My name is George Yin. I am Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation today concerning the proposed income tax protocols with Barbados and the Netherlands.

Overview

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

The proposed protocol with Barbados would amend an existing tax treaty that was signed in 1984 and was modified by a protocol signed in 1991. The proposed protocol with the Netherlands would update the existing treaty signed in 1992 and modified by protocol in 1993. My testimony today will highlight some of the key features of the proposed protocols and certain issues that they raise.

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 the Proposed Tax Protocols with Barbados and the Netherlands (JCX-58-04), September 22, 2004.
Barbados

Elimination of certain inappropriate benefits available under the existing treaty

The most significant change made by the proposed protocol with Barbados is the replacement of the existing treaty’s limitation-on-benefits article with a new article designed to eliminate certain inappropriate benefits that are available under the existing treaty. Specifically, the existing treaty allows a company that is legally resident in Barbados to claim the benefits of reduced U.S. withholding tax rates by virtue of being publicly traded, even in cases in which the company has no meaningful economic presence in Barbados and is subject to only nominal levels of taxation there, under a special tax regime such as the “International Business Companies” regime. This aspect of the existing treaty has been a key element in some recent “corporate inversion” transactions that have been used by U.S.-based multinational enterprises to erode the U.S. tax base. The proposed protocol modifies the limitation-on-benefits provision of the existing treaty to eliminate inappropriate treaty benefits under these and similar circumstances, as explained in detail in our pamphlet.

The Joint Committee staff believes that the proposed protocol should prove effective in curtailing the inappropriate benefits that are available under the existing treaty. Thus, the proposed protocol should be viewed as a significant improvement by those concerned about the use of the existing treaty to facilitate tax-motivated transactions. Nevertheless, we have identified three issues that the Committee might wish to raise with the Treasury Department in connection with the proposed protocol.

Potential availability of inappropriate benefits under other U.S. treaties

First, by rendering the Barbados treaty less suitable for use in tax-motivated transactions, the proposed protocol may cause certain taxpayers to look for “second-best” treaties in the U.S. network that may be suitable for similar use. The Committee may wish to ask the Treasury Department whether it has concerns about any other U.S. tax treaties in this regard, and if so, what measures are being taken to address these concerns.

Treatment of special tax regimes outside the context of withholding taxes

Second, while the proposed protocol disallows treaty benefits in most situations in which the recipient of a payment is entitled to the benefits of a special tax regime, such as the Barbados “International Business Companies” regime, the proposed protocol leaves open the possibility that such a person may qualify for some benefits of the treaty under some circumstances, even though there is no risk of meaningful double taxation in such a case. Some may argue that it would have been best to foreclose entirely the possibility that persons that enjoy tax-haven-type benefits under the laws of a treaty country could qualify for treaty benefits.
Interaction with U.S. rate preference for dividend income

Third, under the Jobs and Growth Tax Relief Reconciliation Act of 2003, dividends received by an individual shareholder from domestic corporations are generally taxed at the preferential rates that apply to certain capital gains. Dividends received from a foreign corporation also may be eligible for this rate preference in some cases. One way in which a dividend from a foreign corporation may qualify is if the foreign corporation is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory for purposes of the rate-preference provision, and which includes an exchange of information program. Consistent with a statement made in the relevant legislative history, the Treasury Department announced in a notice that the existing treaty with Barbados is not satisfactory for purposes of the rate-preference provision. In that same notice, the Treasury Department indicated that the amendment or renegotiation of existing tax treaties may be a factor in deciding whether to amend its list of qualifying treaties. The Committee may wish to ask the Treasury Department whether it intends to amend its list of qualifying treaties to include the U.S.-Barbados treaty, once the modifications made by the proposed protocol enter into force. In addition, if the Treasury Department does intend to add this treaty to the list of qualifying treaties, the Committee may wish to ask how companies that are eligible for the benefits of a special tax regime will be treated for these purposes.

Netherlands

The proposed protocol with the Netherlands modifies several important articles in the existing treaty. Many of the provisions of the proposed protocol are generally consistent with the U.S. model treaty; however, there are a few areas in which the Committee may wish to inquire.

“Zero-rate” dividend provision

One area is the proposed “zero rate” of withholding tax on certain intercompany dividends. The provision would eliminate source-country tax on cross-border dividends paid by one corporation to another corporation that owns 80 percent or more of the stock of the dividend-paying corporation, provided that certain conditions are met. Under the current treaty with the Netherlands, these dividends may be subject to withholding tax in the source country at a rate of five percent. The proposed elimination of the withholding tax is intended to further reduce tax barriers to direct investment.

The principal immediate effects of the zero-rate provision on U.S. taxpayers and the U.S. fisc would be: (1) to relieve U.S. corporations of the burden of Dutch withholding taxes in connection with qualifying dividends received from Dutch subsidiaries; (2) to relieve the U.S. fisc of the requirement to allow foreign tax credits with respect to these dividends; and (3) to eliminate the withholding tax revenues currently collected by the U.S. fisc with respect to qualifying dividends received by Dutch corporations from U.S. subsidiaries.

This provision does not appear in the U.S. or OECD model treaties. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes in similar circumstances. The European Union has also eliminated withholding taxes in similar circumstances under its “Parent Subsidiary Directive.” In 2003, the Senate approved adding
zero-rate provisions to the U.S. treaties with the United Kingdom, Australia, and Mexico, and earlier this year the Senate approved adding a zero-rate provision to the U.S. treaty with Japan. Those provisions are similar to the provision in the proposed protocol.

The Committee may wish to determine whether the inclusion of the zero-rate provision in the proposed protocol signals a broader shift in U.S. tax treaty policy. The Committee also may wish to consider whether and under what circumstances the Treasury Department intends to pursue similar provisions in other treaties and whether the U.S. model will be updated to reflect these developments. In addition, the Committee may wish to inquire further as to the rationale for the October 1, 1998 stock ownership testing date with respect to eligibility for the zero rate on dividends received by companies that satisfy the limitation-on-benefits provision only under certain specific tests contained in that provision. While this limitation on the zero rate for direct dividends apparently is modeled after a similar limitation in the U.S.-U.K. treaty, it is unclear why the October 1, 1998 testing date that applies for purposes of the U.S.-U.K. treaty is relevant in the context of the proposed Netherlands protocol.

Anti-treaty-shopping provision

The limitation-on-benefits provision in the proposed protocol is similar to the anti-treaty-shopping provisions in several recent U.S. income tax treaties; however, the anti-treaty-shopping provisions in the proposed protocol include a new requirement that tests for “substantial presence” in the residence country in order for a public company to qualify for treaty benefits.

Under the U.S. model and more recent U.S. income tax treaties, a public company can qualify for treaty benefits if it is listed in one of the two treaty countries and regularly traded on a recognized stock exchange, thereby allowing a company to qualify for treaty benefits if all the trading takes place in the other country or a third country exchange. Under the proposed protocol, a company must establish substantial presence in the residence country in order to obtain treaty benefits. A company must establish substantial presence by meeting one of two requirements.

The first requirement determines whether public trading constitutes an adequate connection to the residence country. To establish adequate connection, the stock of the company must have a greater volume of trading in its primary economic zone than in the other treaty country and at least 10 percent of its worldwide trading must occur within its primary economic zone. For the United States, the primary economic zone includes all NAFTA countries and for the Netherlands, the primary economic zone includes the European Economic Area and the European Union.

If a company fails the first requirement, it can still establish substantial presence if it meets the second requirement. The second requirement determines whether the company’s primary place of management and control is in the country where it is a resident. This test should be distinguished from the “place of effective management” test that is used by many countries to establish residence and by the OECD model as a tiebreaker. The primary place of management and control test under the proposed protocol looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. This is based on where the executive officers and senior management employees exercise day-to-day
responsibility for more of the strategic, financial and operational policy decision making for the company.

The two requirements I have just mentioned tighten the rules related to public companies by requiring nexus in the residence country in order to obtain treaty benefits. Thus, the new rules address situations where a company may simply invert its corporate structure to change its residence status without changing the situs from which the business is carried on and where it is managed and controlled. In comparing the new rules to other recent U.S. income tax treaties, only the recently signed U.S.-Barbados protocol contains similar rules. The recently ratified U.S.-Japan income tax treaty, which was being negotiated at the same time as this protocol, does not include rules that test for substantial presence. The Committee may wish to consider whether and under what circumstances the Treasury Department intends to pursue similar provisions in future treaties and whether the U.S. model will be updated to reflect these developments.

Finally, some have speculated that developments in the European Union might call into question certain bilateral arrangements between an EU country and a non-EU country, such as tax-treaty benefits that are subject to standard limitation-on-benefits clauses. Of course, EU bodies do not have the authority to require the United States to grant any treaty benefits that the United States has not specifically negotiated. However, in light of the importance of limitation-on-benefits provisions to U.S. treaty policy, the Committee may wish to ask the Treasury Department for its views as to how the ongoing process of European integration might affect the operation and development of the U.S. network of bilateral tax treaties with EU member countries.

Saving clause

The present treaty contains a provision under which the “saving clause” (and therefore U.S. tax jurisdiction) applies to former U.S. citizens, except Dutch nationals, whose loss of citizenship status had as one of its principal purposes the avoidance of U.S. income tax. The proposed protocol expands the saving clause provision in the present treaty to include former long-term residents, except Dutch nationals. This provision makes the treaty largely consistent with amendments to the U.S. tax rules in 1996 related to certain former citizens and former long-term residents. However, the exception for Dutch nationals in the present treaty and proposed protocol is contrary to the U.S. model, other recent U.S. income tax treaties, and U.S. internal law. The Committee may wish to satisfy itself that it is appropriate for the United States arguably to cede its tax jurisdiction with respect to Dutch nationals who are former U.S. citizens and long-term residents and whose loss of citizenship status or termination of residency had as one of its principal purposes the avoidance of U.S. income tax.

Updating the U.S. model income tax treaty

As a general matter, U.S. model tax treaties provide a framework for U.S. tax treaty policy. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on tax treaty matters. Periodically updating the U.S. model tax treaties to reflect changes, revisions, developments, and the viewpoints of Congress with regard to U.S. tax treaty policy ensures that the model treaties remain meaningful and relevant. The current U.S. model income tax treaty was last updated in 1996. As we mentioned at the treaty
hearing earlier this year, the Joint Committee staff believes that this model is becoming obsolete and is in need of an update. At that same hearing, the Treasury Department stated that it intended to update the model. The Committee may wish to inquire of the Treasury Department as to the current status of this project.

*     *     *

I would be happy to answer any questions that the Committee may have at this time or in the future.