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EXPLANATION OF PROPOSED THIRD PROTOCOL TO PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE UNITED KINGDOM

PREPARED FOR THE USE OF THE

COMMITTEE ON FOREIGN RELATIONS

BY THE STAFF OF THE

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INTRODUCTION

The proposed third protocol to the proposed income tax treaty between the United States and the United Kingdom deals with issues which arose during the previous consideration of the treaty by the United States Senate and with other matters raised during discussion of those issues between the United States and the United Kingdom. A public hearing on the proposed protocol is scheduled for June 6, 1979, by the Senate Foreign Relations Committee.

The proposed income tax treaty, as amended by an Exchange of Notes and two Protocols, was considered by the Foreign Relations Committee and the Senate during the Ninety-Fifth Congress. The Foreign Relations Committee reported the treaty favorably on April 25, 1978, without reservation.

Senator Church had proposed in committee a reservation which would have had the effect of deleting from the proposed treaty a provision (*Article 9(4)*) to the extent that it would have placed limitations on the worldwide combination/unitary method of apportionment used by several states of the United States to determine the taxable income of British multinational corporations subject to tax by those states. The reservation was defeated in committee by a vote of 5 yeas, 10 nays. Senator Church again proposed the reservation on the Senate floor, where it lost by a vote of 34 yeas, 44 nays. However, on June 23, 1978, the Senate by a vote of 49 yeas, 32 nays, failed to concur in the proposed treaty (containing the state taxation provision) by the required two-thirds vote. On June 27, 1978, after the Treasury Department had announced that it would accept the treaty with the Church reservation, the Senate reconsidered the treaty and gave its advice and consent to ratification of the treaty, subject to the Church reservation, by a vote of 82 yeas, 5 nays.

In the course of the Senate's consideration of the proposed treaty, a second reservation was introduced by Senator Kennedy to limit a treaty provision (*Article 23(1)(a)*) which would make the U.K. Petroleum Revenue Tax (PRT) eligible for the U.S. foreign tax credit. This reservation was withdrawn because the United Kingdom and the Treasury Department agreed to go forward with discussions to include the provisions of the reservation in a protocol.

The first part of the pamphlet is a summary of the principal provisions of the proposed protocol. This is followed by a detailed, article-by-article explanation of the protocol.

I. SUMMARY

The proposed protocol contains the following modifications to the proposed tax treaty between the United States and the United Kingdom:

(1) *State taxation.*—In conformity with the Church reservation, the protocol makes Article 9(4) of the proposed treaty, which restricts the use of the worldwide combination/unitary method of apportioning income, inapplicable to states or local governments. Its provisions would continue to apply, however, to taxation at the national level by the United States and United Kingdom governments.

(2) *U.K. Petroleum Revenue Tax (PRT).*—In conformity with the proposed Kennedy reservation, the proposed protocol limits the amount of the British PRT which is allowable under the treaty as a tax credit so that the PRT imposed on extraction income from U.K. sources may only offset U.S. tax on that income. In addition, the PRT which is imposed on certain oil transportation, treatment, and storage income may only offset U.S. tax on that income. Under the proposed treaty, the PRT might also have been used to offset U.S. tax on extraction income from operations in other foreign countries.

(3) *Offshore drilling operations.*—Under the proposed protocol, each country will be allowed to tax under its domestic laws persons engaged in activities in connection with the exploration for or exploitation of, for more than 30 days in a 12-month period, seabed mineral resources situated in that country. This provision will primarily affect U.S. independent drilling contractors who are using movable drilling rigs to undertake exploratory drilling for oil in the U.K. sector of the North Sea and other service companies carrying on ancillary services in connection with drilling.

(4) *U.S. insurance excise tax.*—The proposed protocol expressly provides that premiums paid to British insurers will not be subject to the U.S. insurance excise tax even if the British insurers have a U.S. permanent establishment.

(5) *Dividends from dual-resident corporations.*—The protocol allows the United States to impose its withholding tax at source on dividends paid by corporations which, under the treaty, are residents of both the United Kingdom and the United States. This provision allows the United States to continue to impose its withholding taxes on dividends paid to nonresident aliens and foreign corporations by a corporation organized under U.S. law, even if that corporation is managed, and therefore resident, in the United Kingdom.

(6) *Exemption for government employees.*—The proposed protocol eliminates a provision of the proposed treaty which would have allowed the United Kingdom to tax the compensation of a U.S. citizen resident in the United Kingdom who performed services in that country for the U.S. Government if that individual did not become a U.K. resident solely to perform the services.

(7) *Override of statutes of limitations.*—The proposed protocol overrides U.S. and U.K. statutes of limitations to allow refunds to be made on the basis of the treaty provisions if claims are made within 3 years after the end of the year in which the treaty enters into force.

II. EXPLANATION OF PROPOSED PROTOCOL

A detailed, article-by-article explanation of the proposed protocol to the proposed income tax treaty between the United States and the United Kingdom is presented below.

Article I. Use of worldwide combination/unitary method of apportionment

In conformity with the Church reservation, the proposed protocol makes Article 9(4) of the proposed treaty, which restricts the use of the worldwide combination/unitary method of apportioning income, inapplicable to states or local governments. The provisions of Article 9(4) would continue to apply, however, to the United States and United Kingdom governments.

Under the protocol, political subdivisions and local authorities of either country are free to use formula methods to apportion income, deductions and other items among related enterprises in determining income subject to their taxes, so long as such methods do not violate the proposed treaty's nondiscrimination provisions (*Article 24*).

Article 9(4) of the proposed treaty would have limited the methods by which the United States, the United Kingdom, and state and local governments divisions and local authorities of each country could tax enterprises of the other country (or enterprises which are directly or indirectly controlled by enterprises of the other country). (This provision is not found in other U.S. tax treaties.) The proposed treaty would have provided that, in determining the tax liability of such an enterprise doing business within their respective jurisdictions, the United States, the United Kingdom and their political subdivisions and local authorities could not take into account the income, deductions, receipts or outgoings of a related enterprise of the other country, or of any third country. This provision of the proposed treaty was intended to apply to those states of the United States (principally California, Oregon, and Alaska) which, in determining the amount of income of a business operating within the state which is to be apportioned to that state for income tax purposes, require combined reporting of all related business operations (including related business operations of affiliated U.S. and foreign corporations, whether or not doing business within the state). The national governments of the United Kingdom and the United States do not apportion income between jurisdictions under this method but rather allocate income between related enterprises under arm's-length principles. In addition, the political subdivisions and local authorities of the United Kingdom do not impose income taxes.

The proposed protocol modifies this provision by eliminating its applicability to political subdivisions and local authorities of the United States and the United Kingdom. This is in conformity with the reservation proposed by Senator Church and adopted by the Senate as part of its resolution of ratification of the proposed treaty. The provision would, however, continue to apply to the two national governments. (Conforming changes are made in Article 2 of the proposed treaty (*Taxes covered*) to reflect this narrowed scope.)

Moreover, the proposed treaty, like most other U.S. tax treaties, contains a provision (*Article 9(1)*) similar to that contained in the Internal Revenue Code (sec. 482) which recognizes the right of each country to make an allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons. The limitation in Article 9(4) applies only to cases where an allocation is made without regard to any application of the arm's-length standard. Of course, both countries may apply apportionment formulas, including formulas that take into account attributes of related entities, as a method of achieving an arm's-length price for a transaction between related entities. Moreover, apportionment formulas may be used as a method of apportioning income of related entities to the extent that it is established that they are not dealing on an arm's-length basis. The proposed treaty does not affect U.S. tax rules for allocating and apportioning income, deductions, and other items among related enterprises (Code sec. 482), nor is it applicable to the U.S. tax rules concerning the source of income and the deductions attributable thereto (Treas. Reg. § 1.861–8).

Article II. Excise tax on premiums paid to foreign insurers

The proposed protocol amends the proposed treaty so that it expressly provides that insurance premiums paid to a British insurer will not be subject to the U.S. insurance excise tax even if it has a U.S. permanent establishment. The Treasury Department intended this to be a clarification of the provision of the proposed treaty which generally exempts U.K. insurance companies from the U.S. insurance excise tax.

Under the Code, premiums from insuring U.S. risks which are received by a foreign insurer having no U.S. trade or business are not subject to U.S. income tax but are subject to the U.S. insurance excise tax (secs. 4371–4374). However, the proposed treaty includes the insurance excise tax among the taxes covered and thus, under the business profits article and Article 22 (*Other income*), income of a British enterprise derived from the insurance of U.S. risks is subject neither to U.S. income tax nor to the insurance excise tax if that insurance income is not attributable to a U.S. permanent establishment maintained by the British insurer.

Those U.K. insurers which continue to maintain a U.S. permanent establishment after the proposed treaty enters into force will remain subject to the U.S. *income* tax on their net U.S. insurance income attributable to the permanent establishment. However, under the proposed protocol, the U.S. *excise* tax is not to be imposed on insurance or reinsurance premiums which are the receipts of a business of insurance carried on by a U.K. enterprise even if that business is carried on through a U.S. permanent establishment.

The statutory rules governing the taxation of foreign insurance companies insuring U.S. casualty risks have been modified through interpretations of the nondiscrimination provisions of the existing treaty contained in certain closing agreements which have been entered into between the IRS and a number of British insurers.[1]

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[1] A similar but less detailed closing agreement with a German insurer is set forth in Letter Ruling 7846060 (Aug. 18, 1979).

The closing agreements are intended to provide relief in certain limited situations involving casualty insurance where there is the potential liability for both income tax and excise tax because the foreign insurer is subject to the income tax (because it has a U.S. trade or business), but the premium paid is not exempt from the excise tax (because the insurer is not licensed by a state to write insurance). It is understood that U.K. insurers agree in the closing agreements to subject themselves to the U.S. income tax by treating their U.S. operations (frequently an unrelated agent) as a permanent establishment, and the IRS agrees to waive the excise tax with respect to those premiums effectively connected with the U.S. trade or business under the nondiscrimination clause of the present treaty.

The pending treaty, in a departure from the existing tax treaty and other existing U.S. tax treaties, covers the insurance excise tax.[2] As a result, British insurers which do not have U.S. permanent establishments are exempt on income from insuring U.S. risks from the U.S. insurance excise tax as well as the U.S. income tax. It had been assumed that, as a result of this exemption in the proposed treaty for British insurers which did not have U.S. permanent establishments, all British insurers would be exempt from the excise tax because it had been assumed that those others which did have U.S. permanent establishments would continue to be exempt from the excise tax (but not the income tax) under the nondiscrimination clause. (It would no longer be necessary to enter into a closing agreement and agree to be subject to the U.S. income tax in lieu of the excise tax because the exemption from the excise tax would be available under the proposed treaty even if the British insurer had no U.S. permanent establishment.) However, questions have been raised as to whether the imposition of the excise tax on British insurance companies with U.S. permanent establishments does in fact constitute discrimination under the treaty and whether the exemption, which had been provided in the closing agreements pursuant to the nondiscrimination clause to the British insurers, was appropriate. In order to eliminate this doubt as to whether British insurers with U.S. permanent establishments are in fact entitled to an exemption from the insurance excise tax, the proposed protocol states expressly that British insurers are exempt from the U.S. insurance excise tax whether or not they have a U.S. permanent establishment.

The insurance excise tax will continue to be collected in situations where a U.K. enterprise with a U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign reinsurer other than a U.S. resident or a resident of a country which has a similar provision in its treaty with the U.S. (such as is provided in the proposed protocol to the U.S.-France income tax treaty and in the proposed U.S.-Hungary income tax treaty). The tax is imposed on the U.K. insurer which, in this situation, is viewed as a U.S. resident person paying a

[2] The pending income tax treaty with Hungary and the pending protocol to the existing income tax treaty with France both cover the excise tax, and it is covered by the U.S. model income tax treaty. In the case of the pending French protocol, however, the exemption only applies to the extent that the risk is retained by insurers who would also be eligible for the exemption under one of the treaties; to the extent it is reinsured with an insurer not so eligible, the exemption under the pending French protocol does not apply.

premium to a foreign insurer (Code sec. 4372(d)). The excise tax will apply to this reinsurance even where the U.K. insurance company has a U.S. trade or business but no U.S. permanent establishment and thus will not be subject to U.S. income tax on the net income it derives on the portion of the risk it retains. However, no U.S. excise tax will be collected if the U.K. insurer has no U.S. trade or business, regardless of whether or not it reinsures the risk.

Article III. Dividends

The proposed protocol amends the proposed treaty so that it would not prevent the United States from applying its withholding tax on dividends paid by U.S. corporations to foreign shareholders in those situations where the U.S. corporation is also considered to be a resident of the U.K. for purposes of the treaty (i.e., dual residence). This modification corrects a drafting oversight in the propcsed treaty.

Under the proposed treaty, a corporation which is organized under U.S. law, but whose business is managed and controlled in the United Kingdom, is a "resident" of both the United States and the United Kingdom. Under U.S. domestic law, the United States generally imposes a withholding tax on dividends paid by a U.S. corporation to nonresident aliens and foreign corporations unless the dividends are effectively connected with a U.S. trade or business of the recipient or less than 20 percent of the U.S. corporation's gross income is from U.S. sources. The provisions of the proposed treaty as approved by the Senate, however, would generally have prevented the imposition of this withholding tax if the U.S. corporation was managed in the U.K. and thus qualified as a U.K. resident.

This would have resulted because, as in the case of most U.S. tax treaties and the OECD model tax treaty, the proposed treaty contains a general limitation on the taxation by one country of dividends paid by corporations which are residents of the other country. Under this provision, the United States could not impose any tax on dividends paid by a corporation which was a "resident" of the U.K. (even if organized under U.S. law) except where the dividends were paid to a resident or citizen of the United States or where the dividends were effectively connected with a permanent establishment or fixed base of the recipient which was situated in the United States. This exemption from tax applied even if the dividends consisted wholly or partly of profits or income arising in the United States.

The proposed protocol prevents this result by making the treaty provision inapplicable to "dual status" corporations. Accordingly, dividends paid by these corporations would continue to be subject to withholding taxes to the extent provided by U.S. domestic law, except as otherwise provided in applicable treaties.

Article IV. Government service

The proposed protocol eliminates a rule in the proposed treaty which would have allowed the U.K. to tax the compensation of certain U.K. residents working for the U.S. government who did not become U.K. residents solely for the purpose of performing those services. Substantial concern over the treaty provision was voiced to the Foreign Relations Committee by employees of the U.S. Defense Department in the United Kingdom. In general, neither the United States nor the

United Kingdom currently taxes income of employees of the other country's government. However, the protocol will amend the treaty to allay this concern.

Under the proposed treaty as approved by the Senate, compensation, other than a pension, paid by the government of either country to an individual for services rendered to that country is generally taxable only in that country. However, such compensation is taxable in the country in which the services are being performed if the recipient (i) is a resident and national of that country or (ii) did not become a resident solely for the purpose of performing the services. (This provision does not apply to compensation received for services performed in connection with a business carried on by or on behalf of one of the countries or to services performed for political subdivisions and local authorities.) The provision generally follows the OECD and U.S. model tax treaties.

The proposed protocol changes this rule so that compensation for services performed for the government of one country may be taxed by the other country only if performed by a resident of the second country who is also a national of that country. The purpose for which he became a resident is no longer relevant. This is similar to the rule in the current treaty between the United States and the United Kingdom.

Article V. Petroleum Revenue Tax

The proposed protocol limits the extent to which the United States is required under the proposed treaty to allow a foreign tax credit for the U.K. Petroleum Revenue Tax (PRT). The pending treaty as approved by the Senate would in general have required the PRT to be treated as a creditable income tax, subject to the limitations on the foreign tax credit of U.S. statutory law. The proposed protocol would in general prevent excess PRT from offsetting U.S. tax on oil income from other countries.

The proposed treaty as approved by the Senate contains the general rule contained in many U.S. tax treaties under which the United States agrees that it will continue to allow its U.S. citizens and residents to claim a foreign tax credit (Code secs. 901 and 902) against the U.S. tax for the appropriate amount of income taxes paid to the United Kingdom. The credit (direct or indirect) allowed under the proposed treaty is subject to the limitations and in accordance with the provisions of U.S. law (as it may be amended from time to time without changing the general principle of allowing a foreign tax credit) applicable to the year in question.

The proposed treaty also provides that the PRT is to be treated as a creditable income tax for U.S. foreign tax credit purposes. It is the position of the Internal Revenue Service that the PRT is not an income tax in the United States sense and that therefore it would not be eligible for the U.S. foreign tax credit in the absence of the proposed treaty. In the view of the IRS, the PRT is more in the nature of a production or severance tax. Rev. Rul. 78–424, 1978–2 C.B. 197.

The PRT presently is imposed at a 45-percent rate on assessable profits from oil and gas extraction activities in the U.K. (including the North Sea) on a field-by-field basis. It is in addition to, and separate from, the regular U.K. corporate tax (and a 12.5-percent royalty payable on North Sea production). The amount of PRT paid is allowed as a deduction for purposes of computing the regular U.K. corporate income tax. Operating and capital losses from nonextraction activities are not allowed as deductions in computing the PRT. In addition, no deduction is allowed for interest or other financing costs. However, a special additional deduction based on the amount of capital investment is provided to compensate for the disallowance of interest expenses in computing profits for purposes of the PRT. The aggregate amount payable to the U.K. Government in taxes and royalties on oil and gas extraction income is roughly 60 to 70 percent.

During the Senate's consideration of the proposed treaty, Senator Kennedy introduced a reservation which would have allowed a credit for the PRT only to the extent that U.S. tax attributable to U.K. oil and gas extraction income exceeded other U.K. taxes (such as the regular U.K. corporate income tax) on that income.[3] The intent of this reservation was to prevent U.S. oil companies from using the PRT as a credit against their U.S. tax liability on extraction income from other countries, such as OPEC nations. Senator Kennedy withdrew the reservation on the basis of assurances from the Treasury Department and the British Government that the issue would be dealt with in a protocol.[4]

The proposed protocol incorporates the substance of the Kennedy reservation and also applies a number of rules which are similar to provisions of U.S. domestic law limiting the foreign tax credit for foreign oil and gas income (Code sec. 907). To determine the extent to which a credit for the PRT will be allowed, the taxpayer first multi-

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[3] The text of the reservation, which was reprinted at 124 Cong. Rec. S9559 (daily ed. June 27, 1978), was as follows:

"Before the period at the end of the resolution of ratification insert a comma and the following: 'subject to the reservation that, for purposes of the tax laws of the United States, the United States shall allow a credit against tax for any Petroleum Revenue Tax attributable to oil and gas extraction income from sources within the United Kingdom and paid to the United Kingdom by any resident or national of the United States, or by any United States corporation owning at least 10 percent of the voting stock of a corporation which is a resident of the United Kingdom, only to the extent that the United States tax attributable to such income for which such resident or national or such corporation is otherwise liable exceeds any credit allowable by the United States for other United Kingdom tax on such income'."

[4] The assurances were contained in a letter from the Treasury Department to Senator Pell, reprinted *id.*, the text of which was as follows:

"The Treasury very recently discussed with the British Senator Kennedy's suggestion that the creditability of the U.K. Petroleum Revenue Tax (PRT) under the proposed income tax treaty be limited to income from the United Kingdom.

In those discussions, the British indicated that, unlike the provisions of Article 9(4) in the treaty, they have little concern over the specific mechanics which the United States applies to the PRT credit. Thus, the British have agreed to go forward with discussions of a protocol to the proposed treaty which will accomplish the objective suggested by Senator Kennedy.

The Treasury also stands ready to go forward with such a protocol and we hope that in this manner the proposed treaty can be ratified in its present form.

Sincerely,

DONALD C. LUBICK,
Assistant Secretary-Designate for Tax Policy.

plies its U.K. income from the extraction of minerals from oil and gas wells for the taxable year by the maximum statutory U.S. tax rate applicable to a corporation (currently 46 percent). A credit for the PRT for the taxable year cannot exceed the difference (if any) between this product and other U.K. tax (such as the regular U.K. corporate tax) on that income.

If less than the full amount of the PRT is creditable under this provision, the protocol allows a 2-percent limited carryback or carryover of the excess. This is similar to provisions of U.S. law.

In addition to the limits on creditability of the PRT imposed with respect to the taxpayer's U.K. oil and gas extraction income, the protocol imposes comparable limitations on the creditability of the PRT on income from the initial transportation, initial treatment and intitial storage of minerals from oil and gas wells in the U.K. This concept is similar to the limitations of U.S. domestic law relating to the foreign tax credit on foreign oil related income. It applies to a narrower group of activities, however, because the PRT is not imposed on other oil-related activities. Moreover, gains from the sale or exchange of assets used in connection with these activities is not included because the PRT is not imposed on those gains.

Article V of the proposed protocol will not reduce the foreign tax credit which may be claimed for the PRT under U.S. statutory law if it is ultimately held that the PRT is a creditable income tax under that law. Article V of the protocol only imposes a limitation on the amount of the PRT which qualifies as a creditable foreign tax, as opposed to a royalty or noncreditable tax, if the taxpayer must resort to the provisions of the proposed treaty to obtain the credit. However, the taxpayer does not avoid the limitations of U.S. statutory law by claiming the PRT under the treaty. Under paragraph (1) of Article 23 of the proposed treaty, the other limitations on creditability imposed by U.S. domestic law (in particular, those in Code secs. 904 and 907), as they are now in force or as they may be changed without changing the general principle of the foreign tax credit, will continue to apply in determining the amount of the foreign tax credit the taxpayer will ultimately receive as a result of payment of the PRT and other foreign taxes.

Article VI. Offshore activities

The proposed protocol adds a new Article 27A to the proposed treaty covering offshore activities. This provision is intended to deal primarily with the activities of certain U.S. independent drilling contractors in the U.K. sector of the North Sea. As a practical matter, this provision makes it clear that the proposed treaty does not prevent the United Kingdom from taxing the activities of these drilling contractors under its domestic laws. Although the contractors would be allowed a credit against U.S. tax liability for U.K. income taxes, the credit may be less than the full U.K. tax paid. Also, the benefits to the drilling contractors of the investment tax credit may be reduced. While the protocol provisions were added primarily to deal with activities of U.S. persons in the North Sea, they also make it clear that British activities in connection with activities on the U.S. continental shelf are subject to U.S. tax.

Under the treaty, the terms "United Kingdom" and "United States" are defined to include the seabed and subsoil and their natural resources over which the countries exercise rights. Oil companies have entered into contracts with U.S. drilling companies and service and supply companies with respect to mineral exploration and exploitation in the North Sea through the use of movable drilling rigs. It is understood that a number of these drilling and service companies intended to take the position that their income was not subject to U.K. tax because of the absence of a permanent establishment which would allow the U.K. to tax them under the business profits article (*Article 7*) of the proposed treaty. The term "permanent establishment" includes "a building or construction or installation project which exists for more than 12 months" (*Article 5(2) (f)*), but it is not clear whether this language would encompass these drilling rigs. The activities of these independent drilling contractors with respect to any one project generally have been completed in less than 12 months. In addition, individuals who were performing independent services in the North Sea who could establish that they did not themselves have a fixed base in the U.K., might under certain circumstances be exempt from U.K. tax on their income from the performance of services (*Article 14*). It is also understood that some U.S. independent drilling contractors intended to take the position that their activities constituted the operation in international traffic of ships which, under certain circumstances, would be taxable only in the U.S. under Article 8 (*Shipping and air transport*) of the proposed treaty.

The proposed protocol provides that a person who is a resident of one country and carries on activities for more than 30 days in a year in the other country in connection with the exploration or exploitation of the seabed and sub-soil and their natural resources situated in that other country is deemed to be carrying on in respect of those activities a business in that other country through a permanent establishment or fixed base situated therein. This rule would permit this income, whether business profits or income from independent personal services, to be taxed by the other country under its domestic laws. (The treaty and protocol do not themselves impose a tax.) At present the United Kingdom would not, under its domestic law, tax the North Sea income of the U.S. drilling companies.

This provision does not apply where the activities are carried on for a period not exceeding 30 days in aggregate in any 12-month period. However, for purposes of this 30-day threshold, activities carried on by an enterprise related to another enterprise are to be regarded as carried on by the enterprise to which it is related if the activities in question are substantially the same as those carried on by the other enterprise.

Under the general rules for the allowance of the U.S. foreign tax credit, the North Sea drilling contractors would be entitled to claim a dollar-for-dollar credit against their U.S. income tax liability for income taxes paid to the United Kingdom on their income from sources in the North Sea. However, the U.K. tax would not be fully creditable against U.S. tax if the taxpayer is in an excess foreign tax credit position. A fundamental premise of the U.S. foreign tax credit is that it should not offset the U.S. tax on U.S.-source income. Accordingly, the computation of the foreign tax credit contains a limitation to insure that the credit only offsets the U.S. tax on the taxpayer's foreign income.[5]

Thus, if the United Kingdom imposes its tax at a higher effective rate than the U.S. tax, the drilling contractor may not obtain a credit for all U.K. income taxes paid. Moreover, because the foreign tax credit limitation is computed on an overall basis, combining the taxpayer's foreign income taxes and foreign source income from all foreign countries, the taxpayer may not receive a full credit for U.K. taxes because of high tax rates in other countries or losses suffered in those countries. On the other hand, however, if other countries impose taxes at less than the taxpayer's effective U.S. tax rate, the taxpayer may be able to use U.K. taxes imposed at higher rates as a credit against U.S. taxes on income from the other countries. The taxpayer would be allowed to carry over for credit in other years U.K. income taxes for which it could not claim a credit in the current year because of the foreign tax credit limitation, but these credits may also not be usable if the taxpayer were also in an excess credit position in the other years.

However, even to the extent that U.K. taxes are creditable against the drilling company's U.S. taxes, the company may lose some of the benefits of the investment tax credit. The investment credit is limited to a specific percentage of the taxpayer's U.S. tax liability for the year. This is currently 60 percent, and will increase in steps to 90 percent for 1982 and later years. For this purpose, the drilling company's U.S. tax liability is its liability after allowance of the foreign tax credit. Thus, each dollar of foreign tax for which a credit is allowed reduces the company's pre-investment tax credit U.S. tax liability by that amount and also reduces the maximum allowable investment tax credit by 60 cents (increasing to 90 cents in 1982). If a company's allowable investment tax credit for the year exceeds the limitation, it loses the benefit of that excess for that year. The excess credits may be carried over to other years but may also be unusable in those years.

For example, if in 1982 a drilling contractor was not taxable in the United Kingdom and was subject to U.S. taxes (before investment tax credits) of $200, its maximum allowable U.S. investment tax credit would be $180 (90 percent of $200). If, however, it had that amount of credits, its net U.S. taxes would be $20. If it paid U.K. taxes of $100 and those U.K. taxes were fully creditable against its U.S. taxes, its U.S. tax liability (before investment tax credit) would be $100 and its maximum allowable investment tax credit would be $90.Its net U.S. tax would be reduced to $10, but its total taxes paid to both the United States and the United Kingdom would be increased to $110. Even though U.K. taxes are fully creditable, the taxpayer's overall liability is increased by $90 because of the decrease in the investment tax credit limitation. This extra liability is paid entirely to the United

[5] The limitation operates by prorating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") between his U.S. and foreign source taxable income. Therefore, the limitation is determined by using a simple ratio of foreign source taxable income divided by total taxable income. The resulting fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes paid on the foreign income and, thus, the upper limit on the foreign tax credit.

Kingdom, and an additional $10 is shifted from the U.S. to the U.K. Treasury.

The proposed protocol also provides that the provisions of Article 8 (*Shipping and air transport*) of the proposed treaty do not apply to a drilling rig or any vessel the principal function of which is the performance of activities other than the transportation of goods or passengers.

Unlike the other provisions of the proposed protocol, this provision takes effect only after the protocol enters into force and is not retroactive.

Article VII. Statutes of limitations

Certain provisions of the proposed treaty are retroactive as far back as 1973. The statute of limitations (under the domestic laws of the United States and the United Kingdom) may already have run on some of the years involved. For example, a claim for refund of U.S. tax, whether based on a treaty benefit or otherwise, must ordinarily be made within 3 years after a return for the year in question is filed. The proposed protocol overrides these domestic law provisions to allow refunds to be made on the basis of the treaty provisions if claims are made within 3 years after the end of the year in which the treaty enters into force. This rule does not open the statute of limitations for other items on the return except insofar as they are affected, directly or indirectly, by application of the provisions of the treaty.

Article VIII. Entry into force

The proposed protocol will enter into force on the thirty-first day following the date on which the instruments of ratification are exchanged. Once in force, the proposed protocol generally applies retroactively, in accordance with Article 28 (*Entry into force*) of the proposed treaty. For example, Article III of the protocol will generally apply to dividends paid on or after January 1, 1975. However, the provisions of Article VI (*Offshore activities*) of the protocol apply only after the protocol has entered into force.

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