

## The Purpose and Scope of U.S. Income Tax Treaties

For over 70 years, the United States has negotiated bilateral tax treaties with its trading partners to facilitate economic flows and investments between the countries, eliminate double taxation, and provide certainty to taxpayers where overlapping taxing jurisdictions can cause confusion. These income tax treaties are negotiated and signed by the U.S. Treasury Department on a bilateral basis with the other country, and are subject to the guidance, oversight and ratification of the U.S. Senate.

The major focus of these treaties is to provide clear rules as to which taxing authority has the authority to tax income that has some connection to entities or persons in both the United States and the country with whom we have negotiated the treaty. In other words, treaties provide both taxpayers and tax administrators clear guidance as to whether a type of income or payment is taxable by the United States or the other country. The certainty that the treaties provide facilitates capital flows and investments between the United States and the treaty partner as well as the collection of appropriate taxes in an efficient manner.

The U.S. Treasury Department has over many years, under Administrations represented by both parties, regularly renegotiated and updated the U.S. tax treaty network to add protections or secure the assistance of the treaty partner in certain law enforcement commitments. These modernizations to the U.S. treaty network are an ongoing process that specifically involves direct input and oversight by the U.S. Senate (via the Senate Foreign Relations Committee which has immediate oversight jurisdiction for these treaties).

The Treasury Department, the Senate Foreign Relations Committee and the Joint Committee on Taxation coordinate future treaty negotiating objectives, monitor current treaty implementation and even discuss action to withdraw from treaties if they do not believe the treaty is in the U.S. interest. For instance, after consultation with the Foreign Relations Committee and JCT staff in 1987, the United States terminated its treaty relationship with the Netherlands Antilles. More recently, in 1996, the United States terminated its treaty relationship with Malta and Aruba. The U.S. Treasury Department views the possibility of such terminations as an example of the Treasury Department's commitment to prevent misuse of income tax treaties by third country residents, even if it means termination of long-standing relationships.

The U.S. tax treaty network, built up over many years, regularly and thoughtfully updated, is both an economic benefit to the United States and a key tool of law enforcement. Some of the other key features of these treaties include:

**Extensive Provisions to Prevent Abusive Use of Treaties:** First, benefits are accorded only to tax residents of the treaty partners, meaning that the claimant must establish that the income is subject to residency-based taxation in its home jurisdiction. Second, the claimant must be the "beneficial owner" of the income; treaty benefits will not be allowed to a claimant that serves as a conduit for "funneling" treaty-benefited income to another country. Third, each operative article contains limitations on its applications that narrow the types of income eligible for treaty benefits. Fourth, since the 1980s, the United States has included a specific anti-treaty shopping article, known as the "Limitation on Benefits" Article to assure that

residents of third jurisdictions do not inappropriately obtain the benefits of a tax treaty simply by forming an affiliate resident in the treaty jurisdiction. Under this anti-treaty shopping article, in order for a resident of treaty jurisdiction to claim treaty benefits, the resident must show that it has not been established in the treaty jurisdiction for a principal purpose of obtaining the benefits of the treaty either by: (i) complying with objective criteria based on qualified ownership or a substantial business nexus to its residence jurisdiction or (ii) obtaining a discretionary determination from the tax authority of the source state that it has met this principal purpose test.

**Prevention of Income Tax Evasion:** Exchange of information provisions permit tax authorities to obtain tax information concerning assets and income that the resident may have in the other country to ensure collection of taxes.

**Avoiding Double Taxation:** Tax treaties generally avoid the risk of potential double taxation on the same income by allowing an exemption or foreign tax credit in the country of residence for taxes that the country of source has retained the right to impose under the treaty. Where cases of double taxation still exist, the treaties contain mutual agreement provisions under which taxpayers can request one or both countries to provide the necessary relief.

**Reducing Barriers to Cross Border Investment:** The U.S. imposes a 30-percent withholding tax rate on interest, dividends, and royalties U.S. subsidiaries pay to foreign affiliates. This high rate is considered a significant barrier to cross-border investment. The treaties often provide significant relief from these barriers, helping to ensure that foreign-headquartered companies are not double-taxed.

**Avoidance of discriminatory tax treatment.** Treaties generally prevent countries from discriminating against foreign-owned companies as compared to similarly situated U.S.-owned companies.