TESTIMONY OF WILLIAM A. REINSCH

PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL
ON
THE RATIFICATION OF INCOME TAX TREATIES AND A PROTOCOL

BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS
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Mr. Chairman and Members of the Committee:

The National Foreign Trade Council (NFTC) is pleased to recommend ratification of the treaties and protocols under consideration by the Committee today. We appreciate the Chairman's actions in scheduling this hearing, and we strongly urge the Committee to reaffirm the United States' historic opposition to double taxation by giving its full support to the pending Tax Treaty Protocol agreements with Germany, Finland, and Denmark and the Belgium Tax Treaty and Protocol.

The NFTC, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and we seek to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad. As global competition grows ever more intense, it is vital to the health of U.S. enterprises and to their continuing ability to contribute to the U.S. economy that they be free from excessive foreign taxes or double taxation and impediments to the flow of capital that can serve as barriers to full participation in the international marketplace. Foreign trade is fundamental to the economic growth of U.S. companies. Tax treaties are a crucial component of the framework that is necessary to allow that growth and balanced competition.

This is why the NFTC has long supported the expansion and strengthening of the U.S. tax treaty network and why we are here today to recommend ratification of the Tax Protocols with Germany, Finland, Denmark and the Tax Treaty and Protocol with Belgium.

## GENERAL COMMENTS ON TAX TREATY POLICY

While we are not aware of any opposition to the treaties under consideration, the NFTC, as it has done in the past as a general cautionary note, urges the Committee to reject any opposition to the agreements based on the presence or absence of a single provision. No process as complex as the negotiation of a full-scale tax treaty will be able to produce an agreement that will completely satisfy every possible constituency, and no such result should be expected. Tax treaty relationships arise from difficult and sometimes delicate negotiations aimed at resolving conflicts

between the tax laws and policies of the negotiating countries. The resulting compromises always reflect a series of concessions by both countries from their preferred positions. Recognizing this, but also cognizant of the vital role tax treaties play in creating a level playing field for enterprises engaged in international commerce, the NFTC believes that treaties should be evaluated on the basis of their overall effect. In other words, agreements should be judged on whether they encourage international flows of trade and investment between the United States and the other country. An agreement that meets this standard will provide the guidance enterprises need in planning for the future, provide nondiscriminatory treatment for U.S. traders and investors as compared to those of other countries, and meet an appropriate level of acceptability in comparison with the preferred U.S. position and expressed goals of the business community.

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

The NFTC wishes to emphasize how important treaties are in creating, implementing, and preserving an international consensus on the desirability of avoiding double taxation, particularly with respect to transactions between related entities. The tax laws of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners, and treaties are the mechanism by which these taxes are lowered on a bilateral basis. If U.S. enterprises cannot enjoy the reduced foreign withholding rates offered by a tax treaty, noncreditable high levels of foreign withholding tax leave them at a competitive disadvantage relative to traders and investors from other countries that do enjoy the treaty benefits of reduced withholding taxes. Tax treaties serve to prevent this barrier to U.S. participation in international commerce.

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

Tax treaties also provide other features that are vital to the competitive position of U.S. businesses. For example, by prescribing internationally agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring foreign tax laws to be applied in a nondiscriminatory manner to U.S. enterprises, treaties offer a significant measure of certainty to potential investors. Another extremely important benefit which is available exclusively under tax treaties is the mutual agreement procedure. This bilateral administrative mechanism avoids double taxation on cross-border transactions.

The United States, together with many of its treaty partners, has worked long and hard through the OECD and other fora to promote acceptance of the arm's length standard for pricing

transactions between related parties. The worldwide acceptance of this standard, which is reflected in the intricate treaty network covering the United States and dozens of other countries, is a tribute to governments' commitment to prevent conflicting income measurements from leading to double taxation and resulting distortions and barriers for healthy international trade. Treaties are a crucial element in achieving this goal, because they contain an expression of both governments' commitment to the arm's length standard and provide the only available bilateral mechanism, the competent authority procedure, to resolve any disputes about the application of the standard in practice.

We recognize that determination of the appropriate arm's length transfer price for the exchange of goods and services between related entities is sometimes a complex task that can lead to good faith disagreements between well-intentioned parties. Nevertheless, the points of international agreement on the governing principles far outnumber any points of disagreement. Indeed, after decades of close examination, governments around the world agree that the arm's length principle is the best available standard for determining the appropriate transfer price, because of both its economic neutrality and its ability to be applied by taxpayers and revenue authorities alike.

The NFTC strongly supports the efforts of the Internal Revenue Service and the Treasury to promote continuing international consensus on the appropriate transfer pricing standards, as well as innovative procedures for implementing that consensus. We applaud the continued growth of the APA program, which is designed to achieve agreement between taxpayers and revenue authorities on the proper pricing methodology to be used, before disputes arise. We commend the ongoing efforts of the IRS to refine and improve the operation of the competent authority process under treaties, to make it a more efficient and reliable means of avoiding double taxation.

The NFTC also wishes to reaffirm its support for the existing procedure by which Treasury consults on a regular basis with this Committee, the tax-writing Committees, and the appropriate Congressional staffs concerning tax treaty issues and negotiations and the interaction between treaties and developing tax legislation. We encourage all participants in such consultations to give them a high priority. We also commend this Committee for scheduling tax treaty hearings so soon after receiving the agreements from the Executive Branch. Doing so enables improvements in the treaty network to enter into effect as quickly as possible.

We would also like to reaffirm our view, frequently voiced in the past, that Congress should avoid occasions of overriding the U.S. tax treaty commitments that are approved by this Committee by subsequent domestic legislation. We believe that consultation, negotiation, and mutual agreement upon changes, rather than unilateral legislative abrogation of treaty commitments, better supports the mutual goals of treaty partners.

## AGREEMENTS BEFORE THE COMMITTEE

The German, Finnish and Danish Protocols, and the Belgian Tax Treaty that are before the committee today update agreements between the U.S. and these countries that were signed many years ago. The protocols improve conventions that have stimulated increased investment, greater transparency, and a stronger economic relationship between our countries.

The NFTC has consistently urged adjustment of U.S. treaty policies to allow for a zero withholding rate on related-entity dividends, and we congratulate the Treasury for making further progress in these Protocols and Treaty. These agreements make an important contribution toward improving the economic competitiveness of U.S. companies. Indeed, the Protocols bolster and improve upon the standard set in the United Kingdom, Australian, and Mexican agreements ratified just over two years ago, as well as the more recent Japanese tax treaty, by lowering the ownership threshold required to receive the benefit of the zero dividend withholding rate from 100 to 80 percent. We thank the committee for its prior support of this evolution in U.S. tax treaty policy and we strongly urge you to continue that support by approving all four of these Tax Treaties and Protocols.

The existence of a withholding tax on cross-border, parent-subsidiary dividends, even at the five percent rate previously typical in U.S. treaties, has served as a tariff-like impediment to cross border investment flows. These withholding taxes are imposed in addition to the income taxes already paid and often result in a lower return compared to the comparable investment of a foreign competitor. Tax treaties are designed to prevent this distortion in the investment decision-making process by reducing the multiple taxation of profits within a corporate group, and they serve to prevent the hurdle to U.S. participation in international commerce. Eliminating the withholding tax on cross-border dividends means that U.S. companies with stakes in German, Finnish, Danish and Belgian companies will now be able to meet their foreign competitors on a level playing field. The German protocol would apply with respect to withholding taxes paid or credited on or after January 1 of the year in which the protocol comes into force. The other three protocols are effective upon ratification.

Additionally, important safeguards included in these protocols prevent “treaty shopping”. In order to qualify for the lowered rates specified by the treaties, companies must meet certain requirements so that foreigners whose governments have not negotiated a tax treaty with Germany, Finland, Denmark, Belgium or the U.S. cannot free-ride on this treaty. Similarly, provisions in the sections on dividends, interest, and royalties prevent arrangements by which a U.S. company is used as a conduit to do the same. Extensive provisions in the treaties are intended to ensure that the benefits of the treaty accrue only to those for which they are intended. All four of the Tax Treaties and Protocols contain good limitations on benefits provision.

The German Protocol provides for mandatory arbitration of certain cases that cannot be resolved by the competent authorities within a specified period of time. This provision is the first of its kind in a U.S. tax treaty. The provision is limited in its scope with respect to the cases eligible for mandatory arbitration. The Belgium Tax Treaty includes a more broadly defined mandatory arbitration provision. The Belgium treaty provision covers all cases where the competent authorities cannot reach agreement. NFTC member companies view tax treaty arbitration as a tool to strengthen, not replace, the existing treaty dispute resolution procedures conducted by the competent authorities. The existing procedures work well to resolve the great majority of disputes with the great majority of treaty partners, but they are not always adequate to address the most problematic cases and relationships. The inclusion of the arbitration provisions in the German Tax Protocol and the Belgium Tax Treaty will greatly facilitate the mutual agreement procedures in all competent authority cases.

## IN CONCLUSION

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

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