TESTIMONY OF WILLIAM A. REINSCH

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ON
THE RATIFICATION OF AN INCOME TAX TREATY AND
VARIOUS PROTOCOLS
BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS
MARCH 5, 2003

Mr. Chairman and Members of the Committee:

The National Foreign Trade Council (NFTC) is pleased to recommend ratification of the treaty and protocols under consideration by the Committee today. We appreciate the Chairman's actions in scheduling this hearing so promptly, and we strongly urge the Committee to reaffirm the United States' historic opposition to double taxation by giving its full support to the pending treaty and protocols.

The National Foreign Trade Council, organized in 1914, is an association of some 350 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 the NFTC therefore seeks 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 that can serve as a barrier to full participation in the international marketplace. Tax treaties are a crucial component of the framework that is necessary to allow such balanced competition.

That 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 Convention and Protocol with the United Kingdom and the Protocols amending the Tax Conventions with Australia and Mexico.

TAX TREATIES AND THEIR IMPORTANCE TO THE UNITED STATES

Tax treaties are bilateral agreements between the United States and foreign countries that serve to harmonize the tax systems of the two countries in respect of persons involved in cross-border investment and trade. In the absence of tax treaties, income from international transactions or investment may be subject to double taxation: once by the country where the income arises and again by the country of the income recipient's residence. Tax treaties eliminate this double taxation by allocating taxing jurisdiction over the income between the two countries.

In addition, the tax systems 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 earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they are liable to suffer excessive and noncreditable levels of foreign tax and to be at a competitive disadvantage relative to traders and investors from other countries that do have such benefits. Thus, tax treaties serve to prevent this barrier to U.S. participation in international commerce.

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. Similarly, another extremely important benefit, which is available exclusively under tax treaties, is the mutual agreement procedure, a bilateral administrative mechanism for avoiding double taxation on cross-border transactions.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the U.S. Treasury by providing for the exchange of information between tax authorities. Treaties have also provided a framework for the resolution of disputes with respect to overlapping claims by the respective governments. In particular, the practices of the Competent Authorities under the treaties have led to agreements, known as "Advance Pricing Agreements" or "APAs," through which tax authorities of the United States and other countries have been able to avoid costly and unproductive disputes over appropriate transfer prices for the trade in goods and services between related entities. APAs, which are agreements jointly entered into between one or more countries and particular taxpayers, have become common and increasingly popular procedures for countries and taxpayers to settle their transfer pricing issues in advance of dispute. The clear trend is that treaties are becoming an increasingly important tool used by tax authorities and taxpayers alike in striving for fairer and more efficient application of the tax laws.

Virtually all treaty relationships depend upon 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 encouraging international flows of trade and investment between the United States and the other country, in providing the guidance enterprises need in planning for the future, in providing nondiscriminatory treatment for U.S. traders and investors as compared to those of other countries, and in meeting a minimum level of acceptability in comparison with the preferred U.S. position and expressed goals of the business community. Slavish comparisons of a particular treaty's provisions with the U.S. Model or with treaties with other countries do not provide an appropriate basis for analyzing a treaty's value.

TREATIES BEFORE THE COMMITTEE TODAY

The treaty and protocols presently under consideration are a good illustration of the contribution such agreements can make to improving both the economic competitiveness of U.S. companies and the proper administration of U.S. tax laws in the international arena. For example, the U.K., Australian, and Mexican agreements contain a provision, new to U.S. treaty policy, which calls for a zero rate of withholding tax on dividends paid to parent corporations from their 80 percent or greater owned subsidiaries. The existence of a withholding tax on cross-border, parent-subsidiary dividends, even at the 5 percent rate previously typical in U.S. treaties, has served as a tariff-like barrier to cross-border investment flows. Without a zero rate, the combination of the underlying corporate tax and the withholding tax on the dividend will often lead to unusable excess foreign tax credits in the parent's hands, resulting in a lower return from a cross-border investment than a comparable domestic investment. This sort of multiple taxation of profits within a corporate group leads to exactly the kind of distortion in investment decisions that tax treaties are meant to prevent. If U.S. businesses are going to maintain a competitive position around the world, we need a treaty policy that protects us from multiple or excessive levels of foreign tax on our cross-border investments, particularly if our 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. For example, the European Union eliminated this 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. The NFTC has for years urged Treasury to change U.S. treaty policy to allow for this zero rate on dividends, and we highly commend Treasury for taking the first steps in that direction by negotiating the U.K., Australian, and Mexican agreements before the Committee today. It is now up to this Committee to express its support for this important new development in U.S. treaty policy, and we strongly urge you to do that by your prompt approval of each of these agreements. We hope the Senate's ratification of these agreements will help Treasury negotiate similar agreements with many more countries.

We would also like to confirm to the Committee our belief that it is worthwhile to negotiate for the inclusion of this provision even in treaties with countries whose domestic law already provides for a zero rate on dividends, such as the United Kingdom. Doing so has the effect of locking in the benefit of the zero rate, protecting U.S. parent companies from subsequent changes to the foreign tax regime. The formal acceptance of the zero rate principle by treaty also serves as a valuable precedent, confirming to other prospective treaty partners the U.S. commitment to this policy. We would also note that the revenue implications of eliminating the U.S. withholding tax on dividends paid to U.K. parent companies is likely to be substantially affected by the corresponding elimination of the notional 5 percent U.K. withholding tax on dividends to U.S. parents under the current Treaty, thereby eliminating any U.S. obligation to give foreign tax credits for those amounts.

These treaties are important to the U.S. business community because of the actual and precedential effect of eliminating the withholding tax on parent-subsidiary dividends and because of several other benefits they introduce. For example, the U.K. Treaty includes significant new provisions, comparable to the U.S. Model, guaranteeing reciprocal recognition of each country's pension plans. That Treaty also includes arrangements aimed at eliminating double taxation of income and gains from stock option plans. These provisions will eliminate substantial difficulties that would otherwise be faced by migratory employees and by their employers as well. In addition to its elimination of the withholding tax on parent-subsidiary dividends, the Australian Protocol includes welcome reductions in the withholding tax rates on interest, royalties, and equipment rentals, bringing the rates closer to the U.S. Model. The Protocol to the U.S.-Mexico Treaty includes an amendment to the article on Relief from Double Taxation that clarifies the ability of a U.S. taxpayer to treat income that may be taxed by Mexico under the Treaty as having its source in Mexico, so as to allow the U.S. resident a foreign tax credit for that Mexican tax. The zero rate on dividends paid to pension funds under the U.K. and Mexican agreements should attract investment from those funds into U.S. stocks.

We are particularly hopeful that the Senate will be able to complete its ratification procedures during the month of March so that instruments of ratification will be exchanged before April 1, 2003. This will prevent a year's delay in access to the U.K. Treaty's relief from U.K. corporate tax under provisions such as the new pension rules, since that relief goes into effect only for financial years beginning on or after the April 1 immediately following the exchange of instruments of ratification.

These agreements also include important advantages for the administration of U.S. tax laws and the implementation of U.S. treaty policy. They all offer the possibility of administrative assistance between the relevant tax authorities. The agreements also include modern safeguards against treaty-shopping in accordance with U.S. policy. They reflect recent U.S. law changes aimed at preserving taxing jurisdiction over certain individuals who terminate their long-term residence within the United States. They also reflect modern U.S. treaty policy on when reduced U.S. withholding rates will apply to dividends paid by Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs). Finally, the U.K. Treaty includes targeted anti-abuse rules aimed at preventing inappropriate use of the benefits provided by the Treaty.

GENERAL COMMENTS ON TAX TREATY POLICY

As it has done in the past, the NFTC urges you to reject opposition to a treaty based on the presence or absence of a single provision. No process that is as laden with competing considerations as the negotiation of a full-scale tax treaty between sovereign states will be able to produce an agreement that will completely satisfy every possible constituency, and no such result should be expected. On the whole, the U.S. negotiators are to be applauded for achieving agreements that reflect as well as these treaties do the positions of the U.S. Model and the views expressed by the U.S. business community.

The NFTC also wishes to emphasize how important treaties are in creating, preserving, and implementing an international consensus on the desirability of avoiding double taxation, particularly with respect to transactions between related entities. 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 the 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.

The NFTC recognizes 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 by reference to verifiable data.

The NFTC strongly supports the efforts of the Internal Revenue Service and 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 Internal Revenue Service's ongoing efforts 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 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 respectfully encourage this Committee to schedule tax treaty hearings with a minimum of delay after receiving the agreements from the Executive Branch, in order to enable improvements in the treaty network to enter into effect as quickly as possible, as you are doing in this case.

The NFTC also wishes to reaffirm its view, frequently voiced in the past, that Congress should avoid occasions of overriding by subsequent domestic legislation the U.S. treaty commitments that are approved by this Committee. 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.

IN CONCLUSION

Finally, the Council is grateful to the Chairman and the Members of the Committee for giving international economic relations prominence in the Committee's agenda, particularly so soon in a new Congress, and when the demands upon the Committee's time are so pressing. We would also like to express our appreciation for the remarkable efforts of both Majority and Minority staff which have allowed this hearing to be scheduled and held in such a short period of time.

We respectfully urge the Committee to proceed with ratification of these agreements as expeditiously as possible.