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GENERAL GOVERNMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON COMMERCE, CONSUMER

AND MONETARY AFFAIRS

COMMITTEE ON GOVERNMENT OPERATIONS

HOUSE OF REPRESENTATIVES

ON

FEDERAL GOVERNMENT EFFORTS TO PREVENT TAX TREATY ABUSES

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here this morning to assist the Subcommittee in its inquiry into federal government efforts to prevent certain abuses of U.S. bilateral income tax treaties. The Subcommittee is specifically concerned with treaty abuses stemming from improper claims of residency in countries which have tax treaties with the United States. Such claims enable foreign investors to reduce or eliminate the U.S. statutory 30-percent withholding tax on certain investment income paid to non-U.S. residents.

At the Subcommittee's request, we have developed information on how some U.S. treaty partners deal with treaty abuses and have identified some alternatives to our country's present approach. Our testimony today is based primarily on work performed during the past 6 months. Our work focused on Department of the Treasury and Internal Revenue Service (IRS) efforts to deal with abuse of U.S. tax treaties. We discussed the problem with Treasury, IRS, and private sector officials and gathered and analyzed data on U.S.-source income paid to nonresidents. We also visited three U.S. tax treaty partners--France, the Netherlands, and Switzerland and obtained a description of the procedures they follow to prevent abuse of their tax treaties. We obtained this information through meetings with various government and private sector officials in the three countries.

Treasury and IRS have recognized that tax treaty benefits have accrued to foreign persons not entitled to those benefits. While no precise estimate of the tax revenue loss from tax treaty abuse has been made, hearings held by this Subcommittee in June 1982 indicated that Treasury may be losing hundreds of millions of dollars annually. As a result, the Congress enacted Section 342 of the Tax Equity and Fiscal Responsibility Act of 1982. Section 342 directs the Treasury Department to propose regulations, by September 1984, to ensure that tax treaty benefits accrue only to qualified persons.

The Subcommittee asked us to develop information for its use in analyzing Treasury's anticipated proposal. More specifically, the Subcommittee asked us to gather information on the withholding tax systems used by three U.S. tax treaty partners--France, the Netherlands, and Switzerland. We found that:

--France reduces its withholding tax on income paid to residents of treaty partner countries; that is, French payors reduce the statutory tax rate if the recipients of French-source income provide proof of residence in a country which has a tax treaty with France. Generally, France's tax treaties provide for such residence certifications to be made by the treaty partner's tax authorities. The effectiveness of France's system thus is dependent on the willingness and ability of foreign tax authorities to provide complete and accurate residency certifications.

--Like France, the Netherlands typically reduces its withholding tax on Netherlands-source dividends paid to nonresidents--but only after recipients furnish evidence that they are bonafide residents of treaty countries. Usually, the tax authorities of treaty countries certify the residency of the dividend recipients. Like the French system, the effectiveness of the Netherlands' system largely depends on treaty partners' willingness and ability to provide accurate certifications.

--Switzerland imposes a withholding tax on dividend and interest payments flowing out of that country. Unlike most other countries, Switzerland does not reduce the tax at source but instead requires withholding at source at the Swiss statutory tax rate. Also, treaty-related refunds are made by the Swiss government only on receipt of proof that an investor resides in a treaty country. Switzerland's system thus seems to provide a strong degree of assurance that any taxes due are collected.

Through our work on the withholding tax systems used by France, the Netherlands, and Switzerland, we identified some alternatives to the present U.S. withholding tax system. First, the United States could adopt a withholding at source system with refunds granted only on receipt of a certification from the tax authorities of a treaty country. That is, the tax authorities would need to certify that the claimant is a bonafide resident of the treaty country. This kind of system seems most advantageous from a tax administration perspective, but various U.S. and foreign officials are concerned that it might affect foreign investment in the United States.

Second, the United States could adopt a system which grants treaty benefits by reducing tax at source upon payment of the U.S.-source income. Treaty benefits would be granted, however, only on receipt of a certification from the tax authorities of a treaty country. Such a system, referred to as "certification only," would lessen the concern about foreign investment in the United States, but would not provide as much assurance of effective assessment and collection of the U.S. withholding tax.

A third alternative would be a country by country approach where Treasury would choose one of the two previously discussed systems depending on the facts and circumstances pertinent to the country at hand. In effect, the United States could impose a withholding at source system for countries which are unwilling to provide complete and accurate certifications. Where that is not the case, however, the United States could use a certification only system. Such an approach might strike a reasonable compromise between somewhat conflicting tax administration and tax policy concerns.

I would now like to discuss tax treaties in general and the current U.S. withholding tax system.

WHAT ARE TAX TREATIES AND HOW CAN THEY BE ABUSED?

Tax treaties are bilateral agreements between countries generally designed to (1) enhance the flow of capital, goods, and services by relieving taxpayers from being taxed twice on the same income base, (2) establish mechanisms for resolving tax-related disputes, and (3) prevent tax avoidance and evasion through exchange of information. The United States presently has tax treaties with 34 countries.

The Department of the Treasury views a tax treaty as a contract between two countries. As such, a treaty is generally designed for the exclusive benefit of the residents of the countries which are parties to the treaty. Treasury and IRS have recognized, however, that treaty benefits frequently are sought by and inadvertently granted to third-country residents involved in "treaty shopping."

Treaty shopping is the process which frequently results in a resident of a third country channeling funds through an entity organized or located in a treaty country for the purpose of deriving certain benefits. From the United States' standpoint, these benefits include reduction of U.S. tax on various types of investment income paid to actual or purported residents of a country which has a treaty with the United States. The types of "passive" income involved include dividends, interest, rents, and royalties. It is the opportunity to reduce or eliminate U.S. tax on such income which provides the impetus for treaty shopping.

Treaty shopping costs the U.S. Treasury money in the form of unpaid taxes on U.S.-source income paid to persons who do not reside in countries with which the United States has a tax treaty. Moreover, the Assistant Secretary of the Treasury for Tax Policy believes that treaty shopping has a secondary effect on federal tax revenues. In testimony before this Subcommittee on April 13, 1983, the Assistant Secretary stated that treaty shopping "can serve only to erode confidence in the integrity of the U.S. tax system."

Given these concerns about treaty shopping, Mr. Chairman, I would now like to discuss the U.S. system for withholding tax on investment income flowing to nonresidents. In particular, I would like to discuss how the U.S. withholding tax system operates and how the system is subject to abuse. I would also like to describe some of the proposals that have been advanced in recent years to address problems with the present U.S. system.

<u>The United States relies on self-certifications as the basis for granting treaty benefits</u>

The U.S. generally imposes a statutory 30-percent tax on various types of income such as interest, dividends, rents, and royalties paid to nonresidents. The tax is withheld at source by withholding agents such as banks, brokerage firms, and corporations. However, the tax may be reduced or eliminated if the income recipient claims residence in a country which has a tax treaty with the United States. Treaty benefits are generally granted on the basis of self-certifications by nonresidents.

According to the latest available IRS information, U.S. withholding agents paid about $9.6 billion to nonresidents in tax year 1981. The $9.6 billion does not, however, reflect all of the U.S.-source income earned by nonresidents. This is because certain types of U.S.-source interest income paid to nonresidents are not subject to the statutory U.S. 30-percent withholding tax and are not reported to IRS. In any case, for the $9.6 billion, a total of $717 million in U.S. tax was withheld--for an effective tax rate of 7.5 percent. As chart 1 shows, about $8.5 billion, or 89 percent, of the $9.6 billion was paid to foreigners claiming residence in 10 countries, each of which has a tax treaty with the United States. Of the remaining $1.1 billion, about $200 million was paid to foreign persons who claimed residence in one of the other 24 countries which have a tax treaty with the United States; the remaining $900 million went to residents of nontreaty countries.

Nonresidents can claim reductions of or exemptions from U.S. withholding tax in one of two ways. Treaty benefits with respect to interest, rents, and royalties can be claimed by providing a U.S. withholding agent with a completed IRS form 1001. The form 1001 identifies the recipient of the income and the type of income involved. The form also contains a statement that the income recipient qualifies for the relevant treaty benefits. A different procedure applies for obtaining reduced rates of tax on U.S.-source dividends. Under the so-called "address method," withholding agents reduce the 30-percent withholding tax rate to the appropriate treaty rate if the recipient's address is in a country with which the United States has a tax treaty.

Thus, although the method for claiming U.S. treaty benefits differs for interest and dividends, both processes allow nonresidents to, in effect, provide U.S. withholding agents with self-certifications of their foreign residences and, in turn, their eligibility to receive these benefits.

I would now like to illustrate the tax consequences of an investment that qualifies for treaty benefits, an investment that does not qualify, and one that should not but frequently does qualify for U.S. tax treaty benefits. Assume that a resident of a country which has a tax treaty with the United States purchases common stock in a U.S. corporation through a bank or brokerage firm and that the corporation subsequently pays a $1,000 dividend. Since the statutory U.S. tax rate on income paid to residents of treaty countries generally is reduced from 30 percent to 15 percent on portfolio-type investments, the nonresident would receive $850 of the $1,000 payment. Concurrently, the U.S. withholding agent would withhold $150 in tax and submit it to the Treasury Department.

If the same $1,000 dividend was paid to a resident of a country which does not have a tax treaty with the U.S., the statutory 30-percent withholding tax would apply and the nonresident would receive only $700; the remaining $300 would be deposited with the Treasury.

In the final example, a person from a third country claims residence in a country which has a tax treaty with the United States. The person can do so merely by presenting the U.S. withholding agent with an address in the treaty country. This is because U.S. withholding agents grant treaty benefits on dividend income on the basis of the foreign address submitted. The third country resident would thus receive $850 of the $1,000 dividend. In reality, the dividend should have been taxed at the statutory rate of 30 percent which would result in a reduced payment of $700 rather than $850. In this instance then, the U.S. Treasury has foregone collection of $150 in tax due.

In theory, IRS, in conjunction with its treaty partners, should be able to detect and prevent abuse and evasion of taxes through the use of bilateral tax treaties by third-country residents. IRS has the authority to audit withholding agents and, therefore, has some ability to assure that appropriate tax rates are applied. But IRS has been unable to devote many resources to that task. Moreover, there are weaknesses in the information exchange systems operated by the United States and its treaty partners.

Information exchange programs under tax treaties have been of limited value in preventing treaty shopping

One goal associated with exchange of information under tax treaties is to prevent or detect treaty abuses on the part of third-country residents. To this end, IRS provides each U.S. treaty partner with information on persons earning passive income in the United States and claiming residence in the treaty country. Treaty partners can use this information to identify those persons who are not eligible to claim benefits and to assure that their domestic tax on that income is assessed.

Similarly, U.S. treaty partners provide IRS with data on persons who receive income from sources within their countries while claiming U.S. residence. Presumably, IRS can use this data to identify (1) non-U.S. residents who are receiving treaty benefits and (2) U.S. residents who underreport or do not report income earned from foreign sources. However, for a variety of reasons, IRS does not now make extensive use of the information it receives from treaty partners.

Data supplied by IRS to treaty partners

U.S. withholding agents annually provide IRS with information returns--IRS forms 1042S--which reflect U.S.-source income paid to nonresidents. Form 1042S identifies the recipient of the income, the type and amount of income received, the country where residence is claimed, and the amount of tax withheld.

In tax year 1981, IRS received approximately 575,000 forms 1042S reflecting the previously mentioned $9.6 billion of U.S.-source income paid to nonresidents. IRS, in turn, supplied that information to its treaty partners via Forms 5335. The form 5335 is computer-generated and contains information similar to that on the form 1042S.

By matching the information contained on form 5335 against internal records, treaty partners can determine whether recipients of U.S.-source income are bonafide residents eligible for treaty benefits. In addition, they can match the information against internal tax records to determine whether their residents are reporting the U.S.-source income for domestic tax purposes.

Some treaty partners return the forms 5335 to IRS when they have no records on the income recipients or cannot otherwise confirm their residence in the treaty country. In these instances, IRS follows up with the respective U.S. withholding agents in an attempt to recover the taxes due. However, IRS collects no data on the amount of taxes or interest collected from withholding agents.

Data supplied by treaty partners to IRS

Some U.S. treaty partners reciprocate on exchange of information by providing IRS with foreign information returns. As we discussed in our April 1983 testimony before this Subcommittee, foreign information returns are designed to provide data on income earned abroad by U.S. taxpayers. For several reasons, however, the returns have been of only limited value to IRS. In

1980, U.S. tax treaty partners provided IRS with 793,000 foreign information returns, reflecting $11.6 billion in income earned abroad by U.S. taxpayers. However, not all treaty countries and no nontreaty countries routinely provide information returns to IRS; therefore, it seems likely that the $11.6 billion does not reflect all of the income earned overseas by U.S. taxpayers.

In any case, approximately 129,000 of the 793,000 returns, totaling $10.9 billion, represented payments to businesses. None of these information returns were matched against tax returns because IRS does not have a document matching program for business tax returns. For individual taxpayers, 321,000 of the foreign information returns, reflecting $323 million in payments to individual U.S. taxpayers, also were not matched against tax returns. This was because the foreign information returns (1) were incomplete (for example, they contained no taxpayer identification number) or (2) were received too late to be processed by IRS.

IRS was able to use 343,000 of the 793,000 foreign information returns, reflecting $394 million in payments to individual U.S. taxpayers, in its document matching program. However, IRS collected no data on the number of actual matches, or the amount of additional tax assessments or collections resulting from these matches. As a result, IRS does not know how much of the matched foreign-source income went unreported by U.S. taxpayers.

Besides weaknesses in exchange of information programs, Treasury and IRS also have determined that there are significant tax revenue losses associated with various errors made by U.S. withholding agents.

U.S. withholding agent errors account for significant federal tax revenue losses

In August 1981, IRS' Internal Audit Division reported that U.S. withholding agents frequently erred in granting treaty benefits and/or in reporting and remitting taxes due. Specifically, IRS auditors estimated that Treasury was losing at least $115 million annually because U.S. withholding agents were (1) granting treaty benefits to nonqualified persons, (2) using incorrect or invalid tax rates, and/or (3) failing to report and remit withheld taxes.

In September 1982, in response to the audit report, IRS initiated an experimental computer program designed to detect mathematical errors made by withholding agents. As of 1984, the program had generated tax and interest assessments of about $9 million. Of this amount, about $549,000 has been collected.

IRS has also conducted selective audits of 29 of the more than 14,000 U.S. withholding agents to assess the agents' compliance with withholding requirements. The audits identified compliance problems similar to those discussed in the Internal Audit Division's report. Some withholding agents were found to be granting treaty benefits without adequate justification; some were using incorrect tax withholding rates; others were not maintaining or updating documents supporting the appropriateness of treaty benefit claims. As of February 1984, IRS officials were completing a report on the results of the experimental computer program and the withholding agent audits.

Thus, the present U.S. withholding tax system has serious deficiencies and needs to be revised. Several means for doing so have already been discussed before this Subcommittee, but we would like to reiterate them now.

Revisions to the present U.S. withholding tax system have been proposed

IRS, the Treasury Department, and members of the Congress have proposed various alternatives to the present U.S. withholding tax system. Some proposals deal with the mechanics of the withholding system itself; others call for reduction or elimination of the withholding tax on all or certain types of income paid to foreigners.

In recent years, IRS studied several alternative withholding tax systems and concluded in 1982 that a refund with certification withholding tax system would provide the greatest assurance that treaty benefits would be granted only to intended beneficiaries. To this end, IRS submitted a draft of proposed regulations to Treasury in April 1982. The proposed regulations would have required U.S. withholding agents to withhold the maximum potential tax due--30 percent--at source. Subsequently, foreign persons claiming treaty benefits would have been required to file an annual claim for refund in the form of a tax return sent to IRS. The return would have been accompanied by a residence certification from the tax authorities of the country whose treaty benefits were being sought. The certification would have confirmed that the recipient had filed a resident tax return with that country's tax authorities.

In June 1982, Treasury's International Tax Counsel, in testimony before this Subcommittee, discussed IRS' proposed refund with certification system. The Tax Counsel noted that a refund with certification system had merit from a tax administration perspective, but that such a system also had potential drawbacks. For example, the Tax Counsel noted that there could be a decline in the flow of foreign investment into the United States.

Besides a refund with certification system, the Tax Counsel noted other possible alternatives to the present U.S. system, such as

--requiring that residence certifications be provided by the tax authorities of our treaty partners before U.S. withholding agents could reduce the U.S. withholding tax at source;

--changing the address method used for allowing treaty benefits on U.S.-source dividend income to the self-certification method used for interest, royalties, and rents; and

--revising the Form 1001, used by recipients of U.S.-source income to claim treaty benefits on interest, royalties, and rents, so that it would contain more pertinent tax-related information.

Shortly after the June 1982 hearings, the Congress included Section 342 in the Tax Equity and Fiscal Responsibility Act of 1982. This Subcommittee, of course, was instrumental in convincing the Congress as a whole to enact Section 342. That section requires Treasury to propose regulations, by September 1984, to establish procedures which will ensure that treaty benefits are made available only to those persons entitled to them.

Treasury has since sent questionnaires to U.S. tax treaty partners requesting information on their withholding tax systems and the type and level of assistance the treaty partners would be willing to provide if Treasury were to change the U.S. system. Treasury is currently evaluating the information received from treaty partners. In addition, Treasury officials told us that they are studying the economic impact of alternative withholding systems.

Treasury is also addressing the problem of tax treaty abuse through a firm tax treaty negotiation and renegotiation policy. Treasury's International Tax Counsel has sought for several years to incorporate anti-treaty shopping and/or exchange of information provisions in all new and renegotiated tax treaties. During the past 3 years, such provisions have been included in or are being negotiated with respect to some 23 tax treaties.

In addition, Treasury has begun to deal more firmly with treaty countries which traditionally have presented opportunities for treaty abuse and/or have rejected Treasury's anti-abuse proposals. Effective January 1, 1983, for example, the United States terminated its tax treaty with the British Virgin Islands because that country refused to accept stronger anti-abuse and exchange of information provisions. Further, effective January 1, 1984, Treasury terminated its treaty relationships with an additional 18 countries. According to Treasury, the tax treaties involved had not been developed through direct negotiations with the 18 countries. Instead, they had resulted from prior U.S. decisions to extend existing treaties to present and former colonies of the United Kingdom and Belgium. Thus, according to Treasury, the 18 treaties did not reflect the true economic relationship these countries had with the United States. Moreover, 11 of the 18 countries were considered to be tax havens and, consequently, the treaties were believed by Treasury to be susceptible to abuse.

On a related matter, several bills have been introduced which would exempt certain categories of U.S.-source interest income from the U.S. statutory 30-percent withholding tax. Among these is your bill, Mr. Chairman--H.R. 4029--which would exempt Eurobond interest from U.S. tax, and S.1557 and H.R. 3025 which would exempt Eurobond interest and interest on certain types of registered bonds from U.S. tax. In addition to these bills, the Chairman of the Senate Committee on Finance has endorsed a proposal which would reduce the statutory tax rate on payments of interest income to nonresidents from 30 percent to 2.5 percent.

Thus, Mr. Chairman, we are now in a situation where some action to address problems with the U.S. withholding tax system appears imminent. Treasury must propose regulations aimed at improving the current system by September 1984. Recognizing this, the Subcommittee asked us to review the withholding tax systems operated by three U.S. treaty partners--France, the Netherlands, and Switzerland. I would now like to discuss those systems in detail.

FRANCE RELIES ON FOREIGN GOVERNMENT CERTIFICATIONS AS THE BASIS FOR GRANTING TREATY BENEFITS

France imposes a withholding tax on French-source, passive income such as interest and dividends earned by nonresidents. That tax, however, may be reduced or eliminated if the investor is a resident of a country with which France has a tax treaty. But tax reduction at source is granted only on receipt of a certification, generally provided by the foreign country's tax authorities, stating that the investor is a bonafide resident of that tax treaty country. According to French tax authorities, this system serves as an effective means for assuring that treaty benefits accrue only to persons entitled to those benefits--but only to the extent that foreign governments properly monitor their certification systems.

A French resident who invests in a foreign country generally would be subject to that country's withholding tax, but such resident may be entitled to a reduced tax rate if a tax treaty comes into play. This is the case for French residents who invest in the United States. However, because the United States uses self-certification procedures to grant treaty benefits, there is at least some potential for persons who do not actually reside in France to use the France-U.S. treaty for treaty shopping purposes.

Procedures France follows when French-source income is paid to nonresidents

France normally imposes a withholding tax at source on passive income paid to nonresidents: for dividends, the tax is 25 percent; for interest, the tax ranges from 25 to 50 percent; for royalties, the tax is 33-1/3 percent. However, recipients of such income who are residents of countries which have a tax treaty with France can obtain a reduction or elimination of the tax.

To obtain a tax reduction at source, the income recipient must furnish the payor, normally a French financial institution, with the necessary documentation certifying residence in a treaty country. In most cases, the certification is made by the tax authorities of the treaty country. The certification provides assurance that the income recipient is a bonafide resident of the treaty country and, as such, is subject to tax in that country. On receipt of a valid certification, the French payor can reduce or eliminate the tax in accordance with the provisions of the applicable tax treaty. In contrast, if the recipient is a resident of a country which does not have a tax treaty with France, the payor must withhold tax at the statutory rate.

The certification requirements for income recipients who claim to be residents of the United States are an exception to the normal process followed by France's other treaty partners. In the case of a U.S. resident, the treaty allows certification of residency made by a U.S. financial institution. The certification form, developed by France identifies the income recipient and provides a description of the income. The form also has space for a certification by the IRS that the recipient has filed a U.S. income tax return. IRS, however, provides the certification only if the recipient is unable to obtain a certification from a financial institution or other designated agent--an infrequent occurrence.

Chart 2 illustrates the tax consequences of France's certification only withholding system. Assume that a $1,000 dividend is paid to a resident of a country which does not have a treaty with France. Since no reduction in the statutory 25-percent tax on dividends is possible, absent a treaty agreement, the nonresident would receive only $750 of the $1,000 dividend. The remaining $250 goes to the French government.

Under a tax treaty, however, French dividends generally are subject to a tax rate which is lower than the statutory 25-percent. In the case of the U.S.-France tax treaty, for example, the tax rate may be reduced at source to 15 percent. Thus, as shown in chart 2, for a U.S. resident receiving a $1,000 French-source dividend, the French withholding tax would be reduced to $150 and the payee would receive a net of $850. This, of course, assumes that the payee has submitted a valid certification to the French financial institution. Otherwise, the French financial institution would be required to withhold at the 25-percent statutory rate.

Like French-source dividends, interest paid to nonresidents of France on deposits in French banks is subject to a 25-percent withholding tax (in some cases, however, the tax rate may go as high as 50 percent). However, if deposits are made in certain foreign currencies (for example, U.S. dollars, Swiss francs, etc.), the interest is exempt from French tax. French tax authorities told us that the government's tax exemption for such nonresident deposits is based, in part, on France's desire to attract foreign investment. And because France imposes no tax on these interest earnings, French financial institutions are not required to routinely report information concerning these accounts to French tax authorities. The lack of information reporting by the French banks concerning such deposits may create an opportunity for nonresident depositors to avoid declaring the interest income to their domestic tax authorities.

The integrity of France's certification only system relies on the ability of French financial institutions to obtain the required residence certifications from nonresident recipients of French-source income. According to French tax officials, a certification system can be effective--but only to the extent that foreign governments cooperate and monitor the system. In any case, the French tax officials feel that their process works well, particularly with those treaty partners whose tax authorities are responsible for providing the required residency certifications.

The French certification system is deemed effective by French tax officials, in part because France is not generally viewed as a country which presents significant treaty abuse opportunities. This is because relatively high domestic tax rates and strict currency controls generally make France less attractive than other countries to treaty shoppers.

According to French tax authorities, their withholding tax produces at least $25 million in revenue annually--an amount which they do not consider particularly significant from an overall budgetary standpoint. Nonetheless, this revenue is generated at a low cost to the French government because French financial institutions, rather than the government, bear most of the costs associated with computing and collecting the tax.

The French government does, however, incur some costs when it exchanges information with treaty partners. For example, France sends IRS copies of the forms its financial institutions receive from U.S. residents claiming treaty benefits on French-source income. During tax year 1980, for example, IRS received about 7,200 such information documents from the French government which reflected about $436 million of French-source income paid to U.S. residents. However, IRS makes little use of the information documents it receives from France. The documents' usefulness is limited because they generally are not submitted on magnetic tape, contain no taxpayer identification numbers, and/or are not received in time for incorporation into IRS' matching program.

Mr. Chairman, I would now like to discuss the procedures followed when French residents receive foreign-source income.

Procedures followed when foreign-source income is paid to residents of France

A resident of France who earns foreign-source income may be entitled, under a tax treaty, to a reduction or elimination of the treaty country's withholding tax. To obtain that benefit, the French resident generally needs to obtain a certification of residency from a local French tax inspector. On receipt of the residence certification, the foreign payor may reduce the withholding tax at source or refund the amount of overwithheld tax.

The certification procedure for French residents receiving income from U.S. sources, however, is an exception to the process usually followed by France's treaty partners. Under the U.S.-France tax treaty, residents of France who receive income from U.S. sources can claim reduction at source of the U.S. statutory 30-percent withholding tax rate by self-certifying their residence in France. This generally results in interest and dividends being subject to a tax rate of 10 percent and 15 percent respectively, rather than the U.S. statutory tax rate of 30 percent.

French tax officials believe that when residence certifications are made by the tax authorities of its treaty partners, the incidence of unqualified persons claiming tax reductions is small. With regard to the United States and its self-certification method, however, France has established a supplementary withholding system for recipients of U.S.-source income who improperly claim residence in France.

When U.S.-source income is sent to a French bank, the bank is required to verify that the income recipient is a bonafide resident of France. If the recipient is found to be a nonresident and, therefore, not entitled to a reduction in the statutory 30-percent U.S. withholding tax, the French bank withholds the additional amount needed to ensure application of the effective U.S. tax rate of 30 percent. The bank then would remit the additional tax it collected to the French government which, in turn, would forward the funds to the U.S. Treasury. For calendar years 1980, 1981, and 1982, the French government remitted $751,000, $418,000, and $666,000, respectively, to the U.S. Treasury.

In seeking to identify nonresidents of France who claim treaty benefits on U.S.-source income, the French government receives U.S. assistance through IRS-provided forms 5335. Form 5335 identifies the foreign person who earned U.S.-source income and shows the amount of income earned. The French government can match the forms 5335 against its own taxpayer records to determine whether the recipient is a bonafide French resident entitled to receive treaty benefits. As discussed previously, some U.S. tax treaty partners return forms 5335 to IRS when there is no evidence that recipients reside in the treaty country. In addition, the forms 5335 can be matched against treaty partners' domestic tax returns to assure reporting of the U.S.-source income.

Concerning possible changes in the U.S. system for granting treaty benefits, French tax officials expressed the opinion that stricter controls could reduce foreign investment in the United States. They felt that foreign investments currently being channeled into the United States could instead be channeled into countries having less restrictive systems. However, the officials noted that this possible negative effect on foreign investment in the United States would be mitigated somewhat by the general strength of the U.S. economy and the stability of the U.S. government.

At this point, I would like to discuss the withholding system used by the Kingdom of the Netherlands.

THE NETHERLANDS RELIES ON FOREIGN GOVERNMENT CERTIFICATIONS AS THE BASIS FOR GRANTING TREATY BENEFITS

Although the Netherlands does not tax domestic-source interest or royalties paid to nonresidents, it does impose a withholding tax on dividends flowing out of the country. This tax, however, can be reduced at source for an income recipient in a tax treaty country, provided the recipient submits a certification of residence from that country's tax authorities.

Netherlands' tax authorities believe that their certification system substantially limits opportunities for treaty abuse, reduces the need for information exchange, costs less to administer than a refund system, and encourages foreign investment. They emphasized, however, that the effectiveness of the system necessarily depends on the full cooperation of treaty partners.

The U.S. withholding tax system differs from the Netherlands system in that U.S. withholding agents grant treaty benefits based on self-certifications. Because the United States uses self-certifications, the Netherlands has established a supplementary withholding tax system. Under that system, the Netherlands levies a supplementary tax on U.S.-source income when it determines that recipients are not bonafide residents of the Netherlands. According to Netherlands' tax officials, the need for this supplementary tax would essentially be eliminated if the United States were to implement more effective procedures for granting treaty benefits on U.S.-source income paid to persons in the Netherlands. Netherlands' tax authorities indicated that they would cooperate with U.S. attempts to improve the U.S. withholding tax procedures.

The Netherlands uses a certification procedure to reduce tax on domestic source dividends paid to residents of treaty countries

The Netherlands generally uses a certification only procedure when tax is due on Netherlands-source dividends sent to residents of its treaty partners. Normally, a 25-percent withholding tax is applied against dividend income flowing out of the Netherlands. By furnishing evidence that they are bonafide residents of a Netherlands treaty partner, however, nonresidents can have the tax rate reduced. However, as a matter of government policy, the Netherlands employs a second system--refund with certification--for several of its tax treaty partners. Also, as a matter of government policy, the Netherlands does not tax domestic source interest or royalties paid to residents of other countries.

To obtain a reduction of withholding tax at source on Netherlands-source dividends, nonresident investors need to complete and submit a Netherlands Form 92 to the tax authorities of their country of residence. The form 92 identifies the recipient of the dividends and the amount of dividends received. The tax authorities certify on the form that the recipient is a resident for tax purposes. The recipient then submits the form to the Netherlands payor of the dividend, thereby claiming reduction of Netherlands' withholding tax. Depending on the provisions of the particular treaty, the tax would be reduced or eliminated. Generally, the tax rate on investment-related dividends paid to treaty country residents is reduced to 15 percent.

To illustrate the process and the tax consequences of the Netherlands' certification only method for tax withholding, I would like to call your attention to chart 3. In this case, a nonresident receives a $1,000 dividend from a Netherlands corporation. If the recipient is a resident of a country which has a tax treaty with the Netherlands, and the tax authorities of that country provide a certification of residence, the Netherlands payor is authorized to reduce the tax from 25 to 15 percent. Thus, the treaty country resident receives $850 of the $1,000 dividend. If the recipient is a resident of a non-tax treaty country, however, the Netherlands payor must withhold tax at the statutory rate of 25 percent. In such a case, the non-treaty resident receives only $750 of the $1,000 dividend.

The Netherlands' certification only system for computing the tax due on dividends paid to nonresidents has been in force since 1948. Netherlands' tax authorities believe that their system effectively reduces the opportunities for treaty abuse, particularly in those cases where each treaty partner requires a residence certification from the other country's tax authorities.

According to the Netherlands' tax authorities, when residence certifications are made by the treaty partners' tax authorities, there is little need for exchange of information concerning the income earned. This is because a copy of the residence certificate, required by the treaty partner, can be retained by the tax authorities who provide the certification. That copy can then be used to assure that the income earned in the other country is reflected on the resident's tax return.

Despite the perceived usefulness of the Netherlands' certification system, it is not applied under all tax treaties. This is due to domestic policy or legislation or the preference of treaty partners. In such cases, the Netherlands' statutory 25-percent tax is withheld in full by the payor of the dividends and remitted to the Netherlands government. If the income recipients are entitled to a reduced tax rate, they can complete the required form, obtain a residence certification from their country's tax authorities, and apply to the Netherlands' government for a refund of the excess amount of tax withheld. The refund procedure is also used by those recipients who qualify for a tax reduction at source but do not apply for the reduction before the dividends are paid. According to Netherlands' tax officials, it generally takes about 2 months to process refund claims.

Still, Netherlands' tax authorities prefer the certification only procedure to a refund system because fewer tax administration personnel are needed and, therefore, the system is less costly to administer. In fact, the Netherlands' certification system costs the government relatively little because much of the actual processing and control of nonresident certifications is done by the paying agents.

Netherlands' tax officials told us that, from an investor's standpoint, certification only allows for rapid processing of tax reduction requests without unnecessary loss of income. In this regard, the officials believe that investors are sensitive to the procedures countries use to collect taxes. And the officials strongly believe that their certification only procedure does not deter foreign investment.

The Netherlands' tax authorities did, however, emphasize that the effectiveness of any withholding tax system or procedure to assure that tax treaty benefits accrue only to bonafide recipients depends, in large part, on the willingness and ability of treaty partners to provide accurate certifications. They noted from this standpoint, the United States does not have a very effective certification process.

Residents of the United States who receive Netherlands-source dividends generally do so through use of a financial intermediary such as a bank or a brokerage firm. In these cases, like residents of other Netherlands treaty partners, U.S. residents must also submit a form 92 to claim reduction at source of the Netherlands' tax. However, rather than obtaining a residence certification from the IRS, the recipient need only obtain a declaration from a U.S. bank confirming that the securities to which the dividend relates are being kept by the bank in the name of the recipient and/or that the recipient has demonstrated ownership of the securities. According to Netherlands' tax authorities, IRS could not furnish residence certifications in the past, so bank declarations are accepted as a means for providing some assurance that only bonafide U.S. residents apply for the tax reductions afforded by the treaty.

Netherlands' tax authorities routinely furnish IRS with copies of the forms they receive from U.S. residents who earn Netherlands-source dividends. During tax year 1980, IRS received 3,700 such information forms from the Netherlands. However, the usefulness of such information is limited because the information is provided in paper form and usually lacks taxpayer identification numbers. The Netherlands' tax authorities would prefer that IRS provide U.S. residents with certifications. The tax authorities believe that, when the certification is made by the treaty partners' tax authorities, opportunities for treaty abuse are limited.

Procedures used to reduce withholding tax when Netherlands residents receive income from treaty countries

Netherlands' residents who receive income from countries which have a tax treaty with the Netherlands generally can apply for a reduction of that country's withholding tax. To apply for the reduction, the investors first must obtain a certificate of residence from their local Netherlands' tax authority. The tax authority retains a copy of each residence certificate for future use in verifying that Netherlands residents report the foreign-source income on their Netherlands tax return.

Persons earning income in the United States and claiming to be residents of the Netherlands can apply for a reduction at source of the U.S. 30-percent withholding tax. As discussed earlier, however, the United States does not require foreign recipients to obtain residence certifications from their respective countries' tax authorities. Instead, reduction of tax at source can be granted by U.S. withholding agents on the basis of foreign addresses or self-certifications of residence.

Under the United States-Netherlands tax treaty, the Netherlands levies a supplementary tax for the United States if it is determined by the paying agent that an investor is not a bonafide resident of the Netherlands. To illustrate how the supplementary tax levy operates, assume that an investor who claims to be a Netherlands resident receives $1,000 in U.S.-source dividend income. Assume further that the dividend is sent by the U.S. payor directly to the investor's nominee account in a Netherlands bank. According to the United States-Netherlands tax treaty, the tax rate on U.S-source dividends paid to Netherlands residents is 15 percent rather than the U.S. statutory 30 percent. By virtue of the investor's Netherlands address, therefore, the U.S. payor would withhold tax at the 15-percent rate and forward $850 to the Netherlands bank. The bank then is responsible for checking its records to determine whether the investor is a bonafide resident of the Netherlands.

If the investor is a bonafide resident of the Netherlands, the correct U.S. tax has been paid. If the investor is not a bonafide Netherlands resident, the Netherlands' tax authorities require the bank receiving the $850 dividend income to withhold an additional 15 percent in tax. After assessing and collecting the additional tax, the bank remits the funds to the Netherlands' tax authorities and the funds periodically are sent to the U.S. Treasury. During calendar years 1980, 1981, and 1982, the Netherlands government remitted $540,000; $656,000; and $363,000, respectively, to the U.S. Treasury.

As I mentioned previously, IRS routinely provides copies of forms 5335 to its treaty partners. The forms 5335 identify recipients of U.S source-income who have claimed treaty benefits. The forms may be used by treaty partners, such as the Netherlands, to provide some degree of assurance concerning the residency of persons claiming treaty benefits.

According to Netherlands' tax authorities, the forms 5335 received from IRS also are used by local Netherlands tax inspectors to verify that the income is reported for domestic tax purposes. In tax year 1981, IRS sent about 9,700 forms 5335 to the Netherlands.

Netherlands' tax authorities told us that they would be willing to cooperate with the Department of the Treasury and the IRS if the United States decides to change its current self-certification procedure to one requiring certification by treaty country tax authorities. The Netherlands already provides such certifications to most of its tax treaty partners. While the tax authorities would prefer to issue the residence certificates annually, they indicated a willingness to consider more frequent certifications if Treasury were to consider that necessary.

At this point, Mr. Chairman, I would like to proceed to a discussion of the withholding tax system used by Switzerland.

SWITZERLAND RELIES ON A REFUND WITH CERTIFICATION SYSTEM TO COLLECT TAX ON SWISS SOURCE INCOME PAID TO FOREIGNERS

Of the foreign tax withholding systems we studied, Switzerland seemingly operates the most effective--at least in terms of ensuring assessment and collection of taxes due on Swiss-source investment income. This is because Switzerland not only imposes a withholding tax on passive income but, unlike France and the Netherlands, also requires 100-percent withholding of that tax at source. Residents of treaty countries may apply for refunds of a portion of the tax withheld but only after providing certifications of entitlement to treaty benefits to the Swiss tax authorities. Like France and the Netherlands, however, Switzerland necessarily relies on the willingness and ability of treaty partners to provide certifications only to bonafide residents of the treaty country. And, in terms of exchange of information, Switzerland provides some data to IRS on U.S. residents who receive Swiss-source income. Swiss financial institutions, rather than the Swiss government, bear most of the costs of administering this refund with certification system.

For Swiss residents who invest in the United States, treaty benefits are granted by U.S. withholding agents on the basis of self-certifications. Because the United States uses self-certification, Switzerland has established a supplementary tax withholding system to provide some assurance of the legitimacy of the residence claims. Under this system, Switzerland withholds additional tax, up to the U.S. statutory rate of 30 percent, for income recipients who are not bonafide residents of Switzerland.The Swiss government then remits these funds to the U.S. Treasury.

The Swiss withholding system

Switzerland imposes a 35-percent withholding tax on Swiss-source dividends and interest. The tax is levied at source on income derived from (1) Swiss bonds and other long-term investments, (2) profit distributions by Swiss resident corporations and investment trusts, and (3) Swiss bank deposits. The actual amount of tax ultimately collected by Switzerland may be less than 35 percent if tax treaties come into play. The Swiss system calls for withholding at source by Swiss financial institutions as a means for better assuring collection of taxes due and reducing the possibility of treaty shopping. Thus, treaty benefits generally accrue only to those persons entitled to those benefits.

Where appropriate, residents of treaty countries may apply for and receive refunds of a portion of the 35-percent tax withheld by submitting proof of residency in a treaty country to Swiss tax authorities. In most cases the certification of residency is provided by the treaty partner's tax authorities. However, in the case of the United States, investors or financial institutions provide certifications.

To illustrate, chart 4, now before you, shows the first year tax consequences associated with a $20,000 deposit made by a U.S. resident in a Swiss bank which pays 5-percent interest. The Swiss-source interest income generated is subject to withholding at source at the 35-percent Swiss rate. Thus, the U.S. resident initially receives only $650 of the $1,000 in Swiss-source interest earnings. But, in accordance with the U.S.-Swiss tax treaty, the investor may apply for and receive a refund of a portion of the tax withheld. To do so, the investor completes form R82, has it stamped by a notary public, and submits it to the Swiss government. Among other things, the form R82 contains the name, address, and description of the transactions; and the amount of income re-ceived.

On receipt of the form R82, the Swiss government refunds the appropriate portion of the overwithheld tax to the U.S. resident. In the case of interest income, the Swiss withholding tax would be reduced from 35 percent to 5 percent and the refund would amount to $300 of the $350 withheld. For dividends, the tax would be reduced from 35 percent to 15 percent and the refund would amount to $200 of the $350 withheld. Subsequently, the investor would, of course, be subject to U.S. income tax on the entire $1,000 in interest income, but such investor could at least partially offset any tax due through use of a foreign tax credit for the amount of tax actually paid to Switzerland.

In comparison to the certification only systems, used by France and the Netherlands, Switzerland exercises a good deal more control over its withholding tax because the tax is levied in full at source. This is because the Swiss tax authorities initially collect the maximum potential tax due on Swiss-source income without regard to reductions provided by tax treaties. Subsequently, the Swiss tax authorities refund a portion of the overwithheld tax to residents of treaty countries--but only after an acceptable certification has been received. In contrast, under a certification only system, if a certification is deemed unacceptable by the tax authorities (or by bank auditors), it may be difficult for the country to collect the full amount of tax due. This is because a certification only system provides for reduction of tax at source from the statutory tax rate to the applicable treaty rate and, thus, any additional tax due the country as a result of erroneous certifications must be sought directly from foreign investors.

In terms of administrative burden and costs, the Swiss system depends heavily on banks and financial institutions. Generally, those entities bear the responsibility for and the costs associated with collecting and remitting the withholding tax to the government. They are also liable for failing to withhold the proper amount of Swiss tax. However, the Swiss government bears the costs associated with processing certifications and issuing refunds. Although no quantitative data was available on administrative costs--either private or public--the government's costs were not viewed as onerous by Swiss officials.

On a related matter, there are some possible additional costs, in the form of foregone foreign investments in Swiss financial institutions, associated with the Swiss withholding tax system. Because the Swiss withholding tax is high--35 percent--and because the full tax is levied at source, investors may find better opportunities outside Switzerland. To this extent, Switzerland may suffer opportunity costs associated with reduced foreign investment. For instance, if the tax rate were lower and if taxes were not levied at source, more foreign investors might want to invest in Switzerland. However, Swiss tax law distinguishes between bank deposits and fiduciary accounts, and earnings which accrue from the latter accounts, are not subject to Switzerland's withholding tax. Therefore, Swiss financial institutions have another means, besides bank deposits, for attracting foreign investments.

Under the Swiss system of fiduciary deposits, a Swiss bank may accept an investor's funds in the capacity of a trustee. Typically, the bank will then deposit the funds with a foreign bank for subsequent investment in Eurobonds which are free from any withholding tax. Such investments are made in the name of the Swiss bank but are at the risk of the investor. The investor pays a fee to the Swiss bank for its services. The advantage of this arrangement is that the Swiss government deems the invested funds to be held by a foreign bank and the interest earned to merely pass through the Swiss bank to the investor. Further, the interest is considered by Swiss tax law to be derived from foreign sources and, as such, is not subject to Switzerland's statutory 35-percent withholding tax. Given the obvious tax advantages of such transactions, Swiss banks have experienced a rapid and significant growth in fiduciary deposits. Currently, such deposits are estimated to total $80 billion.

Besides the Eurobond market, the fiduciary system can also take advantage of the domestic tax laws of other countries. In the case of the United States for example, Section 861 of the Internal Revenue Code specifies that interest on bank deposits which is paid to nonresidents is exempt from the U.S. statutory

30-percent withholding tax. Countries such as France, Great Britain, the Netherlands, and Luxembourg have similar tax provisions for certain investments. The goal of the provisions is to attract foreign investment to the host country.

To illustrate the advantage of such transactions, assume that a foreign investor deposits $1 million in a fiduciary account with a Swiss bank. The Swiss bank then deposits the funds in a U.S. bank at 10-percent interest. Since the interest on such deposits is exempt from U.S. tax, the U.S. bank pays the entire $100,000 in interest to the Swiss bank. Then, since such income is also exempt from Swiss tax, the investor receives the entire $100,000 interest payment, less a service charge imposed by the Swiss bank. Of course, the investor may be subject to tax on this income in his or her country of residence--but no tax information is sent to that country's tax authorities by the Swiss government because the transaction has no direct tax effect in Switzerland or the United States. From the U.S. perspective, however, IRS would be interested in identifying any U.S. residents who use the Swiss fiduciary system to evade U.S. taxes.

This is not to say that Switzerland condones such activities on the part of U.S. residents. To the contrary, Swiss financial institutions likely would consider such activities inappropriate. This would be the case when Swiss financial institutions can identify the beneficial owners of funds placed with them in a fiduciary capacity. And, while Swiss law requires that bankers be able to do so, it may be beyond the capacity of financial institutions to fully comply with that requirement. For example, investors can pyramid company after company in country after country at relatively low cost in an effort to disguise their true identities, or they can place funds with Swiss financial institutions through nominees who pose as beneficial owners. Given that, it seems possible that some U.S. residents may benefit from the Swiss fiduciary system; it seems infeasible, however, to expect Swiss financial institutions to be able to identify true beneficial owners in every instance.

<u>Exchange of information between the United States and Switzerland</u>

For U.S. residents who derive Swiss-source income, the tax treaty between the two countries provides an exchange of information procedure. Thus, IRS annually receives several thousand information documents--forms R82--from Switzerland. Form R82, as previously mentioned, is sent by a U.S. resident to Switzerland to claim a refund of overwithheld tax. During calendar year 1982, more than 5,000 forms R82 were sent by Switzerland to IRS, according to Swiss tax officials. But these information documents were of only limited value to IRS because they were submitted on paper rather than on magnetic tape. To use these documents in its computer matching program, IRS would first have bo convert them to magnetic tape via a key punching operation. And, to date, IRS has chosen not to apply extensive resources to that task.

In fact, as we noted earlier in this statement as well as in testimony before this Subcommittee in April 1983, IRS generally has made only limited use of the information documents it receives from treaty partners, in part because of resource limitations. The situation with Swiss-generated information documents then is not unique but may be more acute. This is because there may be large dollar amounts involved and because, unlike some other countries, the Swiss tax authorities told us that U.S. residents must provide them with taxpayer identification numbers before refunds will be issued. With an identification number, IRS can associate the information provided with tax returns filed by U.S. residents who have Swiss-source income.

As previously noted, Switzerland can provide the United States with little or no information on U.S. residents who use the Swiss fiduciary system as an investment vehicle. This concerns IRS because any income earned by U.S. residents would be subject to U.S. income tax.

At this point, Mr. Chairman, I would like to discuss how the present U.S. withholding tax system operates for residents of Switzerland and third-country persons who invest in the United States.

How the U.S. withholding tax system operates for residents of Switzerland and third country persons

As previously noted, U.S.-source passive income paid to foreigners is subject to a 30-percent withholding tax. But the U.S. tax treaty with Switzerland provides for a reduction at source to a 15-percent tax rate for Swiss residents investing in the United States.

Chart 5, now before you, illustrates how the U.S. withholding tax system operates for a Swiss resident and/or a person with an address in Switzerland. In this case, the investor purchases U.S. corporate stock using a Swiss bank as an intermediary. When U.S.-source dividends are paid, the U.S. payor grants treaty benefits using the foreign address given by the recipient. If the investor's address is in a nontreaty country, the statutory 30-percent U.S. withholding tax must be withheld and paid to the U.S. Treasury. However, if the recipient has an address within a treaty country, a different tax rate may apply.

In the case of an investor with a Swiss address receiving U.S.-source dividends of $1,000, the tax rate under the treaty is 15 percent and the payor thus sends only $850 of the $1,000 to the Swiss bank. Subsequently, the Swiss bank is required to withhold and submit to the Swiss government an additional 15 percent, or $150. Thus, the investor initially receives only $700 of the $1,000 earned.

The Swiss investor, however, may apply for a refund of a portion of the total $300 withheld. In this instance, the investor must complete form R-US1, which is obtained from and submitted to the Swiss tax authorities. The Swiss government then determines whether the investor is in fact a bonafide resident of Switzerland. If so, a refund of $150 is sent to the investor. If, however, the Swiss government determines that the investor is not a resident of Switzerland, treaty benefits are denied and no refund is made. Instead, the Swiss government periodically submits to the U.S. Treasury the funds that it accumulates through denial of treaty benefits. For calendar years 1980, 1981, and 1982, the Swiss government remitted $64 million, $95 million, and $85 million, respectively, to the U.S. Treasury.

Exchange of information

Under the Swiss withholding tax system, the United States seemingly can be well assured that treaty shopping is not a major problem. That is, where third-country residents are involved, the system provides a means for the United States to collect its full 30-percent withholding tax through a 15-percent withholding at source and a subsequent, additional 15-percent withholding by Swiss financial institutions. Yet the Swiss system also meshes well with that country's confidentiality laws and customs; that is, Switzerland does not disclose to the United States the identities of the parties from whom additional funds are withheld and turned over to the U.S. Treasury.

This of course raises the question of why IRS would want to know the identity of individuals or corporations who apparently have paid the full 30-percent withholding tax on U.S.-source interest and/or dividends. The answer to this question is found in the statistics on U.S. maximum tax rates.

Specifically, individual and corporate U.S. residents are subject to maximum marginal tax rates of 50 percent and 46 percent, respectively. Therefore, an individual or corporation paying only 30-percent tax on marginal investment income could profit significantly from income derived from a deposit in a trust account in a Swiss bank. Thus, IRS would be interested in learning the identities of U.S. residents investing in Swiss banks. Such information could be used by IRS to determine whether the Swiss-source income is reflected on the U.S. resident's tax return.

Still, it is important to note that Switzerland has made substantial concessions in recent years on secrecy issues. For example, the Swiss government signed a mutual assistance agreement with the Department of Justice in 1977 and since then has exchanged information on criminal matters with Justice on a number of occasions. Furthermore, IRS annually sends numerous forms 5335 to the Swiss tax authorities. These forms identify Swiss residents who have claimed tax treaty benefits on U.S.-source income. Swiss tax authorities use the forms 5335 to identify persons who are not bonafide Swiss residents and who thus have improperly claimed treaty benefits. Moreover, the Swiss tax authorities not only deny treaty-based refunds to such persons but also inform U.S. tax authorities of the identity of these persons. Thus, Switzerland has demonstrated a degree of willingness to establish mechanisms of international judicial assistance which help to overcome problems arising from its secrecy laws. The United States needs to build further on this improving relationship with Switzerland. But, that is a matter for continuing negotiation and discussion which necessarily will take some time.

Now, Mr. Chairman, I would like to discuss the results of our study of the French, the Netherlands, and Swiss withholding tax systems in terms of implications for a revised U.S. system.

ALTERNATIVE APPROACHES TO PRESENT U.S. WITHHOLDING TAX PROCEDURES

The Department of the Treasury, in carrying out the mandate of Section 342 of the Tax Equity and Fiscal Responsibility Act of 1982, soon must propose regulations designed to ensure that tax treaty benefits accrue only to eligible persons. Treasury's proposal will, in a sense, be domestic in nature in that it will affect the present U.S. withholding tax system. In another sense, however, Treasury's proposal will be of international concern because it will affect economic relationships between the United States and numerous foreign countries. Accordingly, Treasury officials have noted that, in deciding on how to amend the present U.S. system, they have to take into account the (1) level of cooperation the United States can expect from its treaty partners and (2) effects the procedure selected will have on international investment flows.

Clearly, the success of any bilateral agreement is contingent on mutual assistance and cooperation on the part of the involved governments. Government tax officials from France, the Netherlands, and Switzerland expressed to us a willingness to assist Treasury and IRS in the implementation of a revised withholding tax system. If these three countries are representative of treaty partners in general, Treasury may not face serious difficulties in gaining cooperation in amending the present U.S. system. And, according to data collected by the Treasury Department, most of our treaty partners are willing to cooperate with U.S. efforts to develop an improved withholding tax system.

Thus, in our view, Treasury's major concern may center on trade-offs between tax administration and tax policy objectives. From a tax administration standpoint, the most desirable system would be the one which best assures accurate assessment and collection of the U.S. withholding tax. However, a system which is particularly effective from a tax administration standpoint might prove undesirable from a tax policy perspective. Considerations in this regard include the need to assure equitable treatment of taxpayers and the need to assure that tax policy changes do not inappropriately influence investment decisions. Treasury thus faces a difficult task in deciding among various alternative withholding tax systems.

In any case, based on our study, it appears that Treasury may choose from among at least the following three approaches: refund with certification, certification only, or a country by country approach using the system that is most appropriate for the circumstances. In our view, if Treasury were to make its decision solely on the basis of tax administration concerns, it almost certainly would adopt a refund with certification system. Such a system could be similar to Switzerland's refund with certification system which I discussed earlier. Conceptually, that system provides a high degree of assurance that treaty benefits are granted only to eligible recipients. And, from a U.S. perspective, a refund with certification procedure would provide various other benefits, including the following.

--The U.S. Treasury would receive a significant net revenue gain. According to cost/benefit estimates prepared by IRS in 1981, implementation of a refund with certification system would produce additional revenue of about $142 million annually at a cost of only $1.1 million to IRS. The U.S. Treasury also would gain quick access to taxes withheld at the U.S. statutory tax rate of 30-percent and would maintain control of the funds pending receipt of complete and accurate certifications for refunds from tax treaty partners. Besides better assuring collection of taxes due on U.S.-source income paid to nonresidents, Treasury would also benefit from the "float" preceding payment of refunds.

--The duties and responsibilities of U.S. withholding agents would be limited to computing and collecting tax at the statutory rate and remitting the tax to the U.S. Treasury. Consequently, the problem of withholding agent errors discussed in the August 1981 IRS Internal Audit Division report would be substantially reduced. Specifically, because withholding agents no longer would be in the position of having to determine and apply tax treaty rates to income recipients, they would be far less likely to make errors.

--The United States would obtain more accurate and more timely information concerning non-U.S. residents receiving U.S.-source income. From IRS' perspective, this would minimize the need for reliance on information documents received from treaty partners. As previously noted, information documents have not proven very effective as a means for detecting treaty shopping.

--U.S. treaty partners no longer would need to maintain supplemental withholding systems because the United States would grant treaty benefits only to those nonresidents deemed by the treaty partners to be entitled to those benefits.

--As part of its revised withholding tax system, the United States presumably would begin providing treaty partners with certifications of residence for U.S. persons receiving foreign-source income. IRS would benefit from this revision in that it would be made aware at the outset that a U.S. resident has received, or expects to receive foreign-source income. IRS could match such information with the tax return filed with respect to that income.

On the other hand, a refund with certification system could also result in certain disadvantages, including the following.

--The administrative burden on IRS would increase somewhat in that the Service would be responsible for (1) assuring the completeness and accuracy of certifications received from foreign tax authorities, (2) computing the proper tax rate, and (3) issuing refunds as appropriate.

--Both IRS and U.S. treaty partners would have to assume the additional administrative burden of providing certifications for their residents who receive foreign-source income.

--Full withholding at source together with increased verification requirements has the potential to influence decisions by foreigners concerning investments in the United States.

Many foreign government and private sector officials, as well as U.S. bankers and withholding agents, expressed to us the concern that investors would reevaluate the desirability of investments in the United States if a refund with certification system were adopted. However, the United States offers foreign investors attractive investment opportunities, a growing economy, and political stability.

Thus, a refund with certification system offers both advantages and disadvantages. Accordingly, it seems reasonable to expect that Treasury would want to evaluate a refund with certification system with these considerations in mind and explore other alternatives as well. And, in this regard, one alternative to a refund with certification system is a certification only system, like the system operated by France and the Netherlands.

Under a certification only system, U.S. withholding agents would grant treaty benefits as appropriate--but only on receipt of complete and accurate certifications of investors' residences from the tax authorities of U.S. treaty partners. This would afford the United States a degree of assurance that foreign persons receiving treaty benefits are, in fact, entitled to those benefits. Treaty partners also would benefit in that they would no longer have to use supplementary withholding tax procedures to assure that persons who claim treaty benefits on U.S.-source income are in fact bonafide residents.

Furthermore, IRS presumably would begin providing treaty partners with residence certifications for U.S. residents receiving foreign-source income. By providing such certifications, IRS would be placed in the position of knowing that certain U.S. residents have received, or expect to receive, foreign-source income. Such certifications would also provide our treaty partners with some assurance that only bonafide U.S. residents receive treaty benefits.

A certification only system therefore has some of the advantages associated with a refund with certification system. Such a system would not, however, give Treasury access to and control over funds withheld at the statutory 30-percent tax rate. Nor would it reduce the errors made by withholding agents when computing and withholding the tax amounts due.

Moreover, a certification only system could have disadvantages similar to those associated with a refund with certification system--but probably to a lesser extent in some respects. For example, the administrative burden placed on IRS would increase, although it would not be as great as the administrative burden under a refund with certification system. Also, a certification only system might also affect foreign investment in the United States--an issue that Treasury needs to evaluate as part of its decision process.

Beyond this, Mr. Chairman, I would also like to point out that a certification only system can be effective only to the extent that U.S. treaty partners are willing and able to supply the United States with complete and accurate certifications of foreigners' entitlement to tax treaty benefits. Fortunately, as previously noted, many U.S. treaty partners--including France, the Netherlands, and Switzerland--have indicated that they are willing and able to cooperate in this regard. Other treaty partners, however, may be unwilling or unable to provide the United States with complete and accurate certifications.

To remedy that potential problem, there is a third alternative that Treasury could consider--adopting a country by country approach using either a refund with certification or a certification only system, depending on the circumstances. Under this scenario, Treasury would impose a refund with certification system for those countries unwilling or unable to provide complete and accurate residency certifications. Conversely, for those countries who do provide such certifications, Treasury would be free to impose a certification only system if that system seems best under the circumstances. This country by country approach could help address tax policy concerns relating to foreign investment. It could also limit the extent to which IRS would have to assume a greater administrative burden.

Mr. Chairman, we recognize that the Department of the Treasury is faced with a difficult task in developing and implementing effective withholding tax procedures under Section 342. We also recognize that the Congress is faced with a difficult task in carrying out its oversight role. Each party's task perhaps could be facilitated, however, by using a refund with certification system as a basic starting point for analysis. From a tax administration standpoint, a refund with certification system conceptually provides the greatest assurance that any taxes due will be collected. Given that, the remaining alternatives can be analyzed in light of trade-offs against that most basic approach. In any case, we trust that these hearings and our testimony will prove useful to both parties. This concludes my prepared statement. We would be pleased to respond to any questions you may have.

Chart 1

U.S. Source Income Paid to Foreigners Claiming Residence in Treaty Countries in Tax Year 1981 (In Thousands of Dollars)

Recipient's Country of Residence	Gross Income Paid	Tax Withheld by U.S. Withholding Agents	Percent Withheld
Netherlands Antilles	$1,399,528	$ 26,621	1.9
United Kingdom	1,387,082	101,794	7.3
Netherlands	1,339,633	87,663	6.5
Canada	1,238,255	105,273	8.5
Switzerland	1,203,878	126,046	10.5
France	650,534	51,389	7.9
Germany	621,556	26,035	4.2
Japan	519,568	38,687	7.4
Belgium	117,749	15,206	12.9
Luxembourg	57,609	5,066	8.8
Total	$8,535,392 (89.3%)	$583,780	6.8
Other Treaty Countries	200,481 (2.1%)	25,263	12.6
Total: All Treaty Countries	$8,735,873 (91.4%)	$609,043	7.0
Non-treaty Countries	825,616 (8.6%)	108,171	13.1
Total: All Countries	$9,561,489 (100%)	$717,214	7.5

Chart 2

Withholding Tax System for French—Source Income

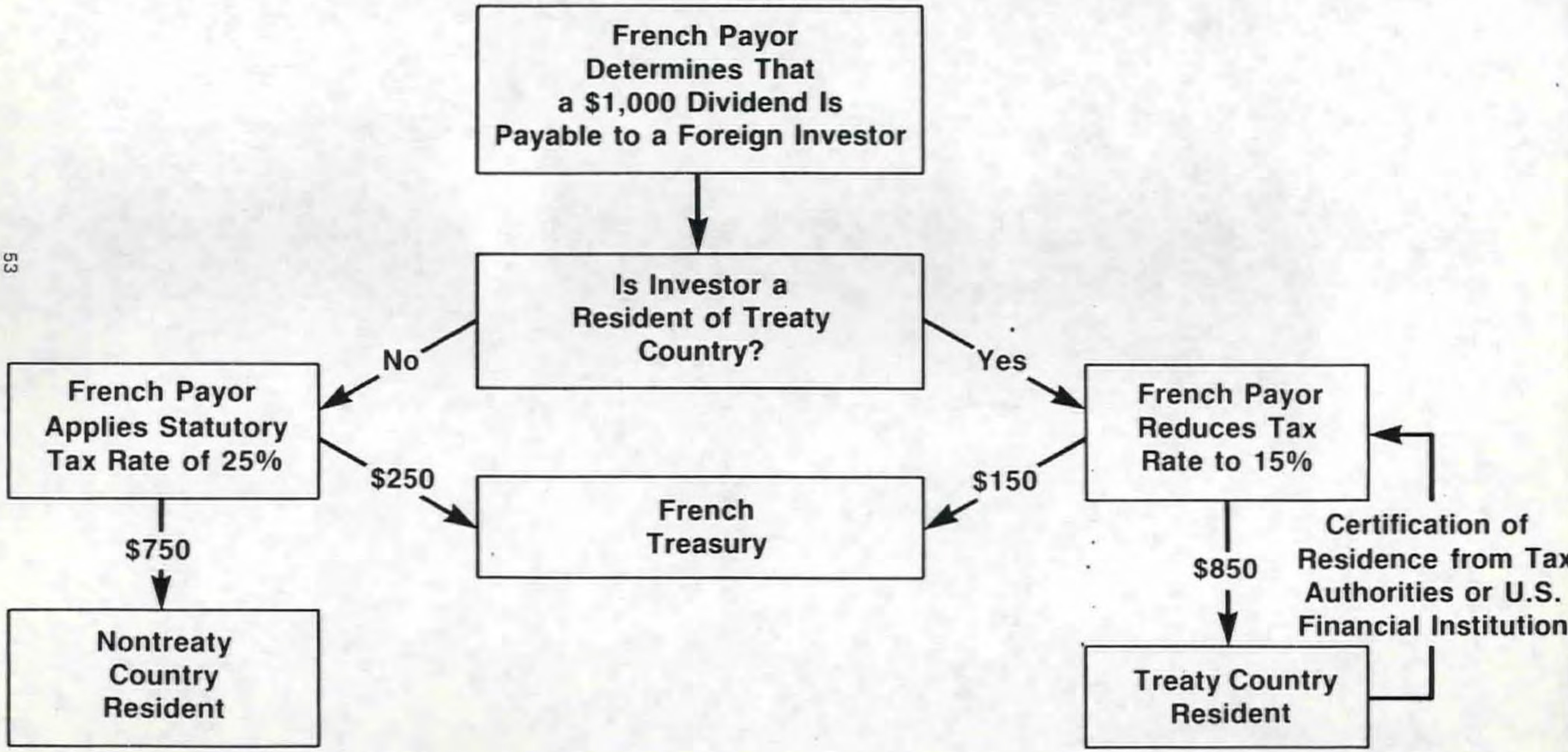

Chart 3

Withholding Tax System for Netherlands—Source Dividends

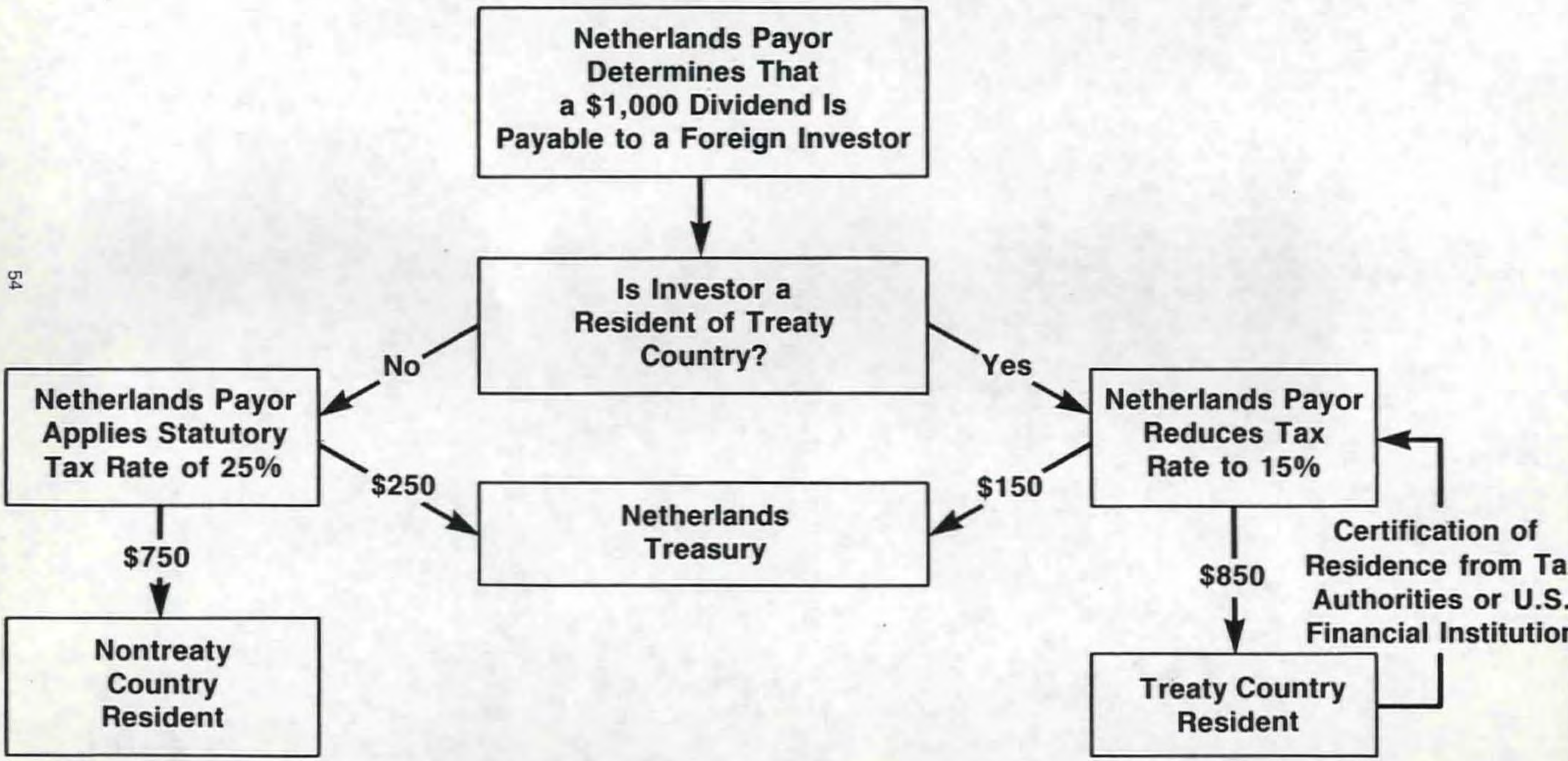

Chart 4

Operation of Swiss Refund with Certification System for U.S. Residents Earning Swiss—Source Interest

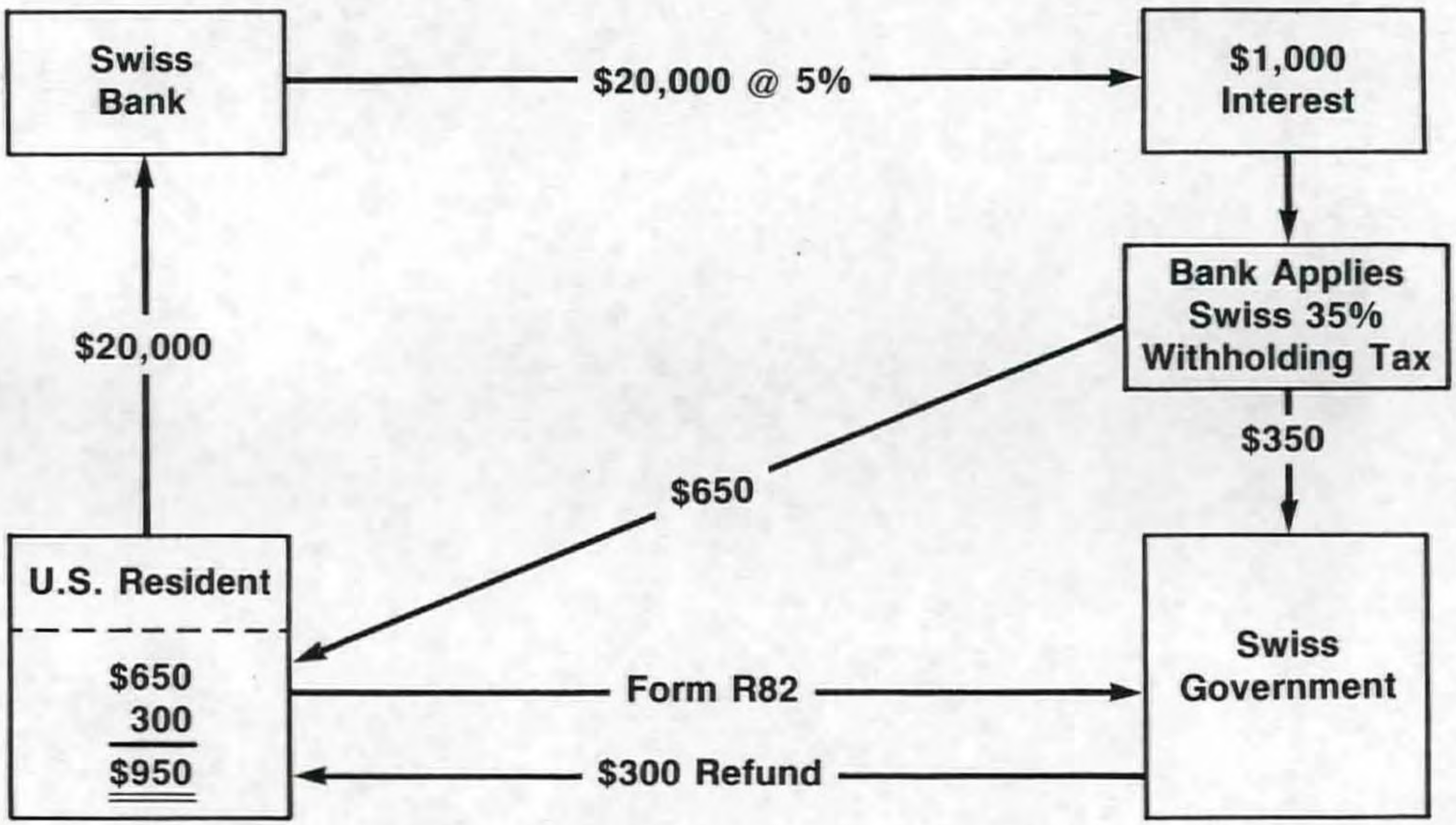

Chart 5

Operation of U.S. Withholding Tax System for Swiss Residents Earning U.S.—Source Dividends