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International Tax Reform: Response to Sheppard

To the Editor:

In "Ending Deferral Without Repatriating Losses," *Tax Notes*, Dec. 10, 2007, p. 996, *Doc 2007-26667*, 2007 TNT 238-6, under "Treaty Benefits," Lee Sheppard misinterprets the sense of section 3204 of House Ways and Means Chair Charles Rangel's, D-N.Y., Tax Reduction and Reform Act of 2007 (H.R. 3970).

For review, here's what Rangel's explanation of the bill says about this section:

The bill would prevent foreign multinational corporations incorporated in tax haven countries from avoiding tax on income earned in the United States by routing their income through structures in which a United States subsidiary of the foreign multinational corporation makes a deductible payment to a country with which the United States has a tax treaty before ultimately repatriating these earnings in the tax haven country. This provision has been modified from a previous version approved by the House of Representatives as part of H.R. 2419, *The Farm, Nutrition and Bioenergy Act*, by a vote of 231 to 191 (with 19 Republicans joining 212 Democrats in support) to ensure that foreign multinational corporations incorporated in treaty partner countries will not be affected by this provision. This proposal is estimated to raise approximately \$6.40 billion over 10 years.

Lee's mistake lies in the following statement: "A genuine foreign parent that is resident in a treaty country would not be affected by the Rangel/Doggett deemed direct payment because the withholding rate on a deemed direct payment would be governed by the treaty between the United States and the foreign parent's country of residence."

That was the sense of Rep. Lloyd Doggett's original provision as incorporated in section 12001 of the pending farm bill (H.R. 2419), but it's not what would happen if section 3204 were enacted. The substantive difference lies in the new IRC section 894(d)(1) that would be created by both bills.

The version of new section 894(d)(1) created by H.R. 2419 requires that the flat 30 percent tax imposed on U.S.-source fixed or determinable, annual or periodical (FDAP) income of nonresident alien individuals and foreign corporations and collected via IRC chapter 3 withholding "shall not be less than the amount which would be imposed if the payment were made directly to the foreign parent corporation (taking into account any income tax treaty between the United States and the country in which the foreign parent corporation is resident)."

In section 3204 of H.R. 3970, the language quoted in the last paragraph is replaced with "may not be reduced under any treaty of the United States unless such withholding tax would be reduced under a treaty of the United States if such payment were made directly to the foreign parent corporation." That is substantively different from the H.R. 2419 language.

Under H.R. 2419, the U.S. withholding agent would compare the withholding required for a particular payment and the withholding required if that payment were made to the recipient's foreign parent, and then withhold the greater of the two amounts.

Under section 3204, the withholding agent looks only to whether a reduction in withholding tax is authorized under a treaty with the country where the parent is located. If so, the reduction in withholding tax authorized by the treaty with the country where the recipient is located will be given effect, *regardless of whether that reduction is more or less than the reduction that would apply if the payment were made directly to the parent.*

If the withholding rates for all U.S. treaty partners were the same, the difference between H.R. 2419 and H.R. 3970 would be meaningless, but withholding rates are not all the same. For interest and non-real-property/natural resource royalties, they vary from 0 percent to 17.5 percent.

The effect of the new language in section 3204, as noted in Rangel's description, is to give effect to favorable withholding reductions as long as the parent is located in a treaty-partner country and would be entitled to some level of reduction if the income were paid directly to it. For parents in countries like Brazil that have no treaty with the U.S., the treaty rate of the subsidiary's country will be overridden and the full 30 percent FDAP withholding will be applied.

Both Senate Finance Chair Max Baucus, D-Mont., and ranking minority member Chuck Grassley, R-Iowa, have denounced section 12001. Grassley almost made his opposition a mantra during the August recess, mentioning it in at least three press conferences. Baucus stated on Aug. 2 that section 12001 would not be in the finance version of the farm bill. The concerns of both senators were that section 12001 would abrogate treaties and perhaps provoke retaliation.

Section 3204 removes that abrogation entirely and offers a carrot that parents in nontreaty countries can use to "motivate" their governments to join the U.S. treaty network.

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