



**The NFTC Tax Treaty Project:**

**TOWARDS A U.S. TAX TREATY  
POLICY FOR THE FUTURE:  
ISSUES AND RECOMMENDATIONS**

**Prepared by the National Foreign Trade Council, Inc.**

**Washington, DC**

**May 26, 2005**

**The NFTC Tax Treaty Project:**  
**TOWARDS A U.S. TAX TREATY POLICY FOR THE  
FUTURE: ISSUES AND RECOMMENDATIONS**

National Foreign Trade Council, Inc.  
1625 K Street, N.W., Suite 200  
Washington, D.C. 20006  
www.nftc.org  
(202) 887-0278

2 West 45<sup>th</sup> Street  
New York, New York 10036

Copyright © 2005 by the National Foreign Trade Council, Inc.

All rights reserved. No part of this book may be reproduced in any form or by any means without written permission from the publisher.

Printed in the United States of America

First Printing

This report was prepared by and for the National Foreign Trade Council, Inc. The views expressed herein are solely those of NFTC, and unless otherwise indicated, they do not necessarily reflect the views on a particular point of the Drafters or reviewers that have participated in this project, and/or the views of their respective firms or institutions.

**The NFTC Tax Treaty Project:**

**TOWARDS A U.S. TAX TREATY POLICY FOR THE  
FUTURE: ISSUES AND RECOMMENDATIONS**

### Preface

The increasing globalization of business has heightened the importance of tax treaties as a crucial mechanism for avoiding double taxation and preventing barriers to international trade and investment. The pace of developments in tax treaty policy has quickened in recent years, as evidenced by the U.S. Treasury's recent decision to revise the 1996 U.S. Model Tax Treaty, its introduction of significant changes to U.S. treaty provisions, the increased frequency of U.S. Senate consideration of pending treaties, and the number of ongoing projects at the Organisation for Economic Co-operation and Development (OECD) addressing important issues of treaty interpretation and implementation. In 2004, the NFTC launched a tax treaty project in order to examine and make recommendations on a number of significant issues of U.S. tax treaty policy. The current document includes Part Two of the project, in Chapters 8 – 10. Part One of the project was previously released, in two phases (Chapters 1 - 3 in September 2004 and Chapters 4 – 7 in November 2004).

**The NFTC Tax Treaty Project:  
TOWARDS A U.S. TAX TREATY POLICY FOR THE  
FUTURE: ISSUES AND RECOMMENDATIONS**

Drafters

**Mary C. Bennett**

*Partner, Baker & McKenzie LLP  
Former Deputy International Tax Counsel,  
U.S. Treasury Department*

**Carol A. Dunahoo**

*Partner, Baker & McKenzie LLP  
Former Director, International, Internal  
Revenue Service  
Former Associate International Tax  
Counsel,  
U.S. Treasury Department*

TABLE OF CONTENTS

<b>INTRODUCTION</b> .....	1
<b>EXECUTIVE SUMMARY</b> .....	3
<b>CHAPTER 8: EFFECTS OF EU DEVELOPMENTS</b> .....	6
I. Introduction .....	6
II. Summary of EU Developments.....	7
A. Background .....	7
B. ECJ Case-law .....	8
C. European Commission’s Proposals for Corporate Tax Harmonization .....	13
III. Implications for U.S. Treaties and Treaty Policy.....	15
A. Limitation on Benefits.....	15
B. Nondiscrimination Standards .....	17
C. The Bilateral Network.....	20
IV. Conclusions and Recommendations.....	23
<b>CHAPTER 9: COORDINATION WITH THE OECD</b> .....	25
I. Introduction .....	25
A. Importance of the OECD.....	25
B. Summary of Current Concerns.....	25
C. Summary of Conclusions and Recommendations.....	25
II. Implications for Business .....	25
III. Implications for Governments.....	26

IV. Current Concerns Regarding Coordination..... 26

    A. Recent Trends..... 26

    B. Government Opportunities for Improvement..... 27

    C. Business Opportunities for Improvement ..... 28

V. Recommendations for Improved Coordination..... 28

    A. Increased Transparency..... 28

    B. Increased Dialogue..... 28

    C. Drafting Improvements ..... 30

    D. Timing of Input ..... 31

    E. Substance of Input..... 31

**CHAPTER 10: NFTC CONTRIBUTIONS TO THE U.S. TREATY PROCESS... 32**

I. Introduction..... 32

    A. Current NFTC Contributions ..... 32

    B. Current Issues and Concerns..... 32

    C. Summary of Conclusions and Recommendations..... 32

II. Negotiation Priorities ..... 33

III. Treaty Negotiation Process ..... 33

IV. Treaty Ratification Process ..... 34

**INTRODUCTION**

The National Foreign Trade Council, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Its membership covers the full spectrum of industrial, commercial, financial, and service activities. The NFTC therefore seeks to foster an environment in which U.S. companies, like their foreign counterparts, can be dynamic and effective competitors in the international business arena. To achieve this goal, businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad. As global competition grows ever more intense, it is vital that global enterprises be free from excessive foreign taxes or double taxation and impediments to the flow of capital that can serve as barriers to full participation in the international marketplace. Foreign trade is fundamental to the economic growth of such companies.

Tax treaties are a crucial component of the framework that is necessary to allow that growth and to promote balanced competition. This is why the NFTC has long supported the expansion and strengthening of the U.S. tax treaty network and why it has undertaken this study of U.S. tax treaty policy, with a view to considering issues and making recommendations for the future.

Tax treaties are bilateral agreements that serve to harmonize the tax systems of the two countries applicable to companies and other persons involved in cross-border investment and trade. In the absence of a tax treaty, income from cross-border transactions or investment would be subject to potential double taxation, first by the country where the income arises and again by the country of the recipient's residence. Tax treaties eliminate this double taxation by allocating taxing jurisdiction over the income between the two countries.

In addition, the tax systems of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners. Treaties are the mechanism by which these taxes are lowered on a bilateral basis. If enterprises earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they are liable to suffer excessive and non-creditable levels of foreign tax and to be at a competitive disadvantage relative to businesses from other countries that do have such benefits. Tax treaties serve to prevent this barrier to participation in international commerce.

Tax treaties also provide other features that are vital to the competitive position of global businesses. For example, by prescribing internationally agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring tax laws to be applied in a nondiscriminatory manner to nonresident enterprises, treaties offer a significant measure of certainty to potential investors. Another extremely important benefit that is available exclusively under tax treaties is the mutual agreement procedure, to resolve disputes in particular cases or reach bilateral agreement on issues of

interpretation or application. This bilateral administrative mechanism avoids double taxation on cross-border transactions.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the United States and other governments by providing assistance for the administration of their tax laws and the implementation of their treaty policy. The article that provides for the exchange of information between tax authorities is an excellent example of the benefits that result from an expanded tax treaty network.

As cross-border trade and investment expand, tax treaties are playing an increasingly important role in preventing the imposition of excessive or inappropriate taxes on global businesses and in ensuring the fairer and more efficient application of the tax laws. To continue to serve their intended purposes, treaties must keep pace with developments in today's global economy. It is appropriate to revisit periodically both the tax policy positions and priorities reflected in treaties and the interpretation and implementation of treaties in practice. The United States and some of its major trading partners have shown an increased willingness in recent years to reconsider such issues, as demonstrated, for example, by recent treaty agreements to eliminate withholding on certain cross-border dividends and to expand cross-border coordination with respect to pensions and stock options. The United States and many other member countries of the Organisation for Economic Co-operation and Development (OECD) also have recently undertaken to evaluate and improve upon current treaty dispute resolution practices and mechanisms.

The increasing magnitude and reach of cross-border trade and investment is prompting the negotiation of an ever-growing international network of tax treaties. A broad international consensus on the interpretation of common treaty terms and provisions is critical to the effectiveness of treaties in achieving their goals. While these issues could be addressed bilaterally as well, this often would be less efficient than a multilateral approach and would be of limited value in addressing issues, such as the attribution of profits, in cases that involve more than two countries.

Much important multilateral work on tax treaties has been undertaken by countries already under the aegis of the OECD, and several OECD projects of great significance to business are presently underway. The international business community appreciates the importance of these efforts, as well as the efforts made by the OECD and its member countries to expand the dialogue with business and to improve the transparency of their deliberations. A number of the topics addressed in this study relate directly to projects currently underway at the OECD. Although the study focuses in particular on U.S. tax treaty policy, the NFTC hopes that it will be of broader interest and relevance.

This study is offered with a view to promoting constructive dialogue. In that spirit, the NFTC would be pleased to discuss its analysis and recommendations with interested governments and organizations.



**EXECUTIVE SUMMARY**

The National Foreign Trade Council, an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment, has undertaken this study of U.S. tax treaty policy with a view to identifying issues and opportunities for improvement. This project was undertaken in recognition of the growing importance of tax treaties in preventing the imposition of excessive or inappropriate taxes on global businesses and in ensuring the fairer and more efficient application of the tax laws. To continue to serve their intended purposes, treaties must keep pace with developments in today's global economy. It is appropriate to revisit periodically both the tax policy positions and priorities reflected in treaties and the interpretation and implementation of treaties in practice. The NFTC hopes that this effort will add value to those already underway on a bilateral basis, among the United States and other countries, and on a multilateral basis at the OECD.

The first phase of Part One of the NFTC study was published in September 2004, and addressed issues relating to the attribution of profits to a permanent establishment, practical treaty implementation concerns, and arbitration. The second phase of Part One, published in November 2004, addressed four additional sets of issues, including issues relating to permanent establishments, withholding rate provisions, pensions and equity-based compensation, and the U.S. Model Treaty. The publication in April 2005 of Part Two completes this study, with chapters addressing the effects of current EU developments, coordination with the OECD, and NFTC contributions to the U.S. tax treaty process.

**Effects of EU Developments**

The tax treaties in force between the United States and 24 of the 25 Member States of the European Union (EU) represent almost one-half of the entire U.S. tax treaty network. Fast-moving legal developments within the EU have the potential to trigger major changes in EU Member States' treaty relationships with the United States in the near future. The developments include a series of important decisions of the European Court of Justice. Some of these decisions are calling into question the compatibility of specific bilateral tax treaty provisions (*e.g.*, Limitation on Benefits provisions) with EU Member States' obligations under the EU Treaty. Certain of these cases are even leaning towards applying "most favored nation" principles to EU Member States' tax relationships with one another and with third countries, so as to call into question the very viability of exclusively bilateral treaty relationships. Other ECJ decisions are revealing a broad interpretation of nondiscrimination principles that are common to the EU Treaty and bilateral tax treaties, which could lead to conflict between EU Member States and the United States when it comes to assessing the scope of their respective nondiscrimination obligations under tax treaties. The ECJ is also critically analyzing the compatibility of fundamental aspects of EU Member States' corporate tax regimes with the EU Treaty (*e.g.*, thin capitalization, cross-border loss relief), thereby creating pressure for a much more coordinated corporate tax system within the EU which could put significant strains

on the bilateral nature of individual EU Member States' treaty relationships with the United States.

In addition to these tensions created by the ECJ decisions, the European Commission is pursuing an ambitious agenda to spur fundamental changes to EU corporate tax regimes. In particular, the Commission is encouraging EU Member States to adopt a common consolidated corporate tax base for the EU-wide activities of corporate groups, and to apportion the profits determined under such a base among EU Member States on some sort of formulary basis. The Commission is also floating the notion that the EU may need to have a model treaty for EU Member States to follow, or even a multilateral treaty to replace existing bilateral relationships with non-EU countries. Any such movement on the part of EU Member States would clearly have potentially important ramifications for those bilateral treaty relationships.

The U.S. Government officials responsible for U.S. treaty policy and the U.S. business community should commit to an open and ongoing dialogue to keep abreast of developments in the EU, to share insights into their significance, and to develop options for U.S. responses. A parallel dialogue should be undertaken with key players within the EU (including the Commission and individual EU Member States' tax policy-makers), to ensure that the United States is fully prepared to respond to whatever EU developments may arise.

### **Coordination With the OECD**

The OECD has long been an influential player in the development of international tax treaty policy, but its importance and influence have grown over the past several years. In recent years, the OECD process has become noticeably more transparent and open to input from business, a fact that the NFTC appreciates. Tension occasionally arises, however, when the business community believes that the OECD has acted without taking its issues and concerns sufficiently into account, or when the government participants view the expectations of business as ineffectively communicated or unrealistic. Although substantial progress already has been made, there is much room for further improvement of this dialogue from both sides of the table.

The transparency of OECD deliberations could be enhanced to promote improved dialogue with business, by more widely publicizing projects from the outset. The dialogue between the OECD and the business community could be expanded and improved, through the creation of additional opportunities for face-to-face discussion, especially at a pre-decisional stage. Other helpful measures that should be considered include the release of an issues paper at the start of each project, the more active solicitation of business input where necessary, the allowance of more time for comments on draft documents, and the expanded use of Technical Advisory Group or similar processes. In addition, steps should be taken to minimize the perception of the Roundtables and other OECD-organized meetings as overly scripted in advance or limited in participation. The study further notes the opportunity for further improvement in the manner in which OECD documents are drafted and the need for clarification

regarding their intended effect. It also identifies some opportunities for additional improvements to the timing and substance of business input at the OECD.

Finally, the study notes the extent to which the U.S. business community has embraced the opportunity to participate actively in those OECD policy projects that have been opened up to business participation. It also acknowledges, however, that the extent of U.S. business participation may give rise to some risk of adverse reaction on the part of member governments not so accustomed to significant business input in policy-making processes. The study suggests some potential causes of this phenomenon and calls for both government and business participants to analyze and address it in a constructive manner.

### **NFTC Contributions to the U.S. Tax Treaty Process**

The NFTC has become the leading voice of business in connection with U.S. tax treaties, acting as a valuable information resource for both the Treasury Department and the Congress on business experiences, concerns, and priorities. Although the U.S. tax treaty process has remained remarkably consistent over many decades, it is working very well at present, with the negotiation of a number of major U.S. treaty agreements and their favorable consideration in record time by the Committee on Foreign Relations and the U.S. Senate. The NFTC fully appreciates these significant accomplishments, but has taken this opportunity to consider potential improvements that would enable its member companies and others to contribute additional value to the process.

The NFTC already has decided to expand the scope of its annual tax treaty survey to gather more information on concerns regarding the implementation of existing treaties. This information will be shared with Treasury Department and IRS officials to inform not only their bilateral treaty negotiations but also, it is hoped, their deliberations at the OECD and their competent authority negotiations. The timely sharing of such information regarding NFTC member company experiences and concerns with particular countries might be facilitated if Treasury announced dates of negotiations, or at least the resumption of suspended negotiations, in advance.

The NFTC encourages Treasury to consider releasing draft texts of its Technical Explanations in advance of Foreign Relations Committee hearings, if feasible. This would give the public an opportunity to comment on those Explanations in advance of their finalization, including giving Treasury useful feedback on practical conditions in the relevant country, as there is no clear method of amending the Technical Explanations after the fact.

## CHAPTER 8

EFFECTS OF EU DEVELOPMENTS

## I. INTRODUCTION

The United States currently has tax treaties in force with 24 of the 25 Member States of the European Union (EU), and a number of those countries are among our most significant treaty partners. Developments within the EU which affect the Member States' tax systems and their treaty relationships therefore have great importance for the United States.

The pace of those developments has accelerated rapidly in recent years, particularly as a result of the large number of decisions issued by the European Court of Justice (ECJ) relating to direct taxation matters. These cases show a potential to affect EU Member States' bilateral tax treaty relationships with the United States in at least three ways. First, the cases signal a willingness on the part of the ECJ to rule that specific provisions of a bilateral tax treaty between an EU Member State and another country, including a non-EU country, may violate the EU Member State's obligations under the EU Treaty,<sup>1</sup> with potential ramifications for the stability of that bilateral treaty relationship. Second, the ECJ's decisions relating to those aspects of the nondiscrimination provisions in the EU Treaty that closely parallel the nondiscrimination provisions of bilateral tax treaties have adopted a much more robust view of the nondiscrimination obligation than the U.S. Government has typically espoused, and the influence of the ECJ's thinking on EU Member States' understanding of the strength of the corresponding tax treaty nondiscrimination obligations could lead to conflicts between the EU Member States and the United States in that area. Third, some of the ECJ cases are striking down certain fundamental aspects of individual EU Member States' corporate tax regimes relating to cross-border transactions within the EU. This "dismantling" of individual EU Member State corporate tax regimes by the ECJ could have the effect of driving the EU Member States toward a much more coordinated approach to corporate taxation within the EU, with far-reaching implications for any individual EU Member State's bilateral relationships with third countries such as the United States.

At the same time as these important trends are developing at the ECJ, the European Commission is also actively pursuing an agenda aimed at removing tax-related obstacles to the formation of the single EU "Internal Market". The Commission is trying to encourage the EU Member States to coordinate their corporate tax regimes through the

---

<sup>1</sup> The Treaty Establishing the European Community (the "EU Treaty" or "Treaty of Rome") entered into force on January 1, 1958. It has been amended by the Treaty on European Union which entered into force on November 1, 1993 (the "Maastricht Treaty") and the Treaty on European Union which entered into force on May 1, 1999 (the "Amsterdam Treaty").

adoption of a “common consolidated corporate tax base” (CCCTB) for the EU-wide activities of corporate groups, with the profits included in that base to be apportioned among the individual EU Member States according to an agreed methodology. The Commission has also announced its intention to publish an analysis of the implications of ECJ case-law for tax treaty relationships, and it is examining options for addressing those issues (possibly including an EU Model Treaty or an EU multilateral treaty).

All these signals point towards a convergence of factors within the EU which could have major implications for the network of U.S. treaties with EU Member States. The NFTC believes it is appropriate for U.S. policymakers and the U.S. business community to analyze the potential implications of these EU changes on the U.S. treaty network and to consider possible U.S. responses to those changes. This paper therefore summarizes the EU developments, attempts to identify their potential implications for U.S. tax treaties and treaty policy, and sets forth certain conclusions and recommendations for future action.

## **II. SUMMARY OF EU DEVELOPMENTS**

### **A. Background**

#### **1. EU Treaty – Four Freedoms**

The EU Treaty contains several provisions that have taken on major significance in the area of direct taxation within the EU. Known as the “four freedoms”, these include the freedom of movement for workers (Article 39), the freedom to provide services (Article 49), the freedom of establishment (Article 43), and the freedom of movement of capital (Article 56). The latter two provisions have proven particularly important in relation to the taxation of business enterprises. The freedom of establishment provision prohibits restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State. This includes restrictions on the setting up of agencies, branches, or subsidiaries by nationals of any Member State in the territory of any other Member State. The freedom of movement of capital provision prohibits restrictions on the movement of capital between Member States and between Member States and third countries. Thus, while the EU Member States have reserved to their national governments the “competence” to design and enact their own tax systems, the EU Treaty imposes certain obligations on the Member States in respect of those tax systems.

#### **2. The European Commission**

The European Commission is one of the key institutions of the EU. It acts in effect as the executive body of the EU, with the goal of upholding the interests of the EU as a whole. It has the exclusive right to propose EU legislation. It acts with the assistance of a civil service. The Commission has the authority to bring EU Member States to the ECJ to oblige them to comply with EU law. As noted above, the Commission actively pursues efforts to remove tax-related obstacles to the formation of the single EU “Internal Market”.

### 3. The ECJ

The ECJ is made up of 25 judges, one from each Member State, who are assisted by eight advocates-general. It can find a Member State guilty of failing to fulfill its obligations under the EU Treaty. It also is empowered, at the request of the national courts, to issue rulings on the interpretation of the EU Treaty and the validity and interpretation of EU law.

#### B. ECJ Case-law

##### 1. An Overview

Over the course of the past several years, the jurisprudence of the ECJ has become an extremely important factor in the direction of tax law within the EU. The ECJ has ruled on over one hundred cases relating to tax issues. Many cases that have come before the ECJ have involved questions about whether particular aspects of a Member State's domestic tax law or tax treaties violate one of the four freedoms. In the vast majority of these cases, the ECJ has found that the relevant provision does violate the EU Treaty. The effect of these rulings has generally been to force the affected Member State to modify its law or even to pay damages to the taxpayers who have been disadvantaged by that State's noncompliance with the EU Treaty.

Several of the ECJ's cases have directly addressed the extent to which certain types of bilateral tax treaty provisions, whether between EU Member States or between such States and third countries, raise issues of consistency with EU law. Those cases could have a fairly direct effect on any U.S. treaties with EU Member States. Other cases are significant because they address concepts of nondiscrimination under the EU Treaty that echo similar concepts under bilateral tax treaties. The ECJ has articulated a robust notion of the nondiscrimination obligations inherent in the four freedoms, and its views on those obligations will likely color EU Member States' understanding of the nondiscrimination obligations in bilateral tax treaties. Yet another category of ECJ case-law focuses on certain fundamental provisions of EU Member States' national tax laws and their consistency with the EU Treaty. To the extent the ECJ finds such provisions to be in violation of the EU Treaty, the result is likely to be substantial changes in the nature of those national tax laws. Ultimately, the momentum of such decisions could lead to broad changes in the manner in which EU Member States' national tax laws interact with one another, resulting in much greater coordination or harmonization in those laws. One outcome which seems increasingly possible is that the EU Member States will move towards adoption of some sort of EU-wide common consolidated corporate tax base, with revenues to be allocated among the Member States according to some system of allocation (*e.g.*, formulary apportionment). Such a system could have a profound impact on the existing bilateral treaty relationships between the United States and individual EU Member States.

While an exhaustive review of the ECJ case-law potentially affecting U.S. treaty relationships is beyond the scope of this study, a sampling of the different categories of cases can give some flavor for the types of challenges they present to the U.S. treaty network.

## 2. ECJ Cases with Potential Ramifications for Treaty Relationships

### a) ECJ Cases on Conflicts between Bilateral Treaty Provisions and the EU Treaty

In its 1999 decision in the case of *Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt* (C-307/97), the ECJ addressed Germany's taxation of the German permanent establishment (PE) of the French company, Saint Gobain SA. The PE received dividends from a U.S. subsidiary, and one of the issues in the case was whether such dividends were taxable in Germany or whether the "freedom of establishment" obligation meant that they should be entitled to an exemption from German tax comparable to that which was provided in the Double Taxation Relief article of the U.S.-Germany Tax Treaty for dividends received by German resident corporations.

The ECJ held that the German PE of Saint Gobain was in an "objectively comparable" situation with a German company. It noted that EU Member States have reserved to themselves the competence to conclude tax treaties, but said that in doing so, the States must exercise those powers consistently with EU law. The ECJ ruled: "In the case of a double-taxation treaty concluded between a Member State and a non-member country, the national treatment principle requires the Member State which is party to the treaty to grant to permanent establishments of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies." The ECJ rejected the argument that its holding, which effectively extended a benefit of the U.S.-Germany Treaty to a company established in a third country, would disturb the principle of reciprocity and balance inherent in double taxation treaties. The ECJ noted that Germany's unilateral extension of the U.S.-Germany Treaty's exemption to German PE's of EU companies would not in any way affect the rights or obligations of the United States.

In a non-tax controversy referred to as the "Open Skies cases",<sup>2</sup> the European Commission brought actions against eight EU Member States, complaining that the bilateral air transport agreements they had entered into with the United States (*i.e.*, the "open skies" agreements) violated the "freedom of establishment" obligation under the EU Treaty. Each agreement contained a "nationality clause" which allowed the United States to deny the U.S. air traffic rights otherwise available under the agreement to airlines established in the Member State that was a party to the agreement unless those

---

<sup>2</sup> The Open Skies case refers to actions brought by the European Commission against eight EU Member States: the United Kingdom (C-466/98); Denmark (C-467/98); Sweden (C-468/98); Finland (C-469/98); Belgium (C-471/98); Luxembourg (C-472/98); Austria (C-475/98); and Germany (C-476/98).

airlines were owned and controlled by nationals of that Member State. The Commission argued that this clause violated the Member State's "freedom of establishment" obligations under the EU Treaty. In its November 2002 decisions, the ECJ agreed with the Commission's argument. In effect, the ECJ ruled that each Member State, by agreeing to include in its treaty with the United States a provision which allowed the United States to deny the benefits of the treaty to entities established in that State but owned by nationals of other EU Member States, had discriminated unlawfully under the EU Treaty. The principle of these holdings is widely viewed as having potential implications for Limitation on Benefits provisions in U.S. tax treaties with EU Member States.

A more recent case has the potential for even more far-reaching implications for EU Member States' tax treaties. In the so-called "*D Case*",<sup>3</sup> an individual German resident and national, ten percent of whose worldwide assets consist of real property located in the Netherlands, has complained about his inability to claim a particular allowance in calculating his liability to Dutch Wealth Tax. Specifically, he complains that a Dutch resident individual, or a Dutch nonresident at least 90 percent of whose worldwide assets are situated in the Netherlands, would be entitled to a personal allowance which he could not obtain. In addition, however, he complains that he is disadvantaged relative to a resident of Belgium in similar circumstances, because a double taxation treaty between Belgium and the Netherlands allows residents of Belgium to claim the same allowances against the Dutch Wealth Tax as residents of the Netherlands may claim. The taxpayer in the *D Case* has argued that both of these distinctions violate the "free movement of capital" obligation under the EU Treaty.

While the ECJ itself has not yet ruled in the *D Case*, the Advocate General issued his opinion on October 26, 2004.<sup>4</sup> On the first question, the Advocate General opined that the ECJ should hold that the Dutch domestic law distinction between Dutch residents (or nonresidents who hold 90 percent of their worldwide assets in the Netherlands) and nonresidents who hold less than 90 percent of their worldwide assets in the Netherlands is a violation of the "freedom of movement of capital" obligation. If the ECJ follows that first recommendation, it will not need to reach the second issue, as to whether the Netherlands discriminated against the German taxpayer by offering the allowance to Belgian residents by treaty but not to him as a German resident. Nevertheless, the Advocate General went on to address that issue in case the ECJ rules differently on the first issue.

The Advocate General reiterated the now well-established principle that Member States must act in accordance with EU law, even in concluding tax treaties with other Member States or with third countries. The opinion concluded that the German resident was

---

<sup>3</sup> *D. v. Inspecteur van de Belastingdienst* (C-376/03).

<sup>4</sup> While opinions of the Advocate General are not binding on the ECJ, the Court has followed such opinions in about 80 percent of its cases.



effectively entitled, on a “most-favored-nation” basis, to enjoy the same benefit in respect of the Dutch Wealth Tax as a Belgian resident could enjoy pursuant to the Netherlands-Belgium Treaty. The Advocate General appears to have been influenced in this case by the fact that the allowance provided by the Netherlands to residents of Belgium under the Netherlands-Belgium Treaty was not necessary to avoid double taxation, because Belgium did not have a wealth tax. That being said, the Advocate General’s opinion appears to endorse a very broad most-favored-nation approach to determining the scope of the “freedom of movement of capital” obligation under the EU Treaty. This approach is all the more significant because that obligation applies not only to the intra-EU movement of capital, but also to the movement of capital between the EU and third countries.

**b) ECJ Cases Relating to the Nondiscrimination Standard in the Tax Area**

A number of ECJ cases have addressed EU Treaty nondiscrimination issues that are broadly comparable to issues that could arise under the nondiscrimination provisions of bilateral tax treaties. While these decisions of the Court do not directly address the compatibility of tax treaty provisions with the EU Treaty, they do provide some interesting insights into the Court’s interpretation of the strength of the nondiscrimination concept in situations that directly parallel nondiscrimination issues that arise under tax treaties.

For example, in its December 2002 decision in *Lankhorst-Hohorst GmbH* (C-324/00), the ECJ addressed the compatibility of the German thin capitalization regime, as it existed for the period at issue, with the freedom of establishment obligation under the EU Treaty. The German rules generally prohibited the deductibility of interest paid to a related foreign party by a German resident corporation if the German company’s debt-equity ratio exceeded 3-to-1. In this case, the parent company lending to the German subsidiary was resident in the Netherlands. The ECJ held that the German regime was a violation of the freedom of establishment obligation. It rejected the defense put forward by the German Government that the same regime applied to German tax-exempt lenders, saying that a foreign parent company carrying on a business for profit “cannot validly be compared” to a German tax-exempt organization. The ECJ also rejected the Government’s argument that the regime was justified based on the need to ensure the “coherence” of the German tax system through application of the internationally recognized arm’s length principle. The ECJ said that the “coherence” argument was relevant only where there was a direct link between a taxpayer’s deduction of a certain item and that same taxpayer’s liability to tax on income from a related item.

In its March 2004 decision in *Hughes de Lasteyrie du Saillant* (C-9/02), the ECJ addressed the French “exit tax” imposed on the built-in gain in securities held by individual French residents at the time of their transfer of residence to a country outside France. The taxpayer argued that this tax hindered his freedom of establishment. The ECJ agreed with the taxpayer. It specifically rejected the argument that the tax was justifiable on the grounds of preventing fiscal erosion of the tax base of France, since it

stressed that “diminution of tax receipts cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify a measure which is, in principle, contrary to a fundamental freedom.”

c) ECJ Cases Involving Fundamental Provisions of EU Member State Corporate Tax Regimes

A number of the opinions issued by the ECJ have addressed fairly fundamental aspects of certain Member States’ corporate tax regimes and have led to significant changes to those regimes. For example, the *Lankhorst-Hohorst* case mentioned above, which held the German thin capitalization regime to be inconsistent with the EU Treaty, led to Germany’s expansion of that regime to apply to purely domestic as well as cross-border loans.

Among the cases attracting the most attention at the time of this writing is the case of *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)* (C-446/03), relating to whether the U.K. “group relief” regime violates the EU Treaty’s freedom of establishment obligation by restricting the transfer of losses within a group of companies to those losses incurred by group members that are residents of the United Kingdom or carry on an economic activity there. While the ECJ has not yet ruled in this case, the Advocate General’s opinion was issued on April 7, 2005. In that case, Marks & Spencer, the U.K.-based department store group, had tried to take the benefit of losses incurred by its German, French, and Belgian subsidiaries against the profits of U.K. members of its group. The U.K. Government has sought to defend its denial of the use of those losses by arguing that its system is justified based on the fiscal principle of territoriality (*i.e.*, since it has no power to tax the income of the EU subsidiaries, it cannot offer a tax advantage in respect of their losses) and based on the need to ensure the “cohesion” of its tax system.

The Advocate General’s opinion in *Marks & Spencer* states that the fiscal principle of territoriality cannot be invoked to enable the Member States to evade their obligations under the EU Treaty. The Advocate General suggests that the United Kingdom’s across-the-board denial of the use of losses incurred by EU subsidiaries is a violation of the freedom of establishment. However, he concludes that the concept of cohesion does authorize a Member State to impose conditions on a tax advantage which are consistent with the aim and logic of the tax regime at issue. In that connection, he states that the aim of the U.K. group relief system is to ensure fiscal neutrality of the effects of the creation of a group of companies. Accordingly, the Advocate General concludes that it would be allowable for the United Kingdom to make entitlement to group relief for the EU subsidiaries’ losses subject to the condition that the taxpayer establish that the losses cannot obtain equivalent treatment in the Member States where the subsidiaries are resident (*i.e.*, either through the transfer of losses to a third party or the carrying forward of losses by the same taxpayer to another tax year). Press reports relating to this case have suggested that a taxpayer-favorable decision at the level of the ECJ could force the United Kingdom and other EU Member States to refund billions of Euros in tax payments to corporate groups that have been denied the right to obtain cross-border loss relief.

### C. European Commission's Proposals for Corporate Tax Harmonization

While the ECJ has been busy striking down numerous aspects of EU Member States' corporate tax regimes over the past several years, the European Commission has been equally busy advocating broad corporate tax reforms across the EU. In particular, the Commission has argued that adoption of a common consolidated corporate tax base for the EU-wide activities of companies is the only means by which the "Internal Market" can truly be achieved in the corporate tax field. The Commission has, however, disavowed any intention to push for minimum or harmonized corporate tax rates across the EU.

In a Communication issued in October 2001<sup>5</sup> the Commission addressed the need to tackle tax-related obstacles to cross-border economic activity in the Internal Market, and it announced a program of activities aimed at achieving some targeted immediate solutions and taking steps toward the longer term goal of providing companies with a common consolidated tax base for their EU wide activities. The Commission issued a follow-up Communication in November 2003<sup>6</sup> which confirmed its commitment to the earlier stated goals. The 2003 document also presented ideas for a pilot "Home State Taxation" scheme that would allow small and medium-sized enterprises to use the tax rules of their home state for computing their EU-wide taxable profits. It also announced the Commission's plans to work with Member States and businesses to develop and refine a proposal for using financial accounts as a starting point for a single EU-wide tax base and for apportioning that single base among the different Member States. The Communication stated that the main focus of attention is on the development of a "formulary apportionment" method for allocating the EU-wide (*i.e.*, "water's edge") corporate tax base.

Among the points addressed in the Commission's November 2003 Communication were the following:

- The Commission said it intended to present a Communication at the end of 2003 on the effect of decision of the ECJ on Member States' dividend tax systems, in order to promote more pro-active co-ordination of those features of the Member States' tax systems that are or are likely to be in conflict with EU law.
- The Commission said it would consult with Member States with a view towards presenting an initiative by early 2005 to tackle the current limits on cross-border loss relief within the EU

---

<sup>5</sup> COM(2001)582 (October 23, 2001).

<sup>6</sup> COM(2003)726 (November 24, 2003).

- The Commission said it was studying possible conflicts between the EU Treaty and the bilateral tax treaties that Member States have concluded with each other and with third countries, and that it intended to present a legal analysis of the relevant ECJ rulings by early 2005.
- The Commission announced its intention to form an Expert Group to discuss the detailed tax principles that would have to be applied for purposes of using International Financial Reporting Standards (IFRS, formerly known as International Accounting Standards or IAS) as a starting point for a single EU-wide corporate tax base.
- It also said it intended to continue research and pursue discussions with Member States and companies on the issues relevant to the apportionment of the single corporate tax base across the Member States.

Of particular interest is the Commission's statement with respect to EU Member States' double tax treaties in its November 2003 Communication, as follows:

The Commission services are looking closely into the **varied and complex problems relating to the bilateral and multilateral double taxation treaties** in the Internal Market and are in the process of assessing the various options set out in the 2001 study for tackling these. An initiative in this field, which will provide a **legal analysis and interpretation of the relevant ECJ rulings**,<sup>17</sup> is planned for 2004. Possible approaches for advancing in this area include, *inter alia*, the development of an EU model tax treaty or the conclusion of a multilateral tax treaty between all EU Member States. Moreover, it is noteworthy that many of the targeted measures are to some extent interlinked. This could have repercussions for Member States' double-taxation treaties.

Particular attention will need to be paid to the enforcement of the equal treatment principle of the Treaty, which seems to conflict with the current distinction between residents and non-residents in many treaties, also in relation to Member States' double taxation treaties with third countries ("limitation on benefits clauses"). The same goes for triangular cases. It will become necessary to examine in detail whether some form of **'most-favoured-nation' clause** between EU Member States might be required at some stage in the future. **First discussions with Member States** on these issues at working group level will be held shortly.

The double-taxation agreements of Member States will continue to be subject to review by the ECJ. In particular, the problems resulting from the current lack of co-ordination in this area, notably **in triangular situations and with regard to third countries**, will increase even further. Without Community action, there may be important political and economic repercussions for Member States' policies in this area.

Therefore, the Commission hopes that its approach of gradual and measured co-ordination of treaty policies will eventually gain support and meet with a constructive attitude from Member States.

<sup>17</sup> E.g. in the case *Saint-Gobain* [C-307/97]. See also the pending case *D. v. Rijksbelastingdienst* [C-376/03].

To date, the Commission has not come forward with its legal analysis of the implications of ECJ decisions on Member States' tax treaty relationships, nor with certain of the other documents promised in the November 2003 Communication. Nevertheless, it is believed that the Commission still intends to proceed with these items.

Moreover, the Commission published a "non-paper" in July 2004 proposing the establishment of a working group to pursue the development of the common tax base, and the EU Council of Economic and Finance Ministers (ECOFIN) approved that proposal at its September 2004 meeting (albeit over the objections of several EU Member States, including the United Kingdom and Ireland). The working group held its first meeting in November 2004, where it discussed a draft work program, general principles for development of the base, and certain issues relating to depreciation of assets. A second meeting was held in March 2005 at which the working group discussed additional issues, and further meetings are planned for later this year. Moreover, a Commission official was quoted soon after publication of the Advocate General's opinion in the *Marks & Spencer* case as expressing the hope that a taxpayer-favorable decision at the ECJ in that case would give impetus to the negotiations underway to agree upon a common consolidated corporate tax base within the EU. EU Tax Commissioner Lazlo Kovacs was quoted as recently as May 24, 2005 as predicting that an agreement to create a common consolidated corporate tax base within the EU could be achieved by 2008.

### III. IMPLICATIONS FOR U.S. TREATIES AND TREATY POLICY

The developments outlined above reveal that there are EU law developments on a number of fronts that could have profound effects on the existing network of tax treaties between the United States and EU Member States. Several of the primary potential implications are described below.

#### A. Limitation on Benefits

One of the cornerstones of U.S. tax treaty policy over the past two decades has been the inclusion of a comprehensive Limitation on Benefits ("anti-treaty shopping") provision in all U.S. tax treaties. Such provisions now appear in almost all of the U.S. treaties with EU Member States, although the form of those provisions varies widely among those treaties. In general, these provisions make it harder for a company resident in an EU Member State to obtain U.S. tax benefits under that State's treaty with the United States if the company is owned or controlled by third country residents, including residents of other EU Member States, than if it is owned or controlled by residents of the Member State that is the party to the U.S. treaty.

The general purpose of the Limitation on Benefits (LOB) provisions is to maximize U.S. negotiating leverage with third country governments by ensuring that their residents cannot freely obtain access to U.S. treaty benefits simply by investing in the United States through an entity resident in a country with which the United States has a favorable treaty. The typical LOB provision allows benefits to a company owned by third country residents where the U.S. income in question is derived in connection with a substantial business carried on by the taxpayer company in the treaty jurisdiction. In addition, several of the U.S. treaties with EU Member States contain “derivative benefits” provisions which effectively allow an EU Member State company to enjoy benefits even if it is controlled by residents of one or more other EU Member States, provided that the U.S. treaties with such other EU Member States provide benefits that are equally as favorable as the U.S. treaty with the company’s State.

As noted above in relation to the *Open Skies* cases, the ECJ has ruled that provisions in various EU Members States’ air transport agreements with the United States that are broadly comparable to the tax treaties’ LOB provisions violate those States’ obligations under the freedom of establishment rule in the EU Treaty. Many EU commentators believe that if the ECJ were called upon to rule on the validity of the U.S. tax treaty Limitation on Benefits provisions, those provisions would similarly be found to be in conflict with the EU Treaty. An ECJ case on this issue could be originated by an EU taxpayer who objects to the inability to obtain U.S. tax benefits due to the restrictions imposed by a particular treaty’s LOB clause. An adverse ECJ decision on this point could expose the offending EU Member State to claims for monetary damages. The issue could also come into sharp focus if the European Commission were to publish a legal analysis taking the position that the various Member States’ LOB provisions with the United States are inconsistent with their obligations under the EU Treaty.

The implications of any such development are not entirely clear at this point. To date, the United States has shown no great willingness to relax its anti-treaty shopping policy as reflected in its various LOB provisions. Moreover, the U.S. negotiators (and the U.S. Senate) are unlikely to be willing to relax those requirements in bilateral treaties with EU Member States so long as the network of U.S. treaties with those States reflects significant differences in benefit levels from treaty to treaty, and so long as there is one or more EU Member State that does not even have a treaty relationship with the United States.<sup>7</sup> While there is significant uniformity across the various U.S. treaties with EU Member States, there remain a number of significant variations as well. For example, most U.S. treaties with EU Member States provide for a zero rate of withholding on cross-border interest and royalties, but important exceptions remain (*e.g.*, there are positive rates of withholding on interest in the treaties with Belgium, Cyprus, Estonia, Greece, Italy, Latvia, Lithuania, Portugal, Slovenia, and Spain, and there are positive

---

<sup>7</sup> Treasury’s International Tax Counsel testified to that effect at a September 2004 tax treaty hearing before the Senate Foreign Relations Committee. At present, the United States has no treaty relationship with Malta, having terminated its treaty with that country with effect from January 1, 1997.

rates of withholding on at least some royalties in the treaties with Austria, the Czech Republic, Estonia, Finland, France, Greece, Italy, Latvia, Lithuania, Poland, Portugal, the Slovak Republic, Slovenia, and Spain). Moreover, as of this writing, only two U.S. treaties with EU Member States (*i.e.*, the Netherlands and the United Kingdom) provide for a zero rate of withholding on cross-border dividends from a U.S. subsidiary to a parent company resident in the treaty country.

In the air transport arena, the *Open Skies* cases led to calls for the offending treaties with the United States to be terminated, and for them to be replaced with a single treaty to be negotiated between the United States and the EU as a whole. Any similar movement in the taxation area could cause severe disruption to the existing treaty relationships between the United States and particular EU Member States, and there is no clear process for the EU as a whole (*e.g.*, through the Commission) to negotiate a multilateral tax treaty with the United States or any other non-EU country. For example, would the Commission in such a case be empowered to offer to the United States only the “lowest common denominator” of treaty benefits currently offered by EU Member States to the United States in their bilateral treaties (which would translate to higher withholding rates across the board)? Or would the Commission be empowered to require all Member States to accept the best deal that could be negotiated with the United States (which could lead to zero withholding rates in many cases where positive rates prevail now)? Would such a treaty be possible at all if it had to include a country such as Malta, with which the United States currently has no treaty relationship? Can the risk of such an unsettled state of affairs be minimized by aggressive bilateral treaty negotiations now on the part of the United States in respect of individual EU Member States in an effort to harmonize treaty benefits across the board (*e.g.*, by spreading as broadly as possible the recently developed U.S. treaty policy of agreeing to a zero rate of withholding on parent-subsidiary dividends)? Efforts should be undertaken now by U.S. treaty negotiators, in consultation with the U.S. business community, to analyze potential implications of the questions being raised about the compatibility of U.S. LOB provisions with the EU Treaty, with a view towards developing acceptable options for responding in case this issue does progress to the stage of disrupting existing treaty relationships.

## **B. Nondiscrimination Standards**

Bilateral tax treaty nondiscrimination provisions typically impose four principal obligations on a Contracting State:

- Not to impose more burdensome taxation on nationals of the other Contracting State who are in the same circumstances as nationals of the taxing State (the “national treatment” provision);
- Not to impose less favorable taxation on a PE that a resident of the other Contracting State has in the taxing State than the taxing State would impose on its own residents carrying on the same activities (the “PE” provision);

- To allow interest, royalties, and other disbursements paid by a resident of the taxing State to a resident of the other Contracting State to be deductible under the same conditions as if paid to a resident of the taxing State, except where certain arm's length requirements apply (the "deductibility" provision); and
- Not to subject enterprises of the taxing State, the capital of which is wholly or partly owned or controlled by residents of the other Contracting State, to more burdensome taxation than other similar enterprises of the taxing State (the "capital ownership" provision).

In essence, these provisions are aimed at preventing certain kinds of discrimination against "inbound" investment into the taxing State. In many respects, the nondiscrimination obligations under the EU Treaty's "four freedoms" provisions are considerably broader than the nondiscrimination obligations under bilateral tax treaties, since they also prohibit certain restrictions on "outbound" investment from the relevant Member State. But to the extent that the EU Treaty's "freedoms" prohibit adverse treatment of inbound investment (*e.g.*, under the "freedom of establishment" or "free movement of capital" obligations), they affect issues which can be closely comparable to those addressed by bilateral tax treaty nondiscrimination provisions.

In the United States, tax treaty nondiscrimination provisions have given rise to only a small number of judicial and administrative rulings on their meaning. Moreover, those few taxpayers who have sought to press nondiscrimination claims at the IRS and before U.S. courts have, with a few notable exceptions, met with very little success. This is in marked contrast to the experience of taxpayers within the EU who have achieved a remarkable series of victories in cases brought to the ECJ under the EU Treaty. The ECJ's decisions have reflected an aggressive interpretation of the strength of the nondiscrimination protections in the EU Treaty. An inevitable question is whether the ECJ's treatment of issues presented to it under the EU Treaty will affect EU Member States' interpretation of the nondiscrimination obligations that exist under bilateral tax treaties, and if so, how that will affect their willingness to accept the relatively weak concept of tax treaty nondiscrimination protection that prevails in the United States. The evolving notion of tax discrimination within the EU could cause EU Member States to object to U.S. Government arguments that various U.S. tax provisions are consistent with U.S. nondiscrimination obligations under tax treaties. This could adversely affect U.S. treaty relationships with EU Member States, particularly in an era when U.S. budgetary difficulties may cause the U.S. Government to look for new sources of revenue, such as through the enactment of provisions the EU Member States may view as discriminatory.

For example, the issues faced by the ECJ in the *Lankhorst-Hohorst* case are quite similar to the issues that have been raised about the compatibility of the U.S. earnings stripping regime (*i.e.*, Internal Revenue Code section 163(j)) with the nondiscrimination obligations under U.S. tax treaties. When section 163(j) was enacted in 1989, one of the arguments cited in its defense under U.S. nondiscrimination provisions was that its denial of an interest deduction applied not only to payments to foreign related parties that were exempt from U.S. withholding by treaty, but also to payments to U.S. related parties that



were tax exempt under U.S. domestic law. The ECJ clearly rejected a similar argument put forward in defense of Germany's thin capitalization regime, saying the two types of entities "cannot validly be compared".<sup>8</sup> Does the ECJ's reaction to this argument reflect a likely reaction by EU Member States if the United States tries to use a similar argument in response to tax treaty nondiscrimination complaints about its thin capitalization regime? Is such a conflict more likely to arise if, as the President's recently issued Budget proposes, the U.S. earnings stripping rules are tightened? How will EU Member States react if they believe the United States is violating its tax treaty nondiscrimination obligations?

A somewhat similar divergence of views may exist with respect to the compatibility of "exit taxes" with nondiscrimination norms. Many EU commentators believe that the holding of the ECJ's *de Lasteyrie* case, which found the French exit tax on individuals incompatible with the freedom of establishment provision of the EU Treaty, would also apply to exit taxes imposed on the built-in gain of assets held by a corporation that might leave a Member State's taxing jurisdiction (e.g., through a change of residence or a liquidation). That approach might be compared to the controversy that erupted in 1987 over whether Code section 367(e)(2) violated the capital ownership nondiscrimination protection under U.S. treaties when it exacted a tax on the appreciation inherent in assets distributed by a U.S. subsidiary in liquidation to a foreign, but not a U.S., parent. The IRS first announced that the provision could not apply where such a capital ownership nondiscrimination guarantee was in effect, but it quickly reversed itself.<sup>9</sup> The second announcement said the distinction was allowable under U.S. treaties, because U.S. and foreign parents were not comparably situated by virtue of the latter's position outside U.S. corporate tax jurisdiction. It drew a comparison between foreign corporate parents and U.S. noncorporate shareholders, indicating that the attributes of both warranted taxing the liquidating U.S. corporation. The IRS's evaluation of the extent of the nondiscrimination protection under tax treaties (i.e., that it did not apply to cases where its application could allow gain to escape U.S. taxing jurisdiction) is in sharp contrast to the ECJ's evaluation of the extent of the corresponding protection under the EU Treaty -- the ECJ clearly stating that the risk of loss of taxing jurisdiction was not a grounds for an exemption from the nondiscrimination obligation under the freedom of establishment provision.

Thus, where the two forms of agreement (i.e., a bilateral tax treaty and the EU Treaty) provide nondiscrimination guarantees that are relevant to the same types of tax issues, the ECJ has been much more likely than the IRS, the U.S. Congress, or U.S. courts to find that a particular tax provision violates those guarantees. There is increasing evidence that national courts within the EU are taking to heart the ECJ's robust approach to the concept of nondiscrimination in tax matters and are applying that approach to questions raised

---

<sup>8</sup> The argument elicited a similar reaction from the esteemed American Law Institute in its 1992 study, *International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties*, pp. 258-59.

<sup>9</sup> See Notices 87-5, 1987-1 C.B. 416, and 87-66, 1987-2 C.B. 376.

under bilateral tax treaty provisions. For example, in a ruling of January 29, 2003 (I R 6/99), the German Supreme Tax Court explicitly relied on the ECJ's interpretation of the EU Treaty's "freedom of establishment" provision in holding that the U.S.-Germany Tax Treaty's "capital ownership" nondiscrimination provision required Germany to allow a German subsidiary to form an *Organschaft* with a U.S.-incorporated, German-managed parent corporation. One can undoubtedly expect that EU Member State treaty negotiators will follow suit. This evolving European view of nondiscrimination standards under tax treaties is likely to be increasingly at odds with traditionally held views of the U.S. Government, which have rested on a very narrow interpretation of nondiscrimination protection in the tax area.

It is by no means clear that the ECJ's approach to the concept of nondiscrimination in the tax area, which has developed in the context of an ambitious undertaking to create a single "Internal Market" within the EU, is appropriate for the much less comprehensive economic integration sought by tax treaty partners. That being said, in order to avoid growing problems attributable to this potential conflict in approaches to interpreting the nondiscrimination provisions of tax treaties, U.S. policymakers should undertake a critical review of those provisions of current or proposed U.S. law which raise nondiscrimination issues, as well as the persuasiveness of the defenses typically put forward for such provisions. Consideration should be given to whether the U.S. positions should migrate in the direction of greater conformity with the principles enunciated in EU jurisprudence, at least where the EU decisions do not rest on aspects of EU law (*e.g.*, prohibitions on discrimination against "outbound" investment) which clearly do not apply in the bilateral tax treaty context. The OECD has recently indicated that it is undertaking a review of the nondiscrimination obligations under the OECD Model Convention. There should be active participation of U.S. representatives in that effort to ensure that a wide consensus on the scope of those obligations can be achieved.

### C. The Bilateral Network

A few of the EU developments outlined above potentially call into question the very viability of the network of bilateral treaties currently existing between the United States and the individual EU Member States. One such development relates to the compatibility of the LOB provisions with EU law -- if an irreconcilable conflict between the two is found to exist, will the United States be willing to maintain treaties without LOB provisions, or will EU Member States be willing to maintain treaties with the United States which have LOB provisions if that exposes those States to potential liability under EU law?

Another development that may have very broad implications is the ECJ's potential holding in the *D Case*, at least if the Court follows the "most-favored-nation" (MFN) rationale of the Advocate General's October 2004 decision and addresses the tax treaty aspect of that case. As described above, that opinion suggested that EU Member States may have an obligation under the "freedom of movement of capital" provision of the EU Treaty to follow an MFN principle vis-à-vis residents of other EU Member States in respect of the provisions of tax treaties they conclude, both with other EU Member States

and with third countries. If broadly construed, such an MFN obligation could profoundly disrupt the balance of rights and obligations reflected in the current network of bilateral treaties, both within the EU and between EU Member States and third countries.<sup>10</sup> Examples of the types of questions raised by the *D Case* are the following:

- Does EU Country 1 discriminate against residents of EU Country 2 by entering into a tax treaty with the United States which gives better *EU Country 1 tax benefits* to U.S. residents than EU Country 1 has given to EU Country 2 residents? (*Example:* If a U.S. resident corporation gets an exemption from Spanish tax under the U.S.-Spain Treaty on capital gain realized from the transfer of a Spanish asset to an affiliated U.S. corporation in the same consolidated group in exchange for shares in the transferee corporation in a transaction treated as a nonrecognition event for U.S. tax purposes, has Spain discriminated against, say, Luxembourg resident companies relative to U.S. residents by not offering a comparable exemption in the Luxembourg-Spain Treaty? If so, does Spain have to extend to Luxembourg unilaterally the exemption it has extended to the United States by mutual agreement? If Spain tried to eliminate the discrepancy by denying the treaty benefit to U.S. residents, how would the United States react?)
- Does EU Country 1 discriminate against residents of EU Country 2 by entering into a tax treaty with the United States which gives better *U.S. tax benefits* to EU Country 1 residents than EU Country 2 has obtained in its treaty with the United States? (*Example:* If U.S. interest paid to a U.K. resident gets a zero rate under U.S.-U.K. Treaty, while U.S. interest paid to a Belgian resident gets a 15% rate under the U.S.-Belgium Treaty, has the United Kingdom discriminated against Belgian residents relative to U.K. residents by obtaining a better treaty rate from the United States for U.K. residents than Belgium has obtained for its own residents? If so, does the United Kingdom have any exposure to monetary damages to Belgian residents to compensate them for the fact that they are suffering higher U.S. withholding rates than U.K. residents? Would this cause an EU country in the United Kingdom's position to reconsider the desirability of maintaining a treaty relationship with the United States that provided for a zero rate on interest?)

---

<sup>10</sup> The Advocate General appeared to be aware of this potential effect when writing the *D Case* opinion: "I am aware of the dangers which the foregoing considerations [relating to the MFN principle] imply for the equilibrium and reciprocity which prevail in the system of double-taxation treaties, but those difficulties must not become obstacles to the establishment of the single market. ... An affirmative reply to the second question referred to the Court would severely fetter the complex system of bilateral agreements for the avoidance of double taxation in the Community, but it would not be the first time that a ruling of the Court of Justice caused upheaval in the legal systems of the Member States." Advocate General's Opinion, paras. 101 and 105.

- Does EU Country 1 discriminate against *U.S. residents* by giving better EU Country 1 tax benefits to EU Country 2 residents than EU Country 1 gives to U.S. residents? (*Example:* If French dividends paid to U.K. parent companies get a zero rate under the EU Parent-Subsidiary Directive and the pending France-U.K. Treaty, while French dividends paid to U.S. parent companies get a 5% rate under the France-U.S. Treaty, has France discriminated against U.S. residents by failing to give them as favorable a French withholding rate on dividends as it has given to U.K. residents? If so, must France unilaterally extend to the United States the zero rate it has extended to U.K. residents by mutual agreement? Could the United States use this argument as leverage in demanding better treaty benefits from individual EU Member States?)

As is clear from these examples, unbridled application of an MFN principle to bilateral treaty relationships within the EU and between EU Member States and third countries could effectively destroy the balance of rights and benefits on which such bilateral relationships depend. Such a development could make an individual EU Member State reluctant to include in its treaties with the United States any provisions that are any more favorable than provisions it has included in its treaties with any other EU Member States (or that are any more favorable that are found in the U.S. treaties with any other EU Member States). One possible response that could mitigate the potential exposure of individual EU Member States in such a scenario would be to transition from a network of bilateral tax treaties between EU Member States and a third country such as the United States to a multilateral treaty between the EU as a whole and the United States. This could obviously dramatically change the nature of the treaty relationship, both in terms of the substantive provisions that may be achievable and the relative negotiating power of the United States.

A final major development that could undermine the continued feasibility of the network of bilateral tax treaties between EU Member States and third countries is the European Commission's proposal to move towards an EU-wide common consolidated corporate tax base, with that base to be allocated among the EU Member States pursuant to some agreed methodology (*e.g.*, formulary apportionment). One purpose of this proposal is to eliminate the need to have transfer pricing determinations made for individual cross-border transactions within the EU. Instead, the "water's edge" approach would allow for a corporate group operating in multiple EU Member States to compute a single corporate tax base for the group's EU activities. The proposal would not, however, eliminate the need to have transfer pricing determinations made for individual cross-border transactions between an EU Member State and a third country, such as the United States.

The adoption of a common consolidated corporate tax base within the EU would certainly call into question the bilateral nature of any treaty relationship between an individual EU Member State and the United States, at least as it relates to affected corporate taxpayers. Under such a system, payments from the United States to a corporation resident in a particular EU Member State could effectively enter into the corporate tax base relevant for computing not only the corporate tax in that EU Member

State but also in all other EU Member States where the recipient's group carries on activities. Resolution of a transfer pricing dispute between the United States and an EU Member State with respect to a related party transaction between a U.S. resident and a resident of that EU Member State could be hampered due to the lack of separate company accounts maintained for that EU Member State resident. For example, would it be possible to do a profit split calculation between a U.S. resident corporation and a company resident in an individual EU Member State if the latter company no longer maintained separate accounting records relating to its own individual profit? It is also not clear how such disputes could be resolved as a procedural matter. For example, would the competent authority of the individual EU Member State be empowered to settle the transfer pricing dispute with the U.S. competent authority, or would the interests of other EU Member States in how much profit ended up within the EU water's edge calculation mean that some EU-wide competent authority would have to be involved? How would the existence of such a common tax base within the EU affect the United States' willingness to forego by treaty its source-based taxing jurisdiction over U.S. income paid to a resident of a particular EU Member State, where the residence-based taxing jurisdiction over that income may effectively be split among multiple EU countries? How will the United States react if the EU Member States decide to develop an EU Model Treaty or even an EU multilateral treaty?

#### IV. CONCLUSIONS AND RECOMMENDATIONS

A number of different factors at play in the development of EU law relating to corporate taxation point towards a period of significant changes to the treaty relationships between EU Member States and the United States. Without proper planning to handle these challenges, the U.S. Government and the U.S. business community could find themselves in a difficult position when faced with the prospect of having to accommodate these changes in the short term.

Steps should be taken sooner rather than later to anticipate the possible ramifications of various developments in the EU on the U.S. treaty network and to analyze the optimal responses to those developments. The U.S. Government officials responsible for U.S. treaty policy and the U.S. business community should engage in an open and ongoing dialogue to keep abreast of the EU developments, to share insights into their significance, and to discuss options open to the United States for responding to those developments. The U.S. policymakers should also engage in a parallel dialogue with key players within the EU (*i.e.*, including both the European Commission and tax policymakers of individual EU Member States) to be sure of having as realistic, up-to-date, and thorough as possible an understanding of the various EU developments and how they may affect treaty relationships with the United States.

The coming years may well see rapid movement towards the development of an EU model treaty for use in negotiations between individual EU Member States and third countries, or even an EU multilateral treaty. On the assumption that a multilateral tax treaty between the EU and the United States may become a practical necessity in the not

too distant future, steps should be taken now to identify the practical and policy issues that raises and to begin to develop a U.S. negotiating strategy for such a scenario.

\* \* \*

**CHAPTER 9****COORDINATION WITH THE OECD****I. INTRODUCTION****A. Importance of the OECD**

The OECD has long been an influential player in the development of international tax treaty policy, but its importance and influence have grown over the past several years. Increasingly, the OECD is sponsoring projects focused on administrative and interpretive issues relating to treaties, in addition to maintaining its historic focus on treaty policy. It is undertaking more regular revisions to the Model Convention and Commentary, an expanded number of targeted projects exploring specific treaty-related issues, and a growing program of outreach to non-member countries. As a result of these developments, the OECD now plays a more central role than ever on tax treaty issues.

**B. Summary of Current Concerns**

In recent years, the OECD process has become noticeably more transparent and open to input from business, and the NFTC appreciates this. Tension occasionally arises, however, when the business community believes that the OECD has acted without taking into account its issues and concerns, or when the government participants see the expectations of business as ineffectively communicated or unrealistic. Although substantial advances have been made, there is much room for further improvement of this dialogue, both from the perspective of the OECD and its member governments and from that of the business community.

**C. Summary of Conclusions and Recommendations**

This study identifies a number of steps that could be taken to enhance the transparency of OECD deliberations and promote increased and improved dialogue with business. It also notes the opportunity for further improvement in the manner in which OECD documents are drafted and the need for clarification regarding their intended effect. Finally, the NFTC has identified some opportunities for additional improvements to the timing and substance of business input at the OECD.

**II. IMPLICATIONS FOR BUSINESS**

The international consensus that the OECD seeks to foster generally is a positive development from the perspective of global businesses, because it tends to reduce the risks of double or inappropriate taxation. It can also reduce compliance costs by encouraging greater consistency in administrative practice.

The focus at the OECD of much of the international dialogue may also prove beneficial in other respects, if it provides business with an effective opportunity to provide input on treaty issues to governments in a more efficient manner.

### **III. IMPLICATIONS FOR GOVERNMENTS**

Many governments have an increased appreciation that cross-border tax issues often can be addressed more effectively and efficiently on a multilateral basis. The OECD provides a unique forum for countries seeking to develop common positions on issues of tax treaty policy, interpretation, and application. In addition, its talented and diligent Secretariat provides participating governments with valuable analytical and organizational support. As a result, many OECD member countries and a growing number of non-member countries are devoting increased attention and resources to OECD projects.

### **IV. CURRENT CONCERNS REGARDING COORDINATION**

#### **A. Recent Trends**

In recent years, the OECD process has become noticeably more transparent and open to input from business. For example, the OECD now releases draft documents for public comment as a matter of course. It has also devoted greater attention and resources in support of an expanded dialogue with business. These opportunities have included the use of innovative processes such as Technical Advisory Groups and annual Roundtable meetings, as well as increased participation by OECD Secretariat officials and Delegates at conferences around the world. Given the diversity of administrative practices among OECD member countries, these developments represent a significant advance.

In many respects, U.S. government and business input at the OECD, together with input from other countries, has helped foster the development of tax treaty policy and administration in directions that are beneficial to global trade and investment. Many businesses and government have an increased appreciation of the importance of the work undertaken at the OECD and are already devoting additional resources to participating in its projects.

Some tension has arisen on occasion, however, from the business community's sense that the OECD has acted without adequately taking into account its issues and concerns, while the government participants sometimes view the expectations of business as ineffectively communicated or unrealistic. Much of this tension may be attributable to the fact that the processes currently in place at the OECD are less transparent in some respects and offer fewer opportunities for input than do those in the United States and some other OECD member countries, although they are more transparent and open than those in certain other countries. Although businesses are becoming more familiar with OECD processes, many may not be sufficiently aware of or sensitive to this fact.



There is much room for further improvement on both sides of the dialogue. This chapter seeks to identify some of the current shortcomings in the communication process and offers specific suggestions for improvement.

## **B. Government Opportunities for Improvement**

### **1. Increased Transparency**

The OECD has made significant strides in recent years in promoting a more transparent dialogue with business, and opportunities for internal consensus-building dialogue among government representatives clearly must be preserved. However, there are still instances in which many members of the business community are caught unawares at a later-than-desirable stage in the development of proposals, either by the proposals themselves or by their intended scope and effect. This reduces the effectiveness of public comments, as they can then be offered only after government participants have committed to particular positions. That makes the ensuing dialogue less productive and more difficult than it might otherwise be.

### **2. Increased Dialogue**

The OECD has devoted substantial resources to creating additional opportunities for dialogue with business, and business appreciates this fact. However, there is still a general perception within the business community that these consultations often involve reports by the OECD on decisions already firmly taken, at least at the technical level, and that comments of substance are not particularly welcome at that stage.

### **3. Drafting Improvements**

The increasing frequency of updates to the OECD Model Convention and accompanying Commentaries generally is a positive development, as it improves the prospects that they will keep pace with current business models. However, the frequency and significance of these changes makes it especially important that they be readily understandable by the various audiences around the world that now rely upon them. In particular, the growing reliance of many tax administrations, courts, and taxpayers upon the Commentaries in interpreting bilateral treaties calls for language that is clear on its face. There has perhaps been greater attention in recent years to the manner in which the Convention and Commentaries are drafted.

Too often, however, the intended meaning of the texts remains ambiguous, perhaps intentionally so where the member governments disagree on a point. Even in the presumably more common situation where the ambiguity is unintended, the focus on brief statements of principle and the absence of realistic examples can lead reasonable persons to draw opposite conclusions.

## **C. Business Opportunities for Improvement**

### **1. Timing of Input**

To have maximum effect, business input must be received as early in the policymaking process as possible. It must also be received sufficiently in advance of any OECD meeting at which the topic concerned is to be addressed. Past delays in providing input have sometimes been attributable to too-short comment periods or to a lack of information regarding the topics or timing of relevant OECD meetings. In some instances, however, business has not appeared to place sufficient importance on the timing of comments, perhaps due to a relative lack of experience with the OECD.

### **2. Substance of Input**

The utility of comments obviously depends in large part upon their substance. Specific comments are more valuable than general objections. In addition, specific suggestions for improvements should be made wherever possible, to make the comment process more constructive and productive.

## **V. RECOMMENDATIONS FOR IMPROVED COORDINATION**

### **A. Increased Transparency**

Several simple steps could easily increase the transparency of OECD deliberations and, thereby, promote improved dialogue with business. First, projects should be widely publicized from the outset, to prompt early input from interested parties and avoid surprises late in the game. This could be accomplished with an initial announcement indicating the topic, initial issues for consideration, and expected timing of the project.

It also would be helpful for the OECD to issue press releases announcing the publication of new documents, in addition to posting them on its website. To address situations in which the local press is unlikely to focus on these materials, the Centre for Tax Policy and Administration should also consider maintaining an automated electronic distribution list of parties interested in receiving its releases, as the U.S. Treasury Department does. These would help ensure that potentially affected businesses are notified quickly of new releases.

### **B. Increased Dialogue**

There are a number of ways in which the OECD-business dialogue could be further increased. First, additional opportunities for face-to-face discussion could be created. Given the increasing pace of OECD work and the growth of interest within the business community, consideration should be given to holding semiannual rather than annual Roundtables on current topics of general interest. Additional consultations with industry sectors on projects of particular interest may also be appropriate. The OECD also should

consider cohosting an increased number of conferences with local businesses organizations in various countries, or having representatives speak more frequently at conferences organized by others. This would facilitate greater participation by persons unable to attend the Roundtables and broaden press coverage of OECD work.

Second, ways should be found to obtain input from business at a pre-decisional stage, before draft changes are prepared. This would improve the prospects for an open and constructive dialogue, and help would avoid the impression that business is being asked to “rubber-stamp” decisions that have already taken. This could be accomplished by issuing a detailed issues paper in the early stages of each project, before conclusions are drawn or specific proposals are drafted. Such papers are now published occasionally, but not consistently. When issues papers describing both the technical and policy issues under consideration are made available, they provide valuable background regarding the context of the project and its likely scope, and help avoid misunderstandings and surprises. They also enable business to provide more targeted and thoughtful comments at an early stage in the process.

Third, U.S. tax officials and their counterparts in other OECD member countries who serve as OECD Delegates should be encouraged to consult as a matter of course with their respective business sectors in advance of key OECD policy discussions and decisions. This will ensure that they are fully informed of current business practices and of any concerns in advance of those discussions and will help avoid unwelcome surprises for all. Where no business input is received from obviously affected sectors, consideration should be given to inviting comments more directly. Affected taxpayers simply may not be aware of the work in progress at the OECD or may not be familiar with the opportunities for comment. Member country Delegates should be able to assist in making contacts where necessary.

Fourth, more time should be allowed for comments on draft documents. Many businesses prefer to comment through organizations to which they belong. It takes a certain amount of time for a large group of companies to evaluate and agree on potential issues and prepare a useful comment letter, particularly if they have not previously considered the issues in depth. Deadlines also should be set with a view to ensuring that government participants will have time to consider the comments provided fully in advance of their discussions.

Fifth, greater use of the Technical Advisory Group or similar processes would be beneficial. This process enables business and government representatives to develop a deeper understanding of each others’ concerns and to engage in more detailed and frank discussions of those concerns.

Sixth, care should be taken to minimize the perception of the Roundtables and other OECD-organized meetings as overly scripted in advance. More time should be allocated on meeting agendas for open discussion, to supplement prepared presentations. Additional opportunities also could usefully be created for informal contact and dialogue

“around the edges” of such meetings (*e.g.*, group luncheons and receptions), to promote greater interaction and foster trust between government and business representatives.

Seventh, to avoid perpetuating the impression that the OECD is an exclusive club, it would be good to make a special effort to include not only persons already known to the OECD and its Delegates, but also others who express an interest.

Historically, tax policy formulation processes in the United States have been somewhat more transparent and open to business input than have those at the OECD. Perhaps because of this, U.S. businesses have tended to be relatively active in participating at the OECD, either directly or through organizations to which they belong. The U.S. business community welcomes and appreciates the opportunity to participate actively in the robust discussion of important tax policy issues at the OECD and hopes that its input will be viewed by the member countries as useful and constructive. It recognizes, however, that not all of the governments represented at the OECD are accustomed to such active participation in the policy-making process on the part of the private sector, and that this may give rise in some cases to misunderstandings or adverse reactions to the views expressed by U.S. business. To the extent this phenomenon exists, it needs to be more thoroughly analyzed and addressed by both government and business participants, so that steps can be taken to reduce it. For example, perhaps businesses and organizations based in other countries could be encouraged to engage in more active participation at the OECD. Both government and business participants should clearly articulate and discuss any concerns they may have in this connection, so that OECD processes can operate effectively and be widely respected as open and fair.

### **C. Drafting Improvements**

If the OECD Model and Commentaries are to fulfill their intended function as a leading source of guidance to both governments and taxpayers, they need to be drafted with greater specificity. This is a daunting task, given the committee-like processes of the OECD and the variety of intended audiences. However, greater specificity in drafting is essential to minimize future disputes regarding interpretation, both among governments and between governments and taxpayers.

Particular care should be taken to avoid “drafting around” disagreements among member countries, because this can create a false impression of a consensus that is later found not to exist. Where there is a disagreement that cannot be resolved, this should be publicly disclosed through the filing of reservations or observations, as the case may be, by the dissenting country or countries. Otherwise, taxpayers may be lead unfairly to rely on the Commentary to their detriment.

To elucidate statements of general principle, which are often preferred by civil law jurisdictions, and avoid misunderstandings, more attention should be devoted to identifying and analyzing realistic examples. Adequate examples should be provided to illustrate clearly the application of general principles over a broad range of situations.

This could improve the quality of the analysis and deliberations as well as the clarity of the resulting documents.

In addition, the intended status and effect of both draft and final OECD documents should be clearly indicated on their face. For example, to avoid misinterpretation and ensure prospective application where appropriate, draft documents should clearly state that their proposed conclusions may not be applied to the disadvantage of taxpayers. Similarly, the intended legal effect of OECD reports relative to OECD Commentary should be made clear in advance of their finalization. Where these materials have a different status under the legal systems of OECD member countries, those countries should also clarify that fact to ensure adequate notice to taxpayers.

#### **D. Timing of Input**

For their part, members of the business community need to provide more input to the OECD and its member governments and ensure that their input is provided on a timely basis so that it can be fully considered. Input should also be provided at the outset of a project rather than at its conclusion, again to facilitate its consideration before decisions are made.

In many cases, this will entail devoting increased attention and resources to participating in the OECD process. This is a worthwhile investment for businesses that operate globally, as much of the world's international tax policy-making effectively occurs now at the OECD. In addition, the OECD offers a unique forum for providing input efficiently to numerous governments at once.

#### **E. Substance of Input**

Just as the OECD sometimes needs to be more precise in the drafting of its proposal, there is often room for members of the business community to make their comments more clear. Rather than simply stating general disagreements, concerns should be identified with as much specificity as possible. The discussion of those concerns should be as detailed as possible, and illustrative examples should be given wherever possible. To provide maximum value, comments should ideally analyze both the technical and the policy aspects of the issue.

When objecting to proposals offered by the OECD, business commentators should be specific regarding the desired outcome. They should offer constructive alternatives of their own if possible. This could take the form of specific drafting requests or other specific suggestions for improvement.

\* \* \*

**CHAPTER 10****NFTC CONTRIBUTIONS TO THE U.S. TREATY PROCESS****I. INTRODUCTION****A. Current NFTC Contributions**

Over the years, the NFTC has become the leading voice of business in connection with U.S. tax treaties. Its annual member survey provides valuable information to U.S. Treasury Department negotiators regarding business priorities for treaty negotiations and specific issues of concern. The NFTC serves as an information resource, as needed, for both the Treasury Department and the Congress during the ratification of a treaty. It regularly testifies before the Senate Committee on Foreign Relations in support of particular treaties and the treaty network as a whole.

**B. Current Issues and Concerns**

All of these processes seem to be working very well at present, with the negotiation of a number of major U.S. treaty agreements and their favorable consideration in record time by the Committee on Foreign Relations and the U.S. Senate. Although the NFTC fully appreciates these significant accomplishments, it has taken this opportunity to give some thought to how U.S. tax treaty processes might be further improved for the future. These processes have remained remarkably consistent over the decades, but it may be time to consider potential refinements, given the greatly increased complexity of international tax laws and cross-border business models. To this end, the NFTC has identified some options relating to the prioritization of negotiations, the negotiation process itself, and the ratification of proposed treaties.

**C. Summary of Conclusions and Recommendations**

The NFTC already has decided to expand the scope of its annual tax treaty survey to gather more information on concerns regarding the implementation of existing treaties. This information will be shared with Treasury Department and IRS officials to inform not only their bilateral treaty negotiations but also, it is hoped, their deliberations at the OECD and their competent authority negotiations. Treasury and the IRS also could use the NFTC more frequently as a resource for current information regarding business experiences and concerns.

NFTC member companies could improve the effectiveness of their communications with the Treasury Department if they shared additional information on a timely basis regarding their experiences and concerns with particular countries at the meetings that the NFTC regularly schedules for tax treaty updates. It would be easier to ensure the timely provision of information if Treasury announced dates of negotiations, or at least the resumption of suspended negotiations, in advance.

The NFTC encourages Treasury to consider releasing draft texts of its Technical Explanations in advance of Foreign Relations Committee hearings. This would give the public an opportunity to comment on those Explanations in advance of their finalization, including giving Treasury useful feedback on practical conditions in the relevant country, as there is no clear method of amending the Technical Explanations after the fact.

## II. NEGOTIATION PRIORITIES

The NFTC annually conducts a survey of its members' priority interests in tax treaty negotiations, in terms of both country priorities and issues of importance with respect to each treaty partner. The results of that survey are typically communicated to the Treasury Department and have been recognized as providing valuable input for the prioritization of treaty negotiations.

The survey generally has done an excellent job of soliciting relevant information from NFTC member companies. To date, however, it has focused almost exclusively on priorities for future negotiations. The survey has not gathered data on concerns regarding the implementation of existing treaties, other than implicitly through its issues ranking. That information has indicated, most recently (in 2004), widespread concern regarding permanent establishment and profit attribution issues, as well as concern regarding the imposition of royalty withholding taxes in many countries.

The NFTC decided this year to enhance the survey's utility by revising it slightly to collect additional information regarding current company experience in the examination and competent authority contexts. This is intended both to gather information regarding situations involving improper treaty interpretation (*e.g.*, overbroad definitions of royalty), and to facilitate the identification of countries in which inappropriate treaty implementation practices are widespread. Such practices include, for example, attempts to force examination settlements that effectively prevent the taxpayer from seeking competent authority review, unusual difficulty or delay in obtaining refunds of withheld taxes, and overly onerous treaty certification processes. The information gathered will be shared with both Treasury and IRS officials to better inform their deliberations at the OECD and in bilateral treaty and competent authority negotiations. Although companies sometimes find the opportunity to share their particular experiences directly, the expanded survey will serve the purpose of collecting and relaying that valuable information on a broader, more systematic, multi-company basis.

## III. TREATY NEGOTIATION PROCESS

The NFTC already serves as a valuable information resource to the Treasury Department during the treaty negotiation process and welcomes the opportunity to participate. However, there may be room for further NFTC involvement in that process.

NFTC member companies would, for example, be very happy to share additional, timely information with the Treasury Department and the IRS regarding their experiences and concerns with particular countries. Such exchanges might be facilitated if Treasury

expanded its current, very helpful practice of issuing a press release soliciting public comments at the beginning of a new treaty negotiation. It would be useful, for example, for Treasury to make similar announcements when long-delayed negotiations are resumed or to announce the dates of negotiation rounds in advance.

Also, at the regularly scheduled tax treaty update meetings with Treasury, it would be useful for the NFTC member companies to communicate general concerns as well as country-specific issues. Consideration should be given to including representatives of the U.S. Competent Authority's office as well in such meetings, or to scheduling additional meetings with that office, so that they are kept informed of actual treaty implementation issues around the world.

As noted above, NFTC member companies and others could also provide additional, more specific input for Treasury's Technical Explanations of proposed treaties if it were possible for draft texts of those Technical Explanations to be released to the public in advance of Foreign Relations Committee hearings.<sup>11</sup>

#### **IV. TREATY RATIFICATION PROCESS**

The NFTC plays a valuable role in the tax treaty ratification process. It interacts directly with Members of Congress, Congressional staff members, and Treasury Department officials on business sector issues and questions regarding proposed treaties. It coordinates its efforts with other business groups and with embassy contacts, as appropriate. The NFTC is regularly called upon to testify at hearings before the Senate Committee on Foreign Relations on proposed tax treaty agreements.

NFTC member companies believe that the treaty ratification process is operating very smoothly at this time. They particularly appreciate the willingness of the Committee on Foreign Relations to hold early and frequent hearings on proposed agreements and the hard work and dedication of the many Congressional and Treasury staff members that have made this possible.

\* \* \*

---

<sup>11</sup> Treasury should consider soliciting comments on subjects of particular interest to be covered in a revision of the Model Treaty. Treasury might also consider soliciting comments on draft articles during any such revision of the Model Tax Treaty, to the extent that is practical, in order to give Treasury practical feedback on their potential implications to the business community.