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INCOME TAX CONVENTION WITH SWEDEN

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

REPORT

[To accompany Treaty Doc. 103–29, 103d Congress, 2d Session]

The Committee on Foreign Relations, to which was referred the Convention Between the Government of 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, together with a related exchange of notes, having considered the same, reports favorably thereon, without amendment, and recommends that the Senate give its advice and consent to ratification thereof.

I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and Sweden 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 income taxes of the two countries. The proposed treaty is intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is also intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

II. BACKGROUND

The proposed treaty was signed on September 1, 1994, and replaces the existing income tax treaty between the two countries that was signed in 1939, and amended by a supplementary protocol signed in 1963.

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The proposed treaty was transmitted to the Senate for advice and consent to its ratification on September 14, 1994 (see Treaty Doc. 103–29). The Committee on Foreign Relations held a public hearing on the proposed treaty on June 13, 1995.

III. SUMMARY

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty (the "U.S. model"),[1] and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed treaty contains certain deviations from those documents. Among other modifications, the proposed treaty includes a number of revisions to accommodate aspects of the Tax Reform Act of 1986.

As in other U.S. tax treaties, the objectives of the proposed treaty are principally 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 proposed treaty contains the standard treaty provisions that neither country will tax business income derived by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base and the income is attributable to the permanent establishment or fixed base (Articles 7 and 14). Similarly, the proposed 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, 15, and 18). The proposed treaty provides that dividends and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10 and 13). Generally, however, dividends 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 (Article 10). The proposed treaty also provides that, as a general rule, the source country may not tax interest and royalties received by a resident of the other treaty country (Articles 11 and 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 requiring the country of residence either to grant a credit against its tax for the taxes paid to the second country or to exempt that income (Article 23).

The treaty contains a "saving clause" similar to that 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

[1] The U.S. model has been withdrawn from use as a model treaty by the Treasury Department. Accordingly, its provisions may no longer represent the preferred position of U.S. tax treaty negotiations. A new model has not yet been released by the Treasury Department. Pending the release of a new model, comparison of the provisions of the proposed treaty against the provisions of the former U.S. model should be considered in the context of the provisions of comparable recent U.S. treaties.

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.

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. and OECD model treaties. It also differs in significant respects from the present treaty with Sweden. (The present treaty predates the 1981 U.S. model treaty.) A summary of the provisions of the proposed treaty, including some of these differences, follows:

(1) The U.S. excise tax on insurance premiums paid to a foreign insurer generally is covered; that is, the excise tax is treated as a tax that may be eliminated by treaty. This treatment is a departure from the prior treaty, which generally allowed the U.S. excise tax to be imposed on premiums paid to Swedish insurers. Similar coverage appears in recent tax treaties (such as the treaties with Germany and the Netherlands and the present and proposed treaties with France), and under the U.S. model treaty (Article 2).

(2) The definition of the term "United States" as contained in the proposed treaty generally conforms to the definition provided in the U.S. model. In both treaties the term generally is limited to the United States of America, thus excluding from the definition U.S. possessions and territories. The proposed treaty, however, makes it clear that the United States includes its territorial sea and the seabed and subsoil of the adjacent area over which the United States may exercise rights in accordance with international law and in which laws relating to U.S. tax are in force. The U.S. model is silent with respect to this point. The definition of the term "Sweden" as contained in the proposed treaty similarly includes its territorial sea and other maritime areas over which Sweden, in accordance with international law, exercises sovereign rights or jurisdiction (Article 3).

(3) By contrast with the present treaty, the proposed treaty introduces rules for determining when a person is a resident of either the United States or Sweden, and hence (subject to the limitation on benefits) entitled to benefits under the treaty. The proposed treaty, like the U.S. model 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 these treaty countries. These rules differ in some respects from the rules in the U.S. model treaty. For example, under the treaty, as under many other U.S. treaties, Sweden need not treat U.S. citizens or green card holders as U.S. residents unless they have a substantial presence, permanent home, or habitual abode in the United States. The U.S. model, by contrast, provides for the other country to reduce taxes on all U.S. citizens, regardless of where they reside. The United States, however, rarely has been able to negotiate coverage for nonresident citizens in its income tax treaties (Article 4).

(4) The proposed treaty does not contain the U.S. model treaty provision under which investors in real property in the country not of their residence, and who make an election to be taxed on those investments on a net basis, are bound by that election for all subsequent years unless the countries agree to allow the taxpayer to terminate it. Instead, the making of the election is controlled by inter-

nal law. Although current U.S. and Swedish law independently provide for elective net basis taxation, the making of a second election under internal U.S. law is restricted once a first election has been revoked. Unlike the U.S. model treaty and most U.S. treaties, but like the OECD model treaty and several recent U.S. treaties, the proposed treaty defines real property to include accessory property, as well as livestock and equipment used in agriculture and forestry (Article 6).

(5) By contrast to most other U.S. treaties, the proposed treaty treats a permanent establishment as if it were a "distinct and separate enterprise" (as in the OECD model treaty) rather than a "distinct and independent enterprise" (as in the U.S. model treaty). The language in other U.S. treaties is intended to make clear that, as described in paragraph 10 of the OECD Commentaries to Article 7, a permanent establishment is to be treated as if it were a totally independent enterprise, i.e., one that deals independently with all related companies, not just its home office. The Treasury Department Technical Explanation of the Convention Between the Government of 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, May 1995 ("Technical Explanation") explains that in the course of the negotiations of the proposed treaty, the Swedish negotiators made clear that they subscribed to the interpretation in the OECD Commentaries, but preferred to retain the language from the OECD model. The explanation further states that there should be no difference in applications between paragraph 2 of Article 7 of the proposed treaty and its analog in other U.S. treaties (Article 7).

(6) The business profits article of the proposed treaty omits the force of attraction rules contained in the Code, providing instead that the business profits to be attributed to a permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. This is consistent with the U.S. model (Article 7).

(7) The proposed treaty, like the present and model treaties, provides that profits of an enterprise of one treaty country from the operation of ships or aircraft in international traffic are taxable only in that country. Like the U.S. model treaty, but unlike the present treaty, the proposed treaty provides that profits of a treaty-country enterprise from the use or rental of containers and related equipment used in international traffic shall be taxable only in that country (Article 8).

(8) Profits derived by the air transport consortium Scandinavian Airlines System (SAS) are subject to the exemption from tax for international traffic under the proposed treaty only to the extent that the SAS profits correspond to the participation held in that consortium by AB Aerotransport (ABA), the Swedish partner of SAS. SAS is an entity in the nature of a partnership which was created jointly by the legislatures of Sweden, Norway and Denmark. The entire income of the consortium will be subject to an exemption from tax for international traffic because, in addition to the proposed treaty, there are treaties between the United States and Norway and Denmark that provide similar exemptions to resi-

dents of those countries. In addition, notes exchanged at the signing of the treaty provide that all income earned by Scandinavian Airlines of North America Inc. (SANA Inc.), a New York corporation, from the operation in international traffic of aircraft would be treated as income of SAS, the consortium whose constituent corporate members own the stock of SANA Inc. The Technical Explanation states that (1) SANA Inc. was created and is operated as an entity apart from SAS to satisfy U.S. regulations regarding foreign airlines, which SAS as a consortium could not meet, (2) SANA Inc. is a conduit for SAS with regard to receipts and its expenses are guaranteed by SAS and, therefore, (3) the income of SANA Inc. will be taxed under the proposed treaty in the same manner as if it were earned directly by SAS. The same result is achieved with respect to the Danish and Norwegian partners in SAS. The result is spelled out in an exchange of notes with Norway, in the same manner as in this treaty. The present Danish treaty predates the establishment of SANA Inc., and is, therefore, silent on this issue. Similar notes were signed in connection with the 1980 treaty with Denmark which was approved by the Committee, but was not approved by the full Senate (on other grounds) (Article 8).

(9) The associated enterprise article of the proposed treaty incorporates the general principles of section 482 of the Internal Revenue Code ("Code"). It also conforms more closely than does the present treaty to the corresponding article in the U.S. model. Under the present treaty, each country may tax an enterprise resident in that country on profits that were, by virtue of its participation in the management or the financial structure of an enterprise of the other contracting State, reduced by non-arm's-length conditions agreed to or imposed upon the second enterprise. In these cases, adjustments may be made in the accounts of the resident enterprise. The proposed treaty contains broader language, similar to the U.S. model, expressly permitting the use of internal law standards such as section 482. It further provides that either treaty country must correlatively adjust any tax liability it previously imposed on an enterprise for profits reallocated to an associated enterprise by the other treaty country, if the first country agrees with the substance of the second country's adjustment (Article 9).

(10) Under the proposed treaty, as well as the U.S. model, 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) will generally be taxable by the source country, after the treaty is fully phased in, at a rate no greater than 5 percent. Portfolio investment dividends (i.e., those paid to companies owning less than a 10 percent voting share interest in the payor, or to noncorporate residents of the other country) are generally taxable by the source country at a rate no greater than 15 percent (Article 10).

(11) Like the U.S. model treaty, the proposed treaty generally defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. Unlike the U.S. model treaty, the proposed treaty also provides that the term dividends includes income from arrangements, including debt obligations, carrying the right to participate in profits to the extent so characterized under the law of the source country. Thus, the treaty

would permit dividend treatment of an "equity kicker" amount that is paid on a loan (Article 10).

(12) The prohibition on source country tax in excess of 5 percent on direct investment dividends does not apply to a dividend from a regulated investment company (a "RIC"). These dividends are generally subject to a 15-percent tax. In addition, a dividend from a real estate investment trust (a "REIT") is taxed at source at the 15-percent portfolio dividend rate if the beneficial owner of the dividend is a Swedish individual who owns less than a 10-percent interest in the REIT (dividends paid by a REIT are taxed at source at the full 30-percent statutory rate in other cases) (Article 10).

(13) The proposed treaty provides an exemption from U.S. excise taxes on private foundations in the case of a religious, scientific, literary, educational, or charitable organization which is resident in Sweden, but only if such organization has received substantially all of its support from persons other than citizens or residents of the United States. This provision is designed to ensure that the Nobel Foundation, a Swedish charitable organization, will not be subject to U.S. excise taxes (Article 10).

(14) Unlike the present treaty, the proposed treaty expressly permits the United States to impose its branch profits tax. The United States may only apply its branch profits tax to the portion of the business profits of a Swedish company attributable to a permanent establishment or to certain income from real property. The amount of profits subject to the branch profits tax is limited to the amount representing the "dividend equivalent amount," as defined under the Code (Article 10).

(15) Like the U.S. model, the proposed treaty generally provides that interest derived and beneficially owned by a resident of a country may be taxed only by that country. Thus, the proposed treaty generally exempts from the U.S. 30-percent tax U.S. source interest paid to Swedish residents, and exempts from Swedish tax interest paid to U.S. residents. The proposed treaty also provides that the exemption at source for interest does not apply to an excess inclusion of a U.S. real estate mortgage investment conduit (a "REMIC"). The U.S. model (which was written before the enactment of the REMIC regime) does not exclude an excess inclusion of a REMIC from the exemption at source for interest (Article 11).

(16) Like the present treaty, the proposed treaty provides that royalties derived and beneficially owned by a resident of a country generally may be taxed only by that country. Thus, the proposed treaty generally exempts from the U.S. 30-percent tax all U.S. source royalties paid to Swedish residents, and exempts from Swedish tax royalties paid to U.S. residents. These reciprocal exemptions are similar to those provided in the U.S. and OECD model treaties. However, unlike under the U.S. model treaty, payments for the use of, or the right to use, any motion pictures and works on film, tape or other means of reproduction used for radio or television broadcasting, are treated as royalties (Article 12).

(17) 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 present treaty (and U.S. model) definition of real prop-

erty 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 (Article 13).

(18) The proposed treaty permits Sweden to impose its statutory tax on gains by an expatriate resident in the United States from any property derived by this individual during the 10 years following the date on which the individual ceased to be a resident of Sweden. Under the proposed treaty, the United States also retains a right to tax its former citizens for 10 years where their loss of citizenship had as one of its principal purposes the avoidance of tax (Article 13).

(19) The proposed treaty generally conforms to the U.S. model treaty the provisions relating to independent personal services. Under the proposed treaty, like the model treaty, independent personal services performed by a resident of one country in the other country can be taxed by the source country only if the income is attributable to a fixed base regularly available to the individual in the source country for the purpose of performing his or her activities (Article 14).

(20) The dependent services article of the proposed treaty varies slightly from that article of the U.S. model. Under the U.S. model, 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. The proposed treaty contains a similar rule, but like the OECD model as revised in 1992, provides that the measurement period for the 183-day test is not limited to the taxable year; rather, the source country may not tax the income if the individual is not present there for a period or periods exceeding in the aggregate 183 days in a 12-month period (Article 15).

(21) The proposed treaty prohibits source country tax on remuneration of a treaty country resident employed as a member of the regular complement of a ship or aircraft operating in international traffic (including an aircraft operated in international traffic by the air transport consortium Scandinavian Airlines System). This is the same as the U.S. model provision, but differs from the present treaty (which provides no special rule for such employment income) and from the OECD model, which permits taxation in such case by the country in which the place of effective management of the employer is situated (Article 15).

(22) The proposed treaty allows directors' fees paid by a company resident in one country to a resident of the other country to be taxed in the first country if the fees are paid for services performed in that country. The U.S. model treaty and the present treaty, on the other hand, subject directors' fees to the normal rules regarding the taxation of persons performing personal services. Under the U.S. model treaty (and the present treaty), 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 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. Thus, the proposed treaty represents a compromise between the U.S. model and the OECD model positions (Article 16).

(23) The proposed treaty, unlike the present treaty, contains a limitation on benefits, or "anti-treaty shopping," article. This proposed treaty provision retains in some respects the outline of the limitation on benefits provisions contained in recent U.S. treaties and in the branch tax provisions of the Internal Revenue Code and Treasury Regulations. The proposed treaty provision is similar to the limitation on benefits article contained in the recent U.S. income tax treaty with Germany (Article 17).

(24) As is true of the U.S. and the OECD model treaties, the proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes" or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services and business profits and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries. The dollar threshold for taxation under the proposed treaty, however, is less than one-third of the threshold provided in the U.S. model. U.S. tax treaties generally follow the U.S. model rules, but often use a lower annual income threshold. Under the OECD model, entertainers and athletes may be taxed by the country of source, regardless of the amount of income they earn from artistic or sporting endeavors (Article 18).

(25) Under the proposed treaty, pensions and other similar remuneration beneficially derived by a resident of either country in consideration of past employment generally are subject to tax only in the recipient's country of residence. However, pensions and other payment made by one of the countries under the provisions of its social security system or similar legislation paid to a resident of the other country or to a citizen of the United States will be taxable only in the paying country. Similar legislation is defined in the notes exchanged at the time of the signing of the proposed treaty to refer to United States Tier 1 Railroad Retirement benefits. The proposed treaty also provides for the deductibility of contributions of an employee in the host country of the employee, under certain circumstances, to a pension or retirement arrangement in the other country, as may be agreed by the competent authorities of the two countries (Article 19).

(26) The proposed treaty retains the present treaty's rule that, as a general matter, employment compensation paid by a treaty country government may only be taxed by that country. If, however, the employee is a citizen of the other country, or did not become a resident of the other country solely for the purposes of his employment, the other country has the exclusive taxing right. A similar set of rules applies to pensions in respect of government service. The proposed treaty applies to all compensation paid by a governmental entity for services rendered to that governmental entity, regardless

of whether the services are rendered in the discharge of governmental functions, so long as the services are not rendered in connection with a business carried on by the governmental entity (Article 20).

(27) The present and proposed treaties, like the U.S. model, preclude a visited country from taxing certain compensation received by students, trainees, and certain other temporary visitors, when that compensation is for purposes of full time education or training and is received from abroad (Article 21).

(28) The proposed treaty, unlike the present treaty, contains the standard other income article, found in the model treaties and more recent treaties, under which income not dealt with in another treaty article generally may be taxed only by the residence country (Article 22).

(29) The relief from double taxation article of the proposed treaty, which generally ensures that each country allow foreign tax credits for the income taxes imposed by the other country, contains a special rule (not contained in the present treaty but contained in many other treaties) for U.S. citizens who reside in Sweden. Under this rule, Sweden will allow as a credit against Swedish tax the U.S. income taxes paid on U.S. source income. The credit, however, will not exceed the amount of tax that would have been paid to the United States if the resident were not a U.S. citizen (Article 23).

(30) The proposed treaty greatly expands the non-discrimination rule in the present treaty, generally conforming it to the U.S. model. The present treaty prohibits only discrimination under the laws of one country against citizens of the other country resident in the first country. The proposed treaty prohibits discrimination under the laws of one country against nationals of the other country in the same circumstances as nationals of the first country. The proposed treaty also prohibits discrimination under the laws of one country against permanent establishments of enterprises of the other country, against the deductibility of amounts paid to residents of the other country, or against enterprises owned by residents of the other country (Article 24).

(31) Like the U.S. model treaty, the proposed treaty makes express provision for competent authorities to mutually agree on topics that would arise under the present 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. Also like the U.S. model, the proposed treaty makes express provision for competent authorities to mutually agree on topics that would arise under the proposed treaty (Article 25).

(32) The proposed treaty provides that its dispute resolution procedures under the mutual agreement article would take precedence over the corresponding provisions of any other agreement between the United States and Sweden in determining whether a law or other measure is within the scope of the proposed treaty. Unless the competent authorities agree that the law or other measure is outside the scope of the proposed treaty, only the proposed treaty's nondiscrimination rules, and not the nondiscrimination rules of any trade or investment agreement in effect between the United States

and Sweden, generally would apply to that law or measure. The only exception to this general rule is that the nondiscrimination rules of the General Agreement on Tariffs and Trade would continue to apply with respect to trade in goods (Article 25).

(33) The proposed treaty contains a provision requiring each country to undertake to lend administrative assistance to the other in collecting taxes covered by the treaty. This provision, carried over with modifications from the present treaty, is more expansive than the administrative assistance provision in the U.S. model treaty. Among other things, the proposed treaty provision specifies that one country's application to the other for assistance must include a certification that the taxes at issue have been "finally determined." A country is not required to lend assistance with respect to the country's own citizens or entities, except as necessary to ensure that exemptions or reduced rates under the treaty will not be enjoyed by those not entitled to them. Neither country, however, is required to carry out administrative measures different from those used in the collection of its own taxes, or which would be contrary to its sovereignty, security, or public policy (Article 27).

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

The proposed treaty will enter into force upon the exchange of instruments of ratification. The proposed treaty will take effect for the United States, with regard to withholding taxes on dividends, interest or royalties, for amounts paid or credited on or after the first day of the January following the date on which the treaty enters into force. With respect to other taxes, the proposed treaty will take effect for taxable years beginning on or after the first of January following the date the treaty enters into force. For Sweden, with regard to taxes on income, the proposed treaty will take effect for income derived on or after the first day of January following the date on which the treaty enters into force; with regard to the Swedish capital tax, for tax that is assessed in or after the second calendar year following the year the treaty enters into force; and with regard to the excise tax imposed on insurance premiums paid to foreign insurers, for premiums paid on or after the first day of January following the date the treaty enters into force.

B. TERMINATION

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it at any time after five years from the date of its entry into force, by giving at least six months prior notice through diplomatic channels.

In the case of the United States, with respect to taxes withheld at source, a termination will be effective for amounts paid or credited on or after the first of January following the expiration of the six-month period. With respect to other taxes, a termination is to be effective for taxable years beginning on or after the first of January following the expiration of the six-month period.

In the case of Sweden, with respect to taxes on income, a termination will be effective for income derived on or after the first day of January following the expiration of the six months period. With

respect to the capital tax, a termination will be effective for tax that is assessed in or after the second calendar year following the expiration of the 6 months period. With respect to the excise tax imposed on insurance premiums paid to foreign insurers, a termination will be effective for premiums paid on or after the first day of January following the expiration of the six months period.

V. Committee Action

The Committee on Foreign Relations held a public hearing on the proposed treaty with Sweden, and on other proposed tax treaties and protocols, on June 13, 1995. The hearing was chaired by Senator Thompson. The Committee considered the proposed treaty on July 11, 1995, and ordered the proposed treaty and protocol favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to the ratification of the proposed treaty.

VI. Committee Comments

On balance, the Committee on Foreign Relations believes that this treaty is in the interest of the United States and urges that the Senate act promptly to give its 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. 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 Sweden 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 a subsidiary, trust, or other investing entity in that treaty country which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives. Although the present Swedish treaty does not contain an anti-treaty-shopping provision, treaty shopping through Sweden apparently has not been a problem. However, as the United States negotiates anti-treaty-shopping provisions with additional countries, treaty shopping through countries with treaties without such provisions may become more of a problem.

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 the anti-treaty-shopping provision of the U.S. model 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 of the U.S. model, but the effect of the change is less clear. The general test applied by the U.S. model 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, except for banking and insurance activities carried on by a bank or an insurance company, 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 practical difference between the proposed treaty tests and the U.S. model test 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 expla-

nation regarding the sufficiency of the anti-treaty shopping provisions in the proposed treaty and other treaties. The relevant portion of Treasury's letter responding to this and other inquires, dated July 5, 1995, is reproduced below:[2]

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

B. 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

[2] Letter from 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 letter").

is fully consistent with the proposed treaty.[3] 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."[4]

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.[5] Some prefer a so-called "formulary apportionment" approach, which can take a variety of forms. The general thrust of formulary apportionment is to first 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.[6]

A debate exists as to 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 nondiscrimination rules embodied in Article 25.[7] Some, who advocate

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[3] 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.

[4] Id. (preface).

[5] 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).

[6] 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).

[7] 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 "[w]orldwide 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.

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. The issue is whether the United States should enter into agreements that might conflict with a move to an alternative approach in the future, and if not, the degree to which U.S. obligations under the proposed treaty would in fact conflict with such a move.

As part of its consideration of the proposed treaty, the Committee requested the Treasury Department to provide additional information on the Administration's current policy with respect to transfer pricing issues. The information requested included a description of the Administration's general position on transfer pricing issues, an analysis of whether the United States should interpret Article 9 of tax treaties regarding transfer pricing as permitting other methods of pricing such as the unitary method or formulary apportionment method and the reasons for industry's support of the arm's-length pricing method. In addition, the Committee also inquired whether the Treasury Department is satisfied that the proposed treaty, and other treaties that are the subject of the hearing, ensure foreign corporations are paying their share of U.S. taxes. The relevant portions of Treasury's response to these inquiries, in the July 5, 1995 Treasury letter, 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.
> >
> > 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

224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department).

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.

C. 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 a General Agreement on Trade in Services ("GATS"). This agreement generally obligates members (such as the United States and Sweden) 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 proposed treaty provides that notwithstanding any other agreement to which the United States and Sweden are parties, 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 proposed treaty 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).

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). The Committee also believes that the provision of the proposed treaty is adequate to preclude the preemption of the mutual agreement provisions of the proposed treaty by the dispute settlement procedures under the GATS.

D. INSURANCE EXCISE TAX

The proposed treaty, unlike the present treaty, contains a waiver of the U.S. excise tax on insurance premiums paid to foreign insurers. Thus, for example, a Swedish insurer or reinsurer without a permanent establishment in the United States can collect premiums on policies covering a U.S. risk or a U.S. person free of this tax. However, the tax is imposed to the extent that the risk is reinsured by the Swedish insurer or reinsurer with a person not entitled to the benefits of the proposed treaty or another treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" clause.

Although waiver of the excise tax appears in the 1981 U.S. model treaty, waivers of the excise tax have raised serious Congressional concerns. For example, concern has been expressed over the possibility that such waivers may place U.S. insurers at a competitive disadvantage to foreign competitors in U.S. markets if insubstantial tax is imposed by the other country to the treaty (or any other country) on the insurance income of its residents (or the income of companies with which they reinsure their risks). Moreover, in such a case waiver of the tax does not serve the purpose of treaties to

avoid double taxation, but instead has the undesirable effect of eliminating all taxation.

The U.S.-Barbados and U.S.-Bermuda tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Foreign Relations Committee expressed the view that those waivers should not have been included. The Committee stated that waivers should not be given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress.[8] Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties. The waiver of the tax in the treaty with the United Kingdom (where the tax was waived without the so-called "anti-conduit rule") has been followed by a number of legislative efforts to redress perceived competitive imbalance created by the waiver.

Technical Explanation explains that the U.S. negotiators agreed to waive these insurance excise taxes "only after a review of Swedish law indicated that the income tax imposed by Sweden on Swedish resident insurers results in a burden that is substantial in relation to the U.S. tax on U.S. resident insurers." Thus, unlike Bermuda and Barbados, Sweden appears to impose substantial tax on income, including insurance income, of its residents. In addition, unlike the U.K. waiver, the Swedish treaty waiver contains the standard anti-conduit language. Thus, although it may be difficult to generalize about the precise tax burdens Swedish insurers bear relative to U.S. insurers, or the precise effects of imposing or waiving the excise tax on Swedish insurers' rates of economic return, there is reason to believe that agreeing not to impose the tax on Swedish insurers is consistent with the criteria the Committee has previously laid down for waiver of the tax.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department to provide additional explanation on the insurance excise tax waiver provision. The relevant portions of the July 5, 1995 Treasury letter responding to this and other inquiries are reproduced below:

> 1. Is Treasury satisfied that no competitive imbalance will result from the insurance excise tax waiver provision?
>
> Our insurance experts reviewed Swedish taxation of insurance companies resident in Sweden to ensure that the competitive position of U.S. insurance companies will not be affected adversely by granting a waiver of the U.S. insurance excise tax to Swedish companies. This review confirmed that Swedish insurance companies bear a significant level of Swedish tax on their income from insuring U.S. risks.
>
> 2. Can this Committee be assured that this waiver is peculiar to the Swedish treaty as a result of the substantial tax burdens and will not provide a precedent for future waivers in tax treaties?
>
> The coverage of the insurance excise tax is not peculiar to the Swedish treaty. It has been U.S. treaty policy for about 20 years to cover the insurance excise tax, and

[8] The Committee understands that such consultations took place in connection with the proposed treaty.

> thereby waive its imposition, where the other country sought coverage, subject to an anti-abuse provision, so long as the other country did not have a comparable tax that it was not willing to cover. In recent years, in accordance with Congressional views, we have modified our policy to cover the tax only in treaties with countries that impose a significant level of tax on their resident insurance companies. As indicated above, Sweden passed this test.

Swedish law may, however, exempt low-taxed foreign income of a Swedish resident from tax; if foreign laws that apply to the foreign insurance income of a Swedish resident were changed in the future (or applied differently than they are now), the result might be a level of tax inconsistent with the criteria previously laid down by the Committee for waiver of the U.S. excise tax on premiums. While the Committee has no reason currently to expect that such foreign law changes will occur, the Committee is aware of this possibility, and thus instructs the Treasury Department promptly to inform the Committee of any changes in foreign laws or business practices that would have an impact on the tax burden of Swedish insurers relative to that of U.S. insurers.

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 Federal budget receipts during the fiscal year 1995–2000 period.

VIII. Explanation of Treaty Provisions

For a detailed, article-by-article explanation of the proposed treaty, see the "Treasury Department Technical Explanation of the Convention Between the Government of 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," May 1995.

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 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, together with related exchange of notes (Treaty Doc. 103–29).

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