EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND FINLAND

Scheduled for a Hearing
Before the
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

On July 17, 2007

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of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the existing income tax treaty between the United States and Finland (the "proposed protocol"). The proposed protocol was signed on May 31, 2006. The Senate Committee on Foreign Relations (the "Committee") has scheduled a public hearing on the proposed protocol for July 17, 2007.[2]

Part I of the pamphlet provides a summary of the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of Finnish tax laws. Part IV provides a discussion of investment and trade flows between the United States and Finland. Part V contains an article-by-article explanation of the proposed protocol. Part VI contains a discussion of issues relating to the proposed protocol.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Finland* (JCX-48-07), July 13, 2007. References to "the Code" are to the U.S. Internal Revenue Code of 1986, as amended.

[2] For a copy of the proposed protocol, *see* Senate Treaty Doc. 109-18.

I. SUMMARY

The principal purposes of the existing treaty between the United States and Finland are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The existing treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

The proposed protocol modifies several provisions in the existing treaty (signed in 1989). The rules of the proposed protocol generally are similar to rules of recent U.S. income tax treaties, the 2006 U.S. model income tax treaty ("U.S. model"), and the 2005 model income tax treaty of the Organisation for Economic Co-operation and Development ("OECD model").[3] The existing treaty, as amended by the proposed protocol, however, includes certain substantive deviations from these treaties and models.

The proposed protocol expands the "saving clause" provision in Article 1 (Personal Scope) of the existing treaty to allow the United States to tax certain former citizens and long-term residents regardless of whether the termination of citizenship or residency had as one of its principal purposes the avoidance of tax. This provision generally allows the United States to apply special tax rules under section 877 of the Code as amended in 1996 and 2004. The proposed protocol makes coordinating changes to Article 23 (Elimination of Double Taxation) with respect to foreign tax credits allowed for former U.S. citizens and long-term residents.

The proposed protocol also adds to Article 1 (Personal Scope) of the existing treaty rules included in recent U.S. treaties and the U.S. model related to fiscally transparent entities.

The proposed protocol amends Article 4 (Residence) of the existing treaty to clarify which persons are residents of a treaty country and to more closely reflect the provisions in the U.S. model and recent U.S. income tax treaties.

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains both the generally applicable maximum rate of withholding at source of 15 percent and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. Like several other recent treaties and protocols, however, the proposed protocol provides a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. A zero rate also generally applies to dividends received by a pension fund. As in the current treaty, special rules apply to dividends received from U.S. regulated investment companies ("RICs") and real estate investment trusts ("REITs"), with

[3] The 2006 U.S. model replaced an earlier U.S. model income tax treaty that dated to 1996. This pamphlet generally compares the provisions of the proposed protocol with the provisions of the 2006 U.S. model because that model took effect less than six months after the signing of the proposed protocol.

certain modifications applicable to dividends from REITs. These modifications are similar to provisions included in other recent U.S. treaties and protocols.

The proposed protocol modifies Article 11 (Interest) and Article 12 (Royalties) of the existing treaty. It adds to Article 11 two new exceptions to the general prohibition on source-country taxation of interest income, one for contingent interest and the other for interest that is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit. It amends Article 12 by deleting a paragraph that permits source-country taxation of royalties that are beneficially owned by a resident of the other treaty country and that are received as consideration for the use of patents and trademarks or for information concerning industrial, commercial, or scientific experience.

The proposed protocol replaces Article 16 (Limitation on Benefits) of the existing treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. model and more recent U.S. income tax treaties. Like the U.S. model, the proposed protocol includes a rule that a treaty-country company may qualify for treaty benefits under a public trading test only if the company satisfies one of two tests – either public trading on a recognized stock exchange in a specified area or management and control in the country of residence – intended to ensure an adequate connection to the company's country of residence.

The proposed protocol replaces Article 26 (Exchange of Information) of the existing treaty with new exchange-of-information rules that are largely similar to the exchange-of-information rules included in the U.S. model.

The proposed protocol will enter into force upon the exchange of instruments of ratification. If the proposed protocol enters into force before December 31, 2007, the dividend withholding tax provisions will have effect for income derived on or after January 1, 2007.

II. OVERVIEW OF TAXATION IN FINLAND[4]

A. National Income Taxes

Overview

Finland imposes an income tax at the national and local levels upon net income from employment, investment, and business activities. The definition of income subject to tax within each enumerated category is, as in the United States, expansive and generally includes capital gains. The tax is computed on an annual basis, and the timing of income and deductions is generally determined by reference to commercial accounting rules. Under Finnish law, substance takes precedence over form, and artificial arrangements that have tax avoidance as a purpose may be ignored.

Individuals

Individuals resident in Finland are taxed on their worldwide income. The rate of income tax imposed upon an item of income depends on its characterization as earned income or capital income.

Earned income, including salaries, wages, pensions, in-kind benefits, and certain dividends from nonlisted corporations, is taxed at progressive national rates of nine to 32 percent (approximately the first €12,400 ($16,371)[5] of an individual's employment income being wholly exempt from tax). A rate of nine percent is levied on individuals whose earned income exceeds €12,400 ($16,371). As earned income rises above €20,400 ($26,934) and €33,400 ($44,097), the rate of tax rises to 19.5 and 24 percent respectively. For all earned income levels above €60,800 ($80,272), the rate of tax is 32 percent. In addition, a municipal tax is levied at a flat rate that varies from 16 to 21 percent of taxable income, depending upon the municipality. A church tax is also payable by members of certain churches, at rates ranging from one to 2.25 percent. In general, a taxpayer may deduct expenses incurred to produce income, subject to certain statutory limitations. A standard deduction of €620 ($819) is allowed; however, if the amount of actual work-related expenses exceeds this amount, the actual amount may be deducted. Travel expenses may be deducted to the extent they exceed €500 ($660) but fall below €7,000 ($9,242).

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[4] The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part Risto Rytöhonka, *Business Operations in Finland*, Tax Management Portfolio 960-2nd (2006). *See also* IBFD European Taxation Analysis, Finland, available at http://checkpoint.riag.com. The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition.

[5] The quoted tax rates and local currency amounts apply in 2007. U.S. dollar equivalents were calculated using the exchange rate for January 1, 2007 according to OANDA's FX Converter, available at http://www.oanda.com.

Capital income is any yield from capital investment, including capital gains, interest, rental income, yield from life insurance, dividends from listed companies, and certain dividends from nonlisted companies. Capital income is subject only to the national tax at a flat rate of 28 percent. A capital gain resulting from the sale of an apartment or house that the seller has used as a primary residence for at least two years is exempt from tax. Capital losses are deductible only from capital gains incurred in the year of the loss or in the three subsequent years.

Income derived from a business and a partner's share in a partnership's income is apportioned between capital income and earned income. Such income is deemed to be capital income to the extent it does not exceed 20 percent (or, at the taxpayer's election, 10 percent) of the taxpayer's net equity and is taxed at the flat rate of 28 percent. The remainder is taxed as earned income according to the progressive income tax scale.

Corporations

Companies resident in Finland are generally subject to a national tax on their worldwide income at a rate of 26 percent. The gross income of a resident corporation consists of all income, including capital gain, whether or not the income is distributed to shareholders. However, capital gains from the sale of shares that are part of a corporation's fixed assets are exempt from tax provided that the selling corporation has owned for one year or longer at least 10 percent of the share capital of the company the shares of which are sold. Similarly, dividends received by a Finnish corporation from a Finnish corporation generally are exempt from tax. In certain circumstances, including when the corporation receiving dividends owns less than 10 percent of the stock of the corporation paying dividends, dividend income is only partially tax-exempt.

Under the European Union Parent-Subsidiary Directive, withholding taxes are eliminated on dividend payments between European Union companies resident in different EU jurisdictions when the dividend recipient owns at least 15 percent of the stock of the dividend paying company.

Although no distinction generally is made between income from domestic and foreign sources, Finland's tax treaties provide a credit for any foreign taxes paid on income taxable in Finland. Where there is no applicable treaty, Finnish law provides a credit for foreign national taxes paid against Finnish corporate tax. Expenses incurred to produce income, including certain organizational expenses, are deductible, and depreciation and amortization of fixed assets is allowed.

B. International Aspects of Taxation in Finland

Individuals

Individuals resident in Finland generally are taxed on their worldwide income. Individuals continually present in Finland for a period of more than six months are generally considered residents for tax purposes. In addition, an individual is deemed to be a resident of Finland for three calendar years after the individual's year of departure, unless that individual can demonstrate that he or she no longer has essential ties with the country. Whether a taxpayer maintains essential ties is determined on an individual basis. Examples of such essential ties are having a spouse or dependent family member who continues to reside in Finland, carrying on a business that requires active management in Finland, and owning substantial real property.

Nonresidents are subject to a national tax of 35 percent on Finnish-source earned income (15 percent in the case of sportsmen and artists). However, a nonresident recipient of salary income who has worked in Finland for less than six months is entitled to a monthly deduction of €510 ($673) from taxable income. Nonresidents are further subject to a flat 28 percent tax on any capital gains derived from Finland, as well as a 28 percent tax on Finnish-source dividends, interest, royalties, and rental income.

Employment income received by Finnish residents for employment abroad generally is exempt from tax, provided that the employment is not on board a Finnish vessel, the employer is not the State of Finland or a Finnish municipality, and the country in which the resident is working is able to tax the income in question.

Corporations

Companies resident in Finland are generally subject to tax on their worldwide income. A nonresident company with a branch that is deemed to constitute a permanent establishment under Finnish law generally is taxed as a resident company on its branch income. Thus, business income is taxed at a rate of 26 percent. Nonresident companies without a permanent establishment in Finland (who are not otherwise subject to a tax treaty) are generally subject to tax of 28 percent only on their income from Finnish sources, including income from real property located in Finland, dividends from a Finnish corporation, and capital gains on the sale of real property located in Finland. However, dividends paid to a corporate shareholder resident in another EU member state owning at least 15 percent of the capital in the Finnish payer corporation are exempt from Finnish tax. A foreign corporation is deemed a controlled foreign corporation ("CFC") if Finnish residents either own 50 percent of the assets or are entitled to 50 percent of the yield on its assets. A Finnish resident owning at least 10 percent of the capital (or who is entitled to at least 10 percent of the yield of the assets) of a CFC is subject to tax on that individual's share of income accrued in the corporation before distribution. The CFC rules generally apply only in respect of companies that are subject to a rate of tax in their country of residence that is less than three-fifths the applicable Finnish tax rate. A corporation resident in a country with which Finland has a tax treaty, other than Barbados, Malaysia, Malta, Pakistan, Switzerland, or the United Arab Emirates, is not subject to the CFC rules.

Relief from double taxation

In the absence of a treaty, Finland generally provides double tax relief by way of a credit against Finnish tax. Finnish statutory law allows a credit only against foreign taxes paid at the national level. Most Finnish treaties provide for relief from double taxation with respect to local taxes as well.

C. Other Taxes

Inheritance, gift, and wealth taxes

Finland levies an inheritance tax on each heir's share of a decedent's estate. For inheritances ranging from €3,400 ($4,489) to €17,000 ($22,445), the rate is 10 percent. For amounts received above €17,000 ($22,445), the rate is 13 percent, and taxable inheritances above €50,000 ($66,014) are taxed at 16 percent. Gifts are taxed at the same rate as inheritances. For both, these rates may be doubled or tripled depending on the degree of kinship between the transferor and transferee. The Finnish net wealth tax was abolished effective January 1, 2006.

Social security

A social security tax, which finances pensions, health insurance, and other social insurance programs, is imposed upon the income of employees at a combined rate of 6.6 percent (7.8 percent for those above age 53). The social security tax is levied against employers as a percentage of gross wages and salaries subject to the withholding tax. The average total percentage of all contributions for private-sector employers in 2005 was 21.5 percent.

Indirect taxes

Finland imposes a value-added tax ("VAT") upon increases in value of goods and services at each stage of the Finnish production and distribution process. The generally applicable rate is 22 percent, with a reduced rate of 8 percent applied to certain commodities including books, medicine, and transport and accommodation services. The VAT is levied only on transactions that occur within Finland. Excise duties are levied on alcohol, tobacco, fuel, and certain other consumer goods. A national real property tax is imposed at rates that vary between 0.22 percent and one percent of the assessed value of the property, depending on the type of property.

III. THE UNITED STATES AND FINLAND: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for business persons in one country who might aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who might aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that will arise from different transactions, but may also increase or decrease that burden. Where there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment has the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed protocol it may be beneficial to examine the cross-border trade and investment between the United States and Finland. Whether measured by trade in goods or services or by direct and non-direct cross-border investment, the United States and Finland engage in significant cross-border activity. The income from cross-border trade and investment generally is subject to net-basis income tax in either the United States or Finland and in many cases also is subject to gross basis withholding tax in the source country.

B. Overview of International Transactions Between the United States and Finland

Cross-border trade

The current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. While detail regarding the balance of payments between the United States and Finland is not publicly available, one can document that the value of trade between the United States and Finland is large. In 2005, the United States exported $2.3 billion of goods and services to Finland and imported $4.3 billion in goods and services from Finland. This made Finland the United States' 44th largest merchandise and service export destination and the 47th largest source of imported merchandise and services.[6]

Numerous disparate activities constitute trade in services. Among the sources of receipts from exported services are payments for transportation of goods, travel by persons and passenger fares, payments for professional services such as management consulting, architecture, engineering, and legal services, financial services, insurance services, computer and information services, and film and television tape rentals. Also included in receipts for services are the returns from investments in intangible assets in the form of royalties and license fees. In 2005, U.S. parent businesses received approximately $115 million in royalty and license fees from their affiliates in Finland. In 2005, U.S. affiliates paid approximately $50 million in royalties and license fees to their Finnish parents.[7]

Cross-border investment

Income from foreign assets is categorized as income from "direct investments" and income from "non-direct investments." Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as "portfolio investments," and bank deposits and loans. Hence, the income from non-direct investments generally is interest, dividends, or gains.

Commensurate with the size of the Finnish economy in comparison to other European countries, the value of cross-border investment between the United States and Finland is smaller

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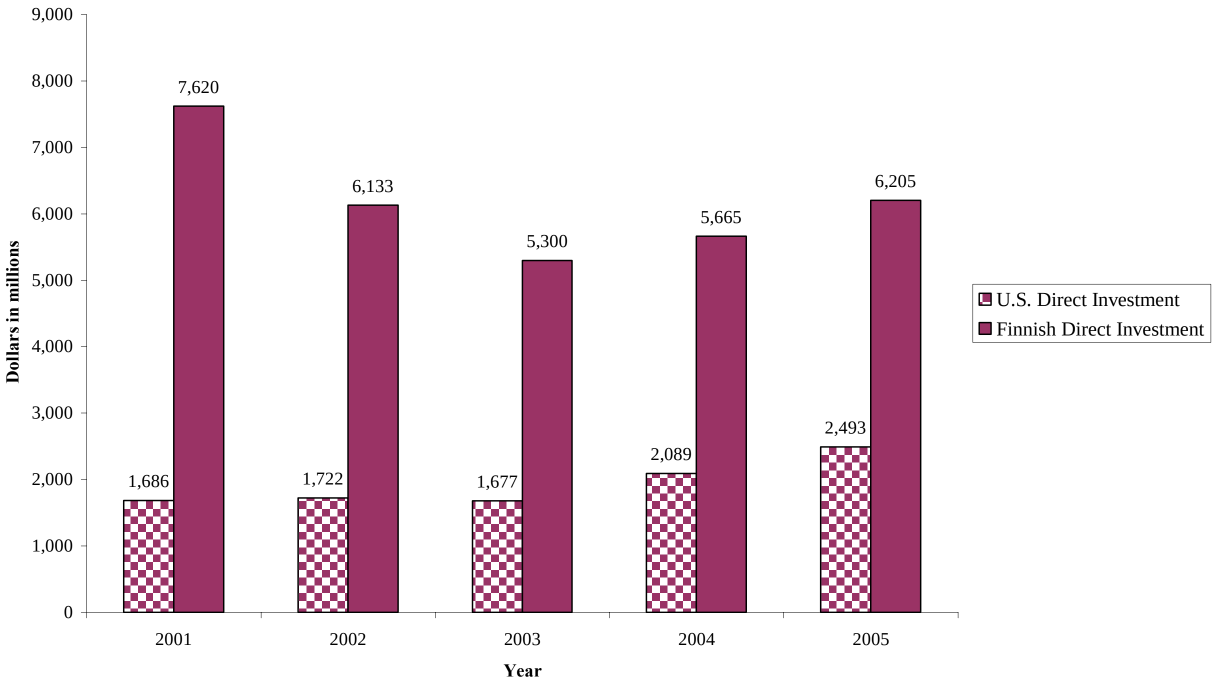
[6] Bureau of Economic Analysis, U.S. Department of Commerce, "U.S. International Trade in Goods and Services, Annual Revision for 2005," June 9, 2006.

[7] Bureau of Economic Analysis, U.S. Department of Commerce, "International Economic Accounts," www.bea.gov/international, May 2007.

than that of cross border investment between the United States and other European countries. In 2005, U.S. persons held direct investments in Finland valued at $2.5 billion on a historic cost basis and Finnish persons held direct investments in the United States valued at $6.2 billion. Figure 1, below, documents the value in U.S. direct investment in Finland and Finnish direct investment in the United States on an historical cost basis at year-end for 2001 through 2005.

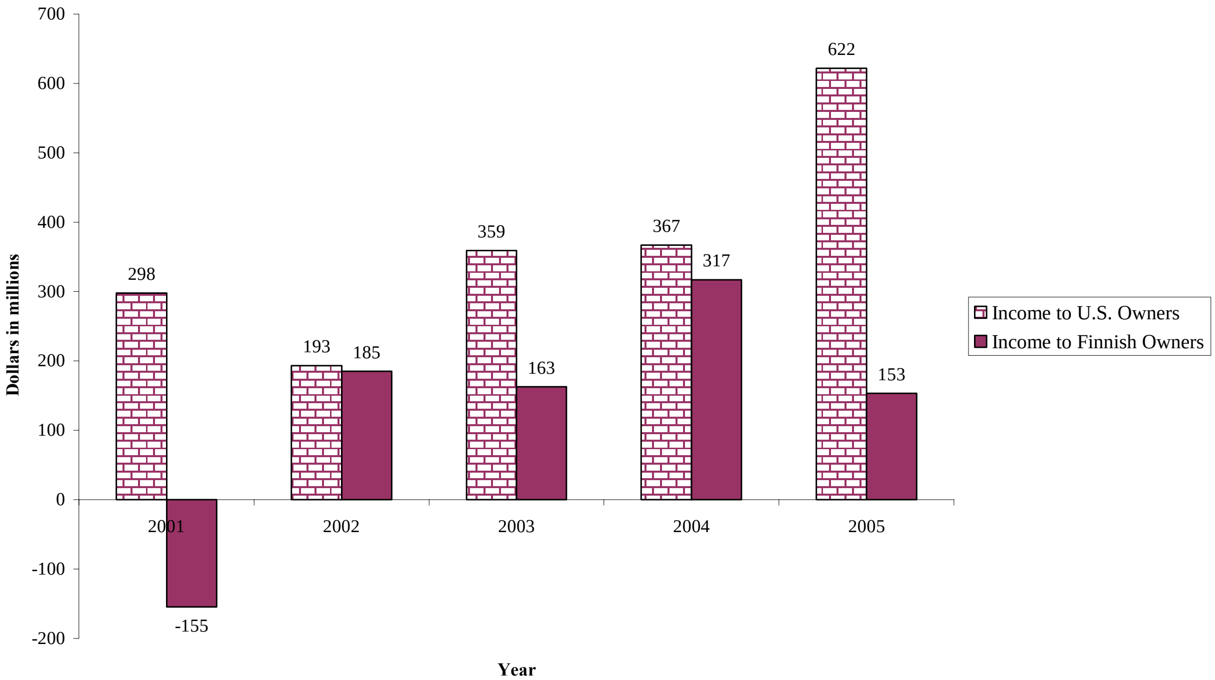
Figure 1.−Value of U.S. Direct Investments in Finland and Finnish Direct Investments in The United States on an Historical Cost Basis, Year-End 2001-2005
[millions of dollars]



Source: Bureau of Economic Analysis, U.S. Department of Commerce, May 2007.

U.S. direct investments in Finland produced approximately $620 million in income (net of withholding taxes) to U.S. persons in 2005. Finnish direct investments in the United States produced approximately $150 million in income (net of withholding taxes) to Finnish persons in 2005. Figure 2, below, details income from U.S. direct investments in Finland and Finnish direct investments in the United States (net of withholding taxes) for the period 2001-2005.

Figure 2.−Income From U.S. Direct Investments in Finland and Finnish Direct Investments in The United States (net of withholding taxes), Year End 2001-2005
[millions of dollars]



Source: Bureau of Economic Analysis, U.S. Department of Commerce, May 2007.

The data presented above do not report the amount of U.S. or Finnish portfolio investment holdings of stocks and bonds (including holdings of U.S. government securities). The Bureau of Economic Analysis generally only reports portfolio holdings by country for the several largest portfolio investment countries.

C. Income Taxes and Withholding Taxes on Cross-Border Income Flows

The data presented above report the amount of direct investment in Finland by U.S. persons and the amount of direct investment in the United States by Finnish persons. Data from tax returns reflect the magnitudes of cross-border investment and trade and income flows reported above. In 2003, U.S. corporations with Finnish parent companies had $0.5 billion of income subject to tax and paid $0.1 billion in U.S. Federal income taxes.[8] U.S. corporations, including U.S. parent companies of Finnish controlled foreign corporations, reported the receipt of $0.1 billion of dividends from Finnish corporations in 2002.[9] U.S. corporations recognized about $0.3 billion in taxable income originating in Finland, including the dividend amounts just cited. This income was subject to an average Finnish corporate income tax rate of approximately 11.2 percent (after allowing for apportionment and allocation of certain expenses incurred in the United States).

Data for withholding taxes from 2000 show that Finland and the United States collected approximately the same amounts of receipts, with each country withholding under $10 million annually, by withholding tax on respective payments to each other.[10] Data on withholding taxes may not be an accurate indicator of cross-border investment and income flows, because a taxpayer can often control the amount and timing of dividend payments to the home country and pays withholding tax only when these payments are made.

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[8] James R. Hobbs, "Foreign Controlled Domestic Corporations, 2003," *Internal Revenue Service, Statistics of Income Bulletin*, Summer 2006, pp. 67-112.

[9] Data Release, "Corporate Foreign Tax Credit, 2002," *Internal Revenue Service, Statistics of Income Bulletin*, Fall 2006, pp. 285-318.

[10] Data Release, "Foreign Recipients of U.S. Income, 2000," *Internal Revenue Service, Statistics of Income Bulletin*, Summer 2003, pp. 177-186.

D. Analyzing the Economic Effects of Protocols to Income Tax Treaties

Among other things, tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant economic effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources will result and economic growth in both countries will be enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation of benefits provision should reduce the potential for outright evasion of U.S. and Finnish income tax liabilities.

Generally, a treaty-based reduction in withholding rates will directly reduce U.S. tax collections in the near term on payments from the United States to foreign persons, but will increase U.S. tax collections on payments from foreign persons to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this initial dampening of collections on payments to Finland and related decrease in foreign tax credits will begin to reverse. The present protocol's reductions in dividend withholding rates will reduce U.S. withholding tax collections on dividend payments from the United States to Finland. Over the longer term, the withholding tax rate changes coupled with other changes in the protocol are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of a withholding change, or any other change in a treaty, would account for both tax and non-tax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

IV. EXPLANATION OF PROPOSED PROTOCOL

<u>Article I. General Scope</u>

<u>In general</u>

The proposed protocol replaces Article 1 of the present treaty with a new Article 1. The general scope article describes the persons who may claim the benefits of the proposed protocol. It also includes a "saving clause" provision similar to provisions found in most U.S. income tax treaties.

The proposed protocol generally applies to residents of the United States and to residents of Finland, with specific modifications. The determination of whether a person is a resident of the United States or Finland is made under the provisions of Article 4 of the treaty (Residence).

The proposed protocol provides that it does not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance accorded by internal law or by any other agreement between the United States and Finland. (However, unlike the U.S. model, the proposed protocol does not explicitly apply this rule in the case of multilateral agreements to which the United States and Finland are parties.) Thus, the proposed protocol will not apply to increase the tax burden of a resident of either the United States or Finland. According to the Treasury Department's Technical Explanation (hereinafter referred to as the "Technical Explanation"), the fact that the proposed protocol only applies to a taxpayer's benefit does not mean that a taxpayer may select inconsistently among treaty and internal law provisions in order to minimize its overall tax burden. In this regard, the Technical Explanation sets forth the following example. Assume a resident of Finland has three separate businesses in the United States. One business is profitable and constitutes a U.S. permanent establishment. The other two businesses generate effectively connected income as determined under the Internal Revenue Code (the "Code"), but do not constitute permanent establishments as determined under the proposed protocol; one business is profitable and the other business generates a net loss. Under the Code, all three businesses would be subject to U.S. income tax, in which case the losses from the unprofitable business could offset the taxable income from the other businesses. On the other hand, only the income of the business which gives rise to a permanent establishment is taxable by the United States under the proposed protocol. The Technical Explanation makes clear that the taxpayer may not invoke the proposed protocol to exclude the profits of the profitable business that does not constitute a permanent establishment and invoke U.S. internal law to claim the loss of the unprofitable business that does not constitute a permanent establishment to offset the taxable income of the permanent establishment.[11]

Like the U.S. model, the proposed protocol includes an exception in the case of two provisions of the General Agreement on Trade in Services ("GATS") to the rule that the proposed protocol does not restrict benefits under other agreements. This exception may not be strictly necessary, if the proposed protocol could be interpreted to apply by its terms only to

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[11] *See* Rev. Rul. 84-17, 1984-1 C.B. 308.

agreements between the United States and Finland and not to multilateral agreements to which the United States and Finland are parties, such as GATS.

The proposed protocol provides that the dispute resolution procedures under the mutual agreement article of the treaty (Article 25) take precedence over the corresponding provisions of paragraph 3 of Article XXII (Consultation) of GATS in interpreting or applying the treaty and in determining whether a taxation measure is within the scope of the treaty.

The proposed protocol also provides that the provisions of Article XVII (Denial of Benefits) of GATS do not apply to any taxation measure, unless the competent authorities agree that the measure is not within the scope of the nondiscrimination provisions (Article 24) of the treaty. The Technical Explanation points out that consequently, the consultation provision of GATS may not be used to bring a dispute before the World Trade Organization unless the competent authorities of the United States and Finland have determined that the relevant taxation measure is not within the nondiscrimination provision (Article 24) of the treaty. For purposes of this provision, the term "measure" means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action.

Saving clause

Like all U.S. income tax treaties and the U.S. model, the proposed protocol includes a "saving clause." Under this clause, with specific exceptions described below, the proposed protocol does not affect the taxation by either treaty country of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed protocol, the United States may continue to tax its citizens who are residents of Finland as if the treaty were not in force. For purposes of the proposed protocol (and, thus, for purposes of the saving clause), the term "residents," which is defined in Article 4 (Residence), includes corporations and other entities as well as individuals.

The proposed protocol contains a provision under which a former citizen or long-term resident of either treaty country may be taxed under that country's law for the period of ten years following the loss of citizenship or long-term resident status. Section 877 of the Code provides special rules for the imposition of U.S. income tax on former U.S. citizens and long-term residents for a period of ten years following the loss of citizenship or long-term resident status.

Under U.S. domestic law, an individual is considered a "long-term resident" of the United States if the individual (other than a citizen of the United States) was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. However, an individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for such year under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

Exceptions to the saving clause are provided for the following benefits conferred by either treaty country: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); provisions for taxation of social security and certain other public pension benefits only in the country of the recipient's residence, and taxation of child support payments only in the source country (Article 18, paragraphs 1(b) and 4); relief from double taxation through the provision of a foreign tax credit (Article 23); protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 24); and benefits under the mutual agreement procedures (Article 25).

In addition, the saving clause does not apply to certain benefits conferred by either treaty country upon individuals who neither are citizens nor have immigrant status. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of Finland who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (i.e., does not hold a "green card"). The benefits that are covered under this set of exceptions are taxation in only one of the treaty countries of remuneration and pensions for government service (Article 19), exemption from host country taxation for certain income received by students and trainees (Article 20), and the application of international law or special agreements to certain income received by members of diplomatic missions and consular posts (Article 27).

Fiscally transparent entities

The proposed protocol contains special rules for fiscally transparent entities that are identical to those in the U.S. model. Under these rules, as explained in the Technical Explanation, income derived through an entity that is fiscally transparent under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in that country as the income of a resident. For example, as explained in the Technical Explanation, if a Finnish company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest income for U.S. tax purposes.

The Technical Explanation states that these rules for income derived through fiscally transparent entities apply regardless of where the entity is organized (i.e., in the United States, Finland, or a third country). The Technical Explanation also states that these rules apply even if the entity is viewed differently under the tax laws of the other country. As an example, the Technical Explanation states that income from U.S. sources received by an entity organized under the laws of the United States, which is treated for Finnish tax purposes as a corporation and is owned by a Finnish shareholder who is a Finnish resident for Finnish tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the proposed protocol, the income is treated as derived by the U.S. entity.

The Technical Explanation generally defines fiscally transparent entities as entities in which income derived by such entities is taxed at the beneficiary, member, or participant level, under the law of either the United States or Finland. Entities are not considered fiscally transparent if the entity tax may be relieved under an integrated system. For example, in the United States, a partnership, common investment trust under Code section 584, or grantor trust, or a limited liability company ("LLC") that is treated for tax purposes as a partnership or disregarded entity, is considered a fiscally transparent entity.

The Technical Explanation also states that the treatment of fiscally transparent entities is not an exception to the saving clause. Therefore, such treatment does not preclude a treaty country from taxing an entity that is treated as a resident of that country under its tax laws. For example, if a U.S. LLC with Finnish members elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether Finland views the LLC as fiscally transparent.

Article II. Residence

The proposed protocol replaces the definition of the term "resident of a Contracting State" that appears in paragraph 1 of Article 4 (Residence) of the present treaty. Under paragraph 1, as modified by the proposed protocol, "resident of a Contracting State" means any person who, under the laws of that country, is subject to tax therein by reason of the person's domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. The proposed protocol also makes explicit the generally understood practice of including in the definition of "resident of a Contracting State" the two treaty countries and any political subdivisions, statutory bodies, or local authorities of those countries. However, the term "resident of a Contracting State" does not include persons who are subject to tax in a treaty country only on income from sources in that country or on profits attributable to a permanent establishment in that country or capital situated therein.

The proposed protocol includes an exception to the general rule described above that residence under internal tax law also determines residence under the treaty. The exception applies to a U.S. citizen or an alien lawfully admitted for permanent residence in the United States (i.e., a "green card" holder). The exception requires that such a person must also have a substantial presence, permanent home, or habitual abode in the United States to be considered a resident of the United States under the treaty and thereby qualify for treaty benefits.

The proposed protocol provides a special rule to treat as residents of a treaty country certain legal entities that generally are exempt from tax in that country. The provision applies to a tax-exempt entity if the entity is organized under the laws of that country and is established and maintained in that country (1) exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, or (2) to provide pensions or other similar retirement benefits pursuant to a plan.

The proposed protocol also replaces the tie-breaker rule that applies to persons other than individuals that appears in paragraph 3 of Article 4 of the present treaty. Under proposed paragraph 3, where a person other than an individual is a resident of both treaty countries as a result of applying the rules of proposed paragraph 1, the competent authorities of the treaty countries will by mutual agreement endeavor to determine the mode of application of the treaty to that person. If the competent authorities are unable to reach mutual agreement, then that person will not be considered a resident of either treaty country for the purposes of claiming any benefits provided by the treaty.

The proposed protocol does not change the other provisions of Article 4 of the present treaty.

Article III. Dividends

Overview

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains both the generally applicable maximum rate of withholding at source of 15 percent and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. Like several other recent treaties and protocols, however, the proposed protocol provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. A zero rate also generally applies to dividends received by a pension fund. As in the current treaty, special rules apply to dividends received from RICs and REITs, with new modifications applicable to dividends from REITs. These new REIT rules are similar to provisions included in other recent treaties and protocols.

Internal taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In that case, the foreign recipient is subject to U.S. tax on the dividends on a net basis at graduated rates in the same manner in which a U.S. person would be taxed.

Under U.S. law, the term “dividend” generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A REIT is a U.S. domestic corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. To qualify for the deduction for dividends paid, a REIT must distribute most of its income. As a result of the deduction for dividends paid, a REIT generally does not pay Federal income tax. Except for capital gain dividends, a distribution of REIT earnings is generally treated by the recipient as a dividend rather than as income of the same type as the underlying earnings.[12] This distribution is subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, the receipt of a distribution from a REIT is generally treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT.[13]

A REIT generally is organized to allow investment in primarily passive real estate investments. As such, income of a REIT often includes rentals from real estate holdings or interest from loans secured by real estate mortgages. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have the rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law. U.S.-source interest income of foreign persons is not subject to U.S. withholding tax in certain circumstances. A REIT dividend does not, however, pass through interest characterization of the REIT's underlying earnings.

U.S. internal law also generally treats a RIC as both a corporation and as an entity not subject to corporate tax to the extent it distributes substantially all of its income. The purpose of a RIC is to allow investors to hold diversified portfolios of securities. Dividends paid by a RIC generally are treated as dividends received by the payee, and the RIC generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, before January 1, 2008, net short-term capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has net capital gains. Nonresident aliens and foreign corporations generally are not subject to tax on capital gains. A distribution before January 1, 2008 to a nonresident alien or foreign corporation made by a RIC that is (or, if certain exceptions were disregarded, would be) a U.S. real property holding corporation, however, is treated as gain recognized by that nonresident alien or foreign corporation from the sale or exchange of a U.S. real property interest to the extent the gain is attributable to gain from sales or exchanges of U.S. real property interests.[14]

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[12] Because a REIT generally does not pay corporate level tax, certain U.S. benefits of dividend treatment are not available. A U.S. corporate shareholder is not generally entitled to a dividends-received deduction for REIT dividends. REIT dividends generally are not qualified dividends eligible for the 15-percent rate available for individual shareholders.

[13] There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Sec. 897(h)(1). These distributions are treated as dividends under U.S. internal law.

[14] The exception described in the immediately preceding footnote also applies for distributions by RICs.

Similarly, a RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")[15] generally may designate a dividend it pays before January 1, 2008 as derived from that interest income, to the extent of that income. Nonresident aliens and foreign corporations are not subject to tax on interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to the interest income.

Finland

Dividends paid by Finnish resident companies to nonresident individuals and nonresident companies generally are subject to a 28-percent gross-basis withholding tax. Dividends paid to a company that is a resident of another EU member state generally are exempt from Finnish tax if the company receiving the dividend owns at least 15 percent of the capital of the dividend-paying Finnish company.

Proposed protocol limitations on internal law

In general

Under the proposed protocol, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in that other country. The dividends also may be taxed by the country in which the payor company is resident, but the rate of tax is limited. Under the proposed protocol, source-country taxation of dividends (that is, taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower rate of five percent applies if the beneficial owner of the dividends is a company that owns directly at least 10 percent of the voting stock of the dividend-paying company.

The term "beneficial owner" is not defined in the current treaty or in the proposed protocol and therefore is defined under the internal law of the country imposing tax (that is, the source country). The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country. Further, companies holding shares through fiscally transparent entities, such as partnerships, are considered to hold their proportionate interests in those shares.

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[15] Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation that is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

The proposed protocol provides a zero rate of withholding tax for certain intercompany dividends in cases in which there is a sufficiently high (80-percent) level of ownership (often referred to as "direct dividends"). A zero rate also applies for dividends received by a pension fund, provided that the dividends are not derived from the carrying on of a business, directly or indirectly, by the fund or through an associated enterprise.

Zero rate for direct dividends

Under the proposed protocol, when a company that is a resident of one treaty country receives and beneficially owns dividends paid by a company that is a resident of the other treaty country, the source-country withholding tax rate is reduced to zero if the company receiving the dividends has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. Under the current treaty, these dividends may be taxed at a five-percent rate. The 80-percent ownership requirement under this provision may be satisfied by either direct or indirect ownership (through one or more residents of either treaty country).[16]

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than the requirements that normally apply under the proposed protocol. Specifically, in order to qualify for the zero rate, the dividend-receiving company must (1) satisfy the public trading test of the limitation-on-benefits article; (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) satisfy the derivative benefits test of the limitation-on-benefits article; or (4) receive a favorable determination from the competent authority with respect to the zero-rate provision.

The Technical Explanation states that these additional restrictions are intended to prevent companies from reorganizing to become eligible for the zero rate. As an example, the Technical Explanation describes a situation in which a company resident in a third country that does not have a zero-rate treaty provision with the United States might contribute the stock of a wholly owned U.S. subsidiary to a wholly owned Finnish subsidiary to secure the benefit of the zero rate on a dividend from the U.S. subsidiary. In that case, the Technical Explanation explains that treaty shopping could occur notwithstanding the Finnish company's satisfaction of the active trade or business test with respect to the dividend. For this reason, the proposed protocol does not allow the benefits of the zero rate to be claimed by a company that meets only the active trade or business test of the limitation-on-benefits article.

[16] The IRS has ruled privately, in connection with a situation arising under the zero-rate provision in the income tax treaty between the United States and the United Kingdom, that entities disregarded under the U.S. entity classification regulations also are disregarded for purposes of determining whether certain ownership requirements of the zero-rate provision are satisfied. Thus, stock owned through a disregarded entity (established under the laws of a third country) was treated as owned directly for purposes of applying the holding period requirement of that provision (which, according to that treaty's Technical Explanation, required direct ownership). *See* Priv. Ltr. Rul. 200522006 (June 3, 2005).

The Technical Explanation notes that, in the case of a Finnish company that receives dividends from a U.S. subsidiary, the derivative benefits test might be satisfied if the Finnish company is wholly owned, for example, by a publicly traded company resident in a European Union ("EU"), European Economic Area ("EEA"), or North American Free Trade Agreement ("NAFTA") country with which the United States has a zero-rate treaty provision.[17] In the case of a U.S. company receiving dividends from a Finnish subsidiary, the derivative benefits test could be satisfied if the U.S. company is wholly owned by a company resident in the EU, because the EU Parent-Subsidiary Directive would exempt from withholding tax a dividend paid directly by the Finnish company to an EU parent company.

The proposed protocol also modifies the application of the derivative benefits test under the zero-rate provision to ensure that certain joint ventures may qualify for the zero rate. Specifically, in determining whether a shareholder of a dividend-receiving company is an equivalent beneficiary, each such shareholder is treated as owning shares in the dividend-paying company with the same percentage voting power as the shares held by the dividend-receiving company for purposes of determining entitlement to the zero rate. Thus, as the Technical Explanation describes, a Finnish company owned 49 percent by another Finnish company and 51 percent by a company resident in another EU country that has an identical zero-rate provision with the United States may qualify under the derivative benefits test for the zero rate on a dividend received from a wholly-owned U.S. company even though neither shareholder of the dividend-receiving company would meet the 80-percent ownership test individually.

Dividends paid by U.S. RICs and REITs

The proposed protocol generally denies the five-percent and zero rates of withholding tax to dividends paid by U.S. RICs and REITs.

The 15-percent rate of withholding generally is allowed for dividends paid by a RIC. The 15-percent rate of withholding is allowed for dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual or a pension fund, in either case holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is diversified (that is, the value of no single interest in real property held by the REIT exceeds 10 percent of the total interests of the REIT in real property).

The Technical Explanation indicates that the restrictions on availability of the lower rates are intended to prevent the use of RICs and REITs to gain inappropriate U.S. tax benefits. For example, a company resident in Finland could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 15 percent on dividends on those shares. Absent the additional RIC restrictions, there is a concern that such a company instead might purchase 10 percent or more of the interests in a RIC, which could even be established as a mere

[17] These countries currently are Mexico, the Netherlands, Sweden, and the United Kingdom.

conduit, and thereby obtain a lower withholding tax rate by holding the portfolio through the RIC (transforming portfolio dividends generally taxable at 15 percent into direct investment dividends taxable under the treaty at zero or five percent).

Similarly, the Technical Explanation provides an example of a resident of Finland that directly holds real property and is required to pay U.S. tax either at a 30-percent rate on gross income or at graduated rates on the net income from the property. By placing the property in a REIT, the investor could transform real estate rental income into dividend income, taxable at the lower rates provided in the proposed protocol. The limitations on REIT dividend benefits are intended to protect against this result.

Definitions and special rules and limitations

The proposed protocol generally defines dividends as income from shares or other corporate participation rights that are not treated as debt, as well as other amounts that are subjected to the same tax treatment by the source country as income from shares (for example, constructive dividends). The term dividends also includes income from arrangements, including debt obligations, carrying the right to participate in profits to the extent characterized as such under the law of the source country.

The proposed protocol's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country, or performs in the source country independent personal services from a fixed base located in that country, and the dividends are attributable to that permanent establishment or fixed base. In these cases, the dividends are taxed as business profits (Article 7) or income from independent personal services (Article 14), as the case may be.

The proposed protocol prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country, unless the dividends are paid to a resident of the first country or are attributable to a permanent establishment or fixed base in that country.

The proposed protocol allows each treaty country to impose a branch profits tax on a company that has income attributable to a permanent establishment in that country, derives income from real property in that country that is taxed on a net basis under the treaty, or realizes gains taxable in that country under the treaty. In the case of the United States, the tax is limited to the "dividend equivalent amount," consistent with the branch profits tax under U.S. internal law (Code section 884). In the case of Finland, which currently does not impose a branch profits tax under its internal law, the tax is limited to the amounts of the aforementioned items equal to the amounts, as defined under Finnish law, that would be distributed as a dividend if the Finnish operations were carried on by a Finnish subsidiary. The rate of branch profits tax is generally limited to five percent, but a zero rate applies where limitation-on-benefits requirements parallel to those applicable to the zero-rate provision for dividends are satisfied.

The proposed protocol defines a pension fund as a person that is organized under the laws of Finland or the United States; is established and maintained in that country primarily to administer or provide pensions or other similar remuneration, including social security payments, or to earn income for the benefit of one or more such arrangements; and is either, in the case of

Finland, a pension institution, but, if such an institution is organized as a company, only a mutual pension insurance company, or, in the case of the United States, is exempt from tax in the United States with respect to its pension activities.

Relation to other Articles

The Technical Explanation notes that the saving clause of paragraph 4 of Article 1 of the treaty (Personal Scope) permits the United States to tax dividends received by its residents and citizens as if the proposed protocol had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 16 of the treaty (Limitation on Benefits).

Article IV. Interest

The proposed protocol adds a new paragraph containing two new exceptions to the general prohibition on source-country taxation of interest income. The first exception provides that so-called "contingent interest" paid by the resident of a (source) treaty country to a resident of the other (residence) country may be taxed by the source country, according to the laws of the source country, but at a rate not exceeding 15 percent. Such contingent interest is defined as any interest paid by a resident of the source country that is determined by reference to the receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor or a related person and paid to a resident of the residence country.

The second anti-abuse exception provides that exemption from source country tax does not apply to interest that is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit. Such income may be taxed in accordance with each country's internal law.

Both changes are consistent with the U.S. model.

Article V. Royalties

Article V of the proposed protocol modifies Article 12 of the existing treaty by deleting paragraph two of that article. Accordingly, paragraphs three, four, five, and six of Article 12 will be renumbered.

Paragraph two of Article 12 permitted the taxation of certain types of royalties in the treaty country in which they arose at a rate not exceeding five percent of the gross amount of the royalties, if the beneficial owner of the royalties was a resident of the other treaty country. The types of royalties subject to tax included those payments for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process or other like right or property and payments for information concerning industrial, commercial, or scientific experience. As noted by the Technical Explanation, the change eliminates withholding on cross-border royalty payments regardless of the type of intellectual property involved, bringing the Convention in line with the U.S. model.

Article VI. Limitation on Benefits

In general

The proposed protocol replaces the rules of Article 16 (Limitation on Benefits) of the present treaty with rules that are similar to the limitation-on-benefits provisions included in recent U.S. income tax treaties. The new rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in Finland or the United States.

The proposed protocol is intended to limit double taxation caused by the interaction of the tax systems of the United States and Finland as they apply to residents of the two countries. At times, however, residents of third countries attempt to benefit from a treaty by engaging in treaty shopping. Treaty shopping by a third-country resident may involve organizing in a treaty country a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents.

Generally, a resident of either treaty country is entitled to all the benefits accorded by the proposed protocol if the resident has any one of six listed attributes. The six attributes are that the resident is (1) an individual; (2) one of the two treaty countries or a political subdivision, statutory body, or local authority of one of the two countries; (3) a company that satisfies a public company test or that is a subsidiary of a public company; (4) a legal person that is generally exempt from tax in its residence country and that is established and maintained in that country exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes; (5) a pension fund that satisfies a beneficiaries test; or (6) an entity that satisfies an ownership test and a base erosion test. A resident that has none of these six attributes may be entitled to treaty benefits with respect to certain items of income under the derivative benefits test or the active business test.

Special anti-abuse rules govern certain items of income derived from the United States by an enterprise resident in Finland in so-called “triangular cases.”

A person that does not satisfy any of the requirements described above may be entitled to the benefits of the treaty if the source country’s competent authority so determines.

Six attributes for qualification for all treaty benefits

Individual

Under the proposed protocol, an individual resident of the United States or Finland is entitled to all treaty benefits. If, however, such an individual receives income as a nominee on behalf of a third-country resident, and thus is not the beneficial owner of the income, benefits may be denied.

Governments

The proposed protocol provides that the United States and Finland, and any political subdivision, statutory body, or local authority of either of the two countries are entitled to all treaty benefits.

Publicly traded companies and subsidiaries

A company that is a resident of Finland or the United States is entitled to all treaty benefits if the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges (the "regular trading test") and either (1) the company's principal class of shares is primarily traded on a recognized stock exchange in its country of residence or, in the case of a Finnish company, on a recognized stock exchange in the European Union or in any other European Economic Area country or, in the case of a U.S. company, on a recognized stock exchange located in another state that is a party to the North American Free Trade Agreement (the "primary trading test"), or (2) the company's primary place of management and control is in its country of residence (the "management and control test"). Certain key elements of the regular trading test, primary trading test, and management and control test are described below.

The term "principal class of shares" means the ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the "principal class of shares" means that class or those classes of shares that in the aggregate represent a majority of the aggregate voting power and value of the company.

A company that is resident in one treaty country has a "disproportionate class of shares" if any outstanding class of shares is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company's income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, a company resident in Finland meets this test if it has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States.

The term "shares" includes depository receipts for shares.

A class of shares is considered to be "regularly traded" in a taxable year if the aggregate number of shares of that class traded on one or more recognized exchanges during the twelve months ending on the day before the beginning of that taxable year is at least six percent of the average number of shares outstanding in that class during that twelve-month period. The Technical Explanation notes that trading on one or more recognized stock exchanges may be aggregated for purposes of meeting the "regularly traded" requirement.

The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; the Helsinki Stock Exchange; the Irish Stock Exchange and the stock exchanges of Amsterdam, Brussels, Copenhagen, Frankfurt, London, Oslo, Paris, Reykjavik, Riga, Stockholm, Tallinn, Vienna, Vilnius, and Zurich; and any other stock exchange agreed upon by the competent authorities of the treaty countries.

The term "primarily traded" is not defined in the proposed protocol and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(3). Based on that provision, the Technical Explanation states that stock of a corporation is primarily traded if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.

A company the principal class of shares (and any disproportionate class of shares) of which is regularly traded on a recognized stock exchange but which does not satisfy the primary trading test (that is, the requirement that a company's principal class of shares be primarily traded on a recognized stock exchange in the required area) may claim treaty benefits if it satisfies the management and control test – that is, if the company's primary place of management and control is in the treaty country of which it is a resident. According to the Technical Explanation, a company's primary place of management is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that country than in the other treaty country or any third country, and if the staffs that support the management in making those decisions are also based in that residence country.

The Technical Explanation notes that the management and control test should be distinguished from the "place of effective management" test used by many countries and in the OECD model to establish residence. The place of effective management test often has been interpreted to mean the place where the board of directors meets. Under the proposed protocol, by contrast, the primary place of management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

A company that does not satisfy the regular trading test and either the primary trading test or the management and control test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits if shares representing at least 50 percent of its aggregate voting power and value (and at least 50 percent of any disproportionate class of its shares) are owned, directly or indirectly, by five or fewer companies that satisfy the regular trading test and either the primary trading test or the management and control test, provided that, in the case of indirect ownership, each intermediate owner is a resident of the United States or Finland. This rule allows certain subsidiaries of publicly-traded companies to be eligible for all benefits under the treaty.

<u>Tax-exempt organizations</u>

A legal person is entitled to treaty benefits if it is organized under the laws of the United States or Finland and is established and maintained in that country exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. The Technical Explanation notes that a tax-exempt organization other than a pension fund qualifies for benefits without regard to the residence of its beneficiaries or members.

Pension funds

A pension fund is entitled to all the benefits of the treaty if more than 50 percent of the fund's beneficiaries, members, or participants are individuals resident in either the United States or Finland. According to the Technical Explanation, for purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the pension fund. In the case of Finland, according to the Technical Explanation, a pension fund includes a pension institution, but if the institution is organized as a company, only a mutual pension insurance company.

Ownership and base erosion tests

An entity that is a resident of one of the treaty countries is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

An entity that is a resident of a treaty country satisfies the ownership test if on at least half the days of the taxable year at least 50 percent of each class of the entity's shares or other beneficial interests is owned, directly or indirectly, by residents of that treaty country who are entitled to treaty benefits under the limitation-on-benefits article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds, provided that in the case of indirect ownership, each intermediate owner also is a resident of that treaty country.

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable year, as determined in that person's country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds. Arm's-length payments made in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank that is not related to the entity making the payment do not count against the entity in determining whether the 50-percent threshold is reached.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Residence) and they otherwise satisfy the ownership and base erosion tests.

Derivative benefits rule

The proposed protocol includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. Under these derivative benefits rules, a treaty country company is eligible for treaty benefits for an item of income only if the company satisfies both an ownership requirement and a base erosion requirement.

A company satisfies the ownership requirement if shares representing at least 95 percent of the company's aggregate voting power and value, and at least 50 percent of any of the company's disproportionate class of shares, are owned directly or indirectly by seven or fewer persons who are equivalent beneficiaries. The term "disproportionate class of shares" has the same definition as the definition previously described.

A company satisfies the base erosion requirement for an item of income only if, in the taxable year in which the income item arises, the amount of the deductible payments or accruals the company makes, directly or indirectly, to persons who are not equivalent beneficiaries is less than 50 percent of the company's gross income for the year, as determined in the company's country of residence. Deductible payments do not include arm's-length payments in the ordinary course of a business for services or tangible property and payments in respect of financial obligations to a bank that is not related to the company making the payment. The Technical Explanation notes that the base erosion requirement under the derivative benefits rule is the same as the base erosion test described previously (that is, the test that is included in the rules for determining whether a treaty country resident has one of the six attributes for qualification for all treaty benefits), except that, for the derivative benefits rule, deductible payments made to equivalent beneficiaries, not just to residents of a treaty country entitled to treaty benefits, are excluded from the payments that count toward the 50-percent limitation.

An equivalent beneficiary must be a resident of a European Union member state, a European Economic Area state, a North American Free Trade Agreement party, or Switzerland (together, "qualifying countries") and must satisfy either of two criteria described below.

The first criterion includes two requirements. First, the person must be entitled to all treaty benefits under a comprehensive income tax treaty between a qualifying country and the country from which the benefits of the U.S.-Finland treaty are being claimed (an "applicable treaty"), and this entitlement to treaty benefits must result from satisfaction of limitation-on-benefits provisions analogous to the proposed protocol's rules, described above, for individuals, governments, publicly-traded companies, tax-exempt organizations, and pension funds. If the applicable treaty does not include a comprehensive limitation on benefits article, this first requirement is satisfied only if the person would meet the proposed protocol's requirements for entitlement to treaty benefits as an individual, a government, a publicly-traded company, a tax-exempt organization, or a pension fund. Second, for insurance premiums and income from dividends, interest, or royalties, the person must be entitled under an applicable treaty to a rate of tax on that income that is at least as low as the rate applicable under the U.S.-Finland treaty, as modified by the proposed protocol (the "tax rate test").

The Technical Explanation gives the following example to illustrate the operation of the tax rate test. A U.S. company is wholly owned by a Finnish company that in turn is wholly owned by an Italian company. Assume the Finnish company otherwise satisfies the requirements of the zero-rate dividend provision, and assume that if the Italian company received a dividend directly from the U.S. company, the applicable dividend withholding tax rate under the U.S.-Italy treaty would be five percent. Under these facts, the Italian company would not be an equivalent beneficiary under the rules described above because it would not be entitled to a withholding tax rate at least as low as the applicable rate (zero) under the U.S.-Finland tax treaty as modified by the proposed protocol.

For dividend, interest, or royalty payments arising in Finland and beneficially owned by a resident of the United States, the proposed protocol includes a special rule for determining whether a company that is a resident of an EU member state satisfies the tax rate test for purposes of determining whether the U.S. resident is entitled to treaty benefits for the payments. The special rule provides that the EU member state resident satisfies the tax rate test if a dividend, interest, or royalty payment arising in Finland and paid directly to that EU member state resident would be exempt from withholding tax under an EU directive even though the income tax treaty between Finland and that EU member state would permit imposition of a higher withholding tax rate on that payment than is permitted by the U.S.-Finland tax treaty, as amended by the proposed protocol. The Technical Explanation states that this special rule takes account of the fact that withholding taxes on many inter-company dividend, interest, and royalty payments are exempt within the EU under various EU directives. The special rule is necessary, according to the Technical Explanation, because many EU member countries have not re-negotiated their tax treaties to reflect the EU directives' elimination of withholding tax.

Under the second criterion for determining whether a resident of a qualifying country is an equivalent beneficiary, the resident must be a Finnish or U.S. resident that is entitled to treaty benefits under one of the rules described previously for individuals, governments, publicly-traded companies, tax-exempt organizations, and pension funds. Under this rule, according to the Technical Explanation, a Finnish individual is an equivalent beneficiary for an item of income received by another treaty country resident regardless of whether the individual would have been entitled to receive the same benefits if it had received the income directly. The Technical Explanation states that this criterion was included to clarify that ownership by certain residents of a treaty country does not disqualify a U.S. or Finnish company from treaty benefits under the derivative benefits rules. If, for example, 90 percent of a Finnish company is owned by five companies that are residents of EU member states and that satisfy the first criterion described previously (the applicable treaty rules and the tax rate test), and 10 percent of the Finnish company is owned by a U.S. or a Finnish individual, the Finnish company still can satisfy the requirements of the ownership test of the derivative benefits rules.

Active business test

Under the proposed protocol, a resident of one treaty country is entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country and (2) the income from the other country is derived in connection with or is incidental to that trade or business. The proposed protocol provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless the business is banking, insurance, or securities activities carried on by a bank, an insurance company, or a registered securities dealer.

The term "trade or business" is not defined in the current treaty or in the proposed protocol. According to the Technical Explanation, under paragraph 2 of Article 3 (General

Definitions) of the current treaty, when determining whether a resident of Finland is entitled to the benefits of the treaty under the active business test with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the law of the United States. Accordingly, the Technical Explanation states, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived "in connection with" or be "incidental to" the resident's trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that "forms a part of" or is "complementary to" the trade or business conducted in the residence country by the income recipient.

According to the Technical Explanation, a business activity generally will be considered to form part of a business activity conducted in the country of source if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the source country, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation states that for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services but should be part of the same overall industry and should be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary, according to the Technical Explanation, to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first out of earnings and profits of the treaty-benefited trade or business and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

The Technical Explanation further states that an item of income derived from the country of source is "incidental to" the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

The proposed protocol provides that if a resident of a treaty country or any of its associated enterprises carries on a trade or business activity in the other country that gives rise to an item of income, the active business test applies to the item of income only if the trade or business activity in the residence country is substantial in relation to the trade or business activity in the source country. The determination is made separately for each item of income derived from the source country.

The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (that is, activities that have little economic cost or effect with respect to the company business as a whole). The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each treaty country, the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country. According to the Technical Explanation, in making each determination or comparison, due regard will be given to the relative sizes of the U.S. and Finnish economies.

The proposed protocol provides that, in determining whether a person is engaged in the active conduct of a trade or business in a treaty country, activities conducted by persons "connected" to that first person are deemed to be conducted by that first person. A person is "connected" to another person if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the beneficial equity interest in the company), or another person possesses, directly or indirectly, that requisite interest in each of the two entities. A person is also considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

The triangular case

The proposed protocol provides a special anti-abuse rule that, according to the Technical Explanation, addresses a Finnish resident's use of the following structure to earn interest income from the United States. The Finnish resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The Finnish resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the Finnish resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between Finland and the third country, Finland does not tax the income earned by the permanent establishment. Consequently, the income is not taxed in Finland or the United States, and is only lightly taxed in the third country.

Under the proposed protocol, the United States may impose withholding tax on the interest payments if the tax actually paid on the income in the third country is less than 60 percent of the tax that would have been payable to Finland if the income were earned in Finland and were not attributable to the permanent establishment in the third country.

Although the example in the Technical Explanation involves interest income, the triangular provision also applies to insurance premiums and royalties. Any interest or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent. Any insurance premiums to which the provision applies are subject to tax under the domestic tax laws of the United States, notwithstanding any other provision of the treaty.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision does not apply to a person’s interest income derived from the United States if the income is derived in connection with or is incidental to the active conduct of a trade or business carried on by the permanent establishment in the third state (other than the business of making, managing, or holding investments for the person’s own account, unless the business is banking or securities activities carried on by a bank or a registered securities dealer). The triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself.

Grant of treaty benefits by the competent authority

Under the proposed protocol, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the other treaty country determines that the establishment, acquisition, or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty. The competent authority of the source country is required to consult with the competent authority of the residence country before denying treaty benefits under this provision.

According to the Technical Explanation, the competent authority’s discretion under this provision is broad. The competent authority, for example, may grant all treaty benefits, may grant benefits only with respect to a particular item of income, and may set time limits on the duration of any relief granted.

Article VII. Double Taxation

The proposed protocol deletes a provision in Article 23 (Elimination of Double Taxation) of the present treaty which provides that, regardless of any other provision of the treaty, Finland may tax an individual Finnish national who is a resident of the United States and who is also regarded as resident in Finland under Finnish taxation law. According to the Technical Explanation, due to changes in Finland's domestic tax laws such a provision is no longer required.

The proposed protocol also makes conforming changes to the Article, reflecting the amendments made to the saving clause of paragraph 4 of Article 1 (Personal Scope). These changes extend the rules regarding the use of foreign tax credits by a United States citizen who is resident in Finland to include and apply to former citizens and former long-term residents of the

United States who remain subject to United States income taxation under section 877 of the Code.

Finally, the proposed protocol amends the source of income rules which apply for purposes of allowing relief under the Article. Under the present treaty, the source rules of Article 23 are subject to such source rules in the domestic laws of the treaty countries as apply for the purpose of limiting the foreign tax credit. The proposed protocol removes this limitation. The Technical Explanation indicates that this change is intended to ensure that the source rules set out in paragraph 4 of Article 23 have their intended effect.

Article VIII. Exchange of Information

The proposed protocol provides that the two competent authorities will exchange such information as is relevant to carry out the provisions of the proposed protocol, or the domestic laws of the two countries concerning all taxes covered by the treaty insofar as the taxation thereunder is not contrary to the treaty. This exchange of information is not restricted by Article 1 (General Scope) or Article 2 (Taxes Covered). Therefore, information with respect to third-country residents is covered by these procedures.

The proposed protocol provides that if specifically requested by the competent authority of a country, the competent authority of the other country must provide information under this article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested country with respect to its own taxes.

Any information exchanged under the proposed protocol is treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed protocol applies, or persons or authorities engaged in the oversight of such taxes (e.g., the tax-writing committees of Congress and the General Accounting Office). Such persons or authorities must use the information for such purposes only. Information received by these bodies must be for use in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

As is true under the U.S. model and the OECD model, under the proposed protocol, a country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information that is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process or information, the disclosure of which would be contrary to public policy.

If information is requested by a country in accordance with this article, the proposed protocol provides that the other country will obtain the requested information in the same manner and to the same extent as if the tax of the requesting country were the tax of the other country and were being imposed by that country, notwithstanding that such other country may not need such information at that time.

Under the proposed protocol, the powers of each country's competent authority to obtain information include the ability to obtain information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity. This does not include the ability to obtain information that would reveal confidential communications between a client and an attorney, where the client seeks legal advice. The proposed protocol also provides that the competent authorities may obtain information relating to the ownership of legal persons, such as the identity of a beneficial owner of bearer shares.

Under the proposed protocol, a country may collect on behalf of the other country such amounts as may be necessary to ensure that relief granted under the treaty by the other country does not inure to the benefit of persons not entitled thereto. However, neither country is obligated to carry out administrative measures that would be contrary to its sovereignty, security, or public policy.

The Technical Explanation states that the provisions of this article will have effect from the date of entry into force of the proposed protocol, without regard to the taxable or chargeable period to which the matter relates. Thus, once the proposed protocol is in force, the competent authority may seek information with respect to a year prior to the entry into force of the proposed protocol.

Article IX. Entry into Force

The proposed protocol is subject to ratification in accordance with the applicable procedures of each country, and provides that instruments of ratification will be exchanged as soon as possible. The proposed protocol will enter into force upon the exchange of instruments of ratification.

With respect to Finland, the proposed protocol will be effective with respect to taxes withheld at source for income derived on or after the first day of the second month following the date on which the proposed protocol enters into force. With respect to other taxes, the proposed protocol will be effective for taxable years beginning on or after the first day of January next following the date on which the proposed protocol enters into force.

With respect to the United States, the proposed protocol will be effective 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 proposed protocol enters into force. With respect to taxes on income that are not withheld at source, the proposed protocol will be effective with regard to taxable years beginning on or after the first day of January next following the date on which the proposed protocol enters into force.

With respect to the provisions of the proposed protocol relating to taxes withheld at source covered by paragraph 3 of Article 10 (Dividends) will have effect with respect to income derived on or after January 1, 2007, provided that the proposed protocol enters into force before December 31, 2007. The Technical Explanation provides that the relevant date for this purpose is the date on which income from the dividend is derived by the beneficial owner, rather than to the date on which the income was originally derived by the company paying the dividend.

The article also provides that the proposed protocol will remain in effect as long as the treaty remains in force.

V. ISSUES

A. Zero Rate of Withholding Tax on Dividends from 80-Percent-Owned Subsidiaries

In general

When certain conditions are met, the proposed protocol eliminates withholding tax on dividends paid by a company that is resident in one treaty country to a company that is a resident of the other treaty country and that owns at least 80 percent of the stock of the dividend-paying company (often referred to as "direct dividends"). The elimination of withholding tax on direct dividends is intended to reduce the tax barriers to direct investment between the two treaty countries.

Under the present treaty, direct dividends may be taxed by the source country at a maximum rate of five percent. Both Finland and the United States impose withholding tax on direct dividends under their internal tax laws. The principal effects of the zero-rate provision on U.S. taxpayers and the U.S. tax base would be (1) to relieve U.S. companies of the burden of Finnish withholding tax on dividends qualifying for the zero rate; (2) to increase the U.S. tax base by eliminating foreign tax credits for Finnish withholding tax that would be imposed in the absence of the zero-rate provision; and (3) to decrease the U.S. tax base by eliminating the U.S. withholding tax on dividends paid by U.S. companies to Finnish companies eligible for the zero rate.

Until 2003, no U.S. income tax treaty provided for a complete exemption from dividend withholding tax, and the U.S. and OECD models do not provide an exemption. By contrast, many bilateral income tax treaties of other countries eliminate withholding taxes on direct dividends between treaty countries, and the EU Parent-Subsidiary Directive repeals withholding taxes on intra-EU direct dividends. Recent U.S. income tax treaties and protocols with Australia, Japan, Mexico, the Netherlands, Sweden, and the United Kingdom include zero-rate provisions. The Senate ratified those treaties in 2003 (Australia, Mexico, United Kingdom), 2004 (Japan, Netherlands), and 2006 (Sweden). The zero-rate provisions in those treaties are similar to the provision in the proposed protocol.[18]

Description of provision

Under the proposed protocol, the withholding tax rate is reduced to zero on dividends paid by a treaty country resident company and beneficially owned by a company that is a resident of the other treaty country and that has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. The 80-percent ownership requirement

[18] The treaty with Japan provides a zero-percent rate at a lower ownership threshold than the threshold in the proposed protocol and the other treaties (more than 50 percent as opposed to at least 80 percent).

under this provision may be satisfied by either direct or indirect ownership (through one or more residents of either treaty country).

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than normally apply under the proposed protocol. To qualify for the zero rate, the dividend-receiving company must: (1) satisfy the public trading test of the limitation-on-benefits article; (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) satisfy the derivative benefits test of the limitation-on-benefits article; or (4) receive a favorable determination from the competent authority.

The proposed protocol provides that the zero-rate provision will have effect for income derived on or after January 1, 2007, provided the proposed protocol enters into force before December 31, 2007.

Issues

In general

The proposed protocols with Denmark, Finland, and Germany and the proposed treaty with Belgium would bring to ten the number of U.S. income tax treaties that provide a zero rate for direct dividends. Because zero-rate provisions are a relatively recent but now prominent development in U.S. income tax treaty practice, the Committee may wish to consider the costs and benefits of zero-rate provisions; the Treasury Department's criteria for determining when a zero-rate provision is appropriate; and certain specific features of zero-rate provisions such as ownership thresholds, holding-period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements. The Committee also may wish to inquire about the effective date for the proposed protocol's zero-rate provision.

Costs and benefits of adopting a zero rate with Finland

Tax treaties mitigate double taxation by resolving potentially conflicting source and residence country claims of taxing rights for a particular item of income. Under most income tax treaties, source countries wholly or partly yield to residence countries the right to tax most dividends (other than dividends attributable to a permanent establishment that a company has in the source country). Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a low rate (five percent, for example) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow the possibility of double taxation. If the residence country allows a foreign tax credit for source-country withholding tax, double taxation may be mitigated or eliminated, but the effect of a credit is to violate the residence country's primary right to tax dividend income. If a residence country imposes limitations on its foreign tax credit (as the United States does with its overall and basket limitations), withholding taxes may not be fully creditable, and some double taxation may remain. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. Removing a barrier to cross-border investment is a principal argument for the proposed protocol's zero-rate provision.

Direct dividends may present an appropriate circumstance for eliminating withholding tax. A company deriving business income in the United States or Finland generally is subject to net-basis income tax in that country on the business income, and when it pays a dividend out of the income to a company in the other country, the dividend income generally is taxed in that other country (subject to allowable foreign tax credits). If the dividend-paying company is at least 80-percent owned by the dividend-receiving company, the dividend-receiving company may be viewed as a direct investor (and taxpayer) in the source country rather than as a portfolio investor. A portfolio investor would be less likely to be subject to net-basis taxation in the source country; a source-country withholding tax on dividends paid to a portfolio investor therefore might be viewed as more appropriate than a withholding tax on direct dividends.

Under domestic laws, both the United States and Finland generally impose withholding tax on cross-border dividends. The zero-rate provision, therefore, would benefit direct investment in Finland by U.S. companies and direct investment in the United States by Finnish companies. Stated differently, the zero-rate provision would provide benefits both when the United States is exporting capital and when it is importing capital. The revenue effect of the zero-rate provision is unclear: the revenue loss to the United States from the elimination of withholding tax on U.S.-source dividends might be offset in whole or part by reduced foreign tax credit claims related to Finnish-source dividend payments.

Many countries have included zero-rate dividend provisions in their income tax treaties for longer than the United States has. These countries include OECD members Austria, Denmark, Finland, France, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, and non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. The EU Parent-Subsidiary Directive also eliminates withholding tax on direct dividends between EU companies. Many countries have eliminated withholding taxes on dividends as a matter of internal law. Thus, although the zero-rate provision in the proposed protocol is part of a relatively recent development in U.S. income tax treaties, there is substantial international precedent. This international precedent may be a reason in itself why the zero-rate provision in the proposed protocol is appropriate: by eliminating withholding tax on direct dividends between the United States and Finland, the proposed protocol joins many existing income tax treaties and domestic and international tax rules in reducing tax barriers to foreign direct investment.

General direction of U.S. tax treaty policy

Because zero-rate provisions are common in U.S. income tax treaties that have entered into force since 2003, the Committee may wish to examine the Treasury Department's criteria for determining the circumstances under which a zero-rate provision may be appropriate. Although zero-rate provisions are common in recent U.S. treaties, recent treaties with Bangladesh, France, and Sri Lanka do not include zero-rate rules. The U.S. model also does not provide a zero dividend withholding tax rate. In previous testimony before the Committee, the Treasury Department has indicated that zero-rate provisions should be allowed only under treaties that have restrictive limitation-on-benefits rules and that provide comprehensive information exchange. Even in those treaties, according to previous Treasury Department statements, dividend withholding tax should be eliminated only based on an evaluation of the overall balance of benefits under the treaty. The Committee may wish to ask what overall balance considerations might prompt the Treasury Department not to seek a zero-rate provision in a treaty that has limitation-on-benefits and information-exchange provisions meeting the highest standards.

Specific design features

The Committee also may wish to examine certain specific design features of zero-rate provisions, features such as ownership thresholds, holding-period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements. The Committee may wish to ask the Treasury Department what factors support a minimum ownership requirement of 80 percent and what factors may argue for a lower ownership threshold. The Committee also may wish to ask the Treasury Department why a 12-month holding period strikes a proper balance between the competing considerations of, on the one hand, preventing short-term shifting of ownership to claim the zero rate and, on the other hand, of allowing the zero rate in connection with ordinary, non-abusive structures.

The Committee may wish to ask whether the rule of the proposed protocol (and the provisions in certain other recent U.S. income tax treaties) allowing indirect ownership through a treaty-country resident reflects the likely resolution of this issue for future provisions. The IRS has ruled privately, in connection with a situation arising under the U.S.-U.K. zero-rate provision, that entities disregarded under the U.S. entity classification regulations also are disregarded for purposes of determining whether certain ownership requirements of the zero-rate provision are satisfied. Thus, stock owned through a disregarded entity (established under the laws of a third country) was treated as owned directly for purposes of applying the holding period requirement of that provision (which, according to that treaty's Technical Explanation, required direct ownership).[19] The Committee may wish to ask the Treasury Department whether the approach taken in this private ruling under the U.S.-U.K. treaty reflects a more general approach that the Treasury Department and the IRS are likely to take in applying zero-rate provisions to structures involving disregarded entities.

The Committee may wish to ask whether the proposed protocol's special limitation-on-benefits conditions for qualification for the zero rate – for example, the active trade or business and ownership and base erosion tests – are likely to be included in future treaties, and how these special provisions might change as zero-rate provisions become more widespread in the U.S. income tax treaty network.

Because the zero-rate provision is effective for income derived on or after January 1, 2007, the provision may have retroactive effect. By contrast, the U.S. model's effective date for taxes withheld at source (and for other taxes) is prospective. The Committee may wish to ask Treasury Department about the rationale for applying the zero-rate provision retroactively; whether this retroactive application may cause administrative problems; and whether retroactive effective dates for dividend withholding rules may be included in future treaties.

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[19] *See* Priv. Ltr. Rul. 200522006.

B. Treaty Shopping

In general

The proposed protocol includes limitation on benefits rules that are similar to the limitation on benefits rules in other recent U.S. income tax treaties; in the proposed protocols with Denmark and Germany and the proposed treaty with Belgium; and in the U.S. model. These rules are intended to prevent the indirect use of the U.S.-Finland income tax treaty by persons who are not entitled to its benefits by reason of residence in Finland or the United States.

When a resident of one country derives income from another country, the internal tax rules of the two countries may cause that income to be taxed in both countries. One purpose of a bilateral income tax treaty is to allocate taxing rights for cross-border income and thereby to prevent double taxation of residents of the treaty countries. Although a bilateral income tax treaty is intended to apply only to residents of the two treaty countries, residents of third countries may attempt to benefit from a treaty by engaging in treaty shopping. This treaty shopping may involve organizing in a treaty country a corporation that is entitled to the benefits of the treaty or engaging in income-stripping transactions with a treaty-country resident. Limitation on benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping.

Although the limitation on benefits rules in the proposed protocol are similar to the rules in other recent and proposed U.S. income tax treaties and protocols and in the U.S. model, they are not identical, and the Committee may wish to inquire about certain differences. In particular, the Committee may wish to examine the rules for publicly-traded companies, derivative benefits, and certain triangular arrangements.

Publicly traded companies

A company that is a resident of a treaty country is eligible for all the benefits of the proposed protocol if it satisfies a regular trading test and either a management and control test or a primary trading test. A company satisfies the regular trading test if its principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges. Under the management and control test, the company's primary place of management and control must be in the treaty country of which the company is a resident. The primary trading test requires that a company's principal class of shares be primarily traded on a recognized stock exchange located in the treaty country of which the company is a resident or, in the case of a Finnish company, on a recognized stock exchange in another EU or EEA country, or in the case of a U.S. company, in another NAFTA country. A recognized stock exchange specifically includes, in addition to U.S. and Finnish exchanges, the Irish Stock Exchange and the stock exchanges of Amsterdam, Brussels, Copenhagen, Frankfurt, London, Oslo, Paris, Reykjavik, Riga, Stockholm, Tallinn, Vilnius, Vienna, and Zurich.[20]

[20] Trading on only recognized stock exchanges located in the United States, Finland, or (for Finnish companies) an EEA or EU country, or (for U.S. companies) a NAFTA country may be used to

The Committee may wish to inquire about the primary trading test in the proposed protocol. That test is similar to the primary trading test in the proposed protocol with Denmark, the proposed treaty with Belgium, and the recent protocol with Sweden but differs from the test in the U.S. model and the test included in the proposed protocol with Germany. Under the primary trading test in the U.S. model and in the proposed protocol with Germany, the required trading must occur on a stock exchange in the treaty country of which the relevant company is a resident; trading on a stock exchange in another country may not be used to satisfy the test. A possible rationale for this narrower primary trading test, and for the management and control test that may be satisfied instead of the primary trading test, is that a publicly-traded company should be eligible for treaty benefits only if it has a nexus with its country of residence. A company that is a resident of the United States or Finland may not have this nexus if it satisfies the proposed protocol's primary trading test because of trading on an exchange in a third country. The Committee may wish to ask the Treasury Department about the circumstances that justify allowing trading on third country exchanges to be used to satisfy the primary trading test. In particular, the Committee might ask when it is more appropriate to consider trading in the economic areas of the treaty countries (for example, NAFTA, EU, and EEA countries) than to consider only trading in the treaty countries of which companies are resident. The Committee also may wish to inquire whether trends toward greater or lesser integration in Europe might affect Treasury Department considerations when negotiating about primary trading rules.

Although the proposed protocol's primary trading test is similar to the tests in the recent protocol with Sweden, the proposed protocol with Denmark, and the proposed treaty with Belgium, the stock exchanges specifically included in the definition of "recognized stock exchange" (under both the regular trading test and the primary trading test) differ among the three protocols and the treaty. The Committee may wish to inquire about the criteria the Treasury Department considers when negotiating over the definition of a recognized stock exchange.

Derivative benefits

Like the proposed protocols with Denmark and Germany and the proposed treaty with Belgium, and like other recent treaties, the proposed protocol includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners (referred to in the proposed protocol as equivalent beneficiaries) would have been entitled to the same benefits for the income had those owners derived the income directly.

The derivative benefits rules may grant treaty benefits to a treaty country resident company in circumstances in which the company would not qualify for treaty benefits under any of the other limitation on benefits provisions. The U.S. model does not include derivative benefits rules. The Committee may wish to inquire about the circumstances that justify inclusion of these rules in treaties notwithstanding their absence from the U.S. model.

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satisfy the primary trading test. Trading on recognized stock exchanges located in any country may be used to satisfy the regular trading test.

Triangular arrangements

The proposed protocol includes special anti-abuse rules intended to deny treaty benefits in certain circumstances in which a Finnish resident company earns U.S.-source income attributable to a third-country permanent establishment and is subject to little or no tax in the third jurisdiction and Finland. Similar anti-abuse rules are included in other recent treaties and in the proposed protocols with Denmark and Germany and the proposed treaty with Belgium. The U.S. model, however, does not include rules addressing triangular arrangements. The Committee may wish to ask the Treasury Department about the circumstances that justify inclusion of the anti-abuse rules notwithstanding their absence from the U.S. model. In particular, the Committee may wish to inquire whether the Treasury Department will insist on inclusion of anti-abuse rules whenever a treaty partner's internal tax rules provide an exemption for the income of a third-country permanent establishment of a treaty partner resident.