Joint Committee on Taxation
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ISSUES RELATING TO PROPOSED INCOME TAX TREATIES SCHEDULED FOR HEARING BY THE SENATE COMMITTEE ON FOREIGN RELATIONS, SEPTEMBER 24, 1981

Introduction

Twelve income tax treaties, a protocol to an existing income tax treaty, and one estate and gift tax treaty have been submitted to the Senate for consideration and are scheduled for hearings before the Senate Foreign Relations Committee on September 24. The Treasury has requested that the proposed treaties with the British Virgin Islands and with Cyprus be removed from the hearing agenda so that they can be renegotiated to strengthen the anti-abuse provisions.1/

Today, the United States has in force 28 income tax treaties applicable to 50 jurisdictions. Negotiations with a number of additional countries are near completion. If the instant treaties are ratified, the result will be a greatly expanded treaty network with an increased control of that network over U.S. taxation of international transactions. Accordingly, it is important that the issues raised by the pending treaties receive attention.

This memorandum summarizes some general issues presented by these treaties and then lists some specific issues raised by the individual treaties. It is generally intended only to highlight aspects of the treaties which might be viewed as raising significant issues or which are otherwise noteworthy as significant provisions not typically found in U.S. tax treaties. It is not intended to be a summary of all important aspects of these treaties. Thus, only passing reference, if any, is made to the various provisions typically found in tax treaties which are of benefit to the United States and its taxpayers.

What treaties do

Tax treaties serve two principal functions. They limit double taxation of income from international trade and investment, and they provide a framework for an exchange of tax information between the treaty partners and a mechanism for resolution of disputes.

Treaties generally deal with double taxation of income received by residents of either country from sources within the other by limiting the maximum rate of tax (frequently zero) that the source country can impose on investment type income and by limiting the cases in which the source country can tax business or personal service income. In those cases where source basis taxation is not barred, treaties typically guarantee that the residence country will grant a credit for income taxes imposed

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1/ The proposed treaty with Denmark has been withdrawn at the request of the Danish Government because of changes in Danish law.

by the source country. The U.S. already provides unilateral relief of double taxation in most cases, and in many cases the treaty may be limiting excess taxation (i.e., situations where the level of tax on nonresidents exceeds that generally imposed on residents) rather than double taxation.

I. Generic Issues

A. Desirability of Treaties in General

Most of the generic and specific issues cannot be addressed without considering the overall desirability of income tax treaties. A country clearly has the right to tax income earned within its borders at the rate it chooses. The wisdom of the rates and method of computing the tax base may be debated, the right to tax cannot be.

Most countries do tax local income, and most tax local income paid to foreigners. When a country enters into a treaty, it agrees to limit its taxation of some local income. For example, if a U.S. resident works in a foreign country for one day, that country can tax that day's wages. By treaty, however, the country will generally agree not to tax those wages unless the U.S. resident works there for some significant period of time. The United States, of course, reciprocally agrees not to tax residents of the foreign country temporarily working in the United States. Likewise, a country can tax the gross dividends, interest, and royalties paid to foreign investors at whatever rate it chooses. (For example, the Internal Revenue Code imposes a flat rate 30-percent tax on the gross amount of U.S. source passive income paid to foreign investors. Most other countries have comparable taxes.) By treaty, however, the United States and the foreign country will usually agree to make reciprocal reductions of this tax on income paid to investors in the other country.

By treaty, therefore, countries agree to limit both their jurisdiction to tax and their levels of tax. A U.S. resident's foreign tax burden is therefore generally reduced by a treaty. Accordingly, most taxpayers will argue that any treaty that resembles the U.S. model treaty 2/ is better than no treaty.

A treaty with one country is, however, often perceived as precedent by other treaty partners. Accordingly, a treaty with

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2/ U.S. negotiators start from the U.S. model income tax treaty (or, in the case of an estate and gift tax treaty, the U.S. model estate and gift tax treaty), which is a public document prepared by the Treasury Department setting out its preferred position on each article. The model income and estate tax treaties of the Organization for Economic Cooperation and Development (the OECD) and the United Nations model for income tax treaties between developed and developing countries are also used as guides.

one country that provides for a relatively high rate of tax on passive income may save U.S. investors some tax as compared to no treaty at all with that country, but it may also encourage other countries not to lower their rates as much as they otherwise would. Also, if a treaty can be used by persons who are resident in third countries, it can lead to an erosion of the U.S. tax base without any reciprocal benefits. For example, if residents of nontreaty countries (in which U.S. persons invest) can invest in the U.S. through a treaty country, nontreaty countries have less incentive to enter into a treaty with the United States. Accordingly, U.S. investors in nontreaty countries pay higher taxes than they otherwise might.

Treaties also provide U.S. persons investing in foreign countries with some certainty as to how their income will be taxed by that country. Establishing a treaty relationship can be a significant factor in making the climate for investment in that country more attractive to U.S. businesses.

A significant advantage to the United States as well as the treaty partner is that treaties provide for the exchange of tax information by the two countries and for a competent authority mechanism to resolve double taxation problems by mutual assistance. The IRS receives tax information from its treaty partners which help it in auditing multinational corporations and their dealings with their affiliates. Joint audit procedures, such as those with Canada, Germany, and the United Kingdom, are also possible if a treaty relationship is established.

B. Developing countries

Most existing U.S. tax treaties are with industrialized countries. In many situations these treaties provide that each country will give up the jurisdiction to tax income arising in the country if it is received by a resident of the other country. That is, the country of residence is given the primary right to tax income. Residence taxation is the approach of the United States and OECD model income tax treaties.

For a variety of reasons, including the potential revenue loss, developing countries generally are opposed to yielding jurisdiction to tax income at its source. With the exception of Canada and the Norway Protocol, this group of income tax treaties is with developing countries and the treaties, to various extents, include fewer limitations on source basis taxation than normally is the case in U.S. income tax treaties. It is generally believed that the United States cannot get treaties with developing countries without making these concessions. The developing countries position is set out in the United

Nations' model for tax treaties between developed and developing countries.

As described above, a significant advantage to a treaty relationship is the exchange of information the treaty provides for. Expanding the treaty network to developing countries gives the IRS access to tax information from developing countries and opens up the potential for joint audits with those countries.

C. Competent Authority

(1) Adjustments outside the scope of the treaty.--A number of the treaties (Argentina, Bangladesh, British Virgin Islands, Canada, Cyprus, Denmark, Jamaica and Malta) contain a provision which allows the competent authorities (the IRS and the foreign tax administrators) to consult together "... for the elimination of double taxation in cases not provided for in the Convention." Similar provisions are contained in the existing treaties with Hungary and Poland as well as the United States model treaty and the OECD model treaty. Assuming this is intended to permit the tax authorities to make adjustment of tax liabilities in cases of double taxation that are not specifically covered by the treaty, an issue arises as to whether this is an appropriate delegation of legislative power to the IRS. Another question is the scope of this provision. Presumably, this authority cannot be exercised to effect items of substance outside the scope of the treaty and is limited to resolving noncontroversial items which are within the general scope of the treaty but which are not adequately dealt with by the treaty in some technical respect. This interpretation, however, is not clear from the provision which is broad on its face.

(2) Adjustment of currency amounts without Congressional approval.-- A number of the pending treaties would give the competent authorities the right to increase amounts specified in currency. The effect is to permit the competent authorities to increase the amounts individuals must earn before they will be subject to tax in the country where services are performed. The treaties do not contain standards for determining when the amounts should be increased, although most do say that economic developments should be taken into account. This is also the first explicit Congressional delegation to the competent authorities (in the case of the United States, in effect, the Assistant IRS Commissioner for Compliance, or his delegate) of the right to set taxing jurisdiction. There is no comparable delegation in the Code. Thus, issues to be considered are whether it is appropriate to delegate this authority to the IRS, and, if so, whether any standards should be articulated by the Senate to provide guidance to the IRS in the exercise of that authority (e.g., any increases in amounts specified in currency in the treaties should be modified only to reflect the impact of inflation).

D. Congressional Oversight of Competent Authority Cases

All of the treaties contain a provision that limits access to information received by the United States and the treaty partner under the treaty to persons involved in the assessment or collection of taxes. This provision has been interpreted by the IRS as precluding Congressional access, specifically General Accounting Office access, to mutual agreement case files. Accordingly, the Congressional Oversight Committees, and the GAO at their request, have been hampered in their recent attempts to audit the IRS administration of mutual agreement cases. Treasury has indicated that this problem will be taken care of in future treaties, and that they are attempting to work out the problem for existing treaties. Most of the instant treaties, however, do not contain specific new language that permits Congressional access. The Canadian treaty does contain language which we understand permits continued access to information obtained from Canada. The issue is the extent to which Congressional oversight should be permitted and, if so, whether some change in the treaty language is necessary to accomplish that objective.

E. Nondiscrimination

Most of the treaties contain a comprehensive nondiscrimination provision providing that neither country can discriminate by imposing more burdensome taxes on nationals of the other country than it imposes on its own nationals in the same circumstances. The scope and the meaning of the nondiscrimination provisions are not clear in several respects. As a consequence, it is not clear what, if any, provisions of U.S. law are (or are intended to be) overriden by this provision.

(1) Foreign investors in U.S. real estate.--One area of particular concern is whether the nondiscrimination provision overrides the recently enacted legislation which is intended to subject foreign persons to capital gains tax when they sell United States real property. An argument could be made that the basic structure of that legislation technically violated the nondiscrimination provisions of certain existing U.S. tax treaties. In order to prevent foreign investors from taking the position that this arguable technical conflict relieved them from tax liability under the legislation, the legislation specifically overrode the existing treaties on this point to the extent, if any, that a conflict existed and provided an exclusive remedy under the statute. While this statutory relief provision resolves the possible conflict with respect to existing treaties, the problem can arise with the pending treaties since they will be ratified after the legislation was enacted and thus, to the extent of any conflict,

will supercede it. An issue, therefore, arises as to whether it should be made clear that the nondiscrimination provisions of the pending treaties do not conflict with the real estate legislation. We understand that Treasury takes the position that these treaties do not conflict with the legislation.

(2) Exclusion for U.S.-source dividends.--An issue has also been raised as to whether the nondiscrimination rules give a foreign corporation the dividends received exclusion given to U.S. companies. An argument has been made that a foreign corporation is entitled to the Code dividends received exclusion under the nondiscrimination provision where stock of the domestic corporation paying the dividend is owned by a U.S. permanent establishment of the foreign corporation. Under the Code, a U.S. corporation can exclude dividends received from a wholly owned subsidiary. The taxpayer's argument is that the non-discrimination provision requires that it not be taxed in a more burdensome manner than U.S. companies in the same circumstances. Not permitting them the full exclusion subjects them to more burdensome tax, they argue. If the taxpayers were to prevail, a significant and apparently unintended benefit would accrue to foreign corporations resident in treaty countries.

F. Relationship between Treaties and the Code

Tax treaties, in implementing their objectives, necessarily modify the tax rules and policies established by Congress in the Code. As a result, there are two overlapping systems governing the U.S. taxation of international transactions, creating a variety of problems which have been increasing in recent years for several reasons. This is in part attributable to expansion of the treaty network. Another contributing factor is that treaties have become more detailed and complex. Also, the displacement of the Code rules and policies established through the tax legislative process by those established through the treaty process has been a cause of some concern. However, the Code does contemplate that its rules may be adjusted by treaty. See Code section 894.

Consideration should be given to revisions of both the treaty process and the Code rules governing its relationship with the treaties to improve the coordination between the two systems. This might also extend to greater involvement of the Congress in the process of formulating U.S. tax treaty policy and other changes which might be expected to remove certain hurdles to Congressional approval of the treaties which have existed in recent years and generally expedite the process.

II. Specific Issues

A. Argentina

(1) Territorial system.--This treaty raises several unique issues because Argentina is one of the very few countries that has a strict territorial tax system; that is, it does not tax any foreign source income. This would be our first treaty with a country having a total territorial tax system. The first issue is whether it is appropriate to forego U.S. tax when, because of the general tax system of the treaty partner, the result will be the total elimination of any tax paid by the foreign investor on that U.S. source income. In the case of this treaty total elimination can occur in only a few cases not including investment income.

As outlined in the introduction, one way in which treaties attempt to avoid having one item of income be taxed by both the source country and the residence country is to have the source country cede jurisdiction to tax the income to the residence country. This rationale breaks down where the residence country exempts the income. In our treaties with countries having remittance basis taxation of certain types of income (the country does not tax certain types of income earned abroad by its taxpayers until and unless it is repatriated), the United States has generally insisted on a provision denying U.S. rate reductions and exemptions for income which is not remitted to, and thus subject to tax by, the treaty partner. At issue is whether a similar limitation is appropriate here.

(2) Lack of anti-treaty shopping provision.--If a treaty is appropriate, should it contain an anti-treaty shopping provision? Many recent U.S. treaties contain a provision that limits the use of the treaty to corporations controlled by persons who are residents of the treaty partner. These provisions are intended to prevent third country residents from establishing a company in a treaty partner in order to take advantage of reduced withholding rates (i.e., "treaty-shopping"). While withholding rates on interest and royalties are not reduced under this treaty, and while the withholding rate on dividends is relatively high, Argentina's territorial system raises the potential for other abuses. For example, a third country resident could establish an Argentine company to conduct certain types of activities in the United States. If those activities do not give rise to a U.S. permanent establishment, the treaty would exempt the income from the otherwise applicable U.S. tax. The income would also avoid Argentine taxes because Argentina does not tax foreign source income.

(3) Source basis taxation.--The limitations on source basis taxation in the proposed treaty are much weaker than in other U.S. treaties. The proposed treaty does not limit source basis

taxation on interest and royalties, and the limitation on dividend withholding taxes is fairly high (generally 20 percent). In addition, under this treaty, royalties include film rentals with the result that Argentina can continue to tax film rentals at 22.5 percent of the gross payment to the U.S. company. To some degree, this reflects Argentina's territorial tax system which relies solely on source basis taxation for revenue. Nevertheless, it could be viewed as precedent by developing countries many of whom, in practice, also rely solely on source basis taxation.

In the view of some, the United States will not be able to get treaties with many developing countries, particularly those in South America, unless we agree to extensive taxation at source. Others have argued that if Congress sends a clear signal that they will not approve treaties without relatively substantial limitations on source basis taxation, then some of these countries will enter into treaties closer to the U.S. position.

B. Bangladesh

The proposed treaty exempts international airline income from tax. It does not, however, exempt shipping income. The U.S. model, and most U.S. treaties, contain a source exemption for both aircraft and shipping. The issue is whether the United States wants to establish the precedent of a treaty without a shipping exemption. The treaty also provides developing country type concessions in that less substantial restrictions are imposed on source basis taxation than are typically provided for in U.S. tax treaties.

As is the case with Malta, the proposed treaty also raises the issue of the expansion of our treaty network to jurisdictions with which the United States has only minimal economic contacts.

C. British Virgin Islands

The British Virgin Islands (BVI) is a tax haven. It has a relatively low level of internal taxes and special holding company legislation. The United States currently has a treaty with the BVI which is the result of the extension of the 1945 United States--United Kingdom income tax treaty to former British colonies. Under the existing treaty, U.S. source royalties can be paid to BVI investors free of U.S. tax and dividends at reduced rates of tax. By special arrangements, interest can also be paid out free of tax.

The proposed treaty operates to permit foreigners resident in any country to invest in the U.S. and pay a 15 percent rather than the 30 percent of gross statutory rate of tax on that investment. Little, if any, investment affected by the treaty will originate in or will be destined for the British Virgin Islands. Instead, the principal use of the treaty will be for third country residents (or even U.S. taxpayers) to establish BVI holding companies through which they will route their investment into the United States, claiming the reductions in U.S. tax provided for in the treaty for BVI companies rather than paying the U.S. statutory rates. The effect in this case is similar to an amendment to the Code reducing the tax rate on investment income to foreigners to 15 percent from 30 percent. While the appropriate rate of U.S. tax on investment income is open to debate, the issue is whether the United States should enter into a treaty that is intended to be used principally by non-BVI investors to lower their U.S. tax on U.S. source income.

As with Cyprus, the treaty also raises the issue whether the standard exchange of information provision contained in the treaty is sufficient to ensure the U.S. tax administrators that they will be able to obtain information to enforce the tax laws.

It is for these reasons that the Administration requested this treaty not be considered at this time.

D. Canada

The proposed treaty would replace the existing tax treaty with Canada which was initially entered into in 1942 and has been modified by protocols several times. Since Canada is our principal foreign trading partner, the proposed treaty is obviously important.

(1) Nondiscrimination.--Canada's tax system evidently contains certain provisions that discriminate against foreign investors as opposed to Canadian investors. For example, it is understood that Canadian corporations receive a surtax exemption if they are owned by Canadians but not if they are owned by foreign persons.

The United States generally insists that its tax treaties contain a broad nondiscrimination provision that would prohibit the treaty partner from discriminating against U.S. investors. At the insistence of Canada, the nondiscrimination provision in the proposed treaty is not as comprehensive as that sought by the United States or as that contained in the U.S. or the OECD model treaties or the U.N. guidelines. On the other hand, the nondiscrimination provision in the proposed treaty is much broader than that contained in the present treaty with Canada which only applies to individual U.S. citizens resident in Canada. We understand that the provision is the broadest agreed to by Canada in any of its treaties.

This raises the issue of whether the United States should enter into a treaty that countenances the right of a developed country to discriminate against U.S. investors in circumstances not generally permitted in tax treaties. At the present, staff does not have sufficient information to identify and evaluate the provisions of Canadian tax law which may be viewed as discriminating against U.S. investors but which would be permitted under the proposed treaty language.

(2) Mineral royalties.--The present treaty contains an overall 15-percent limit on the rate of tax that either country can impose on investment income paid to residents of the other country. The proposed treaty removes this overall limitation but replaces it with limitations on the level of source basis taxation of various types of investment income. There is, however, no limitation on taxation of mineral rents and royalties. Accordingly, the Canadian tax on mineral royalties will be increased to the 25 percent of gross Canadian staturory rate. The U.S. rate will increase to the statutory 30 percent rate. The U.S. and OECD models do not contain a limitation on the taxation of mineral royalties.

(3) Real property.--The proposed treaty contains special rules for Canadian residents investing in U.S. real property that would override U.S. real estate legislation. (The proposed treaty was negotiated before the real estate legislation was enacted.) Among the more important of these changes is that it gives Canadian investors a step-up in the basis of their U.S. real property (for purposes of computing the U.S. tax on sale of the property) to the effective date of the new treaty. Others include various limitations on the situations where the United States can tax Canadians on their sales, their interest in U.S. corporations, and other entities whose assets include U.S. real estate. Also included is a provision which prevents either country from taxing gains on the sale of real property holding companies by residents of the other unless the other country would tax foreign investors in its real property holding companies in comparable circumstances. The purpose of this last limitation is not clear. Some may argue that Canadian investors should not be allowed such preferential treatment on their U.S. real estate investments. Conversely, others may argue that the limitations on taxing real estate related gains should be expanded to protect U.S. investors in Canada from Canadian tax.

The present treaty exempts gain from tax at source. Accordingly, it can be argued that the step-up in basis is a reasonable transition rule.

(4) Exempt organizations.--Unlike other U.S. tax treaties, the proposed treaty would exempt charitable organizations of either country from tax imposed by the other. In addition, Canadian private foundations which receive substantially all their support from non-U.S. persons would be exempt from the 4-percent U.S. excise tax on income of private foundations. An exemption is also provided for pension funds but the exemption is limited to interest and dividends received from sources within the other country.

(5) Conventions.--The proposed treaty contains a provision that would permit U.S. persons to deduct expenses incurred in attending business conventions in Canada. At the time this provision was negotiated, deductions for conventions held in all foreign countries, including Canada, were subject to substantial restrictions pursuant to amendments to the Code made by the 1976 Act. However, the Code was amended in 1980 to permit deductions for conventions in Canada and Mexico on the same basis as those held in the United States and its possessions. Accordingly, the treaty provision would no longer have any impact on U.S. taxpayers attending Canadian conventions. Unless a contrary intention is expressed by the Senate, however, the inclusion of this provision in the treaty could be taken as precedent for other negotiations. (The Jamacan protocol, discussed below, also contains a convention provision.) It should be noted that Canada also has statutory provisions denying Canadian taxpayers deductions for attending foreign business conventions, so the principal impact of the provision is to allow Canadians deductions for Canadian tax purposes for attending business conventions in the United States.

(6) Foreign tax credit.--The U.S. foreign tax credit provided for by the treaty is to be applied on a per-country basis: that is, Canadian taxes will only be permitted to offset U.S. tax imposed on Canadian income. Also, the source rules will be applied on a per-country basis. This contrasts with the Code limitation which is computed on an overall, worldwide basis. The interaction between the treaty limitation and the limitations provided by the Internal Revenue Code is complex, and a number of questions arise as to exactly how the two overlapping systems are to be applied. However, the treaty rules are used only if the taxes are not creditable under the Code.

Another issue is which Canadian taxes are creditable for U.S. purposes. Treasury's technical explanation says that the Canadian general corporate tax will continue to be creditable even if Canada imposes a flat rate tax on natural resource income that is not deductible in computing the general corporate tax. The technical explanation refers to a possible 8-percent tax, but it is now possible that the tax will be significantly higher. This issue is relevant only to persons realizing income from natural resources.

E. Cyprus

The proposed treaty presents potential problems because Cyprus is a tax haven. Cypriot corporations controlled by foreign investors are exempt from tax on their foreign income. The treaty contains anti-abuse provisions intended to prevent its use in those situations where the Cypriot tax haven rules apply. These provisions go further than similar provisions in any existing treaty and would appear to eliminate many, but not all, possible abuses. However, as a practical matter, the IRS must depend on the Cypriot tax administration for information to enforce the anti-abuse provisions. Cyprus is actively promoting itself as a tax haven, and the treaty raises the issue whether the United States should enter into a treaty with an aggressive tax haven. Cyrpus' status as a tax haven also raises the issue whether the standard exchange of information provision contained in the treaty is sufficient to insure the United States that is will be able to get information to enforce its tax laws.

It is for these reasons that the Administration requested that this treaty not be considered at this time.

F. Jamaica

(1) Developing country concessions.--Jamaica is a less-developed country, and this treaty departs from the U.S. and OECD models in that it allows significantly more source basis taxation. These departures could become precedent for negotiations with other developing countries. The relevant provisions include (i) relatively high limitations on withholding taxes in investment income, (ii) the expansion of the cases in which a business of one country will be considered to have a permanent establishment in the host country (and thus taxable on its business profits in the host country), and (iii) lower dollar limits for determining when income earned by a resident of one of the countries from the performance of personal services in the other country can be taxed by the host country.

(2) Foreign conventions.--Under provisions (Code sec. 274(h)) adopted in 1976 and modified in 1980, U.S. taxpayers are generally not allowed deductions for attending business conventions outside the United

States, its possessions, Canada, and Mexico unless it is as reasonable to hold the convention outside that North American area as within it. The recently negotiated protocol to the pending treaty would expand the North American area exception to the U.S. foreign convention expense rules and would thus permit Americans to deduct expenses of attending a convention in Jamaica. This granting of a deduction otherwise denied represents an expansion of the general scope of treaties which usually seek only to minimize double taxation and could serve as a precedent for similar provisions in other treaties. The Jamaican protocol does contain a quid pro quo in the form of a strong anti-treaty shopping provision and a commitment from Jamaica to negotiate a mutual assistance treaty.

(3) Anti-treaty shopping provisions.--The proposed protocol to the proposed treaty contains the broadest anti-treaty shopping provision found in any U.S. income tax treaty. In effect, Jamaican companies owned by persons who are not residents of Jamaica will not be entitled to treaty benefits unless they can establish that the company was not established to take advantage of the treaty.

G. Egypt

Egypt grants a tax exemption to certain businesses that make investments in Egypt. The exemption is generally applicable if the Egyptian corporation is controlled by a foreign corporation. The tax exemption is not applicable if the Egyptian corporation is controlled by foreign individuals who are residents of a country which will tax the income when the shareholders receive it as dividends. The United States does tax the dividends and therefore it would appear that Egyptian companies owned by individuals who are U.S. residents will be discriminated against when compared to residents of other countries. This is a relatively minor issue as few individuals own Egyptian companies.

H. Israel

(1) Forced loans-- The proposed treaty would require the United States to treat as income taxes certain loans which a U.S. business operating in Israel is required to make the Israeli government. Thus, the U.S. business would be allowed a foreign tax credit for the amount of the loan. However, a repayment of the loan will be treated as a refund of Israeli tax to the U.S. business, and thus the taxpayer's creditable foreign taxes would be reduced in the year of repayment. As a practical matter, this amounts to a loan from the U.S. government to Israel, with the taxpayer as the middleman. This treatment is accorded only to corporations which become subject to the loans requirements before April 1, 1977, but only if levied for taxable years ending before April 1, 1988. We understand that the Israeli government no longer requires loans. A similar, but more expansive provision is contained in the proposed treaty with Morocco.

(2) Dividends.--The dividend rates are not reciprocal in certain tax holiday cases. Dividends on a direct investment in an Israeli corporation subject to a tax holiday are taxed at a 15-percent rate while dividends on a direct investment in

either a U.S. corporation or an Israeli corporation not subject to a tax holiday would be taxed at a 12.5-percent rate. Dividends from portfolio investment are taxed at a 25-percent rate.

(3) Interest.--The treaty permits a 17.5-percent rate of tax at source on payments to persons other than banks, insurance companies, or governmental units. The rate for payments to financial institutions, which generally have the greatest problems, is 10 percent. The 17.5-percent rate is the highest agreed to by the United States in any treaty and might establish a precedent for negotiations with other countries. We understand that Treasury would not have agreed to such a high rate without the lower rate for interest paid to financial institutions.

(4) Charitable contributions.-- On a reciprocal basis, the protocol to the treaty would permit a U.S. person to treat as a charitable contribution a contribution to an Israeli charitable organization. In the case of an individual, the amount treated as a contribution (which is subjected to U.S. Code limits) cannot exceed 25 percent of adjusted gross income from Israeli sources (25 percent of taxable income for a corporation). A similar provision is contained in the existing Canadian treaty and the pending revision of that treaty.

(5) Exchange of information.--An exchange of notes makes clear that due to resource and technical problems Israel cannot, at this time, provide routine information as to U.S. recipients of dividends, interest, and royalties from Israel. They have agreed to provide the United States with this information as soon as possible. This type of information is normally received from treaty partners, and is supplied to them by the IRS. The failure to receive this information would make it more difficult for the IRS to detect such amounts that may not be reported. We are, of course, better off in this regard with a treaty than without one. Also, information on specific cases will be supplied by Israel.

I. Malta

The proposed treaty presents no significant special issues other than the question of the expansion of the tax treaty network to jurisdictions with which the United States has only minimal economic contacts.

J. Morocco

The proposed treaty contains a provision that is similar to the provision contained in the Israeli treaty and would require the United States to allow a foreign tax credit for loans which U.S. businesses operating in Morocco are required to make to the Moroccan government. Like the Israeli provision, this forced loan rule can be viewed as a loan from the U.S. government to Morocco, with the taxpayer as the intermediary. While similar to the provisions contained in the proposed treaty with Israel, it will have a more significant impact here because the forced loans are still required by Morocco.

K. Philippines

Air transport income.--The committee held hearings on this treaty during the 95th Congress but did not act on it because of the opposition of the airline industry (apparently the primary complaining airline was Pan American). This opposition arises because it would be the first U.S. income tax treaty that does not contain a reciprocal exemption for air transport income. In the past, the Philippines have refused to negotiate a complete exemption. The airlines now appear willing to accept a compromise that would most likely include treating airline income like shipping income so that it would be taxed at 60 percent of the normally applicable rate, and making it clear that certain activities will not result in the Philippines taxing income as if earned by an office there. The airline industry is not completely satisfied, but they have indicated that they would not oppose a treaty containing these provisions. The industry will, however, continue to oppose the treaty until the provision is added.

U.S. real estate.--The proposed treaty prevents the U.S. from taxing the gain of a Philippine resident from the sale or other disposition of an interest in a U.S. entity that owned United States real estate. This provision overrides the 1980 foreign investment in U.S. real property legislation. Arguably, it would be appropriate to reserve on this provision which was negotiated long before the real estate legislation was enacted.

L. Norway

(1) Submarine Petroleum Resource Tax.--The treaty would provide that a special tax levied by Norway on income from offshore petroleum resources is creditable for U.S. tax purposes. The amounts are creditable, however, only against U.S. taxes imposed on petroleum income from Norwegian sources. A limited carryback and carryforward of taxes not used in the current year is also provided for. A similar provision is contained in the third Protocol to the U.S.-United Kingdom treaty. There was a threatened reservation on the provision in that treaty making the U.S. Petroleum Revenue Tax creditable. In response, a per-country limitation was inserted in the treaty. It can be argued that the Norwegian offshore tax is not creditable under U.S. law, at least under the Treasury's proposed foreign tax credit regulations.

The issue is the extent to which treaties should be used to provide a credit for taxes that may not otherwise be creditable and in cases where the treaty does provide creditability, to what extent treaties should impose limitations not contained in the Code. Also at issue is whether the highly controversial area of U.S. policy on the tax credits it allows its oil companies on their foreign extraction operations should be established through the treaty process rather than the regular legislative process.

(2) Offshore activities.--Norway would have the right to tax income from offshore mineral-related activities after the activities have taken place for more than 30 days in any 12-month period. Wages relating to exploration or exploitation of offshore resources would be taxable, but only after 60 days of personal services in any one taxable year. The United States has reciprocal rights to tax, but as a practical matter there is little, if any, Norwegian exploration in the United States. The periods which must elapse before a country may tax this type of income are relatively short, although the same as provided for in the U.K. treaty. Also, without the treaty Norway would tax the income from the first day the activities begin. The issue raised is whether the United States should give up the primary right to tax service income after only a relatively short period of time.

(3) Withholding rates.--The proposed protocol would increase the maximum rate of withholding tax on direct investment dividends from 10 to 15 percent. Under the present treaty the rate is 10 percent on direct investment dividends and 15 percent on all others. Also, the present complete exemption from tax at source for interest would be replaced with a provision permitting a 10 percent withholding tax. However, interest on bank loans, commercial credit, certain government obligations, and debt outstanding at the signing of the proposed protocol would be exempt. Also, interest will continue to be exempt at source unless the other country imposes a tax on interest paid to nonresidents. As Norway does not now impose such a tax all interest would remain exempt from tax. These new rate limitations are higher than those generally provided for in the U.S. model treaty.