[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY AND PROPOSED PROTOCOL BETWEEN THE UNITED STATES AND UKRAINE

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON MAY 25, 1995

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty, as modified by the proposed protocol, between the United States and Ukraine. The proposed treaty and the proposed protocol were signed in Washington, D.C., on March 4, 1994. Currently, the United States and Ukraine adhere to the provisions of a tax treaty signed June 20, 1973 between the Soviet Union and the United States (the "USSR treaty"). The proposed treaty would replace the USSR treaty with respect to Ukraine. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty and the proposed protocol on May 25, 1995.

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty (the "U.S. model"),[2] and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed treaty contains certain deviations from those models.

Part I of the pamphlet summarizes the principal provisions of the proposed treaty. Part II is a discussion of issues related to the proposed treaty. Part III provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. For a copy of the proposed treaty and protocol, see Senate Treaty Doc. 103–30, September 14, 1994. For a detailed, article-by-article explanation of the proposed treaty, see the "Treasury Department Technical Explanation of the Convention and Protocol Between the United States of America and Ukraine for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital Signed at Washington on March 4, 1994," May 1995 (hereinafter "Technical Explanation").

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty and Proposal Protocol Between the United States and Ukraine* (JCS-11-95), May 22, 1995.

[2] The U.S. model has been withdrawn from use as a model treaty by the Treasury Department. Accordingly, its provisions may no longer represent the preferred position of U.S. tax treaty negotiations. A new model has not yet been released by the Treasury Department. Pending the release of a new model, comparison of the provisions of the proposed treaty against the provisions of the former U.S. model should be considered in the context of the provisions of comparable recent U.S. treaties.

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and Ukraine are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation and facilitate trade and investment between the two countries. It is intended to enable the two countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard treaty provisions that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 14–17). The proposed treaty provides that dividends and royalties derived by a resident of either country from sources within the other country generally may be taxed by both countries (Article 10). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit (Article 24).

The treaty 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 (Article 1). In addition, the treaty contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries (Article 1); that is, the treaty will only be applied to the benefit of taxpayers.

Summary of treaty provisions

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model treaty. It also differs in significant respects from the USSR treaty. (That treaty predates the 1981 U.S. model treaty, and was not representative of U.S. treaty policy.) A summary of the provisions of the proposed treaty and the proposed protocol, including some of these differences follows:

(1) Like all treaties, the proposed treaty is limited by a "saving clause" (Article 1(3)), under which the treaty is not to affect (subject to specific exceptions) the taxation by either treaty country of its residents or its nationals. Exceptions to the saving clause are similar to those in the U.S. model and other U.S. treaties; the USSR treaty, in contrast, flatly states that it shall not restrict the right of a treaty country to tax its own citizens.

(2) The U.S. excise tax on insurance premiums paid to a foreign insurer is not a covered tax; that is, the proposed treaty would not preclude the imposition of the tax on insurance premiums paid to Ukrainian insurers (Article 2). This is a departure from the USSR treaty and the U.S. model tax treaty, but one that is shared by many U.S. treaties, including recent ones. In addition, the proposed treaty, like the model treaty but unlike the USSR treaty, does not contain a general prohibition on source country taxation of reinsurance premiums derived by a resident of the other country. Nor does the proposed treaty contain the provision of the USSR treaty under which, if the income of a resident of one country is tax-exempt in the other country, the transaction giving rise to that income is exempt from any tax that is or may otherwise be imposed on the transaction.

(3) Like the U.S. model but unlike the USSR treaty, the proposed treaty generally does not cover U.S. taxes other than income taxes, although it does cover taxes on property and excise taxes with respect to private foundations. Nor does the proposed treaty cover the accumulated earnings tax, the personal holding company tax, and social security taxes.

(4) The proposed treaty makes it clear that each country includes its territorial sea, and also the economic zone and continental shelf in which certain sovereign rights and jurisdiction may be exercised in accordance with international law (Article 3).

(5) By contrast with the USSR treaty, but like the U.S. model, U.S. citizens are entitled to treaty benefits regardless of actual residence in a third country. In addition, the proposed treaty introduces rules for determining when a person is a resident of either the United States or Ukraine, and hence entitled to benefits under the treaty (Article 4). The proposed treaty, like the model, provides tie-breaker rules for determining the residence for treaty purposes of "dual residents," or persons having residence status under the internal laws of each of the treaty countries.

(6) Article 5 of the proposed treaty introduces the permanent establishment threshold for one country's imposition of tax on the business profits of a resident of the other country, in conformity with the U.S. and OECD model treaties. This replaces the concept of a "representation" used in the USSR treaty.

(7) Under the U.S. model treaty, a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, constitutes a permanent establishment only if it lasts more than 12 months. The corresponding rule in the proposed treaty shortens that time period to six months. Under the USSR treaty, the source country is prohibited from taxing the income of a resident of the other country from furnishing engineering, architectural, designing, and other technical services in connection with an installation contract with a resident of the source country and which are carried out in a period not longer than 36 months at one location. Thus, the proposed treaty represents a move past the U.S. model, allowing source country taxation under some circumstances that the model would preclude.

(8) The proposed treaty, unlike the model treaties or other U.S. treaties, provides in Article 5(2)(g) that a store or other premises used as a sales outlet constitutes a permanent establishment.

(9) The USSR treaty in general imposes no restriction on the taxation of income from real property by the country in which the property is located. The proposed treaty contains a provision similar to the corresponding model treaty provision permitting taxation of such income by the country in which the real property is located, including the U.S. model treaty provision under which investors in real property in the country not of their residence must be permitted to elect to be taxed on those investments on a net basis. Unlike the U.S. model treaty and most U.S. treaties, but like the OECD model treaty and several recent U.S. treaties, Article 6 of the proposed treaty defines real property to include accessory property, as well as livestock and equipment used in agriculture and forestry.

(10) The business profits article (Article 7) of the proposed treaty overrides the force of attraction rules contained in the Code, providing instead that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. Paragraph 2 of the proposed protocol provides an expansive description of this rule. This is consistent with the U.S. model treaty.

(11) The proposed treaty clarifies that a country may tax profits or income if the other-country resident carries on "or has carried on" business, or has "or had" a fixed base, in that country. Addition of the words "or has carried on" and "or had" clarifies that, for purposes of the treaty rules stated above, any income attributable to a permanent establishment (or fixed base) during its existence is taxable in the country where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) has ceased to exist.

(12) The proposed treaty provides that expenses incurred for the purposes of the permanent establishment are to be allowed as deductions from the taxable income of a permanent establishment. However, the proposed treaty provides that no deductions may be taken in respect of amounts paid by the permanent establishment to the head office in the form of royalties, fees, or other payments, to the extent that they exceed reimbursements of costs incurred by the head office and allocable to the permanent establishment.

(13) The proposed treaty, similar to the model treaty and similar in some respects to the USSR treaty, provides that income of a resident of one treaty country from the operation of ships or aircraft in international traffic is taxable only in that country (Article 8). Similar to the model treaty, the proposed treaty includes bareboat leasing income in the category of income to which this rule applies. Similar to the model treaty and unlike the present treaty, the proposed treaty provides that income of a treaty-country resident from the use or rental of containers and related equipment used in international traffic shall be taxable only in that country.

(14) Article 9 of the proposed treaty corresponds to the associated enterprises article in the U.S. model treaty. In particular, the proposed treaty contains a "correlative adjustment" clause, providing that either treaty country must correlatively adjust any tax liability it previously imposed on a person for income reallocated to a related person by the other treaty country. The USSR treaty contains no associated enterprises article.

(15) The USSR treaty generally imposes no restriction on the source-country taxation of dividends. The proposed treaty, similar to the U.S. model treaty, provides in Article 10 that direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting shares of the payor) generally will be taxable by the source country at a rate no greater than 5 percent. Other dividends generally are taxable by the source country at a rate no greater than 15 percent.

(16) Like recent U.S. treaties, the proposed protocol provides that dividends paid by a U.S. regulated investment company (a "RIC") would be subject to source country taxation at the 15-percent limit (paragraph 3). In addition, like some recent U.S. treaties, the proposed treaty and proposed protocol impose no general restriction on the source country taxation of dividends paid by a U.S. real estate investment trust (a "REIT").

(17) The USSR treaty generally imposes no restriction on the U.S. branch profits tax. The proposed treaty, similar to U.S. treaties negotiated since 1986, expressly permits the United States to impose the branch profits tax, but at a rate not exceeding 5 percent (Article 10(5)).

(18) The USSR treaty limits the source-country taxation of interest only in the case of interest in connection with the financing of trade between the United States and the Soviet Union. The proposed treaty, like the U.S. model and numerous U.S. treaties, generally prohibits source country taxation on interest (Article 11). However, the proposed treaty provides that income from any arrangement, including a debt obligation, carrying the right to participate in profits and treated as a dividend by the source country according to its internal laws, may be taxed by the source country as a dividend. Thus, for example, the country of source could withhold tax on deductible interest paid under an "equity kicker" loan, at rates applicable to dividends. There is no similar provision in the U.S. or OECD models.

(19) The proposed protocol (paragraph 4) provides that the interest article in the proposed treaty does not interfere with the jurisdiction of the United States to tax under its internal law an excess inclusion with respect to a residual interest in a real estate mort-

gage investment conduit (a "REMIC"). Currently, internal U.S. law applies regardless of treaties that were in force when the REMIC provisions were enacted.

(20) Unlike the model treaties and the USSR treaty, the proposed treaty provides that royalties may be taxed by both treaty countries, rather than by the residence country only. Taxation of royalties by the source country is limited by the proposed treaty to a rate of 10 percent (Article 12). Royalties are defined as payments for the use of certain rights, property, or information. Unlike the model treaty, the proposed treaty does not treat as royalties gains from the alienation of rights or property which are contingent on the productivity, use, or further alienation of such right or property. The taxation of such gains is governed by the proposed treaty's "Gains" article, which, in a manner similar to the royalties article of the model treaties, generally reserves taxing jurisdiction to the residence country (Article 13).

(21) Both the U.S. model treaty and the proposed treaty provide for source-country taxation of capital gains from the disposition of property used in the business of a permanent establishment in the source country. Unlike most recent U.S. tax treaties, however, the proposed treaty does not specifically provide for source-country taxation of such gains where the payments are received after the permanent establishment has ceased to exist.

(22) Both the U.S. model treaty and the proposed treaty provide for source-country taxation of capital gains from the disposition of real property regardless of whether the taxpayer is engaged in a trade or business in the source country. The proposed treaty expands the U.S. model treaty definition of real property for these purposes to encompass U.S. real property interests. This safeguards U.S. tax under the Foreign Investment in Real Property Tax Act of 1980, which applies to dispositions of U.S. real property interests by nonresident aliens and foreign corporations.

(23) The proposed treaty exempts all other gains from source-country taxation (Article 13(4)). This includes gains from the alienation of ships, aircraft, or containers operated in international traffic.

(24) In a manner similar to the U.S. model treaty, Article 14 of the proposed treaty provides that income derived by a resident of one of the treaty countries from the performance of professional or other personal services in an independent capacity generally would not be taxable in the other treaty country unless the services are or were performed in that other country and the person has or had a fixed base there regularly available for the performance of his or her activities. In such a case, the other country would be permitted to tax the income from services performed in that country as are attributable to the fixed base.

(25) The dependent personal services article of the proposed treaty (Article 15) is similar to that article of the U.S. model. Under the proposed treaty, salaries, wages, and other similar remuneration derived by a resident of one treaty country in respect of employment exercised in the other country is taxable only in the residence country (i.e., is not taxable in the other country) if the recipient is present in the other country for a period or periods not ex-

ceeding in the aggregate 183 days in the taxable year concerned and certain other conditions are satisfied.

(26) Article 16 of the proposed treaty allows directors' fees and similar payments derived by a resident of one treaty country for services performed outside the residence country in his or her capacity as a member of the board of directors (or another similar organ) of a company which is a resident of the other country to be taxed in that other country. The U.S. model treaty, on the other hand, generally treats directors' fees under other applicable articles, such as those on personal service income. Under the U.S. model (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income and the source country tax on directors' fees is limited. By contrast, under the OECD model treaty the country where the company is resident has full taxing jurisdiction over directors' fees and other similar payments the company makes to residents of the other treaty country, regardless of where the services are performed. Thus, the proposed treaty represents a compromise between the U.S. model and the OECD model positions.

(27) Similar to the U.S. model treaty, Article 17 of the proposed treaty allows a source country to tax income derived by artistes and sportsmen from their activities as such, without regard to the existence of a fixed base or other contacts with the source country. The U.S. model treaty, however, allows such taxation by the source country only if that income exceeds $20,000 in a taxable year. U.S. income tax treaties generally follow the U.S. model rule, but often use a lower annual income threshold. Unlike the U.S. model treaty, but like the OECD model treaty, the proposed treaty allows entertainers and sportsmen to be taxed by the country of source, regardless of the amount of income that they earn from artistic or sporting endeavors.

The proposed treaty includes an exception from source country taxation of artistes and sportsmen resident in the other country if the visit to the source country is substantially supported by public funds from the country of residence. Neither the U.S. model nor the OECD model contains such an exception, although it is found in some recent U.S. tax treaties.

(28) The proposed treaty modifies the USSR treaty's rule, similar to the U.S. model rule, that compensation paid by a treaty country government to one of its citizens for services rendered to that government in the discharge of governmental functions may only be taxed by that government's country. Under Article 18 of the proposed treaty, as under the OECD model treaty and other U.S. treaties, such compensation generally may only be taxed by the recipient's country of residence, if the recipient is a citizen of that country, or (in the case of remuneration other than a pension) did not become a resident of that country solely for the purpose of rendering the services.

(29) The proposed treaty, like the U.S. model treaty and unlike the USSR treaty, expressly provides for the taxation of pensions in general only by the residence country, and for the taxation of social security benefits and other public pensions not arising from government service only in the source country (Article 19).

(30) Unlike the U.S. model treaty, the proposed treaty makes no special provision for the treatment of annuities, alimony, or child support payments. Taking into account the "Other Income" article, the result in the case of annuities and alimony is generally similar to that under the model; the result in the case of child support may not be.

(31) The USSR treaty, unlike the models, precludes each country from taxing a resident of the other country who is temporarily present in the first country as a journalist, media correspondent, teacher, or researcher; or who is temporarily present to participate in an exchange program for intergovernmental cooperation in science and technology, or to study or gain technical, professional, or commercial experience. These exemptions generally extend only to income or allowances connected with the purpose of the visit, and only for such period as is required to effectuate the purpose of the visit, and in no case more than 2 years in the case of teachers and researchers, 5 years in the case of students, and one year in other cases.

The proposed treaty contains a narrower set of limitations on host-country taxation of temporary visitors (Article 19) than does the USSR treaty. The limitations do not apply to visits for teaching or for journalism. They also do not provide an exemption for employment income. The proposed treaty prohibits the host country from taxing certain payments from abroad for the purpose of the individual's maintenance, education, study, research, or training. Temporary presence in the host country must be for the purpose of studying at an educational institution; training as required to practice a profession; or studying or doing research as a recipient of a grant from a governmental, religious, charitable, scientific, literary, or educational organization. In the last case, the proposed treaty prohibits the host country from taxing the grant. The exemptions apply no longer than the period of time ordinarily necessary to complete the study, training or research. Moreover, no exemption for training or research will extend for a period exceeding five years. The exemption from host country tax does not apply to income from research if the research is undertaken for private benefit.

(32) The proposed treaty, unlike the USSR treaty, contains a version of the standard "other income" article, found in the model treaties and more recent U.S. treaties, under which income not dealt with in another treaty article generally may be taxed only by the residence country (Article 21).

(33) The proposed treaty contains a limitation on benefits, or "anti-treaty shopping," article similar to the limitation on benefits articles contained in recent U.S. treaties and protocols and in the branch tax provisions of the Code (Article 22). The limitation on benefits article in the proposed treaty is virtually identical to the corresponding provisions of the recent U.S. income tax treaty with the Russian Federation.

(34) Unlike most U.S. treaties and the model treaties, the USSR treaty has no provision providing relief from double taxation. In the general case this absence may have little or no impact on a U.S. person, as the United States provides relief from double taxation by internal law, through the foreign tax credit. The proposed treaty

provides that each country shall allow its residents (and the United States its citizens) a credit for income taxes imposed by the other country (Article 24). However, such credits need only be in accordance with the provisions and subject to the limitations of internal law (as it may be amended from time to time without changing the general principle that credits must be allowed). In addition, unlike the U.S. model and other U.S. treaties, the proposed treaty does not include a specific provision for the operation of foreign tax credits in the case of a U.S. citizen resident in Ukraine.

(35) U.S. law allows taxpayers credit for foreign taxes only if the foreign taxes are directed at the taxpayer's *net* gain. Thus the sufficiency of deductions allowed under foreign law is relevant to the creditability of foreign tax against U.S. tax liability. At times, Soviet and Ukrainian law have in effect placed significant restrictions on labor and interest cost deductions. In order to assist U.S. taxpayers' ability to take U.S. credits for Ukrainian taxes, Ukraine confirms under the proposed protocol (paragraph 7) that its law permits certain Ukrainian entities deductions for interest (whether paid to a bank or another person and without regard to the term of the loan) and for actual wages and other remuneration for personal services, regardless of its internal law, if U.S. residents beneficially own at least 20 percent of the entity, and the entity has total corporate capital of at least $100,000. This confirmation also applies to Ukrainian permanent establishments of U.S. entities, and individual U.S. citizens and residents pursuing entrepreneurial activities in Ukraine. On the basis of these required deductions, the proposed protocol treats Ukraine's taxes as income taxes that are eligible for the U.S. foreign tax credit.

(36) The proposed treaty does not provide for "tax sparing" or other fictitious credits for taxes forgiven by one treaty country to residents of the other country under an incentive program. Like some other U.S. treaties, however, paragraph 7(d) of the proposed protocol indicates that the United States and Ukraine will amend the proposed treaty to provide such credits in the event that the United States either amends its internal laws to allow such credits or agrees to provide them in a tax treaty with any other country.

(37) Article 25 of the proposed treaty greatly expands the nondiscrimination rule in the USSR treaty, in some respects conforming it to the U.S. model, and in other respects providing additional benefits. The USSR treaty requires "national treatment" to the extent of prohibiting discrimination under the laws of one country against citizens of the other country resident in the first country. It requires "most-favored-nation treatment" to the extent of prohibiting less favorable treatment, under the laws of one country, of citizens of the other country resident in the first country, or of local representations of residents of the other country, than the treatment afforded to third-country citizens and representations of third-country residents. The proposed treaty also requires both "national treatment" to the extent required in the U.S. model *and* a form of "most-favored-nation treatment" (not taking into account special agreements, such as bilateral income tax treaties, with third countries) to be applied to citizens and residents of the treaty countries. The proposed treaty affords these benefits to citizens of the other country in the same circumstances as citizens of the first

country, regardless of residence; to the local permanent establishments of residents of the other country, and to enterprises owned by residents of the other country. In addition, the proposed treaty prohibits discrimination against the deductibility of amounts paid to residents of the other country. Like the U.S. model treaty, the nondiscrimination rules of the proposed treaty apply not only to all national-level taxes, but also to all taxes imposed by each country's political subdivisions and local authorities.

(38) Like the U.S. model treaty, and unlike the USSR treaty, the proposed treaty makes express provision for the competent authorities to mutually agree on topics that would arise under the proposed treaty, but are not mentioned in the present treaty's mutual agreement article, such as the characterization of particular items of income, the common meaning of a term, the application of procedural aspects of internal law, and the elimination of double taxation in cases not provided for in the treaty (Article 26).

(39) Unlike some of the other pending treaties, the proposed treaty does not provide that its dispute resolution procedures under the mutual agreement article would take precedence over the corresponding provisions of any other agreement between the United States and Ukraine in determining whether a law or other rule is within the scope of the proposed treaty. Therefore, if Ukraine accedes to the General Agreement on Trade in Services and the proposed treaty is not amended to provide such a rule of precedence, tax issues between the United States and Ukraine may be subject to the dispute resolution procedures of the World Trade Organization. Staff understand that the Treasury Department expects to address this issue in an exchange of notes.

(40) While the USSR treaty requires exchanges of information only to the extent of providing information about changes in internal law, the proposed treaty includes the standard exchange of information article, similar to that in the U.S. model, which contemplates that each competent authority will assist the other in obtaining and transmitting information that relates to the assessment, collection, enforcement, and prosecution of tax claims against particular taxpayers (Article 27). The proposed treaty omits the U.S. model provision pledging assistance in collecting such amounts as may be necessary to ensure that treaty relief does not enure to the benefit of persons not entitled thereto.

(41) Paragraph 5 of the proposed protocol expressly provides that where the treaty limits the right to collect taxes, which taxes are nevertheless withheld at source at the rates provided for under internal law, refunds will be made in a timely manner on application by the taxpayer.[3]

(42) The proposed treaty would enter into force on the date of the exchange of instruments of ratification, and would be effective for matters other than withholding tax on January 1 of the year fol-

[3] The provision of the proposed protocol refers specifically to Article 14 (independent personal services) of the proposed treaty. Staff understand that the reference to Article 14 was intended solely to emphasize that the refund provision applies to withholding taxes on payments for personal services as well as withholding taxes on, for example, dividends, interest, and royalties.

lowing entry into force. With respect to withholding taxes, the proposed treaty would be effective on the first day of the second month following entry into force. During the first taxable year in which the proposed treaty is in effect, taxpayers may elect to be taxed instead as if the USSR treaty continued to have effect (Article 29).

II. ISSUES

The proposed treaty between the United States and Ukraine, as amended by the proposed protocol, presents the following specific issues.

A. Relationship to Uruguay Round Trade Agreements

The multilateral trade agreements encompassed in the Uruguay Round Final Act, which entered into force as of January 1, 1995, include a General Agreement on Trade in Services ("GATS"). This agreement generally obligates members (including the United States but not Ukraine) and their political subdivisions to afford persons resident in member countries (and related persons) "national treatment" and "most-favored-nation treatment" in certain cases relating to services. The GATS applies to "measures" affecting trade in services. A "measure" includes any law, regulation, rule, procedure, decisions, administrative action, or any other form. Therefore, the obligations of the GATS extend to any type of measure, including taxation measures.

However, the application of the GATS to tax measures is limited by certain exceptions under Article XIV and Article XXII(3). Article XIV requires that a tax measure not be applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services. Article XIV(d) allows exceptions to the national treatment otherwise required by the GATS, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other members. "Direct taxes" under the GATS comprise all taxes on income or capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises as well as taxes on capital appreciation.

Article XXII(3) provides that a member may not invoke the GATS national treatment provisions with respect to a measure of another member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In case of disagreement between members as to whether a measure falls within the scope of such an agreement between them, either member may bring this matter before the Council for Trade in Services. The Council is to refer the matter to arbitration; the decision of the arbitrator is final and binding on the members. However, with respect to agreements on the avoidance of double taxation that are in force on January 1, 1995, such a matter may be brought before the Council for Trade in Services only with the consent of both parties to the tax agreement.

Article XIV(e) allows exceptions to the most-favored-nation treatment otherwise required by the GATS, provided that the difference

in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the member is bound.

The proposed treaty, which was signed prior to the completion of the Uruguay Round negotiations, includes no provision coordinating its dispute resolution provisions with those under the GATS.[4] In contrast, however, each of the proposed treaties with France, Portugal, and Sweden (which were signed subsequent to the completion of such negotiations) provides that notwithstanding any other agreement to which the United States and that country are parties, a dispute concerning whether a measure is within the scope of such proposed treaty is to be considered only by the competent authorities under the dispute settlement procedures of such proposed treaty. Moreover, each such proposed treaty provides that the nondiscrimination provisions of such proposed treaty are the only nondiscrimination provisions that may be applied to a taxation measure unless the competent authorities determine that the taxation measure is not within the scope of such proposed treaty (with the exception of nondiscrimination obligations under the General Agreement on Tariffs and Trade (GATT) with respect to trade in goods).

The Committee may wish to seek an understanding providing that, should Ukraine accede to the GATS, the mutual agreement provisions of the proposed treaty would not be preempted by the dispute settlement procedures under the GATS, as in the proposed treaties with France, Portugal, and Sweden.

B. Foreign Tax Credit for Ukrainian Taxes

Tax policy

To be creditable under the limitations of U.S. law, a foreign tax must be directed at the taxpayer's net gain. Like any foreign taxes, the Ukrainian tax on income (profits) of enterprises as well as the income tax on individuals have been imposed on a base that is not necessarily identical to the U.S. income tax base. For example, staff understand that at the time the proposed treaty was signed, Ukrainian tax laws did not allow full deductions for labor costs. In order to assist U.S. taxpayers seeking eligibility of Ukrainian taxes for use as credits against U.S. income, as discussed above in Part I, the proposed protocol requires Ukraine to provide interest and labor cost deductions in the case of certain U.S. persons and U.S.-participating entities. In addition, on the basis of those required deductions, the proposed protocol provides that the Ukrainian taxes will be creditable for U.S. purposes.[5]

It generally has not been consistent with U.S. tax policy for deductions from the U.S. tax base of a U.S. person to be granted by treaty. Nor has it been consistent with U.S. tax policy to guarantee by treaty the U.S. creditability of an otherwise noncreditable for-

[4] It is understood that the Jackson-Vanik amendment (section 402 of the Trade Act of 1974, 19 U.S.C. sec. 2432) would prevent the United States from utilizing the GATS dispute resolution procedures with respect to Ukraine.

[5] Staff understand that the proposed protocol would not treat as creditable the Ukrainian taxes as imposed on a taxpayer that is not eligible for the full deductions, as provided in the proposed protocol.

eign tax. It is believed that both functions are generally more appropriately served in the normal course of internal U.S. tax legislation. The proposed treaty attempts to be consistent with these principles, while accommodating the differences between Ukraine's and the United States's internal constitutional processes. As a result, the treaty commits Ukraine to altering its internal tax base with respect to foreign-owned investments, in order to conform Ukraine's taxes to the requirements of the U.S. foreign tax credit. However, the proposed treaty takes the unusual additional step of guaranteeing that the Ukrainian tax, with the assurances described in the proposed protocol, is eligible for the U.S. foreign tax credit.

Stability of Ukrainian tax law

Staff understand that Ukraine enacted one phase of its tax reform in April 1995. The Treasury Department has advised the staff that the Ukrainan tax reform is changing the tax base generally from gross receipts to net income. In particular, it is understood that businesses are allowed deductions for wages and salaries and related expenses, interest and bank charges, as well as costs of production and depreciation charges.

The 1992 U.S. income tax treaty with the Russian Federation included a similar provision to the proposed protocol's special deduction rules for the labor and interest expenses of certain foreign-owned entities. However, despite allowing deductions for all wages paid under the treaty, the Russian Federation subsequently enacted an excess-wage tax that applies to wages that exceed six times the minimum monthly wage. The package of amendments to the Russian tax laws that took effect last month continue the excess-wage tax at least through 1995.[6] Under the terms of the U.S.-Russia tax treaty, the United States is not permitted to terminate the treaty until 1999.[7]

Most tax treaty partners of the United States have long-established tax systems. The states of the former Soviet Union generally have not yet had the opportunity to fully develop their economies and tax systems. It is less common for the United States to use a tax treaty as a device to stabilize the economy or tax system of a country undergoing development or transition. The Russian excess-wage tax is an example of how a tax treaty alone may not be completely effective toward this goal. Nonetheless, in such circumstances as those found in the Russian Federation, the tax treaty may afford U.S. investors and the U.S. Government a useful forum in which to air certain grievances that may arise in the area of fiscal policy. The Committee may wish to satisfy itself that the terms of the proposed treaty adequately protect U.S. investors from double taxation.

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[6] Bureau of National Affairs, *Daily Tax Report*, May 1, 1995, p. G–2. Staff understand that the Russian Federation may intend to terminate the excess-wage tax as of 1996.

[7] The United States has rarely terminated a tax treaty in response to changes in the tax laws of a treaty partner. Despite the changes, it is usually desirable to continue the tax treaty relationship for the sake of other treaty benefits until the treaty can be renegotiated.

C. Developing Country Concessions

The proposed treaty contains a number of developing country concessions, some of which are found in other U.S. income tax treaties with developing countries. The most significant of these concessions are listed below.

Definition of permanent establishment

The proposed treaty departs from the U.S. and OECD model treaties by providing for broader source-basis taxation. The proposed treaty's permanent establishment article, for example, would permit the country in which business activities are carried on to tax the activities sooner, in certain cases, than it would be able to under either of the model treaties. Under the proposed treaty, a building site or construction or installation project (or supervisory activities related to such projects) would create a permanent establishment if it exists in a country for more than six months; under the U.S. model, a building site, etc., must last for at least one year. Thus, for example, under the proposed treaty, a U.S. enterprise's business profits that are attributable to a construction project in Ukraine would be taxable by Ukraine if the project lasts for more than six months. Similarly, under the proposed treaty, the use of a drilling rig or ship for the exploration or exploitation of natural resources (or related supervisory activities) in a country for more than six months would create a permanent establishment there; under the U.S. model, drilling rigs or ships must be present in a country for at least one year. It should be noted that many tax treaties between the United States and developing countries provide a permanent establishment threshold of six months for building sites and drilling rigs. In addition, unlike the model treaties or other U.S. tax treaties, a permanent establishment under the proposed treaty includes a store or other premises used as a sales outlet.

Source basis taxation

Additional concessions to source basis taxation in the proposed treaty include a maximum rate of source country tax on royalties (10 percent) that is higher than that provided in the U.S. model treaty; and broader source country taxation of personal services income (especially directors' fees) and income of artistes and athletes than that allowed by the U.S. model.

Taxation of business profits

Unlike the U.S. model treaty, but similar to the United Nations model treaty, the proposed treaty would limit certain deductions for expenses incurred on behalf of a permanent establishment by the enterprise's head office. Unlike some other U.S. tax treaties with developing countries (such as Mexico and India), the proposed treaty's prohibition on deductions for amounts paid by the permanent establishment to its home office does not apply differently to interest payments than to royalties or other fees.

Issue presented

One purpose of the proposed treaty is to reduce tax barriers to direct investment by U.S. firms in Ukraine. The practical effect of these developing country concessions could be greater Ukrainian taxation of future activities of U.S. firms in Ukraine than would be the case under the rules of either the U.S. or OECD model treaties.

The issue is whether these developing country concessions represent appropriate U.S. treaty policy and, if so, whether Ukraine is an appropriate recipient of these concessions. There is a risk that the inclusion of these concessions in the proposed treaty could result in additional pressure on the United States to include them in future treaties negotiated with developing countries, especially other nations of the former Soviet Union. However, these precedents already exist in the UN model treaty, and a number of existing U.S. income tax treaties with developing countries already include similar concessions. Such concessions arguably are necessary in order to obtain treaties with developing countries. Tax treaties with developing countries can be in the interest of the United States because they provide developing country tax relief for U.S. investors and a clearer framework within which the taxation of U.S. investors will take place.

D. Treaty Shopping

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty is intended to benefit residents of Ukraine and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of tax by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing in that treaty country a subsidiary, trust, or other investing entity which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty-shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties, including the treaties that are the subject of this hearing. Some aspects of the provision, however, differ either from an anti-treaty-shopping provision proposed at the time that the U.S. model treaty was proposed, or from the anti-treaty-shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty-shopping provision of the treaty effectively forestalls potential treaty shopping abuses.

One provision of the anti-treaty-shopping article of the proposed treaty is more lenient than the comparable rule in one version pro-

posed with the U.S. model. That U.S. model proposal allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like several newer treaties and an anti-treaty-shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, this safe harbor is considerably easier to enter, under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty-shopping article differs from the comparable rule in some earlier U.S. treaties and proposed model provisions, but the effect of the change is less clear. The general test applied by those treaties to allow benefits, short of meeting the bright-line ownership and base erosion test, is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty gives the competent authority of the source country the ability to override this standard. The Technical Explanation accompanying the treaty provides some elaboration as to how these rules will be applied.

The practical difference between the proposed treaty tests and the earlier tests will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed treaty could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty tests (i.e., would operate to deny benefits in potentially abusive situations more often).

The Committee continues to believe that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible. The Committee continues to believe further that, in exercising any latitude Treasury has to adjust the operation of the proposed treaty, the rules as applied should adequately deter treaty shopping abuses. The USSR treaty does not contain anti-treaty shopping rules. Further, the proposed anti-treaty shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Ukraine since third-country investors may be unwilling to share ownership of such investing entities on a 50–50 basis with

U.S. or Ukrainian residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. The base erosion test provides protection from certain potential abuses of a Ukrainian conduit. Finally, Ukraine imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use Ukrainian entities to make U.S. investments. On the other hand, implementation of the tests for treaty shopping set forth in the treaty may raise factual, administrative, or other issues that cannot currently be foreseen. Thus, the Committee may wish to satisfy itself that the provision as proposed is an adequate tool for preventing possible treaty-shopping abuses in the future.

E. Transfer Pricing

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to reallocate profits among related enterprises residing in each country, if a reallocation is necessary to reflect the conditions which would have been made between independent enterprises. The Code, under section 482, provides the Secretary of the Treasury the power to make reallocations wherever necessary in order to prevent evasion of taxes or clearly to reflect the income of related enterprises. Under regulations, the Treasury Department implements this authority using an arm's-length standard, and has indicated its belief that the standard it applies is fully consistent with the proposed treaty.[8] A significant function of this authority is to ensure that the United States asserts taxing jurisdiction over its fair share of the worldwide income of a multinational enterprise. The arm's-length standard has been adopted uniformly by the leading industrialized countries of the world, in order to secure the appropriate tax base in each country and avoid double taxation, "thereby minimizing conflict between tax administrations and promoting international trade and investment."[9]

Some have argued in the recent past that the IRS has not performed adequately in this area. Some have argued that the IRS cannot be expected to do so using its current approach. They argue that the approach now set forth in the regulations is impracticable, and that the Treasury Department should adopt a different approach, under the authority of section 482, for measuring the U.S. share of multinational income.[10] Some prefer a so-called "formulary apportionment" approach, which can take a variety of forms. The general thrust of formulary apportionment is to first measure total profit of a person or group of related persons without regard to geography, and only then to apportion the total, using a mathematical formula, among the tax jurisdictions that claim primary taxing rights over portions of the whole. Some prefer an approach that is

[8] The OECD draft report on transfer pricing generally approves the methods that are incorporated in the current Treasury regulations under section 482 as consistent with the arm's-length principles upon which Article 9 of the proposed treaty is based. See OECD Committee on Fiscal Affairs, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, Discussion Draft of Part I: Principles and Methods," 1994.

[9] *Id.* (preface).

[10] See generally *The Breakdown of IRS Tax Enforcement Regarding Multinational Corporations: Revenue Losses, Excessive Litigation, and Unfair Burdens for U.S. Producers: Hearing before the Senate Committee on Governmental Affairs*, 103d Cong., 1st Sess. (1993) (hereinafter, *Hearing Before the Senate Committee on Governmental Affairs*).

based on the expectation that an investor generally will insist on a minimum return on investment or sales.[11]

A debate exists whether an alternative to the Treasury Department's current approach would violate the arm's-length standard embodied in Article 9 of the proposed treaty, or the nondiscrimination rules embodied in Article 25.[12] Some, who advocate a change in internal U.S. tax policy in favor of an alternative method, fear that U.S. obligations under treaties such as the proposed treaty would be cited as obstacles to change. The issue is whether the United States should enter into agreements that might conflict with a move to an alternative approach in the future, and if not, the degree to which U.S. obligations under the proposed treaty would in fact conflict with such a move.

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[11] See *Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means*, 101st Cong., 2d Sess. 360–61 (1990) (statement of James E. Wheeler); H.R. 460, 461, and 500, 103d Cong., 1st Sess. (1993); sec. 304 of H.R. 5270, 102d Cong., 2d Sess. (1992) (introduced bills); see also *Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means*, 102d Cong., 2d Sess. (1992).

[12] Compare *Tax Conventions with: The Russian Federation, Treaty Doc. 102–39; United Mexican States, Treaty Doc. 103–7; The Czech Republic, Treaty Doc. 103–17; The Slovak Republic, Treaty Doc. 103–18; and The Netherlands, Treaty Doc. 103–6. Protocols Amending Tax Conventions with: Israel, Treaty Doc. 103–16; The Netherlands, Treaty Doc. 103–19; and Barbados, Treaty Doc. 102–41. Hearing Before the Committee on Foreign Relations, United States Senate*, 103d Cong., 1st Sess. 38 (1993) ("A proposal to use a formulary method would be inconsistent with our existing treaties and our new treaties.") (oral testimony of Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Treasury Department); a statement conveyed by foreign governments to the U.S. State Department that "[w]orldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States" (letter dated 14 October 1993 from Robin Renwick, U.K. Ambassador to the United States, to Warren Christopher, U.S. Secretary of State); and *American Law Institute Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties* (1992), at 204 (n. 545) ("Use of a world-wide combination unitary apportionment method to determine the income of a corporation is inconsistent with the "Associated Enterprises" article of U.S. tax treaties and the OECD model treaty") with *Hearing Before the Senate Committee on Governmental Affairs* at 26, 28 ("I do not believe that the apportionment method is barred by any tax treaty that United States has now entered into.") (statement of Louis M. Kauder). See also *Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Committee on Ways and Means*, 102d Cong., 2d Sess. 224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department).

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States generally taxes nonresident alien individuals and foreign corporations on their U.S. source income that 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, in certain limited situations on foreign source income, that 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 individual or foreign corporation that 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 that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch-level excess interest tax, which amounts to 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (generally including interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such persons, the tax is 1 or 4 percent of the premium paid. These taxes generally are collected by means of withholding (hence these taxes are often called "withholding taxes").

Withholding taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. In addition, certain statutory exemptions from withholding taxes are provided. For example, interest on de-

posits with banks or savings institutions is exempt from tax unless the interest is effectively connected with the conduct of a U.S. trade or business carried on by the recipient. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio debt obligations is exempt from the 30-percent tax. Certain U.S. income tax treaties also provide for exemption from tax in certain cases.[13]

U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real estate.

The source of income received by nonresident alien individuals and foreign corporations is determined under rules contained in the Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S. source income. Interest paid by the U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, interest paid by that person will be foreign source rather than U.S. source. Moreover, even though dividends paid by a corporation meeting this test (an "80/20" company) are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period is not subject to U.S. withholding tax. Conversely, dividends and interest paid by a foreign corporation are generally treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend will be considered U.S. source income. The U.S. source portion of such dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient of a dividend to the extent of such U.S. source portion unless a treaty prevents application of the branch profits tax on the paying Corporation.)

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

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

[13] Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that its net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited however, by the amount of tax-exempt interest paid to related persons and the amount of interest paid on obligations guaranteed by related tax-exempt persons.

income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions of the Code contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis (as opposed to a "per-country" basis). Pursuant to rules enacted as part of the Tax Reform Act of 1986 ("1986 Act"), the overall limitation is computed separately for certain classifications of income (i.e., passive income, high withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the crediting of foreign taxes on certain types of traditionally high-taxed foreign source income against the residual U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

Prior to the Deficit Reduction Act of 1984 ("1984 Act"), a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided lookthrough rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic taxable income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act provided that foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction).

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

B. United States Tax Treaties—In General

The traditional objectives of 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 that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if each country considers the same deduction allocable to income that it treats as foreign source income, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

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 a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation generally is 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. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each

of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base in that jurisdiction. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent withholding tax and agrees to reduce this tax (or in the case of some income, eliminate it entirely) in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. Such a treaty provision generally is referred to as a so-called "saving clause." Double taxation also may arise, notwithstanding the existence of a treaty, because most countries will not exempt passive income from tax at the source.

Double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income is exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further enhanced under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individ-

ual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, the treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against enterprises owned by residents of the other country.

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