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PROTOCOL AMENDING THE TAX CONVENTION WITH SWEDEN (TREATY DOC. 109–8)

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

REPORT

[To accompany Treaty Doc. 109–8]

The Committee on Foreign Relations, to which was referred the Protocol Amending the Convention Between the United States of America and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, together with an Exchange of Notes, signed at Washington on September 30, 2005, having considered the same, reports favorably thereon and recommends that the Senate give its advice and consent to ratification thereof, as set forth in this report and the accompanying resolution of ratification.

CONTENTS

I. PURPOSE

The principal purposes of the existing income tax treaty between the United States and Sweden[1] and the proposed protocol amending the existing treaty are to reduce or eliminate double taxation

[1] All references to the treaty between the United States and Sweden are to the Convention Between the United States of America and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Stockholm on September 1, 1994.

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of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The existing treaty and proposed protocol also are intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

II. BACKGROUND

The proposed protocol was signed at Washington on September 30, 2005. The United States and Sweden exchanged notes on the same day to provide clarification with respect to the application of the proposed protocol. The proposed protocol would amend the U.S.-Sweden income tax treaty, which was signed at Stockholm on September 1, 1994.

The proposed protocol was transmitted to the Senate for advice and consent to its ratification on November 10, 2005 (see Treaty Doc. 109–8). The Committee on Foreign Relations held a public hearing on the proposed protocol on February 2, 2006.

III. SUMMARY

The proposed protocol modifies several provisions in the existing treaty to make it similar to more recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated ("OECD model"). However, the existing treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models.

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol would retain both the generally applicable maximum rate of withholding at source of 15 percent and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. However, like several other recent treaties and protocols, the proposed protocol would provide for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. A zero rate also generally would apply to dividends received by a pension fund. As in the current treaty, special rules would apply to dividends received from RICs and REITs, with some new modifications applicable to dividends from REITs, similar to provisions included in other recent treaties and protocols.

The proposed protocol replaces Article 17 (Limitation on Benefits) of the existing treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. model and more recent U.S. income tax treaties. Unlike the U.S. model, but like the recent protocol amending the Netherlands income tax treaty, the proposed protocol includes a requirement to determine whether a company's public trading or management constitutes an adequate connection to its residence in a treaty country to prevent certain companies from qualifying for treaty benefits.

The proposed protocol amends Article 20 (Government Service) of the existing treaty to include a special new rule related to Swedish tax on a U.S. Government pension.

The proposed protocol expands the "saving clause" provision in Article 1 (Personal Scope) of the existing treaty to allow the United States to tax certain former citizens and long-term residents regardless of whether their termination of residency has as one of its principal purposes the avoidance of tax. This provision generally allows the United States to apply special tax rules under section 877 of the Code as amended in 1996 and 2004. The proposed protocol makes coordinating changes to Article 23 (Relief from Double Taxation) with respect to foreign tax credits allowed in such situations.

The proposed protocol updates Article 1 of the existing treaty to include the rules in recent U.S. treaties related to fiscally transparent entities, modifies outdated references in Article 2 (Taxes Covered), and brings Article 4 (Residence) of the existing treaty into conformity with the U.S. model and more recent U.S. income tax treaties.

Article VIII of the proposed protocol provides for the entry into force of the modifications made by the proposed protocol.

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

In order for the proposed protocol to enter into force, each country must notify the other when it has completed its required ratification procedures, accompanied by an instrument of ratification. The proposed protocol will enter into force on the thirtieth day after the later of such notifications. The effective dates of the protocol's provisions, however, vary.

With respect to withholding taxes, the proposed protocol will have effect for amounts paid or credited on or after the first day of the second month next following the date on which the proposed protocol enters into force. With respect to taxes on income covered by Article VI of the proposed protocol, relating to the taxation by Sweden of pensions of certain employees of the U.S. embassy in Stockholm or the U.S. consulate general in Gothenburg, the proposed protocol will have effect for income derived on or after January 1, 1996. With respect to other taxes, the proposed protocol will have effect for taxable years beginning on or after the first day of January next following the date on which the proposed protocol enters into force.

B. TERMINATION

The proposed protocol will remain in force as long as the existing treaty remains in force. Either country may terminate the treaty, after the expiration of a period of five years from the date of its entry into force, by giving six months prior written notice of termination to the other country through diplomatic channels.

V. Committee Action

The Committee on Foreign Relations held a public hearing on the proposed protocol with Sweden (Treaty Doc. 109–8) on February 2,

2006. The hearing was chaired by Senator Lugar.[2] The committee considered the proposed protocol at its business meeting on March 14, 2006, and ordered the proposed protocol with Sweden favorably reported by voice vote, with a quorum present and without objection.

VI. Committee Comments

On balance, the Committee on Foreign Relations believes that the proposed protocol with Sweden 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 protocol and believes that the following comments may be useful to Treasury Department officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

A. ZERO RATE OF WITHHOLDING TAX ON DIVIDENDS FROM 80-PERCENT-OWNED SUBSIDIARIES

In General

The proposed protocol would eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend—paying corporation (often referred to as "direct dividends"), provided that certain conditions are met. The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two countries.

Under the present treaty, these dividends may be taxed by the source country at a maximum rate of five percent, a tax that the United States, but not Sweden, imposes as a matter of internal law. Thus, the principal immediate effect of this provision would be to exempt dividends that U.S. subsidiaries pay to Swedish parent companies from U.S. withholding tax. With respect to dividends paid by Swedish subsidiaries to U.S. parent companies, the effect of this provision would be to provide greater certainty as to the continued availability of a zero rate of Swedish withholding tax, regardless of how Swedish domestic law might change in this regard.

Until 2003, no U.S. treaty provided for a complete exemption from withholding tax under these circumstances, and the U.S. and OECD models currently do not provide for such an exemption. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its Parent-Subsidiary Directive. Moreover, in 2003 and 2004, the Senate approved U.S. treaties and protocols containing zero-rate provisions with the United Kingdom, Australia, Mexico, Japan, and the Netherlands. These provisions are similar to the provision in the proposed protocol, although the treaty with Japan allows a lower ownership threshold (i.e., more than 50 percent, as opposed to at least 80 percent) than do the other provisions, among other differences discussed below.

[2] The transcript of this hearing ("Tax Treaties," February 2, 2006, S. Hrg. 109–308) has been printed and is available at http://www.gpoaccess.gov/congress/senate/foreignrelations/index.html.

Description of Provision

Under the proposed protocol, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. The 80-percent ownership requirement under this provision may be satisfied by either direct or indirect ownership (through one or more residents of either contracting state).

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than normally would apply under the proposed protocol. Specifically, in order to qualify for the zero rate, the dividend-receiving company must either: (1) meet the public trading test of the limitation-on-benefits article; (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) meet the derivative benefits test of the limitation-on benefits article; or (4) receive a favorable determination from the competent authority with respect to the zero-rate provision.

Issues

Benefits and costs of adopting a zero rate with Sweden

Tax treaties mitigate double taxation by resolving the potentially conflicting claims of a residence country and a source country to tax the same item of income. In the case of dividends, standard international practice is for the source country to yield mostly or entirely to the residence country. Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a relatively low rate (e.g., five percent) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist. To the extent that the residence country allows a foreign tax credit for the withholding tax, this remaining double taxation may be mitigated or eliminated, but then the priority of the residence country's claim to tax the dividend income of its residents is not fully respected. Moreover, if a residence country imposes limitations on its foreign tax credit,[3] withholding taxes may not be fully creditable as a practical matter, thus leaving some double taxation in place. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. The principal argument in favor of eliminating withholding taxes on certain direct dividends in the proposed protocol is that it would remove one such barrier.

Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee. Whether in the United States or in Sweden, the dividend-paying corporation generally faces full net-basis income taxation in the source country, and the dividend-receiving corporation generally is taxed in the residence country on the receipt of the dividend (sub-

[3] *See, e.g.*, IRC § 904.

ject to allowable foreign tax credits or, in the case of Sweden, the participation exemption). If the dividend-paying corporation is at least 80-percent owned by the dividend receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-receiving corporation as having a more remote investor-type interest warranting the imposition of a second-level source-country tax.

Because Sweden does not currently impose a withholding tax on these dividends under its internal law, the zero-rate provision would principally benefit direct investment in the United States by Swedish companies, as opposed to direct investment in Sweden by U.S. companies. In other words, the potential benefits of the provision would accrue mainly in situations in which the United States is importing capital, as opposed to exporting it.

However, it should be noted that although Swedish internal law currently does not impose a withholding tax on dividends paid by Swedish subsidiaries to U.S. parent companies, there is no guarantee that this will always be the case. Thus, the inclusion of a zero-rate provision under the proposed protocol would give U.S.-based enterprises somewhat greater certainty as to the applicability of a zero rate in Sweden, which arguably would facilitate long-range business planning for U.S. companies in their capacities as capital exporters. Along the same lines, the provision would protect the U.S. fisc against increased foreign tax credit claims in the event that Sweden were to change its internal law in this regard.

Although the United States only recently first agreed to bilateral zero rates of withholding tax on direct dividends, many other countries have a longer history of including such provisions in one or more of their bilateral tax treaties. These countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its Parent-Subsidiary Directive. Finally, many countries have eliminated withholding taxes on dividends as a matter of internal law. Thus, although the zero-rate provision in the proposed protocol is a relatively recent development in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment.

Committee Conclusions

The committee believes that every tax treaty must strike the appropriate balance of benefits in the allocation of taxing rights. The agreed level of dividend withholding for inter-company dividends is one of the elements that make up that balance, when considered in light of the benefits inuring to the United States from other concessions the treaty partner may make, the benefits of facilitating stable cross-border investment between the treaty partners, and each partner's domestic law with respect to dividend withholding tax.

In the case of this protocol, considered as a whole, the committee believes that the elimination of withholding tax on intercompany dividends appropriately addresses a barrier to cross-border investment. The committee believes that the Treasury Department should only incorporate similar provisions into future treaty or protocol negotiations on a case-by-case basis. It notes with approval Treasury's statement that it does not view the elimination of withholding tax on intercompany dividends as a blanket change in the United States' tax treaty practice.

The committee notes with approval that the Treasury Department has set forth basic criteria for determining the circumstances under which the elimination of withholding tax on intercompany dividends would be appropriate in future negotiations with other countries. The zero rate will be agreed to only if the agreement includes limitation on benefits and information exchange provisions that meet the highest standards, and if the overall balance of the agreement is appropriate.[4] The committee expects the Treasury Department to consult with the committee regarding the evolution of these criteria and the consideration of elimination of the withholding tax on intercompany dividends in future treaties.

B. U.S. MODEL INCOME TAX TREATY

It has been longstanding practice for the Treasury Department to maintain, and update as necessary, a model income tax treaty that reflects the current policies of the United States pertaining to income tax treaties. The U.S. policies on income tax treaties are contained in the U.S. model. Some of the purposes of the U.S. model are explained by the Treasury Department in its Technical Explanation of the U.S. model:

> [T]he Model is not intended to represent an ideal United States income tax treaty. Rather, a principal function of the Model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries. In this regard, the Model can be especially valuable with respect to the many countries that are conversant with the OECD Model. . . . Another purpose of the Model and the Technical Explanation is to provide a basic explanation of U.S. treaty policy for all interested parties, regardless of whether they are prospective treaty partners.[5]

U.S. model tax treaties provide a framework for U.S. treaty policy. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on often complicated treaty matters. For purposes of clarity and transparency in

[4] Testimony of Patricia Brown, Deputy International Tax Counsel, United States Department of the Treasury, before the Senate Committee on Foreign Relations on Pending Income Tax Agreements, February 2, 2006.

[5] Treasury Department, Technical Explanation of the United States Model Income Tax Convention, at 3 (September 20, 1996).

this area, the U.S. model tax treaties should reflect the most current positions on U.S. treaty policy. Periodically updating the U.S. model tax treaties to reflect changes, revisions, developments, and the viewpoints of Congress with regard to U.S. treaty policy would ensure that the model treaties remain meaningful and relevant.

With assistance from the staff of the Joint Committee on Taxation, the Senate Committee on Foreign Relations reviews tax treaties negotiated and signed by the Treasury Department before advice and consent to ratification by the full Senate is considered. The U.S. model is important as part of this review process because it helps the Senate determine the administration's most recent treaty policy and understand the reasons for diverging from the U.S. model in a particular tax treaty. To the extent that a particular tax treaty adheres to the U.S. model, transparency of the policies encompassed in the tax treaty is increased and the risk of technical flaws and unintended consequences resulting from the tax treaty is reduced.

Committee Conclusions

The committee recognizes that tax treaties often diverge from the U.S. model due to, among other things, the unique characteristics of the legal and tax systems of treaty partners, the outcome of negotiations with treaty partners, and recent developments in U.S. treaty policy. However, even without taking into account the central features of tax treaties that predictably diverge from the U.S. model (e.g., withholding rates, limitation on benefits, exchange of information), the technical provisions of recent U.S. tax treaties have increasingly diverged from the U.S. model. The important purposes served by the U.S. model tax treaty are undermined if that model does not accurately reflect current U.S. positions. The committee notes with approval the intention of the Treasury Department to update the U.S. model treaty [6] and strongly encourages the Treasury Department to complete the update soon. In the process of revising the U.S. model, the committee expects the Treasury Department to consult with the committee generally, and specifically regarding the potential implications for U.S. trade and revenue of the policies and provisions reflected in the new model.

VII. Budget Impact

The committee has been informed by the staff of the Joint Committee on Taxation that it has assessed the likely budget impact of the proposed protocol to the income tax treaty between the United States and Sweden. The Joint Committee staff estimates that the withholding tax changes and other provisions of the proposed protocol will cause a negligible change in the federal budget receipts during the fiscal year 2006–2015 period, based solely on the amount and type of historical income flows between Sweden and the United States.

[6] Testimony of Patricia Brown, Deputy International Tax Counsel, United States Department of the Treasury, before the Senate Committee on Foreign Relations on Pending Income Tax Agreements, February 2, 2006.

VIII. Explanation of Proposed Protocol

A detailed, article-by-article explanation of the proposed protocol between the United States and Sweden can be found in the pamphlet of the Joint Committee on Taxation entitled Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Sweden (JCX–1–06), January 26, 2006.

IX. Text of Resolution of Advice and Consent to Ratification

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Protocol Amending the Convention Between the United States of America and Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income of September 1, 1994, signed at Washington on September 30, 2005 (Treaty Doc. 109–8).

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