JOINT COMMITTEE ON TAXATION
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TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS HEARING ON THE PROPOSED TAX PROTOCOL WITH SPAIN AND THE PROPOSED TAX TREATY WITH POLAND[1]

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My name is Thomas A. Barthold. 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 protocol with Spain and proposed treaty with Poland.

Overview

As in the past, the Joint Committee staff has prepared pamphlets covering the proposed treaty and protocol.[2] The pamphlets provide detailed descriptions of the proposed treaty and protocol, including comparisons with the United States Model Income Tax Convention of November 15, 2006 ("U.S. Model treaty") and with other recent U.S. tax treaties. The pamphlets also provide detailed discussions of issues raised by the proposed treaty and protocol. We consulted with the Treasury Department and with the staff of the Committee in analyzing the proposed treaty and protocol and in preparing these pamphlets.

The principal purposes of the proposed income tax treaty and protocol are to reduce or eliminate double taxation of income earned by residents of either country from sources within

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[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 Protocol with Spain and the Proposed Tax Treaty with Poland* (JCX-XX-14), June 19, 2014. This publication can also be found at http://www.jct.gov.

[2] Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Spain* (JCX-67-14), June 17, 2014; Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Poland* (JCX-68-14), June 17, 2014. These publications can also be found at http://www.jct.gov. The proposed protocol with Spain was signed on January 14, 2013, and includes provisions amending the existing protocol ("1990 protocol") as well as a contemporaneous Memorandum of Understanding.

the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed income tax treaty and protocol also are intended to promote close economic cooperation between the treaty countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the treaty countries. As in other U.S. income tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country.

My testimony today will first summarize several significant features of these agreements, followed by a more detailed discussion of two issues: first, the extent to which the deviations from the U.S. Model treaty in the proposed protocol and proposed treaty raise questions about possible U.S. positions in current and future income tax treaty negotiations, and, second, how the commitment in the proposed protocol with Spain to begin discussions toward an agreement to avoid double taxation of cross-border investment between Spain and Puerto Rico fits with broader U.S. tax and treaty policy related to Puerto Rico and the other U.S. territories.

The U.S. Model treaty was published after the existing treaties with Spain and Poland entered into force. The proposed protocol with Spain would amend an existing tax treaty signed on February 22, 1990 its protocol. The proposed treaty with Poland would replace an existing income tax treaty signed on October 8, 1974. The proposed protocol with Spain and proposed treaty with Poland include a number of significant changes that, if entered into force, would conform the existing treaties to the U.S. Model treaty and to other recent U.S. treaties, including in the following areas:

- Both treaties would include rules similar to those of the U.S. Model treaty for payments derived through entities that are fiscally transparent. These rules are intended, on the one hand, to ensure that investors who derive payments through entities such as partnerships or limited liability companies are eligible in appropriate circumstances for treaty benefits such as reduced withholding and, on the other hand, to prevent reductions in source-country taxation when a resident is not subject to tax on payments derived through an entity because the entity is not fiscally transparent in the residence country.

- Both treaties would include definitions of pension funds. The existing treaty with Spain did not have a special provision exempting dividends paid to pension funds from withholding tax; the proposed protocol includes a new paragraph 4 in Article 10 (Dividends), which exempts dividends from source-country tax if the beneficial owner of the dividends is a pension fund and the dividends are not derived in the carrying on of a trade or business by the pension fund or through an associated enterprise.

- Both treaties would conform to the U.S. Model treaty Article 5 (Permanent Establishment) in providing that a construction site, installation project, drilling rig or exploration site is not a permanent establishment unless it lasts more than 12 months, instead of the six and 18 month periods included in the existing treaties with Spain and Poland, respectively.

- Both treaties would provide reduced rates of withholding taxes for dividends, interest, and royalties. For Spain and Poland, in conformity with the U.S. Model treaty, the generally prevailing dividend withholding rates would be either five or 15 percent, depending on the level of ownership of the dividend-paying company, with special rules for dividends paid by regulated investment companies and real estate investment trusts. The proposed protocol with Spain also provides a zero withholding rate on cross-border dividends paid by a subsidiary in one treaty country to its parent corporation in the other treaty country. In conformity with the U.S. Model treaty, the proposed protocol with Spain eliminates source-country withholding tax on many interest and royalty payments, while the proposed treaty with Poland permits source-country taxation of these payments at a five-percent rate.

- Both treaties would include modern limitation-on-benefits provisions (Poland, Article 22; Spain, Article IX of the proposed protocol, amending Article 17 of the existing treaty), closing a significant treaty-shopping opportunity presented by the existing treaty with Poland, which is one of only two U.S. income tax treaties that do not include any limitation-on-benefits rules (the other is the existing treaty with Hungary) but provide for complete exemption from withholding on interest payments from one treaty country to the other treaty country.

- Binding arbitration procedures would be mandatory in certain cases presented to the U.S. and Spanish competent authorities and unresolved under the mutual agreement procedures.

<u>The extent to which the U.S. Model treaty continues to reflect U.S. tax policy</u>

The current U.S. Model treaty was published in 2006 and provides a framework for U.S. income tax treaty policy and a starting point for income tax treaty negotiations with our treaty partners. A number of U.S. income tax treaties and protocols to earlier treaties have entered into force since then. Significant deviations from the U.S. Model treaty have, understandably, proliferated. This proliferation can be expected to continue as the U.S. State Department and Treasury Department negotiate new income tax treaties and protocols. Each of the agreements before the Committee today differs from the U.S. Model treaty in several significant aspects: the limitation-on-benefits provisions proposed for both Spain and Poland (replacing a provision in the existing treaty with Spain and included for the first time in the proposed treaty with Poland); the extension of mandatory and binding arbitration to Spain; the zero-rate of dividend withholding for Spain; and the attribution of profits to a permanent establishment for Poland. The Committee may wish to consider, among other questions described below, the extent to which these deviations represent actual U.S. income tax treaty policy notwithstanding that they differ from the policy as provided in the U.S. Model treaty. The Committee also may wish to inquire whether the Treasury Department expects to publish a new model treaty in the near future and, if it does so expect, whether that new model would include provisions similar to the deviations described below.

1. Limitations on benefits: Spain and Poland

The Committee may wish to inquire of the Treasury Department as to its plans to address the remaining U.S. income tax treaties that do not include limitation-on-benefits provisions, or include outdated versions of these provisions. In particular, you may wish to inquire about the rationale for several of the deviations, and to the extent that the provisions vary among recent treaties, whether one or another of the provisions reflects a preferred approach.

The limitation-on-benefits rules in the proposed treaty and protocol with Poland and Spain, respectively, are similar to the rules in other recent and proposed U.S. income tax treaties and protocols and in the U.S. Model treaty, but they are not identical. The principal differences from the U.S. Model treaty are the inclusion of the headquarters company category of qualified person, the derivative benefits rule, and the anti-abuse rule for triangular arrangements. In addition, the proposed protocol and proposed treaty differ slightly in formulating the derivative benefits rule. Finally, both the proposed protocol with Spain and the proposed treaty with Poland conform to the U.S. Model in permitting a treaty country the discretion to extend benefits to persons that do not otherwise qualify under the limitations-on-benefits provisions, but the proposed protocol with Spain differs in establishing the applicable standard for exercise of that discretion, as explained below.

First, with respect to publicly traded companies, the Committee may wish to explore the rationale underlying the identification of recognized stock exchanges for purposes of limitations of benefits and the criteria the Treasury Department considers when negotiating over the definition of a recognized stock exchange. Under both the proposed treaty with Poland and proposed protocol with Spain, a publicly traded company that is a resident of a treaty country is eligible for all the benefits of the proposed treaty if it satisfies a regular trading test, which requires that the company's principal class of shares is primarily traded on a recognized stock exchange, and also satisfies either a management and control test or a primary trading test. As in the U.S. Model treaty, in both the proposed treaty with Poland and the proposed protocol with Spain, a recognized stock exchange includes certain exchanges specified in the treaty as well as any other stock exchange agreed upon by the competent authorities of the treaty countries.

With respect to the headquarters company rule, the Committee may wish to explore the rationale for granting benefits to an entity that is not otherwise eligible for benefits. Both agreements also allow full treaty benefits for an entity that functions as a headquarters company, but does not satisfy the other categories of persons entitled to full treaty benefits. In doing so, they conform to U.S. income tax treaties in force with Austria, Australia, Belgium, the Netherlands, and Switzerland but not the U.S. Model treaty. The conditions for qualifying as a headquarters company include requirements intended to ensure that the headquarters company performs substantial supervisory and administrative functions for a group of companies, including its multinational nature, that the headquarters company is subject to the same income tax rules in its country of residence as would apply to a company engaged in the active conduct of a trade or business in that country; and that the headquarters company has independent authority in carrying out its supervisory and administrative functions.

The derivative benefits rules may grant treaty benefits to a treaty-country resident company in circumstances in which the company itself would not qualify for treaty benefits under any of the other limitation-on-benefits provisions. Like other recent treaties, including those with Canada and Iceland as well as several European treaty countries, the proposed treaty with Poland and the proposed protocol with Spain include a derivative benefits rule. Under the derivative benefits rule, a treaty-country company receives treaty benefits for an item of income if the company's owners (referred to in the proposed treaty as equivalent beneficiaries) reside in a country that is in the same trading bloc as the treaty country and would have been entitled to the same benefits for the income had those owners derived the income directly. The definition of equivalent beneficiary differs in the proposed agreements. With respect to Spain, a party whose ownership interest is held indirectly is not an equivalent beneficiary unless the intermediate owner also qualifies as an equivalent beneficiary.

Finally, the Committee may wish to inquire whether it is appropriate to grant discretion to competent authorities to extend treaty benefits to persons not otherwise entitled to such benefits, and, if so, the standard for exercise of any such authority. As in the U.S. Model and other recently negotiated treaties with modern limitations on benefits articles, the proposed treaty with Poland includes a grant of discretion to the competent authority to extend otherwise unavailable treaty benefits to a party that is not otherwise entitled to treaty benefits if the competent authority determines that the organization or operation of the person claiming benefits did not have as a principal purpose the obtaining of treaty benefits. By contrast, the proposed protocol with Spain requires that the competent authority evaluate the extent to which the resident of the other country met any of the criteria under other provisions in the article, without regard to motivation.

The Committee may wish to inquire of the Treasury Department about the alternative formulations of the standard for discretion to extend tax treaty benefits that have been proposed as part of Action Plan on Base Erosion and Profit Shifting, undertaken by the Organisation for Economic Co-operation and Development ("OECD") at the request of the G-20.[3] Action Six in that plan is identifying ways to prevent inappropriate extension of treaty benefits. A discussion draft report on the issue includes two draft articles designed to stem treaty abuse.

2. Mandatory arbitration: Spain

Although U.S. tax treaties traditionally have not included a mechanism to ensure resolution of disputes, the addition of mandatory procedures for binding arbitration as part of the mutual agreement procedures has become increasingly frequent in recent years. If the proposed protocol enters into force, the U.S.-Spain treaty will be the fifth bilateral U.S. income tax treaty to require binding arbitration of unresolved cases. Mandatory binding arbitration is provided upon request of the taxpayer in paragraph 5 of Article 25 (Mutual Agreement Procedure) of the the 2010 Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (the "OECD Model treaty"). Proponents of mandatory arbitration believe that incorporating into the mutual agreement process a mechanism that would ensure the resolution of disputes would impel the competent authorities to reach mutual agreement, so as to avoid any arbitration proceedings. As a result, these proponents hold the

[3] The full Action Plan, published July 19, 2013 is available at www.oecd.org/ctp/BEPSActionPlan.pdf.

view that cases will be resolved more promptly and on more appropriate bases through the mutual agreement procedure than previously, although actual arbitration may be rare.

In considering the proposed protocol, the Committee may wish to consider the extent to which the inclusion of mandatory arbitration rules and the particular features of the arbitration provisions in the proposed protocol now represent the United States policy regarding mandatory binding arbitration. In particular, the Committee may wish to inquire about the criteria on which the Treasury Department determines whether to include such provisions in a particular treaty, the appropriate scope of issues eligible for determination by binding arbitration, the absence of precedential value of arbitration determinations, the role of the taxpayer in an arbitration proceeding and how to ensure adequate oversight of the use of mandatory arbitration.

Regardless of whether the Treasury Department expects mandatory arbitration to become a standard feature in all future U.S. tax treaties, the Committee may wish to inquire whether the Treasury Department intends to develop and publish a standardized set of arbitration principles and procedures for inclusion in a revision to the U.S. Model treaty.

3. Zero-rate of dividend withholding: Spain

When certain conditions are satisfied, the proposed protocol with Spain eliminates withholding tax on dividends paid by a company that is resident in one treaty country to a company that is a resident of the other treaty country and that owns at least 80 percent of the stock of the dividend-paying company (often referred to as "direct dividends"). The elimination of withholding tax on direct dividends is intended to reduce the tax barriers to direct investment between the two treaty countries.

Until 2003, no U.S. income tax treaty provided for a complete exemption from dividend withholding tax, and the U.S. and OECD models do not provide an exemption. By contrast, many bilateral income tax treaties of other countries eliminate withholding taxes on direct dividends between treaty countries, and the European Union ("EU") Parent-Subsidiary Directive repeals withholding taxes on intra-EU direct dividends. Recent U.S. income tax treaties and protocols with Australia, Japan, Mexico, the Netherlands, Sweden, the United Kingdom, Belgium, Denmark, Finland, Germany, France, and New Zealand include zero-rate provisions. The Senate ratified those treaties and protocols in 2003 (Australia, Mexico, United Kingdom), 2004 (Japan, Netherlands), 2006 (Sweden), 2007 (Belgium, Denmark, Finland, and Germany), 2009 (France), and 2010 (New Zealand). The proposed protocol with Spain therefore would bring to 13 the number of U.S. income tax treaties that provide a zero rate for direct dividends.

Because zero-rate provisions are a relatively recent but now prominent development in U.S. income tax treaty practice, the Committee may wish to consider possible costs and benefits of zero-rate provisions such as revenue considerations and diminishing of barriers to cross-border investment; the Treasury Department's criteria for determining when a zero-rate provision is appropriate; and certain specific features of zero-rate provisions such as ownership thresholds, holding-period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements. These issues have been described in detail in connection with the Committee's previous consideration of proposed income tax treaties and protocols that have included zero-rate provisions.[4]

Although zero-rate provisions for direct dividends have become a common feature of U.S. income tax treaties signed in the last decade, the U.S. Model treaty does not provide a zero-rate for direct dividends. In previous testimony before the Committee, the Treasury Department has indicated that zero-rate provisions should be allowed only under treaties that have restrictive limitation-on-benefits rules and that provide comprehensive information exchange. Even in those treaties, according to previous Treasury Department statements, dividend withholding tax should be eliminated only on the basis of an evaluation of the overall balance of benefits under the treaty. Every recent U.S. income tax treaty or protocol has included restrictive limitation-on-benefits provisions and comprehensive information exchange provisions. The Committee therefore may wish to inquire into whether there are other particular considerations that the Treasury Department will now take into account in deciding whether to negotiate for zero-rate direct dividend provisions in future income tax treaties and protocols. The Committee also may wish to ask whether any new U.S model income tax treaty might eliminate withholding tax on direct dividends and, if it would not so provide, why it would not.

4. Attribution of profits to a permanent establishment: Poland

In the OECD and U.S. Model treaties, Article 7 (Business Profits) provides rules for the taxation by a treaty country of the business profits of an enterprise located in the other treaty country. The proposed treaty between the United States and Poland is the first to generally adopt the language of Article 7 (Business Profits) of the OECD Model treaty. Although the language used in the OECD Model treaty differs from the U.S. Model treaty, the policy toward, and implementation of, the business profits article under the two models are substantively similar. The Committee may wish to ask the Treasury Department whether the use of the OECD Model treaty Article 7 in the Polish treaty represents a change in U.S. income tax treaty policy, or whether instead it achieves the same or a similar policy outcome.

Article 7 in both the OECD and U.S. Model treaties sets forth the basic rule that the business profits cannot be taxed unless the enterprise carries on a business through a permanent establishment in the other treaty country. Although there are slight differences in the language, the provisions in the two models are identical in operation. This principle is based on the general international consensus that a country should not have taxing rights over the profits of an enterprise if the enterprise is not participating in the economic life of the country. Additionally, if an enterprise carries on business in the other treaty country through a permanent establishment, only the profits attributable to the permanent establishment determined under Article 7 are taxable in the country where the permanent establishment is located.

The separate entity and arm's-length pricing principles are the basic principles upon which the attribution of profits rule in Article 7 is based. The article does not allocate profits of the entire enterprise between the permanent establishment and the other parts of the enterprise;

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[4] See, for example, Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany* (JCX-47-07), July 13, 2007, pp. 82-84.

rather, it requires that the profits attributable to a permanent establishment be determined as if the permanent establishment were a separate enterprise operating at arm's length. These principles are incorporated into both the OECD and U.S. Model treaties.

Both model treaties adopt the Authorized OECD Approach (the "AOA"), as set out under the OECD report, "2010 Report on the Attribution of Profits to Permanent Establishments (the "2010 OECD Report"). The AOA attributes profits to the permanent establishment from all its activities, including transactions with independent enterprises, transactions with associated enterprises, and dealings with other parts of the enterprise. Article 7 of the U.S. and OECD Model treaties specifically refers to the dealings between the permanent establishment and other parts of the enterprise in order to emphasize that the treatment of the permanent establishment requires that these dealings be treated the same way as similar transaction taking place between independent enterprises.

The U.S. Model treaty includes, and, historically, the OECD Model treaty included, explicit language allowing expenses incurred for the purposes of the permanent establishment, including executive and general administrative expenses, whether in the treaty country where the permanent establishment is situated or elsewhere, to be deducted in determining the profits attributed to that permanent establishment. This language was intended to clarify that the determination of profit attributable to a permanent establishment required that expenses incurred directly or indirectly for the benefit of that permanent establishment be deducted. However, the paragraph was sometimes read as limiting the deduction of expenses to the actual amount of the expense rather than an arm's-length amount of expense. The OECD views its current Article 7 wording as requiring the recognition and arm's-length pricing of the dealings through which one part of the enterprise performs function for the benefit of the permanent establishment (e.g., through the provision of assistance in day-to-day management).[5] The Technical Explanation of the U.S. Model treaty also clarifies that the U.S. Model treaty requires recognition and arm's-length pricing for functions performed for the benefit of the permanent establishment by another part of the enterprise. This requires that a deduction be allowed based on an arm's-length charge for these dealings, as opposed to a deduction limited to the actual amount of the expense. The Committee may wish to inquire about the experience of the United States with its treaty partners related to the allowance and determination of the price for functions provided by one part of the enterprise for the benefit of the permanent establishment.

The proposed treaty between the United States and Poland applies the principles of Article 7 only for purposes of attributing profits to a permanent establishment and does not affect the application of other articles. However, the OECD Model treaty applies the Article 7 principles to attributing profits to a permanent establishment and for purposes of Article 23 (Elimination of Double Taxation). The OECD Model treaty requires that where an enterprise of one treaty country carries on business through a permanent establishment located in the other treaty country, the first country must either exempt the profits that are attributable to the permanent establishment (exemption system) or give a credit for the tax levied by the other country on the profits (foreign tax credit system).

[5] See the Commentaries to the OECD Model Treaty, paragraphs 38-40.

The significance of this difference relates to the computation of the foreign tax credit limitation. The United States does not apply the principles of Article 7 to the computation of the foreign tax credit limitation; rather, it applies the principles set forth by the Code. A taxpayer seeking to obtain additional foreign tax credit limitation to prevent double taxation must do so through the mutual agreement procedures. The taxpayer would have to prove that double taxation of the permanent establishment profits which resulted from the conflicting domestic law has been left unrelieved after applying mechanisms under domestic law. The Committee may ask the Treasury Department about this difference as well as about the standard to be applied in determining whether a taxpayer meets the level of proof to show that double taxation was not relieved under the mechanisms of local law.

The OECD Model treaty provides that where, in accordance with Article 7, one treaty country adjusts the profits attributable to a permanent establishment and taxes accordingly profits of the enterprises which have been charged to tax in the other treaty country, the other country will, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the tax charged on those profits. In determining such adjustment, the competent authorities of the treaty countries will, if necessary, consult each other. The OECD acknowledges that some countries may prefer to resolve issues related to appropriate adjustments through the mutual agreement procedure if one treaty country does not unilaterally agree to make a corresponding adjustment, without any deference given to the adjusting treaty country's preferred position, and provides an alternative approach.[6] The proposed treaty between the United States and Poland follows the alternative approach, providing that the appropriate adjustment be made by the other treaty country only if the other treaty country agrees with the adjustment made by the first treaty country. The alternative approach provides that where the other treaty country does not agree with the adjustment made by the first treaty country, the treaty countries will eliminate any double taxation through mutual agreement. The Committee may wish to inquire about this alternative OECD approach, including the concerns raised by the Treasury Department related to the requirement to make appropriate adjustments as a result of an adjustment made by another treaty country.

Commitment to negotiate an agreement to avoid double taxation of investments between Puerto Rico and Spain

The Committee may wish to consider the appropriate U.S. tax policy toward the Commonwealth of Puerto Rico in the context of the income tax treaty relationship between the United States and Spain. This consideration might include a broader evaluation of U.S. tax treaty policy in relation to the U.S. territories.

The Memorandum of Understanding signed contemporaneously with the proposed protocol includes a paragraph (paragraph 3) under which the United States and Spain "commit to initiate discussions as soon as possible, but no later than six months after the entry into force of the 2013 Protocol, regarding the conclusion of an appropriate agreement to avoid double taxation on investments between Puerto Rico and Spain."

[6] See the Commentaries to the OECD Model Treaty, paragraph 68.

Paragraph 3 of the Memorandum of Understanding references paragraph 3 of the 1990 protocol. Paragraph 3 of the 1990 protocol provides, "The Parties [the United States and Spain] agreed to initiate, as soon as possible, the negotiation of a Protocol to extend the application of this Convention to Puerto Rico, taking into account the special features of the taxes applied by Puerto Rico."

Following U.S. income tax treaty policy not to apply treaties to the U.S. territories, the existing treaty with Spain generally does not apply to Puerto Rico or the other U.S. territories, and the proposed protocol does not extend the application of the treaty to Puerto Rico or the other U.S. territories.[7] Consequently, among other things, when a resident of Puerto Rico derives income in Spain or a resident of Spain derives income in Puerto Rico, the treaty's restrictions on source-basis taxation, such as reduced or zero withholding tax rates on dividends, interest, and royalties, are not available. Instead, the domestic tax laws of Puerto Rico and Spain apply to income from cross-border investments between the two jurisdictions.

It is understandable that U.S. income tax treaties do not cover Puerto Rico or the other U.S. territories: Individuals resident in the territories are generally taxed in the United States in a manner more similar to non-U.S. residents than to U.S. residents, and corporations organized in the territories likewise are subject to U.S. tax in a manner more similar to foreign corporations than to domestic corporations.[8] Moreover, territory residents may benefit from favorable tax regimes in the territories, such as the U.S. Virgin Islands' economic development incentives and, more recently, Puerto Rico's tax incentives for individuals and businesses.[9] If U.S. income tax treaty benefits were conferred on territory residents, consideration would need to be given to whether those benefits should be restricted in any way as a result of preferential tax regimes in the territories.[10] Restrictions on treaty benefits as a result of territory tax preferences would be consistent with the long-standing U.S. treaty policy against tax sparing.

On the other hand, the exclusion of territory residents from treaty benefits such as reductions in source country taxation may be in tension with the goals of some U.S. internal laws applicable to the territories. For example, the possession tax credit was intended to encourage economic activity in the territories. Economic activity might be discouraged, though, if, because

[7] See Art. 3(1)(b) (defining "United States," when used in a geographic sense, to include the 50 U.S. states and the District of Columbia but not the U.S. territories). Under U.S. internal law (section 7651), however, the IRS is permitted to obtain information from Puerto Rico and the other U.S. territories in response to a proper request for information made under Article 26 of the treaty. For more detail, see the description above of proposed protocol Article XIII.

[8] We have described tax rules applicable to the U.S. territories in more detail in documents that we have published previously. See, for example, Joint Committee on Taxation, *Federal Tax Law and Issues Related to the United States Territories* (JCX-41-12), May 14, 2012.

[9] For a description of recently enacted incentives, see Ivan Castano, "Puerto Rico Moves to Encourage Profit Shifting, Boost Collections," *Bloomberg BNA Daily Tax Report,* May 28, 2014, p I-1.

[10] In the context of the income tax treaty between the United States and Spain, the 1990 protocol's special provision related to Puerto Rico would require the United States and Spain to "tak[e] into account the special features of the taxes applied by Puerto Rico."

they are not eligible for the benefits of U.S. income tax treaties, territory residents with cross-border income must pay more in source country income taxes on that income than their peers in the United States or in foreign countries with similar treaty reductions in source taxation would face on the same income.

If no agreement is reached to address taxation of cross-border investments between Spain and Puerto Rico, the Puerto Rican government could, as one example, choose unilaterally to reduce Puerto Rican taxation of Puerto-Rico-source income derived by residents of Spain (or by residents of other countries with which the United States has income tax treaties in force).

Even if Puerto Rico were to reduce or eliminate under its domestic tax law source-basis taxation of Puerto Rico source income derived by residents of Spain, Puerto Rican investors in Spain would be taxed under Spain’s generally applicable internal tax laws unless Spain also were to grant unilateral relief to Puerto Rico residents.

More broadly, assuming the existing treaty is not extended in application to Puerto Rico, resolution of bilateral legal questions otherwise addressed by the treaty would instead be governed by the domestic laws of Puerto Rico and Spain.

Conclusion

The matters that I have described in this testimony are addressed in more detail in the Joint Committee staff pamphlets on the proposed treaty and protocol. I am happy to answer any questions that the committee may have at this time or in the future.