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INCOME TAX CONVENTION WITH KAZAKHSTAN

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Mr. HELMS, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 103–33, Treaty Doc. 104–15, and Exchange of Notes dated June 16 and 23, 1995 (EC–1431)]

The Committee on Foreign Relations, to which was referred the Convention Between the Government of the United States of America and the Government of the Republic of Kazakhstan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, with Protocol, signed at Almaty on October 24, 1993, and two related exchanges of notes dated August 1 and September 7, 1994, and August 15 and September 7, 1994; an exchange of notes dated at Washington July 10, 1995 relating to such convention and protocol; and an exchange of notes dated June 16 and 23, 1995, having considered the same, reports favorably thereon, without amendment, and recommends that the Senate give its advice and consent to ratification thereof, subject to a proviso.

I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and Kazakhstan are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation and facilitate trade and investment between the two countries. It also is intended to enable the two countries to cooperate in preventing avoidance and evasion of taxes.

II. BACKGROUND

The proposed treaty and the proposed protocol were both signed on October 24, 1993. Two related exchanges of notes were dated

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August 1 and September 7, 1994 and August 15 and September 7, 1994. In addition, there was an exchange of notes dated July 10, 1995, and an exchange of notes dated June 16 and 23, 1995. Currently, the United States and Kazakhstan adhere to the provisions of a tax treaty signed June 20, 1973 between the Soviet Union and the United States (the "USSR treaty"). The proposed treaty replaces the USSR treaty with respect to Kazakhstan.

The proposed treaty, together with the related protocol and the two related exchanges of notes, was transmitted to the Senate for advice and consent to its ratification on September 19, 1994 (see Treaty Doc. 103–33). The exchange of notes dated July 10, 1995 was transmitted to the Senate for advice and consent to its ratification on August 3, 1995 (see Treaty Doc. 104–15). The exchange of notes dated June 16 and 23, 1995 was transmitted to the Senate on September 18, 1995 (see EC–1431). The Committee on Foreign Relations held a public hearing on the proposed treaty on June 13, 1995.

III. Summary

In general

As in other U.S. tax treaties, the principal objectives of the proposed income tax treaty generally are achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard treaty provisions that neither country will 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 or fixed base (Articles 6 and 14). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 14–16). The proposed treaty provides that dividends, interest, and royalties derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10–12). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10–12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit (Article 23).

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

(Article 1); that is, the treaty will only be applied to the benefit of taxpayers.

Summary of treaty provisions

The proposed treaty is similar to other U.S. income tax treaties, the 1981 U.S. model treaty (the "U.S. model"),[1] and the model income tax treaty of the Organization for Economic Development (the "OECD model"). However, the proposed treaty contains certain deviations from those models. It also differs in significant respects from the USSR treaty. (That treaty predates the 1981 U.S. model treaty and was not representative of U.S. treaty policy.) A summary of the provisions of the proposed treaty and the proposed protocol, including some of these differences, follows:

(1) Like all treaties, the proposed treaty is limited by a "saving clause" (Article 1(3)), under which the treaty is not to affect (subject to specific exceptions) the taxation by either treaty country of its residents or its nationals. Exceptions to the saving clause are similar to those in the U.S. model and other U.S. treaties; the USSR treaty, in contrast, flatly states that it shall not restrict the right of a treaty country to tax its own citizens.

(2) The U.S. excise tax on insurance premiums paid to a foreign insurer is not a covered tax; that is, the proposed treaty does not preclude the imposition of the tax on insurance premiums paid to Kazakhstani insurers (Article 2). This is a departure from the USSR treaty and the U.S. model tax treaty, but one that is shared by many U.S. treaties, including recent ones. In addition, the proposed treaty, like the model treaty but unlike the USSR treaty, does not contain a general prohibition on source country taxation of reinsurance premiums derived by a resident of the other country. Nor does the proposed treaty contain the provision of the USSR treaty under which, if the income of a resident of one country is tax-exempt in the other country, the transaction giving rise to that income is exempt from any tax that is or may otherwise be imposed on the transaction.

(3) Like the U.S. model but unlike the USSR treaty, the proposed treaty generally does not cover U.S. taxes other than income taxes, although it does cover taxes on property. Nor does the proposed treaty cover the accumulated earnings tax, the personal holding company tax, and social security taxes.

(4) The proposed treaty makes it clear that each country includes its territorial sea, and also the economic zone and continental shelf in which certain sovereign rights and jurisdiction may be exercised in accordance with international law (Article 3).

(5) By contrast with the USSR treaty, but like the U.S. model, U.S. citizens are entitled to treaty benefits regardless of actual residence in a third country. In addition, the proposed treaty introduces rules for determining when a person is a resident of either the United States or Kazakhstan, and hence entitled to benefits under the treaty (Article 4). The proposed treaty, like the model,

[1] The Treasury Department has withdrawn the U.S. model from use as a model treaty. Accordingly, its provisions may no longer represent the preferred position for U.S. treaty negotiations. Comparison of the provisions of the proposed treaty against the provisions of the U.S. model should be considered in the context of the provisions of comparable recent U.S. treaties with other countries. The Treasury Department's new model, released on September 20, 1996, was released too late for consideration by the Committee in connection with the proposed treaty.

provides tie-breaker rules for determining the residence for treaty purposes of "dual residents," or persons having residence status under the internal laws of each of the treaty countries.

(6) Article 5 of the proposed treaty introduces the permanent establishment threshold for one country's imposition of tax on the business profits of a resident of the other country, in conformity with the U.S. and OECD model treaties. This replaces the concept of a "representation" used in the USSR treaty.

(7) Under the U.S. model treaty, a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, constitutes a permanent establishment only if it lasts more than 12 months. The corresponding rule in the proposed treaty is the same. Under the USSR treaty, the source country is prohibited from taxing the income of a resident of the other country from furnishing engineering, architectural, designing, and other technical services in connection with an installation contract with a resident of the source country and which are carried out in a period not longer than 36 months at one location. The proposed treaty treats as a permanent establishment the furnishing of services, including consultancy services, within a country for a period of more than 12 months.

(8) The USSR treaty in general imposes no restriction on the taxation of income from real property by the country in which the property is located. The proposed treaty contains a provision similar to the corresponding model treaty provision permitting taxation of such income by the country in which the real property is located, including the U.S. model treaty provision under which investors in real property in the country not of their residence must be permitted to elect to be taxed on those investments on a net basis (Article 9).

(9) The business profits article of the U.S. model treaty omits the force of attraction rules contained in the Code, providing instead that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. The proposed treaty, on the other hand, contains a limited force of attraction rule (Article 6) under which a country (the first country) could tax sales in that country by a resident of the other country of goods or merchandise of the same or similar kind as the goods or merchandise that are sold by that person through its permanent establishment in the first country and other business activities in that country of the same kind as those effected through its permanent establishment. This rule is narrower in scope than the Code's force of attraction rules.

(10) The proposed treaty clarifies that a country may tax profits or income if the other-country resident carries on "or has carried on" business, or has "or had" a fixed base, in that country. Addition of the words "or has carried on" and "or had" clarifies that, for purposes of the treaty rules stated above, any income attributable to a permanent establishment (or fixed base) during its existence is taxable in the country where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) has ceased to exist.

(11) The proposed treaty provides that expenses incurred for the purposes of the permanent establishment are to be allowed as deductions from the taxable income of a permanent establishment. However, the proposed treaty provides that no deductions may be taken in respect of amounts paid by the permanent establishment to the head office in the form of royalties, fees, or other payments, to the extent that they exceed reimbursements of costs incurred by the head office and allocable to the permanent establishment.

(12) The proposed treaty, similar to the model treaty and similar in some respects to the USSR treaty, provides that income of a resident of one treaty country from the operation of ships or aircraft in international traffic is taxable only in that country (Article 8). Similar to the model treaty, the proposed treaty includes bareboat leasing income in the category of income to which this rule applies. Similar to the model treaty and unlike the present treaty, the proposed treaty provides that income of a treaty-country resident from the use or rental of containers and related equipment used in international traffic shall be taxable only in that country.

(13) Article 7 of the proposed treaty corresponds to the associated enterprises article in the U.S. model treaty. In particular, the proposed treaty contains a "correlative adjustment" clause, providing that either treaty country must correlatively adjust any tax liability it previously imposed on a person for income reallocated to a related person by the other treaty country. The USSR treaty contains no associated enterprises article.

(14) The USSR treaty generally imposes no restriction on the source-country taxation of dividends. The proposed treaty, similar to the U.S. model treaty, provides in Article 10 that direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting shares of the payor) generally will be taxable by the source country at a rate no greater than 5 percent. Other dividends generally are taxable by the source country at a rate no greater than 15 percent.

(15) Like recent U.S. treaties, the proposed protocol provides that dividends paid by a U.S. regulated investment company (a "RIC") are subject to source country taxation at the 15-percent limit (paragraph 2(a)). In addition, like some recent U.S. treaties, the proposed treaty and proposed protocol impose no general restriction on the source country taxation of dividends paid by a U.S. real estate investment trust (a "REIT").

(16) The USSR treaty generally imposes no restriction on the U.S. branch profits tax. The proposed treaty, similar to U.S. treaties negotiated since 1986, expressly permits the United States and Kazakhstan to impose a branch profits tax, but at a rate not exceeding 5 percent (Article 10(5)).

(17) The USSR treaty limits the source-country taxation of interest only in the case of interest in connection with the financing of trade between the United States and the Soviet Union. Unlike the model treaties, the proposed treaty provides that interest may be taxed by both treaty countries, rather than by the residence country only. Taxation of interest by the source country generally is limited by the proposed treaty to a rate of 10 percent (Article 11). Certain governmental interest is exempt from source-country taxation under the proposed treaty. In addition, the proposed treaty

provides that income from any arrangement, including a debt obligation, carrying the right to participate in profits and treated as a dividend by the source country according to its internal laws, may be taxed by the source country as a dividend. Thus, for example, the country of source could withhold tax on deductible interest paid under an "equity kicker" loan, at rates applicable to dividends. There is no similar provision in the U.S. or OECD models.

The proposed protocol (paragraph 3(a)) provides that any lower rate of withholding tax on interest agreed to in a treaty between Kazakhstan and another OECD country will be applicable between the United States and Kazakhstan. The Memorandum of Understanding (point 4) clarifies that this modification in the applicable withholding-tax rate will be subject to the usual ratification processes.

(18) The proposed treaty permits the United States to impose its branch-level interest tax on a permanent establishment's "excess interest amount," as defined in U.S. law (Article 11(7)). Kazakhstan is permitted under the proposed treaty to impose a similar tax.

(19) The proposed protocol (paragraph 3(c)) provides that the interest article in the proposed treaty does not interfere with the jurisdiction of the United States to tax under its internal law an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (a "REMIC"). Currently, internal U.S. law applies regardless of treaties that were in force when the REMIC provisions were enacted.

(20) Unlike the model treaties and the USSR treaty, the proposed treaty provides that royalties may be taxed by both treaty countries, rather than by the residence country only. Taxation of royalties by the source country is limited by the proposed treaty to a rate of 10 percent (Article 12). Royalties generally are defined as payments for the use of certain rights, property, or information. Unlike the model treaty, the proposed treaty does not treat as royalties gains from the alienation of rights or property which are contingent on the productivity, use, or further alienation of such right or property. The taxation of such gains is governed by the proposed treaty's "Gains" article, which, in a manner similar to the royalties article of the model treaties, generally reserves taxing jurisdiction to the residence country (Article 13).

(21) Also included in the proposed treaty's definition of royalties are payments for the use of, or the right to use, industrial, commercial, or scientific equipment. However, the proposed treaty provides an election for such equipment rentals to be taxed on a net basis, as if attributable to a permanent establishment (Article 12(2)).

(22) The proposed protocol expressly provides in paragraph 4 that where the treaty limits the right to collect taxes, which taxes are nevertheless withheld at source at the rates provided for under internal law, refunds will be made in a timely manner on application by the taxpayer.

(23) Both the U.S. model treaty and the proposed treaty provide for source-country taxation of capital gains from the disposition of property used in the business of a permanent establishment in the source country (Article 13(4)). Unlike most recent U.S. tax treaties, however, the proposed treaty does not specifically provide for

source-country taxation of such gains where the payments are received after the permanent establishment has ceased to exist. The Treasury Department's Technical Explanation (hereinafter referred to as the "Technical Explanation") states that, unlike the United States, Kazakhstan does not impose tax in that circumstance.

(24) Both the U.S. model treaty and the proposed treaty provide for source-country taxation of capital gains from the disposition of real property regardless of whether the taxpayer is engaged in a trade or business in the source country. The proposed treaty expands the U.S. model treaty definition of real property for these purposes to encompass U.S. real property interests. This safeguards U.S. tax under the Foreign Investment in Real Property Tax Act of 1980, which applies to dispositions of U.S. real property interests by nonresident aliens and foreign corporations.

(25) Article 13(3) of the proposed treaty permits a treaty country (the first country) to impose its statutory tax on gains from the disposition, by a resident of the other country, of stock, participation, or other rights in the capital of a company or other legal person which is a resident of the first country if the recipient of the gain, during the 12-month period preceding the disposition, had a direct or indirect participation of at least 25 percent in the capital of that company or other legal person. Such gains are treated as arising in the first country to the extent necessary to avoid double taxation. The Committee understands that Kazakhstan has enacted such a tax. The proposed protocol provides for competent authority consultations regarding the application of appropriate rules respecting tax-free reorganizations.

(26) The proposed treaty exempts all other gains from source-country taxation. This includes gains from the alienation of ships, aircraft, or containers operated in international traffic.

(27) Article 14 of the proposed treaty provides that income derived by a resident of one of the treaty countries from the performance of professional or other personal services in an independent capacity generally is not taxable in the other treaty country unless the services are or were performed in that other country and the person either (a) has or had a fixed base there regularly available for the performance of his or her activities, or (b) is or was present there for more than 183 days in any 12-month period. In such a case, the other country is permitted to tax the income from services performed in that country as are attributable to the fixed base.

(28) The dependent personal services article of the proposed treaty (Article 15) is similar to that article of the U.S. model. Under the proposed treaty, salaries, wages, and other similar remuneration derived by a resident of one treaty country in respect of employment exercised in the other country is taxable only in the residence country (i.e., is not taxable in the other country) if the recipient is present in the other country for a period or periods not exceeding in the aggregate 183 days in the taxable year concerned and certain other conditions are satisfied.

(29) Article 16 of the proposed treaty allows directors' fees and similar payments derived by a resident of one treaty country for services performed in his or her capacity as a member of the board of directors (or another similar organ) of a company which is a resident of the other country to be taxed in that other country. The

U.S. model treaty, on the other hand, generally treats directors' fees under other applicable articles, such as those on personal service income. Under the U.S. model, the country where the recipient resides generally has primary taxing jurisdiction over personal service income and the source country tax on directors' fees is limited. By contrast, under the OECD model treaty (and the proposed treaty), the country where the company is resident has full taxing jurisdiction over directors' fees and other similar payments the company makes to residents of the other treaty country, regardless of where the services are performed.

(30) The proposed treaty omits the U.S. model treaty reservation to the source country of jurisdiction to tax an entertainer or athlete, residing in the other country, who earns more than $20,000 in the source country during a taxable year, without regard to the existence of a fixed base or other contacts with the source country. Thus, under the proposed treaty, the rules applicable to personal service income apply to entertainers and athletes.

(31) The proposed treaty modifies the USSR treaty's rule, similar to the U.S. model rule, that compensation paid by a treaty country government to one of its citizens for services rendered to that government in the discharge of governmental functions may only be taxed by that government's country. Under Article 17 of the proposed treaty, as under the OECD model treaty and other U.S. treaties, such compensation generally may only be taxed by the recipient's country of residence, if the recipient is a citizen of that country, or (in the case of remuneration other than a pension) did not become a resident of that country solely for the purpose of rendering the services.

(32) The proposed treaty, like the U.S. model treaty and unlike the USSR treaty, expressly provides for the taxation of pensions in general only by the residence country, and for the taxation of social security benefits and other public pensions not arising from government service only in the source country (Article 18). Also like the U.S. model, the proposed treaty provides for taxation of annuities and alimony only by the residence country, and taxation of child support payments only by the source country.

(33) The USSR treaty, unlike the models, precludes each country from taxing a resident of the other country who is temporarily present in the first country as a journalist, media correspondent, teacher, or researcher; or who is temporarily present to participate in an exchange program for intergovernmental cooperation in science and technology, or to study or gain technical, professional, or commercial experience. These exemptions generally extend only to income or allowances connected with the purpose of the visit, and only for such period as is required to effectuate the purpose of the visit, and in no case more than two years in the case of teachers and researchers, five years in the case of students, and one year in other cases.

The proposed treaty contains a narrower set of limitations on host-country taxation of temporary visitors (Article 19) than does the USSR treaty. The limitations do not apply to visits for teaching or for journalism. They also do not provide an exemption for employment income. The proposed treaty prohibits the host country from taxing certain payments from abroad for the purpose of the individual's maintenance, education, study, research, or training. Temporary presence in the host country must be for the purpose of studying at an educational institution; training as required to practice a profession; or studying or doing research as a recipient of a grant from a governmental, religious, charitable, scientific, literary, or educational organization. In the last case, the proposed treaty prohibits the host country from taxing the grant. The exemptions apply no longer than the period of time ordinarily necessary to complete the study, training or research. Moreover, no exemption for training or research will extend for a period exceeding five years. The exemption from host country tax does not apply to income from research if the research is undertaken for private benefit.

(34) The proposed treaty contains an "other income" article which differs fundamentally from the "other income" article of the U.S. model treaty and more recent U.S. treaties. Under the U.S. model, income not dealt with in another treaty article generally may be taxed only by the residence country. By contrast, Article 20 of the proposed treaty, like, for example, the recent U.S.-Mexico treaty, specifies that items of income of a resident of a treaty country which are not dealt with elsewhere in the treaty and which arise in the other treaty country are taxable in the other country.

(35) The proposed treaty contains a limitation on benefits, or "anti-treaty shopping," article similar to the limitation on benefits articles contained in recent U.S. treaties and protocols and in the branch tax provisions of the Code (Article 21). The limitation on benefits article in the proposed treaty is virtually identical to the corresponding provisions of the recent U.S. income tax treaty with the Russian Federation.

(36) Unlike most U.S. treaties and the model treaties, the USSR treaty has no provision providing relief from double taxation. In the general case this absence may have little or no impact on a U.S. person, as the United States provides relief from double taxation by internal law, through the foreign tax credit. The proposed treaty provides that each country shall allow its residents (and the United States its citizens) a credit for income taxes imposed by the other country (Article 23). However, such credits need only be in accordance with the provisions and subject to the limitations of internal law (as it may be amended from time to time without changing the general principle that credits must be allowed).

Paragraph 8(a) of the proposed protocol provides an additional credit rule for a U.S. citizen who is a resident of Kazakhstan. To such a person Kazakhstan must allow credits even for U.S. taxes imposed solely by reason of the person's citizenship, but to no greater extent than the Kazakhstani tax on income from sources outside Kazakhstan.

(37) U.S. law allows taxpayers credit for foreign taxes only if the foreign taxes are directed at the taxpayer's net gain. Thus the sufficiency of deductions allowed under foreign law is relevant to the creditability of foreign tax against U.S. tax liability. At times, Soviet and Kazakhstani law have in effect placed significant restrictions on labor and interest cost deductions. The Committee understands that the Kazakhstan Tax Code permits the deduction of wage and interest expense. In order to assist U.S. taxpayers' ability

to take U.S. credits for Kazakhstani taxes, Kazakhstan confirms under the proposed protocol (paragraph 8) that its law permits certain Kazakhstani entities deductions for actual wages paid and for interest (whether paid to a bank or another person and without regard to the term of the loan). The deductions are limited by Kazakhstani law, but only to the extent that such limitation is not less than an arm's-length rate (taking into account a reasonable risk premium). This confirmation applies to U.S.-owned entities, to joint ventures with U.S. ownership, and to Kazakhstani permanent establishments of U.S. entities. On the basis of these required deductions, the proposed protocol treats Kazakhstan's taxes as income taxes that are eligible for the U.S. foreign tax credit. The Technical Explanation states that the United States is not obligated to treat the Kazakhstani taxes as eligible for U.S. foreign tax credits in the event that these required deductions are denied under Kazakhstani law.

(38) The proposed treaty does not provide for "tax sparing" or other fictitious credits for taxes forgiven by one treaty country to residents of the other country under an incentive program. Like some other U.S. treaties, however, paragraph 8(d) of the proposed protocol indicates that the United States and Kazakhstan will amend the proposed treaty (subject to the usual ratification procedures) to provide such credits in the event that the United States either amends its internal laws to allow such credits or agrees to provide them in a tax treaty with any other country.

(39) Article 24 of the proposed treaty greatly expands the nondiscrimination rule in the USSR treaty, in some respects conforming it to the U.S. model, and in other respects providing additional benefits. The USSR treaty requires "national treatment" to the extent of prohibiting discrimination under the laws of one country against citizens of the other country resident in the first country. It requires "most-favored-nation treatment" to the extent of prohibiting less favorable treatment, under the laws of one country, of citizens of the other country resident in the first country, or of local representations of residents of the other country, than the treatment afforded to third-country citizens and representations of third-country residents. The proposed treaty also requires both "national treatment" to the extent required in the U.S. model and a form of "most-favored-nation treatment" (not taking into account special agreements, such as bilateral income tax treaties, with third countries) to be applied to citizens and residents of the treaty countries. The proposed treaty affords these benefits to citizens of the other country in the same circumstances as citizens of the first country, regardless of residence; to the local permanent establishments of residents of the other country, and to enterprises owned by residents of the other country. In addition, the proposed treaty prohibits discrimination against the deductibility of amounts paid to residents of the other country. The Technical Explanation states that, like the U.S. model treaty, it was intended that the nondiscrimination rules of the proposed treaty apply not only to all national-level taxes, but also to all taxes imposed by each country's political subdivisions and local authorities.

(40) Like the U.S. model treaty, and unlike the USSR treaty, the proposed treaty makes express provision for the competent authori-

ties to mutually agree on topics that arise under the proposed treaty, but are not mentioned in the present treaty's mutual agreement article, such as the characterization of particular items of income, the common meaning of a term, the application of procedural aspects of internal law, and the elimination of double taxation in cases not provided for in the treaty (Article 25).

(41) Paragraph 9 of the proposed protocol provides for competent authority consultations in the event of a change in law (or the application thereof) that may eliminate or significantly limit a benefit provided by the proposed treaty. If the issue cannot be resolved by the competent authorities, the proposed treaty is subject to termination under its termination provisions, but without regard to the prohibition on termination during the first five years after entry into force.

(42) The proposed treaty, like the U.S. treaties with Germany, Mexico, and the Netherlands, provides for a binding arbitration procedure to be used to settle disagreements between the two countries regarding the interpretation or application of the treaty (Article 25(5)). The arbitration procedure can only be invoked by the agreement of both countries. The effective date of this provision is delayed until the two countries have agreed that it will take effect, to be evidenced by a future exchange of diplomatic notes.

(43) Unlike some other recent U.S. treaties, the proposed treaty does not provide that its dispute resolution procedures under the mutual agreement article takes precedence over the corresponding provisions of any other agreement between the United States and Kazakhstan in determining whether a law or other rule is within the scope of the proposed treaty. Therefore, under the treaty as proposed, if Kazakhstan accedes to the General Agreement on Trade in Services (the "GATS"), tax issues between the United States and Kazakhstan may be subject to the dispute resolution procedures of the World Trade Organization. This issue is addressed in the exchange of notes dated July 10, 1995 which constitutes an agreement that will enter into force on the date the treaty enters into force. The exchange of notes provides that, in the event the GATS applies between the United States and Kazakhstan, the dispute resolution procedures under the mutual agreement article of the proposed treaty will take precedence.

(44) While the USSR treaty requires exchanges of information only to the extent of providing information about changes in internal law, the proposed treaty includes the standard exchange of information article, similar to that in the U.S. model, which contemplates that each competent authority will assist the other in obtaining and transmitting information that relates to the assessment, collection, enforcement, and prosecution of tax claims against particular taxpayers (Article 26). The proposed treaty, like some other U.S. treaties, omits the U.S. model provision pledging assistance in collecting such amounts as may be necessary to ensure that treaty relief does not enure to the benefit of persons not entitled thereto.

(45) The proposed treaty would enter into force on the date of the exchange of instruments of ratification, and would be effective for matters other than withholding tax on January 1 of the year the treaty enters into force. With respect to withholding taxes, the pro-

posed treaty will be effective on the first day of the second month following entry into force (Article 28). Paragraph 10 of the proposed protocol states that, during the first taxable year in which the proposed treaty is in effect, a taxpayer may elect to be taxed under the USSR treaty in its entirety.

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country, and instruments of ratification are to be exchanged as soon as possible. In general, the proposed treaty will enter into force when the instruments of ratification are exchanged. The exchanges of notes will enter into force when the treaty enters into force.

With respect to taxes withheld at source on dividends, interest or royalties, the proposed treaty will be effective for amounts paid or credited on or after the first day of the second month following entry into force. With respect to other taxes, the proposed treaty will be effective for taxable periods beginning on or after the first of January of the year the treaty enters into force.

Where greater benefits would have been available to a taxpayer under the USSR treaty than under the proposed treaty, the proposed protocol provides that a taxpayer may elect to be taxed under the USSR treaty (in its entirety) for the first taxable year with respect to which the proposed treaty would otherwise have effect.

B. TERMINATION

The proposed treaty will continue in force until terminated by either country. Either country may terminate the treaty at any time after five years from the date of its entry into force by giving at least six months prior written notice through diplomatic channels. A termination will be effective with respect to taxes withheld at source for amounts paid or credited on or after the first of January following the expiration of the six month period. A termination will be effective with respect to other taxes for taxable periods beginning on or after the first of January following the expiration of the six-month period.

V. Committee Action

The Committee on Foreign Relations held a public hearing on the proposed treaty with Kazakhstan, the related protocol, and the two related exchanges of notes (Treaty Doc. 103–33), as well as on other proposed tax treaties and protocols, on June 13, 1995. The hearing was chaired by Senator Thompson. The Committee considered the proposed treaty with Kazakhstan on September 25, 1996, and ordered the proposed treaty, the protocol, and the two related exchanges of notes; the exchange of notes dated July 10, 1995; and the exchange of notes dated June 16 and 23, 1995 favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty, the protocol, and the exchanges of notes, subject to a proviso.

VI. Committee Comments

On balance, the Committee on Foreign Relations believes that the proposed treaty with Kazakhstan is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. The Committee has taken note of certain issues raised by the proposed treaty, and believes that the following comments may be useful to U.S. Treasury officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

A. RELATIONSHIP TO URUGUAY ROUND TRADE AGREEMENTS

The multilateral trade agreements encompassed in the Uruguay Round Final Act, which entered into force as of January 1, 1995, include the GATS. This agreement generally obligates members and their political subdivisions to afford persons resident in member countries (and related persons) "national treatment" and "most-favored-nation treatment" in certain cases relating to services. The GATS applies to "measures" affecting trade in services. A "measure" includes any law, regulation, rule, procedure, decisions, administrative action, or any other form. Therefore, the obligations of the GATS extend to any type of measure, including taxation measures.

However, the application of the GATS to tax measures is limited by certain exceptions under Article XIV and Article XXII(3). Article XIV requires that a tax measure not be applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services. Article XIV(d) allows exceptions to the national treatment otherwise required by the GATS, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other members. "Direct taxes" under the GATS comprise all taxes on income or capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises as well as taxes on capital appreciation.

Article XXII(3) provides that a member may not invoke the GATS national treatment provisions with respect to a measure of another member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In case of disagreement between members as to whether a measure falls within the scope of such an agreement between them, either member may bring this matter before the Council for Trade in Services. The Council is to refer the matter to arbitration; the decision of the arbitrator is final and binding on the members. However, with respect to agreements on the avoidance of double taxation that are in force on January 1, 1995, such a matter may be brought before the Council for Trade in Services only with the consent of both parties to the tax agreement.

Article XIV(e) allows exceptions to the most-favored-nation treatment otherwise required by the GATS, provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the member is bound.

The United States is a party to the GATS, but Kazakhstan is not yet a party thereto. If Kazakhstan accedes to the GATS, under the treaty as proposed, tax issues between the United States and Kazakhstan could be subject to the dispute resolution procedures of the World Trade Organization. At the time of the June 13, 1995, hearing, the Committee understood that the Treasury Department expected to address this issue in an exchange of notes. Thus, as part of its consideration of the proposed treaty, the Committee inquired of the Treasury Department what assurance did the Committee have that the exchange of notes addressing this issue would occur. The relevant portion of the Treasury Department's July 5, 1995, letter [2] responding to this inquiry is reproduced below:

> 1. What assurances does this Committee have that an exchange of notes will occur, and effectively permit the treaty to preempt the dispute settlement procedures under the GATS, should Kazakhstan accede to the GATS?
>
> We have been advised that the Ministries of Finance and Trade and Industry have approved the notes. We hope to complete promptly the formalities associated with the exchange.

The subsequent exchange of notes dated July 10, 1995, addresses the relationship between the proposed treaty and the GATS, in the event that the GATS applies between the United States and Kazakhstan, and the relationship between the proposed treaty and other agreements that apply between the two countries. The exchange of notes dated July 10, 1995, provides that, in the event the GATS applies between the United States and Kazakhstan, a dispute concerning whether a measure is within the scope of the proposed treaty is to be considered only by the competent authorities under the dispute settlement procedures of the proposed treaty. Moreover, the exchange of notes dated July 10, 1995, provides that the nondiscrimination provisions of the proposed treaty are the only nondiscrimination provisions that may be applied to a taxation measure unless the competent authorities determine that the taxation measure is not within the scope of the proposed treaty (with the exception of nondiscrimination obligations under the General Agreement on Tariffs and Trade ("GATT") with respect to trade in goods, provided that GATT applies between the United States and Kazakhstan).

The Committee believes that it is important that the competent authorities are granted the sole authority to resolve any potential dispute concerning whether a measure is within the scope of the proposed treaty and that the nondiscrimination provisions of the proposed treaty are the only appropriate nondiscrimination provisions that may be applied to a tax measure unless the competent authorities determine that the proposed treaty does not apply to it (except nondiscrimination obligations under GATT with respect to trade in goods, if it applies between the United States and

[2] Letter from then Assistant Secretary of the Treasury (Tax Policy) Leslie B. Samuels to Senator Fred Thompson, Committee on Foreign Relations, July 5, 1995 ("July 5, 1995 Treasury Department letter").

Kazakhstan). The Committee also believes that the provision of the exchange of notes dated July 10, 1995, is adequate to preclude the preemption of the mutual agreement provisions of the proposed treaty by the dispute settlement procedures under the GATS (in the event that it applies between the United States and Kazakhstan).

B. FOREIGN TAX CREDIT FOR KAZAKHSTANI TAXES

Tax policy

To be creditable under the limitations of U.S. law, a foreign tax must be directed at the taxpayer's net gain. Like any foreign taxes, the Kazakhstani tax on income (profits) of enterprises and the income tax on individuals have been imposed on a base that is not necessarily identical to the U.S. income tax base. For example, the Committee understands that at the time the proposed treaty was signed, Kazakhstani tax laws may not have allowed full deductions for labor costs and interest expense. However, the Committee understands that the Kazakhstan Tax Code permits the deduction of wage and interest expense. In order to assist U.S. taxpayers seeking eligibility of Kazakhstani taxes for use as credits against U.S. tax, as discussed above in Part III, the proposed protocol requires Kazakhstan to provide interest and labor cost deductions in the case of certain U.S. persons and U.S.-participating entities. In addition, on the basis of those required deductions, the proposed treaty provides that the Kazakhstani taxes will be creditable for U.S. purposes.[3]

It generally has not been consistent with U.S. tax policy for deductions from the U.S. tax base of a U.S. person to be granted by treaty. Nor has it been consistent with U.S. tax policy to guarantee by treaty the U.S. creditability of an otherwise non-creditable foreign tax. It is believed that both functions are generally more appropriately served in the normal course of internal U.S. tax legislation. The proposed treaty attempts to be consistent with these principles, while accommodating the differences between Kazakhstan's and the United States' internal constitutional processes. As a result, the treaty commits Kazakhstan to providing special features of its internal tax base with respect to foreign-owned investments, in order to conform Kazakhstan's taxes to the requirements of the U.S. foreign tax credit. However, the proposed treaty takes the unusual additional step of guaranteeing that the Kazakhstani tax, with the assurances described in the proposed protocol, is eligible for the U.S. foreign tax credit.

Stability of Kazakhstani tax law

The tax laws of Kazakhstan were adopted, by presidential decree, in April 1995.[4] The Committee understands that the Kazakhstan Tax Code has been in place since 1995. A set of technical amendments to the Tax Code were enacted in December 1995.

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[3] The Committee understands that the proposed protocol will not treat as creditable the Kazakhstani taxes imposed on a taxpayer that is not eligible for the full deductions, as provided in the proposed protocol.

[4] The Decree of the President of the Republic of Kazakhstan, Having the Force of a Law, "On Taxes and Other Obligatory Payments to the Budget" (Almaty, April 24, 1995).

The 1992 U.S. income tax treaty with the Russian Federation included a similar provision to the proposed protocol's special deduction rules for the labor and interest expenses of certain foreign-owned entities. However, despite allowing deductions for all wages paid under the treaty, the Russian Federation subsequently enacted an excess-wage tax that applies to wages that exceed six times the minimum monthly wage. The package of amendments to the Russian tax laws that took effect recently continue the excess-wage tax at least through 1995.[5] Under the terms of the United States-Russia tax treaty, the United States is not permitted to terminate the treaty until 1999.[6]

The Committee understands that one of the December 1995 amendments to the Kazakhstan Tax Code resulted in the enactment of an excess-wage tax. However, the Committee has been informed that the Kazakhstani government has assured the Treasury Department that the excess-wage tax will not be imposed on any U.S.-owned businesses. In addition, unlike the United States-Russia tax treaty, the proposed treaty includes a provision that requires competent authority consultations in the event of a change in law (or the application thereof) that may eliminate or significantly limit a benefit provided by the proposed treaty. If the issue cannot be resolved by the competent authorities, the proposed treaty is subject to termination under its termination provisions, but without regard to the prohibition on termination during the first five years after entry into force. Had such a provision been included in the U.S.-Russia tax treaty, the Committee understands that the United States would have been permitted to terminate the treaty.

Most tax treaty partners of the United States have long-established tax systems. The states of the former Soviet Union generally have not yet had the opportunity fully to develop their economies and tax systems. It is less common for the United States to use a tax treaty as a device to stabilize the economy or tax system of a country undergoing development or transition. The Russian excess-wage tax is an example of how a tax treaty alone may not be completely effective toward this goal. Nonetheless, in such circumstances as those found in the Russian Federation, the tax treaty may afford U.S. investors and the U.S. Government a useful forum in which to air certain grievances that may arise in the area of fiscal policy.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department the reason for entering into a treaty with a country whose government is not stable and the precedent for bilateral tax treaties where the content of a country's tax laws are not known in detail. The relevant portion of the July 5, 1995 Treasury Department letter responding to this inquiry is reproduced below:

> 2. Why should the United States enter into a treaty with a country whose government is not stable?

[5] Bureau of National Affairs, Daily Tax Report, May 1, 1995, p. G–2.

[6] The United States has rarely terminated a tax treaty in response to changes in the tax laws of a treaty partner. Despite the changes, it is usually desirable to continue the tax treaty relationship for the sake of other treaty benefits until the treaty can be renegotiated.

Kazakhstan entered a period of political uncertainty in March [1995], when a court ruling resulted in the dissolution of Parliament. In April [1995], President Nazarbayev held and won a national referendum on extending his term in office until December 1, 2000. Neither Treasury nor the State Department endorse this development, which has been made known to Kazakhstan. Both agencies, however, are convinced that proceeding with the tax treaty is a prudent course and that the treaty relationship will provide opportunities for the United States to influence future developments within Kazakhstan.

In particular, the treaty will cement our already excellent relationship with our tax counterparts in the Ministry of Finance. The treaty process has helped move Kazakhstan's tax system in line with international norms. The treaty also is important to U.S. investors in Kazakhstan. In response to Kazakhstan's "open door" policy to outside investment, Kazakhstan has attracted two of the largest commitments of U.S. investment in all of the former Soviet Union, including the single largest, Chevron's project in the Tengiz oil field. Kazakhstan received more long-term investment commitments in 1994 than did Russia, and some 70 U.S. firms have representative offices in Kazakhstan. By supporting development of Kazakhstan's rich oil and mineral reserves, the treaty will open the way for entrepreneurial activities by other U.S. investors, enhance the opportunity for reducing dependence on Persian Gulf oil, and encourage continued development of a stable economic system that is more compatible with free markets and democratic reforms.

3. What precedent is there for bilateral tax treaties where the content of [a country's] tax laws are not known in detail?

The content of Kazakhstan's tax laws is actually known in considerable detail. The United States side extensively reviewed the relevant provisions of the Kazakhstan tax code in effect at the time of the negotiation. This review raised questions about whether wage and interest expenses were fully deductible, resulting in the Protocol provisions confirming that these deductions would be available to U.S. investors in Kazakhstan.

The U.S. side also has followed closely the development of Kazakhstan's new law. This law was drafted with the assistance of U.S. advisors familiar to Treasury. It represents a significant step forward. It regularizes and stabilizes the various contractual arrangements for the taxation of royalties and profits, and it eliminates more than 30 separate taxes, mandatory "contributions," and other Communist-era levies. The rules in the new law are more comprehensive than under the old law, reducing the need to rely on easily-changed "instructions" (akin to regulations). There also is a greater consistency among different parts of the law. This increased transparency not only aids Treasury's review of Kazakhstani law, it will greatly en-

> hance investors' certainty as to the tax results of their activities.
>
> The English translation of the law indicates that it is consistent with the treaty. The fact that there is an English translation so soon is another indication of Kazakhstan's interest in foreign investment. It usually is as difficult to obtain English translations of foreign tax laws as it is to obtain foreign language translations of the Internal Revenue Code.
>
> 4. What is the current legal status of the USSR tax treaty in Kazakhstan?
>
> The United States considers the USSR tax treaty to apply to Kazakhstan. Similarly, Kazakhstan publicly undertook to honor the USSR's treaty obligations. Kazakhstan has been applying the USSR treaty, and has made known its intention to continue applying it until the new treaty takes effect. Like the United States, Kazakhstan is understandably eager to have a more appropriate new treaty in place, and anticipates that the new treaty will replace the USSR treaty as of January 1, 1996.

Subsequent to the June 13, 1995 hearing, the Committee was informed that Kazakhstan adopted a new law permitting the creation of anonymous bank accounts. The Treasury Department expressed concerns that the existence of such accounts would be inconsistent with Kazakhstan's obligation to exchange information under the proposed treaty. Consequently, the Treasury Department requested the Committee to suspend its consideration of the proposed treaty. The Committee has had several communications with the Treasury Department concerning the status of the Kazakhstani anonymous bank accounts. In a letter to Senator Helms dated September 13, 1996, the Treasury Department provided an update of the situation. The relevant portion of the letter is reproduced below:

> I am writing to update you with respect to the pending income tax treaty between the United States and Kazakhstan (the "Convention"), which is under consideration by the Senate Foreign Relations Committee. Your Committee held a hearing on the proposed treaty on June 13, 1995. At that time, Kazakhstan had recently adopted a law permitting the creation of anonymous bank accounts. We were concerned that the existence of such accounts would be inconsistent with Kazakhstan's obligation to exchange information under the proposed Convention. At Treasury's request, the Committee agreed to hold the Convention until we received adequate assurances from the Government of Kazakhstan regarding access to bank account information.
>
> During the past year, the U.S. and Kazakhstani governments have had numerous discussions and exchanges of correspondence regarding bank secrecy and its implications for tax enforcement and tax treaties. While this process has taken longer than we might have liked, we believe that our efforts have been successful. It appears that Kazakhstan now may go even farther than simply ensur-

> ing access to anonymous bank account information. The government of Kazakhstan has prepared and sent to Parliament legislation that will completely repeal the earlier law allowing anonymous bank accounts to be established. The government of Kazakhstan has provided Treasury with drafts of the legislation, and, upon review, Treasury believes it resolves the outstanding issues with respect to bank account information. The legislation has been designated "urgent," and we therefore expect it to be adopted within 30 days. We are advised by the Kazakhstani government that there is no opposition to the legislation. They also have assured us that no anonymous accounts exist within Kazakhstan at present and that no such accounts will be permitted to be opened prior to adoption of the new legislation.

The Committee believes that the political and economic situation in countries with which the United States is entering into bilateral agreements is an important aspect in the Senate's decision to advise and consent to ratification. The Committee supports the progress that Kazakhstan is making in democratic reforms.

Kazakhstan holds great potential for U.S. investors and ratification of the proposed treaty will provide a more predictable investment climate. Due to accelerating reforms it is likely that, in the short term, related economic duress and discontent will increase. Ratification of the proposed treaty now will lock in a framework for United States-Kazakhstan economic relations that may be politically untenable later. The United States has a strong interest in the success of Kazakhstan's economic and democratic reform process. Ultimately, a strong and independent Kazakhstan is important to the stability of Europe and to overall U.S. foreign policy interests.

C. DEVELOPING COUNTRY CONCESSIONS

The proposed treaty contains a number of developing country concessions, some of which are found in other U.S. income tax treaties with developing countries. The most significant of these concessions are listed below.

Definition of permanent establishment

The proposed treaty departs from the U.S. and OECD model treaties by providing for broader source-basis taxation. The proposed treaty's permanent establishment article, for example, permits the country in which business activities are carried on to tax the activities on a broader basis, in certain cases, than it would be able to under either of the model treaties. Under the proposed treaty, the furnishing of services, including consultancy services, will create a permanent establishment if it exists in a country for more than 12 months. Thus, for example, under the proposed treaty, a U.S. enterprise's business profits that are attributable to providing consultancy service without a fixed base in Kazakhstan could be taxed by Kazakhstan.

Source basis taxation

Additional concessions to source basis taxation in the proposed treaty include maximum rates of source country tax on interest (10 percent)[7] and royalties (10 percent) that are higher than those provided in the U.S. model treaty, treatment of certain equipment rentals as royalties, taxing jurisdiction on the part of the source country as well as the residence country with respect to income not otherwise specifically dealt with by the proposed treaty, and broader source country taxation of personal services income (especially directors' fees) than that allowed by the U.S. model.

Taxation of business profits

Under the U.S. model and many other U.S. income tax treaties, a country may only tax the business profits of a resident of the other country to the extent those profits are attributable to a permanent establishment situated within the first country. The proposed treaty expands the definition of business profits to include profits that are derived from sources within the country where a permanent establishment exists from sales of goods or merchandise of the same kind as those sold through the permanent establishment or from other business activities of the same kind as those effected through the permanent establishment.

Also unlike the U.S. model treaty, the proposed treaty limits certain deductions for expenses incurred on behalf of a permanent establishment by the enterprise's head office. Unlike some other U.S. tax treaties with developing countries (such as Mexico and India), the proposed treaty's prohibition on deductions for amounts paid by the permanent establishment to its home office does not apply differently to interest payments than to royalties or other fees.

Certain equipment leasing

In addition to containing the traditional definition of royalties which is found in most U.S. tax treaties (including the U.S. model), the proposed treaty provides that royalties include payments for the use of, or the right to use, industrial, commercial, or scientific equipment. These payments are often considered rentals in other treaties, subject to business profits rules which generally permit the source country to tax such profits only if they are attributable to a permanent establishment located in that country, and in such case, the tax is computed on a net basis. By contrast, the proposed treaty permits gross-basis source country taxation of these payments, at a rate not to exceed 10 percent, with an election for taxation on a net basis. The proposed treaty permits source country taxation of these payments irrespective of the existence of any permanent establishment.

Committee conclusions

One purpose of the proposed treaty is to reduce tax barriers to direct investment by U.S. firms in Kazakhstan. The practical effect of these developing country concessions could be greater

[7] The proposed protocol (paragraph 3(a)) provides that any lower rate of withholding tax on interest agreed to in a treaty between Kazakhstan and another OECD country would be applicable (subject to the usual ratification processes, as clarified by point 4 of the Memorandum of Understanding) between the United States and Kazakhstan.

Kazakhstani taxation of future activities of U.S. firms in Kazakhstan than would be the case under the rules of either the U.S. or OECD model treaties.

There is a risk that the inclusion of these developing country concessions in the proposed treaty could result in additional pressure on the United States to include them in future treaties negotiated with developing countries, especially other nations of the former Soviet Union. However, these precedents already exist in the U.N. model treaty, and a number of existing U.S. income tax treaties with developing countries already include similar concessions. Such concessions arguably are necessary in order to obtain treaties with developing countries. Tax treaties with developing countries can be in the interest of the United States because they provide developing country tax relief for U.S. investors and a clearer framework within which the taxation of U.S. investors will take place.

The Committee is concerned that developing country concessions not be viewed as the starting point for future negotiations with developing countries. It must be clearly recognized that several of the rules of the proposed treaty represent substantial concessions by the United States, and that such concessions must be met with substantial concessions by the treaty partner. Thus, future negotiations with developing countries should not assume, for example, that the definition of permanent establishment provided in this treaty necessarily will be available in every case; rather, such a definition will be only adopted in the context of an agreement that satisfactorily addresses the concerns of the United States.

D. TREATY SHOPPING

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty is intended to benefit residents of Kazakhstan and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as “treaty shopping.” Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of tax by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing in that treaty country a subsidiary, trust, or other investing entity which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty-shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Code (as interpreted by Treasury regulations) and in several newer treaties. Some aspects of the provision, however, differ either from an anti-treaty-shopping provision in the U.S. model treaty, or from the anti-treaty-shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty-shopping provision of the treaty effectively forestalls potential treaty shopping abuses.

One provision of the anti-treaty-shopping article of the proposed treaty is more lenient than the comparable rule in one version proposed with the U.S. model. That U.S. model proposal allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like several newer treaties and an anti-treaty-shopping provision in the Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, this safe harbor is considerably easier to enter under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty-shopping article differs from the comparable rule in some earlier U.S. treaties and proposed model provisions, but the effect of the change is less clear. The general test applied by those treaties to allow benefits, short of meeting the bright-line ownership and base erosion test, is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits" under the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty gives the competent authority of the source country the ability to override this standard. The Technical Explanation accompanying the treaty provides some elaboration as to how these rules will be applied.

The practical difference between the proposed treaty tests and the earlier tests will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed treaty could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty tests (i.e., would operate to deny benefits in potentially abusive situations more often).

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department to provide additional explanation regarding the sufficiency of the anti-treaty shopping provisions in the proposed treaty and other treaties. The relevant portion of the July 5, 1995 Treasury Department letter responding to this inquiry is reproduced below:

7. Is Treasury confident that the anti-treaty shopping provisions in these treaties will ensure full payment of taxes by multinational corporations and eliminate abuse of the treaties to lower taxes?

In conjunction with various domestic statutes and regulations, the limitation on benefits provisions should be very effective in preventing underpayment of U.S. withholding taxes by non-residents, including multinationals.

The Committee believes that limitation on benefits provisions are important to protect against "treaty shopping" by limiting benefits of a treaty to bona fide residents of the treaty partner. It also is important, however, for these provisions to be crafted to avoid interfering with legitimate and desirable economic activity. For example, the Committee believes that U.S. open-end regulated investment companies ("RICs") generally should be eligible for treaty benefits under limitation on benefits provisions in order to facilitate cross-border investments from this important source of capital. Because these funds are required to stand ready to redeem their shares on a daily basis, the Committee believes they generally should be entitled to treaty benefits to the same extent as closed-end RICs, which qualify for benefits under standard limitation on benefits provisions because they are publicly traded on stock exchanges. While the Committee understands that open-end RICs may be determined by the competent authority to qualify for treaty benefits under limitation on benefits provisions in existing treaties, the Committee believes that, in future negotiations, the negotiators should address directly the treatment of open-end RICs under limitation of benefits provisions. The manner in which the eligibility of open-end RICs for treaty benefits is addressed may vary from treaty to treaty, for example, to permit the negotiators to ensure that investment companies established in the treaty country are not used to promote treaty shopping.

The Committee continues to believe that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible. The Committee continues to believe further that, in exercising any latitude Treasury has to adjust the operation of the proposed treaty, the rules as applied should adequately deter treaty shopping abuses. The USSR treaty does not contain anti-treaty shopping rules. Further, the proposed anti-treaty shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Kazakhstan since third-country investors may be unwilling to share ownership of such investing entities on a 50–50 basis with U.S. or Kazakhstani residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. In addition, the base erosion test provides protection from certain potential abuses of a Kazakhstani conduit. Finally, Kazakhstan imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use Kazakhstani entities to make U.S. investments. On the other hand, implementation of the tests for treaty shopping set forth in the treaty may raise factual, administrative, or other issues that cannot currently be foreseen. The Committee emphasizes that the proposed provision must be implemented so as to serve as an adequate tool for preventing possible treaty-shopping abuses in the future.

E. TRANSFER PRICING

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to reallocate profits among related enterprises residing in each country, if a reallocation is necessary to reflect the conditions which would have been made between independent enterprises. The Code, under section 482, provides the Secretary of the Treasury the power to make reallocations wherever necessary in order to prevent evasion of taxes or clearly to reflect the income of related enterprises. Under regulations, the Treasury Department implements this authority using an arm's-length standard, and has indicated its belief that the standard it applies is fully consistent with the proposed treaty.[8] A significant function of this authority is to ensure that the United States asserts taxing jurisdiction over its fair share of the worldwide income of a multinational enterprise. The arm's-length standard has been adopted uniformly by the leading industrialized countries of the world, in order to secure the appropriate tax base in each country and avoid double taxation, "thereby minimizing conflict between tax administrations and promoting international trade and investment."[9]

Some have argued in the recent past that the IRS has not performed adequately in this area. Some have argued that the IRS cannot be expected to do so using its current approach. They argue that the approach now set forth in the regulations is impracticable, and that the Treasury Department should adopt a different approach, under the authority of section 482, for measuring the U.S. share of multinational income.[10] Some prefer a so-called "formulary apportionment" approach, which can take a variety of forms. The general thrust of formulary apportionment is first to measure total profit of a person or group of related persons without regard to geography, and only then to apportion the total, using a mathematical formula, among the tax jurisdictions that claim primary taxing rights over portions of the whole. Some prefer an approach that is based on the expectation that an investor generally will insist on a minimum return on investment or sales.[11]

A debate exists whether an alternative to the Treasury Department's current approach would violate the arm's-length standard embodied in Article 9 of the proposed treaty, or the nondiscrimina-

[8] The OECD report on transfer pricing generally approves the methods that are incorporated in the current Treasury regulations under section 482 as consistent with the arm's-length principles upon which Article 9 of the proposed treaty is based. See "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," OECD, Paris 1995.

[9] *Id.* (preface).

[10] See generally The Breakdown of IRS Tax Enforcement Regarding Multinational Corporations: Revenue Losses, Excessive Litigation, and Unfair Burdens for U.S. Producers: Hearing before the Senate Committee on Governmental Affairs, 103d Cong., 1st Sess. (1993) (hereinafter, Hearing Before the Senate Committee on Governmental Affairs).

[11] See Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, 101st Cong., 2d Sess. 360–61 (1990) (statement of James E. Wheeler); H.R. 460, 461, and 500, 103d Cong., 1st Sess. (1993); sec. 304 of H.R. 5270, 102d Cong., 2d Sess. (1992) (introduced bills); see also Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means, 102d Cong., 2d Sess. (1992).

tion rules embodied in Article 25.[12] Some, who advocate a change in internal U.S. tax policy in favor of an alternative method, fear that U.S. obligations under treaties such as the proposed treaty would be cited as obstacles to change.

As part of its consideration of the proposed treaty, the Committee requested the Treasury Department to provide additional explanation regarding the Administration's current policy with respect to transfer pricing issues, the use of the arm's-length pricing method, and the application of treaties to ensure full payment of required taxes by foreign corporations. The relevant portions of the July 5, 1995, Treasury Department letter responding to these inquiries are reproduced below:

> 1. Please describe the position of the U.S. Treasury with regard to the transfer pricing issue.
>
> While estimates of the magnitude of the problem vary, Treasury regards transfer pricing as one of the most important international tax issues that it faces. Treasury believes that both foreign and U.S.-owned multinationals have engaged in significant income shifting through improper transfer pricing.
>
> Treasury identified three problems that allowed these abuses to occur: (1) lack of substantive guidance in U.S. regulations for taxpayers and tax administrators to apply in cases where the traditional approaches did not work; (2) lack of an incentive for taxpayers to attempt to set their transfer prices in accordance with the substantive rules; and (3) lack of international consensus on appropriate approaches. To resolve these problems, Treasury has taken the following steps in the last two years:
>
> In July 1994, Treasury issued new final regulations under section 482 of the Internal Revenue Code. These regulations contain methods that were not reflected in prior final regulations: the Comparable Profits and Profit Split Methods. These methods are intended to be used when the more traditional methods are unworkable or do not provide a reliable basis for determining an appropriate transfer price.

[12] Compare "Tax Conventions with: The Russian Federation," Treaty Doc. 102–39; "United Mexican States," Treaty Doc. 103–7; "The Czech Republic," Treaty Doc. 103–17; "The Slovak Republic," Treaty Doc. 103–18; and "The Netherlands," Treaty Doc. 103–6. "Protocols Amending Tax Conventions with: Israel," Treaty Doc. 103–16; "The Netherlands," Treaty Doc. 103–19; and "Barbados," Treaty Doc. 102–41. Hearing Before the Committee on Foreign Relations, United States Senate, 103d Cong., 1st Sess. 38 (1993) ("A proposal to use a formulary method would be inconsistent with our existing treaties and our new treaties.") (oral testimony of Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Treasury Department); a statement conveyed by foreign governments to the U.S. State Department that "[worldwide unitary taxation is contrary to the internationally agreed arm's-length principle embodied in the bilateral tax treaties of the United States" (letter dated 14 October 1993 from Robin Renwick, U.K. Ambassador to the United States, to Warren Christopher, U.S. Secretary of State); and "American Law Institute Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties" (1992), at 204 (n. 545) ("Use of a world-wide combination unitary apportionment method to determine the income of a corporation is inconsistent with the 'Associated Enterprises' article of U.S. tax treaties and the OECD model treaty") with Hearing Before the Senate Committee on Governmental Affairs at 26, 28 ("I do not believe that the apportionment method is barred by any tax treaty that United States has now entered into.") (statement of Louis M. Kauder). See also Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Committee on Ways and Means, 102d Cong., 2d Sess. 224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department).

In August 1993, Congress enacted a Treasury proposal to amend section 6662(e) of the Internal Revenue Code. This provision penalizes taxpayers that both (1) are subject to large transfer pricing adjustments and (2) do not provide documentation indicating that they made a reasonable effort to comply with the regulations under section 482 in setting their transfer prices. Treasury issued temporary regulations implementing the statute in February 1994.

In July 1994, the Organization for Economic Cooperation and Development issued a draft report on transfer pricing. The United States is an active participant in this body. The OECD transfer pricing guidelines serve as the basis for the resolution of transfer pricing cases between treaty partners and it therefore is critical that any approach adopted in any country be sanctioned in this report in order to reduce the risk of double taxation. The draft report permits the use of the new U.S. methods in appropriate cases.

2. Why shouldn't the United States interpret Article 9 of the tax treaties regarding transfer pricing as permitting other methods of pricing such as the unitary or formulary apportionment method?

If Treasury adopted such an interpretation, it would send a signal to our treaty partners that we were moving away from the arm's-length standard to a different, more arbitrary approach. Sending such a signal would be very destructive and, if implemented, would inevitably result in double (and under) taxation due to the fundamental inconsistency between the approach used in the United States and that used elsewhere. Further, adopting such an interpretation would invite non-OECD countries to introduce their own approaches that currently cannot be foreseen, but that could inappropriately increase their tax bases at the expense of the United States and other countries.

3. The consensus regarding transfer pricing methods is currently the arm's-length standard. Will the U.S. remain open to the possibility of better or alternative methods without moving to such alternative methods unilaterally?

If it appeared that another approach was superior to the current approach, the U.S. would push for the adoption of this new approach on a multilateral basis so that there would be the necessary international consensus in favor of the new approach.

4. Why does industry support the arm's-length pricing method?

Most multinationals are willing to pay their fair share of tax. Their primary concern is that they not be subjected to double taxation. Because the arm's-length standard is the universally adopted international norm and the major countries of the world have adopted a consensus interpretation of that standard within the OECD, the risks of double taxation are infinitely smaller under the arm's-length standard than under any other approach.

5. A recent GAO report suggested that many foreign corporations are not paying their fair share of taxes. Is Treasury satisfied that these treaties ensure full payment of required taxes?

A tax treaty by itself will not prevent transfer pricing abuses. Rather, the treaty leaves it to the internal rules and practices of the treaty partners to deal with such issues. In the United States, Treasury has taken the measures described above to ensure that foreign—and domestic—corporations pay their fair share of taxes. A tax treaty can make these internal measures more effective, particularly through the exchange of information provisions that enable the U.S. tax authorities to obtain transfer pricing information on transactions between related parties in the United States and the treaty partner. The treaties also facilitate Advance Pricing Agreements that preclude the possibility of double taxation and at the same time ensure that each country receives an appropriate share of the taxes paid by a multinational.

F. ARBITRATION OF COMPETENT AUTHORITY ISSUES

In a step that has been taken only recently in U.S. income tax treaties (i.e., beginning with the 1989 income tax treaty between the United States and Germany), the proposed treaty provides for a binding arbitration procedure, if both competent authorities and the taxpayers involved agree, for the resolution of those disputes in the interpretation or application of the treaty that it is within the jurisdiction of the competent authorities to resolve. This provision is effective only after diplomatic notes are exchanged between Kazakhstan and the United States. Consultation between the two countries regarding whether such an exchange of notes should occur will take place after a period of three years after the proposed treaty has entered into force.

Generally, the jurisdiction of the competent authorities under the proposed treaty is as broad as it is under any U.S. income tax treaties. Specifically, the competent authorities would be required to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They could also consult together regarding cases not provided for in the treaty.

As an initial matter, it is necessary to recognize that there are appropriate limits to the competent authorities' own scope of review.[13] The competent authorities would not properly agree to be bound by an arbitration decision that purported to decide issues that the competent authorities would not agree to decide themselves. Even within the bounds of the competent authorities' deci-

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[13] In discussing a clause permitting the competent authorities to eliminate double taxation in cases not provided for in the treaty, Representative Dan Rostenkowski, then Chairman of the House Committee on Ways and Means, submitted the following testimony in 1981 hearings before the Senate Committee on Foreign Relations:

> Under a literal reading, this delegation could be interpreted to include double taxation arising from any source, even state unitary tax systems. Accordingly, the scope of this delegation of authority must be clarified and limited to include only noncontroversial technical matters, not items of substance.

Tax Treaties: Hearings on Various Tax Treaties Before the Senate Committee on Foreign Relations, 97th Cong., 1st Sess. 58 (1981).

sion-making power, there likely will be issues that one or the other competent authority will not agree to put in the hands of arbitrators. Consistent with these principles, the Technical Explanation expects that the arbitration procedures will ensure that the competent authorities would not accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either treaty country.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department whether the fact that Kazakhstan has a new tax code meets the Committee's criteria for arbitration provisions. The relevant portion of the July 5, 1995 Treasury Department letter responding to these inquiries are reproduced below:

> 5. How does a treaty with a country that has a one-month old tax code meet [the Committee's criteria for arbitration provisions]?
>
> The arbitration provision in the proposed treaty with Kazakhstan was negotiated and drafted consistently with our understanding of the Senate's views on arbitration as expressed in the Report of the Senate Foreign Relations Committee on the treaty between the United States and Germany. The Committee recognized "that the tax system potentially may have much to gain from use of a procedure, such as arbitration, in which independent experts can resolve disputes which otherwise may impede efficient administration of the tax laws" and endorsed the "experiment" of arbitration. In each treaty signed since the Senate's consideration of the German treaty, Treasury has included an arbitration provision only if the treaty partner agrees to delay its implementation. The delay affords us the opportunity to evaluate our experience under the German treaty.
>
> Thus, in the treaty with Kazakhstan we have agreed to establish an arbitration mechanism only after an exchange of diplomatic notes, which cannot occur until after the Convention has been in force for three years and then only after the Competent Authorities have consulted and agreed that arbitration is an appropriate means of resolving treaty disputes. Therefore the new Kazakhstani tax law will be at least several years old before this arbitration procedure could be initiated.
>
> We do not believe that Kazakhstan's new tax code has any bearing on the advisability of an arbitration procedure. However, if some aspect of Kazakhstani law made it unadvisable to initiate the procedure, the United States would refrain from exchanging the diplomatic notes necessary to initiate it.

As stated in recommending ratification of the U.S.-Germany treaty and the United States-Netherlands treaty, the Committee still believes that the tax system potentially may have much to gain from use of a procedure, such as arbitration, in which independent experts can resolve disputes that otherwise may impede efficient administration of the tax laws. However, the Committee believes that the appropriateness of such a clause in a treaty depends strongly on the other party to the treaty, and the experience that the competent authorities have under the corresponding provision in the German and Netherlands treaties. The Committee understands that to date there have been no arbitrations of competent authority cases under the German treaty or the Netherlands treaty, and few tax arbitrations outside the context of those treaties. The Committee believes that the negotiators acted appropriately in conditioning the effectiveness of this provision on the outcome of future developments in this evolving area of international tax administration.

VII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to have a negligible effect on annual Federal budget receipts during the fiscal year 1997–2003 period.

VIII. Explanation of Proposed Treaty

For a detailed article-by-article explanation of the proposed tax treaty, see the "Treasury Department Technical Explanation of the Convention and Protocol Between the United States of America and the Republic of Kazakhstan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Signed at Almaty on October 24, 1993."

IX. Text of the Resolution of Ratification

Resolved, (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention Between the Government of the United States of America and the Government of the Republic of Kazakhstan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Together with the Protocol, signed at Almaty on October 24, 1993, and Two Related Exchanges of Notes dated August 1 and September 7, 1994 and dated August 15 and September 7, 1994 (Treaty Doc. 103–33); an Exchange of Notes dated at Washington July 10, 1995, Relating to the Convention Between the Government of the United States of America and the Government of the Republic of Kazakhstan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Together With a Related Protocol, signed at Almaty on October 24, 1993 (Treaty Doc. 104–15); and an Exchange of Notes dated June 16 and 23, 1995 (EC–1431). The Senate's advice and consent is subject to the following proviso, which shall not be included in the instrument of ratification to be signed by the President:

> The United States shall not exchange the instruments of ratification with the Government of the Republic of Kazakhstan until such time as the Government of the Republic of Kazakhstan has notified the Government of the United States that its laws no longer permit anonymous bank accounts to be established.

X. APPENDIX 1.—EXCHANGE OF NOTES (EC 1431)

U.S. DEPARTMENT OF STATE,
Washington, DC, September 5, 1995.

Hon. AL GORE,
President of the Senate
Washington, DC.

DEAR MR. PRESIDENT: In accordance with established State Department practice regarding corrections to treaties, I am enclosing authentic copies of an exchange of notes dated June 16 and 23, 1995, correcting the text of the Convention Between the Government of the United States of America and the Government of the Republic of Kazakhstan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, together with a related Protocol, signed at Almaty on October 2,4 1993, and exchanges of notes transmitted with the Convention. The Convention was submitted to the Senate for advice and consent to ratification on September 19, 1994, and is printed in Senate Treaty Document 103–33, 103d Congress, 2d Session.

These notes are being sent to the Committee on Foreign Relations in order to correct the Convention. We would appreciate it if the Committee on Foreign Relations and the Senate would consider the text of this Convention as corrected.

Sincerely,

WENDY R. SHERMAN,
Assistant Secretary, Legislative Affairs.

Enclosures: As stated.

EMBASSY OF THE UNITED STATES OF AMERICA,
Almaty, June 16, 1995.

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of the Republic of Kazakhstan and has the honor to refer to the Convention Between the Government of the United States of America and the Government of the Republic of Kazakhstan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, together with a related Protocol, signed at Almaty on October 24, 1993, and Exchanges of Notes (the "Convention"):

The United States has discovered a discrepancy between the English and Russian texts of paragraph 2 b) of Article 28 (Entry in Force) of the Convention. The Embassy proposes correcting this discrepancy through an exchange of diplomatic notes. The Ministry of Foreign Affairs is requested to correct the signed Russian-language copies of the Convention that are held in Kazakhstan so that the Russian-language text conforms to the English-language text. The Kazakh-language version, currently in process of conformation, will also reflect these changes.

The full text of paragraph 2 b) of Article 28 reads as follows in the English:

> b) in respect of other taxes, for taxable periods beginning on or after the first day of January of the year in which the Convention enters into force.

The Russian text of this paragraph should be corrected to read as follows:

Insert offset folio 35A here

Following notification to the Embassy in Kazakhstan that this correction is acceptable to Kazakhstan the United States original will be corrected. The exchange of diplomatic notes would be considered a correction of the Convention and would become part of the official treaty record, but would not be considered by the United States to be an amendment of the Convention. The Convention will be printed in the United States Treaties and Other International Acts Series as corrected.

The Embassy of the United States of America avails itself of this occasion to renew to the Ministry of Foreign Affairs of the Republic of Kazakhstan the assurances of its high consideration.

DEPARTMENT OF STATE,
OFFICE OF LANGUAGE SERVICES,
Translating Division.

MINISTRY OF FOREIGN AFFAIRS OF THE REPUBLIC OF KAZAKHSTAN:

The Ministry of Foreign Affairs of the Republic of Kazakhstan presents its compliments to the Embassy of the United States of America in the Republic of Kazakhstan and has the honor to report that it received the note of June 16, 1995, regarding the Convention between the Government of the Republic of Kazakhstan and the Government of the United States of America for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, together with a related Protocol, signed at Almaty on October 24, 1993, and Exchanges of Notes (the "Convention").

The note stated:

[The Russian translation of the English note cited above agrees in all substantive respects with the English original—translator's note]

The Ministry of Foreign Affairs has the honor to advise that the Republic of Kazakhstan agrees to this correction. This correction will be regarded as a part of the official Agreement.

The Ministry avails itself of the occasion to renew to the Embassy the assurance of its high consideration.

Almaty, June 23, 1995.
Embassy of the United States of America.

XI. APPENDIX 2.—STATEMENT

WRITTEN STATEMENT OF JOSEPH H. GUTTENTAG, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY, BEFORE THE COMMITTEE ON FOREIGN RELATIONS, U.S. SENATE, SEPTEMBER 24, 1996

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am pleased to submit this statement on behalf of the Administration to recommend favorable action on the protocols to two tax treaties, with Indonesia and with the Netherlands with respect to the Netherlands Antilles, that are on the Committee's business meeting agenda. Also on the agenda is the tax treaty with Kazakhstan, on which the Administration recommended favorable action in testimony before the Committee on June 13, 1995. There are also three additional bilateral tax treaties that the President has transmitted to the Senate, with Austria, Luxembourg, and Turkey. All these agreements provide significant benefits to the United States, as well as to our treaty partners. Treasury appreciates the Committee's interest in these agreements, and requests the Committee and the Senate to take favorable action at this time on the three agreements that are on the Committee's agenda, and on the remaining three treaties as soon as possible.

The tax treaty program is designed to remove obstacles to international trade and investment, such as double taxation, and to prevent fiscal evasion, such as through treaty shopping and information concealing. Accordingly, tax treaties provide substantial benefits to taxpayers as well as to the fiscs of both treaty partners.

For example, high withholding taxes at source are an impediment to international economic activity. Under United States domestic law, all payments to non-United States persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Inasmuch as this tax is imposed on a gross rather than net amount, it imposes a high cost on investors receiving such payments. Indeed, in many cases the cost of such taxes can be prohibitive. Most of our trading partners impose similar levels of withholding tax on these types of income.

Tax treaties alleviate this burden by reducing the levels of withholding tax that the treaty partners may impose on these types of income. In general, United States policy is to reduce the rate of withholding taxation on interest and royalties to zero. Dividends normally are subject to tax at one of two rates, 15 percent on portfolio investors and 5 percent on direct corporate investors, with certain exceptions.

The Treasury Department has included in all its recent tax treaties comprehensive "limitation on benefits" provisions that limit the benefits of the treaty to *bona fide* residents of the treaty partner. These provisions are not uniform, as each country has its own characteristics that make it more or less inviting to treaty shopping in particular ways. Consequently, each provision must to some extent be tailored to fit the facts and circumstances of the treaty partners' internal laws and practices. Moreover, these provisions should be crafted to avoid interfering with legitimate and desirable economic activity. For example, in the future we plan to address directly in our negotiations the issue of how open-end United States regulated investment companies (RICs) should be treated under limitation on benefits provisions in order to facilitate cross-border investments from this important source of capital. Because these funds are required to stand ready to redeem their shares on a daily basis, we believe they generally should be entitled to treaty benefits to the same extent as closed-end RICs, which qualify for benefits under standard limitation on benefits provisions because they are publicly traded on stock exchanges. However, the extent to which this goal may be achieved is likely to vary from treaty to treaty, as the negotiators need to ensure that mutual funds established in the treaty partner cannot be used to promote treaty shopping.

Our tax treaties and treaty positions are subject to continual review. We reexamine the appropriateness and effectiveness of our treaty provisions, and receive comments from both public and private sources. The release last week of the new U.S. model income tax treaty, copies of which were provided to the Committee, is an important step in this process but does not represent its conclusion. The new model represents our favored treaty positions at this time; we will reevaluate and update the model over time as we evaluate model treaty positions as employed in our recent tax treaties and receive comments and further suggestions on the model itself.

Discussion of pending agreements—Indonesia, Netherlands Antilles, and Kazakhstan

I would like to discuss the importance and purposes of each agreement that the Committee has set for consideration. We have submitted Technical Explanations of each agreement that contain detailed discussions of each treaty and protocol. These Technical Explanations serve as an official guide to each agreement. We have furnished our treaty partners with a copy of the relevant technical explanation and offered them the opportunity to submit their comments, suggestions and concurrence.

Indonesia

The proposed protocol with Indonesia, which was signed at Jakarta on July 24, 1996, amends the income tax treaty with Indonesia that was signed in 1988 and entered into force on December 30, 1990. In many cases, the withholding tax rates permitted under the existing tax treaty with Indonesia significantly exceed those found in Indonesia's treaties with other OECD countries. This places United States business at a substantial competitive disadvantage in Indonesia relative to competitors from other industrialized countries. Because Indonesia is one of the world's most populous countries, with a rapidly expanding market that is located in a region of dynamic economic growth, it is especially important that United States firms be able to compete there without this disadvantage.

The proposed protocol achieves this objective by reducing the withholding tax rates permitted to bring them into line with those in Indonesia's recent treaties with other OECD countries. The protocol reduces the maximum rates of tax on direct-investment dividends, interest, and royalty income, which are generally 15 percent under the current treaty, to 10 percent.

Netherlands Antilles

Many years ago, the United States and the Netherlands agreed to extend the then treaty between them to the Netherlands Antilles. The extension became a contentious issue, and in 1987 most of the provisons of the treaty as extended to the Netherlands Antilles were terminated, except for the taxation of interest at source and ancillary provisions. The proposed protocol to the Netherlands treaty relates only to the Netherlands Antilles and would complete the termination by eliminating the exemption from United States withholding tax for interest, except with respect to certain grandfathered debt instruments.

The proposed protocol relating to the Netherlands Antilles would eliminate ongoing treaty shopping through the Netherlands Antilles by limiting the exemption from United States withholding tax to certain debt instruments issued on or before October 15, 1984. These debt instruments were issued in connection with Eurobond offerings by Netherlands Antilles subsidiaries of United States companies, generally before the Deficit Reduction Act of 1984 allowed United States companies to issue debt, free of United States withholding tax, directly into the international capital markets. It is appropriate to provide a continued exemption for these debt instruments because the Eurobonds were issued in reasonable reliance on the continued existence of the exemption and it is believed that eliminating the exemption entirely would have an adverse effect on international capital markets.

Kazakhstan

In addition to the five new treaties and protocols, the Committee still has under consideration a treaty between the United States and Kazakhstan. This treaty was the subject of a hearing last year. At our request, the Committee delayed its vote on this treaty until we received adequate assurances from the Government of Kazakhstan regarding access to bank account information. At the time of last year's hearing, Kazakhstan had recently adopted laws permitting the opening of anonymous bank accounts, and we wanted to be certain that the existence of these accounts would not, as a legal or a practical matter, impeded our access to bank account information in order to enforce our tax laws.

I am pleased to report that Kazakhstan is now clearly moving away from bank secrecy. The Government of Kazakhstan has submitted legislation to the Kazakhstan Parliament to repeal the earlier laws permitting the establishment of anonymous bank accounts. We understand that the lower house of the Kazakhstan Parliament has passed the legislation and that the Government of Kazakhstan expects the law to be enacted without opposition this week.

We appreciate the Committee's support on this very important issue and hope that we can work cooperatively to move this treaty forward while at the same time protecting the integrity of the treaty's exchange of information provisions. One alternative that we would support is for the Committee to report the treaty recommending that the Senate give its advice and consent to ratification assuming Kazakhstan's adoption of the new law. The full Senate then could approve the recommendation with appropriate conditions concerning the elimination of anonymous bank accounts. We have provided the committee with the latest information we have regarding the status of this issue and will continue to keep the Committee advised. If the Senate chooses to give its advice and consent to the treaty at the present time, the Administration is willing and able to accept the responsibility of not permitting instruments of ratification to be exchanged until it is fully satisfied that the conditions described above have been fully satisfied. Absent this procedure, entry into force of the treaty could be further substantially delayed. Based on information we have received it would be in the interest of the United States to have the treaty enter into force as promptly as possible.

We will continue to work with the Committee and its staff to bring this issue to a mutually satisfactory conclusion.

Conclusion

Let me conclude by again thanking the Committee for its continuing interest in tax treaty program. We appreciate the assistance and cooperation of the staffs of this Committee and of the Joint Committee on Taxation in the tax treaty process. With your and their help, we have over the past several years brought into force 19 new treaties and protocols.

We urge the committee to take prompt and favorable action on the three agreements before you at the business meeting. We further urge the Committee to take favorable action as soon as possible on the remaining three tax treaties that the President has submitted to the Senate. Such action will send an important message to our trading partners and our business community. It will demonstrate our desire to expand the United States treaty network with income tax treaties formulated to enhance the worldwide competitiveness of United States companies. It will strengthen and expand our economic relations with countries that have seen significant economic and political changes in recent years. Finally, it will make clear our intention to deal bilaterally in a forceful and realistic way with treaty abuse.

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