, which provides detailed rules designed to deny treaty shoppers the benefits of the treaty. The proposed treaty also sets out the mechanisms used in each country to relieve double taxation. There are provisions to ensure non-discriminatory treatment and rules for resolution disputes under the treaty.

We urge the committee to take prompt and favorable action on the agreements before you today. Such action will help to reduce barriers to cross-border trade and investment by further strengthening our economic relationship with a country that has been a significant economic and political partner for many years, and by expanding our economic relations with an important trading partner in the developing world.

Let me conclude by expressing our appreciation for the hard work of the staff of this committee and the Joint Committee on Taxation in the tax treaty process. I would be happy to answer any questions. Thank you.

[The prepared statement of Ms. Angus follows:]

PREPARED STATEMENT OF BARBARA M. ANGUS, INTERNATIONAL TAX COUNCIL, U.S. DEPARTMENT OF THE TREASURY

Mr. Chairman and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing to recommend, on behalf of the Administration, favorable action on two income tax treaties that are pending before this Committee. We appreciate the Committee's interest in these agreements as demonstrated by the scheduling of this hearing.

This Administration is dedicated to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers to trade and investment are bilateral tax treaties. Tax treaties eliminate barriers by providing greater certainty to taxpayers regarding their potential liability to tax in the foreign jurisdiction: by allocating taxing rights between the two jurisdictions so that the taxpayer is not subject to double taxation; by reducing the risk of excessive taxation that may arise because of high gross-basis withholding taxes: and by ensuring that taxpayers will not be subject to discriminatory taxation in the foreign jurisdiction. The international network of over 2000 bilateral tax treaties has established a stable framework that allows international trade and investment to flourish. The success of this framework is evidenced by the fact that countless cross-border transactions, from investments in a few shares of a foreign company by an individual to multi-billion dollar purchases of operating companies in a foreign country, take place each year. with only a relatively few disputes regarding the allocation of tax revenues between governments.

The Administration believes that these agreements with Japan and Sri Lanka would provide significant benefits to the United States and to our treaty partners, as well as our respective business communities. The tax treaty with Japan is a critically important modernization of the economic relationship between the world's two largest economies. The agreement with Sri Lanka represents the first tax treaty between our two countries, and reflects our continuing commitment to extending our treaty network to emerging economies. We urge the Committee and the Senate to take prompt and favorable action on both agreements.

PURPOSES AND BENEFITS OF TAX TREATIES

Tax treaties provide benefits to both taxpayers and governments by setting out clear ground rules that will govern tax matters relating to trade and investment between the two countries. A tax treaty is intended to mesh the tax systems of the two countries in such a way that there is little potential for dispute regarding the amount of tax that should be paid to each country. The goal is to ensure that taxpayers do not end up caught in the middle between two governments, each of which claims taxing jurisdiction over the same income. A treaty with clear rules addressing the most likely areas of disagreement minimizes the time the two governments (and taxpayers) spend in resolving individual disputes.

One of the primary functions of tax treaties is to provide certainty to taxpayers regarding the threshold question with respect to international taxation: whether the taxpayer's cross-border activities will subject it to taxation by two or more countries. Treaties answer this question by establishing the minimum level of economic activity that must be engaged in within a country by a resident of the other country before the first country may tax any resulting business profits. In general terms, tax treaties provide that if the branch operations in a foreign country have sufficient substance and continuity, the country where those activities occur will have primary (but not exclusive) jurisdiction to tax. In other cases, where the operations in the foreign country are relatively minor, the home country retains the sole jurisdiction

to tax its residents. In the absence of a tax treaty, a U.S. company operating a branch or division or providing services in another country might be subject to income tax in both the United States and the other country on the income generated by such operations. Although the United States generally provides a credit against U.S. tax liability for foreign taxes paid, there remains potential for resulting double taxation that could make an otherwise attractive investment opportunity unprofitable, depriving both countries of the benefits of increased cross-border investment.

Tax treaties protect taxpayers from potential double taxation through the allocation of taxing rights between the two countries. This allocation takes several forms. First, the treaty has a mechanism for resolving the issue of residence in the case of a taxpayer that otherwise would be considered to be a resident of both countries. Second, with respect to each category of income, the treaty assigns the "primary" right to tax to one country, usually (but not always) the country in which the income arises (the "source" country), and the "residual" right to tax to the other country. usually (but not always) the country of residence of the taxpayer. Third, the treaty provides rules for determining which country will be treated as the source country for each category of income. Finally, the treaty provides rules limiting the amount of tax that the source country can impose on each category of income and establishes the obligation of the residence country to eliminate double taxation that otherwise would arise from the exercise of concurrent taxing jurisdiction by the two countries.

As a complement to these substantive rules regarding allocation of taxing rights, tax treaties provide a mechanism for dealing with disputes or questions of application that arise after the treaty enters into force. In such cases, designated tax authorities of the two governments—known as the "competent authorities" in tax treaty parlance—are 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 that might otherwise result. The U.S. competent authority under our tax treaties is the Secretary of the Treasury. That function has been delegated to the Director, International (LMSB) of the Internal Revenue Service.

In addition to reducing potential double taxation, treaties also reduce "excessive" taxation by reducing withholding taxes that are imposed at source. Under U.S. domestic law. payments to non-U.S. 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. Most of our trading partners impose similar levels of withholding tax on these types of income. This tax is imposed on a gross, rather than net, amount. Because the withholding tax does not take into account expenses incurred in generating the income, the taxpayer frequently will be subject to an effective rate of tax that is significantly higher than the tax rate that would be applicable to net income in either the source or residence country. The taxpayer may be viewed, therefore, as having suffered "excessive" taxation. Tax treaties alleviate this burden by setting maximum levels for the withholding tax that the treaty partners may impose on these types of income or by providing for exclusive residence-country taxation of such income through the elimination of source-country withholding tax. Because of the excessive taxation that withholding taxes can represent, the United States seeks to include in tax treaties provisions that substantially reduce or eliminate source-country withholding taxes.

Our tax treaties also include provisions intended to ensure that cross-border investors do not suffer discrimination in the application of the tax laws of the other country. This is similar to a basic investor protection provided in other types of agreements, but the non-discrimination provisions of tax treaties are specifically tailored to tax matters and therefore are the most effective means of addressing potential discrimination in the tax context. The relevant tax treaty provisions provide guidance about what "national treatment" means in the tax context by explicitly prohibiting types of discriminatory measures that once were common in some tax systems. At the same time, tax treaties clarify the manner in which possible discrimination is to be tested in the tax context. Particular rules are needed here, for example, to reflect the fact that foreign persons that are subject to tax in the host country only on certain income may not be in the same position as domestic taxpayers that may be subject to tax in such country on all their income.

Tax treaties also include provisions dealing with more specialized situations, such as rules coordinating the pension rules of the tax systems of the two countries or addressing the treatment of employee stock options, Social Security benefits, and alimony and child support in the cross-border context. These provisions are becoming increasingly important as the number of individuals who move between countries or otherwise are engaged in cross-border activities increases. While these subjects may not involve substantial tax revenue from the perspective of the two govern-

ments, rules providing clear and appropriate treatment can be very important to each of the individual taxpayers who are affected.

In addition, tax treaties include provisions related to tax administration. A key element of U.S. tax treaties is the provision addressing the exchange of information between the tax authorities.

Under tax treaties, the competent authority of one country may request from the other competent authority such information as may be necessary for the proper administration of the country's tax laws; the requested information will be provided subject to strict protections on the confidentiality of taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank secrecy rules that would operate to prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not conclude a treaty with that country. In fact, information exchange is a matter we raise with the other country before commencement of formal negotiations because it is one of a very few matters that we consider non-negotiable.

TAX TREATY NEGOTIATING PRIORITIES AND PROCESS

The United States has a network of 56 bilateral income tax treaties covering 64 countries. This network includes all 29 of our fellow members of the OECD and covers the vast majority of foreign trade and investment of U.S. businesses. It is, however, appreciably smaller than the tax treaty networks of some other countries. There are a number of reasons for this.

The primary constraint on the size of our tax treaty network 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, make the negotiation process exacting and time-consuming.

A country'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. Numerous features of the treaty partner's particular tax legislation and its interaction with U.S. domestic tax rules must be considered in negotiating an appropriate treaty. Examples include whether the country eliminates double taxation through an exemption system or a credit system, the country's 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 treaty negotiation must take into account all of these and many other aspects of the treaty partner's tax system in order to arrive at an agreement that accomplishes the United States' tax treaty objectives.

In any tax treaty negotiation, the two countries may come to the table with very different views of what a final treaty should provide. Each country will have its own list of positions that it considers non-negotiable. The United States, which insists on effective anti-treaty-shopping and exchange of information provisions, and which must accommodate the uniquely complex U.S. tax laws, probably has more non-negotiable positions than most countries. For example, the United States insists on inclusion of a special provision—the "saving clause"—which permits the United States to tax its citizens and residents as if the treaty had not come into effect, as well as special provisions that allow the United States to apply domestic tax rules covering former citizens and long-term residents. Other U.S. tax law provisions that can complicate negotiations include the branch profits tax and the branch level interest tax, rules regarding our specialized investment vehicles, such as real estate mortgage investment conduits, real estate investment trusts and regulated investment companies. and the Foreign Investors in Real Property Tax Act rules. As our international tax rules become more and more complicated, the number of special tax treaty rules that are required increases as well.

Obtaining the agreement of our treaty partners on provisions of importance to the United States sometimes requires other concessions on our part. Similarly, other countries sometimes must make concessions to obtain our agreement on matters that are critical to them. In most cases, the process of give-and-take produces a document that is the best tax treaty that is possible with that other country. In other cases, we may reach a point where it is clear that it will not be possible to reach an acceptable agreement. In those cases, we simply stop negotiating with the understanding that negotiations might restart if circumstances change. Each treaty that we present to the Senate represents not only the best deal that we believe we can achieve with the particular country, but also constitutes an agreement that we believe is in the best interests of the United States.

In establishing our negotiating priorities, our primary objective is the conclusion of tax treaties or protocols that will provide the greatest economic benefit to the United States and to U.S. taxpayers. We communicate regularly with the U.S. business community, seeking input regarding the areas in which treaty network expansion and improvement efforts should be focused and information regarding practical problems encountered by U.S. businesses with respect to the application of particular treaties and the application of the tax regimes of particular countries.

The U.S. commitment to including comprehensive provisions designed to prevent "treaty shopping" in all of our tax treaties is one of the keys to improving our overall treaty network. Our tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes agreed to in a particular treaty mean that U.S. persons pay less tax to that country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents can exploit one of our treaties to secure reductions in U.S. tax, the benefits would flow only in one direction. Such use of treaties is not consistent with the balance of the deal negotiated. Moreover, preventing this exploitation of our treaties is critical to ensuring that the third country will sit down at the table with us to negotiate on a reciprocal basis, so that we can secure for U.S. persons the benefits of reductions in source-country tax on their investments in that country.

Despite the protections provided by the limitation on benefits provisions, there may be countries with which a tax treaty is not appropriate because of the possibility of abuse. With other countries there simply may not be the type of cross-border tax issues 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 possibility of the double taxation of income in the cross-border context that tax treaties are designed to address: with such jurisdictions, an agreement focused on the exchange of tax information can be very valuable in furthering the goal of reducing U.S. tax evasion.

The situation is more complex when a country adopts a special preferential regime for certain parts of the economy that is different from the rules generally applicable to the country's residents. In those cases, the residents benefiting from the preferential regime do not face potential double taxation and so should not be entitled to the reductions in U.S. withholding taxes accorded by a tax treaty, while a treaty relationship might be useful and appropriate in order to avoid double taxation in the case of the residents who do not receive the benefit of the preferential regime. Accordingly, in some cases we have tax treaty relationships that carve out certain categories of residents and activities from the benefits of the treaty. In other cases, we have determined that economic relations with the relevant country were such that the potential gains from a tax treaty were not sufficient to outweigh the risk of abuse, and have therefore decided against entering into a tax treaty relationship (or have terminated an existing relationship).

Prospective treaty partners must evidence a clear understanding of what their obligations would be under the treaty, including those with respect to information exchange, and must demonstrate that they would be able to fulfill those obligations. Sometimes a potential treaty partner is unable to do so. In other cases we may feel that a tax treaty is inappropriate because the potential treaty partner is not willing to agree to particular treaty provisions that are needed in order to address real tax problems that have been identified by U.S. businesses operating there.

Lesser developed and newly emerging economies, for which capital and trade flows with the United States are often disproportionate or virtually one way, may be reluctant to agree to the reductions in source-country withholding taxes preferred by the United States because of concerns about the short-term effects on their tax revenues. These countries have two somewhat conflicting objectives. They need to reduce barriers to investment, which is the engine of development and growth, and reducing source-country withholding taxes reduces a significant barrier to inward investment. On the other hand, reductions in source-country withholding taxes may reduce tax revenues in the short-term. Because this necessarily involves the other country's judgment regarding the level of withholding taxes that will best balance these two objectives, our tax treaties with developing countries often provide for higher maximum rates of source-country tax than is the U.S. preferred position. Such a treaty nevertheless provides benefits to taxpayers by establishing a stable framework for taxation. Moreover, having an agreement in place makes it easier to agree to further reductions in source-country withholding taxes in the future. It is important to recognize that even where the current capital and trade flows between two treaty countries are disproportionate, conclusion of a tax treaty is not a zero-

sum exercise. The goal of the tax treaty is to increase the amount and efficiency of economic activity, so that the situation of each party is improved.

For a country like the United States that has significant amounts of both inbound and outbound investment, treaty reductions in source-country withholding taxes do not have the same one-directional impact on tax revenues, even looking just at the short-term effects. Reductions in withholding tax imposed by the source country on payments made to foreign investors represent a short-term static reduction in source-country tax revenues. However, reductions in foreign withholding taxes borne by residents on payments received with respect to foreign investments represent an increase in tax revenues because of the corresponding reduction in the foreign tax credits that otherwise would offset the residents' domestic tax liabilities. Thus, the reciprocal reductions in source-country withholding taxes accomplished by treaty will have offsetting effects on tax revenues even in the short term.

More importantly, looking beyond any net short-term effect on tax liabilities, an income tax treaty is a negotiated agreement under which both countries expect to be better off in the long run. These long-term economic benefits far outweigh any net short-term static effects on tax liabilities. Securing the reduction or elimination of foreign withholding taxes imposed on U.S. investors abroad can reduce their costs and improve their competitiveness in connection with international business opportunities. Reduction or elimination of the U.S. withholding tax imposed on foreign investors in the United States may encourage inbound investment, and increased investment in the United States translates to more jobs. greater productivity and higher wage rates. The tax treaty as a whole creates greater certainty and provides a more stable environment for foreign investment. The agreed allocation of taxing rights between the two countries reduces cross-border impediments to the bilateral flow of capital, thereby allowing companies and individuals to more effectively locate their operations in such a way that their investments are as productive as possible. This increased productivity will benefit both countries' economies. The administrative provisions of the tax treaty provide for cooperation between the two countries, which will help reduce the costs of tax administration and improve tax compliance.

DISCUSSION OF PROPOSED NEW TREATIES AND PROTOCOLS

I now would like to discuss the two agreements that have been transmitted for the Senate's consideration. We have submitted Technical Explanations of each agreement that contain detailed discussions of the provisions of each treaty and protocol. These Technical Explanations serve as an official guide to each agreement.

Japan

The proposed Convention and Protocol with Japan was signed in Washington on November 6, 2003. The Convention and Protocol are accompanied by an exchange of diplomatic notes, also dated November 6, 2003. The Convention, Protocol and notes replace the existing U.S.-Japan tax treaty. which was signed in 1971.

Because the existing treaty dates back to 1971, it does not reflect the changes in economic relations between the two countries that have taken place over the last thirty years. Today, the trade and investment relationship between the United States and Japan. the world's two largest economies, is critical to creating economic growth throughout the world. The proposed new treaty significantly reduces existing tax-related barriers to trade and investment between Japan and the United States. Reducing these barriers will help to foster still-closer economic ties between the two countries, enhancing the competitiveness of both countries' businesses and creating new opportunities for trade and investment.

The existing treaty also is inconsistent in many respects with U.S. tax treaty policy. The proposed new treaty brings the treaty relationship into much closer conformity with U.S. policy and generally modernizes the agreement in a manner consistent with other recent treaties. At the same time, several key provisions of the new treaty represent "firsts" for Japan. The evolution embodied in this agreement may very well provide important precedents for many countries in the region that look to Japan for guidance and leadership in this regard.

Perhaps the most dramatic advances in the proposed new treaty are reflected in the reciprocal reductions in source-country withholding taxes on income from cross-border investments. The existing treaty sets maximum rates for withholding taxes on cross-border interest, royalty and dividend payments that are much higher than the rates reflected in the U.S. model tax treaty and provided in most U.S. tax treaties with developed countries. The new treaty substantially lowers these maximum withholding tax rates, bringing the limits in line with U.S. preferred tax treaty provisions. The maximum rates of source-country withholding tax provided in the new treaty are as low as, and in many cases significantly lower than, the rates provided for in any other tax treaty entered into by Japan. These important reductions in

source-country withholding tax agreed in this new treaty reflect the commitment of both governments to facilitating cross-border investment.

In today's knowledge-driven economy, intangible property developed in the United States, such as trademarks, industrial processes or know-how, is used around the world. Given the importance of the cross-border use of intangibles between the United States and Japan, a primary objective from the U.S. perspective in negotiating a new tax treaty with Japan was to overhaul the existing rules for the treatment of cross-border income from intangible property. This goal is achieved in the proposed new treaty through the complete elimination of source-country withholding taxes on royalties. This is the first treaty in which Japan has agreed to eliminate source-country withholding taxes on royalties.

The proposed new treaty is a major change from the existing treaty, which allows the source country to impose a 10 percent withholding tax on cross-border royalties. The gross-basis taxation provided for under the existing treaty is particularly likely to lead to excessive taxation in the case of royalties because the developer of the licensed intangible who receives the royalty payments typically incurs substantial expenses, through research and development or marketing. The existing treaty's 10-percent withholding tax imposed on gross royalties can represent a very high effective rate of source-country tax on net income when the expenses associated with such income are considered. In addition, because withholding taxes can be imposed on cross-border payments where the taxpayer has no presence in the source country, the existing treaty's allowance of such taxes on royalties created a significant disparity in treatment between royalty income and services and other income. This has been particularly problematic as the line between the types of income is not always clear.

With the elimination of source-country royalty withholding taxes provided for in the proposed new treaty, royalties will be taxed exclusively by the country of residence on a net basis in the same manner as other business profits. This eliminates the excessive taxation that can occur under the existing treaty. Moreover, treating royalties in the same manner as business profits removes the disparity in treatment between royalty income and services and other income and therefore eliminates what has been a significant source of dispute and potential double taxation for U.S. taxpayers under the existing treaty. As a final note, this change in the U.S.-Japan treaty relationship may well have positive effects for other U.S. treaty negotiations. Japan's historic policy of retaining its right to impose withholding tax on royalties in its tax treaties has encouraged other countries to do the same. The change in this policy reflected in the new treaty may serve as an impetus to other countries to consider agreeing by treaty to greater reductions in source-country withholding taxes on royalties.

The proposed new treaty also reflects significant improvements in the rules regarding cross-border interest payments. The existing treaty provides for a maximum withholding tax rate of 10 percent for all interest payments other than a narrow class of interest paid to certain government entities. The new treaty includes provisions eliminating source-country withholding taxes for significant categories of interest. The most important of these is the elimination of source-country withholding tax for interest earned by financial institutions. Due to the highly-leveraged nature of financial institutions, imposition of a withholding tax on interest received by such enterprises could result in taxation that actually exceeds the net income from the transaction. The new treaty will eliminate this potential for excessive taxation, with cross-border interest earned by financial institutions taxed exclusively by the residence country on a net basis. The new treaty also provides for the elimination of source-country withholding taxes in the case of interest received by the two governments, interest received in connection with sales on credit, and interest earned by pension funds. This elimination of source-country withholding taxes on income earned by tax-exempt pension funds ensures that the assets expected to accumulate tax-free to fund retirement benefits are not reduced by foreign taxes: a withholding tax in this situation would be particularly burdensome because there is no practical mechanism for providing individual pension beneficiaries with a foreign tax credit for withholding taxes that were imposed on investment income years before the retiree receives pension distributions. These exemptions from source-country withholding tax for interest provided in the new treaty are broader than in any other Japanese tax treaty.

In addition, the proposed new treaty significantly reduces source-country withholding taxes with respect to all types of cross-border dividends. Under the existing treaty, direct investment dividends (that is, dividends paid to companies that own at least 10 percent of the stock of the paying company) generally may be taxed by the source country at a maximum rate of 10 percent and portfolio dividends may be taxed at a maximum rate of 15 percent. The new treaty reduces the maximum

rates of source-country withholding tax to 5 percent for direct investment dividends and 10 percent for portfolio dividends. The new treaty also provides for the elimination of source-country withholding taxes on certain intercompany dividends where the dividend is received, by a company that owns more than fifty percent of the voting stock of the company paying the dividend. This provision is similar to provisions included in the U.S. treaties with the United Kingdom. Australia, and Mexico. The elimination of withholding taxes on this category of intercompany dividends is substantially narrower than provisions in other Japanese treaties. In addition, the new treaty includes a provision that eliminates source-country withholding taxes on dividends paid to pension funds. which parallels the treatment of interest paid to pension funds.

Treasury believes that this provision eliminating source-country withholding taxes on certain intercompany dividends is appropriate in light of our overall treaty policy of reducing tax barriers to cross-border investment and in the context of this important treaty relationship. As I have testified previously, the elimination of source-country taxation of dividends is something that is to be considered only on a case-by-case basis. It is not the U.S. model position because we do not believe that it is appropriate to agree to such an exemption in every treaty. Consideration of such a provision in a treaty is appropriate only if the treaty contains anti-treaty-shopping rules that meet the highest standards and the information exchange provision of the treaty is sufficient to allow us to confirm that the requirements for entitlement to this benefit are satisfied. Strict protections against treaty shopping are particularly important when the elimination of withholding taxes on intercompany dividends is included in relatively few U.S. treaties. In addition to these prerequisites, the overall balance of the treaty must be considered.

These conditions and considerations all are met in the case of the proposed new treaty with Japan. The new treaty includes the comprehensive anti-treaty-shopping provisions sought by the United States, provisions that are not contained in the existing treaty. The new treaty includes exchange of information provisions comparable to those in the U.S. model treaty. In this regard, Japan recently enacted domestic legislation to ensure that it can obtain and exchange information pursuant to a tax treaty even in cases where it does not need the particular information for its own tax purposes.

The United States and U.S. taxpayers benefit significantly both from this provision in the new agreement and from the treaty overall. The elimination of source-country withholding taxes on intercompany dividends provides reciprocal benefits because Japan and the United States both have dividend withholding taxes and there are substantial dividend flows going in both directions. U.S. companies that are in an excess foreign tax credit position will be able to keep every extra dollar they receive if the dividends they repatriate to the United States are free of Japanese withholding tax. The treaty as a whole reflects dramatic reductions in source-country withholding taxes relative to the existing treaty. The elimination of withholding taxes on royalties and certain interest was a key objective for the United States; while these provisions secured in this new treaty are consistent with U.S. tax treaty policy, they are an unprecedented departure from historic Japanese tax treaty policy.

Another important change reflected in the proposed new treaty is the addition of an article providing for the elimination of source-country withholding taxes on "other income", which include types of financial services income that under the existing treaty could have been subject to gross-basis tax by the source country. In particular, the Protocol confirms that securities lending fees, guarantee fees, and commitment fees generally will not be subject to source-country withholding tax and rather will be taxable in the same manner as other business profits.

The proposed new treaty provides that the United States generally will not impose the excise tax on insurance policies issued by foreign insurers if the premiums on such policies are derived by a Japanese enterprise. This provision, however, is subject to the anti-abuse rule that denies the exemption if the Japanese insurance company were to enter into reinsurance arrangements with a foreign insurance company that is not itself eligible for such an exemption.

Another significant modernization reflected in the proposed new treaty is the inclusion of specific rules regarding the application of treaty provisions in the case of investments in one country made by residents of the other country through partnerships and other flow-through entities. These rules coordinate the domestic law rules of Japan and the United States in this area in order to provide for certainty in results for cross-border businesses operated in partnership form.

In the case of shipping income, the proposed new treaty provides for exclusive residence-country taxation of profits from the operation in international traffic of ships or aircraft. This elimination of source-country tax covers profits from the rental of

ships and aircraft on a full basis; it also covers profits from rentals on a bareboat basis if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. In addition, the new treaty provides an exemption from source-country tax for all income from the use, maintenance or rental of containers used in international traffic.

The proposed new treaty generally provides for exclusive residence-country taxation of gains with narrow exceptions, which is generally consistent with U.S. tax treaty preferences but is a departure from the source-country taxation of gains that is provided for in recent Japanese treaties. The new treaty provides for source-country taxation of share gains in two circumstances. First, the new treaty includes a rule similar to that in U.S. domestic law under which gains from the sale of shares or other interests in an entity investing in real estate may be taxed by the country in which the real estate is located. Second, it contains a narrow rule dealing with gains on stock in restructured financial institutions that was included at the request of Japan. Under this rule, the source country may tax gains on stock of a financial institution if the financial institution had received substantial financial assistance from the government under rules relating to distressed financial institutions, the stock was purchased from the government, and the stock is sold within five years of such assistance. Under a very broad grandfather rule, this provision does not apply to any stock held by an investor who made an investment in such a financial institution prior to the entry into force of the new treaty including any additional stock in the financial institution that the investor acquires subsequently.

Like the existing treaty, the proposed new treaty provides that pensions and social security benefits may be taxed only by the residence country. The new treaty also provides rules regarding the allocation of taxing rights with respect to compensation earned in the form of employee stock options.

The proposed new treaty provides rules governing income earned by entertainers and sportsmen, corporate directors, government employees, and students that are consistent with the rules of the U.S. model treaty. The new treaty continues and improves a host-country exemption for income earned by teachers that is found in the existing treaty, although not in the U.S. model.

The proposed new treaty contains a comprehensive limitation on benefits article, which provides detailed rules designed to deny "treaty shoppers" the benefits of the treaty. These rules, which were not contained in the existing treaty and which have not been included in this form in other Japanese tax treaties, are comparable to the rules contained in recent U.S. treaties.

At the request of Japan, the proposed new treaty includes an additional limit on the availability of treaty benefits obtained in connection with certain back-to-back transactions involving dividends, interest, royalties or other income. This provision is substantially narrower than the "conduit arrangement" language found in the 2003 treaty with the United Kingdom. It is intended to address abusive transactions involving income that flows to a third-country resident. Japanese domestic law does not provide sufficient protection against these abusive transactions. The stricter protections against this type of abuse that are provided under U.S. domestic law will continue to apply.

The proposed new treaty provides relief from double taxation in a manner consistent with the U.S. model. The new treaty also includes a re-sourcing rule to ensure that a U.S. resident can obtain a U.S. foreign tax credit for Japanese taxes paid when the treaty assigns to Japan primary taxing rights over an item of gross income. A comparable rule applies for purposes of the Japanese foreign tax credit.

The proposed new treaty provides for non-discriminatory treatment (i.e., national treatment) by one country to residents and nationals of the other. Also included in the new treaty are rules necessary for administering the treaty, including rules for the resolution of disputes under the treaty. The information exchange provisions of the new treaty generally follow the U.S. model and make clear that Japan will provide U.S. tax officials such information as is relevant to carry out the provisions of the treaty and the domestic tax laws of the United States. Inclusion of this U.S. model provision was made possible by a recent change in Japanese law.

Sri Lanka

The United States does not currently have an income tax treaty with Sri Lanka. The proposed income tax Convention with Sri Lanka was signed in Colombo on March 14, 1985 but was not acted on by the Senate at that time because changes made to U.S. international tax rules by the Tax Reform Act of 1986 necessitated some modifications to the agreement. The proposed Protocol, which was signed on September 20, 2002, amends the 1985 Convention to reflect changes in domestic law since 1985 as well as developments in U.S. tax treaty policy and includes modifica-

tions that better reflect U.S. tax treaty preferences. We are requesting the Committee to report favorably on both the 1985 Convention and the 2002 Protocol.

The proposed new treaty generally follows the pattern of the U.S. model treaty, while incorporating some provisions found in other U.S. treaties with developing countries. The maximum rates of source-country withholding taxes on investment income provided in the proposed treaty are generally equal to or lower than the maximum rates provided in other U.S. treaties with developing countries (and some developed countries).

The proposed treaty generally provides a maximum source-country withholding tax rate on dividends of 15 percent. Special rules consistent with those in the U.S. model treaty apply to certain dividends paid by a U.S. real estate investment trust. The proposed treaty provides a maximum source-country withholding tax rate on interest of 10 percent. This source-country tax is eliminated in the case of interest paid by one of the two governments or received by one of the two governments or one of the central banks.

Under the proposed treaty, royalties may be subject to source-country withholding taxes at a maximum rate of 10 percent. As in many treaties with developing countries, the royalties article also covers rents with respect to tangible personal property: in the case of such rents, however, the maximum withholding tax rate is 5 percent. These rules in the proposed treaty do not apply to rental income with respect to the lease of containers, ships or aircraft, which is instead covered by the specific rules in the shipping article.

The rules in the proposed treaty relating to income from shipping and air transport are complicated in terms of drafting, but produce results that in most cases are consistent with many recent U.S. tax treaties. First and simplest, under the proposed treaty income derived from the rental of containers used in international traffic is taxable only in the country of residence and not in the source country. Exclusive residence-country taxation of such income is the preferred U.S. position reflected in the U.S. model treaty. Second. the proposed treaty provides that income derived from the international operation of aircraft also is taxable only in the country of residence. This rule eliminating source-country tax covers income derived from aircraft leases on a full basis as well as profits from the rental of aircraft on a bareboat basis if the aircraft are operated in international traffic by the lessee or if the lease is incidental to other profits from the operation of aircraft. Third, the rules in the treaty provide for some source-country taxation of income from the operation and rental of ships, but not to exceed the source-country tax that may be imposed under any of Sri Lanka's other treaties. Sri Lanka has entered into two treaties that eliminate source-country tax on income from the operation of ships and has confirmed through diplomatic note that this exemption from source-country tax will apply in the case of the United States as well.

The proposed treaty provides the basic tax treaty rule that business profits of a resident of one of the treaty countries generally may be taxed in the other country only when such profits are attributable to a permanent establishment located in that other country. The rules in the proposed treaty permit broader host-country taxation than is provided for in the U.S. model treaty. In this regard, the definition of permanent establishment in the proposed treaty is somewhat broader than the definition in the U.S. model, which lowers the threshold level of activity required for imposition of host-country tax. This permanent establishment definition is consistent with other U.S. treaties with developing countries. In addition, the proposed treaty provides that certain profits that are not attributable to the permanent establishment may be taxed in the host state if they arise from business activities carried on in the host state that are similar to those carried on through the permanent establishment. These rules are quite similar to rules found in our tax treaties with other developing countries.

The proposed treaty's rules for taxation of income from personal services similarly are consistent with our recent treaties with developing countries. Under the proposed treaty, income earned through independent personal services may be taxed in the host country if they are performed through a fixed base or if the individual performing the services was in the host country for more than 183 days in any 12-month period. The proposed treaty provides rules governing income earned by entertainers and sportsmen. corporate directors and government employees that are broadly consistent with the rules of the U.S. model treaty. The proposed treaty also includes a limited exemption from source country taxation of students.

The proposed treaty contains a comprehensive limitation on benefits article, which provides detailed rules designed to deny "treaty shoppers" the benefits of the treaty. These rules are comparable to the rules contained in the U.S. model and recent U.S. treaties.

The proposed treaty also sets out the manner in which each country will relieve double taxation. Both the United States and Sri Lanka will provide such relief through the foreign tax credit mechanism, including a deemed paid credit for indirect taxes paid by subsidiary companies.

The proposed treaty provides for non-discriminatory treatment (i.e.. national treatment) by one country to residents and nationals of the other. 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 includes an exchange of information provision that generally follows the U.S. model. Under these provisions, Sri Lanka will provide U.S. tax officials such information as is relevant to carry out the provisions of the treaty and the domestic tax laws of the United States. Sri Lanka has confirmed through diplomatic note, its ability to obtain and exchange key information relevant for tax purposes. The information that may be exchanged includes information held by financial institutions, nominees or persons acting in an agency or fiduciary capacity.

TREATY PROGRAM PRIORITIES

We continue to maintain a very active calendar of tax treaty negotiations. We currently are in ongoing negotiations with Bangladesh, Canada, Chile, Hungary, Iceland and Korea. We also have substantially completed work with the Netherlands, France and Barbados and look forward to the conclusion of these new agreements.

With respect to future negotiations, we expect to begin discussions soon with Germany and Norway. Another key priority is updating the few remaining treaties that provide for low withholding tax rates but do not include the limitation on benefits provisions needed to protect against the possibility of treaty shopping. Also a priority is entering into new treaties with the former Soviet republics that are still covered by the old U.S.S.R. treaty (which does not include an adequate exchange of information provision). We also are focused on continuing to expand our treaty network by entering into new tax treaty relationships with countries that have the potential to be important trading partners in the future.

Significant resources have been devoted in recent years to the negotiation of new tax treaties with Japan and the United Kingdom, two major trade and investment partners for the United States and two of our oldest tax treaties. With the completion of these important negotiations, we believe that it would be appropriate to update the U.S. model treaty to reflect our negotiating experiences since 1996. A new model will help facilitate the negotiations we expect to begin in the near future. We look forward to working with the staffs of the Senate Foreign Relations Committee and Joint Committee on Taxation on this project.

CONCLUSION

Let me conclude by again thanking the Committee for its continuing interest in the tax treaty program, and the Members and staff for devoting the time and attention to the review of these new agreements. We appreciate the assistance and cooperation of the staffs of this Committee and of the Joint Committee on Taxation in the tax treaty process.

We urge the Committee to take prompt and favorable action on the agreements before you today. Such action will help to reduce barriers to cross-border trade and investment by further strengthening our economic relations with a country that has been a significant economic and political partner for many years and by expanding our economic relations with an important trading partner in the developing world.

The CHAIRMAN. Well, thank you very much, Ms. Angus. Nice little introduction for you, Mr. Yin, a commendation. We likewise appreciate that help with our staff. Would you please proceed with your testimony.

STATEMENT OF GEORGE YIN, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mr. YIN. Thank you very much, Mr. Chairman. It's a pleasure to be here today to offer the testimony of the staff of the Joint Committee on Taxation. As in the past, the Joint Committee on Taxation staff has prepared pamphlets describing the proposed treaties and the issues raised by them, and we've consulted with the Treasury staff as well as members of your staff.

With your permission, I'm just going to highlight a few of the points that are made in my written testimony.

The CHAIRMAN. Yes. And the full testimony of both of you will be in the record in full, and if you would summarize, that would be great.

Mr. YIN. Thank you very much. With respect to the Japan treaty, one of the most significant issues certainly is the proposed zero withholding tax rate on direct dividends. That is, under certain conditions, the treaty would eliminate source-country taxation on cross-border dividends by one corporation to another owning over 50 percent of the payer. Under the current treaty, there's a 10 percent withholding tax.

I'd like to illustrate the significance of this change by directing your attention to appendix A and appendix B in my written statement. These are the last two pages of my written statement. Appendix A shows a little diagram of a typical arrangement where a United States taxpayer has a direct investment in Japan, and what this diagram is trying to illustrate is that under both the current treaty as well as the proposed treaty, there are two aspects that are completely unchanged by the proposal.

The first thing is that under current law as well as under the proposed treaty, the Japanese operating company, the subsidiary company that's doing business in Japan, will continue to pay source-country taxation to Japan on its operating profits, currently at a 30 percent rate.

The treaty also does not change the taxation of the U.S. parent company by the United States. That is, the United States will impose a corporate tax on the dividend paid by the operating subsidiary to the parent, generally at a 35 percent tax rate.

So those two aspects are completely unchanged by the proposed treaty. What will be changed is, if the treaty is approved, is that under the current treaty arrangement, the source country, in this case Japan, imposes an additional 10 percent withholding tax on the distribution of a dividend from the subsidiary to the parent. This is in addition to the tax that Japan imposes on the operating profits of the company. The withholding tax will be eliminated under the proposed treaty, and so that's one aspect that's changed.

And the second aspect is, because U.S. taxpayers in general are entitled to claim a foreign tax credit for taxes that they pay to Japan, the foreign tax credit claims of U.S. taxpayers would be reduced in this situation, which would then therefore increase U.S. taxes collected.

If you turn to appendix B, you see exactly the opposite situation where you have a typical arrangement of Japanese direct investment in the United States. And here again, essentially the same conclusions can be reached. That is, the treaty does not change the U.S.'s taxation of the operating subsidiary's profits. The treaty does not change Japan's taxation of the dividend received by the Japanese parent company. The treaty simply changes the amount of the additional source-country tax imposed by the U.S. currently on the distribution of the dividend to the Japanese parent, and that in turn will then reduce the amount of Japanese foreign tax credits that the Japanese taxpayer can claim against its Japanese tax.

These two examples illustrate essentially what this proposed reduction in withholding tax would do. One is to shift some of the taxing jurisdiction of the income from the source country to the residence country. And second, because under current law foreign tax credits, both in Japan and the United States, are limited in certain circumstances, some taxpayers under the current treaty are required to pay some amount of international double taxation to the amount they're unable to fully utilize their foreign tax credits. The zero rate would reduce that and thereby produce a reduction in the worldwide tax liability of those taxpayers.

In terms of issues on this, I might point out a couple of things. One is that the entitlement to this zero rate under the proposed treaty would apply to parent companies that own over 50 percent of subsidiaries. This is less than the 80 percent standard that was in the three treaties approved by the Senate last year. This also may have an implication in terms of the Mexico treaty, because the Mexican treaty has a most favored nation provision, which might trigger some consultations.

Another issue, a broader issue, is of course whether this proposal by the Treasury signals some broader shift in U.S. treaty policy. Under what circumstances, for example, would the Treasury continue to offer a zero rate arrangement? Those are issues that certainly the committee might want to inquire.

Let me just mention a few other issues that are raised by the Japanese treaty and then a few issues in the Sri Lanka agreement. First, in terms of anti-conduit rules, these are rules which essentially deny benefits of certain provisions where the taxpayer in a treaty country serves in essence as a mere conduit for the actual transaction, which involves a taxpayer which is not a resident of either treaty country.

The issue here is simply a question of confusion, or potential confusion. The United States, as part of its domestic law, already has more comprehensive anti-conduit rules than is provided in the treaty, and so the question is why the treaty, in providing these rules, simply didn't limit them to Japanese law purposes and not given the rules any applicability for U.S. law purposes.

The second issue involves the insurance excise tax. The proposed treaty proposes to waive the U.S. excise tax on foreign insurance companies, such as Japanese insurance companies insuring or reinsuring U.S. risks. The question the committee may wish to raise is whether Japan imposes a significant enough tax on the insurance income of Japanese insurance companies to ensure that U.S. insurers would not be placed at a competitive disadvantage as a result of this proposal.

The third issue involves a unique provision which would permit Japan to tax gains in certain circumstances of U.S. investors on investments they make in restructured Japanese financial institutions. This is, of course, contrary in general to the U.S. model treaty position, which would preserve the jurisdiction of the residence country, in this case that would be the United States, and not permit source-country jurisdiction over those gains. The question for the committee is whether this deviation in this instance would be considered justified.

Next issue involves certain recharacterizations of certain kinds of non-arm's-length payments and contingent interest. The U.S. model treaty position with respect to these is to permit the recharacterization to take place as under the domestic laws of each nation. The question for the committee is why the proposed treaty doesn't follow that model position. In fact, there are some instances in which the treaty provision would produce a different result than would be produced under U.S. domestic law.

Another issue involves the FIRPTA jurisdiction. Under the U.S. model, the U.S. preserves its jurisdiction to tax foreign investors of either direct or indirect investments in U.S. real property. Under the proposed treaty, the U.S. jurisdiction to tax these gains is generally preserved, but not completely preserved. That is, the treaty allows certain types of gains to escape U.S. taxation which would otherwise be taxed under U.S. domestic law. And so the question the committee might want to raise is why did the U.S. choose to surrender some jurisdiction in this area.

And then finally I'll mention that the U.S. model treaty is important to keep up. It's very helpful to taxpayers, to Congress, and to foreign governments, in articulating what the U.S. treaty policy is, and we believe that the current model is becoming somewhat obsolete. In that regard, we welcome the indication in the Treasury's written statement that they do intend to update this model.

Very briefly, I'll mention a couple of issues with respect to the Sri Lanka agreement. First is that in this Sri Lanka agreement, unlike the U.S. model, the agreement would permit some degree of greater source-country jurisdiction over taxation of cross-border investment and activities. This is typical of developing country concessions, and the question would be whether it would be appropriate in this case for Sri Lanka.

The second question is that in certain circumstances it isn't clear that the proposed agreement with Sri Lanka took into account the most recent changes in Sri Lankan tax law, and that would be an area that might be—the committee might wish to inquire about.

Third, there's a provision which, in the Sri Lanka agreement, which limits the disclosure of exchanged information and does not permit persons engaged in oversight of the tax system, such as the GAO and tax writing committees of Congress, to examine the information. That would be something the committee may wish to consider.

And last, the State Department has indicated that Sri Lanka is currently experiencing a domestic political crisis, and so the question would be whether it would be appropriate to reach an agreement in this environment.

Thank you very much. I'd be happy to answer any questions either now or in the future.

[The prepared statement of Mr. Yin follows:]

PREPARED STATEMENT OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION [1]

My name is George Yin. I am Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on

[1] This document may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Tax Treaties with Japan and Sri Lanka* (JCX-13-04), February 23, 2004.

Taxation today concerning the proposed income tax treaties with Japan and Sri Lanka.

OVERVIEW

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

The proposed treaty with Japan would replace an existing tax treaty signed in 1971. The proposed treaty with Sri Lanka represents a new tax treaty relationship for the United States. The proposed treaty with Sri Lanka was signed in 1985, but it never entered into force, and a protocol updating the proposed treaty was signed in 2002. My testimony today will highlight some of the key features of the proposed treaties and certain issues that they raise.

JAPAN

The proposed treaty with Japan is a comprehensive update of the 1971 treaty. The provisions of the proposed treaty are generally consistent with the U.S. model treaty; however, there are some exceptions.

"Zero-rate" dividend provision

One such exception is the relatively novel "zero rate" of withholding tax on certain intercompany dividends. The provision would eliminate source-country tax on cross-border dividends paid by one corporation to another corporation that owns more than 50 percent of the stock of the dividend-paying corporation, provided that certain conditions are met. Under the current treaty with Japan, these dividends may be subject to withholding tax in the source country at a rate of 10 percent. The proposed elimination of the withholding tax is intended to further reduce tax barriers to direct investment.

Let me illustrate the significance of this change by directing your attention to the figure in Appendix A. This figure shows a common arrangement for U.S. investment in Japan, where a U.S. company wholly owns a Japanese subsidiary operating in Japan. In this case, Japan would be considered the "source" country and the United States would be considered the "residence" country. Under both the current and proposed treaties, the income of the Japanese subsidiary would generally be taxed by the source country—Japan—at the Japanese corporate tax rate of 30 percent. Further, the proposed treaty would not change the taxation by the residence country-the United States—of any dividends received by the U.S. parent from the Japanese subsidiary. The only change made by the proposed treaty would be to eliminate any additional taxation of the dividend income by the source country, Japan, in the form of a withholding tax. The reduction in Japanese tax would, in turn, reduce the amount of U.S. foreign tax credits that may be claimed by the U.S. parent.

The figure in Appendix B illustrates the opposite situation of Japanese investment in the United States through a wholly owned U.S. operating subsidiary. Once again, the proposed treaty would not affect either the U.S. tax on the U.S. subsidiary's operating income or the Japanese tax on any dividends received by the Japanese parent from the U.S. subsidiary. The only change would be to eliminate the additional source country tax currently collected by the United States upon the distribution of a dividend to the Japanese parent, and the amount of Japanese foreign tax credits the parent may claim against its Japanese tax liability.

These examples illustrate that the effect of a zero-rate provision is generally to reduce the taxing jurisdiction of the source country and increase the taxing jurisdiction of the residence country. In this regard, the provision serves the common objective of tax treaties to resolve the competing tax claims of the source and residence country, and thereby reduce or eliminate double taxation under the current treaty, which provides for a positive rate of withholding tax on dividends, double taxation may be eliminated through the foreign tax credit. However, both the United States and Japan limit the amount of foreign tax credits that may be claimed by taxpayers. Consequently, the current treaty may result in some degree of double taxation, and a zero-rate provision may lead to an overall reduction for some taxpayers of this double taxation.

This provision does not appear in the U.S. or OECD model treaties. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes in similar circumstances. The European Union has also eliminated

withholding taxes in similar circumstances under its "Parent Subsidiary Directive." In 2003, the Senate approved adding zero-rate provisions to the U.S. treaties with the United Kingdom, Australia, and Mexico. Those provisions are similar to the provision in the proposed treaty, although the proposed treaty allows a lower ownership threshold than the provisions in the United Kingdom, Australia, and Mexico treaties (i.e., it allows the zero rate to apply in the case of parent corporations owning more than 50 percent of a subsidiary, as opposed to at least 80 percent). Thus, the proposed treaty would be the fourth U.S. tax treaty to provide a complete exemption from withholding tax on direct dividends, and generally would define the category of exempt dividends more broadly than the previous three treaties.

The Committee may wish to determine whether the inclusion of the zero-rate provision in the proposed treaty signals a broader shift in U.S. tax treaty policy. In addition, the Committee may wish to consider whether and under what circumstances the Department of the Treasury intends to pursue similar provisions in other treaties and whether the U.S. model will be updated to reflect these developments.

Other issues

I will mention very briefly several other issues. These and other issues are described in greater detail in the Joint Committee staff pamphlets.

Anti-conduit rules.—The proposed treaty contains anti-conduit rules that can operate to deny the benefits of several articles of the proposed treaty. These rules are similar to, but significantly narrower and more precise than the "main purpose" rules that the Senate rejected in 1999 in connection with its consideration of the U.S.-Italy and U.S.-Slovenia treaties. These rules were included in the proposed treaty at the request of Japan. The rules are largely unnecessary for U.S. purposes because U.S. domestic law provides generally stronger anti-conduit rules. The potential confusion between the proposed treaty provision and U.S. domestic law raises the question whether application of the treaty provision should have been limited to Japanese law purposes.

Insurance excise tax.—The proposed treaty also provides an exemption for Japanese insurance companies from the U.S. excise tax on insurance and reinsurance premiums paid to foreign insurers with respect to U.S. risks. The waiver may place U.S. insurers at a competitive disadvantage with respect to Japanese competitors in U.S. markets, depending upon the level of Japanese taxation of such competitors. The Committee may wish to satisfy itself that the tax imposed on insurance income by Japan is significant enough that no such disadvantage arises.

Gains on shares in restructured financial institutions.—The proposed treaty contains a unique provision that would permit Japan to tax certain gains of U.S. investors on shares in Japanese financial institutions that have received substantial Japanese financial assistance. (The proposed treaty provision is reciprocal, but it has no current relevance in the United States.) The U.S. investor may be able to claim a U.S. foreign tax credit for the Japanese tax paid, in which case U.S. tax collections would be reduced. The Committee may wish to consider whether this special provision is warranted.

Non-arm's length payments and contingent interest.—With respect to non-arm's length payments of interest and royalties (as well as certain other income) between related parties, the proposed treaty provides that these amounts are taxable in the source country at five percent of the amount of the excess of the payment over the arm's-length amount. The U.S. model and most of our tax treaties do not contain any such limitation, and provide that non-arm's length amounts are taxable according to the laws of each country, taking into account the other provisions of the treaty.

In addition, the U.S. model and most of our tax treaties provide a special rule with regard to payments of contingent interest, where the yield on the debt instrument tracks one or more variables such as the profits of the debtor. Under the U.S. model, such contingent interest generally may be taxed in the source country in accordance with its laws, up to the maximum withholding rate prescribed for portfolio dividends under the treaty if the recipient of the contingent interest is a resident of the other treaty country. In contrast, the proposed treaty provides that contingent interest remains subject to the interest provisions of the proposed treaty. The Committee may wish to inquire why the U.S. model position was not followed in these two cases.

Gains on sale of U.S. real property holding corporations.—The proposed treaty largely preserves U.S. taxing jurisdiction under the Foreign Investment in Real Property Tax Act ("FIRPTA") over the gain derived by a resident of Japan from the alienation of direct or indirect interests in U.S. real property. However, the proposed treaty generally waives some U.S. taxing jurisdiction with respect to these gains by relaxing certain definitional requirements. The Committee may wish to inquire why

the United States has waived this jurisdiction, which is inconsistent with the U.S. model.

Updating the U.S. model income tax treaty.—As a general matter, U.S. model tax treaties provide a framework for U.S. tax treaty policy. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on tax treaty matters. Periodically updating the U.S. model tax treaties to reflect changes, revisions, developments, and the viewpoints of Congress with regard to U.S. tax treaty policy would ensure that the model treaties remain meaningful and relevant. The current U.S. model income tax treaty was last updated in 1996. The staff of the Joint Committee believes that it is becoming obsolete and is in need of an update.

SRI LANKA

Let me now mention a few issues relating to the proposed tax treaty with Sri Lanka.

The proposed treaty differs from the U.S. model by not reducing source country taxation as much as the model. In this regard, the proposed treaty is similar to other treaties that the United States has entered into with developing countries. The Committee may wish to consider whether these concessions are appropriate in the case of Sri Lanka.

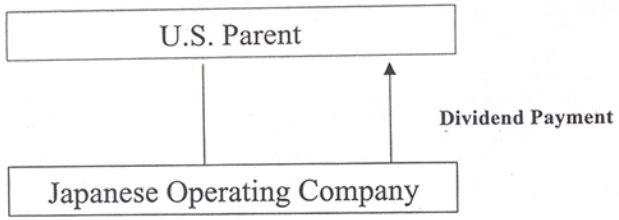
In several places, the proposed treaty appears not to reflect recent changes in Sri Lankan tax law.

Finally, Sri Lanka is currently experiencing a domestic political crisis. The Committee may wish to consider the impact of this political instability on the proposed treaty.

I would be happy to answer any questions that the Committee may have at this time or in the future.

[Attachments.]

U.S. Investment in Japan



Current Treaty

(1) Japanese operating company's operating income subject to 30-percent Japanese corporate income tax.

(2) Dividend of after-tax earnings by the Japanese operating company subject to 10-percent Japanese withholding tax.

(3) Dividend income of U.S. parent subject to 35-percent U.S. corporate income tax.

(4) The U.S tax may be offset by a U.S. foreign tax credit for the Japanese withholding tax and corporate income tax paid, subject to the foreign tax credit limitation.

Proposed Treaty

(1) Unchanged

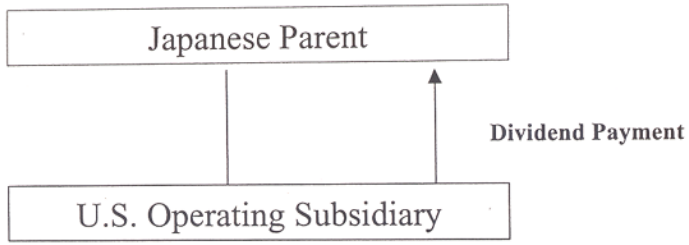
(2) Dividend of after-tax earnings by the Japanese operating company subject to no withholding tax.

(3) Unchanged

(4) The U.S tax may be offset by a U.S. foreign tax credit for the Japanese corporate income tax paid, subject to the foreign tax credit limitation.

APPENDIX B

Japanese Investment in the United States



Current Treaty

(1) U.S. operating company's operating income subject to 35-percent U.S. corporate income tax.

(2) Dividend of after-tax earnings by the U.S. operating company subject to 10-percent U.S. withholding tax.

(3) Dividend income of Japanese parent subject to 30-percent Japanese corporate income tax.

(4) The Japanese tax may be offset by a Japanese foreign tax credit for the U.S. withholding tax and corporate income tax paid, subject to the foreign tax credit limitation.

Proposed Treaty

(1) Unchanged

(2) Dividend of after-tax earnings by the U.S. operating company subject to no withholding tax.

(3) Unchanged

(4) The Japanese tax may be offset by a Japanese foreign tax credit for the U.S. corporate income tax paid, subject to the foreign tax credit limitation.

The CHAIRMAN. Well, thank you very much, Mr. Yin. Let me begin by asking some questions of you, Ms. Angus. First of all, what are the criteria that Treasury looks at in designating countries for these negotiations? Do they look at the size of the country or the scope of American business activity, or are these developments that just simply happen, that become topical and then you seize upon them?

Ms. ANGUS. Yes, Mr. Chairman, we look at a variety of factors including the types of factors that you've just identified. As part of the process of prioritizing what treaties to consider and how to proceed with the negotiations, one of the first considerations is whether there are tax problems faced by investors that can be corrected by a tax treaty.

Under U.S. domestic law we provide a credit for foreign taxes, and so what we're looking to see is whether the interaction of our domestic law with the law of the other partner gives rise to the kind of double taxation that the treaties are designed to address.

If there are those sorts of potential issues, given the interaction of the laws of the two countries, we also take into account the extent of bilateral economic relations between the two countries, as well as the structure of the other country's tax system, its development, whether it's continuing to evolve, and some of the fundamentals of the structure of the system to make sure that the system is such that a treaty would serve to accomplish the function of meshing the two systems.

Because a tax treaty is an individualized agreement that coordinates the systems of the countries, it is important that the other country have a relatively stable tax system. I say that with some hesitation because we do make changes to our own tax law now and again, and those changes sometimes require that we make changes to existing tax treaties. But what we're looking to in terms of the country is are they contemplating or about to embark on a fundamental change in their tax system, in which case it might be better to wait until the system is more settled so that we can make sure that the treaty has lasting value.

The CHAIRMAN. Are there significant differences in the proposed treaty with Japan from that which we have adopted with Great Britain or the United Kingdom?

Ms. ANGUS. I think that the two treaties, the treaty that the committee considered last year with the U.K. and the treaty with Japan are really quite similar. Obviously both very significant partners of ours, both modernizations of existing treaties. I think perhaps the biggest difference is really a difference in how much evolution there was from the existing treaty to the new treaty. There were important changes and very necessary changes made from the then existing U.K. treaty to the now current U.K. treaty to reflect changes in U.K. law as well as developments with respect to relations between the two countries and developments in treaty policy.

The changes between the existing treaty, the 1971 treaty with Japan, which is an even older treaty, and the treaty before you today, are much more dramatic.

The CHAIRMAN. Mention has been made by Mr. Yin, and also in your overall testimony, about the model treaty and the fact that Treasury has recognized that in some ways this treaty may need

to be updated. How does that procedure progress? For instance, Mr. Yin has raised a number of issues today, some of which might be overtaken by modernization of the model. Maybe some other issues might not, but can you discuss the process a bit just as background, because we shall probably have some more of these hearings?

Ms. ANGUS. Certainly. We agree that it would be an appropriate time to update the model. The model dates back to 1996. Now that we've completed negotiations with both the U.K. and Japan it's a particularly good time to revisit the model in light of the negotiating experience that we've had since the model was last updated in 1996.

In terms of the process, I think we would look forward to beginning discussions with this committee and the Joint Committee on Taxation about some of the issues related to an update of the model and we would be hopeful of being in a position to issue a new model this year.

Given the age of the model and given developments, I think it would make the most sense to do an update of the model. There are parts of the model that continue to work very well and there's no need to revisit those. Instead, we should focus our attention on updating it to take into account changes in policy. There have been some developments with respect to, for example, the treatment of dividends from real estate investment trusts that began to be included in treaties in 1997 and ought to be reflected in the model.

There have been some changes in our domestic law and we ought to consider whether that would require any tweaking to the model. And then there have been some developments with respect to practice, experiences that we've gained from the many negotiations since the model was updated, such as some modernization of the limitation on benefits provisions, the provisions that prevent treaties from being improperly used by residents of third countries. Those provisions, that concept of having a detailed limitation on benefits provisions, was relatively new in 1996 and we have more experience with that, and so, as I said, we are in complete agreement that an update of the model would be valuable to provide guidance.

The CHAIRMAN. Having said that, you've carefully negotiated each of the provisions of the Japanese treaty. I mention this because it seems to me that Mr. Yin raises a number of interesting questions of deviations either from that model or from others. But clearly those were in the mind of Treasury negotiators, both the model as well as the precedent.

Are there any of the areas in which Mr. Yin has directed the committee's attention that are especially important to highlight or that should lead to any controversy about the treaty?

Ms. ANGUS. I think a number of the areas that Mr. Yin highlighted are differences from our model or from other U.S. treaties that are because of features of Japanese law or Japanese treaty practice, and as you've noted, a treaty is an individualized agreement that is meshing those systems. And so there are situations that arise in any bilateral relationship that require particular tailoring.

One provision that Mr. Yin noted was the inclusion of anti-conduit rules in the treaty to prevent benefits of the treaty from flowing inappropriately to residents of third countries through back-to-back types of transactions that are structured to get those benefits. The provisions in the treaty are quite narrow. They are narrower than provisions that were considered by the committee last year in connection with the U.K. treaty. They really are in some senses more like the back-to-back provisions that were included in our treaty with Australia and our treaty with Mexico. They are provisions that were included at the request of Japan because Japan didn't have the anti-abuse rules in its domestic law that would allow it to deal with these abuse situations.

As Mr. Yin noted, the United States does have such anti-abuse rules. In fact, we have more comprehensive anti-abuse rules and we took great care in the technical explanation to make clear that those rules continue to apply, that the U.S. anti-abuse rules will continue to be applied by the United States. We appreciate that the Joint Committee in its description of the treaty also made that point too, to eliminate any potential for confusion because of this difference.

The alternative here would have been to put a one-sided provision in, to say that in the case of Japan these back-to-back rules would apply. We were concerned that that itself could create confusion, because it might create the implication that those rules didn't apply in the United States, when instead the intended implication was that our more comprehensive rules would apply.

Just to note, another provision where there's a difference between our model treaty in the drafting but not in the result, this is another that Mr. Yin noted, was the treatment of what are referred to as payments in excess of arm's length. The situation can arise when a company, for example, a subsidiary may make an interest payment to its parent and the tax authorities conclude that that interest payment exceeds the amount of interest that would be paid on an arm's-length transaction. Typically under U.S. law in that situation we recharacterize any excess as dividends, since the other relationship between the subsidiary and the parent would be to deliver money through dividends.

Our model treaty addresses this by saying that in the cases of payments that are determined to be in excess of the arm's-length payment of interest, for example, you don't look to the rules of withholding taxes on interest, but instead you look to domestic law with due regard to the provisions of the treaty. So under U.S. domestic law, we would characterize that as a dividend and we would apply the dividend withholding tax rate.

In Japan in that same situation, so if it's a Japanese subsidiary of U.S. company, in Japan they look at that transaction and deny a deduction for the excess amount of interest, but then they apply their domestic law withholding tax rate. They don't recharacterize the transaction as a dividend. Instead they apply a 20 percent tax rate. That's a potentially punitive result, and had we put in our model provision that simply said to look to domestic law, we would have continued that result. So instead we chose drafting that was intended to get to the result that you apply a withholding tax on

that amount of income at the lower rate, 5 percent, which is a rate that applies in the case of dividends.

So, again, that's a situation designed to tailor provisions in order to deal with the specifics of Japanese domestic law.

The CHAIRMAN. I appreciate very much this additional, very technical testimony. Clearly the intent of Treasury, of the Joint Committee, of this committee, and of the Congress is to try to make available to American business export opportunities, as well incentives to be involved with fairness, with Japan in this case or with Sri Lanka as well as toward ourselves. But there are differences in the codes.

There is an ongoing controversy that you face in the Treasury. Our colleagues in the Finance Committee might have you face this constantly, in terms of international transactions and taxes. From time to time, as you have witnessed in your career, allegations of invasion surface.

The technicalities here are extremely important. I appreciate you reciting them because they indicate the care you have given to make sure that our anti-abuse aspect of this, which means that fairness to all American taxpayers, has been uppermost. You have considered the ways in which we can expedite business, encourage it. All of these equities have to be weighed. They are important, and this is why this hearing is mandatory before we consider a treaty of this complexity, so that there is an open record. We appreciate the contributions of both of you to this.

Now, one point you've made, Mr. Yin—and I would like your comments likewise, Ms. Angus—with regard to Sri Lanka, you have commented that currently the political situation in that country may not be such that it would be appropriate to proceed at this point. I referenced in my opening comments an acknowledgment of ongoing difficulties that clearly Sri Lankan statesmen have mentioned to us as they have visited here. My own judgment, at least initially, prior to hearing this discussion, was that even notwithstanding the fact that turmoil has continued in some parts of the country, still the overall stability of the country is such that it would be appropriate to consider the treaty.

Do either one of you want to make any further comment on whether it is timely to proceed with Sri Lanka, at least as the committee intends to do? Is there important testimony that we should not?

Ms. Angus.

Ms. ANGUS. We certainly do think that it is important and timely to proceed with respect to the treaty. The treaty with Sri Lanka is one that has a long history with the underlying treaty first signed in 1985. Because of development in U.S. law and other developments, it has taken some time to conclude a final agreement.

We believe that there is sufficient stability that we don't see any problems in Sri Lanka going forward with this agreement. We think this agreement will provide valuable certainty to investors that are in that region, a certainty that will allow them greater confidence in the tax results of their transactions, and so we do believe that it is appropriate to go forward with this agreement.

Again, it is always important when we have an opportunity like this to expand our tax treaty network to emerging economies in

parts of the world and countries where we don't currently have those relations, and so we think it is important to go forward.

The CHAIRMAN. Do you have a further comment, Mr. Yin?

Mr. YIN. Yes, Senator. Of course, we're not in a position to be able to give guidance on the degree of instability in the country, but to the extent the country's political situation is unstable, it does raise some questions to consider. Certainly one of the aspects of tax treaties is reliance upon the competent authority in each country, and to the extent the country is unstable, it's not necessarily going to be clear who the competent authority is.

Another aspect that is important is what the substantive tax law is, and the greater the instability the greater uncertainty as to what the law is.

And finally, potentially the most important issue is that as part of a tax treaty, typically, as in the case of Sri Lanka and as well as Japan, there's some authorization of an exchange of information. This is, of course, very important information from the U.S. taxpayer's standpoint, privacy rights and so forth, and so there would be concerns as to whether, if the government is unstable, those kinds of protections would be preserved.

We quite agree that cutting the other way is that there are taxpayers both in the United States and in Sri Lanka that are continuing and will continue to do business in the other country, and to the extent the proposed agreement provides them with greater certainty as to the consequences of their transactions, that may be a benefit that even despite the political instability, may make the proposed treaty worth pursuing.

The CHAIRMAN. I think that's an important point, in addition the one that Ms. Angus made about the fact that we are trying to expand the scope of these treaties to developing countries. On some occasions that is going to mean something less stable than perhaps Great Britain and Japan—to take archetypes of those countries that are the largest and most stable.

Well, I thank both of you. Let me just mention before I ask the other two witnesses to come forward that we have as always enforced some scheduling problems in our hearings. We are going to have a rollcall vote at 10:30. What I would propose, without I hope outraging anyone, is that both of the next two witnesses summarize their testimony perhaps in 4 or 5 minutes each. We would thus accept the testimony and conclude the hearing. Otherwise, could declare a recess, I am prepared to do that and to come back after the vote, but we will have a gap of about a half an hour because of the length of the rollcall due to its being the first one in the morning on a very controversial issue.

Let me thank both of you. I now ask the next two witnesses, Mr. Reinsch and Mr. Fatheree, to come forward. I thank you both of you for preparing very thoughtful testimony. You heard an explanation of our timing situation. Is it acceptable to both of you to summarize your statements in a few minutes. Alternatively, do you feel that we ought to devote more time to the points that you're going to make, in which case we would need to recess for about a half an hour and then come back and consider them at that point? Do you have any thought about procedure quite apart from content?

Mr. REINSCH. I'm happy to summarize, Mr. Chairman.

Mr. FATHEREE. Likewise.

The CHAIRMAN. Well, I appreciate that very much. Would you please proceed, Mr. Reinsch.

STATEMENT OF HON. WILLIAM A. REINSCH, PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL

Mr. REINSCH. Yes. Thank you, Mr. Chairman. The quickest summary is just to say we're for it. We're for both of them, and I could stop talking right now, but let me make a few comments, trusting that my full statement will be in the record.

The CHAIRMAN. It will be, both statements will be in the record in full.

Mr. REINSCH. Thank you. You know who the NFTC is, so I don't need to give you that part, and I think that I will leave for the record the question about why these matters are important. I will just say that we have supported the tax treaty negotiation process because we believe that these agreements are important to harmonize the tax systems of the two countries that are involved in any treaty with respect to persons involved in cross-border investment in trade so that you eliminate double taxation by allocating taxing jurisdiction over the income between the two countries.

If we didn't have tax treaties, income from international transactions or investment may be subject to double taxation, which is a real obstacle for business, and that is something that we strive to eliminate and work very closely with the Treasury to that end.

Now, with respect to the agreements that are before the committee right now, as I said a minute ago, we support them. We believe the Japan tax treaty is a much needed update to an agreement between the world's two largest economies that's over 30 years old. Its completion will enhance an already flourishing economic relationship between our two countries.

We have for years urged adjustment of U.S. treaty policies to allow for a zero withholding rate on related dividends, and we congratulate the Treasury for making further progress in this treaty with Japan. This agreement makes an important contribution toward improving the economic competitiveness of U.S. companies. It bolsters and improves upon the standards set in the United Kingdom, Australia, and Mexican agreements ratified last year by lowering the ownership threshold required to receive the benefit of the zero dividend withholding rate from 80 to 50 percent.

We thank the committee for its prior support of this evolution in U.S. tax treaty policy, and we strongly urge you to continue that support by approving the Japan treaty. The treaty, as Ms. Angus noted, also deals with the elimination of withholding tax on parent subsidiary dividends as well as on royalties and interest, and I won't dwell on the details of that as she has already gone into a much more detailed analysis than I was prepared to go into anyway.

We believe that the Senate's ratification of these treaties will help Treasury in its continuing effort to negotiate similar agreements with other countries. Among the reasons that this treaty is important to the U.S. business community is the actual and precedential effect of eliminating the withholding tax on parent sub-

sidiary dividends, royalties, and interest, and because of several other benefits they introduce.

We're particularly hopeful the Senate will complete its ratification procedures so that instruments of ratification may be exchanged before April 1. This will prevent a delay in access to the Japan treaty's relief from withholding taxes since those provisions go into effect July 1 only if both parties have completed their process by the end of March. If ratification of the treaty is completed in 2004 but after the end of March, the treaty benefits will be delayed until next January, which is something that we would not like to see. That's why we're particularly grateful, Mr. Chairman, for your efforts to schedule this hearing rapidly and your commitment in your opening statement to move the committee forward on it.

Let me say we also support the tax treaty and protocol with Sri Lanka. We believe it represents a new tax treaty relationship for the United States, and it is a significant step forward in our economic relationship with Sri Lanka. I can't comment on the stability question either except simply to say that to the extent that we regularize and improve the bilateral tax relationship, we improve the business climate there, improve the likelihood there will be U.S. investment there, and that will be a good thing for stability in Sri Lanka. And so that is one of the reasons why we in particular support that treaty.

My statement includes a number of general comments on the tax treaty process that endorses the thoroughness with which this committee has gone about this business in the past, and I urge you to continue doing it with that same both thoroughness and efficiency.

We also want to reaffirm our support for the existing procedure by which Treasury consults on a regular basis with your committee, Mr. Chairman, and the Finance and Ways and Means Committees and the appropriate staffs concerning tax treaty issues and negotiations, and on the interaction between treaties and tax legislation.

We encourage all participants in the consultations to give them a high priority. As I said, we also commend you on moving so quickly on this. Let me also say in conclusion, Mr. Chairman, that we're very grateful to you and the other members of the committee for giving international economic relations such prominence in your committee's agenda. We work very closely with your staff on these matters and we're very pleased at your own focus.

I will conclude, Mr. Chairman, on a related note by thanking you in particular for coming to appear at USA Engage's annual meeting 2 weeks ago. I regret I couldn't be there, but we very much appreciated your appearance there and your remarks. We look forward to working with you both on the tax treaties, but also on your sanctions reformat act, which we also support. Thank you.

[The prepared statement of Mr. Reinsch follows:]

PREPARED STATEMENT OF WILLIAM A. REINSCH, PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL

Mr. Chairman and Members of the Committee:

The National Foreign Trade Council (NFTC) is pleased to recommend ratification of the treaties and protocol under consideration by the Committee today. We appreciate the Chairman's actions in scheduling this hearing so promptly, and we strong-

ly urge the Committee to reaffirm the United States' historic opposition to double taxation by giving its full support to the pending Japanese Tax Treaty and the Sri Lanka Tax Treaty and Protocol.

The NFTC, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and 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 and impediments to the flow of capital that can serve as barriers to full participation in the international marketplace. Foreign trade is fundamental to the economic growth of U.S. companies. Tax treaties are a crucial component of the framework that is necessary to allow that growth and to balanced competition.

This is why the NFTC has long supported the expansion and strengthening of the U.S. tax treaty network and why we are here today to recommend ratification of the Tax Convention with Japan and the Tax Convention and Protocol with Sri Lanka.

TAX TREATIES AND THEIR IMPORTANCE TO THE UNITED STATES

Tax treaties are bilateral agreements between the United States and foreign countries that serve to harmonize the tax systems of the two countries in respect of persons involved in cross-border investment and trade. Tax treaties eliminate this double taxation by allocating taxing jurisdiction over the income between the two countries. In the absence of tax treaties, income from international transactions or investment may be subject to double taxation, first by the country where the income arises and again by the country of the recipient's residence.

In addition, the tax systems of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners, and treaties are the mechanism by which these taxes are lowered on a bilateral basis. If U.S. enterprises earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they are liable to suffer excessive and noncreditable levels of foreign tax and to be at a competitive disadvantage relative to traders and investors from other countries that do have such benefits. Tax treaties serve to prevent this barrier to U.S. participation in international commerce.

If U.S. businesses are going to maintain a competitive position around the world, we need a treaty policy that protects them from multiple or excessive levels of foreign tax on cross border investments, particularly if their competitors already enjoy that advantage. The United States has lagged behind other developed countries in eliminating this withholding tax and leveling the playing field for cross-border investment. The European Union (EU) eliminated the tax on intra-EU, parent-subsidiary dividends over a decade ago and dozens of bilateral treaties between foreign countries have also followed that route. The majority of OECD countries now have bilateral treaties in place that provide for a zero rate on parent-subsidiary dividends.

Tax treaties also provide other features that 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 which is available exclusively under tax treaties is the mutual agreement procedure. This bilateral administrative mechanism avoids double taxation on cross-border transactions.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the United States by providing for the administration of U.S. tax laws and the implementation of U.S. treaty policy. The article that provides for the exchange of information between tax authorities is an excellent example of the benefits that result from an expanded tax treaty network. Treaties also offer the possibility of administrative assistance in the collection of taxes between the relevant tax authorities.

A framework for the resolution of disputes with respect to overlapping claims by the respective governments are also provided for in tax treaties. In particular, the

practices of the Competent Authorities under the treaties have led to agreements, known as "Advance Pricing Agreements" or "APAs," through which tax authorities of the United States and other countries have been able to avoid costly and unproductive proceedings 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.

AGREEMENTS BEFORE THE COMMITTEE

The Japan Tax Treaty that is before the committee today is a much needed update to an agreement between the world's two largest economies that is over thirty years old. Its completion will enhance an already flourishing economic relationship between our two countries. We highly commend Treasury for its unparalleled commitment to completing this historic agreement.

The NFTC has for years urged adjustment of U.S. treaty policies to allow for a zero withholding rate on related-entity dividends, and we praise the Treasury for making further progress in this treaty with Japan. This agreement makes an important contribution toward improving the economic competitiveness of U.S. companies. Indeed, it bolsters and improves upon the standard set in the United Kingdom, Australian, and Mexican agreements ratified last year by lowering the ownership threshold required to receive the benefit of the zero dividend withholding rate from 80 to 50 percent. We thank the committee for its prior support of this evolution in U.S. tax treaty policy and we strongly urge you to continue that support by approving the Japan Treaty.

The existence of a withholding tax on cross-border, parent-subsidiary dividends, even at the five percent rate previously typical in U.S. treaties, has served as a tariff-like impediment to cross border investment flows. Without a zero rate, the combination of the underlying corporate tax and the withholding tax on the dividend will often leave parent companies with an excess of foreign tax credits. Because these excesses are unusable, the result is a lower return from a cross-border investment than a comparable domestic investment. Tax treaties are designed to prevent this distortion in the investment decision-making process by reducing multiple taxation of profits within a corporate group, and they serve to prevent the hurdle to U.S. participation in international commerce. Eliminating the withholding tax on cross-border dividends means that U.S. companies with stakes in Japanese companies will now be able to meet their foreign competitors on a level playing field.

In addition to the elimination of the withholding tax on parent-subsidiary dividends, the Japan Treaty includes the welcome elimination of the withholding tax on royalties. Under normal circumstances, withholding tax by the source nation on payments for the use or right to use certain property is completely eliminated, a positive development for U.S. companies selling copyrighted products in Japan. U.S. software companies are just one example of an industry that will benefit from the freedom from double taxation arising from the uncertainty regarding whether the Japanese withholding tax will qualify for the U.S. foreign tax credit. A U.S. software company, for example, that developed a standardized program for use by companies around the world will no longer be subject to the 10% withholding tax associated with selling the rights to use the technology in Japan, eliminating the competitive disadvantage previously faced by U.S. companies.

The Japan Treaty also removes the withholding tax on certain interest payments leveling the playing field for U.S. financial institutions. Without the benefit of the new treaty, a Japanese entity financing its U.S. operations using a U.S. financial institution, would have to withhold Japanese tax on the interest payments paid to the U.S. financial institution increasing the cost of the loan and making the transaction cost prohibitive. The elimination of the 10 percent withholding tax on interest payments enables Japanese entities to apply to a U.S. financial institution for a loan to fund their U.S. operations providing an opportunity for U.S. financial institutions to compete for that business.

Another notable inclusion is a zero withholding rate on dividends paid to pension funds which should attract investment from those funds into U.S. stocks. A section which should give more appropriate tax treatment in Japan to the profusion of hybrid business structures which has occurred since the negotiation of the original treaty is also available under the new agreement. Also reflected is modern U.S. tax treaty policy regarding when reduced U.S. withholding rates will apply to dividends paid by Regulated Investment Companies (RICs) and Real Estate Investment Trusts

(REITs), as well as recent U.S. law changes aimed at preserving taxing jurisdiction over certain individuals who terminate their long-term residence within the United States.

Important safeguards are included in this treaty to prevent treaty shopping. In order to qualify for the lowered rates specified by the treaty, companies must meet certain requirements so that foreigners whose governments have not negotiated a tax treaty with Japan or the U.S. cannot free-ride on this treaty. Similarly, provisions in the sections on dividends, interest, and royalties prevent arrangements by which a U.S. company is used as a conduit to do the same. Extensive provisions in the treaty are intended to ensure that the benefits of the treaty accrue only to those for which they are intended.

The Senate's ratification of this agreement will help Treasury in its continuing effort to negotiate similar agreements with other countries. Among the reasons that this treaty is important to the U.S. business community is the actual and precedential effect of eliminating the withholding tax on parent-subsidiary dividends, royalties and interest, and because of several other benefits they introduce. We are particularly hopeful that the Senate will be able to complete its ratification procedures so that instruments of ratification may be exchanged before April 1, 2004. This will prevent a delay in access to the Japan Treaty's relief from withholding taxes, since those provisions go into effect July 1, 2004 only if both parties have completed their ratification process by the end of March 2004. If ratification of the treaty is completed in 2004, but after the end of March, those treaty benefits will be delayed until January 1, 2005.

The tax treaty and protocol with Sri Lanka represents a new tax treaty relationship for the United States. The agreements are a significant step forward in the U.S. economic relationship with Sri Lanka. They expand on the ongoing discussions under the U.S. Sri Lanka Trade and Investment Framework Agreement aimed at developing and diversifying trade between the two countries.

As a modernizing nation, Sri Lanka is in a developmental phase, which gives rise to opportunities for American business because of the projects and the economic development that an expanding infrastructure will allow. Sri Lanka is taking important steps to open its economy as part of its commitment to the World Trade Organization.

Sri Lanka has tax treaties in force with several of its other major trading partners in the EU and Asia. As a member of the British Commonwealth, Sri Lanka enjoys special treatment under that regime. Without a similar tax arrangement, U.S. companies that are interested in investing in or trading with Sri Lanka are at a competitive disadvantage.

While the Sri Lanka Treaty does not go as far at the Japan Treaty (e.g., in eliminating withholding taxes for dividends, interest, and royalties), it represents an important starting point in a growing economic relationship with Sri Lanka. The corresponding Sri Lanka Protocol reflects current U.S. tax treaty policy, and like the Japan Treaty, the Sri Lanka Treaty includes appropriate measures to prevent treaty shopping. The NFTC urges action to restore the competitive balance afforded to U.S. enterprises by this tax treaty.

GENERAL COMMENTS ON TAX TREATY POLICY

While we are not aware of any opposition to the treaties under consideration, the NFTC as it has done in the past as a general cautionary note, urges the Committee to reject opposition to the agreements based on the presence or absence of a single provision. No process that is as laden with competing considerations as the negotiation of a full-scale tax treaty between sovereign states will be able to produce an agreement that will completely satisfy every possible constituency, and no such result should be expected. Virtually all treaty relationships arise from 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 NFFC believes that treaties should be evaluated on the basis of their overall effect. In other words, agreements should be judged on whether they encourage international flows of trade and investment between the United States and the other country. An agreement that meets this standard will provide the guidance enterprises need in planning for the future, provide nondiscriminatory treatment for U.S. traders and investors as compared to those of other countries, and meet a minimum level of acceptability in comparison with the preferred U.S. position and expressed goals of the business community.

Slavish comparisons of a particular treaty's provisions with the U.S. Model or with treaties with other countries do not provide an appropriate basis for analyzing a treaty's value. U.S. negotiators are to be applauded for achieving agreements that reflect as well as these treaties do the positions of the U.S. Model and the views expressed by the U.S. business community.

The NFTC also wishes to emphasize how important treaties are in creating, implementing, and preserving an international consensus on the desirability of avoiding 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 through the OECD and other fora 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 governments' commitment to prevent conflicting income measurements from leading to double taxation and resulting distortions and barriers for healthy international trade. Treaties are a crucial element in achieving this goal, because they contain an expression of both governments' commitment to the arm's length standard and provide the only available bilateral mechanism, the competent authority procedure, to resolve any disputes about the application of the standard in practice.

We recognize 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 that 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 the Treasury to promote continuing international consensus on the appropriate transfer pricing standards, as well as innovative procedures for implementing that consensus. We applaud the continued growth of the 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 ongoing efforts of the IRS to refine and improve the operation of the competent authority process under treaties, to make it a more efficient and reliable means of avoiding double taxation.

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 tax 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 commend this Committee for scheduling tax treaty hearings so soon after receiving the agreements from the Executive Branch. Doing so enables improvements in the treaty network to enter into effect as quickly as possible.

We would also like to reaffirm our view, frequently voiced in the past, that Congress should avoid occasions of overriding the U.S. tax treaty commitments that are approved by this Committee by subsequent domestic legislation. 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.

IN CONCLUSION

Finally, the NFTC is grateful to the Chairman and the Members of the Committee for giving international economic relations prominence in the Committee's agenda, particularly so soon in this new year, and when the demands upon the Committee's time are so pressing. We would also like to express our appreciation for the efforts of both Majority and Minority staff which have allowed this hearing to be scheduled and held at this time.

We commend the Committee for its commitment to proceed with ratification of these important agreements as expeditiously as possible.

The CHAIRMAN. Well, thank you very much, Mr. Reinsch, for coming before the committee, again, today. We appreciate in a personal way your relationship with the Congress, with the Senate, as well as your distinguished public service which now continues with

the Trade Council. During the earlier testimony we had tried to highlight the stability problem in Sri Lanka, as well as the problem of tax abuse. The Treasury people today were able to give answers to both the public and our staffs that there is fairness to all American taxpayers, even as we are attempting to enhance American business abroad. I thank you for mentioning those aspects.

Mr. Fatheree.

STATEMENT OF JAMES W. FATHEREE, PRESIDENT, U.S.-JAPAN BUSINESS COUNCIL

Mr. FATHEREE. Mr. Chairman, thank you very much. I will touch briefly on the highlights of my testimony, which has been submitted for the record.

First of all, I'm here on behalf of the U.S.-Japan Business Council, which is a broad group encompassing U.S. companies that do business in Japan across a range of industries from agribusiness to aerospace to the automotive sector to financial services and pharmaceuticals. Our general mission is to promote the business interests of our members through policy issues such as this, and in general improve U.S.-Japan relations.

First, let me say there is broad U.S. and Japanese business support for the treaty. As Mr. Reinsch noted, the treaty clearly is a win-win situation for both economies and for companies from both countries. We've cooperated very closely with the NFTC but also the American Chamber of Commerce in Japan, the U.S. Chamber of Commerce, and significantly, Japanese business through our counterpart organization, the Japan-U.S. Business Council.

As you may recall, the chairman of the U.S.-Japan Business Council, Sir Deryck Maughan, sent you a letter advocating on behalf of the treaty, and that was co-written with Taizo Nishimuro, the chairman of Toshiba Corporation.

Subsequent to that, it's significant that Japan's leading business organization Keidanren—has also issued its own statement of support.

Second, we, of course, are for ratification of the treaty. To echo Mr. Reinsch's comments, we would certainly like to see ratification before March 31 because of the significant impact that it will have on both economies and our companies. The letter from Mr. Maughan and Mr. Nishimuro echoed that as well.

I would just note that the timing of the Senate action is important because Japan is prepared to take the unprecedented step of ratifying a treaty early. They have worked it through the legislative process through the Diet and through the government to get this thing done. If it is ratified—and I would note without amendment or reservation by the Senate—I would respectfully encourage the committee and the full Senate to move as quickly as possible.

Third, as has been noted amply by Ms. Angus and Mr. Reinsch and others, the economic relationship between the two economies has changed dramatically since the original treaty was reached. I would briefly note that while there has been some imbalance in the relationship during that period of time, particularly because of the large U.S. trade deficit with Japan and actually an imbalance between the level of Japanese investment in the United States and vice versa, I would note that over the past 5 years there have been

significant changes. We still have a meaningful trade deficit with Japan without question. It's smaller in relative terms than it was a couple of years ago, and proportionately it's a smaller part of the U.S. trade deficit.

The significant change, however, has been in U.S. investment in Japan. Over that 5-year period, U.S. investment measured on a stock basis has risen from about $33 billion to close to $70 billion. That sounds significant, except when you take into account that overall foreign investment in Japan is very low relative to the United States and other major industrial countries. And second, I think it could be substantially higher were the additional barriers to that investment removed.

Some U.S. companies are doing very well in Japan, and in fact the largest companies that have been there for a significant amount of time are generating over 10 percent of their total earnings out of Japan. As has been noted, some of this is subject to double taxation, which is something that needs to be addressed and is being addressed through the treaty.

Finally, just to note the benefits to the business communities and to the two economies, I think, trade and investment between the United States and Japan has grown immensely, but I think it could be substantially enhanced, and that in fact is my job to help promote that. The revised treaty will help improve business conditions by removing tax barriers and providing additional incentives to investment, both by Japanese companies in the United States, and I think particularly by American companies in Japan.

Ms. Angus adequately noted the benefits of the treaty. I would just note in closing that for U.S. corporations obviously the significant reductions in the withholding rates are the most significant impact that the treaty would have. The bottom line impact, I think, is hard to measure, but anecdotally I hear from some of the largest U.S. companies that it would have a very significant impact on what they're able to repatriate back to the United States. In that sense, as that money is repatriated, that means additional capital that those companies can invest in U.S. jobs and in U.S. facilities.

But I think it also offers additional encouragement to Japanese corporations to continue their investments in the United States, and on that I would note that Japanese investment in the United States supports over 800,000 jobs, and in this day and age, that's a very important factor.

So I think in closing there are clear benefits to both sides, both companies and countries, and in that respect, again I would urge the Senate to move as expeditiously as possible to ratify by mid-March. Thank you very much.

[The prepared statement of Mr. Fatheree follows:]

PREPARED STATEMENT OF JAMES W. FATHEREE, PRESIDENT, U.S.-JAPAN BUSINESS COUNCIL

I am pleased to be here today to testify in support of the "Convention between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income," hereafter referred to as the revised U.S.-Japan Tax Treaty.

The U.S.-Japan Business Council (USJBC) is comprised of many of the largest U.S. companies operating in Japan across a broad range of industries, including agribusiness, automotive, consumer products, financial services, information technology, and pharmaceuticals. The USJBC's mission is to promote the business inter-

ests of its members on policy issues regarding Japan, as well as improved U.S. relations with Japan.

U.S. AND JAPANESE BUSINESS SUPPORT A NEW TREATY

A revised U.S.-Japan Tax Treaty is clearly in the interests of U.S. business and the two economies, and the U.S.-Japan Business Council and its members support this very strongly. The USJBC is working closely with the American Chamber of Commerce in Japan (ACCJ), National Foreign Trade Council (NFTC), and U.S. Chamber of Commerce to support ratification of the Treaty in the Senate and the Japanese Diet.

Unique among these organizations, the USJBC has a long-standing relationship with a Japanese counterpart organization, the Japan-U.S. Business Council, comprised of Japan's leading companies. For 40 years, senior corporate executives belonging to the two organizations have met to discuss economic and trade issues. In light of the strong relationship between our two governments and with U.S. companies making more headway in the Japanese market, these meetings are more amicable than ever.

For the past five years, we have worked together to help realize a new U.S.-Japan Tax Treaty. Our backing helped move things from informal discussions to formal negotiations. We continue to cooperate during the ratification process in the U.S. Senate and Japanese Diet, as the Treaty is a clear "win-win" for both economies. Our goal is not only for the Treaty to be ratified, but that it be ratified before the March 31, 2004 date specified for making the withholding rate reduction effective July 1, 2004.

The Chairman of the USJBC, Sir Deryck Maughan, Chairman and CEO of Citigroup International, and his counterpart, Toshiba Corporation Chairman Taizo Nishimuro, have written to Senator Lugar, the Chairmen of the Foreign Affairs committees in Japan's Upper and Lower Houses of Parliament, and the Japanese Ministers of Finance and Foreign Affairs to express support for early ratification. To quote from the letter:

> The Treaty . . . is a major achievement benefiting U.S. and Japanese companies and the two economies. U.S. companies operating in Japan, and Japanese companies operating in the United States, will benefit significantly from the elimination of withholding taxes on all royalty income, certain interest income, and dividend income as stipulated in the treaty, as well as other provisions. The revised treaty will provide incentives to further bilateral trade and investment by eliminating tax-related bathers.

The letter also states that an early effective date of July 1, 2004, for the withholding provisions would "provide immediate economic benefits to U.S. and Japanese companies at a time when more foreign investment is needed to supplement employment and provide needed economic impetus in both countries."

On this point, I would like to note that the timing of Senate action is important. The Japanese Diet is poised to ratify the Treaty before March 31st if the Senate ratifies it without amendment or reservation. Japan's process is more complicated in that there is a parallel budgetary action that must be taken, and the Emperor must also sign the Treaty. As a practical matter, Senate approval in early March would therefore be essential. The fact that the Diet is prepared to ratify a treaty early is unprecedented, so we encourage the Foreign Relations Committee, and the full Senate, to approve the Treaty as quickly as possible in order to leave sufficient time for the Diet to act before March 31.

CHANGES IN U.S.-JAPAN BUSINESS NECESSITATE A NEW TREATY

It is entirely appropriate that the treaty governing income tax treatment between the U.S. and Japan be adjusted to reflect the enormous growth and changes in our economic relationship over the past 30 years. The existing treaty reflects both the great disparities, as well as the much smaller trade and investment flows, between the two economies when the original Treaty was ratified in 1972. Although hard to imagine now, when the original treaty was negotiated, Japan was a "developing" economy, a bilateral trade deficit amounting to a few billion dollars was considered a major problem, and cross-border investment flows were a fraction of what they are today.

Since then, the bilateral economic relationship and our respective tax systems have grown tremendously in magnitude and complexity. Two-way trade now exceeds $180 billion annually. More significant for purposes of the treaty is the sharp rise in direct investment by U.S. and Japan companies in each other's economy. For

years, the imbalanced nature of the economic relationship led to considerable friction.

Given much greater access to U.S. markets, Japanese companies exported to and invested in the U.S. to a much greater extent than U.S. companies did to/in Japan. Japanese foreign direct investment, or FDI, in the United States grew tremendously, and today is over $150 billion on a stock basis. Japan's global companies have established production, distribution, and R&D facilities throughout the U.S. from which they generate sizable revenues and earnings—and provide over 800,000 domestic jobs.

Over the past five years, the Japanese market has become relatively more open to U.S. goods, services and investment. Financial hardship has helped bring about important changes in certain industries, particularly financial services. While U.S. exports to Japan have fallen due to weak Japanese demand, U.S. FDI in Japan has, despite many obstacles, doubled, from $33 billion in 1997 to almost $70 billion in 2002. U.S. companies have made inroads into sectors such as autos, health care, IT and, particularly, financial services that were unimaginable a few years ago. Some U.S. companies are generating significantly more revenue and income in Japan, with a few deriving over 10% of total profits from their Japanese activities. U.S. companies are currently subject to double taxation on this income.

BENEFITS OF THE NEW TREATY

Trade and investment between the two largest economies could and should be greater. The revised Treaty will help improve business conditions and provide incentives to more activity. Thus, while there are many important provisions in the new Treaty, from my perspective the primary benefit for U.S.—and Japanese companies—is the elimination or significant reduction of withholding rates on dividends, royalties, and interest:

- *Royalties*—Most significantly, the treaty would lower the withholding rate on royalties from 10% to 0% in most cases except those involving certain back-to-back payments. Japan previously has not agreed to a full exemption in other treaties. Given the extensive cross-border technology and intellectual property flows, media and technology companies will benefit most, but any U.S. or Japanese company licensing patents, trademarks, designs or formulas will benefit as well.
- *Dividends*—The full exemption on dividends in cases such as qualifying pension funds and those in which the beneficial owner has at least a 50% stake in the foreign subsidiary is a major improvement over the current 10% rate. Even in cases not qualifying for full exemption, the new 5% rate is a significant improvement.
- *Interest*—The full exemption provides significant benefits to specified companies such as banks, insurance companies, securities dealers and other financial institutions meeting a 50% test for liabilities or assets claimed; some pension finds; cases of government-insured or financed debt; and debt arising from specified credit and equipment sales.

While aggregate numbers are difficult to come by, I can provide some sense of the magnitude of benefit to U.S. companies and the U.S. Treasury. For some U.S. companies with the largest operations in Japan, the reduction in Japanese withholding taxes could amount to as much as $100-$200 million annually. Some portion of this amount may result from the reduction of the double taxation experienced under the current regime. These savings will produce greater cash flow that can be used for additional U.S. investment and job creation. In addition, the increased flow from these savings will directly benefit the U.S. Treasury in the form of greater U.S. tax receipts.

CONCLUSION

The USJBC and the Japan-U.S. Business Council strongly support the revised U.S.-Japan Tax Treaty and would like to see the Senate and Japanese Diet ratify it before March 31, 2004, so that withholding rates are reduced starting July 1, 2004. This will provide immediate savings to U.S. and Japanese companies as well as long-term incentives for new investments that will boost economic activity and employment in both countries.

On behalf of the member companies of the U.S.-Japan Business Council, I thank you for the opportunity to express our support for expeditious ratification of the revised Treaty.

The CHAIRMAN. Thank you very much for the testimony and the work of the council. It is very important. It is good to have you before the committee today. I appreciate the point you have made about Japanese investment in the United States, particularly its size and its importance to the creation of new jobs in our country, which are significant in many of our states.

I thank both of you for the testimony and for the lucid summaries. We will proceed as expeditious as we can in the committee with our consideration of the treaty. We will encourage the leadership to understand the importance of completing this work in the month ahead. Thank you for coming. The hearing is adjourned.

[Whereupon, at 10:39 a.m., the committee adjourned, to reconvene subject to the call of the Chair.)

ADDITIONAL QUESTIONS SUBMITTED FOR THE RECORD

RESPONSES OF THE U.S. DEPARTMENT OF THE TREASURY TO ADDITIONAL QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR PAUL SARBANES

Question 1. In response to my question last year about the elimination of the withholding tax on cross-border dividends concerning the U.S.-U.K. treaty, the U.S.-Australia protocol, and the U.S.-Mexico protocol, Treasury said it "does not view this as a blanket change in the United States' tax treaty practice. Accordingly, we do not envision a change to the U.S. model tax treaty provisions relating to the allocation of taxing rights with respect to cross-border dividends."

As the proposed U.S.-Japan tax treaty is the next major tax treaty following the ones last year (containing the elimination of the withholding tax on cross-border dividends), isn't Treasury establishing a pattern on this provision?

Answer. A primary objective of tax treaties is reducing tax barriers to cross-border investment. One way in which treaties achieve this objective is by reducing or eliminating source-country withholding taxes on cross-border payments of investment income, thereby allocating taxing rights to the residence country and reducing the potential for double taxation or excessive taxation of such income by the source country. The United States has long sought by treaty to eliminate source-country withholding taxes on royalties and interest and to reduce source-country withholding taxes on dividends. The agreements with the United Kingdom, Australia, and Mexico approved by the Senate last year also included provisions eliminating source-country withholding taxes on certain intercompany dividends. The elimination of withholding taxes on intercompany dividends in appropriate circumstances can serve to further the key objective of tax treaties to reduce barriers to cross-border investment.

The proposed treaty with Japan includes a provision eliminating source-country withholding taxes on certain intercompany dividends. This provision provides reciprocal benefits because the United States and Japan both currently impose dividend withholding taxes to the full extent provided for under the current treaty and there are substantial dividend flows in both directions. The provision eliminating source-country withholding taxes on intercompany dividends benefits U.S.-based companies by eliminating the 10% withholding tax currently imposed by Japan on the repatriation of corporate profits to the United States. U.S. companies that are in an excess foreign tax credit position will be able to keep every extra dollar they receive if the dividends they repatriate to the United States are free of Japanese withholding tax. Looking at the treatment of investment income more generally, the proposed treaty includes the complete elimination of withholding taxes on royalties and on key categories of interest. Inclusion of these provisions was a major priority for the United States but was an unprecedented departure from its traditional tax treaty policy for Japan. The proposed treaty also includes strict anti-treaty shopping rules and information exchange provisions that are completely consistent with U.S. tax treaty policy. The conditions for inclusion of the provision eliminating source-country withholding taxes on intercompany dividends are overwhelmingly met in the case of this agreement with Japan.

The inclusion of this provision in the proposed treaty with Japan does not signal a blanket change in practice and it is not a provision we expect to consider or include in every case. (For example, the agreement with Sri Lanka that is also cur-

rently before the Committee provides for source-country withholding taxes on intercompany dividends.) Treasury continues to believe that the elimination of source-country withholding taxes on intercompany dividends is something that is to be considered on a case-by-case basis. A prerequisite to such consideration is anti-treaty-shopping rules and information exchange provisions that meet the highest standards. The optimal treatment of intercompany dividends in the context of any treaty relationship will continue to require a focus on the balance of benefits from the allocation of taxing rights in the treaty and from the treaty relationship overall.

Question 2. In the three tax treaties of last year, a foreign subsidiary must be 80 percent owned by its parent company to take advantage of the 0 rate of withholding taxes on cross-border dividends. In the proposed U.S.-Japan tax treaty, this ownership ratio drops to just over 50 percent.

Why did Treasury agree to this 50 percent ownership ratio?

Do you plan to repeat this 50 percent ownership ratio in any future tax treaties?

Answer. The relevant provision in the proposed treaty with Japan generally provides for the elimination of source-country withholding taxes on intercompany dividends where the parent company receiving the dividend controls the subsidiary company paying the dividend. Where one company controls another, there is the close economic relationship between the companies that underlies the rationale for the elimination of source-country withholding taxes on dividends paid from the subsidiary to the parent.

A primary objective of tax treaties is to reduce barriers to cross-border investment. In seeking to negotiate a new tax treaty with Japan, a key goal for the United States was to overhaul the existing treaty to eliminate source-country withholding taxes on royalties and certain interest income. Such provisions are consistent with long-standing U.S. treaty policy but had never been included in any Japanese tax treaty. On the other hand, recent Japanese tax treaties include provisions eliminating source-country withholding taxes on intercompany dividends that are broader than had been included in U.S. tax treaties. The inclusion of this provision in the proposed treaty, which reflects an ownership threshold for the application of the elimination of source-country withholding taxes on intercompany dividends that is lower than in other U.S. treaties but is significantly higher than in other Japanese treaties, is appropriate in the context of this treaty relationship and the dramatic improvements reflected in the treaty overall.

As with the consideration of whether to include in any treaty a provision eliminating source-country withholding taxes on intercompany dividends, the details and parameters of this provision should be determined on a case-by-case basis, taking into account the tax systems of both countries and the balance of benefits from the allocation of taxing rights with respect to investment income and from the treaty overall. While an ownership threshold that looks to economic control is appropriate in the context of the proposed treaty with Japan, a different ownership threshold may be appropriate in the context of other agreements.

Question 3. There is a provision in the U.S.-Mexico tax protocol which allows Mexico to reopen negotiations if the U.S. concludes a tax treaty with another country under conditions "more beneficial" than those in the U.S.-Mexico treaty.

Will Mexico press for this 50 percent ownership ratio between a parent company and its subsidiary concerning the elimination of the withholding tax for cross-border dividends?

Did Treasury plan for the consequences of this measure?

Answer. The protocol with Mexico approved by the Senate last year provides for the elimination of source-country withholding taxes on certain intercompany dividends. The protocol also includes a provision regarding consultations between the two treaty countries with respect to withholding taxes on dividends. In this regard, the protocol provides:

> If the United States agrees in a convention with another country to a provision similar to Article 10(3) of the Convention taxes on intercompany dividends], but with more beneficial conditions than those contained in Article 10(3), the Contracting States shall, at Mexico's request, consult each other with a view to concluding an additional protocol to incorporate similar provisions into Article 10(3) to restore the balance of the benefits provided under the Convention.

Provisions regarding consultations with respect to a particular issue, such as the provision in the protocol with Mexico, are not uncommon in tax treaties where there is an issue that is of particular importance to one of the treaty countries. In other cases, tax treaties include provisions to the effect that the two countries will consult

within a specified time frame to determine whether the treaty continues to further its intended purposes. Such a provision is included in the recent tax treaty with the United Kingdom. Whether or not a treaty specifically provides for such consultations, it is a matter of courtesy for countries to be open to this sort of consultation with existing treaty partners when developments of interest occur with respect to a country's domestic law or a country's other tax treaties.

Our tax treaty partners study carefully any new agreements that the United States enters into, just as we study the new agreements that our treaty partners enter into. We anticipate that various aspects of the proposed treaty with Japan will be of interest to other countries. For example, we hope that the provisions regarding the elimination of source-country withholding taxes on royalties and certain interest will be of particular interest to those of our current and potential treaty partners who have followed Japan's historical lead in retaining by treaty source-country withholding taxes on these categories of income. Whether it would be appropriate to include any particular provision from the proposed treaty with Japan in a treaty or protocol with any other country would depend on the overall agreement and the benefits that the United States could be expected to reap from any such agreement. This aspect of the practice regarding consultations is reflected in the provision in the protocol with Mexico, which refers to "restor[ing] the balance of the benefits of the Convention."

It is important to note that the ownership threshold is only one aspect of the conditions for qualification for the elimination of the source-country withholding tax on intercompany dividends. As with other treaty provisions, these provisions regarding intercompany dividends differ in their technical details because they are tailored to the particular circumstances of each country. Some aspects of the conditions for elimination of withholding taxes on intercompany dividends in the proposed treaty with Japan could be considered "more beneficial" than those in the treaty with Mexico. Other aspects of the conditions in the proposed treaty with Japan are more restrictive than those in the treaty with Mexico. Whether Mexico will choose to request consultations will depend on its evaluation of the implications of these differences. Should a request be initiated, any consultations would then require a determination of whether all the circumstances result in an imbalance in the treaty relationship between the United States and Mexico that should be adjusted through a new agreement between the countries.

Any proposed changes with respect to the tax treaty with Mexico in the future, just like any proposed changes in any tax treaties, would be effected through a protocol or a new treaty which would be subject to the advice and consent of the Senate.

Question 4. What would be the revenue impact of the proposed U.S.-Japan tax treaty?

Answer. Tax treaties serve important economic purposes by reducing tax barriers to cross-border investment and by improving tax compliance with respect to such international investment flows. A tax treaty is an overall package of reciprocal provisions through which both countries and both countries' business communities will benefit. In evaluating the economic implications of a new or revised treaty relationship, one factor that can be considered based on historical investment flows is the expected static effect on tax revenues of the treaty provisions relating to withholding taxes. Looking beyond the short-term effects of these treaty provisions, tax treaties provide long term economic benefits to both countries that ultimately result in enhanced income flows and associated tax receipts.

Included in the proposed treaty with Japan are important provisions providing reciprocal reductions in source-country withholding taxes on royalties, interest, and dividends. These reciprocal withholding tax reductions have offsetting effects on U.S. tax revenues. Reductions in U.S. withholding taxes imposed on foreign persons result in a direct reduction in U.S. tax revenue. However, reductions in foreign withholding taxes imposed on U.S. persons have a positive effect on U.S. tax revenue due to the corresponding reduction in the foreign tax credits that otherwise would offset U.S. tax liability. In the case of the United States and Japan, the flows of investment income subject to withholding taxes are generally balanced between the two countries. Therefore we agree with the staff of the Joint Committee on Taxation that the proposed treaty will result in an approximately balanced short-term static reduction in U.S. and Japanese withholding tax revenues. The positive effect on U.S. tax revenue due to the corresponding reduction in foreign tax credits will essentially offset the reductions in U.S. withholding tax revenue in the short term.

In assessing the impact of the tax treaty, however, it is important to recognize that the long-term economic benefits from the proposed treaty outweigh any net short-term static effects on tax revenues. By creating greater certainty and pro-

viding a more stable environment for foreign investment, cross border investment flows will increase in both directions and improve economic efficiency. In the future, U.S. businesses should benefit from the increased openness of the Japanese economy. With greater U.S. investment in Japan will come greater flows of dividends, interest and royalties from Japan to the United States, increasing the importance of the reductions in source-country withholding taxes that are provided for in the treaty. Reductions in U.S. withholding taxes on Japanese investors in the United States encourage greater inbound investment, resulting in an enhanced U.S. tax base. In addition, the administrative provisions of the tax treaty will further enhance cooperation between the United States and Japan, enhancing U.S. tax administration and enforcement and resulting in further long-term revenue gains.

Question 5. The proposed U.S.-Japan tax treaty contains a unique exception to the traditional residence-based taxing rule applicable to capital gains. Under this exception, if a treaty country provides substantial financial assistance to a financial institution resident in that country, pursuant to its bank insolvency laws, and a resident of the other treaty country acquires shares in the financial institution from the first treaty country, the first treaty country may tax gains derived from the later disposition of such shares by such acquirer. This exception is not in the U.S. tax model. Why did Treasury agree to this exception?

Answer. Under Japanese domestic law, nonresidents are subject to Japanese tax on certain gains from the sale of stock in Japanese companies. Japan consistently seeks to preserve its rights to tax such gains in its tax treaties. Each of Japan's recent tax treaties, other than the proposed treaty with the United States, contains a broad provision allowing the source country to tax residents of the other country on gains from the sale of stock.

The U.S. preferred approach in tax treaties is to provide for exclusive residence-country taxation of gains from the sale of stock generally, subject to special provisions preserving source-country tax tailored to reflect U.S. rules regarding real property investments. Thus, Treasury seeks to include in tax treaties provisions for exclusive residence-country taxation of gains from the sale of stock with narrow exceptions. Treasury was not willing to consider a provision similar to the provisions in all recent Japanese tax treaties that would allow more generally for the source-country taxation of gains from the sale of stock.

In this context, the Japanese expressed particular concern about preserving Japan's taxation rights in a relatively narrow set of circumstances involving the infusion of capital by the Japanese government into distressed financial institutions. The proposed treaty includes a provision that is tailored to accommodate this Japanese position under very narrow conditions. The provision applies only in circumstances where (1) there is a provision of substantial financial assistance to a financial institution by the government pursuant to its bank insolvency restructuring laws; (2) a resident of the other country acquires stock in the financial institution from that government; and (3) the resident sells stock in the financial institution within five years from the first date on which the financial assistance was provided. If all of these conditions are met, the proposed treaty provides for source-country taxation of any gains on the sale of the stock in the financial institution.

The provision in the proposed treaty is further limited by a very broad grandfather rule. The provision does not apply to gains from the sale of stock held by an investor that made an investment in such a financial institution prior to the entry into force of the new treaty, including gains from the sale of any additional stock in the financial institution that the investor acquires subsequently. Thus, the special rule providing for source-country tax does not apply in any case where an investor has an investment that pre-dates the entry into force of the proposed treaty.

The provision included in the proposed treaty responds to a particular Japanese concern with a very narrowly crafted rule coupled with broad protection for current and future investments of any existing investors. Given the overall balance of the treaty, the inclusion of this narrow provision is a reasonable accommodation to the Japanese policies and concerns in this context.

Question 6. Unlike the U.S. tax model, the proposed U.S.-Sri Lanka tax treaty does not contain a provision permitting disclosure of information to persons or authorities engaged in oversight (like the GAO and certain Congressional committees). Why was this provision not included in the treaty? Does Treasury support inclusion of an understanding permitting disclosure of such information in the resolution of ratification?

Answer. The provisions in the proposed treaty with Sri Lanka regarding exchange of information are consistent with the U.S. model provision in all material respects. The matter of access to information in connection with oversight by the GAO and

certain Congressional committees was discussed during the course of the negotiations, and it was agreed with Sri Lanka that the language included in the provision allowed the necessary disclosures. Therefore, a specific reference to "oversight" was not considered necessary. Nevertheless, an understanding clarifying this issue might be helpful in order to eliminate any doubt.

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