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SHIPPING AND AIRCRAFT TAX AGREEMENT BETWEEN THE UNITED STATES AND THE PEOPLE'S REPUBLIC OF CHINA

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON MAY 24, 1983

PREPARED BY THE STAFF OF THE

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INTRODUCTION

This pamphlet provides an explanation of the proposed shipping and aircraft income tax agreement between the United States and the People's Republic of China. The proposed agreement was signed on March 5, 1982. The agreement expands the scope of an exchange of notes and letters of understanding between the two countries that occurred November 18, 1981, effective retroactively since January 1, 1981, and currently in force. The proposed treaty has been scheduled for a public hearing on May 24, 1983, by the Senate Committee on Foreign Relations.

The provisions of the proposed agreement do not differ greatly from certain provisions in recent U.S. income tax treaties, the U.S. model income tax treaty, and the model income tax treaty of the Organization for Economic Cooperation and Development. Its scope, however, is limited to only one industry. The Treasury Department is in the process of negotiating a more comprehensive income tax treaty between the two countries.

The first part of the pamphlet is a summary of the applicable provisions of the proposed agreement. The second part provides an overview of relevant U.S. tax rules relating to international trade and of U.S. tax treaties as they deal with the matters presented in the agreement. This is followed by a detailed, article-by-article explanation of the proposed agreement.

I. SUMMARY

In General

The principal purpose of the proposed shipping and aircraft income tax agreement between the United States and the People's Republic of China is to reduce or eliminate double taxation of certain income earned by enterprises and residents of either country from shipping and air transportation. The proposed agreement is intended to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. This objective is principally achieved by each country agreeing not to tax income derived in international traffic by enterprises of residents of the other (or, in the case of the People's Republic of China, state-owned enterprises).

In addition, each country agrees not to tax gains from the alienation by an enterprise of the other country of ships, aircraft and containers operated in international traffic. Each country also agrees to exempt from taxation salaries of residents of the other country employed as crew members in international traffic.

The agreement would expand on an existing exchange of notes and letters of understanding between the two countries. The existing exchange of notes and letters of understanding do not provide reciprocal exemption for (1) shipping profits of enterprises of a country that do not register under its laws, (2) air transport profits of enterprises of a country that do not register under its laws in certain circumstances, (3) certain income from rental of ships, aircraft, or containers, (4) gains from alienation of property, or (5) salaries of crew members. The proposed agreement would provide reciprocal exemption in each of these cases.

The agreement would specifically benefit a U.S. airline that leases one or more aircraft to the People's Republic of China and which is subject to PRC tax on that rental income, and any similarly situated U.S. taxpayers. It would also benefit those U.S. and PRC shipping enterprises that fly flags of countries not of their residence.

Although the proposed agreement does not specifically provide for the exchange of tax information between the competent authorities of the two countries, it provides for the competent authorities to resolve problems arising under the agreement.

The agreement contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect.

The treaty would be effective retroactively to January 1, 1981.

Issue

The proposed agreement would be the first tax treaty entered into by the United States covering only one industry, in this case the shipping, airline and container leasing industry. Accordingly, it represents an expansion of the tax treaty process. This raises the issue whether limited treaties are appropriate.

On the one hand it might be argued that a limited treaty is appropriate as the most efficient way of handling a particular problem where a regular treaty would take more time to negotiate. It might also be argued that a limited treaty is appropriate to deal with a problem of particular concern to the United States where a general treaty would not be negotiated.

On the other hand, it might be argued that such a treaty is inappropriate because it can remove the incentive for a country to enter into a general income tax treaty with the United States which might benefit a wider range of U.S. taxpayers. Furthermore, it is not clear that a proliferation of limited treaties would be administerable, or would be the best way to use the resources devoted to the tax treaty program.

II. OVERVIEW OF RELEVANT UNITED STATES RULES TAXING INTERNATIONAL TRADE AND OF TAX TREATIES

A. Relevant United States Tax Rules

The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income which is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income which is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income of a nonresident alien or foreign corporation which is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent they are connected with income which is effectively connected and provided a true and accurate return is filed.

United States source fixed or determinable annual or periodical income (e.g., interest, dividends, rents, salaries, wages, premiums, annuities) which is not effectively connected income and which is received by a nonresident alien or foreign corporation is subject to tax at a rate of 30 percent of the gross amount paid. This gross tax is often reduced or eliminated in the case of certain payments to residents of countries with which the United States has an income tax treaty.

U.S. source capital gains of nonresident alien individuals and foreign corporations that are not effectively connected with the conduct of a trade or business in the United States are generally exempt from U.S. tax with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of U.S. real estate or real property interests.

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income.

B. United States Tax Treaties

The traditional objectives of comprehensive U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions which take into account the particular tax system of the treaty country. Given the diversity of tax systems in the world, it would be virtually impossible to develop in the Code rules which unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and our treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Significant problems arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when the contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation is generally accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents.

In its treaties, the United States, as a matter of policy, retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause." The treaties also provide for administrative cooperation between the countries. This cooperation includes a competent authority mechanism to resolve double taxation problems arising in individual cases, or more generally, by consultation between tax officials of the two governments.

III. EXPLANATION OF PROPOSED AGREEMENT

Article I. (Income from Operation of Ships and Aircraft)

U.S. Rules.—As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the ship or aircraft is documented under the laws of a foreign country that grants an equivalent exemption to U.S. citizens and corporations (secs. 872 & 883). Thus, for its ships and aircraft to benefit from the U.S. tax exemption, a foreign country would have to exempt from tax the income that U.S. persons earn from ships and aircraft documented under the laws of the United States. The foreign country could have its ships and aircraft benefit from this exemption, however, without exempting from its tax the income that U.S. persons earn from ships and aircraft documented under the laws of a third country. The United States has entered into agreements with a number of countries under which that country grants an exemption which results in the United States exempting that country's shipping under the reciprocal exemption provision of the Internal Revenue Code (secs. 872 & 883).

The statutory exemption for shipping income of ships and aircraft documented under the laws of countries extending a reciprocal exemption includes the income of a lessor from leasing ships under time or voyage charters, and the income of a charterer from the operation of ships under time, voyage, or bare boat charters. The exemption generally does not apply to the income of a lessor from leasing under a bare boat charter. Such income is generally treated as rent received from an investment rather than as shipping income (Rev. Rul. 74-170, 1974-1 C.B. 175). Leasing under a bare boat charter gives rise to exempt shipping income, however, when the lessor is actively engaged in the shipping business and leases a vessel to another as an activity incidental to his shipping business. Whether the lessor of a bare boat chartered vessel is entitled to the exemption is determined on a case by case basis (*id.*).

Certain interest income of a foreign corporation engaged in the shipping business may also be free of U.S. tax. Interest income of such a corporation from funds held for immediate use in the shipping business was held tax exempt on the ground that the interest was incidental to the operation of ships (Rev. Rul. 70-263, 1970-1 C.B. 158).

Proposed Agreement.—The proposed agreement expands upon an exchange of notes and letters of understanding between the two countries of November 18, 1981. Those documents were effective retroactively on January 1, 1981, and are now in effect. The exchange of notes governs shipping income (pursuant to sec. 883), and the exchange of letters of understanding governs income from air transportation.

Article I of the proposed agreement provides that income and profits which are derived by an enterprise of one country from the operation of ships and aircraft in international traffic shall be taxable only in that country. Other articles, discussed below, define the terms used in this Article.

The proposed agreement does not contain the domestic registration, or "flag," requirement found in the exchange of notes between the United States and the the People's Republic of China that now governs shipping earnings. Thus, under the proposed agreement, income of a U.S. resident from a ship flying the Liberian flag would generally not be subject to PRC tax. Likewise, income of a PRC enterprise from a ship flying the U.S. flag or the flag of a third country would not be subject to U.S. tax. One benefit of removal of the "flag" requirement is that PRC shipping companies will be able to lease equipment from U.S. owners who obtained the benefits of the investment tax credit. These benefits may be passed on by the U.S. owners to the PRC shipping companies in the form of lower rentals. The credit is available for ships which are used predominantly outside the United States only if they are registered or documented under U.S. law. (Code sec. 48(a)(2)(B)(iii)). Because a PRC shipping company could benefit from the exchange of notes only if its vessels were registered under PRC law, it was not possible under the the exchange of notes to combine its benefits with those of the investment tax credit (which requires U.S. registration). This modification would in no way restrict the right of the United States to amend its statutory investment credit rules so that the credit would not be available to ships used predominantly outside the United States by persons exempt from U.S. tax under a treaty.

In connection with the exchange of notes now in force, the United States and the People's Republic of China exchanged a letter of understanding about taxation of international aviation operations. That understanding was that as long as earnings from international transportation by PRC air transport enterprises operated in the United States are not taxed in the United States, the People's Republic of China will continue on a reciprocal basis not to tax the earnings of United States international air transport enterprises operated in the People's Republic of China. The reciprocal exemption contemplated by the Internal Revenue Code (and used for shipping income) was not used in the case of aviation income because the PRC airline uses aircraft documented in the United States. However, the PRC airline was not profitable, so no U.S. tax had been due. Therefore, so long as the PRC airline remains unprofitable, this understanding will prevent PRC taxation of earnings from the operations of U.S. aviation enterprises, wherever their aircraft may be registered. The proposed agreement embodies the reciprocal exemption for income from aviation agreed to in that understanding. The proposed agreement's reciprocal exemption will apply regardless of the profitability of the PRC airline. As is the case with ships, it would permit the PRC airline to lease airplanes from U.S. owners who obtained the benefit of the investment tax credit. (See Code sec. 48(a)(2)(B)(i)).

The agreement applies to local surcharges collected by the PRC national government. However, if any state or locality of the

United States imposes tax on PRC enterprises on income and profits from the operation of ships or aircraft in international traffic, then the People's Republic of China may impose any local surcharge on such income and profits of U.S. enterprises.

Article II. (General Definitions)

Article II defines two terms: "income and profits from the operation of ships and aircraft," and "international traffic." These definitions are similar to those of the U.S. model income tax treaty.

The term income and profits from the operation of ships and aircraft includes (but is not limited to) four categories of income and profits derived by an enterprise of the United States or the People's Republic of China. Items in each of these categories are generally exempt from tax in the country of source so long as the taxpayer earns them in international traffic.

The first category of income and profits from the operation of ships and aircraft is income and profits from the operation of passenger, cargo, or mail transportation by the owner or charterer of a ship or aircraft, and the sale of tickets related to such transportation. The intent of this provision is to exempt such income and profits from tax in the country not the country of residence of the taxpayer only if the taxpayer earns them in international traffic.

The second category is income and profits of a lessor from the rental of ships or aircraft that the lessee operates in international traffic. Thus, if a U.S. bank leases a vessel to a third party of any nationality, the U.S. bank's rental income is exempt from PRC tax if the lessee operates the vessel in international traffic.

The third category is income and profits from the rental of ships or aircraft if such rental is incidental to the operation of ships or aircraft in international traffic. If a U.S. shipping enterprise charters a vessel to a third party, the resulting rental income would be exempt from PRC tax since such a charter would be incidental to the U.S. enterprise's shipping operations, regardless of whether the operator uses the vessel in international traffic. That is, the operator (the lessee) in such a case could operate the vessel solely between places in the People's Republic of China without subjecting the lessor to PRC tax. The income of the lessor (the U.S. shipping enterprise) in this example is from the operation of a ship in international traffic, even though the lessee operates in PRC waters, because the lessor's income is incidental to its international operations.

The fourth category is income and profits from the rental or use of containers (and related equipment for the transport of containers) used in international traffic.

Rental income and profits in the second, third, and fourth categories are governed by the proposed agreement whether the rental is on a time, voyage, or bare boat basis.

International traffic means, with respect to an enterprise of a country, any transportation by ship or aircraft, except where the transportation is solely between places in the other country. The meaning of the term "international traffic" is the same as that in the U.S. model income tax treaty and is substantially similar to that in the OECD model. Thus, coastal shipping along the Atlantic coast of the United States is not international traffic with respect to a PRC enterprise. Transport between the United States and American Samoa, however, is international traffic with respect to a PRC enterprise. If a resident of the People's Republic of China transports goods by ship from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the portion of the transport between New York and Norfolk is international traffic; if it also loads other merchandise in New York which it takes to Norfolk, the income from the transport of the goods loaded in New York is not from international traffic.

Article III. (Alienation of Ships, Aircraft, and Containers)

Under the Code, capital gains derived from U.S. sources by foreign investors are generally exempt from U.S. tax. The proposed agreement provides that gains derived by an enterprise of one country from the sale or exchange of ships, aircraft or containers operated in international traffic are taxable only by the country of residence. This rule appears in the U.S. model income tax treaty.

Article IV. (Definition of Enterprise)

The proposed agreement applies only to the income of an enterprise of the United States or the People's Republic of China. For purposes of the proposed agreement, the term "enterprise" means: in the case of the People's Republic of China, a state-owned or collectively-owned enterprise of, and an enterprise carried on by a resident of, the People's Republic of China; and in the case of the United States, an enterprise carried on by a company incorporated in the United States (under the laws of the United States, a state thereof, or the District of Columbia), and an enterprise carried on by a U.S. resident. Citizens of one of the countries who are not residents of one of the countries are not covered by the agreement. U.S. citizens and PRC citizens who are not resident in either country remain subject to the exchange of notes and letters of understanding, however, which remain in force only for such persons.

The term "enterprise" also includes a participation in a partnership or joint business by an enterprise referred to in the general definition of enterprise above. This definition generally conforms to that of the U.S. Model.

Article V. (Salaries and Other Remuneration)

The proposed agreement provides that compensation derived by a resident of one country employed as a member of the crew of a ship or aircraft operated in international traffic shall be exempt from tax in the other country. This rule is substantially identical to the rule of the U.S. model treaty.

Article VI. (Mutual Agreement Procedure)

The proposed agreement contains an abbreviated version of the mutual agreement provision contained in U.S. tax treaties generally. The proposed agreement's provision directs the competent authorities to resolve any difficulties or doubts arising as to the application of the convention. Although the proposed agreement does not define the term competent authority, that term means, in the case of the United States, the Secretary of Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of the Internal Revenue Service, who has redelegated the authority to the Associate Commissioner (Operations). The Assistant Commissioner (Examination) has been delegated the authority to administer programs for simultaneous, spontaneous, and industry-wide exchanges of information. The Director, Foreign Operations District (formerly called the Director of Office of International Operations), has been delegated the authority to administer programs for routine and specific exchanges of information and mutual assistance in collection.

The proposed agreement does not contain a provision for the exchange of information between the competent authorities of the two countries. The mutual agreement provision of Article VI would allow the U.S. competent authority access to information adequate to enforce U.S. taxes affected by the agreement.

Article VII. (Saving Clause)

The proposed agreement contains the "saving clause" contained in all U.S. income tax treaties that provides that the agreement is not to affect the taxation by either country of its citizens or its residents. Consequently the United States could continue to tax its citizens who are residents of the People's Republic of China and who are members of the crew of a ship or aircraft operated in international traffic despite the rule of Article V. Residents for purposes of the agreement (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals.

Article VIII. (Entry into Force)

The proposed agreement is subject to completion of legal procedures in each country. Each country is to notify the other in writing through diplomatic channels of completion of those procedures. The agreement is to enter into force on the date of the later of those two notifications and its provisions are to take effect retroactively as of January 1, 1981. Thus, entry into force may entitle certain U.S. or PRC residents to tax refunds upon the filing of appropriate claims.

It is intended that in the United States the agreement will apply to taxable years beginning on or after January 1, 1981, and that in the People's Republic of China, its provisions apply to taxes paid on or after January 1, 1981.

Article IX. (Termination)

The proposed agreement will continue in force indefinitely, but either country may terminate it at any time by giving at least six months prior notice to the other through diplomatic channels. Any termination will be effective on the first day of January following the expiration of the six months notice.

It is intended that in the United States termination will apply to taxable years beginning on or after that January 1, and that in the People's Republic of China, termination will apply to taxes paid on or after that January 1.

IV. REVENUE EFFECT

The treaty is expected to have a negligible effect on budget receipts.