Joint Committee on Taxation
October 25, 1999
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TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS HEARING ON TAX TREATIES AND PROTOCOLS WITH EIGHT COUNTRIES

October 27, 1999

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

Overview

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

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

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

Baltic Countries (Estonia, Latvia, and Lithuania)

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

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

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

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

Under the proposed treaties, as under certain other U.S. tax treaties, the reduced rates of U.S. withholding tax applicable to dividends generally would not apply to dividends from U.S. Real Estate Investment Trusts ("REITs"). Thus, REIT dividends may be subject to U.S. withholding tax at the full statutory rate of 30 percent. In 1997, the Treasury Department modified its policy with respect to the exclusion of REIT dividends from the reduced withholding tax rates applicable to other dividends under the treaties. Under this policy, REIT dividends paid to a resident of a treaty country will be eligible for the reduced rate of withholding tax applicable to portfolio dividends (typically, 15 percent) in certain cases. The proposed treaties do not incorporate this new policy with respect to the treatment of REIT dividends (i.e., the 30-percent U.S. withholding tax for REIT dividends generally would not be reduced under the proposed treaties).

Denmark

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

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provisions of the U.S. model treaty and other recent treaties. The proposed treaty includes a "derivative benefits" provision under which treaty benefits generally would be available to Danish companies owned by residents of countries that are members of the European Union or the European Economic Area, or are parties to the North American Free Trade Agreement.

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

Germany

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

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

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

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

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

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

Italy

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

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

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

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

The proposed treaty includes an arbitration provision that is similar to the provision that was included in the 1989 U.S.-Germany treaty. However, like the provisions in several other recent U.S. treaties, such as the treaties with Ireland and Switzerland, the arbitration provision in the proposed treaty will take effect only upon a future exchange of diplomatic notes. It is intended that this arbitration approach be evaluated by taking into account experience arbitrating cases under the U.S.-Germany treaty.

The exchange of information article contained in the proposed treaty conforms in most respects to the corresponding articles of the U.S. and OECD model treaties. As is true under these model treaties, the proposed treaty requires the countries to exchange such information as is necessary for carrying out the provisions of the proposed treaty and the domestic tax laws of the countries. There is one significant respect in which the exchange of information article does not conform to the corresponding article of the U.S. model treaty. The proposed treaty omits the provision in the U.S. model treaty that requires information to be provided to the requesting country notwithstanding that such disclosure may be precluded under bank secrecy laws or similar legislation.

Slovenia

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

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

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Venezuela

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

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

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

In general, the new worldwide tax system is similar to the U.S. system. Under the new worldwide tax system, Venezuelan residents and domiciled entities would be taxable on

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

worldwide income while nonresidents and non-domiciled entities would be taxable only on certain income from Venezuelan sources. Taxpayers generally would be permitted to claim a credit against their Venezuelan tax liability for foreign taxes paid on their foreign source income.

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

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

Second, the proposed treaty would allow broader source-country taxation of business activities of residents of the other country than the U.S. model treaty. For example, the proposed treaty expands the definition of a permanent establishment to include cases in which an enterprise provides services through its employees in a country if the activities continue for more than 183 days.

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

Venezuela currently is in a period of constitutional and institutional change. In the past ten months, the Venezuelan people have elected a new President, Hugo Chavez. In April, a new National Constituent Assembly was formed to draft a new constitution. Among other things, conflicts have developed between the new National Constituent Assembly and established political institutions, such as the Venezuelan Congress. The Committee should consider the implications of ongoing political changes in Venezuela as they relate to the proposed treaty. For example, if there are competing claims as to who is authorized to exercise legislative, executive, or judicial functions, it may be difficult to identify the responsible competent authority with respect to the proposed treaty. These uncertainties may make it difficult to administer the treaty.

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

Conclusion

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