



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 PROTOCOL TO THE INCOME TAX TREATY WITH CANADA
AND THE PROPOSED INCOME TAX TREATIES WITH ICELAND AND BULGARIA¹**

JULY 10, 2008

My name is Emily S. McMahon. I am Deputy Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present today the testimony of the staff of the Joint Committee on Taxation concerning the proposed protocol to the income tax treaty with Canada and the proposed income tax treaties with Iceland and Bulgaria.

Overview

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

The principal purposes of the protocol and each treaty are to reduce or eliminate double taxation of income earned by residents of either the United States or the treaty country from

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 Protocol to the Income Tax Treaty with Canada and the Proposed Tax Treaties with Iceland and Bulgaria* (JCX-60-08), July 10, 2008. This publication can also be found at www.jct.gov.

² Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada* (JCX-57-08), July 8, 2008; Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Iceland* (JCX-58-08), July 8, 2008; Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Bulgaria* (JCX-59-08), July 8, 2008.

sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed protocol and each treaty also are intended to promote close economic cooperation between the United States and the respective treaty country and to eliminate possible barriers to trade and investment caused by the overlapping taxing jurisdictions of the United States and the treaty country. 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.

The proposed protocol with Canada would make several modifications to an existing income tax treaty that was signed in 1980. The U.S.-Canada income tax treaty has been modified by four previous protocols, in 1983, 1984, 1995, and 1997. The proposed income tax treaty with Iceland, together with a contemporaneously signed protocol, would replace an existing treaty signed in 1975. The proposed income tax treaty with Bulgaria, together with the proposed 2007 and 2008 protocols, would be the first income tax treaty between the United States and Bulgaria.

My testimony today will highlight some of the significant features of the proposed protocol and treaties and certain issues that they raise.

U.S. Model treaty

In November 2006, the Treasury Department released the present U.S. Model treaty.³ As a general matter, the U.S. model tax treaties are intended to provide a framework for U.S. tax treaty policy and a starting point for negotiations with our treaty partners. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on tax treaty matters. Periodical updates to reflect new developments and congressional views with regard to particular issues of U.S. tax treaty policy ensure that the model treaties remain meaningful and relevant.

The present U.S. Model treaty incorporates the key developments in U.S. income tax treaty policy that are reflected in recent U.S. income tax treaties. The proposed protocol and treaties that are the subject of this hearing are generally consistent with the provisions found in the U.S. Model treaty. However, there are some significant differences from the U.S. Model treaty that I will discuss.

Limitation-on-benefits provisions

One important area in which the proposed protocol and treaties are generally consistent with the U.S. Model treaty is the inclusion in all three proposed instruments of a comprehensive limitation-on-benefits provision. These limitation-on-benefits provisions generally are intended to make it more difficult for residents of countries other than the United States and the treaty partner to benefit inappropriately from the treaty.

³ For a comparison of the 2006 U.S. model income tax treaty with its 1996 predecessor, see Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 15, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

When a resident of one country derives income from another country, the internal tax rules of the two countries may cause that income to be taxed in both countries. One purpose of a bilateral income tax treaty is to allocate taxing rights for cross-border income and thereby to prevent double taxation of residents of the treaty countries. Although a bilateral income tax treaty is intended to apply only to residents of the two treaty countries, residents of third countries may attempt to benefit from a treaty by engaging in a practice known as “treaty shopping.” Treaty shopping may involve directing an investment in one treaty country through an entity organized in the other treaty country or engaging in income-stripping transactions with a treaty-country resident. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping.

The proposed treaty with Iceland contains a detailed limitation-on-benefits provision (Article 21) that reflects the anti-treaty-shopping provisions included in the U.S. Model treaty and more recent U.S. income tax treaties. In contrast, the present treaty between the United States and Iceland is one of only eight remaining U.S. income tax treaties that do not include any limitation-on-benefits rules. Three of those eight treaties, including the treaties with Iceland, Hungary, and Poland, provide for a complete exemption from withholding on interest payments from one treaty country to the other treaty country. Consequently, those three treaties present particularly attractive opportunities for treaty-shopping. In fact, a November 2007 report prepared by the Treasury Department at the request of the U.S. Congress suggests that the income tax treaties with Hungary and Iceland have increasingly been used for treaty-shopping purposes in recent years as the United States adopted modern limitation-on-benefits provisions in its other treaties.⁴ The proposed treaty with Iceland, including its modern limitation-on-benefits rules, would thus eliminate a significant treaty-shopping opportunity. Nevertheless, the Committee may wish to inquire of the Treasury Department regarding its plans to address the remaining U.S. income tax treaties that do not include limitation-on-benefits provisions, and in particular the treaties with Hungary and Poland.

The proposed protocol with Canada replaces Article XXIX A (Limitation on Benefits) of the present treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. Model treaty and more recent U.S. income tax treaties. Unlike the rules in the present treaty (which may be applied only by the United States), the new rules are reciprocal and are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in Canada or the United States.

The proposed treaty with Bulgaria also contains a detailed limitation-on-benefits provision similar to that of the U.S. Model treaty to prevent the inappropriate use of the treaty by third-country residents (Article 21).

⁴ Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (Nov. 28, 2007). The report states that, as of 2004, it does not appear that the U.S.-Poland income tax treaty has been extensively exploited by third-country residents.

“Zero-rate” dividend provisions

Another significant similarity between the U.S. Model treaty and the proposed protocol and treaties is the lack of a “zero-rate” of withholding tax on certain intercompany dividends. Until 2003, no U.S. income tax treaty provided for a complete exemption from dividend withholding tax, and the U.S. Model treaty and the 2005 Model Convention on Income and Capital of the Organisation for Economic Co-operation and Development (“OECD”) 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 (determined by reference to a 15-percent ownership threshold in 2007).

Moreover, the recent U.S. income tax treaties and protocols with Australia, Japan, Mexico, the Netherlands, Sweden, the United Kingdom, Germany, Belgium, Denmark, and Finland include zero-rate dividend provisions. Eligibility for this zero rate generally is contingent on meeting an 80-percent ownership threshold and certain additional requirements. The Senate ratified those treaties and protocols in 2003 (Australia, Mexico, and the United Kingdom), 2004 (Japan and the Netherlands), 2006 (Sweden), and 2007 (Germany, Belgium, Denmark, and Finland). On the other hand, neither the recent protocol with France nor the recent treaties with Bangladesh and Sri Lanka include an exemption from dividend withholding.

In general, the dividend articles of the proposed protocol and treaties provide a maximum source-country withholding tax rate of 15 percent (10 percent under the proposed treaty with Bulgaria) and a reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. A zero rate of withholding is generally available under the proposed protocol and treaties for dividends received by a pension fund. The proposed protocol and treaties also include special rules for dividends received from U.S. regulated investment companies and real estate investment trusts. These special rules generally are similar to provisions included in other recent U.S. treaties and protocols.

In previous testimony before the Committee, the Treasury Department has indicated that zero-rate dividend 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 based on an evaluation of the overall balance of benefits under the treaty. The Committee may wish to consider what overall balance of considerations prompted the Treasury Department not to seek a zero-rate provision in the proposed protocol and treaties, all of which have comprehensive limitation-on-benefits and information-exchange provisions.

Mandatory and binding arbitration provision in proposed protocol with Canada

One important feature of the proposed protocol with Canada is the replacement of the voluntary arbitration procedure of Article XXVI (Mutual Agreement Procedure) of the present treaty with a mandatory arbitration procedure that is sometimes referred to as “last best offer” arbitration. Under this procedure, each of the competent authorities proposes one and only one figure for settlement of a dispute, and the arbitrator must select one of those figures as the award. The last best offer approach is intended to induce the competent authorities to moderate their

positions, including before arbitration proceedings would commence, and thus to increase the possibility of a negotiated settlement. Under the proposed protocol, unless a taxpayer or other “concerned person” (in general, a person whose tax liability is affected by the arbitration determination) does not accept the arbitration determination, it is binding on the treaty countries with respect to the case.

The U.S. Model treaty does not include a mandatory arbitration procedure. However, the use of mandatory and binding arbitration in tax disputes between countries is not a novel concept. A provision similar to the provision in the proposed protocol with Canada does appear in the protocol with Germany and the treaty with Belgium, both ratified by the Senate in 2007. Also in 2007, the OECD Committee on Fiscal Affairs adopted proposed changes to its model treaty and commentary that incorporate a mandatory and binding arbitration procedure, some elements of which are generally similar to those of the proposed protocol. The OECD has announced that it will be adopting those changes in final form shortly. In addition, the EU has adopted certain mandatory and binding arbitration procedures that are applicable to transfer pricing disputes between members of the EU.

Judging from the actions taken by the OECD and the EU, unresolved competent authority proceedings appear to be a multinational occurrence. As a general matter, it is beneficial to resolve tax disputes effectively and efficiently. The new arbitration procedures included in the proposed protocol are intended to ensure that the mutual agreement procedures occur pursuant to a schedule and that all cases are resolved within a limited time period.

We understand that there are a significant number of competent authority cases pending between the United States and Canada, and that, historically, a substantial number of double taxation cases have not been satisfactorily resolved by the U.S. and Canadian competent authorities. The Treasury Department does not release statistics that reflect competent authority activities by individual treaty partners. While many expect that the proposed mandatory and binding arbitration procedures will be successful in resolving recurring issues and will encourage the competent authorities to settle cases without resort to arbitration, it will take time to ascertain if these procedures are effective or if unexpected problems arise.

Meanwhile, the Treasury Department or other trading partners may seek to negotiate treaty provisions with current or future treaty partners that are similar, in whole or in part, to the arbitration procedures of the proposed treaty and protocol. It is still too early to assess the effect of the addition of mandatory arbitration provisions to the Germany and Belgium treaties on the competent authority processes with respect to those countries. Therefore, the Committee may wish to better understand how the Treasury Department intends to monitor the competent authority function, as well as arbitration developments with respect to other countries, to determine the overall effects of the new arbitration procedures on the mutual agreement process. The Committee may wish to consider what information is needed to measure whether the proposed arbitration procedures result in more efficient case resolution, both before and during arbitration, and whether they enhance the quality of the outcome of the competent authority cases. In addition, the Committee may wish to inquire as to whether and under what circumstances the Treasury Department intends to pursue similar provisions in other treaties.

The Committee may also wish to consider certain specific features of the arbitration procedures included in the proposed protocol. For example, the mandatory arbitration procedure is available under the proposed protocol only with respect to certain articles specified by the treaty partners in diplomatic notes accompanying the protocol.⁵ The Committee may wish to inquire about the basis for selection of those particular articles and the implications of excluding the others. Other points that the Committee may wish to clarify include the extent to which decisions of the arbitration board will be taken into account in subsequent competent authority cases involving the same taxpayer, the same issue and substantially similar facts, and the application of the mandatory arbitration procedures to competent authority cases already pending on the date on which the proposed protocol enters into force.

Other provisions of the proposed protocol with Canada

The proposed protocol modifies a number of the provisions in the existing treaty. The rules of the proposed protocol generally are similar to rules of recent U.S. income tax treaties, the U.S. Model treaty, and the 2005 Model Convention on Income and on Capital of the Organisation for Economic Cooperation and Development (the “OECD Model treaty”). However, the existing treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models.

The proposed protocol amends Article IV (Residence) of the existing treaty specifically to address companies that are residents of both treaty countries. The proposed protocol provides that if such a dual-resident company is created under the laws in force in a treaty country but not under the laws in force in the other treaty country, the company is deemed to be a resident only of the first treaty country. If that rule does not apply (for example, because a company created in one country is continued in the other country in accordance with its corporate law), the competent authorities of the treaty countries must endeavor to settle the question of residency by mutual agreement and determine the mode of application of the treaty to the company. In the absence of such an agreement, the company is not considered to be a resident of either treaty country for purposes of claiming any benefits under the treaty.

The proposed protocol also amends Article IV of the existing treaty to provide specific rules regarding the circumstances in which amounts of income, profit, or gain are deemed to be derived through or paid by fiscally transparent entities. In general, an amount of income, profit, or gain is considered to be derived by a resident of a treaty country if (1) that person is considered under the taxation law of that country to have derived the amount through an entity, other than an entity that is a resident of the other treaty country, and (2) by reason of that entity being treated as fiscally transparent under the laws of the first treaty country, the treatment of the amount under the taxation law of that country is the same as its treatment would be if that amount had been derived directly by that person. Notwithstanding the general rule, an amount of income, profit, or gain is considered not to be paid to or derived by a person who is a resident of

⁵ These articles are: Article IV (Residence), but only to the extent the case relates to the residence of natural persons; Article V (Permanent Establishment); Article VII (Business Profits); Article IX (Related Persons); and Article XII (Royalties), but only to the extent the case relates (1) to the application of Article XII to transactions involving related persons, or (2) to an allocation of amounts between taxable and non-taxable royalties.

a treaty country if (1) that person is considered under the taxation law of the other treaty country as deriving the amount through an entity that is not a resident of the first treaty country, but (2) by reason of the entity not being treated as fiscally transparent under the laws of that treaty country, the treatment of the amount under the taxation law of that country is not the same as its treatment would be if that amount had been derived directly by the person. These rules are consistent with present U.S. tax rules.

The proposed protocol provides an additional rule applicable in the area of fiscally transparent entities that is new to the U.S. tax treaty network. Under this new rule, an amount of income, profit, or gain is not considered to be paid to or derived by a person who is a resident of a treaty country if (1) the person is considered under the tax law of the other treaty country to have received the amount from an entity resident in the other treaty country, but (2) by reason of the entity being treated as fiscally transparent under the laws of the first treaty country, the treatment of the amount received by that person under the tax law of that country is not the same as its treatment would be if the entity were treated as not fiscally transparent under the laws of that country. Thus, treaty benefits may not be claimed with respect to such payments. There is some uncertainty with regard to how this rule applies to deductible payments made by hybrid partnerships, and the Committee may wish to inquire about this point.

The proposed protocol amends Article V of the existing treaty to add a special rule under which services performed by an enterprise of a treaty country in the other treaty country may give rise to a permanent establishment in the other country if the enterprise exceeds certain levels of presence in the other country and if certain other conditions are met. The special rule applies if the enterprise does not have a permanent establishment in the other country by virtue of any of the customary treaty standards. A similar provision appears in several existing U.S. tax treaties with developing countries (and in the proposed treaty with Bulgaria), but this is the first time such a provision has been proposed with a developed country. If certain additional conditions are met, the provision would subject individual employees to taxation as well. There are several unresolved questions regarding the administration of this provision. The Committee may wish to inquire whether active discussion is occurring between the United States and Canada on these matters, and whether these questions will be resolved before the protocol becomes effective.

The proposed protocol applies the treaty partners' interpretation of the arm's-length standard in a manner consistent with the OECD Transfer Pricing Guidelines to the attribution of profits to a permanent establishment under Article VII, taking into account the different economic and legal circumstances of a single legal entity. Under the proposed protocol, the business profits to be attributed to a permanent establishment include only the profits derived from the assets used, risks assumed, and activities performed by the permanent establishment. The proposed protocol also amends Article VII of the existing treaty to clarify that income may be attributable to a permanent establishment that no longer exists in one of the treaty countries. In addition, the proposed protocol provides that income derived from independent personal services (i.e., income from the performance of professional services and of other activities of an independent character) is included within the meaning of the term "business profits." Accordingly, the treatment of such income is governed by Article VII rather than by present treaty Article XIV (Independent Personal Services), which the proposed protocol deletes. These new rules are similar to provisions included in other recent U.S. treaties and protocols, including the U.S Model treaty.

The proposed protocol modifies Article X (Dividends) of the present treaty to reflect more closely the dividend provisions included in the U.S. Model treaty and recent U.S. income tax treaties. The modifications include a revised definition of the term “dividends” and an updated special rule that applies to dividends paid by U.S. REITs.

The proposed protocol replaces Article XI (Interest) of the present treaty with a new article that generally provides for exclusive residence-country taxation of interest. Limited exceptions permit source-country taxation of interest if the beneficial owner of the interest carries on, or has carried on, business through a permanent establishment in the source country and the debt-claim in respect of which the interest is paid is effectively connected with that permanent establishment. Two anti-abuse provisions relating to contingent interest payments and residual interests in real estate mortgage investment conduits also permit source-country taxation of interest. Special rules apply to cases involving a non-arm’s-length interest charge between a payer and a beneficial owner that have a special relationship.

The proposed protocol conforms Article XII (Royalties) to the proposed elimination of Article XIV (Independent Personal Services) and clarifies the treatment of income attributable to a permanent establishment that has ceased to exist.

The proposed protocol modifies Article XIII (Gains) of the present treaty in two principal respects. First, the proposed protocol narrows the emigration exception to the Article’s rule providing for exclusive residence-country taxation of gains from the alienation of property in cases other than those specifically enumerated in Article XIII. The proposed protocol provides that this exception will not apply if the property was treated as alienated immediately before an individual’s emigration. Second, the proposed protocol provides a revised election intended to coordinate U.S. and Canadian taxation of gains in the case of timing mismatches.

The proposed protocol conforms Article XV (Dependent Personal Services) of the present treaty to the U.S. and OECD Model treaties, as well as to the proposed elimination of Article XIV (Independent Personal Services), and broadens the definition of “remuneration.” In addition, the proposed protocol changes the rules with respect to calculating the number of days an individual is present in the other treaty country for purposes of determining if a resident of one treaty country may be taxed by the other treaty country. The proposed protocol also contains provisions intended to eliminate potential abuses through the use of intermediary employers. The diplomatic notes exchanged in connection with the proposed protocol set forth new rules for allocating income from the exercise or disposal of an option between the two treaty countries.

The proposed protocol modifies some of the existing treaty rules of Article XVIII of the present treaty (Pensions and Annuities), mostly to address Roth individual retirement accounts, and adds several new provisions that address cross-border pension contributions and benefits accruals. Many of the new rules are similar to those found in the U.S. Model treaty, but several reflect the uniquely large cross-border flow of personal services between Canada and the United States, including the large number of cross-border commuters. These rules are intended to remove barriers to the flow of personal services between the two countries that could otherwise result from discontinuities under the laws of each country regarding the deductibility of pension contributions and the taxation of a pension plan's earnings and accretions in value. In addition,

the proposed protocol adds a new provision to address the source of certain annuity or life insurance payments made by branches of insurance companies.

The proposed protocol replaces Article XX (Students) of the present treaty with a new article that generally corresponds to the treatment provided under the present treaty. The proposed protocol adds a one-year limitation on the exemption from income tax in the host country in the case of apprentices and business trainees.

The proposed protocol modifies Article XXI (Exempt Organizations). The new rules are intended to permit charitable-type organizations to invest indirectly and to pool their investments with pension-type organizations.

The proposed protocol adds a new paragraph to Article XXII (Other Income) of the treaty for guarantee fees. The new paragraph provides that compensation derived by a resident of a contracting state in respect of a guarantee of indebtedness shall be taxable only in that state, unless the compensation is business profits attributable to a permanent establishment in the other contracting state, in which case Article VII (Business Profits) shall apply.

The proposed protocol changes the obligations of Canada under Article XXIV (Elimination of Double Taxation) of the treaty with respect to dividends received by a Canadian company from a U.S. resident company. Under the proposed protocol, a Canadian company receiving a dividend from a U.S. resident company of which it owns at least 10 percent of the voting stock, is allowed a credit against Canadian income tax for the appropriate amount of income tax paid or accrued to the United States by the dividend paying company with respect to the profits out of which the dividends are paid.

The proposed protocol revises the general rules of Article XXV (Non-Discrimination) of the present treaty to bring those rules into closer conformity with the U.S. Model treaty and recent U.S. income tax treaties. The proposed protocol generally prohibits a treaty country from discriminating against nationals of the other treaty country by imposing on those nationals more burdensome taxation than it imposes or may impose on its own nationals in the same circumstances.

The proposed protocol modifies Article XXVI A (Assistance in Collection) of the present treaty to further limit, in a narrow class of cases, one treaty country's obligation to assist the other treaty country in collecting taxes. The modifications also explicitly provide that the assistance-in-collection provisions apply to contributions to social security and employment insurance premiums levied by or on behalf of the government of a treaty country.

The proposed protocol replaces Article XXVII (Exchange of Information) of the present treaty with rules similar to those in the U.S. model treaty. The proposed rules generally provide that the two competent authorities will exchange such information as may be relevant in carrying out the provisions of the domestic laws of the United States and Canada concerning taxes to which the treaty applies to the extent the taxation under those laws is not contrary to the treaty.

The proposed protocol amends the saving clause in Article XXIX (Miscellaneous Rules) to bring the treaty generally in conformity with the U.S. taxation of former citizens and former long-term residents under section 877 of the Code. The proposed protocol provides that

notwithstanding the other provisions of the treaty, a former citizen or former long-term resident of the United States, may, for a period of ten years following the loss of such status, be taxed in accordance with the laws of the United States with respect to income from sources within the United States (including income deemed under the domestic law of the United States to arise from such sources). Section 877 is applicable to individuals who relinquish their U.S. citizenship or cease to be a lawful permanent resident prior to June 17, 2008.

For any individual who relinquishes U.S. citizenship or ceases to be a lawful permanent resident of the United States on or after June 17, 2008, a new set of rules applies. In general, to the extent those rules impose U.S. tax on an individual after the individual expatriates, they require or deem the individual to waive any rights to claim a reduction in U.S. tax under a U.S. tax treaty and any other rights under a U.S. tax treaty that would preclude the assessment or collection of tax imposed by the new rules.

The proposed protocol replaces Article XXIX B (Taxes Imposed by Reason of Death) of the present treaty with a new article that generally addresses certain concerns regarding the application of Canadian tax rules and regarding the availability of tax credits or deductions when the United States and Canada impose tax on the same items of income or property.

Article 27 of the proposed protocol provides for the entry into force of the proposed protocol. The provisions of the proposed protocol are generally effective on a prospective basis. However, the provisions with respect to dual-residence tie breakers (Article 2 of the proposed protocol) and an emigrant's gain (Article 8 of the proposed protocol) are effective retroactive to September 17, 2000. In certain situations, the reduction of interest withholding rates is also retroactive, with the initial phase-in rate applicable for the year in which the proposed protocol becomes effective. Also, the provisions for assistance in the collection of taxes are retroactively effective to revenue claims that have been definitively determined after November 9, 1985.

With respect to certain payments through fiscally transparent entities and the new provisions regarding permanent establishments, the proposed protocol is effective as of the first day of the third year that ends after the proposed protocol enters into force. Special rules apply for determining when to start counting (1) days present, (2) services rendered, and (3) gross active business revenues for purposes of the permanent establishment provision. With respect to the arbitration provisions, the proposed protocol clarifies that a competent authority matter currently in progress will be deemed to have started on the date on which the proposed protocol enters into force.

Iceland

The proposed treaty replaces the existing treaty that was signed in 1975. The rules of the proposed treaty generally are similar to rules of recent U.S. income tax treaties, the U.S Model treaty, and the OECD Model treaty. However, the proposed treaty contains certain substantive deviations from these treaties and models.

The proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a

permanent establishment (Article 7). Similarly, the proposed treaty contains certain exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 7, 14, and 16). The proposed treaty also provides that pensions and other similar remuneration paid to a resident of one country may be taxed only by that country, and only at such time and to the extent that a pension distribution is made (Article 17).

The proposed treaty provides that dividends and certain gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10 and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends may be limited by the proposed treaty. The proposed treaty provides that, subject to certain rules and exceptions, interest and most types of royalties derived by a resident of either country from sources within the other country may be taxed only by the residence country (Articles 11 and 12). Notwithstanding this general rule, the source country may impose tax on certain royalties in an amount not to exceed five percent of such royalties.

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for foreign taxes paid to the other country (Article 22).

The proposed treaty contains the standard provision (the “saving clause”) included in U.S. tax treaties pursuant to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). In addition, the proposed treaty contains the standard provision that the treaty may not be applied to deny any taxpayer any benefits to which the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries (Article 1).

The proposed treaty (Article 19) generally provides that students, business trainees, and researchers visiting the other treaty country are exempt from host country taxation on certain types of payments received.

The proposed treaty includes the standard provision (Article 20) that assigns taxing jurisdiction over income not addressed in the other articles of the proposed treaty. In general, such income is taxable solely by the residence country. The proposed treaty provides authority for the two countries to resolve disputes (Article 24) and exchange information (Article 25) in order to carry out the provisions of the proposed treaty.

The provisions of the proposed treaty will have effect generally on or after the first day of January following the date that the proposed treaty enters into force. The proposed treaty allows taxpayers to temporarily continue to claim benefits under the present treaty for up to an additional year if they would have been entitled to greater benefits under the present treaty. In addition, a teacher entitled to benefits under the present treaty at the time the proposed treaty enters into force will continue to be entitled to the benefits available under the present treaty for as long as such individual would have been entitled to the previously existing benefits.

Bulgaria

The United States and Bulgaria do not have an income tax treaty currently in force. The rules of the proposed treaty and protocols generally are similar to various rules of recent U.S. income tax treaties, the U.S. Model treaty, the OECD Model treaty, and the 1980 United Nations Model Double Taxation Convention between Developed and Developing Countries, as amended January 11, 2001 (“the U.N. Model treaty”). However, the proposed treaty, as amended by the proposed 2007 and 2008 protocols, also contains certain substantive deviations from these treaties and models.

The proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 5). The proposed treaty includes a special rule under which services performed by an enterprise of a treaty country in the other treaty country may give rise to a permanent establishment in the other country if the enterprise’s activities in the other country occur for a certain number days and if certain other conditions are met. The special rule applies if the enterprise does not have a permanent establishment in the other country by virtue of any of the customary treaty standards.

The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends, interest, and royalties may be limited by the proposed treaty (Articles 10, 11, and 12). Withholding tax on dividends is limited to 10 percent in most cases and is limited to five percent for dividends received by a company owning at least 10 percent of the dividend-paying company. A zero rate of withholding tax generally applies to dividends received by pension funds. In general, withholding tax on interest and royalties is limited to five percent under the proposed treaty. Under the proposed 2007 protocol, the treaty countries agree to reconsider source-country taxation of interest and royalties arising in Bulgaria and beneficially owned by a resident of the United States, at a time that is consistent with the December 31, 2014 conclusion of the transition period under a European Union Council Directive applicable to interest and royalties deemed to arise in Bulgaria and beneficially owned by a resident of the European Union.

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation, in the case of residents of the United States, through the allowance of a credit for foreign taxes paid to Bulgaria, and, in the case of residents of Bulgaria, through a combination of credits and exemptions (Article 22).

The proposed treaty contains the standard provision (the “saving clause”) included in U.S. tax treaties pursuant to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). In addition, the proposed treaty contains the standard provision providing that the treaty may not be applied to deny any taxpayer any benefits the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries (Article 1).

The proposed treaty includes the standard provision (Article 20) that assigns taxing jurisdiction over income not addressed in the other articles of the proposed treaty. In general, such income is taxable solely by the residence country. The proposed treaty provides authority for the two countries to exchange information (Article 25) in order to carry out the provisions of the proposed treaty. The proposed treaty also contains a detailed limitation-on-benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 21).

Conclusion

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