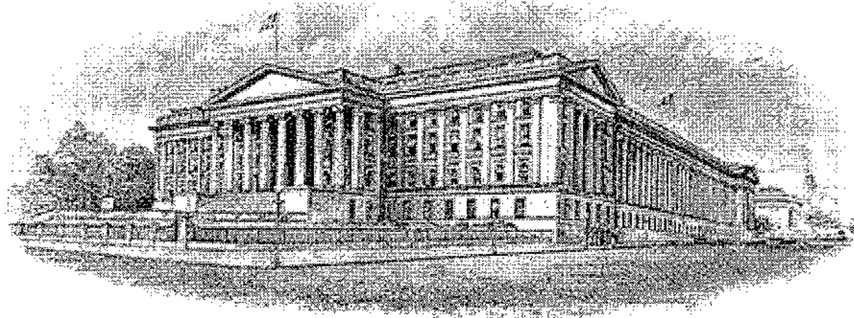

U.S. TREASURY DEPARTMENT
OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 2:30 P.M. July 17, 2007
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TESTIMONY OF TREASURY INTERNATIONAL TAX COUNSEL JOHN HARRINGTON BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS ON PENDING INCOME TAX AGREEMENTS

Washington, D.C.--Mr. Chairman, Ranking Member Lugar, and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing to recommend, on behalf of the Administration, favorable action on four tax agreements that are pending before this Committee. We appreciate the Committee's interest in these agreements and in the U.S. tax treaty network, as demonstrated by the scheduling of this hearing.

This Administration is dedicated to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers to trade and investment are bilateral tax treaties. Tax treaties eliminate barriers by providing greater certainty to taxpayers regarding their potential liability to tax in the foreign jurisdiction; by allocating taxing rights between the two jurisdictions so that the taxpayer is not subject to double taxation; by reducing the risk of excessive taxation that may arise because of high gross-basis withholding taxes; and by ensuring that taxpayers will not be subject to discriminatory taxation in the foreign jurisdiction. The international network of over 2,500 bilateral tax treaties has established a stable framework that allows international trade and investment to flourish. The success of this framework is evidenced by the fact that countless cross-border transactions, from an individual's investment in a few shares of a foreign company to a multi-billion dollar purchase of a foreign operating company, take place each year, with only a relatively few disputes regarding the allocation of tax revenues between governments.

To ensure that our tax treaties cannot be used inappropriately, we continually monitor our existing network of tax treaties to make sure that each treaty continues to serve its intended purposes and is not being exploited for unintended purposes. A tax treaty reflects a balance of benefits that is struck when the treaty is negotiated and that can be affected by future developments. In some cases, changes in law or policy in one or both of the treaty partners may make it possible to increase the benefits provided by the treaty; in these cases, negotiation of a new or revised agreement may be very beneficial. In other cases, developments in one or both countries, or international developments more generally, may require a revisiting of the

agreement to prevent exploitation and eliminate unintended and inappropriate consequences; in these cases, it may be necessary to modify or even terminate the agreement. Both in setting our overall negotiation priorities and in negotiating individual agreements, our focus is on ensuring that our tax treaty network fulfills its goals of facilitating cross border trade and investment and preventing fiscal evasion.

The agreements before the Committee today with Belgium, Denmark, Finland, and Germany serve to further the goals of our tax treaty network and improve long-standing treaty relationships. We urge the Committee and the Senate to take prompt and favorable action on all of these agreements.

Purposes and Benefits of Tax Treaties

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

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

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

As a complement to these substantive rules regarding allocation of taxing rights, tax treaties provide a mechanism for dealing with disputes or questions of application that arise after the treaty enters into force. In such cases, designated tax authorities of the two governments – known as the "competent authorities" in tax treaty parlance – are to consult and reach an agreement under which the taxpayer's income is allocated between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation that might otherwise result. The U.S. competent authority under our tax treaties is the Secretary of the Treasury. That function

has been delegated to the Deputy Commissioner of the Internal Revenue Service, Large and Mid-Size Business (International).

In addition to reducing potential double taxation, tax treaties also reduce potential "excessive" taxation by reducing withholding taxes that are imposed at source. Under U.S. domestic law, payments to non-U.S. persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Most of our trading partners impose similar levels of withholding tax on these types of income. This tax is imposed on a gross, rather than net, amount. Because the withholding tax does not take into account expenses incurred in generating the income, the taxpayer that bears the burden of withholding tax frequently will be subject to an effective rate of tax that is significantly higher than the tax rate that would be applicable to net income in either the source or residence country. The taxpayer may be viewed, therefore, as suffering "excessive" taxation. Tax treaties alleviate this burden by setting maximum levels for the withholding tax that the treaty partners may impose on these types of income or by providing for exclusive residence-country taxation of such income through the elimination of source-country withholding tax. Because of the excessive taxation that withholding taxes can represent, the United States seeks to include in tax treaties provisions that substantially reduce or eliminate source-country withholding taxes.

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

In addition to these core provisions, tax treaties include provisions dealing with more specialized situations, such as rules coordinating the pension rules of the tax systems of the two countries or addressing the treatment of Social Security benefits and alimony and child-support payments in the cross-border context. These provisions are becoming increasingly important as more individuals move between countries or otherwise are engaged in cross-border activities. While these matters may not involve substantial tax revenue from the perspective of the two governments, rules providing clear and appropriate treatment are very important to the affected taxpayers.

Tax treaties also include provisions related to tax administration. A key element of U.S. tax treaties is the provision addressing the exchange of information between the tax authorities. Under tax treaties, the competent authority of one country may request from the other competent authority such information as may be relevant for the proper administration of the first country's tax laws; the information provided pursuant to the request is subject to the strict confidentiality protections that apply to taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank-secrecy rules that would operate to prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not conclude a tax treaty with that country. Indeed, the need for appropriate information exchange provisions is one of the treaty matters that we consider non-negotiable.

Tax Treaty Negotiating Priorities and Process

The United States has a network of 58 income tax treaties covering 66 countries. This network covers the vast majority of foreign trade and investment of U.S. businesses. In establishing our negotiating priorities, our primary objective is the conclusion of tax treaties or protocols that will provide the greatest economic benefit to the United States and to U.S. taxpayers. We communicate regularly with the U.S. business community, seeking input regarding the areas in which treaty network expansion and improvement efforts should be focused and information regarding practical problems encountered under particular treaties and particular tax regimes.

The primary constraint on the size of our tax treaty network may be the complexity of the negotiations themselves. The various functions performed by tax treaties, and most particularly the need to mesh the particular tax systems of the two treaty partners, make the negotiation process exacting and time consuming. Accordingly, it frequently will make more sense for the United States to negotiate an update to an existing agreement, rather than to negotiate a new tax treaty.

Numerous features of the treaty partner's particular tax legislation and its interaction with U.S. domestic tax rules must be considered in negotiating a treaty or protocol. Examples include whether the country eliminates double taxation through an exemption system or a credit system, the country's treatment of partnerships and other transparent entities, and how the country taxes contributions to pension funds, earnings of the funds, and distributions from the funds.

Moreover, a country's fundamental tax policy choices are reflected not only in its tax legislation but also in its tax treaty positions. These choices differ significantly from country to country, with substantial variation even across countries that seem to have quite similar economic profiles. A treaty negotiation must take into account all of these aspects of the particular treaty partner's tax system and treaty policies to arrive at an agreement that accomplishes the United States' tax treaty objectives.

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

In some situations, the right result may be no tax treaty at all or may be a substantially curtailed form of tax agreement. With some countries a tax treaty may not be appropriate because of the possibility of abuse. With other countries there simply may not be the type of cross-border tax issues that are best resolved by treaty. For example, if a country does not impose significant income taxes, there is little possibility of double taxation of cross-border income, and an agreement that is focused on the exchange of tax information may be the most appropriate agreement. Alternatively, a bifurcated approach may be appropriate in situations where a country has a special preferential tax regime for certain parts of the economy that is different from the tax rules generally applicable to the country's residents. In those cases, the residents benefiting from the preferential regime may not face potential double taxation and so should not be entitled to the reductions in U.S. withholding taxes accorded by a tax treaty, while a full treaty

relationship might be useful and appropriate to avoid double taxation in the case of the residents who do not receive the benefit of the preferential regime.

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

A high priority for improving our overall treaty network is continued focus on prevention of "treaty shopping." The U.S. commitment to including comprehensive limitation on benefits provisions is one of the keys to improving our overall treaty network. Our tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes agreed to in a particular treaty mean that U.S. persons pay less tax to that country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents are able to exploit one of our tax treaties to secure reductions in U.S. tax, the benefits would flow only in one direction as third-country residents would enjoy U.S. tax reductions for their U.S. investments, but U.S. residents would not enjoy reciprocal tax reductions for their investments in that third country. Moreover, such third-country residents may be securing benefits that are not appropriate in the context of the interaction between their home country's tax systems and policies and those of the United States. This use of tax treaties is not consistent with the balance of the deal negotiated. Preventing this exploitation of our tax treaties is critical to ensuring that the third country will sit down at the table with us to negotiate on a reciprocal basis, so that we can secure for U.S. persons the benefits of reductions in source-country tax on their investments in that country.

Consideration of Arbitration

Tax treaties cannot facilitate cross-border investment and provide a more stable investment environment unless the agreement is effectively implemented by the tax administrations of the two countries. Under our tax treaties, when a U.S. taxpayer becomes concerned about implementation of the treaty, the taxpayer can bring the matter to the U.S. competent authority who seeks to resolve the matter with the competent authority of the treaty partner. The competent authorities will work cooperatively to resolve genuine disputes as to the appropriate application of the treaty.

The U.S. competent authority has a good track record in resolving disputes. Even in the most cooperative bilateral relationships, however, there will be instances in which the competent authorities will not be able to reach a timely and satisfactory resolution. Moreover, as the number and complexity of cross-border transactions increases, so does the number and complexity of cross-border tax disputes. Accordingly, we have considered ways to equip the U.S. competent authority with additional tools to resolve disputes promptly, including the possible use of arbitration in the competent authority process.

The first U.S. tax agreement that contemplates arbitration is the current U.S.-Germany income tax treaty, signed in 1989. Tax treaties with several other countries, including Canada, Mexico, and the Netherlands, incorporate authority for establishing voluntary binding arbitration procedures based on the provision in the U.S.-Germany treaty. Although we believe that the

presence of these voluntary arbitration provisions may have provided some limited assistance in reaching mutual agreements, it has become clear that the ability to enter into voluntary arbitration does not provide sufficient incentive to resolve problem cases in a timely fashion.

Over the past few years, we have carefully considered and studied mandatory arbitration procedures. In particular, we examined the experience of countries that adopted mandatory binding arbitration provisions with respect to tax matters. Many of them report that the prospect of impending mandatory arbitration creates a significant incentive to compromise before commencement of the process. Based on our review of the U.S. experience with arbitration in other areas of the law, the success of other countries with arbitration in the tax area, and the overwhelming support of the business community, we concluded that mandatory binding arbitration as the final step in the competent authority process can be an effective and appropriate tool to facilitate mutual agreement under U.S. tax treaties.

Two of the agreements before the Committee (Germany and Belgium) adopt an expedited approach to mandatory arbitration designed to achieve the benefit of an arbitration provision with the least disruption to the process of competent authority negotiation. Thus, the mandatory arbitration process is formulated as part of the mutual agreement procedure rather than as a separate, extra-judicial procedure.

As in the current mutual agreement procedure, a U.S. taxpayer presents its problem to the competent authority and participates in formulating the position the U.S. competent authority will take in discussions with the treaty partner. Under the new arbitration provisions, if the competent authorities cannot come to resolution within two years, the competent authorities must present the issue to an arbitration board for resolution unless both competent authorities agree that the case is not suitable for arbitration. The arbitration board can resolve the issue only by choosing the position of one of the competent authorities. That position is adopted as the agreement of the competent authorities and is treated like any other mutual agreement (i.e., one that has been negotiated) under the treaty.

Because the arbitration board can only choose between the positions of each competent authority, the expectation is that the differences between the positions of the competent authorities will tend to narrow as the case moves closer to arbitration. If the arbitration provision is successful, difficult issues will be resolved without resort to arbitration. Thus, it is our expectation that these arbitration provisions will be rarely utilized, but that their presence will encourage the competent authorities to take approaches to their negotiations that result in mutually agreeable conclusions.

The arbitration process adopted in the agreements with Germany and Belgium is mandatory and binding with respect to the competent authorities. However, consistent with the negotiation process under the mutual agreement procedure, the taxpayer can terminate the arbitration at any time by withdrawing its request for competent authority assistance. Moreover, the taxpayer retains the right to litigate the matter in lieu of accepting the result of the arbitration, just as it would be entitled to litigate in lieu of accepting the result of a negotiation under the mutual agreement procedure.

Arbitration is a growing and developing field, and there are many forms of arbitration from which to choose. We intend to continue to study other arbitration provisions and to monitor the performance of the provisions in the agreements with Belgium and Germany once ratified. Although the competent authorities of these countries generally work well with our competent authority, we believe that these proposed arbitration provisions will supplement and reinforce the

current competent authority process in those treaties and will facilitate negotiation of arbitration provisions with other countries with which we need to bolster the competent authority process.

In short, the goal is to craft, in a manner acceptable to each appropriate treaty partner, an effective mechanism to facilitate the ordinary process of negotiation under the treaty's mutual agreement procedure.

Discussion of Proposed New Treaty and Protocols

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

Before describing specific aspects of each agreement, I would like to point out one item shared by all four agreements: the elimination of source-country withholding tax on certain intercompany dividends. As we have stated previously to this Committee, we believe that the elimination of source-country taxation of dividends should be considered only on a case-by-case basis. It is not the U.S. Model position because we do not believe that it is appropriate in every treaty. Consideration of such a provision in a treaty is appropriate only if the treaty contains anti-treaty-shopping rules and an information exchange provision that meet the highest standards. In addition to these prerequisites, the overall balance of the treaty must be considered. We believe that these conditions and considerations are met in all four agreements, and that the United States and U.S. taxpayers will benefit significantly from the elimination of the withholding tax in each agreement.

Finland

The proposed Protocol with Finland was signed in Helsinki on May 31, 2006, and amends the current Convention, which entered into force in 1990. The most significant provisions in this agreement relate to dividends, royalties, anti-abuse provisions, and exchange of information. The Protocol also makes a number of necessary updates to the current Convention and brings the Convention more in line with recent agreements with other Nordic countries.

The proposed Protocol makes a number of changes to the dividend article of the current Convention. As mentioned above, the proposed Protocol eliminates the source-country withholding tax on many intercompany dividends. In general, a company receiving a dividend must have a substantial interest in the distributing corporation for a 12-month period and meet special limitation on benefits provisions to qualify for the exemption from withholding tax. The proposed Protocol also eliminates the source-country withholding tax on dividends paid to pension funds. This provision is necessary to eliminate the double taxation that occurs when tax is imposed on distributions to pension funds that cannot be credited or used against further tax in the hands of the beneficiaries of the fund. The proposed Protocol also updates the dividend article to incorporate policies reflected in the U.S. Model provision, such as those regarding real estate investment trusts (REITs).

The proposed Protocol makes a significant change to the royalty article of the current Convention. The current Convention allows the source country to withhold on royalty payments with respect to certain types of property to residents of the other treaty partner, but limits the withholding rate to a maximum of five percent. The proposed Protocol eliminates source-country withholding on royalties payments regardless of the type of intellectual property involved, bringing the Convention in line with the U.S. Model treaty.

The proposed Protocol makes a number of changes to the limitation on benefits article of the current Convention. It tightens the limitation on benefits rules applicable to publicly-traded companies to ensure a closer nexus between the company and its residence country through regional trading or local management and control. The Protocol further tightens the limitation on benefits provision by including a so-called "triangular provision" adopted in many U.S. treaties with countries that exempt income earned in third countries. Under the provision, the United States need not allow full treaty benefits to a Finnish enterprise with respect to certain income exempt from Finnish tax and attributable to a permanent establishment in a third state if the income is not subject to a sufficient level of tax in the third state. The proposed Protocol also includes a provision adopted in U.S. agreements with many European countries that allows a company resident in one of the contracting states to qualify for treaty benefits in the other state if the company is substantially owned by third-country residents that would themselves qualify for equivalent benefits under their own treaties with the other state.

The proposed Protocol includes other anti-abuse rules. It extends the provision in the current Convention that preserves the U.S. right to tax certain former citizens also to cover certain former long-term residents, and updates the provision to reflect changes in U.S. law. The proposed Protocol conforms the interest article in the current Convention to the U.S. Model treaty by including special contingent interest and real estate mortgage investment conduit (REMIC) exceptions to the elimination of withholding tax on interest payments.

The proposed Protocol also includes several other important administrative and technical modifications. Significantly, it updates the exchange of information provisions to specify the obligation to obtain and provide information held by financial institutions, and to otherwise reflect U.S. Model standards in this area.

Once ratified by the Senate, the proposed Protocol will enter into force upon the exchange of instruments of ratification. For taxes withheld at source, the proposed Protocol will generally have effect within two months after entry into force. However, if such instruments are exchanged before December 31, 2007, the countries agreed to eliminate withholding taxes for intercompany dividends and dividends to pension funds for dividends derived on or after January 1, 2007. With respect to other taxes, the Protocol will have effect January first of the year following the year in which the Protocol enters into force.

Denmark

The proposed Protocol with Denmark was signed in Copenhagen on May 2, 2006. The proposed Protocol closely follows the recent protocol with Sweden, which entered into force in 2006, and the proposed Protocol with Finland, described above, with respect to dividends and limitation on benefits.

As noted above, the proposed Protocol amends the dividend article to eliminate the withholding tax on intercompany dividends when a company meets certain ownership and limitation on benefits requirements. In addition, the proposed Protocol conforms to current U.S. tax treaty policy by eliminating withholding tax on dividends to pension funds. The provisions of the current Convention applicable to regulated investment companies (RICs) and REITs are updated to apply reciprocally, should Denmark and the United States agree that certain Danish companies are similar to U.S. RICs and REITs. In addition, the proposed Protocol includes other updates to the dividend article, including a definition of "diversified" to clarify the application of the REIT provisions adopted in 1999.

The proposed Protocol makes changes to the limitation on benefits provision to tighten the publicly traded test, consistent with the policy reflected in the U.S. Model treaty. It also tightens the limitation on benefits provision by adopting a triangular provision similar to the provision adopted in the proposed Protocol with Finland and in many other U.S. tax treaties; the provision would deny full U.S. treaty benefits to Danish enterprises with respect to certain income exempt from tax in Denmark. The Protocol continues the special rules applicable to Danish taxable nonstock corporations. A Danish taxable nonstock corporation is a vehicle used to prevent takeovers of operating companies through control of voting shares, with public shareholders receiving most rights to dividends of the operating company. Because of the constraints applicable to such corporations, the structure is not likely to be subject to treaty shopping abuses.

The proposed Protocol also amends the current Convention to address individuals who have expatriated. The new language better reflects the current statutory language regarding the taxation of former citizens and long-term residents of the United States. The provision now states that the United States may, for the period of ten years following the loss of such status, tax such individuals in accordance with the laws of the United States.

Following Senate ratification, the proposed Protocol will enter into force upon the receipt of the later of the notifications that the requirements for entry into force have been met in each country. It will have effect within two months of entry into force for taxes withheld at source. With respect to other taxes, the proposed Protocol will have effect January first of the year following the year in which the Protocol enters into force.

Germany

The proposed Protocol was signed in Berlin on June 1, 2006, and amends the current Convention, concluded in 1989. The most significant provisions in this agreement relate to taxation of cross-border dividend payments, coordination of pension rules, and adoption of mandatory arbitration as part of the mutual agreement procedure. The proposed Protocol also makes a number of changes to reflect changes in U.S. and German law, and to bring the Convention into closer conformity with current U.S. tax treaty policy.

As mentioned above, the proposed Protocol eliminates the source-country withholding tax on many intercompany dividends. The proposed Protocol also eliminates withholding tax on cross-border dividend payments to pension funds.

The proposed Protocol updates the current Convention's treatment of pensions. It removes barriers to the flow of personal services between the United States and Germany that could otherwise result from discontinuities in the laws of the two countries regarding the deductibility of pension contributions. Like the U.S. Model treaty, an individual employed in one country who participates in a pension plan in the other may, subject to certain conditions, be allowed in his country of employment to deduct contributions to his plan in the other country. Because significant changes in German law will phase in over time to allow Germany to tax distributions of retirement income rather than taxing contributions and accretions to pension funds, the United States has agreed to consult with Germany in the future (but not before January 1, 2013) to provide for limited source-based taxation of certain distributions of retirement income.
As discussed above, the proposed Protocol provides for mandatory arbitration of certain cases that have not been resolved by the competent authorities within a specified period, generally two years from the commencement of the case. This provision is the first of its kind in a U.S. tax treaty. Under the Protocol, the arbitration process may be used to reach an agreement with respect to certain issues relating to residence, permanent establishment, business profits, associated enterprises, and royalties. The arbitration board must deliver a determination within

nine months of the appointment of the Chair of the Board. Consistent with the current mutual agreement procedure, the taxpayer can terminate arbitration at any time by withdrawing its request for competent authority assistance. The taxpayer also retains the right to litigate in lieu of accepting the result of the arbitration, just as it would be entitled to litigate in lieu of accepting the result of a negotiation under the mutual agreement procedure.

The proposed Protocol makes a number of changes to the current Convention to reflect legislative changes since 1989 and current treaty policy. For example, the proposed Protocol provides that former citizens or long-term residents of the United States may for the period of ten years following the loss of such status be taxed in accordance with the laws of the United States, makes technical changes to the article dealing with the elimination of double taxation, significantly strengthens the treaty's limitation on benefits provisions, and adopts the U.S. Model treaty approach to attribution of profits to a permanent establishment.

Once ratified by the Senate, the proposed Protocol will enter into force upon the exchange of instruments of ratification. For taxes withheld at source, the proposed Protocol will generally have effect January first of the year in which it enters into force. With respect to other taxes, the Protocol generally will have effect January first of the year following the year in which the Protocol enters into force. Special effective date rules apply to arbitration in the mutual agreement process, taxation of income from government service, and coordination of the treaty's nondiscrimination provisions with those of non-tax agreements. The taxpayer may elect to apply the current Convention, as unmodified by the proposed Protocol, for the year following these effective dates.

Belgium

The proposed income tax Convention and accompanying Protocol (the proposed Treaty) with Belgium was negotiated to replace the current Convention, concluded in 1970 and amended by protocol in 1987 (the existing Convention). The proposed Treaty makes a number of changes to conform to changes in U.S. law and to reflect current U.S. tax treaty policy, particularly with respect to exchange of information. Highlights of the proposed Treaty are discussed under appropriate headings below.

a. Taxation of Investment Income

The proposed Treaty is similar to the other agreements before the Committee in that it eliminates the withholding tax on many intercompany dividends. The proposed Treaty eliminates withholding tax on dividends paid by a U.S. company to a Belgian company with respect to a significant (80 percent or more) and long-term (12 month or more) interest, and only if the Belgian company meets special limitation on benefits provisions. Unlike the other agreements, a U.S. company need only own 10 percent or more of a Belgian company to receive such benefits with respect to intercompany dividends. This difference reflects the different tax treaty policy of the countries and Belgian domestic tax initiatives. Consistent with the existing Convention, the proposed Treaty generally allows for taxation at source of five percent on direct dividends (i.e., where a 10-percent-ownership threshold is met) and 15 percent on all other dividends that do not qualify for the zero rate. The proposed Treaty also provides for a withholding rate of zero on cross-border dividend payments to pension funds. The proposed Treaty also updates the dividend article to incorporate policies reflected in the U.S. Model provision, such as those regarding RICs and REITs.

Agreeing to eliminate withholding tax on dividends was key to achieving our important policy goal of improving exchange of information with Belgium. In the proposed Treaty, the United

States reserves the right to terminate this exemption if it is determined that Belgium has not complied with its obligations under the new provisions included in Article 24 (Mutual Agreement Procedure) and Article 25 (Exchange of Information and Administrative Assistance) of the proposed Treaty. If the United States terminates the provision eliminating the withholding tax on dividends, then, as discussed below, Belgium's obligation to provide information held by a bank or other financial institution pursuant to the new exchange of information provision would also terminate.

The proposed Treaty generally eliminates source-country withholding taxes on cross-border interest payments. This is a substantial improvement over the existing Convention, which provides for a general withholding tax rate of 15 percent on such payments, with certain exceptions. Consistent with U.S. tax treaty policy, source-country tax may be imposed on certain contingent interest and payments from a U.S. REMIC.

Consistent with the existing Convention, the proposed Treaty provides that royalties generally may not be taxed at source.

The taxation of capital gains under the proposed Treaty generally follows the format of the U.S. Model treaty. Gains derived from the sale of real property and from real property interests may be taxed by the state in which the property is located. Likewise, gains from the sale of personal property forming part of a permanent establishment situated in a contracting state may be taxed in that state. All other gains, including gains from the alienation of ships, boats, aircraft and containers used in international traffic and gains from the sale of stock in a corporation, are taxable only in the state of residence of the seller.

b. Taxation of Business Income

The proposed Treaty changes the rules in the existing Convention by adopting the U.S. Model approach to attribution of profits to a permanent establishment. The proposed Treaty generally defines a "permanent establishment" in a manner consistent with the U.S. Model treaty.

The proposed Treaty preserves the U.S. right to impose its branch profits tax on U.S. branches of Belgian corporations. The proposed Treaty also accommodates a provision of U.S. domestic law that attributes to a permanent establishment income that is earned during the life of the permanent establishment but not received until after the permanent establishment no longer exists.

The proposed Treaty updates the existing Convention with respect to international transport. It provides, consistent with the U.S. Model treaty, for exclusive residence-country taxation of profits from international transport by ships and aircraft. This reciprocal exemption extends to income from the rental of ships and aircraft on a full basis, as well as income from rentals on a time or voyage basis if the ship or aircraft is operated in international traffic by the lessee or the income is incidental to income from the operation of ships or aircraft in international traffic by the lessor. Income from other rentals of ships or aircraft is treated as business profits under Article 7. As such, this class of income is taxable only in the country of residence of the beneficial owner of the income unless the income is attributable to a permanent establishment in the other country, in which case it is taxable in that country on a net basis. In addition, as provided in the U.S. Model treaty, only the country of residence may tax profits from the maintenance or rental of containers used in international traffic.

c. Taxation of Personal Services Income

The rules for the taxation of income from the performance of personal services under the proposed Treaty are similar to those under the U.S. Model treaty and the existing Convention.

d. Arbitration

Like the proposed Protocol with Germany, the proposed Treaty provides for mandatory arbitration of certain cases before the competent authorities. The arbitration provision and procedures adopted in the proposed Treaty follow closely the approach in the proposed Protocol with Germany, except that Belgium and the United States agreed that the scope of the arbitration process would cover all issues within the purview of the competent authority and that the process must be completed in six months. The agreement with Belgium reflects both countries' recognition of the positive role arbitration can play in facilitating agreement between the competent authorities.

e. Pensions

The proposed Treaty also updates the existing Convention's treatment of pensions. The proposed Treaty removes barriers to the flow of personal services between the countries that could otherwise result from discontinuities in the laws of the countries regarding the deductibility of pension contributions. The proposed Treaty generally allows a deduction in the country where an individual is employed for payments made to a plan resident in the other country, if the structure and legal requirements of such plans in the two countries are similar. Similarly, if a resident of one of the countries participates in a pension plan established in the other country, the country of residence will not tax the income of the pension plan with respect to that resident until a distribution is made from the pension plan. The pension provision in the proposed Treaty recognizes that triangular cases may increasingly arise due to the flows of services within Europe and the North American Free Trade Agreement (NAFTA) countries, and provides for beneficial treatment of contributions and accretions in to certain funds in comparable third states. A comparable third state is a member state of the European Union or the European Economic Area, Switzerland, or a party to NAFTA, provided that treaty provisions with that third state provide certain reciprocal benefits and satisfactory information exchange.

f. Anti-Abuse Provisions

The proposed Treaty also strengthens the limitation on benefits provision and brings it into closer conformity with current U.S. treaty policy. This updated provision is designed to deny "treaty-shoppers" the benefits of the proposed Treaty. Like some of U.S. treaties, the proposed Treaty also allows treaty benefits to certain companies functioning as headquarters for multinational groups if certain conditions are met.

The proposed Treaty preserves the U.S. right to tax individuals who expatriated for tax purposes. The proposed Treaty updates this provision to reflect legislative changes since 1987. Accordingly, the proposed Treaty provides that a former citizen or long-term resident of the United States may, for the period of ten years following the loss of such status, be taxed in accordance with the laws of the United States.

g. Exchange of Information

The information exchange provision of the proposed Treaty specifically addresses a number of problems that have prevented effective information exchange under the existing Convention. The new provision makes clear that Belgium is obligated to provide the United States with such information as is necessary to carry out the provisions of the proposed Treaty and the domestic

laws of the parties. Further, information can be obtained and provided by Belgium whether or not Belgium needs the information for its own tax purposes. The Treasury Department is satisfied that under this provision Belgium is able to provide adequate tax information, including bank information, to the United States.

Finally, as discussed above, if the United States terminates the dividend-withholding-exemption provision, then Belgium will no longer be required to provide information held by a bank or other financial institution.

h. Entry into Force

Following Senate ratification, the proposed Treaty will enter into force upon the exchange of instruments of ratification and notification through diplomatic channels. For taxes withheld at source, the proposed Treaty will generally have effect within two months after entry into force. With respect to other taxes, the proposed Treaty will have effect January first of the year following the year in which the proposed Treaty enters into force. Special effective date rules apply to the limitation on benefits provision relating to headquarters companies, arbitration in the mutual agreement process and exchange of information. In general, the taxpayer may elect to extend the application of the existing Convention (in its entirety) to the 12-month period following the effective dates of this proposed Treaty. However, the election does not affect the effective date of the new exchange of information provisions.

Treaty Program Priorities

We continue to maintain a very active calendar of tax treaty negotiations. We recently signed treaties with Bulgaria and Iceland. We have substantially completed work with Canada and Norway, and we currently are in ongoing negotiations with Chile and Hungary. We also expect to announce soon the onset of other negotiations.

A key continuing priority is updating the few remaining U.S. tax treaties that provide for low withholding tax rates but do not include the limitation on benefits provisions needed to protect against the possibility of treaty shopping. We also have undertaken exploratory discussions with several countries in Asia and South America that we hope will lead to productive negotiations later in 2007 or 2008.

Conclusion

Mr. Chairman and Ranking Member Lugar, let me conclude by thanking you for the opportunity to appear before the Committee to discuss the Administration's efforts with respect to the four agreements under consideration. We appreciate the Committee's continuing interest in the tax treaty program, and the Members and staff for devoting time and attention to the review of these new agreements. We are also grateful for the assistance and cooperation of the staffs of this Committee and of the Joint Committee on Taxation in the tax treaty process.

On behalf of the Administration, we urge the Committee to take prompt and favorable action on the agreements before you today.