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EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE PHILIPPINES

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BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet describes the proposed income tax treaty between the United States and the Republic of the Philippines. The purpose of the proposed treaty is to reduce any double taxation on income earned within one country by residents of the other country and to provide various administrative procedures to aid in resolving interpretative disputes and in enforcing the taxes of both countries. The proposed treaty was signed on October 1, 1976, and was modified by an exchange of notes dated November 24, 1976. No similar treaty between the two countries is in force at the present time. A public hearing on the proposed treaty was held on July 19 and 20, 1977, by the Senate Committee on Foreign Relations, but was not reported out. The proposed treaty has been scheduled for a further public hearing on September 24, 1981, by the Senate Committee on Foreign Relations.

The proposed treaty is similar to other recent U.S. income tax treaties, the U.S. model income tax treaty, and the model income tax treaty of the Organization of the Economic Cooperation and Development (OECD). However, there are certain deviations from the model to reflect the Philippines' status as a developing country. Also, its form differs somewhat from the current U.S. and OECD models because it was signed five years ago.

The first part of the pamphlet is a summary of the principal provisions of the proposed tax treaty. The second part provides an overview of U.S. tax rules relating to international trade and investment and U.S. tax treaties in general. This is followed by a detailed, article-by-article explanation of the proposed treaty.

I. SUMMARY

In General

The proposed treaty is similar to recent U.S. income tax treaties the U.S. model income tax treaty, and to the model tax treaty of the Organization of Economic Cooperation and Development (OECD). However, a few provisions depart from the model provisions.

(1) 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. Accordingly, both countries may tax air transportation profits at their statutory rates. 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. A further limitation is provided so that the tax imposed will not exceed the lowest rate of tax that the Philippines imposes on residents of third countries. Under this provision (Article 9) U.S. residents operating aircraft in international traffic may be subject to more burdensome taxation in the Philippines than Philippine corporations, which under normal treaty rules would violate the provisions against discrimination. However, the treaty specifically excepts this provision from the discrimination provisions (Article 24).

(2) The treaty provides that the United States will limit its withholding tax on royalty income to 15 percent. However, the Philippine withholding tax is to be 25 percent, with exceptions for royalties paid with respect to investments under Philippine incentive programs, which are subject to a 15 percent withholding tax. An exception is also provided in any case where the Philippines agrees by treaty with a third country to a lower withholding tax on any type of royalty income.

(3) The treaty provides that each country may impose a withholding tax of up to 25 percent on dividends paid to portfolio investors of the other country; a withholding tax of up to 20 percent is permitted on dividends paid to direct investors.

(4) The withholding tax on interest is generally limited to 15 percent with respect to interest paid to resident of either country. However, interest derived from public issues of bonded indebtedness may not be subject to withholding in excess of 10 percent.

(5) The proposed treaty contains a nondiscrimination provision (Article 24) which applies to all taxes of every kind proposed at the national, State or local levels of either country. The provision generally follows the nondiscrimination provisions in other U.S. tax treaties. However, the proposed treaty does allow the Philippines to provide solely for Philippine nationals the incentives granted under specific provisions of existing law. These exemptions permit: (a) A

deduction for certain amounts invested in new shares of pioneer industries and a shorter holding period to qualify for capital gains treatment on the sale of such shares; (ii) a deduction for certain local costs of export production to firms which are 60 percent Philippine owned; and (iii) limited incentives to investments in tourist facilities.

(6) The proposed treaty contains a relief from double taxation provision (Article 23) similar to those contained in other U.S. treaties under which each country agrees to allow its citizens and residents a credit for taxes paid to the other country. However, the exchange of notes modifying Article 23(2) allows the Philippines to provide a deduction for U.S. taxes paid by Philippine citizens resident abroad, rather than a foreign tax credit, so long as the present relatively low rates of Philippine tax (up to 3 percent) currently in effect with respect to such income remain unchanged.

(7) 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 90-day period is consistent with the U.S. statutory rule concerning employees of foreign companies in the United States but is shorter than the 183-day period ordinarily provided for in U.S. tax treaties and the OECD model tax treaty. The proposed treaty contains a separate provision which permits taxation of entertainers and athletes (Article 17) performing services in the other country where their income exceeds the lesser of $100 per day or $3,000 per year.

(8) The treaty would exempt Philippine residents from U.S. tax on their disposition of an interest in a U.S. entity owning U.S. real property. This provision would override the Foreign Investment in U.S. Real Property Tax Act which was passed at the end of 1980.

Specific Issues

(1) Air transport income.—The committee held hearings on this treaty during the 95th Congress but did not act on it because of the opposition of the airline industry. It is understood that the industry still opposes the treaty as submitted. This opposition arises in large part because the proposed treaty would be the first U.S. income tax treaty that does not contain a reciprocal exemption for air transport income. In the past, the Philippines have refused to negotiate a complete exemption. They have, however, negotiated a reduced rate of tax with the Japanese.

A second problem is that in addition to the gross billing tax, the Philippines apparently imposes a number of additional taxes on the income of airlines. These taxes do not apply to Philippine Airlines. Therefore, the U.S. carriers would be subject to discriminatory taxation. The airline industry has expressed concern that the nondiscrimination provision does not prevent these taxes from being imposed and they have expressed the opinion that they will continue to be.

A third problem concerns certain U.S. airlines that do not provide regular service to the Philippines, but are represented in the Philippines by General Sales Agents (GSA). These agents sell tickets for trips originating in the Philippines where the passenger transfers to the U.S. airline outside of the Philippines. The Philippine Revenue Service has explained that they will expand the Philippines 2½ percent gross billings tax to the revenues of these U.S. airlines from tickets purchased in the Philippines from GSAs.

It is understood that the airline industry might now be willing to support a treaty that (1) in effect reduced the present 2½ percent billings tax to 1½ percent with provision that the tax is creditable for U.S. purposes; (2) contained an understanding that the nondiscrimination provision applies to U.S. airlines; and (3) contained an understanding that a GSA is not a permanent establishment.

It has been argued that the treaty should not be approved as presented because it would be the first U.S. tax treaty which does not provide for reciprocal exemptions for air transport income, and the reciprocal exemption of airlines operating in international traffic is provided for in the OECD model tax treaty and in accepted international practice. Also, ratification of the proposed treaty could be considered as a precedent by those countries, particularly developing countries, which want tax treaties with the United States but also want to tax U.S. airlines.

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. airlines at a higher rate on income from Philippine sources than it taxes its own airlines.

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 taxes significicantly greater than those to which Philippine airlines will be subject.

On the other hand, it has been argued that the treaty should be approved because its benefits outweigh its detriments and the airline problems can be worked out later. Further, it has been argued that the Philippines have indicated a willingness to compromise on some issues. Also, it has been argued that the U.S. should not treat a reciprocal airline exemption as an overriding issue where a developing country insists on collecting some tax. The Philippines have apparently agreed to a 1½ percent rate with Japan and might be expected to agree to a similar rate with the United States.

(2) ***Developing country concessions.***—The proposed treaty contains a number of concessions to source basis taxation. For example, a permanent establishment is considered to exist if a building site or construction project, etc., continues for more than 183 days. The furnishing of services, including consultancy services, may also give rise to a permanent establishment if those services are provided for more than 183 days. The withholding rates which the countries may impose on investment income are high when compared to other U.S. treaties and the U.S. model. Further, the Philippines is specifically permitted to discriminate by limiting to its citizens or corporations the advantages of certain tax incentives. These provisions raise the issue of the desirability of concessions to source basis taxation in treaties with developing countries. They also raise the issue of the extent

to which the U.S. should provide for source basis taxation in treaties of developing countries. It also presents the issue whether the United States should neter into a treaty with a developing country that permits discrimination where that discrimination is intended to encourage residents of a developing country to invest in that country.

It is important that this treaty be addressed one way or another. The United States is negotiating more treaties with developing countries, and many of them could refuse to exempt airline income, and take a similar stand on shipping income.

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

II. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND TAX TREATIES

A. United States Tax Rules

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

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

United States source fixed or determinable, annual or periodical income (e.g. interest, dividends, rents, salaries, wages, premiums, annuities) which is noneffectively connected income and which is received by a nonresident alien or foreign corporation is subject to tax at a rate of 30 percent of the gross amount paid. This gross tax on fixed or determinable income is often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty.

The 30-percent (or lower treaty rate) tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence they are often called withholding taxes).

Certain exemptions from the gross tax are provided. Bank account interest is defined as foreign source interest and, therefore, is exempt. Exemptions are also provided for certain original issue discount and for income of a foreign government from investments in U.S. securities. Our treaties also provide for exemption from tax in certain cases.

Net U.S. source capital gains are also subject to the 30 percent tax but only in the case of a nonresident alien who is present in the United States for at least 183 days during the taxable year. Otherwise foreign corporations and nonresident aliens are only subject to U.S. taxation (at the graduated rates) on those capital gains that are effectively connected with the conduct of a trade or business in the United States.

Prior to June 18, 1980, noneffectively connected capital gains from the sale of U.S. real estate were subject to U.S. taxation only if received by a nonresident alien who was present in the United States for at least 183 days. However, in the Omnibus Reconciliation Act of 1980 a provision was added to the Internal Revenue Code that the sale, exchange or disposition of U.S. real estate by a foreign corporation or a nonresident alien would be taxed as effectively connected income. Also taxable under the legislation are dispositions by foreign investors of their interests in certain U.S. corporations and other entities whose assets include U.S. real property and associated personal property.

The source of income received by nonresident aliens and foreign corporations is determined under special rules contained in the Internal Revenue Code. Under these rules interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are considered U.S. source income. However, if the U.S. corporation derives more than 80 percent of its gross income from foreign sources, then dividends and interest paid by such corporation will be a foreign source rather than U.S. source. Conversely, dividends and interest paid by a foreign corporation, which has at least 50 percent of its income as effectively connected income, are U.S. source to the extent of the ratio of its effectively connected income to total income.

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

Since it taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person will be taxed by the country in which the income is earned and also by the United States. The U.S. seeks to mitigate this double taxation by allowing U.S. taxpayers 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 contain a limitation that insures that the foreign tax credit only offset the U.S. tax on foreign source income. This limitation is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income.

A U.S. corporation that owns 10 percent or more of the stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that corporation on earnings that are received as dividends. These deemed paid taxes are included in total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Separate limitations on the foreign tax credit are provided for certain interest, DISC dividends, and oil income.

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, modifying the generally applicable statutory rules with provisions which take into account the particular tax system of the treaty country. Given the diversity of tax systems in the world, it would be virtually impossible to develop in the Code rules which unilaterally would achieve these objectives for all countries.

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

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates which 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 income basis. (Most countries, like the United States, generally tax domestic source income on a gross income basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax is imposed at a rate which exceeds the tax which 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 where the contracts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation is generally accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes which 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 tax as a resident by each of the two countries. The treaty also provides that neither country will tax business income derived from sources within it 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. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to file tax returns and pay tax in that other country unless their contacts exceed certain specified minimums, normally presence for a set number of days or earnings of over a certain fixed dollar amount.

The treaties deal with passive income such as dividends, interest, or royalties, or capital gains, 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 withholding tax generally imposed on those payments is reduced. As described above, the U.S. generally imposes a 30 percent tax and seeks to reduce this tax in some cases on some income to zero in its tax treaties.

In its treaties, the United States, as a matter of policy, retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "savings clause". Double taxation can therefore still arise. Double taxation can also still arise because most countries will not exempt passive income from tax at source.

This double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or by, in the case of some of our treaty partners, by providing that income will be exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against United States tax for income taxes paid to the treaty partners, subject to the limiations of U.S. law. An important function of the treaty is to define the taxes to which it applies to provide that they will be considered creditable incomes taxes for purposes of the treaty.

The treaties also provide for administrative cooperation between the countries. This cooperation includes a competent authority mechanism to resolve double taxation problems arising in individual cases, or more generally, by consultation between tax officials of the two governments.

Administrative cooperation also includes provision for an exchange of tax-related information to help the United States and its treaty partners administer their tax laws. The treaties generally provide for the exchange of information between the tax authorities of the two countries where 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 which 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 IRS (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.

III. EXPLANATION OF PROPOSED TAX TREATY

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

Article 1. Taxes Covered

The proposed treaty applies to the U.S. Federal income taxes imposed under the Internal Revenue Code. It does not apply to the tax on accumulated earnings or the personal holding company tax which means that the United States can continue to impose these taxes on Philippine corporations. It likewise applies to the income tax imposed by Title II of the National Internal Revenue Code of the Philippines, but not including the tax on improperly accumulated earnings or the personal holding company tax.

The proposed treaty also contains a provision generally found in U.S. income tax treaties which applies the treaty to substantially similar taxes which either country may subsequently impose.

Article 2. General Definitions

The standard definitions found in most of U.S. income tax treaties are contained in the proposed treaty. The definition of the term "United States," is interpreted by the Treasury Department to incorporate the territorial sea of the United States and the continental shelf of the United States insofar as the exploration and exploitation of natural resources on the continental shelf is concerned. The definition of the Philippines is interpreted in the same manner.

The proposed treaty also contains the standard provision that undefined terms are to have the meaning which they have under the applicable tax laws of the country applying the treaty. Where a term is defined in a different manner by the two countries or where its meaning under the laws of either country is not readily determinable, the competent authorities of the two countries may establish a common meaning for the term in order to prevent double taxation or to further any other purpose of the treaty.

Article 3. Fiscal Residence

The benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on the U.S. source income and on his income that is effectively connected with a U.S. trade or business. The Code, however, does not define the term. Instead, IRS regulations state that an alien is a resident of the United States if he is actually present in the U.S. and is not a mere transient or sojourner. Whether he is a transient is determined by his intentions as to the length and nature of his stay. (See Treas. Reg. § 871–2(b)). A corporation is resident in the U.S. if it is organized in the U.S.

The proposed treaty defines "resident of the Philippines" and "resident of the United States," and in addition provides a set of rules to determine residence in the case of an individual with dual residence. This provision of the proposed treaty is based on the fiscal domicile article of the OCED model treaty and is similar to the provisions found in other U.S. tax treaties.

An individual whom both countries consider to be a resident according to their general rules for determining residence will be deemed for all purposes of the treaty to be a resident of the country in which he has his permanent home (where an individual dwells with his family), his center of vital interests (his closest economic and personal relations), his habitual abode, or his citizenship. If the residence of an individual cannot be determined by these tests, applied in the order stated, the competent authorities of the countries will settle the question by mutual agreement.

Article 4. Source of Income

The source of income rules establish the framework for the basic provision in the treaty (Article 6) that one country may tax residents and corporations of the other country only on income from sources within the taxing country (provided, with certain exceptions, that the resident is not a citizen of the taxing country). The rules are also important because the U.S. foreign tax credit is limited to the U.S. tax on income from sources outside the United States. Several of the source rules contained in the proposed treaty differ in some degree from the source rules provided in the Internal Revenue Code. However, since the general rules of taxation contained in the proposed treaty (Article 6) provide that the treaty will not be applied to increase a person's tax, a taxpayer is not bound to apply the rules described below where the treaty rules would increase his U.S. tax liability.

The proposed treaty provides that dividends will be treated as income from sources within a country if paid by a corporation of that country. However, dividends paid by a corporation of any country are to be treated as income from sources within one country if for the prior three years at least 50 percent of that corporation's gross income constituted industrial or commercial profits attributable to a permanent establishment in that country. However, the dividend will be treated as from sources within the country of the permanent establishment only in proportion to the corporation's gross income from the permanent establishment. This provision is similar to the U.S. Code provision and permits the United States to continue to impose its so-called second withholding tax on dividends paid by Philippine corporations doing business in the United States.

Under the proposed treaty, interest will be treated as income from sources within a country only if paid by that country, a political subdivision or a local authority thereof, or by a resident of that country. However, interest paid on an indebtedness incurred in connection with a permanent establishment will be sourced in the country where the permanent establishment is situated. This exception permits one country, under the proper circumstances, to tax interest paid by a permanent establishment maintained in that country by a resident of the other country or by a resident of a third country.

In addition, the source rule for interest paid by permanent establishments will operate to exempt interest from tax in the country of the taxpayer's residence if the interest is paid to a resident of the other country by a permanent establishment situated in a third country (and the indebtedness was incurred in connection with the third country permanent establishment). This results from the restriction in Article 6 (General Rules of Taxation) that a resident of one country who is not a citizen of the other country may be taxed by the other country only on income from sources within that other country.

The proposed treaty provides that royalties for the use of, or the right to use, property or rights will be treated as income from sources within a country only to the extent that such royalties are for the use of, or the right to use, the property or rights within that country. However, an exception is also provided under which royalties are allocated to the country in which a permanent establishment is situated if the royalty is incurred in connection with the permanent establishment.

Income (including mineral royalties) to which the provision relating to income from real property (Article 7) applies will be treated as income from sources within a country only if the real property (or, in the case of a mineral royalty, the underlying real property) is situated in that country.

Income received by an individual for his performance of labor or personal services, whether as an employee or in an independent capacity, will be treated as income from sources within a country only to the extent that such services are performed in that country. Income from personal services performed aboard ships or aircraft operated by a resident of one country in international traffic will be treated as income from sources within that country if performed by a member of the regular complement of the ship or aircraft. However, compensation described in Article 20 (Governmental functions) and social security payments (Article 19) will be treated as income from sources within the country making the payments.

The treaty contains a rule not provided in other U.S. treaties that income from the operation of ships in international traffic is to be treated as from sources within the country from which the ship's travel originated. This new source rule becomes significant with the provisions of the shipping and air transportation article (Article 9) and is discussed in some detail in the discussion of those provisions.

Industrial or commercial profits attributable to a permanent establishment will be considered to be from sources within the country in which the permanent establishment is located. This rule also applies to passive income of the types described above (interest, royalties, etc.) in situations where the passive income is treated as industrial or commercial profits because it is effectively connected with the permanent establishment.

The source of any item of income not specified in this article will be determined by each country in accordance with its own law. However, if the source of any item of income under the laws of one country is different from its source under the laws of the other country, or if its source is not readily determinable under the laws of either, the competent authorities of the two countries may, in order to prevent double taxation or further any other purpose of the proposed treaty, establish a common source of the item of income for purposes of the proposed treaty.

Article 5. Permanent Establishment

The proposed treaty contains a definition of permanent establishment which generally follows the pattern of the OECD model tax treaty and other recent U.S. income tax treaties. The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, a resident of one country is not taxable on its business profits by the other country unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties are applicable.

In general, a fixed place of business through which a resident of one country engages in industrial or commercial activities in the other country is considered a permanent establishment. The treaty specifies that a fixed place of business includes a seat of management; a branch; an office; a store or other sales outlet; a factory; a workshop; a warehouse; a mine quarry, or other place of extraction of other natural resources; and any building site or construction or assembly project (or supervision activity connected therewith and conducted within the country where a site or project is located) which was maintained for more than 183 days; and the furnishing of services, including consulting services, by a resident of one country through employees or other personnel where the activities making up the services continue within the other country for over 183 days.

The 183-day threshold period for treating a building, etc., project as a permanent establishment and the inclusion of supervisory activities as part of the project, as well as the inclusion of the consulting services, represent an expansion of the permanent establishment concept, and thus an expansion of source basis taxation, as compared to the U.S. and OECD models. They are similar to the United Nations model. This expansion reflects the status of the Philippines as a developing country.

This general rule is modified to provide that a fixed place of business which is used for any of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities for storing, displaying, or delivering merchandise belonging to the resident; the maintenance of a stock of goods belonging to the resident for purposes of storage, display, delivery, or processing by another person; the purchase of goods, collection of information, advertising, scientific research, or other auxiliary activities, for the resident; and the furnishing of services in accordance with an agreement between the countries regarding technical cooperation (such as the Economic and Technical Cooperation Agreement of April 27, 1951).

A resident shall not be deemed to have a permanent establishment in the other country merely because the resident sells goods which were displayed at trade fairs or conventions in that other country. The trade fair exception is not intended to apply with respect to goods in the resident's inventory.

A resident of one country who collects premiums in the other country or insures risks located there, except through an independent agent, is to be treated as having a permanent establishment in the other country, except with respect to reinsurance.

A resident of one country will be deemed to have a permanent establishment in the other country if it maintains an agent in the other country who has, and habitually exercises, a general contracting authority (other than for the purchase of merchandise) in that other country. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent or other agent of independent status acting in the ordinary course of its business.

The determination of whether a resident of one country has a permanent establishment in the other country is to be made without regard to the fact that the resident may be related to a resident of the other country or to a person who engages in business to that other country.

Article 6. General Rules of Taxation

The proposed treaty contains the basic general rules of taxation which are found in many U.S. income tax treaties. A resident of one country may be taxed by the other country only on income from sources within that other country (which includes business profits only to the extent they are attributable to a permanent establishment in that other country). For this purpose, the source rules of Article 4 are to be applied. The proposed treaty also contains the customary rule that it may not be applied to increase the tax burden of either country beyond what it would be in the absence of the treaty—that is, the treaty only applies in those situations where it benefits taxpayers.

Additionally, the proposed treaty contains the standard saving clause that provides that, with certain exceptions, the treaty is not to affect the taxation by the United States or the Philippines of their citizens or residents. However, this saving clause does not apply in several cases where its application would nullify specific policies contained in the proposed treaty which are designed to benefit residents and citizens. The principal exceptions involve social security payments, the foreign tax credit, and nondiscrimination. The saving clause also does not affect the benefits provided to resident aliens under the provisions relating to diplomatic or consular officers or other governmental employees, teachers, and students, provided they do not have immigrant status in the country imposing the tax.

Article 7. Income from Real Property

The proposed treaty provides that income from real property may be taxed in the country where the real property is located. Income from real property includes income from the direct use or renting of the property and gains on the sale, exchange, or other disposition of the property. It also includes royalties and other payments in respect of the exploitation of natural resources (e.g., oil wells) and gains on the sale, exchange or other disposition of the royalty rights on the underlying natural resource.

Generally, under U.S. law, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended, a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain was effectively connected with a trade or business conducted in the United States. The real estate provision of the proposed treaty preserves the right of the United States to tax the gain from the sale of U.S. real estate. However, it does not preserve the right of the United States to tax dispositions of interests in U.S. entities. Accordingly, the provisions of the U.S. foreign investment in real property law are overridden and the United States could not tax a Philippine resident on his disposition of stock of U.S. real property holding corporations under the provisions of the 1980 legislation. It also retains the right of the United States to impose relevant reporting or withholding requirements.

Article 8. Business Profits

U.S. Code rules.—United States law separates the business and investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent (or lower treaty rate) rate of tax on its U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to U.S. source income which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income, such as interest, dividends, rents, wages, and capital gains is effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. sources income is treated as effectively connected income.

Foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign source income can be effectively connected income; rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock or debt derived in the active conduct of a banking, financing or similar business in the United States; and certain sales income attributable to a United States sales office.

Except in the case of a dealer, the trading in stocks, securities or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the U.S. as business income. This concept includes trading through a U.S. based employee, a resident broker, commission agent, custodian or other agent or trading by a foreign person physically present in the United States.

Proposed treaty rules.—Under the proposed treaty, business profits of a resident of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in which the enterprise in the other country carries on business. This is one of the basic limitations on a source country's right to tax income of a nonresident.

The taxation of business profits under the proposed treaty differs from United States rules for taxing business profits primarily in requiring more than merely being engaged in trade or business before a country can tax business profits. Under the Internal Revenue Code, all that is necessary for effectively connected business profits to be taxed is that a trads or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present.

In computing the taxable business profits, the deduction of expenses, wherever incurred, which are reasonably connected with the business profits are allowed. Deductible expenses include executive and general administrative expenses, wherever incurred. However, no deduction shall be allowed for amounts paid by the permanent establishment to its head office as: royalties, fees or other payments in return for use of patent rights or other rights; commissions for specific services performed for management; and interest on loans made to the permanent establishment other than to a banking institution.

The profits of a permanent establishment are determined on an arm's length basis. Thus, there is to be attributed to it the business profits which would reasonably be expected to have been derived if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the resident of which it is a permanent establishment. Moreover, the treaty adds a rule providing that profits derived from business activities similar to those effected through the permanent establishment can be attributed to the permanent establishment if the activities were structured to avoid taxation.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment (or by the resident of which it is a permanent establishment) for the account of that resident. Thus, where a permanent establishment purchases goods for its head office, business profits attributed to the permanent establishment with respect to its other activities will not be increased by any profit element on its purchasing activities.

For purposes of the proposed treaty, the term "business profits" includes income derived from any trade or business (regardless of the form of business structure used) including the rental of tangible movable property.

Aritcle 9. Shipping and Air Transport

Unlike other U.S. tax treaties, the proposed treaty provides that both countries may tax the profits from sources within one country derived from the operation of ships and aircraft in international traffic by a resident of the other country. The treaty places no limitation on the source country's right to tax income of a resident of the other country derived from the operation of aircraft in international traffic. In the case of shipping profits, however, the tax imposed by the source country may not exceed 1.5 percent of the gross revenues derived from sources within that country (which, as determined under Article 4, is income from outgoing traffic originating in that country), or, if less, the lowest rate of Philippine tax which may be imposed on shipping profits of a resident of a third country under other Philippine tax treaties.

The treaty does not provide for exemption of shipping and air transport income derived from international traffic because the Philippines, like most developing countries, imposes a tax on the earings of foreign residents providing transportation services out of the Philippines and, we understand, considers the collection of this tax to be important. The Philippine tax is generally 2½ percent of gross revenues. Thus, the treaty lowers the rate of tax (from 2½ to 1½ percent) which U.S. shippers must pay, although no reduction is provided for operators of U.S. aircraft.

The treaty is not, however, likely to significantly affect any Philippine resident shipping into or out of the United States since the U.S. tax imposed under the Internal Revenue Code is substantially less than that permitted by the treaty. The Internal Revenue Code includes as U.S. source income only that amount of shipping income attributable to shipping within U.S. waters (using the 3-mile limit). Thus, regardless of the treaty limitation, a Philippine resident shipping in international commerce would be subject to U.S. tax on only a very small portion of his income.

Since the Philippine Government grants to Philippine air carriers (other than Philippine Airlines) recurring 10-year exemptions from tax on income derived from international traffic and since Philippine Airlines is subject to tax on a different basis, the treaty provision could result in U.S. air carriers being subject to more burdensome taxation in the Philippines than these Philippine residents. This would not violate the nondiscrimination provision (Article 24) because of specific exceptions provided in this article for the taxation of income from the operation of aircraft. However, neither this provision nor the nondiscrimination provision prevents the President from adjusting the U.S. income tax on Philippine air carriers (under Code sec. 896) to retaliate against this discrimination. What impact, if any, such retaliation would have is not known.

This provision also applies to income derived by residents through participation in a pool, a joint venture, or an international operating agency.

Article 10. Related Persons

The proposed treaty, like most other U.S. tax treaties, contains a provision similar to section 482 of the Internal Revenue Code which recognizes the right of each country to make an allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons.

When a redetermination has been made by one country with respect to the income of a related person, the other country will attempt to reach an agreement with the first country in connection with the redetermination and, if it agrees with the redetermination, it will make a corresponding adjustment to the income of the other person.

Article 11. Dividends

The United States imposes a 30-percent tax on the gross amount of United States source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. The treaty reduces this tax, and also limits Philippines tax on dividend income. United States source dividends are dividends paid by a United States corporation, and dividends paid by a foreign corporation if at least 50 percent of the gross income of the corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that foreign corporation.

The proposed treaty limits the rate of withholding tax imposed by either country to 25 percent on dividends paid to residents of the other country generally and to 20 percent on dividends paid to corporations which have at least a 10-percent ownership interest in the paying corporation.

As other treaties have provided, dividends which are paid on shares that are effectively connected with a permanent establishment in one country or with a fixed base of an individual performing independent personal services in that country are to be treated as business profits (and taxed under Article 8) or income from the performance of personal services (treated under Article 15), rather than as dividends.

The treaty also provides that dividends paid by a corporation of one country to a person other than a citizen or resident of the other country is to be subject to tax in the other country only if such dividend is from sources within the other country or the recipient of the dividend has a permanent establishment or fixed base in the other country and the stock with respect to which the dividend is paid is effectively connected with the permanent establishment or fixed base.

The Article specifically provides that nothing in the treaty is to prevent the Philippines from imposing its additional tax on branches of foreign corporations (branch profits tax) in a manner similar to the withholding tax permitted on distributions from Philippine corporations which are 10 percent or more owned by U.S. residents. Under the provision, the Philippines may levy an additional tax of up to 20 percent of earnings (net of the regular Philippine income tax) of a permanent establishment of a corporation other than a Philippine corporation.

Article 12. Interest

The U.S. imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that are applicable to dividends. U.S. source interest generally is interested on debt obligations of U.S. persons, but not interest on deposit in banks. U.S. source interest also includes interest paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three year period was effectively connected with a U.S. trade or business of that corporation.

The proposed treaty generally limits the withholding tax on interest derived by a resident of one country from sources within the other country to 15 percent of the gross amount of interest paid. However, a special exception is established for interest derived from publicly issued bonds, which are subject to a 10-percent withholding rate.

The reduced rates of withholding tax on interest will apply unless the recipient has a permanent establishment in the source country or performs independent personal services from a fixed base in that country and the interest is paid on a debt claim that is effectively connected with the permanent establishment or the fixed base. Such interest will be taxed under the business profits provisions (Article 8) or the independent personal services provision (Article 15), as the case may be. This treatment generally conforms to that provided by other recent U.S. tax treaties and the OECD model tax treaty.

The proposed treaty also provides that interest derived beneficially by either country, or by a tax-exempt instrumentality of either country, will be exempt from tax by the other country. Under this rule income derived by the Export-Import Bank of the United States and the Overseas Private Investment Corporation (OPIC) on loans made to Philippine residents will be exempt from tax by the Philippines. This exemption also applies where a resident of one country receives interest income on debt obligation guaranteed or insured by that country or an instrumentality of that country.

The proposed treaty defines interest as income from debt-claims of every kind (whether or not the claim carries a right to participate in the debtor's profits). It is intended that this provision permits the United States to apply its domestic rules (section 385) for distinguishing between debt and equity, with the competent authorities settling disputes if this causes double taxation.

In situations where the payor and recipient are related, the interest provision of the proposed treaty only applies to the amount of interest to that which would have been paid had they not been related.

Article 13. Royalties

Under the same system that applies to dividends and interest, the U.S. imposes a 30-percent tax on all U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are from property located in the United States including royalties for the use of or the right to use intangibles in the United States.

Under the proposed treaty, the withholding tax imposed by the United States on royalties derived by a resident of the Philippines is limited to 15 percent of the gross amount of the royalty. The withholding tax on royalties imposed by the Philippines is generally limited to 25 percent of the gross amount of the royalties. However, if the royalties are paid by a corporation which is registered with the Philippine Board of Investment and is engaged in preferred areas of activity, the withholding tax is limited to 15 percent of the gross amount of the royalties. In no case is either the 25-percent or the 15-percent limitation to exceed the lowest withholding rate of Philippine tax which may be imposed on similar types of royalties paid to residents of a third State. Thus, U.S. residents will automatically receive the benefits of any lower withholding rates on royalties established in Philippine tax treaties with any third country.

Under the entry-into-force provisions (Article 29(2)), the provision giving U.S. residents the benefit of lower withholding rates established in other Philippine treaties was not to take effect until January 1, 1979, with respect to payments for the use of, or the right to use, films or radio or television films or tapes. Since the Philippines has existing treaties with Sweden and Denmark establishing a 10 percent withholding on royalty payments for films and radio and television tapes or films, U.S. residents will be subject to the same 10 percent rate with respect to those types of royalties unless the Swedish and Denmark treaties are renegotiated.

Royalties are defined in the proposed treaty as payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, and payments of any kind made as consideration for the use of, or the right to use, patents, designs, models, plans, secret processes or formulas, trademarks, or other like property or rights. Payments made for the use of or the right to use motion picture films or films or tapes used for radio or television broadcasting are also treated as royalties. Royalties include gains derived from the sale, exchange, or other disposition of such property or rights to the extent the amounts received are contingent on the productivity, use, or disposition of the property or rights. If the amounts realized are not contingent, the capital gain provisions (Article 14) may apply.

The reduced withholding rates do not apply where the recipient has a permanent establishment or performs services from a fixed base in the source country and the property on which the royalties are paid is permanent establishment or the fixed base. Such royalties will be taxed under the business profits provision (Article 8) or the independent personal services provision (Article 15).

As in the case of the interest provision, the royalty provision does not apply to that part of a royalty paid to a related person which is considered excessive.

Article 14. Capital Gains

Under the Code, U.S. source capital gains derived by foreign investors are generally exempt from U.S. tax. Gain from the disposition of U.S. real estate, or a U.S. real property interest are taxed by the United States. (See discussion under Article 6 (Income from real property)).

The proposed treaty generally provides that capital gains derived by a resident of one country will be exempt from tax by the other country. However, the exemption does not apply to sales of tangible personal property of a resident of one country which form part of the business property of a permanent establishment or of a fixed base to perform independent personal services in the other country. These gains are fully subject to tax in the other country, except that gains from the sale of ships, aircraft or containers operated by a resident of one country in international traffic are not to be subject to tax in the other country.

As discussed under Article 7, gain on the disposition of real estate may be taxed at source, but the United States could no longer tax a Philippine resident on his sale of a U.S. entity holding U.S. real property.

Article 15. Independent Personal Services

Under the proposed treaty, income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) in one country by a resident of the other country is exempt from tax in the country where the services are performed, unless (i) the person performing the personal service has a fixed base regularly available to him in the one country for the purpose of performing the activities, (ii) is present in the country for 90 or more days during the taxable year, or (iii) receives gross remuneration from residents of the country for such services in excess of $10,000 (or the equivalent amount in Philippine pesos). This provision is modified by Article 17 in the case of entertainers.

Article 16. Dependent Personal Services

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will not be taxable in the source country if three requirements are met: (1) the individual is present in the source country for less than 90 days during the taxable year; (2) the individual is an employee of a resident of or of a permanent establishment in the country in which he is a resident; and (3) the compensation is not borne by a permanent establishment of the employer in the source country.

Compensation derived by an employee aboard a ship or aircraft operated by a resident of one country in international traffic is exempt from tax by the other country, provided that the employee is a member of the regular complement of the ship or aircraft.

Article 17. Entertainers and Athletes

This proposed treaty provides that, notwithstanding Articles 15 (Independent personal services) and 16 (Dependent personal services), income derived by an individual resident of one country from the performance of personal services in the other country as a public entertainer, such as a theater, motion picture, radio or television artist, a musician or an athlete may be taxed by the other country, but only if the gross amount of such income exceeds $100 for each day the individual is present in the other country for the purpose of performing such services therein or a total of $3,000 per year.

However, income from activities supported or sponsored by the government of one country (and for which the entertainer or athlete is certified by that government) is exempt from tax by the host country.

In addition, income with respect to the above types of activities which accrues to another person is to be taxed in the country where the activity is conducted without regard to the rules which would otherwise apply under other Articles of the treaty. This provision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income.

Article 18. Private Pensions and Annuities

Under the proposed treaty, annuities paid to residents of one country are exempt from tax by the other country. In addition, child support payments paid by a resident of one country to a resident of the other are exempt in the recipient's country. However, unlike most U.S. treaties, this treaty does not provide that private pensions or alimony payments are taxable only in the country of residence. Instead the treaty provides that private pensions and other similar remuneration is to be taxable in the country where the employment services were rendered. However, both countries would remain able to tax their residents and, under the saving clause of Article 6, their citizens on pensions received from the other country (subject to allowance of a foreign tax credit).

Article 19. Social Security Payments

Under the proposed treaty, social security payments and other public pensions paid by one country to residents of the other are to be taxable only in the source country. The saving clause does not apply to social security payments. Accordingly, the United States would not tax a U.S. citizen who is resident in the United States on his Philippine social security payments.

Article 20. Governmental Functions

Under the proposed treaty, wages, including pensions or similar benefits, paid by one country to a citizen of that country for labor or personal services performed for that country in the discharge of governmental functions of the national government of that country is exempt from tax by the other country. This exemption also applies to citizens of any third country who come to the other country expressly for the purpose of performing such services.

Article 21. Teachers

The proposed treaty provides that a teacher or researcher who is a resident of one country will be exempt from tax in the other country on income from teaching or engaging in research in the host country if he is present in that country for a period not expected to exceed two years. The exemption applies only if the individual comes to the other country primarily for the purpose of teaching or engaging in research pursuant to an invitation of the host country or a recognized educational institution of the host country. It is not to apply with respect to income from research which is undertaken primarily for the benefit of a specific person or persons. If the teacher or researcher remains in the other country for a period exceeding two years, the exemption only applies to income earned during the 2-year period.

Article 22. Students and Trainees

Under the proposed treaty, residents of one country who become students in the other country will be exempt from tax in the host country on gifts from abroad used for maintenance or study and on any grant, allowance or award. In addition, a $3,000 annual exemption from tax by the host country is provided for personal service income (such as income from a part-time job) derived from sources within the country in which the individual is studying.

These exemptions and the visiting teachers' exemption (Article 22) may only be utilized for a period of 5 years. In addition, the benefits under the teacher's article are not available to an individual if during the immediately preceding period, the individual received the benefit of the student provision.

In addition to the exemption regarding students, the proposed treaty follows the approach of other recent U.S. tax treaties and provides a limited exemption for personal service income of residents of one country who are employees of a resident of that country and who are temporarily present in the other country to study at an educational institution or to acquire technical, professional, or business experience. This exemption is available for a period of 12 consecutive months and is limited to $7,500. The proposed treaty also provides an exemption for income from personal services performed in connection with training, research, or study by residents of one country who are temporarily present in the other country as participants in Government-sponsored training programs. This exemption is limited to $10,000.

If an individual qualifies for the benefits of more than one of the provisions of this article, the individual may choose the most favorable provision but may not claim the benefits of more than one provision in any taxable year.

Article 23. Relief from Double Taxation

One of the principal reasons for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks to unilaterally mitigate double taxation by allowing U.S. taxpayers to credit the foreign income taxes that they pay 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 contain a limitation that insures that the foreign tax credit only offset the U.S. tax on foreign source income. This limitation is computed on world-wide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income.

Separate limitations on the foreign tax credit are provided for certain interest, DISC dividends, and oil income.

A U.S. corporation that owns 10 percent or more of the stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends (deemed paid credit). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credit.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem was dealt with in previous articles that limited the right of a source country to tax income, and that coordinated the source rules. This article provides further relief where both the Philippines and the United States still tax the same item of income.

The proposed treaty provides separate rules for relief of double taxation by the United States and Philippines.

Under the proposed treaty, each country agrees to provide its citizens and residents with a foreign tax credit for the appropriate amount of income taxes paid to the other country. The credits allowed under this provision are subject to the provisions of U.S. or Philippine law applicable to the year in question.

The proposed treaty also provides that a deemed-paid foreign tax credit will be made available to a United States corporation with respect to dividends from a Philippine corporation in which it has at least a 10-percent ownership interest. In this case, a credit will be allowed for the Philippine corporate tax paid on the earnings out of which the dividend is paid. (A deemed-paid foreign tax credit satisfying the treaty requirements is presently provided under the Internal Revenue Code.) Similarly, the proposed treaty provides that the Philippines is to provide a deemed-paid foreign tax credit for U.S. tax attributable to dividends received by Philippine corporations from U.S. corporations in which they are 50-percent shareholders.

For the purpose of applying the U.S. foreign tax credit under the treaty in relation to taxes paid to the Philippines, the rules set forth under Article 4 will be applied to determine the source of income. The Philippine taxes which the proposed treaty provides are creditable for U.S. tax purposes are the income taxes imposed by Title II of the National Internal Revenue Code of the Philippines, but not including the accumulated earnings tax or personal holding company tax.

Under an exchange of notes (dated November 24, 1976), it was agreed that citizens of the Philippines who reside outside of that country may be permitted only a deduction rather than a credit for U.S. income taxes for Philippine tax purposes. These Philippine citizens are currently subject to Philippine tax at rates not exceeding 3 percent of worldwide income. The exchange of notes indicates that in the event these rates are increased, the treaty would require the Philippine Government to grant their nonresident citizens a foreign tax credit for U.S. taxes paid.

Article 24. Nondiscrimination

The proposed treaty contains a comprehensive nondiscrimination provision relating to taxes imposed at the national, State or local level, similar to provisions which have been embodied in other recent U.S. income tax treaties, except that the treaty permits certain Philippine incentive programs to be limited to Philippine citizens or corporations. Generally, one country cannot discriminate by imposing more burdensome taxes on its residents who are citizens of the other country, or on permanent establishments of residents of the other country, than it imposes on comparable taxpayers who are resident citizens of the first country. This provision does not, however, require either country to grant to residents of the other country the personal allowances, reliefs, or deductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents. The nondiscrimination provision also applies to corporations of one country which are owned by residents of the other country.

However, the article provides that the Philippines may limit to its citizens and corporations the benefits from the income tax incentive provided under the Philippine Investment Incentives Act, the Export Incentives Act, and the Investment Incentives Program for the tourism industry. The treaty provides that these exceptions to the nondiscrimination provisions are permitted only for these incentive programs to the extent they were in effect on, and have not been modified in any substantial way since, the date of signature of the treaty (October 1, 1976). In addition, other similar incentives provided by the Philippines or by political subdivisions or local authorities of the Philippines may similarly be limited to Philippine citizens and corporations to the extent they were in effect on the date of signature and have not since been substantially modified.

Article 25. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision which authorizes both the competent authority of the United States and the Philippines to consult together to attempt to alleviate individual cases of double taxation or cases of taxation not in accordance with the proposed treaty.

Under the proposed article a resident or citizen of one country who considers that the action of the countries or either of them will cause him to pay a tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or citizen. The competent authority then makes a determination as to whether or not the claim has merit. If it is determined that the claim does have merit, and if the competent authority cannot unilaterally solve the problem, that competent authority endeavors to come to an agreement with the competent authority of the other country to limit the taxation which is not in accordance with the provisions of the treaty.

In the case of the United States, the provision requires the waiver of the statute of limitations so as to permit the issuance of a refund or credit notwithstanding the statute of limitation. The provision, however, does not authorize the imposition of additional taxes after the statute of limitations has run.

In the case of the Philippines, a mutual agreement is to be carried out by the Philippines issuing a tax credit certificate. The certificate will only be issued if a claim is filed with the Philippine Competent Authority within two years from the close of the taxable year in which any U.S. tax imposed by a competent authority adjustment is paid, but only if it is filed within five years from the end of the year at issue. After that five year period the claim must be supported by the taxpayer's books and records. The Philippines will not give a tax refund, only a credit against future Philippine tax.

A second provision directs the competent authorities to resolve any difficulties or doubts arising as to the application of the convention. Specifically, they are authorized to agree as to the attribution of profits to a resident of one country and its permanent establishment in another country, the allocation of income deductions or credits and the readjustment of taxes, the determination as to source of income, the characterization of items of income, and to the common meaning of terms. Under this authority, the Internal Revenue Service from time to time issues rulings defining terms in a treaty. The proposed treaty contains a provision, not found in most treaties, that permits the competent authorities to agree to increase dollar amounts reflected in the treaty to reflect monetary or economic developments.

The treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of the mutual agreement provision. It also authorizes them to meet together for an oral exchange of opinions. These provisions make clear that it is not necessary to go through normal diplomatic channels in order to discuss problems arising in the application of the treaty and also removes any doubts as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or the Philippines.

Article 26. Exchange of Information

This article forms the basis for cooperation between the two countries to better enable them to deal with avoidance or evasion of their respective taxes and to enable them to obtain information so that they can properly administer their tax systems and the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or for the prevention of fraud or for the administration of statutory provisions concerning taxes to which the convention applies. Unlike many recent treaties the exchange of information is limited to taxes generally covered by the proposed treaty.

The information exchanged may relate to tax compliance generally and not merely to avoidance or evasion of tax.

Information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the receiving country, except that it may be disclosed to persons involved in the assessment or collection, or litigation concerning, the taxes to which the treaty applies. The information may be used for such purposes only. Accordingly, it is not clear that Congress in the exercise of its oversight responsibilities, could obtain the information.

The proposed treaty denies information where supplying it would be contrary to public policy. It does not contain the usual limitations on the obligations of the countries to supply requested information under which a country is not required to carry out administrative measures contrary to its law or administrative practice, to supply particulars not obtainable under its laws or in the normal course of administration, or to supply information that would disclose a trade secret. It is assumed, however, that such activities would be contrary to public policy.

The proposed treaty provides that a country receiving a request will endeavor to obtain the information requested the same way as if its own taxation was involved, notwithstanding the fact that the requested country does not, at that time, need the information. A requested country will use its subpoena or summons powers and any other powers that it has under its own laws collect information requested by the other country, even though it itself does not need that information for its own purposes. What this means is that a requested country will use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country, even though it itself does not need that information for its own purposes. It is intended that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that provision be strictly reciprocal. For example, once the U.S. Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the United States investigators can no longer use an administrative summons to obtain information. If, however, Canada could still use administrative process to obtain requested information, it would be expected to do so even though the U.S. cannot. The United States could not, however, tell Canada which of its procedures to use.

The requested competent authority will attempt to provide the information requested in the form requested. Specifically, the competent authority will attempt to provide depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts or writings) to the extent that they can be obtained under the laws and practices of the requested country in the enforcement of its own tax laws.

The proposed treaty specifically provides for both a routine exchange of information and an exchange on specific request.

Article 27. Assistance in Collection

The provision requires that each country aid in collecting the taxes of the other country to the extent necessary to insure that exemptions or reduced rates of tax under the treaty are not enjoyed by persons not entitled to its benefits.

Article 28. Diplomatic and Consular Officials

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or the provisions of special agreements.

Article 29. Entry into Force

The proposed treaty will enter into force 30 days following the exchange of the instruments of ratification. It will become effective, with respect to withholding tax rates for amounts paid on or after, and, with respect to all other taxes for taxable years beginning on or after, January 1st of the year following the date on which the proposed treaty comes into force.

Article 30. Termination

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after 5 years from its entry into force by giving at least 6 months' prior notice through diplomatic channels. If terminated, the termination will be effective with respect to income of taxable years beginning (or, in the case of withholding taxes, payments made) on or after January 1 immediately following the expiration of the 6-month period.

Exchange of Notes

At the signing of the treaty, notes were exchanged that indicate that the Philippines may grant a deduction rather than a credit for U.S. taxes paid by Philippine citizens resident outside of the Philippines. The notes are discussed under Article 23 (Relief from double taxation).

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