

Senate Foreign Relations Committee Hearing: Treaties  
July 10, 2008

Today's hearing was chaired by Senator Menendez (D-New Jersey) and attended by the committee's ranking member, Senator Lugar (R-Illinois). Although not unusual for a treaty hearing, it is noteworthy that only two Senators were in attendance, as the attendance of more Senators could well have signified undesirable attention on the part of the Senate.

The two witnesses testifying in regards to the tax treaties were Michael Mundaca, Deputy Assistant Secretary (International), and Emily S. McMahon, the Deputy Chief of Staff of the Joint Committee on Taxation. Three tax treaties were discussed: the U.S.-Canada protocol, the U.S.-Iceland treaty and protocol, and the U.S.-Bulgaria treaty and protocol. Because there were eleven different treaties on the agenda, only approximately a third of the hour-and-a-half hearing was spent discussing the tax treaties, although much of the discussion that was devoted to tax treaties centered on the U.S.-Canada protocol. The discussions of the protocol mainly concerned the binding arbitration provision and the services PE provision.

Mr. Mundaca and Ms. McMahon each explained the major provisions of the protocol, providing mostly description. Mr. Mundaca addressed the reduction of the interest withholding rate, the significance of binding arbitration, and the services permanent establishment ("PE") provision. He specifically stated that including the services PE provision was one of the keys to achieving the overall agreement with Canada. Mr. Mundaca also explained the addition of a limitation on benefits provision in the Iceland treaty, specifically stating that the Iceland and Hungary treaties have been used for treaty shopping.

Ms. McMahon explained many of the same provisions, noting the reduction of the interest withholding rate (specifically noting that the dividend withholding rate was not reduced) and the recognition of fiscally transparent entities. Ms. McMahon also commented on the binding arbitration provision, saying that there are presently many questions about how the provision will work in practice and that it is too early to assess the efficacy of the binding arbitration provisions in the Germany and Belgium treaties. Ms. McMahon also commented on the services PE provision, noting that the services PE provision was also included in the new Bulgaria treaty and has been included in other developing country treaties, but has not yet been included in a treaty with a developing country.

Senator Menendez's opening statement provided a general explanation of the importance of tax treaties and the significant provisions in the U.S.-Canada protocol, which he identified as the reduction of the interest withholding rate, the recognition of fiscally transparent entities, the services PE provision, and the binding arbitration provision. Mr. Menendez stated that the addition of binding arbitration was positive, but also declared that improvements are necessary. He expanded on these concerns in a question to Mr. Mundaca, stating that he had expressed certain concerns regarding the provisions in the amended Germany and Belgium tax treaties. He asked why these concerns had not been addressed, stating that he may not have been as supportive of those arbitration provisions if he had known that his concerns would not be addressed in the future. Specifically, Senator Menendez stated that he was concerned about the lack of a provision for direct taxpayer input. Mr. Mundaca responded that the binding arbitration

provisions were negotiated at the same time as the provisions in the Germany and Belgium treaties, and therefore the provision had been agreed upon before such concerns were raised. Although acknowledging that Senator Menendez's concerns had not been addressed, Mr. Mundaca stated that the Treasury Department takes such concerns "seriously."

In response to another of Senator Menendez's queries about the arbitration provision, Mr. Mundaca stated that he expected that transfer pricing disputes would comprise the largest category of arbitration cases. Mr. Mundaca also discussed the requirement that arbitration proceedings may not begin for two year after the commencement date of the case, and that such two-year period would begin for existing cases the date the treaty enters into force, stating that the Treasury Department is discussing with Canada the possibility of allowing cases that are already two years old to move forward more quickly.

Senator Menendez also addressed the services PE provision in another question, asking why this provision was included in a treaty with a developed country, whether it was now the policy of the Treasury Department to include such provisions in treaties with developed countries, and how the provision will work administratively. Mr. Mundaca responded that the Treasury Department understands his concerns regarding the administrative difficulties posed by the new provision and that the Treasury Department also understands the need for additional guidance, especially on the connected projects language and the administrative issues associated with the provision. Mr. Mundaca said that it was not the Treasury Department's general treaty policy to include services PE provisions in tax treaties, and that the Treasury Department was still opposed the inclusion of a services PE provision in the OECD Model. He stated that the Treasury Department is in discussions with Canada to provide guidance on the services PE provision, specifically stating that the Treasury Department would like to address the connected projects language.

Senator Lugar explained the general function of tax treaties in his opening statement, the significant provisions of the protocol, and noted the importance of the arbitration provision. Several of Senator Lugar's questions concerned the new limitation on benefits provisions in the Iceland treaty, asking Mr. Mundaca to explain what treaty shopping is and why it is a problem. Mr. Mundaca specifically mentioned Hungary in his response, stating that taxpayers have set up businesses in Hungary to claim benefits under the U.S.-Hungary treaty. In a follow-up question, Senator Lugar asked how countries can verify whether persons claiming treaty benefits are actually entitled to benefits, and Mr. Mundaca explained that there are information sharing provisions in place that facilitate such determinations.

In hallway talk after the hearing, we learned that Senators Feingold (D-Wisconsin) and Dorgan (D-North Dakota) had not to date expressed opposition to the binding arbitration provision as they had in connection with the German and Belgian treaties, but it should be noted that they did not express that opposition until a point later in the approval process than we are at currently with respect to the Canadian agreement.