Joint Committee on Taxation
March 3, 2003
JCX-14-03

TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS HEARING ON A PROPOSED TAX TREATY WITH THE UNITED KINGDOM AND PROPOSED PROTOCOLS TO TAX TREATIES WITH AUSTRALIA AND MEXICO[1]

March 5, 2003

My name is David Noren. I am Legislation Counsel to the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation (the "Joint Committee staff") today concerning the proposed income tax treaty with the United Kingdom and the proposed protocols to the existing income tax treaties with Australia and Mexico.

Overview

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

The proposed treaty with the United Kingdom would replace an existing treaty signed in 1975. The proposed protocol with Australia would make several modifications to an existing treaty signed in 1982. The proposed protocol with Mexico would make several modifications to an existing treaty signed in 1992.

---

[1] This document may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on a Proposed Tax Treaty with the United Kingdom and Proposed Protocols to Tax Treaties with Australia and Mexico* (JCX-14-03), March 3, 2003.

My testimony will highlight some of the key features of the proposed treaty and protocols and certain issues that they raise.

<u>"Zero-rate" dividend provisions</u>

One new feature of the proposed treaty and protocols is the "zero rate" of withholding tax on certain intercompany dividends provided under all three instruments. These provisions do not appear in the U.S. model treaty or in any existing U.S. treaty, and their inclusion in the proposed treaty and protocols represents a significant development in U.S. tax treaty practice.

These provisions would eliminate source-country withholding tax on cross-border dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation, provided that certain conditions are met. Under the current treaties with the United Kingdom and Mexico, these dividends may be subject to withholding tax at a rate of 5 percent. Under the current treaty with Australia, these dividends may be subject to withholding tax at a rate of 15 percent. The elimination of the withholding tax under these circumstances is intended to further reduce the tax barriers to direct investment between the United States and these treaty partners.

Although no existing U.S. treaty provides for a complete exemption from withholding tax under these circumstances, many bilateral treaties to which the United States is not a party eliminate withholding taxes under similar circumstances. The same result has been achieved within the European Union by E.U. directive. Thus, although these zero-rate provisions are unprecedented in U.S. treaty history, there is substantial precedent for them in the experience of other countries.

Looking beyond the three treaty relationships directly at issue, the Committee may wish to determine whether the inclusion of zero-rate provisions in the proposed treaty and protocols signals a broader shift in U.S. tax treaty policy. Specifically, the Committee may want to know whether and under what circumstances the Department of the Treasury intends to pursue similar provisions in other treaties, and whether the U.S. model treaty will be amended to reflect these developments.

<u>United Kingdom</u>

The proposed treaty with the United Kingdom is a comprehensive update of the 1975 treaty. The provisions of the proposed treaty are generally consistent with the U.S. model treaty. While the zero-rate provision is of particular interest, the proposed treaty includes several other key features.

The proposed treaty includes a comprehensive anti-treaty-shopping provision, which resembles the provisions of the U.S. model treaty and other recent treaties. The existing treaty with the United Kingdom, like other treaties of its era, does not include a comprehensive anti-treaty-shopping provision.

The proposed treaty also includes an extensive set of rules designed to coordinate the pension plans and other retirement arrangements provided under the laws of the two countries. These rules would facilitate retirement planning using the tax-favored vehicles available under

U.S. and U.K. law in cases involving individuals who live for some period of time in both countries.

The proposed treaty includes a general "anti-conduit" rule that can operate to deny the benefits of several articles of the treaty. This rule is not found in any other U.S. treaty, and it is not included in the U.S. model. The rule is similar to, but significantly narrower and more precise than, the "main purpose" rules that the Senate rejected in 1999 in connection with its consideration of the proposed U.S.-Italy and U.S.-Slovenia treaties. The rule was included at the request of the United Kingdom, which has similar provisions in many of its tax treaties. The purpose of the rule, from the U.K. perspective, is to prevent residents of third countries from improperly obtaining the reduced rates of U.K. tax provided under the treaty by channeling payments to a third-country resident through a U.S. resident. From the U.S. perspective, the rule is generally unnecessary, because U.S. domestic law provides detailed rules governing arrangements to reduce U.S. tax through the use of conduits.

The proposed treaty also raises issues with respect to the waiver of the U.S. insurance excise tax, the treatment of dividend substitute payments, the attribution of profits to permanent establishments, the treatment of shipping income, the creditability of the U.K. petroleum revenue tax under the U.S. foreign tax credit rules, and the treatment of visiting teachers, all of which are discussed in detail in the Joint Committee staff pamphlet on the proposed treaty.

Australia

The proposed protocol with Australia makes several modifications to the 1982 treaty. The provisions of the proposed protocol are generally consistent with the U.S. model treaty.

The proposed protocol reduces source-country withholding tax rates under the existing treaty with respect to dividends, interest, and royalties. In addition to adopting the zero-rate provision for certain intercompany dividends, the modified dividends provision also provides a maximum withholding tax rate of 5 percent on dividends meeting a 10-percent ownership threshold, consistent with the U.S. model. In other cases, the 15-percent rate of the existing treaty is maintained, also consistent with the U.S. model.

With respect to interest, the proposed protocol continues to allow source-country withholding tax at a rate of 10 percent, but generally allows a zero rate for interest received by financial institutions and governmental entities. The U.S. model does not allow source-country withholding tax with respect to interest.

The proposed protocol also retains source-country taxation of royalties under the existing treaty, but reduces the maximum level of withholding tax from 10 percent to 5 percent. In addition, the proposed protocol amends the definition of royalties to remove equipment leasing income, thus eliminating the withholding tax on this income and rendering it taxable by the source country only if the recipient has a permanent establishment in that country. The U.S. model does not allow source-country withholding tax with respect to royalties.

The proposed protocol also amends the shipping income provisions under the existing treaty to reflect more closely the treatment of such income under the U.S. model treaty.

Mexico

The proposed protocol with Mexico makes several modifications to the 1992 treaty, but the adoption of the zero-rate dividends provision is the principal change and was the impetus behind the protocol. Under the existing treaty, if the United States adopts a withholding tax rate on dividends lower than 5 percent in another treaty, the United States and Mexico have agreed to promptly amend their treaty to incorporate that lower rate. The inclusion of zero-rate dividends provisions in the proposed treaty with the United Kingdom and the proposed protocol with Australia would trigger this obligation, and the inclusion of the provision in the proposed protocol with Mexico is responsive to it.

Conclusion

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