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ON
THE RATIFICATION OF INCOME TAX TREATIES AND A PROTOCOL

BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS
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Mr. Chairman and Members of the Committee:

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

The NFTC, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and the NFTC therefore seeks to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad. As global competition grows ever more intense, it is vital to the health of U.S. enterprises and to their continuing ability to contribute to the U.S. economy that they be free from excessive foreign taxes or double taxation and impediments to the flow of capital that can serve as barriers to full participation in the international marketplace. Foreign trade is fundamental to the economic growth of U.S. companies. Tax treaties are a crucial component of the framework that is necessary to allow that growth and to balanced competition.

This is why the NFTC has long supported the expansion and strengthening of the U.S. tax treaty network and why we are here today to recommend ratification of the Tax Convention with Japan and the Tax Convention and Protocol with Sri Lanka.

TAX TREATIES AND THEIR IMPORTANCE TO THE UNITED STATES

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

In addition, the tax systems of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners, and treaties are the mechanism by which these taxes are lowered on a bilateral basis. If U.S. enterprises earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they are liable to suffer excessive and noncreditable levels of foreign tax and to be at a competitive disadvantage relative to traders and investors from other countries that do have such benefits. Tax treaties serve to prevent this barrier to U.S. participation in international commerce.

If U.S. businesses are going to maintain a competitive position around the world, we need a treaty policy that protects them from multiple or excessive levels of foreign tax on cross border investments, particularly if their competitors already enjoy that advantage. The United States has lagged behind other developed countries in eliminating this withholding tax and leveling the playing field for cross-border investment. The European Union (EU) eliminated the tax on intra-EU, parent-subsidiary dividends over a decade ago and dozens of bilateral treaties between foreign countries have also followed that route. The majority of OECD countries now have bilateral treaties in place that provide for a zero rate on parent-subsidiary dividends.

Tax treaties also provide other features that are vital to the competitive position of U.S. businesses. For example, by prescribing internationally agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring foreign tax laws to be applied in a nondiscriminatory manner to U.S. enterprises, treaties offer a significant measure of certainty to potential investors. Another extremely important benefit which is available exclusively under tax treaties is the mutual agreement procedure. This bilateral administrative mechanism avoids double taxation on cross-border transactions.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the United States by providing for the administration of U.S. tax laws and the implementation of U.S. treaty policy. The article that provides for the exchange of information between tax authorities is an excellent example of the benefits that result from an expanded tax treaty network. Treaties also offer the possibility of administrative assistance in the collection of taxes between the relevant tax authorities.

A framework for the resolution of disputes with respect to overlapping claims by the respective governments are also provided for in tax treaties. In particular, the practices of the Competent Authorities under the treaties have led to agreements, known as “Advance Pricing Agreements” or “APAs,” through which tax authorities of the United States and other countries have been able to avoid costly and unproductive proceedings over appropriate transfer prices for the trade in goods and services between related entities. APAs, which are agreements jointly entered into between one or more countries and particular taxpayers, have become common and increasingly popular procedures for countries and taxpayers to settle their transfer pricing issues in advance of dispute. The clear trend is that treaties are becoming an increasingly important tool used by tax authorities and taxpayers alike in striving for fairer and more efficient application of the tax laws.

AGREEMENTS BEFORE THE COMMITTEE

The Japan Tax Treaty that is before the committee today is a much needed update to an agreement between the world's two largest economies that is over thirty years old. Its completion will enhance an already flourishing economic relationship between our two countries. We highly commend Treasury for its unparallel commitment to completing this historic agreement.

The NFTC has for years urged adjustment of U.S. treaty policies to allow for a zero withholding rate on related-entity dividends, and we praise the Treasury for making further progress in this treaty with Japan. This agreement makes an important contribution toward improving the economic competitiveness of U.S. companies. Indeed, it bolsters and improves upon the standard set in the United Kingdom, Australian, and Mexican agreements ratified last year by lowering the ownership threshold required to receive the benefit of the zero dividend withholding rate from 80 to 50 percent. We thank the committee for its prior support of this evolution in U.S. tax treaty policy and we strongly urge you to continue that support by approving the Japan Treaty.

The existence of a withholding tax on cross-border, parent-subsidiary dividends, even at the five percent rate previously typical in U.S. treaties, has served as a tariff-like impediment to cross border investment flows. Without a zero rate, the combination of the underlying corporate tax and the withholding tax on the dividend will often leave parent companies with an excess of foreign tax credits. Because these excesses are unusable, the result is a lower return from a cross-border investment than a comparable domestic investment. Tax treaties are designed to prevent this distortion in the investment decision-making process by reducing multiple taxation of profits within a corporate group, and they serve to prevent the hurdle to U.S. participation in international commerce. Eliminating the withholding tax on cross-border dividends means that U.S. companies with stakes in Japanese companies will now be able to meet their foreign competitors on a level playing field.

In addition to the elimination of the withholding tax on parent-subsidiary dividends, the Japan Treaty includes the welcome elimination of the withholding tax on royalties. Under normal circumstances, withholding tax by the source nation on payments for the use or right to use certain property is completely eliminated, a positive development for U.S. companies selling copyrighted products in Japan. U.S. software companies are just one example of an industry that will benefit from the freedom from double taxation arising from the uncertainty regarding whether the Japanese withholding tax will qualify for the U.S. foreign tax credit. A U.S. software company, for example, that developed a standardized program for use by companies around the world will no longer be subject to the 10% withholding tax associated with selling the rights to use the technology in Japan, eliminating the competitive disadvantage previously faced by U.S. companies.

The Japan Treaty also removes the withholding tax on certain interest payments leveling the playing field for U.S. financial institutions. Without the benefit of the new treaty, a Japanese entity financing its U.S. operations using a U.S. financial institution, would have to withhold Japanese tax on the interest payments paid to the U.S. financial institution increasing the cost of the loan and making the transaction cost prohibitive. The elimination of the 10 percent withholding tax on interest payments enables Japanese entities to apply to a U.S. financial

institution for a loan to fund their U.S. operations providing an opportunity for U.S. financial institutions to compete for that business.

Another notable inclusion is a zero withholding rate on dividends paid to pension funds which should attract investment from those funds into U.S. stocks. A section which should give more appropriate tax treatment in Japan to the profusion of hybrid business structures which has occurred since the negotiation of the original treaty is also available under the new agreement. Also reflected is modern U.S. tax treaty policy regarding when reduced U.S. withholding rates will apply to dividends paid by Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs), as well as recent U.S. law changes aimed at preserving taxing jurisdiction over certain individuals who terminate their long-term residence within the United States.

Important safeguards are included in this treaty to prevent treaty shopping. In order to qualify for the lowered rates specified by the treaty, companies must meet certain requirements so that foreigners whose governments have not negotiated a tax treaty with Japan or the U.S. cannot free-ride on this treaty. Similarly, provisions in the sections on dividends, interest, and royalties prevent arrangements by which a U.S. company is used as a conduit to do the same. Extensive provisions in the treaty are intended to ensure that the benefits of the treaty accrue only to those for which they are intended.

The Senate's ratification of this agreement will help Treasury in its continuing effort to negotiate similar agreements with other countries. Among the reasons that this treaty is important to the U.S. business community is the actual and precedential effect of eliminating the withholding tax on parent-subsidiary dividends, royalties and interest, and because of several other benefits they introduce. We are particularly hopeful that the Senate will be able to complete its ratification procedures so that instruments of ratification may be exchanged before April 1, 2004. This will prevent a delay in access to the Japan Treaty's relief from withholding taxes, since those provisions go into effect July 1, 2004 only if both parties have completed their ratification process by the end of March 2004. If ratification of the treaty is completed in 2004, but after the end of March, those treaty benefits will be delayed until January 1, 2005.

The tax treaty and protocol with Sri Lanka represents a new tax treaty relationship for the United States. The agreements are a significant step forward in the U.S. economic relationship with Sri Lanka. They expand on the ongoing discussions under the U.S. Sri Lanka Trade and Investment Framework Agreement aimed at developing and diversifying trade between the two countries.

As a modernizing nation, Sri Lanka is in a developmental phase, which gives rise to opportunities for American business because of the projects and the economic development that an expanding infrastructure will allow. Sri Lanka is taking important steps to open its economy as part of its commitment to the World Trade Organization

Sri Lanka has tax treaties in force with several of its other major trading partners in the EU and Asia. As a member of the British Commonwealth, Sri Lanka enjoys special treatment under that regime. Without a similar tax arrangement, U.S. companies that are interested in investing in or trading with Sri Lanka are at a competitive disadvantage.

While the Sri Lanka Treaty does not go as far at the Japan Treaty (e.g., in eliminating withholding taxes for dividends, interest, and royalties), it represents an important starting point in a growing economic relationship with Sri Lanka. The corresponding Sri Lanka Protocol reflects current U.S. tax treaty policy, and like the Japan Treaty, the Sri Lanka Treaty includes appropriate measures to prevent treaty shopping. The NFTC urges action to restore the competitive balance afforded to U.S. enterprises by this tax treaty.

GENERAL COMMENTS ON TAX TREATY POLICY

While we are not aware of any opposition to the treaties under consideration, the NFTC as it has done in the past as a general cautionary note, urges the Committee to reject opposition to the agreements based on the presence or absence of a single provision. No process that is as laden with competing considerations as the negotiation of a full-scale tax treaty between sovereign states will be able to produce an agreement that will completely satisfy every possible constituency, and no such result should be expected. Virtually all treaty relationships arise from difficult and sometimes delicate negotiations aimed at resolving conflicts between the tax laws and policies of the negotiating countries. The resulting compromises always reflect a series of concessions by both countries from their preferred positions. Recognizing this, but also cognizant of the vital role tax treaties play in creating a level playing field for enterprises engaged in international commerce, the NFTC believes that treaties should be evaluated on the basis of their overall effect. In other words, agreements should be judged on whether they encourage international flows of trade and investment between the United States and the other country. An agreement that meets this standard will provide the guidance enterprises need in planning for the future, provide nondiscriminatory treatment for U.S. traders and investors as compared to those of other countries, and meet a minimum level of acceptability in comparison with the preferred U.S. position and expressed goals of the business community.

Slavish comparisons of a particular treaty's provisions with the U.S. Model or with treaties with other countries do not provide an appropriate basis for analyzing a treaty's value. U.S. negotiators are to be applauded for achieving agreements that reflect as well as these treaties do the positions of the U.S. Model and the views expressed by the U.S. business community.

The NFTC also wishes to emphasize how important treaties are in creating, implementing, and preserving an international consensus on the desirability of avoiding double taxation, particularly with respect to transactions between related entities. The United States, together with many of its treaty partners, has worked long and hard through the OECD and other fora to promote acceptance of the arm's length standard for pricing transactions between related parties. The worldwide acceptance of this standard, which is reflected in the intricate treaty network covering the United States and dozens of other countries, is a tribute to governments' commitment to prevent conflicting income measurements from leading to double taxation and resulting distortions and barriers for healthy international trade. Treaties are a crucial element in achieving this goal, because they contain an expression of both governments' commitment to the arm's length standard and provide the only available bilateral mechanism, the competent authority procedure, to resolve any disputes about the application of the standard in practice.

We recognize that determination of the appropriate arm's length transfer price for the exchange of goods and services between related entities is sometimes a complex task that can lead to good faith disagreements between well-intentioned parties. Nevertheless, the points of international agreement on the governing principles far outnumber any points of disagreement. Indeed, after decades of close examination, governments around the world agree that the arm's length principle is the best available standard for determining the appropriate transfer price, because of both its economic neutrality and its ability to be applied by taxpayers and revenue authorities alike by reference to verifiable data.

The NFTC strongly supports the efforts of the Internal Revenue Service and the Treasury to promote continuing international consensus on the appropriate transfer pricing standards, as well as innovative procedures for implementing that consensus. We applaud the continued growth of the APA program, which is designed to achieve agreement between taxpayers and revenue authorities on the proper pricing methodology to be used, before disputes arise. We commend the ongoing efforts of the IRS to refine and improve the operation of the competent authority process under treaties, to make it a more efficient and reliable means of avoiding double taxation.

The NFTC also wishes to reaffirm its support for the existing procedure by which Treasury consults on a regular basis with this Committee, the tax-writing Committees, and the appropriate Congressional staffs concerning tax treaty issues and negotiations and the interaction between treaties and developing tax legislation. We encourage all participants in such consultations to give them a high priority. We also commend this Committee for scheduling tax treaty hearings so soon after receiving the agreements from the Executive Branch. Doing so enables improvements in the treaty network to enter into effect as quickly as possible.

We would also like to reaffirm our view, frequently voiced in the past, that Congress should avoid occasions of overriding the U.S. tax treaty commitments that are approved by this Committee by subsequent domestic legislation. We believe that consultation, negotiation, and mutual agreement upon changes, rather than unilateral legislative abrogation of treaty commitments, better supports the mutual goals of treaty partners.

IN CONCLUSION

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

We commend the Committee for its commitment to proceed with ratification of these important agreements as expeditiously as possible.