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CONTACT: Sean Keveleghan
(202) 622-6865

Testimony of Patricia A. Brown, Deputy International Tax Counsel (Treaty Affairs), United States Department of the Treasury Before the Senate Committee on Foreign Relations on Pending Income Tax Agreements

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 four tax agreements that are pending before this Committee. We appreciate the Committee's interest in these agreements and in the U.S. tax treaty network, as demonstrated by the scheduling of this hearing.

As you expressed so well, Mr. Chairman, tax treaties are "part of the basic infrastructure of the global marketplace". 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. Individuals, too, benefit from the rules regarding allocation of investment income, but also from the rules regarding income from employment, the tax treatment of cross-border pension contributions and distributions, and, of course, the estate tax rules.

Just like our physical infrastructure, our tax treaty network requires constant attention. Countries introduce new preferential taxing regimes, or tighter anti-abuse rules; they may introduce bank secrecy or abolish it; or they may enter into an agreement with another country that is more advantageous than the agreement they have with the United States. Any of these situations may create an opportunity or a risk that needs to be addressed by a new or revised agreement. We must be creative and flexible in how we approach issues to find solutions to particular problems that are consistent with our overall goals. We are also becoming more efficient, concluding short protocols in order to update an agreement without calling into question every one of its provisions. Of course, this Committee's willingness to consider these agreements quickly has been a tremendous help in this regard. It can change the entire tone (and pace) of a treaty negotiation when the other side discovers that an advantageous change can be approved and implemented within the space of a year.

Three of the four agreements that are before you now are updates to relatively recent agreements. The fourth, the full treaty with Bangladesh, is an updated version of a 1980 treaty that never entered into force because of Senate concerns about several provisions. The Administration believes that these agreements with Bangladesh, France and Sweden will serve to further the goals of our tax treaty network. We urge the Committee and the Senate to take prompt and favorable action on all of these 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.

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 potential "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 that bears the burden of withholding tax 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 suffering "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.

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.

In addition to these core provisions, tax treaties 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 Social Security benefits and alimony and child support payments 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 matters may not involve substantial tax revenue from the perspective of the two governments, rules providing clear and appropriate treatment are very important to the individual taxpayers who are affected.

Tax treaties also 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 relevant 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. Indeed, the need for appropriate information exchange provisions is one of the treaty matters that we consider non-negotiable.

Tax Treaty Negotiating Priorities and Process

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 United States has a network of 57 bilateral income tax treaties covering 65 countries. This network includes all 29 of our fellow members of the OECD. It also covers the vast majority of foreign trade and investment of U.S. businesses. Because the coverage of our treaty network is already quite comprehensive, it frequently will make more sense, as an economic matter, for the United States to negotiate an update to an existing agreement, rather than to negotiate a full treaty with a new treaty partner. Such a full agreement will require the potential treaty partner to grapple with many of the complexities of U.S. domestic and international tax rules and U.S. tax treaty policy, and how it interacts with its own domestic law and policies. Thus, 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 most particularly the need to mesh the particular tax systems of the two treaty partners, make the negotiation process exacting and time-consuming.

A country's tax policy 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, earnings of the funds, and distributions from the funds. A treaty negotiation must take into account all of these and many other aspects of the particular treaty partner's tax system in order to arrive at an agreement that accomplishes the United States' tax treaty objectives.

A country's fundamental tax policy choices are reflected not only in its tax legislation but also in its tax treaty positions. The choices in this regard can and do differ significantly from country to country, with substantial variation even across countries that seem to have quite similar economic profiles. A treaty negotiation also must reconcile differences between the particular treaty partner's preferred treaty positions and those of the United States.

Obtaining the agreement of our treaty partners on provisions of importance to the United States sometimes requires other concessions on our part. Similarly, the other country sometimes must make concessions to obtain our agreement on matters that are critical to it. 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 some situations, the right result may be no tax treaty at all or may be a substantially curtailed form of tax agreement. With some countries a tax treaty may not be 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, with a country that does not impose significant income taxes, where there is little possibility of the double taxation of income in the cross-border context that tax treaties are designed to address, an agreement that is focused on the exchange of tax information may be most valuable. Alternatively, a bifurcated approach may be appropriate in situations where a country has a special preferential tax regime for certain parts of the economy that is different from the tax 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 full 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.

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 tax treaty may not be appropriate because a potential treaty partner is unable to do so. In other cases, a tax treaty may be 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.

The U.S. commitment to including comprehensive limitation of benefits 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 are able to exploit one of our tax treaties to secure reductions in U.S. tax, the benefits would flow only in one direction as third-country residents would enjoy U.S. tax reductions for their U.S. investments but U.S. residents would not enjoy reciprocal tax reductions for their investments in that third country. Moreover, such third-country residents may be securing benefits that are not appropriate in the context of the interaction between their home country's tax systems and policies and those of the United States. This use of tax treaties is not consistent with the balance of the deal negotiated. Preventing this exploitation of our tax 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.

Update on the Treasury Department's Position on Inter-Company Dividends

In earlier testimony before this Committee, Treasury Department representatives have discussed the decision, first made in connection with the negotiation of the treaty with the United Kingdom in 2001, to eliminate the source-country withholding tax on certain inter-company dividends. The position of the Treasury Department has been, and continues to be, that this decision is made independently with respect to every treaty negotiation. The United States will agree to the provision only if the agreement includes limitation on benefits and information exchange provisions that meet the highest standards, and if the overall balance of the agreement is appropriate.

Since we first expressed our willingness to eliminate the source-country withholding tax on inter-company dividends, a number of treaty relationships that had been at best stagnant and at worst problematic have changed for the better. Suddenly, there was some leverage to achieve goals that had seemed out of reach for one reason or another. Thus, although the new policy has been in place for only about five years, it has enabled us to achieve the following goals in one or more treaties:

- Strengthening our provisions to prevent treaty shopping, including the introduction of rules that prevent the use of tax treaties after a corporate inversion transaction;
- Significantly improving information exchange provisions, allowing access to information even when the treaty partner does not need the information for its own tax purposes;
- Reducing withholding taxes on interest and royalties to levels lower than those to which those treaty partners had ever previously agreed;
- Eliminating withholding taxes on dividends paid to pension funds, a tax that otherwise would inevitably lead to double taxation; and
- Protecting U.S. companies against the retaliatory re-imposition of withholding taxes on inter-company dividends.

The reductions we have achieved in our own treaties also are influencing the negotiation of agreements between other countries. U.S. companies benefit from those agreements as well, as many of them have subsidiaries that may benefit if similar reductions in rates are adopted under a new U.K.-Japan treaty, for example.

We believe that these significant achievements demonstrate that the current policy is having very positive effects and will continue to do so in the foreseeable future.

Discussion of Proposed New Treaties and Protocols

I now would like to discuss the four 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.

Sweden

The proposed Protocol amends the income tax treaty between the United States and Sweden that was signed in 1994. The most significant provisions in the Protocol relate to the treatment of dividends and limitation on benefits. The Protocol also rectifies a mistake that was made in the 1994 treaty that caused a great deal of hardship for a number of former employees of the U.S. government. It also makes a number of necessary updates to the treaty.

Like a number of recent agreements, the Protocol will eliminate the source-country withholding tax on most inter-company dividends and on dividends paid to pension funds. The provision dealing with inter-company dividends was very important to Sweden, because it had unilaterally eliminated its withholding tax on inter-company dividends. The legislative history to that domestic law change makes it clear that the main beneficiaries of that change were expected to be U.S. companies. In fact, it refers specifically to assurances given to the Swedish negotiators that the United States would not agree to eliminate the withholding tax on inter-company dividends in any bilateral agreement with any country. Now that U.S. policy has changed, failure to provide a reciprocal benefit for Swedish companies would have jeopardized the exemption from Swedish withholding tax that currently benefits U.S. companies. We believe that securing that protection, as well as eliminating the withholding tax on dividends paid to pension funds, is a sufficient quid pro quo.

Nevertheless, we also took this opportunity to add anti-inversion provisions to the limitation on benefits provisions of the treaty. The new provision represents a somewhat simplified version of a similar provision introduced in the recent protocol with the Netherlands. Although we have no reason to believe that Sweden would be an attractive destination for an inverted U.S. corporation, including the provision in a mainstream agreement such as this helps to establish a precedent that will be extremely useful in other treaty negotiations.

The Protocol also resolves a long-standing problem regarding the taxation of local employees of the Embassy in Stockholm and consulate in Gothenburg. The Protocol provides a grandfather rule to eliminate the unintended consequences resulting from a change made by the 1994 U.S.-Sweden income tax treaty regarding the taxation of local employees (or former employees) of the Embassy in Stockholm and consulate in Gothenburg. To rectify this problem, the Protocol provides that Sweden may not tax a pension under the U.S. Civil Service Retirement Pension Plan paid by the United States to employees of the U.S. embassy in Stockholm or the U.S. consulate general in Gothenburg if the individual was hired prior to 1978.

Other provisions in the Protocol reflect changes in U.S. domestic law or are intended to bring it into closer conformity with current U.S. treaty practice. For example, the current treaty preserves the U.S. right to tax former citizens whose loss of citizenship had, as one of its principal purposes, the avoidance of tax. The proposed Protocol updates this provision to reflect legislative changes since 1994. In order to reflect 1996 changes to the Internal Revenue Code, the Protocol provides that a former citizen or long-term resident of the United States may, for the period of ten years following the loss of such status, be taxed in accordance with the laws of the United States.

United States and Sweden will notify each other through the diplomatic channel, accompanied by an instrument of ratification, when their respective requirements for entry into force have been completed. The proposed Protocol will enter into force on the thirtieth day after the later of the notifications. It will have effect, with respect to taxes withheld at source, on or after the first day of the second month next following the date upon which the Protocol enters into force. With respect to other taxes, it will have effect for taxable years beginning on or after the first day of January next following the date upon which the Protocol enters into force.

<u>French Income Tax Protocol</u>

The proposed income tax protocol amends the 1994 income tax treaty between the United States and France, which entered into force in 1995.

The primary impetus for the negotiation of the income tax Protocol was to clarify the treatment of investments made in France by U.S. investors through partnerships located in the United States, France, or third countries. Because France taxes French partnerships on their worldwide income, and does not treat them as fiscally transparent, the Protocol confirms that France maintains taxing rights with respect to French partnerships. However, the Protocol provides that French treaty benefits will apply to U.S. residents who invest through U.S. partnerships or partnerships located in certain third countries. These partnership provisions will eliminate uncertainty and provide significant benefits to U.S. investors.

The income tax Protocol also reforms the treatment of certain French investment vehicles, which would have been entitled to U.S. treaty benefits under the 1994 treaty. Under the revised provision, a "fonds commun de placement" will not itself qualify for U.S. treaty benefits, but holders of interests in such an investment vehicle may qualify for treaty benefits if they are residents of France or of a third country that has an appropriate tax treaty with the United States.

The income tax Protocol modifies the provisions of the treaty dealing with pensions and pension contributions in order to achieve parity given the two countries' fundamentally different pension systems. The French pension system relies almost entirely on the state social security system with much more limited use of private pension arrangements such as employer plans and individual plans. The provisions in the 1994 treaty that treated private pension payments and social security payments differently are replaced in the proposed Protocol with provisions that treat the two systems the same. Under the proposed Protocol, the country of source is assigned taxing rights with respect to both state social security payments and private pension payments. The proposed Protocol also includes a provision that allows U.S. persons to deduct voluntary contributions to the French social security system to the same extent that contributions to a U.S. plan would be deductible, which is comparable to the provision in the 1994 treaty that allows French residents deductions for contributions to U.S. private pension plans.

The proposed Protocol makes other changes to the1994 treaty to reflect more closely current U.S. treaty policy. The proposed Protocol updates the treatment of dividends paid by U.S. REITs to reflect a change in approach adopted in 1997, which is intended to prevent the use of structures designed to avoid U.S. withholding taxes on outbound dividends while providing appropriate benefits to portfolio investors in REITs. The proposed Protocol also extends the provision in the 1994 treaty preserving U.S. taxing rights with respect to certain former citizens to cover certain former long-term residents in order to reflect 1996 changes to the Internal Revenue Code.

Each state will notify the other when it has completed the necessary steps to bring the proposed Protocol into force. The Protocol will enter into force upon the receipt of the later of those two notices. In general, it will have effect, with respect to taxes withheld at source, for amounts paid or credited on or after the first day of the second month following the date on which the Protocol enters into force and, with respect to other taxes, for taxable periods beginning on or after the first day of January following entry into force. However, because the rules benefiting U.S. residents investing through partnerships are intended to ensure that the treaty provides results that are consistent with the intent of the negotiators of the 1995 treaty, those changes will be applicable as of the effective dates of the 1994 treaty.

French Estate Tax Protocol

The proposed estate tax Protocol amends the estate and gift tax treaty between the United States and France, which was signed in 1978 and entered into force in 1980.

In 1988, U.S. estate tax law was changed to tax currently transfers of property to non-citizen surviving spouses. France, along with several other countries with which the United States has estate tax treaties, objected to this change.

Although the U.S. rejected claims by estate tax treaty partners that the 1988 change violated treaty nondiscrimination clauses, we indicated our willingness to amend our estate tax treaties with certain treaty partners to provide relief to surviving non-citizen spouses in appropriate cases. Accordingly, the proposed Protocol eases the impact of the 1988 provisions upon certain estates of limited value. Pursuant to the

Protocol, transfers of non-community property from a French domiciliary to a spouse who is not a United States citizen that may be taxed by the United States solely on the basis of situs under the treaty can be included in the tax base only to the extent that the value of the property, after applicable deductions, exceeds 50 percent of the value of all property that may be taxed by the United States.

In addition to the allowance of the marital exclusion, the Protocol also provides for a limited elective estate tax marital deduction which, if elected, waives the right to any available marital deduction that would be allowed under United States domestic law. The election is available only where the spouses satisfy certain domiciliary and citizenship requirements and only to “qualifying property” (generally, property that passes to the surviving spouse and that would have qualified for the marital deduction if the surviving spouse had been a United States citizen). The amount of the deduction is equal to the lesser of the value of the qualifying property or the “applicable exclusion amount” (generally, the amount which the unified credit shelters from estate tax) for the year of the decedent’s death.

The United States, in a 1995 protocol to the U.S.-Canada income tax treaty and a 1998 protocol to the U.S.-Germany estate tax treaty, provided similar relief to certain estates of limited value involving Canadians and Germans. The United States’ willingness to enter into the proposed Protocol was a significant factor in France’s ratification of the current U.S.-France income tax treaty, which was signed in 1994.

The proposed Protocol also provides a pro rata unified credit to the estate of a French domiciliary for purposes of computing the U.S. estate tax. Under this provision, a French domiciliary is allowed a credit against U.S. estate tax ranging from the amount ordinarily allowed to the estate of a nonresident under the Code ($13,000) to the amount of credit allowed to the estate of a U.S. citizen under the Code ($555,800 in 2004 and 2005), based on the extent to which the assets of the estate are situated in the United States (with either amount reduced to the extent of any credit previously allowed with respect to lifetime gifts). Congress anticipated the negotiation of such pro rata unified credits in Internal Revenue Code section 2102(c)(3)(A), and a similar credit was included in the 1995 U.S.-Canada income tax protocol and the 1998 German estate tax treaty protocol.

The proposed Protocol also modernizes the provisions dealing with the elimination of double taxation. In determining the French tax, if the transferor was a French domiciliary at the time of the transfer, France may tax any property which may also be taxed by the United States, but must allow a deduction from that tax in an amount equal to the United States tax paid upon such transfer.

If the transferor is a domiciliary or citizen of the United States and a transfer of property is subject to situs taxation by France, the United States must allow a credit equal to the amount of tax imposed by France with respect to such property. If the transferor is a United States citizen (or former citizen or long-term resident who lost such status with a principal purpose of tax avoidance) but a French domiciliary, the United States must allow a credit for the amount of tax imposed by France (after allowance for the deduction from French tax referred to in the first paragraph) with respect to such property. All of the credits allowed under the Protocol are limited to the tax imposed (and actually paid) on the property for which the credit is claimed.

The proposed estate tax Protocol also makes other changes to the Convention to reflect more closely current U.S. treaty policy. For example, the proposed Protocol extends the United States’ ability to tax former citizens and long-term residents to conform with 1996 legislative changes to the Internal Revenue Code. The proposed Protocol also defines the term "real property" in a manner consistent with the definition provided in Treas. Reg. § 1.897-1(b) and our income tax treaties. The proposed Protocol adds a rule that allows source state taxation of stock in real property holding companies.

Each state will notify the other when it has completed the necessary steps to bring the proposed estate tax Protocol into force. The Protocol will enter into force upon the receipt of the later of those two notices. Although the proposed Protocol generally will be effective with respect to gifts made and deaths occurring after the exchange of instruments of ratification, the relief provided with respect to surviving non-citizen spouses and the pro rata unified credit will be effective with respect to gifts made and deaths occurring after November 10, 1988 (the effective date of the 1988 legislative changes). Claims for refund asserting the benefits of the proposed Protocol that otherwise would be barred by the statute of limitations must be made within one year of entry of the Protocol, however, and all claims for retroactive relief are subject to the rules regarding the United States' ability to tax former citizens and long-term residents.

The negotiators believed that retrospective relief was not inappropriate, given the fact that the 1988 legislative changes were the impetus for negotiation of the proposed Protocol and negotiations commenced soon after the enactment of those changes. The United States agreed to similar retrospective relief in the 1995 U.S.-Canada income tax treaty protocol and the 1998 U.S.-Germany estate tax treaty protocol.

Bangladesh

The United States does not currently have an income tax treaty with Bangladesh. The proposed income tax treaty with Bangladesh was signed in Dhaka September 26, 2004.

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 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. Direct investment dividends are subject to taxation at source at a 10-percent rate. The proposed treaty requires a 10-percent ownership threshold for application of the 10-percent tax rate.

The proposed treaty provides for a 10 percent rate of tax at source on most interest payments. However, interest received by any financial institution (including an insurance company) and interest earned on trade credits are subject to a 5 percent rate of tax at source. In addition, interest derived by the Governments of the Contracting States and instrumentalities of those Governments, as well as debt guaranteed by government agencies (e.g., the U.S. Export-Import Bank) is exempt from tax at source.

The proposed treaty provides that royalties are subject to a 10 percent tax at source. Consistent with the U.S. and OECD Model treaties, income from the rental of tangible personal property is not treated as a royalty, but as business profits, thus eliminating any withholding tax at source.

The standard U.S. anti-abuse rules are provided for certain classes of investment income. For example, dividends paid by non-taxable conduit entities, such as U.S. RICs and REITs, are subject to special rules to prevent the use of these entities to transform what is otherwise high-taxed income into lower-taxed income.

The proposed treaty follows the standard rules for taxation by the source country of the business profits of a resident of the other country. The source country's right to tax such profits is generally limited to cases in which the profits are attributable to a permanent establishment located in that country. The proposed treaty, however, defines a "permanent establishment" in a way that grants rights to tax business profits that are somewhat broader than those found in the U.S. and OECD Models. However, these rules are quite similar to rules found in our tax treaties with other developing countries.

In the case of shipping and aircraft, the proposed Convention, consistent with current U.S. treaty policy, provides for exclusive residence-country taxation of profits from the international operation of ships or aircraft. Like the U.S. Model, only the country of residence may tax profits from the rental or maintenance of containers used in international traffic.

The proposed treaty provides rules that are similar to the U.S. Model with respect to the taxation of income from the performance of personal services. However, like some other U.S. treaties with developing countries, the proposed treaty grants a taxing right to the host country with respect to some classes of personal services income that is broader in a few respects than in the OECD or U.S. Model.

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 Bangladesh will provide such relief through the foreign tax credit mechanism. The proposed Convention does not include a "tax sparing credit", since such credits are contrary to U.S. treaty policy. At Bangladesh's request, the exchange of notes provides that, if the United States alters its policy regarding the granting of tax sparing credits or provides for such credits in another treaty, negotiations will be reopened with a view to concluding a protocol that would offer similar benefits to Bangladesh.

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, Bangladesh 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.

The proposed Convention is subject to ratification. It will enter into force upon the exchange of instruments of ratification. It will have effect, with respect to taxes withheld at the source, for amounts paid or credited on or after the first day of the second month following entry into force. In other cases the Convention will have effect with respect to taxable periods beginning on or after the first day of January following the date on which the Convention enters into force.

Treaty Program Priorities

We continue to maintain a very active calendar of tax treaty negotiations. We currently are in ongoing negotiations with Canada, Chile, Germany, Hungary, Iceland, Korea and Norway. In addition, we are beginning negotiations with Bulgaria. We also have substantially completed work on agreements with Denmark and Finland and look forward to their conclusion.

A key continuing priority is updating the few remaining U.S. tax 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. We have also had informal exploratory discussions with several countries in Asia; we hope that those discussions will lead to productive negotiations later in 2006 or in 2007.

Work on the U.S. Model was well advanced last year but was delayed due to other commitments. However, we expect to forward a draft text to the staffs of the Senate Foreign Relations Committee and Joint Committee on Taxation within the next month. We look forward to working with them 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 time and attention to the review of these new agreements. We greatly 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.

Technical Explanation: Protocol with Sweden
Technical Explanation: Income Tax Protocol with France
Technical Explanation: Estate Tax Protocol with France

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