[COMMITTEE PRINT]

ISSUES RELATING TO PROPOSED INCOME TAX TREATIES

WITH THE

UNITED KINGDOM, THE PHILIPPINES, AND KOREA

PREPARED FOR THE USE OF THE

COMMITTEE ON FOREIGN RELATIONS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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I. UNITED KINGDOM INCOME TAX TREATY

The proposed tax treaty was signed on December 31, 1975, and was amended by a subsequent Exchange of Notes and two Protocols. The proposed treaty, as amended by the Exchange of Notes and the first Protocol, has been approved by the United Kingdom House of Commons. The second Protocol has not been ratified.

The proposed treaty is intended to replace the existing tax treaty between the two countries. It is substantially similar to other recent United States income tax treaties and to the model tax treaty of the Organization for Economic Cooperation and Development (OECD). The most significant and controversial departures from standard treaty provisions are summarized below.

A. Limitations on State Taxation

The proposed treaty contains a new provision (*Article 9(4). Associated enterprises*) not found in other tax treaties, which places limitations on the combined reporting method used by certain States of the United States to determine the taxable income which corporations derive from sources within the State. Under this apportionment method, there is taken into account on a consolidated basis the operations of all related corporations, both domestic and foreign. The proposed treaty provides generally that in determining the tax liability of a British corporation doing business within a State, or of any U.S. or foreign corporation doing business within a State which is controlled by a British corporation, the State may not use the combined reporting method to take into account the operations of any related foreign enterprise which is not doing business within the State.

The principal arguments presented to the committee in favor of this provision are:

(1) The combined reporting method used by these States creates problems in our international relations because foreign governments and companies view the method as subjecting foreign corporations to State tax on business profits which are not properly attributable to operations in these States.

(2) The internationally accepted norm for allocating income among related corporations is the arm's-length method which is used by the Federal Government. The use by the States of a different method often results in double taxation of the same income.

(3) The combined reporting method used by the States can misallocate income where the various corporations in the combined group operate in countries where the profit levels are considerably higher relative to payroll and property values than is generally the case in the United States.

(4) The combined reporting method creates serious reporting burdens because a separate allocation of income is required for State tax purposes from the allocation required for Federal and foreign tax purposes. This separate allocation requires the companies to collect

and submit substantial financial and operating data for all affiliates worldwide which would not otherwise need to be collected. Moreover, this administrative burden is substantially increased because the records and information must be translated from foreign languages, currencies, and accounting systems.

(5) Even assuming the combined reporting method is theoretically acceptable where the business operations of the various corporations in a combined group are closely interrelated, in practice serious distortions of income occur because the States apply the method too broadly, sometimes in situations where the operations of the foreign affiliates have no significant connection with the State.

(6) The provision was a U.S. concession required to obtain beneficial provisions in the treaty, such as the refund of U.K. Advance Corporation Tax (Act) for U.S. direct investors. Thus, a reservation on the limitation on combined reporting might jeopardize U.S. final ratification of the entire treaty.

The principal arguments presented in opposition to this provision are:

(1) It is an unprecedented interference by the Federal Government (through legislation or treaty) with the traditional taxing powers of the States and was negotiated without prior consultation with the States.

(2) It will have a substantial impact on those States using the combined reporting method, causing a significant revenue loss (particularly if extended in future treaties to other countries).

(3) It is not at all clear that the unitary method is a less accurate method of allocating income among affiliated corporations than the arm's-length method.

(4) The treaty provision results in discrimination against U.S. multinationals and multinationals from third countries that compete with British multinationals in those States because their State tax liabilities will continue to be determined under the combined reporting method.

(5) States may be "whipsawed" because British multinationals may be able to compute their State tax liability under the combined reporting method where it is more favorable than the arm's-length method but will be able to insist on the arm's-length method under the treaty when the combined reporting method is less favorable. (The States may be able to solve this problem by denying the use of the combined reporting method to companies entitled to treaty protection, provided such legislation would not violate State constitutional provisions relating to nondiscrimination.)

(6) Because the provision is drafted in general terms, interpretative questions are likely to arise in the determination of the State tax liability of British multinationals. However, the procedures for resolving such disputes do not provide for any formal involvement of the State governments whose tax laws and revenues are at stake.

(7) Even assuming that it may be appropriate for the Federal Government to place some limitations on the States' use of the combined reporting method, it would be preferable to impose any such limitations by legislation rather than by treaty. Serious issues of Federalism and tax policy are involved, and the legislative process would give both Houses of Congress and the tax-writing committees

an opportunity to consider the matter. The legislative process would permit the affected parties, the States, to participate in the formulation of limitations. In addition, legislation would permit uniform rules to be applied to all taxpayers, U.S. and foreign.

B. Dividends and the ACT

The proposed treaty contains a new and complex set of provisions (*Articles 10 and 23*) with respect to the taxation of dividends. Under the new British tax system, a tax is imposed upon U.K. corporations with respect to dividend payments (the ACT), and it is refunded to U.K. shareholders. No refunds are paid to nonresident aliens, however, in the absence of an income tax treaty.

Under the proposed treaty, the U.K. is to provide full refunds of the ACT to U.S. portfolio investors in British corporations, but the ACT refunds and dividend payments are to be subject to a 15-percent withholding tax. In the case of U.S. corporate direct investors, the proposed treaty provides for a refund of one-half of the ACT, but also for a 5-percent withholding tax on the dividend and the refund.

The proposed treaty also provides rules governing the treatment of the ACT for U.S. foreign tax credit purposes and provides for the allowance of an indirect foreign tax credit for ACT which is not refunded.

The United States agrees to reduce its withholding tax to 15 percent on dividends to United Kingdom portfolio investors and to 5 percent on dividends to United Kingdom direct investors.

The following factors are relevant to the consideration of the treatment of dividends:

(1) The discrimination of the British integration system against U.S. shareholders is eliminated (in the case of portfolio shareholders) or substantially reduced (in the case of direct investors). This is the first U.S. tax treaty which provides for refunds to foreign direct investors.

(2) The treaty will be an important precedent in U.S. treaty negotiations with other foreign countries (e.g., France, Germany, Denmark, and Canada) which in part integrate corporate and shareholder taxation. On the other hand, if the U.S. adopts an integration system, other countries will be able to use it as a precedent for the U.S. refunds to foreign shareholders of some or all of the U.S. tax paid by U.S. corporations.

(3) U.S. shareholders of U.K. corporations will receive substantial refunds of British taxes (approximately $90 million a year). The ACT refunds of U.K. tax paid to U.S. shareholders in British corporations will not significantly increase U.S. tax revenues because of the special rules contained in the treaty and Treasury's technical explanation which govern the treatment of the ACT for U.S. tax credit purposes. While these technical rules may be appropriate in the context of this particular treaty, the application of those rules to other situations raise complex and difficult issues which require careful examination. Consequently, the committee may want to indicate that these rules should not necessarily be considered a precedent for future treaties.

(4) If the ACT would not be treated as a creditable tax for U.S. foreign tax credit purposes in the absence of the treaty (it is not clear

how it would be treated), the treatment of it as a creditable tax results in a substantial U.S. revenue loss. In addition, the treaty reduction in the statutory U.S. withholding tax rates on dividends paid to British shareholders in U.S. corporations results in a U.S. revenue loss of roughly $70 million a year.

C. Petroleum Revenue Tax

The proposed treaty provides (Article 23) that the U.K. Petroleum Revenue Tax (the PRT) is to be treated as a creditable income tax for U.S. foreign tax credit purposes. The PRT is imposed at a 45-percent rate on assessable profits from oil and gas extraction activities in the United Kingdom (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 separate royalty.

The IRS has indicated that in the absence of a treaty provision it would not view the PRT as a creditable tax for U.S. foreign tax credit purposes.

It can be argued that the determinations of whether a foreign income tax is creditable should be solely a matter of tax policy and thus should only be determined by the Internal Revenue Service through its normal administrative processes. In this particular case, however, it can also be argued that the economic substance of the tax is closely comparable to U.S. notions of what constitutes an income tax and that the treaty can thus be viewed as merely overcoming technical deficiencies in the structure of the U.K. tax.

D. Public Entertainers and Athletes

The proposed treaty contains a separate set of rules, not contained in the existing treaty, which govern the taxation of income earned by public entertainers and athletes (*Article 17*). These rules provide that public entertainers and athletes who are residents of either the U.S. or the U.K. and whose gross receipts from performing in the other country exceed $15,000 for the year may be taxed on that income by the country where the services are performed. These rules insure that highly paid entertainers and athletes will be taxable in the country where they perform regardless of the length of their stay in that country.

The arguments presented to the committee against the provision are:

(1) The provision discriminates against entertainers and athletes. Personal service income earned by other individuals is generally taxable only by the country of their residence (Articles 14 and 15) as long as they are present in the other country for no more than 183 days during the year. In contrast, income earned by entertainers and athletes will be taxed by the source country without regard to the amount of time spent there during the year if the $15,000 limit is exceeded.

(2) The discriminatory treatment of entertainers and athletes will serve as a precedent for similar treatment in other U.S. tax treaties. This is particularly true since it is the current U.S. treaty negotiating position to apply this special treatment to entertainers and athletes.

The arguments in favor of the provision are:

(1) Separate rules for entertainers and athletes recognize that their situation is somewhat different than most individuals earning income

in a foreign country on a temporary basis. Entertainers and athletes often receive large amounts of income over a relatively short period of time, and in most cases there is no substantial problem in determining the amount of income attributable to their performances in a particular country.

(2) Because of the special circumstances, most tax treaties of other countries do not provide any exemption for services performed by public entertainers. Similarly, the OECD model tax treaty does not exempt income earned by public entertainers. Thus, the proposed treaty is more favorable to U.S. entertainers than the international standard.

(3) This is not the first U.S. tax treaty providing that the country of source may tax income of public entertainers which exceeds a dollar (rather than duration of stay) limit. Similar provisions are contained in the recent U.S. tax treaties with Belgium, Iceland, Japan, Romania, and Trinidad and Tobago.

(4) The British tax rates applicable to income earned by U.S. entertainers in the U.K. are generally lower than U.S. rates. Although British tax rates on British residents are high, U.S. entertainers are only subject to British tax on half their income earned in the U.K. (provided they do not work for a British company).

(5) U.S. entertainers will not be subject to double taxation on income earned in the U.K. because the foreign tax credit will reduce any U.S. tax on that income dollar-for-dollar.

E. Shipping Income

The treaty provides (under Article 8) that income of ships or aircraft in international traffic operated by residents of one country is to be exempt from tax in the other country. By itself, this provision does not represent a major departure from past treaties, although it does not require, as many prior U.S. tax treaties do, that a ship be registered in the country of the operator's residence to qualify for the treaty exemption.

International shipping generally pays no tax anywhere in the world. In recent years there has been significant interest in changing the U.S. tax laws, and the U.S. negotiating position in tax treaties, to tax shipping into and out of the United States at least in some cases. Those arguing for such a change (including a Task Force of the Ways and Means Committee) believe it can be a first step toward initiating international arrangements (through bilateral treaties and perhaps multilateral agreements) whereby all international shipping income would generally be taxed in some jurisdiction. Moreover, some advocates view these changes as an effort toward minimizing the competitive advantages of operators locating their shipping operations in countries which do not tax shipping income. It is likely that Congress will seriously consider statutory changes in this area when it takes up the Administration's tax reform proposals.

The United Kingdom has been regarded as one country which effectively exempts from tax the shipping income of its residents (including U.K. corporations owned by U.S. interests) even in cases where these ships are not engaged in the international commerce of the United Kingdom As a result, some U.S. companies (and other non-U.K. companies) have tended to establish U.K. corporations to conduct worldwide shipping operations. They thus avoid any tax liability in any country in the world. The treaty provision, in effect, validates this method of operation.

If the United States changes its policy toward international shipping, it can be argued that the exemption in the proposed treaty should be modified. Consequently, it may be appropriate to make it clear in the committee report that the treaty should not be viewed as a precedent for future U.S. treaty policy—particularly as that policy applies to countries which encourage the incorporation and registry of ships which neither operate in the international commerce of that country nor are owned ultimately by residents of that country.

F. Compensation of Government Employees

Questions have been raised as to the tax treatment of governmental employees provided under the proposed U.S.-U.K. Income Tax Treaty. The provision of the proposed treaty dealing with governmental employees follows the OECD model tax treaty. It provides that compensation (other than pensions) paid by the government of either country to an individual for services rendered in the other country is generally taxable only by the first country. There are, however, two exceptions to that general rule relating to situations in which the employee is a resident of the country where the services are performed. Such compensation is taxable in the country in which the services are being performed if the recipient is either (1) a resident national of that country, or (2) did not become a resident of that country solely for purposes of performing the services.

This second exception is not contained in the existing treaty with the United Kingdom. As a result, U.S. citizens employed by the U.S. Government in the United Kingdom, who are presently exempt from British taxes under the existing treaty, will be subject to British tax under the proposed treaty if they are residents of the U.K. and if they did not become British residents solely for purposes of performing the services (e.g., they were British residents before they began to work for the U.S. Government). These individuals will also be subject to U.S. tax on the income earned in the U.K. as U.S. Government employees (Article 1(3)), but the foreign tax credit allowed with respect to those British taxes will reduce their U.S. tax on that income on a dollar-for-dollar basis.

This revised treaty provision will not affect dependents and spouses of military personnel. They will remain exempt from British tax pursuant to the Status of Forces Agreement regardless of their reasons for becoming residents of the U.K.

II. PHILIPPINE INCOME TAX TREATY

There is presently no income tax treaty in force between the U.S. and the Philippines. The proposed treaty is similar to recent U.S. income tax treaties and to the model tax treaty of the Organization of Economic Cooperation and Development (OECD) in virtually all respects.

The two most significant and controversial departures from the standard treaty provisions are summarized below.

A. Shipping and Transport Income

The proposed treaty departs from prior U.S. treaties and does not provide for a reciprocal exemption of income from the operation of ships or aircraft in international traffic. Under the treaty, both countries may tax income from the operation of aircraft in international traffic in accordance with their own domestic laws. In the case of income from the operation of ships in international traffic, the tax imposed by either country is not to exceed 1.5 percent of the gross revenues derived from outgoing traffic originating in that country. U.S. residents operating ships or aircraft in international traffic may be subject to more burdensome taxation in the Philippines than Philippine corporations because this provision is specifically excepted from the nondiscrimination provisions (Article 24).

The U.S. airlines have taken the position that the treaty should be rejected in order to demonstrate clearly that the United States will not under any circumstances enter into a tax treaty that does not contain a reciprocal exemption for airlines. The airlines make the following points:

(1) This is the first U.S. tax treaty which does not provide for reciprocal exemptions for air transport income.

(2) The reciprocal exemption of airlines operating in international traffic is provided for in the OECD model tax treaty and is accepted international practice.

(3) Ratification of the proposed treaty will be considered as a precedent by those countries, particularly less-developed countries, which want tax treaties with the United States but also want to tax U.S. airlines.

(4) The proposed treaty, and in particular the nondiscrimination provisions, do not apply to air transport income. Thus, the Philippines can, and apparently does in fact, tax U.S. airline at a higher rate on income from Philippine sources than it taxes its own airlines.

Philippines Air Lines (PAL) is subject to a Philippine franchsise tax of 2 percent of worldwide gross revenues; U.S. airlines are subject to a 2 percent franchise tax on gross revenues from Philippine sources and, in addition, a 2.5 percent tax on gross billings in the Philippines.

(5) The actual tax rates imposed by the United States and the Philippines on airlines of the other country will not be reciprocal. U.S. airlines operating in the Philippines will be subject to aggregate

Philippine taxes equal to 4.5 percent of their gross revenues from Philippine sources. In contrast, the U.S. tax on Philippine Air Lines will be insignificant because there are few PAL flights to the United States and the U.S. will tax PAL only on income it earns within the U.S. 3-mile limit.

The following arguments are made in favor of the treaty:

(1) It is not unreasonable for a country to tax foreign airlines on income earned from sources within that country; the U.S. taxes the U.S. source income of foreign airlines from countries not providing a reciprocal exemption to U.S. airlines. Thus, while it has in the past been U.S. treaty policy to provide for reciprocal exemption of airlines, and will presumably continue to be U.S. policy in the future, it is not clear that the United States should treat reciprocal exemptions as an overriding issue if the other country, particularly a developing country such as the Philippines, insists on collecting at least some tax from foreign airlines operating in its commerce.

(2) The willingness of the United States to accept the Philippine treaty without a reciprocal exemption is not likely to serve as a precedent for other countries to insist in treaty negotiations with the United States on retaining the right to tax U.S. airlines. The OECD treaty provides for reciprocal exemption, and it is the treaty policy of most countries. Moreover, those countries which impose any significant tax on foreign airlines are not likely to eliminate their tax because of a refusal of the United States to enter into tax treaties which do not reciprocally exempt airlines.

(3) The treaty does not apply to air transport income at the specific request of the U.S. airlines. Treasury originally negotiated a reduction in the gross billings tax from 2.5 percent to 1.5 percent of revenues from outbound traffic, but it was deleted at the request of the U.S. airlines. This provision would have substantially reduced any discrimination against U.S. airlines. Treasury believes that it is still possible to enter into a protocol which would reinstate that originally negotiated 1.5 percent limit on the taxation of air transport income.

(4) The Philippine tax paid by U.S. airlines will not result in any actual increase in aggregate taxes they pay (U.S. and foreign) to the extent they are allowed as foreign tax credits.

B. Public Entertainers and Athletes

The proposed treaty provides that income derived by residents of one country from performing personal services as an employee in the other country is exempt from tax in that other country unless the individual remains there for 90 days or longer during the year (Article 16), or, in the case of services performed in an independent capacity (Article 15), if the gross remuneration exceeds $10,000 (or a higher amount agreed to by the tax authorities of the two countries.)

The proposed treaty contains a separate provision which exempts public entertainers and athletes (Article 17) performing services in the other country only where the income does not exceed the lesser of $100 per day or $3,000 per year.

The issues presented by the separate treatment provided entertainers and athletes are substantially the same as those presented by the special entertainers and athletes provision contained in the proposed U.K. treaty.

III. KOREAN INCOME TAX TREATY

There is presently no income tax treaty in force between the United States and Korea. The proposed treaty is substantially similar to other recent United States income tax treaties and to the model income tax treaty of the Organization for Economic Cooperation and Development (OECD).

The only significant departure from standard treaty provisions contained in the proposed treaty is a special exemption from U.S. social security taxes for Korean residents who are working on a temporary basis in Guam. A similar exemption is provided in the Internal Revenue Code for Philippine residents temporarily present in Guam. The provision was included to prevent the Philippine exemption from providing an advantage to Philippine residents in seeking temporary employment in Guam. The proposed treaty provides that Korean residents will be exempt from social security taxes only so long as the statutory exemption is in effect for Philippine residents.

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