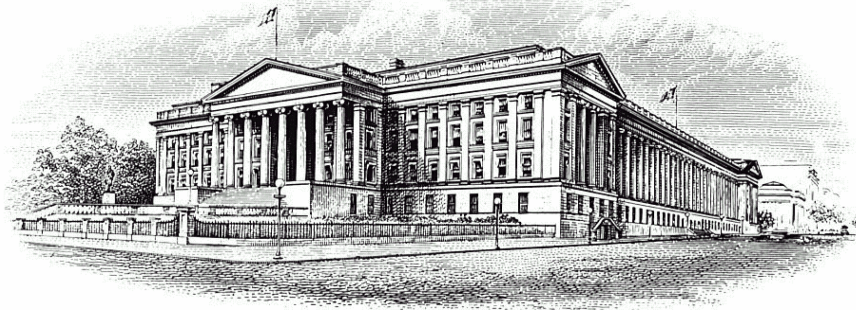

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

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TESTIMONY OF
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UNITED STATES DEPARTMENT OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS
ON PENDING INCOME TAX AGREEMENTS

Mr. Chairman and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing to recommend, on behalf of the Administration, favorable action on three income tax agreements that are pending before this Committee. We appreciate the Committee's interest in these agreements 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; 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 2000 bilateral tax treaties has established a stable framework that allows international trade and investment to flourish. The success of this framework is evidenced by the fact that the millions of cross-border transactions that take place around the world each year give rise to relatively few disputes regarding the allocation of tax revenues between governments.

The Administration believes that these three agreements, which update important treaty relationships with the United Kingdom, Australia and Mexico, would provide significant benefits to the United States and to our treaty partners, as well as our respective business communities. We request the Committee and the Senate to take prompt and favorable action on all three agreements.

Purposes and Benefits of Tax Treaties

Tax treaties provide benefits to both taxpayers and governments by setting out clear ground rules that will govern tax matters relating to trade and investment between the two countries. A tax treaty is intended to mesh the tax systems of the two countries in such a way that there is little potential for dispute regarding the amount of tax that should be paid to each country. The goal is to ensure that taxpayers do not end up caught in the middle between two governments, each of which would like to tax the same income. Once a treaty relationship is in place and working as it should, governments need expend little additional resources negotiating to resolve individual cases because the general principles for taxation of cross-border transactions and activities will have been agreed in the treaty.

One of the primary functions of tax treaties is to provide certainty to taxpayers with respect to the "threshold" question – that is, whether the taxpayer's cross-border activities will subject it to taxation by two or more countries. Treaties answer this question by establishing the minimum level of economic activity that a resident of one country must engage in within the other country before the latter country may tax any resulting business profits. In general terms, tax treaties provide that if the branch operations have sufficient substance and continuity, the country where the activities occur will have primary (but not exclusive) jurisdiction to tax. In other cases, where the operations are relatively minor, the home country retains the sole jurisdiction to tax its residents. In the absence of a tax treaty, a U.S. company operating a branch or division or providing services in another country might be subject to income tax in both the United States and the other country on the income generated by such operations. Although the United States generally provides a credit against U.S. tax liability for foreign taxes paid, there remains potential for resulting double taxation that could make an otherwise attractive investment opportunity unprofitable, depriving both countries of the benefits of increased cross-border investment.

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 determining the residence of a taxpayer that otherwise would be a resident of both countries. Second, with respect to each category of income, the treaty assigns the "primary" right to tax to one country, usually (but not always) the country in which the income arises (the "source" country), and the "residual" right to tax to the other country, usually (but not always) the country of residence of the taxpayer. Third, the treaty provides rules for determining which country will be treated as the source country for each category of income. Finally, the treaty establishes both limitations on the amount of tax that the source country can impose on each category of income and 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, 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 Acompetent authorities@ in tax treaty parlance – are to consult and reach an agreement under which the taxpayer's income is allocated between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation that might otherwise result. The U.S. competent

authority under our tax treaties is the Secretary of the Treasury. That function has been delegated to the Director, International (LMSB) of the Internal Revenue Service.

In addition to reducing potential double taxation, treaties also reduce "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 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 having suffered "excessive" taxation.

Tax treaties alleviate this burden by providing maximum levels of withholding tax that the treaty partners may impose on these types of income. In general, U.S. tax treaty policy is to reduce the rate of withholding tax on interest and royalties to zero, so that such payments are taxed exclusively in the country of residence and not in the country of source. In contrast, U.S. tax treaties have allowed some source-country taxation of dividends, with many U.S. treaties providing for a maximum source-country withholding tax of 5 percent on dividends paid to direct corporate investors and a maximum source-country withholding tax of 15 percent on dividends paid to all other shareholders. Over the years, U.S. treaty negotiators have considered proposals to treat intercompany dividends in the same manner as interest and royalties and therefore to provide for exclusive residence-country taxation of intercompany dividends in some cases. The three treaties before the Committee are the first U.S. tax treaties to do so.

Our 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. While this is similar to a basic investor protection provided in several types of agreements, the non-discrimination provisions of tax treaties are more effective because they are specifically tailored to tax concerns. They provide guidance about what "national treatment" means in the tax context by specifically prohibiting types of discriminatory measures that once were common in some tax systems. At the same time, they clarify the manner in which 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.

Treaties also include provisions dealing with more specialized situations. Some of these provisions are becoming increasingly important as the number of individuals engaged in cross-border activities increases. For example, provisions coordinating the pension rules of the tax systems of the two countries are needed to ensure that individuals who are expecting in their retirement to be subject to a certain manner and level of taxation do not find their pensions eaten into by unexpected taxation by another country. Other quite specific rules address the treatment of employee stock options, Social Security benefits, and alimony and child support in the cross-border context. While these subjects may not involve a lot of revenue from the perspective of

the two governments, rules providing clear and appropriate treatment can be very important to each of the individual taxpayers who are affected.

Other treaty provisions deal with the administration of the treaty and, to a certain extent, the domestic tax law of the two countries. One of the most important of these is the provision addressing the exchange of information between the tax authorities. Under tax treaties, the competent authority of one country may provide to the other competent authority such information as may be necessary for the proper administration of that country's tax laws, subject to strict protections on the confidentiality of taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank secrecy rules that would prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not conclude a treaty with that country. In fact, information exchange is a matter we raise with the other country before commencement of formal negotiations because it is one of a very few matters that we consider non-negotiable.

Treaty Program and Negotiation Priorities

The United States has a network of 56 bilateral income tax treaties, the oldest of which currently in force now dates from 1950. This network includes all 29 of our fellow members of the OECD and covers the vast majority of foreign trade and investment of U.S. companies.

The Treasury Department is working to renegotiate our older tax treaties to ensure that they reflect current U.S. tax treaty policy. The treaties before you are evidence of how even good treaty relationships can be made better. At the same time, we are actively working to establish new treaty relationships that will fill gaps in our treaty network.

In establishing priorities, our primary objective is the conclusion of treaties or protocols that will provide the greatest benefits 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 they face with respect to the application of particular treaties and the application of the tax regimes of particular countries.

The U.S. commitment to including comprehensive provisions designed to prevent "treaty-shopping" in all of our tax treaties is one of the keys to improving our overall treaty network. Our tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes agreed to in a particular treaty mean that U.S. persons pay less tax to that country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents can exploit one of our treaties to secure reductions in U.S. tax, the benefits would flow only in one direction. Such use of treaties is not consistent with the balance of the deal negotiated. Moreover, preventing this exploitation of our treaties is critical to ensuring that the third country will sit down at the table with us to negotiate

benefits and reductions in tax 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.

Treaty-shopping can take a number of forms, but it generally involves a resident of a third country that either has no treaty with the United States or has a treaty that offers relatively less benefit. The third-country resident establishes an entity in a treaty partner that has a relatively more favorable treaty with the United States in order to hold title to the resident's investments in the United States, which could range from portfolio stock investments to substantial operating subsidiaries. By interposing the new entity so that the U.S. investment appears to be made through the treaty partner, the third-country resident is able to withdraw the returns from the U.S. investment subject to the favorable rates of tax provided in the tax treaty, rather than the higher rates that would be imposed on such returns if the person had held the U.S. investments directly.

If treaty-shopping is allowed to occur, then there is less incentive for the third country with which the United States has no treaty (or has a treaty that does not reflect our preferred positions on reductions in source-country withholding taxes) to negotiate a tax treaty with the United States. The third country could maintain inappropriate barriers to investment and trade from the United States and yet its companies could obtain the benefits of lower U.S. tax by organizing their investment and trade in the United States so that they flow through a country with a favorable tax treaty with the United States.

For these reasons, all recent U.S. tax treaties contain comprehensive "limitation on benefits" provisions that limit the benefits of the treaty to *bona fide* residents of the treaty partner. These provisions are not uniform, as each country has particular characteristics that affect both its attractiveness as a country through which to treaty shop and the mechanisms through which treaty shopping may be attempted. Consequently, the specific limitation on benefits provision in each treaty must to some extent be tailored to fit the facts and circumstances of the treaty partner's internal laws and practices. Moreover, the provisions need to strike a balance that prevents the inappropriate exploitation of treaty benefits while ensuring that the treaty benefits flow smoothly to the legitimate and desirable economic activity for which the benefits were intended.

Despite the protections of the limitation on benefits provisions, there may be countries with which we choose not to have a tax treaty because of the possibility of abuse. With other countries there may not be the type of cross-border tax issues that are best resolved by treaty. For example, we generally do not conclude tax treaties with jurisdictions that do not impose significant income taxes, because there is little possibility of double taxation of income in such a case. In such cases, an agreement focused on the exchange of tax information can be very valuable in furthering the goal of reducing U.S. tax evasion.

The situation is more complex when a country adopts a special preferential regime for certain parts of the economy that is different from the rules generally applicable to the country's residents. In those cases, the residents benefiting from the preferential regime do not face potential double taxation and so should not be entitled to reductions in U.S. withholding taxes, while a treaty relationship might be useful and appropriate in order to avoid double taxation in the case of the residents who do not receive the benefit of the preferential regime. Accordingly,

in some cases we have treaty relationships that carve out certain residents and activities from the benefits of the treaty. In other cases, we have determined that economic relations with the relevant country were such that the potential gains from a treaty were not sufficient to outweigh the risk of abuse, and have therefore decided against entering into a tax treaty relationship (or have terminated an existing relationship).

Prospective treaty partners must indicate that they understand their obligations under the treaty, including those with respect to information exchange, and must demonstrate that they are able to comply with those obligations. Sometimes a potential treaty partner is unable to do so. In other cases we may feel that a treaty is inappropriate because the potential treaty partner may be unwilling to address in the treaty real tax problems identified by U.S. businesses operating there. Lesser developed and newly emerging economies, for which capital and trade flows with the United States are often disproportionate or virtually one-way, may not be willing to reduce withholding taxes to a level acceptable to the United States because of concerns about the short-term effects on tax revenues.

The primary constraint on the size of our tax treaty network, however, may be the complexity of the negotiations themselves. The various functions performed by tax treaties, and particularly the goal of meshing two different tax systems, make the negotiation process exacting and time-consuming. While the starting point for all U.S. tax treaty negotiations is the U.S. Model Tax Convention, it is never the ending point.

A country's tax policy, as reflected in its domestic tax legislation as well as its tax treaty positions, reflects the sovereign choices made by that country. Numerous features of the treaty partner's unique tax legislation and its interaction with U.S. domestic tax rules must be considered in negotiating an appropriate treaty. Examples include whether the country eliminates double taxation through an exemption or a credit system, the country's treatment of partnerships and other transparent entities, and how the country taxes contributions to pension funds, the funds themselves, and distributions from the funds. A treaty negotiation must take into account all of these and many other aspects of the treaty partner's tax system in order to arrive at an acceptable treaty from the perspective of the United States. Accordingly, a simple side-by-side comparison of two treaties, or of a proposed treaty against a model treaty, will not enable meaningful conclusions to be drawn as to whether a proposed treaty reflects an appropriate balance. Moreover, there may be differences that are of little substantive importance, reflecting language issues, cultural obstacles or other impediments to the use of particular U.S. or other model text.

Each treaty is the result of a negotiated bargain between two countries that often have conflicting objectives. Each country has certain positions that it considers non-negotiable. The United States, which insists on effective anti-treaty-shopping and exchange of information provisions, and which must accommodate its uniquely complex tax laws, probably has more non-negotiable positions than most countries. For example, every U.S. treaty must contain the Asaving clause@, which permits the United States to tax its citizens and residents as if the treaty had not come into effect, and allow the United States to apply its rules applicable to former citizens and long-term residents. Other U.S. tax law provisions that may complicate negotiations are the branch profits tax and the branch level interest tax, rules regarding contingent interest, real estate mortgage

investment conduits, real estate investment trusts and regulated investment companies, and the Foreign Investors in Real Property Tax Act rules.

Obtaining the agreement of our treaty partners on provisions of importance to the United States sometimes requires other concessions on our part. Similarly, other countries sometimes must make concessions to obtain our agreement on matters that are critical to them. In most cases, the process of give-and-take produces a document that is the best treaty that is possible with that other country. In others, 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. Accordingly, each treaty that we present here represents not only the best deal that we believe we can achieve with the particular country at this time, but also constitutes an agreement that we believe is in the best interests of the United States.

Discussion of Treaties and Protocols

I would now like to discuss the importance and purposes of each agreement that has been transmitted for your consideration. We have submitted Technical Explanations of each agreement that contain detailed discussions of the provisions of each treaty and protocol. These Technical Explanations serve as an official Treasury Department guide to each agreement. Before discussing the individual treaties, however, I would like to discuss a development common to all three agreements.

Elimination of Source Country Tax on Certain Intercompany Dividends

As discussed above, U.S. tax treaty policy for many years has been to eliminate (or when that is not possible, to substantially reduce) source-country withholding taxes on interest and royalties. By contrast, the United States regularly reduces by treaty the withholding tax on intercompany dividends but has never agreed in a treaty to eliminate source-country withholding taxes on intercompany dividends. These three agreements each include provisions eliminating source-country withholding taxes on intercompany dividends if certain conditions are satisfied. Treasury believes that this is an appropriate development in light of our overall treaty policy of reducing tax barriers to cross-border investment and in the context of these three treaty relationships.

Bilateral reductions in source-country withholding taxes have two offsetting effects on U.S. tax revenues in the short term. Reductions in the U.S. withholding taxes imposed on foreign persons with investments in the United States represent a short-term static reduction in U.S. tax revenues. On the other hand, reductions in foreign withholding taxes imposed on U.S. persons with foreign investments represent a short-term static increase in tax revenues for the United States because the U.S. persons that pay less in foreign withholding taxes therefore claim less in foreign tax credits to offset their U.S. tax liability. When U.S. companies receive more in payments from their foreign subsidiaries than U.S. subsidiaries make in payments to their foreign parents, the reduction in foreign tax credit claims will offset the reduction in withholding tax collections. This should hold true with respect to dividends, as U.S. companies receive significantly more direct dividends from abroad than foreign companies receive from the United States.

Reductions in foreign withholding taxes borne by U.S. taxpayers result in a direct benefit to the U.S. fisc to the extent that the U.S. taxpayer otherwise would have been able to use the foreign tax credits associated with such withholding taxes to offset its U.S. tax liability. Reductions in foreign withholding taxes result in a direct benefit to the U.S. taxpayer to the extent that the taxpayer could not have used the foreign tax credits to offset its U.S. tax liability because of applicable limitations of domestic law. In cases where the U.S. taxpayer has excess foreign tax credits, a reduction in foreign withholding taxes represents a dollar-for-dollar reduction in its overall tax burden. The reduction in foreign withholding taxes thus represents a reduction in costs that may increase competitiveness in connection with international business opportunities.

For example, if a U.S. company is considering an investment in a foreign country, it of course must consider the after-tax cost of that investment. If the potential investment is the purchase of an existing business in a foreign country, the U.S. company likely will compete against bidders from other countries. If the U.S. company is in an excess foreign tax credit position, any withholding tax paid to the host country will decrease the U.S company's expected return on the foreign investment. If another bidder is not subject to the host country withholding tax (perhaps because of its home country's treaty relationship with the host country), it may be willing to pay a higher price for the target.

Similarly, a foreign company that is in an excess foreign tax credit position in its home country might be discouraged from investing in the United States because of the five percent withholding tax that the United States is permitted to impose on direct investment dividends under most of its tax treaties. The same is true of a company that is based in a country that relieves double taxation by exempting direct investment dividends from taxation. In either case, the imposition of a five percent U.S. withholding tax reduces the return on the investment in the United States dollar-for-dollar. Eliminating the withholding tax by treaty therefore may encourage inbound investment. Increased investment in the United States means more jobs, greater productivity and higher wage rates.

The historical U.S. position of not eliminating by treaty withholding taxes on direct investment dividends was consistent with general treaty practice throughout the world. When most major trading partners imposed such a tax, then the tax would not create the competitive advantages and disadvantages described above, since every company would be subject to it. In addition, many of our treaties were negotiated at a time when corporate tax rates in Europe tended to be higher than those in the United States, making it less likely for foreign companies to be in an excess foreign tax credit position. As a result, a five percent U.S. withholding tax on direct investment may not have been seen as a significant cost of doing business here. However, more and more countries are eliminating their withholding taxes on intercompany dividends. In this regard, it should be noted that the Parent-Subsidiary Directive adopted by the European Union in 1990 eliminated all withholding taxes on dividends paid by a subsidiary in one EU member country to a parent in another of the fifteen (soon to be 25) members of the European Union. Moreover, corporate tax rates have been falling around the world. In this climate, it was appropriate for the United States to consider agreeing by treaty to eliminate source-country withholding taxes on certain intercompany dividends.

We believe that it is in the interest of the United States to take a flexible approach, agreeing to eliminate the withholding tax on intercompany dividends in appropriate cases. This would not be a blanket change in policy, and the Treasury Department does not recommend a change to the U.S. negotiating position in this respect, because it may not be appropriate to agree to such reductions in every treaty with every country. Therefore, we would approach each case individually.

Some key parameters apply across the board. We do not believe that it is appropriate to eliminate source-country taxation of intercompany dividends by treaty unless the treaty contains anti-treaty-shopping rules that meet the highest standards and the information exchange provision of the treaty is sufficient to allow us to confirm that the requirements for entitlement to this benefit are satisfied. Strict protections against treaty shopping are particularly important when the elimination of withholding taxes on intercompany dividends is included in relatively few U.S. treaties.

In addition to these conditions, we must be satisfied with the overall balance of the treaty. This assessment will be relatively simple in cases where the other country imposes a withholding tax on dividends comparable to the U.S. withholding tax and the dividend flows are roughly equal (or favor the United States). In other cases, eliminating withholding taxes on intercompany dividends nevertheless may be appropriate if the United States benefits from concessions made by the other country with respect to other provisions of the treaty. As with many treaty elements, it is a matter of balance. Finally, there may be cases where the elimination of withholding taxes by treaty is desirable from the U.S. perspective in order to lock in a treaty partner whose domestic law regarding withholding taxes may be in flux and to establish certainty and stability with respect to the tax treatment of investments in a particular country. We do not believe that we should attempt now to set all the parameters for when elimination of source-country withholding taxes on intercompany dividends is appropriate and when it is not. The optimal treatment of source-country withholding taxes on intercompany dividends must be considered in the context of each treaty relationship.

<u>United Kingdom</u>

The proposed Convention with the United Kingdom was signed in London on July 24, 2001, and was amended by a Protocol, signed in Washington on July 19, 2002. The Convention is accompanied by an exchange of diplomatic notes, also dated July 24, 2001. The Convention, Protocol and notes replace the existing Convention, which was signed in London in 1975 and modified by subsequent notes and protocols. The proposed Convention generally follows the pattern of other recent U.S. treaties and the U.S. Model treaty.

A significant impetus for the re-negotiation of the U.S.-U.K. tax treaty was the impact on the operation of the treaty of changes made by the United Kingdom to its domestic laws regarding the treatment of dividends. The dividend article of the current treaty (along with corresponding provisions of the article regarding foreign tax credits) contains unusual rules intended to extend to U.S. shareholders the benefit of the United Kingdom's imputation system for the taxation of dividends, while dividing the cost of that benefit between the United States and the United

Kingdom. Changes in the United Kingdom's domestic system for taxing dividends mean that the provisions no longer work as intended.

The start of negotiations also provided an opportunity to bring the treaty into greater conformity with U.S. tax treaty policy. The current treaty does not include an effective anti-treaty-shopping provision, and it grants a waiver of the insurance excise tax without the anti-abuse protection that has become standard in other U.S. tax treaties. There were substantial problems under the information exchange provisions of the current treaty because the United Kingdom could obtain information for the United States only if it too needed the information for its own domestic tax purposes. Moreover, because the treaty was negotiated in the late 1970's, it did not include any of the provisions that are included in modern treaties to reflect the changes in U.S. domestic law made over the last 20 years.

The maximum withholding tax rates on investment income in the proposed Convention are the same or lower than those in the existing treaty. Although the Convention continues the rule under which the country of source may tax direct investment dividends and portfolio dividends at a maximum rate of 5 and 15 percent, respectively, the proposed Convention provides for a withholding rate of zero percent on dividends from certain 80-percent-owned corporate subsidiaries and those derived by pension plans. The proposed Convention was the first income tax treaty signed by the United States that contains this elimination of source-country tax for intercompany dividends.

Dividends paid by non-taxable conduit entities, such as U.S. regulated investment companies and real estate investment trusts, and any comparable investment vehicles in the United Kingdom, are subject to special rules to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available.

The proposed Convention, like the existing treaty and the U.S. Model, provides for the elimination of source-country tax on interest and royalties. Excess inclusions with respect to residual interests in U.S. real estate mortgage investment conduits may be taxed under U.S. domestic rules, without regard to the rest of the provisions relating to interest, and contingent interest may be taxed by the source country at a maximum rate of 15 percent rate.

The proposed Convention confirms that the United States generally will not impose the excise tax on insurance policies issued by foreign insurers if the premiums on such policies are derived by a U.K. enterprise. This rule is a continuation of the waiver of the excise tax that applies under the existing Convention. However, the proposed Convention has been improved through the addition of an anti-abuse rule that will prevent companies in third countries that do not benefit from a waiver of the insurance excise tax from using a U.K. insurance company as a conduit to avoid imposition of the tax.

The proposed Convention provides for exclusive residence-country taxation of profits from the operation in international traffic of ships or aircraft, including profits from the rental of ships and aircraft on a full basis, or on a bareboat basis if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. All income from the use, maintenance or

rental of containers used in international traffic is likewise exempt from source-country taxation under the proposed Convention.

The proposed Convention carries over from the existing treaty special rules regarding offshore exploration and exploitation activities. These rules were included at the request of the United Kingdom. The proposed Convention reflects technical changes to avoid some unintended consequences of the old rules and provides a slightly higher threshold for taxation of employees working in the offshore oil sector.

The proposed Convention contains rules to coordinate the two countries' regimes for the tax treatment of pensions and pension contributions. These rules are more comprehensive than those in recent U.S. treaties and the existing Convention. Under the proposed Convention, the United States and the United Kingdom each will treat pension plans established in the other State the same way comparable domestic plans are treated. A similar rule applies to earnings and accretions of pension plans and to employer contributions to pension plans. In addition, the proposed Convention provides for the exclusive residence-based taxation of Social Security payments, which is different from the U.S. Model but consistent with the existing Convention.

The proposed Convention also deals with income earned by entertainers and sportsmen, corporate directors, government employees and students in a manner consistent with the rules of the U.S. Model. The Convention continues a host-country exemption for income earned by teachers that is found in the existing treaty, although not in the U.S. Model.

The proposed Convention contains comprehensive rules in its "Limitation on Benefits" article, designed to deny "treaty-shoppers" the benefits of the Convention. This article is essentially the same as the limitation on benefits articles contained in recent U.S. treaties.

At the request of the United Kingdom, the proposed Convention includes an additional limit on the availability of certain treaty benefits obtained in connection with "conduit arrangements." The conduit arrangement test may apply to deny treaty benefits in certain tax avoidance cases involving the payment of insurance premiums, dividends, interest, royalties, or other income. The conduit arrangement test is not contained in the U.S. Model. The test is designed primarily to allow the United Kingdom to address treaty shopping transactions that would not be caught by the limitation on benefits article of the proposed Convention. U.K. domestic law does not provide sufficient protection against such abusive transactions, but U.S. domestic law does. The tax authorities of the two countries have agreed on an interpretation of the term "conduit arrangement" that is consistent with existing tax avoidance doctrines and measures under U.S. law.

The proposed Convention provides relief from double taxation in a manner consistent with the U.S. Model and eliminates the provision of the existing treaty that obligates the United States to provide a foreign tax credit for "phantom" dividend withholding taxes. The proposed Convention also contains a re-sourcing rule to ensure that a U.S. resident can obtain a U.S. foreign tax credit for U.K. taxes paid when the Convention assigns to the United Kingdom primary taxing rights over an item of gross income. A comparable rule applies for purposes of the U.K. foreign tax

credit. Although the U.S. Model does not contain a re-sourcing rule, the existing Convention contains a similar rule.

Like the existing treaty, the proposed Convention provides a credit for the U.K. Petroleum Revenue Tax, limited to the amount of the tax attributable to sources within the United Kingdom. The credit allowed by the proposed Convention is somewhat broader than that allowed under the existing Convention to account for intervening changes in U.S. domestic law.

The proposed Convention provides for non-discriminatory treatment (i.e., national treatment) by one country to residents and nationals of the other. Also included in the proposed treaty are rules necessary for administering the treaty, including rules for the resolution of disputes under the Convention. The information exchange provisions generally follow the U.S. Model and make clear that the United Kingdom will provide U.S. tax officials such information as is relevant to carry out the provisions of the Convention and the domestic tax laws of the United States. Inclusion of this U.S. Model provision was made possible by a recent change in U.K. law.

Australia

The proposed Protocol to the Income Tax Convention with Australia was signed in Canberra on September 27, 2001. It was negotiated to bring the current Convention, concluded in 1982, up to date and into closer conformity with current U.S. tax treaty practice, while also incorporating some provisions found in the Australian Model income tax convention.

The most important aspects of the proposed Protocol deal with the taxation of cross-border dividend, royalty and interest payments. The current treaty provides for levels of source-country taxation that are consistent with Australian treaty practice but substantially higher than the preferred U.S. position. We were able to negotiate substantial reductions with respect to all three categories of payments.

Whereas the existing Convention allows for taxation at source of 15 percent on all dividends, the proposed Protocol provides for a maximum source-country withholding tax rate of 5 percent on direct dividends that meet a 10 percent ownership threshold. The proposed Protocol also provides for the elimination of the source-country withholding taxes with respect to dividends from certain 80 percent owned corporate subsidiaries. Portfolio dividends will continue to be subject to a 15 percent rate of withholding. Australia imposes a withholding tax on dividends paid out of earnings that have not been subject to full corporate tax ("unfranked dividends"), which will be eliminated under the proposed Protocol.

Dividends paid by U.S. regulated investment companies and real estate investment trusts are subject to special rules to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available. The provision was adapted to recognize the special investment structure of Australian unit trusts and their participation in the U.S. REIT industry.

The proposed Protocol provides for the elimination of source-country withholding taxes on interest payments in two key cases. Interest derived by a financial institution that is unrelated to the payor and interest paid to governmental entities are exempt from withholding tax at source.

All other types of interest (including interest received by financial institutions in back-to-back loans or their economic equivalent) continue to be subject to source-country withholding tax at the 10 percent maximum rate prescribed in the existing Convention.

The proposed Protocol also reduces the maximum level of withholding tax on royalty payments from the 10 percent limit prescribed in the existing Convention to 5 percent. The existing Convention treats rental payments for the use of or the right to use any industrial, commercial or scientific equipment as royalties that may be taxed by the source country at a maximum rate of 10 percent. The proposed Protocol eliminates the source-country withholding tax on such income by treating this category of income as business profits. These changes in the treatment of royalties represent a major concession by Australia, which has never agreed in a treaty to lower its withholding tax on royalties below 10 percent.

The proposed Protocol brings the existing Convention's treatment of income from the operation of ships, aircraft and containers in international traffic closer to that of the U.S. Model. The proposed Protocol provides for exclusive residence-country taxation of profits from the rental of ships and aircraft on a bareboat basis when the rental activity is incidental to the operation in international traffic of ships or aircraft by the lessor. All income from the use, maintenance or rental of containers used in international traffic is likewise exempt from source-country taxation under the proposed Protocol.

The proposed Protocol clarifies that Australia's tax on capital gains will be a covered tax for purposes of the existing Convention. This closes a gap in the existing Convention and increases the likelihood that U.S. taxpayers subject to capital gains tax in Australia will be able to claim a foreign tax credit with respect to that tax thereby avoiding potential double taxation. The proposed Protocol generally preserves the existing Convention's tax treatment of capital gains, while incorporating some aspects of Australia's domestic law regarding expatriation. The proposed Protocol also provides rules that coordinate both countries' tax systems with respect to these expatriation rules.

The proposed Protocol contains an updated version of a comprehensive "Limitation on Benefits" article, designed to deny "treaty-shoppers" the benefits of the Convention. This article is essentially the same as the limitation on benefits article contained in recent U.S. treaties.

The current Convention preserves the U.S. right to tax former citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax. The proposed Protocol expands this right to include former long-term residents whose loss of such status had, as one of its principal purposes, the avoidance of tax. Therefore, the United States may fully apply the provisions of section 877 of the Internal Revenue Code.

Mexico

The proposed Protocol to the Income Tax Convention with Mexico was signed in Mexico City on November 26, 2002. It was negotiated to bring the existing Convention, concluded in 1992, into closer conformity with current U.S. tax treaty policy.

The major feature of the proposed Protocol is the treatment of intercompany dividends. As in the agreements with the United Kingdom and Australia, the proposed Protocol eliminates source-country withholding taxes on certain types of cross-border direct dividends. Under the existing Convention, dividends may be taxed by the country of source at a maximum rate of 5 percent on direct dividends (where the recipient of the dividends owns at least 10 percent of the company paying the dividends) and 10 percent with respect to all other dividends. The proposed Protocol eliminates withholding taxes with respect to dividends from certain 80-percent owned corporate subsidiaries. The other rules will remain in place with respect to those dividends that do not qualify for the elimination of the source-country withholding tax. Dividends paid to qualified pension funds also will be exempt from withholding tax at source.

While Mexico does not currently impose a withholding tax on dividends, it has enacted such a tax and then repealed it since the existing treaty was negotiated in the early 1990's. As a result, locking in the elimination of source-country withholding taxes on intercompany dividends will provide greater certainty to U.S. taxpayers regarding the long-term tax environments for their investments in Mexico.

Dividends paid by U.S. regulated investment companies and real estate investment trusts are subject to special rules to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available.

The current treaty preserves the U.S. right to tax former citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax. The proposed Protocol expands this right to include former long-term residents whose loss of such status had, as one of its principal purposes, the avoidance of tax. Therefore, the United States may fully apply the provisions of section 877 of the Internal Revenue Code.

The proposed Protocol incorporates a modernized provision regarding the source of income that will be more effective in eliminating double taxation. Under the new provision, income that may be taxed by one of the parties to the Convention will generally be treated as arising in that country. Thus, the other country generally will exempt that income or provide a credit for the taxes paid with respect to such income.

Treaties under Negotiation

We continue to maintain an active calendar of tax treaty negotiations. We are in active negotiations with Japan, the Netherlands, Iceland, Hungary, Barbados, France, Bangladesh, Canada, and Korea. We have also signed an agreement with Sri Lanka which we expect will be ready for transmittal to the Senate soon. In accordance with the treaty program priorities noted earlier, we continue to seek appropriate opportunities for tax treaty discussions and negotiations with several countries in Latin America and in the developing world generally.

Conclusion

Let me conclude by again thanking the Committee for its continuing interest in the tax treaty program, and the Members and staff for devoting the time and attention to the review of the

agreements that are pending before you. We also appreciate the assistance and cooperation of the staffs of this Committee and of the Joint Committee on Taxation in the tax treaty process.

We urge the Committee to take prompt and favorable action on the three agreements before you today. Such action will strengthen and expand our economic relations with countries that have been significant economic and political partners for many years and will help to further reduce barriers to cross-border trade and investment.

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