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# PREPARED STATEMENT OF DAVID H. BROCKWAY, DEPUTY CHIEF OF STAFF, RICHARD A. GORDON, INTERNATIONAL TAX COUNSEL, AND THOMAS B. JOYCE, ACCOUNTANT, STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE COMMITTEE ON FOREIGN RELATIONS, UNITED STATES SENATE ON THE PROPOSED TAX TREATIES SCHEDULED FOR HEARING SEPTEMBER 24, 1981*

It is our pleasure to appear before you to provide staff assistance on the tax treaties and protocols which are currently under consideration by your Committee. As in the past, our staff has prepared separate pamphlets on each of the treaties and protocols before you; these pamphlets give an article by article description of each treaty or protocol and generally indicate those provisions which differ significantly from those normally found in U.S. treaties. The summaries of each of these pamphlets highlight the provisions of the proposed treaties which present significant policy issues. In addition, we have prepared a memorandum summarizing some of the general and specific issues raised by the various tax treaties before the Committee.

In preparing for this hearing, we analyzed the treaties, and also spoke with a number of attorneys, accountants, and business people who are familiar with the treaties. In this process, we worked closely with staff of the Senate Foreign Relations Committee and with Treasury.

The proposed treaties and protocols are, for the most part, noncontroversial. There are, however, a few controversial provisions in some of the treaties. In addition, the large number of treaties and the extension of the treaty network

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*The proposed tax treaties other than that with Canada which is discussed in a separate statement.

to less-developed countries which these treaties would represent present several important issues. Also, as treaties have become more specific, technical problems have developed which require greater attention.

In light of the materials which have already been provided to you, we will not describe the features of each treaty in this presentation. Instead, we would like to focus our discussion today on the relatively important tax policy issues presented by various provisions in these treaties. We will first discuss a number of issues which are raised in more than one treaty and then focus on some of the more controversial issues in the individual treaties.

In a few cases the committee may want to consider the option of a reservation or an understanding on a particular provision of the treaty. However, it is more likely that in most cases the provisions are not sufficiently troublesome or controversial that a recommendation of reservation or understanding with respect to any particular treaty provision need be seriously considered. Instead, in a number of instances the committee may want to consider stating in its report accompanying the resolution approving ratification that a particular provision is intended to be interpreted in a certain way or that the policy reflected in a particular provision not be viewed as precedent for future U.S. tax treaty negotiations. Indeed, in some of these areas the committee may want to recommend that, subsequent to ratification of these treaties, the policies embodied in certain provisions be reexamined by the Treasury Department, both in the context of legislative changes and in the context of the U.S. treaty negotiating position.

## I. Background

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

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

By treaty, therefore, countries agree to limit both their jurisdiction to tax and their levels of tax. A U.S. resident's foreign tax burden is therefore generally reduced by a treaty. Accordingly, most taxpayers will argue that any treaty that resembles the U.S. model treaty 1/ is better than no treaty.

A treaty with one country is, however, often perceived as precedent by other treaty partners. Accordingly, a treaty with one country that provides for a relatively high rate of tax on passive income may save U.S. investors some tax as compared to no treaty at all with that country, but it may also encourage other countries not to lower their rates as much as they otherwise would. Also, if a treaty can be used by persons who are resident in third countries, it can lead to an erosion of the U.S. tax base without any reciprocal benefits.

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

For example, if residents of nontreaty countries (in which United States persons invest) can invest in the United States through a treaty country, nontreaty countries have less incentive to enter into a treaty with the United States. Also, those that do negotiate treaties with us are under less pressure from their businesses investing in the United States to agree to reciprocal reductions in source basis taxation. Accordingly, in either case United States investors in foreign countries pay higher taxes than they otherwise might.

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

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

We would now like to address some issues raised by the particular treaties before you.

## II. General Issues

### A. Developing Countries

Most existing United States tax treaties are with industrialized countries who are also members of the OECD. With a few notable exceptions, these treaties follow a consistent pattern that generally gives the country of residence of the taxpayer the primary right to tax income with two exceptions: business income that is attributable to a permanent establishment in the other country; and income from real property.

The treaties and protocols before you this afternoon, other than the Norwegian Protocol and the German Estate tax treaty, are with developing countries.

For a variety of reasons, including the potential revenue loss and the difficulties in administering an extra territorial tax system, developing countries generally are opposed to yielding jurisdiction to tax income at its source. This philosophy is reflected in the United Nations Model for tax treaties between developed and developing countries, which includes fewer limitations on source basis taxation, than is the case in most United States income tax treaties, the United States Model, and the OECD Model.

Let us give you two examples of the lower limitations. First, treaties generally provide that a country can tax business profits only if they are attributable to a permanent establishment. A permanent establishment is defined in the most recent United States Model to include a building site or construction or installation project or the like but only if it lasts more than 12 months. Under this definition a construction project that lasts less than 12 months would not be a permanent establishment and the country of source would not be able to tax any of the profits generated. The U.N. Model, however, privides that the construction site will be a permanent establishment if it exists for 183 days or approximately 6 months. Accordingly, a permanent establishment will arise sooner under the U.N. Model, and the developing country will be able to tax those profits sooner. All of the treaties before you contain the 6-month rule. The model treaties contain a listing of activities that will generate a permanent establishment. Developing countries like to include in this list supervisory or consulting services. The U.S. Model does not provide for treating those activities as a permanent establishment and accordingly they would generally not be taxed at source. However, in deference to the status of many of the proposed treaty partners, most of the treaties before the committee today contain supervisory or construction services as a permanent establishment.

Developing countries also seek relatively high rates of tax at source on passive income while the United States generally seeks low withholding taxes at source. The U.S. Model calls for 5 percent on direct investment dividends and 15 percent on portfolio investment dividends. The U.S. Model takes the position that interest and royalties should be exempt from tax at source. Developing countries do not want to relinquish source basis taxation and insist on higher rates. In the case of one treaty, Argentina, there is no limitation on interest and royalty taxation at source. Some of the others have very high limits.

Israel, for example, will be permitted to impose a 17.5 percent rate of tax on interest. The Philippine Treaty contains some of the highest limitations found in U.S. tax treaties.

While there may be an argument for insisting on adherence to residence basis taxation, most people would seem to agree that such a position would limit our ability to negotiate treaties for developing countries. To the extent that treaties with developing countries are desirable the concessions are probably necessary. The committee may wish to determine whether guidelines are appropriate.

A significant advantage of treaties with developing countries is the ability of the parties to exchange tax-ralated information. An expanded treaty network could also generally help the tax administrators to better administer the treaties.

B. Competent Authority

Income tax treaties contain a provision commonly called the Mutual Agreement Procedure article which provides that the competent authorities of the countries (the IRS and the foreign tax authorities) can consult to deal with cases which give rise to double taxation under the convention and also develop procedures and interpretations to attempt to avoid double taxation. A number of the treaties (Argentina, Bangladesh, Canada, Denmark, Jamaica, and Malta) contain a provision which allows the competent authorities to consult together "...for the elimination of double taxation in cases not provided for in the Convention." Similar provisions are contained in the existing treaties with Hungary and Poland as well as the U.S. Model and the OECD Model. Questions have arisen as to the meaning of this language. Assuming it is intended to permit the tax authorities to make adjustment of tax liability in cases of double taxation that are not specifically covered by the treaty, an issue arises as to whether this is an appropriate delegation of legislative power to the IRS.

Another question is the scope of this provision. Presumably, this authority cannot be exercised to affect items of substance outside the scope of the treaty. It has been said that it is to be used to resolve noncontroversial items which are within the general scope of the treaty but which are not adequately dealt with by the treaty in some technical respect. Other questions have been raised by commentators as to its appropriateness. [See Jones, John F. Avory, "Mutual Agreement Procedure", Bulletin for International Fiscal Documentation, 556 (1980).] Questions have also been raised as to the validity of the delegation. Questions as to whether a decision under this provision will be binding on the courts or even binding on the competent authority himself have been raised.

Arguably, the provision is too broad on its face and should be appropriately limited. If the committee is concerned, it could recommend ratification with an understanding that the provision is limited to relatively minor technical problems, or it could make clear in the committee report that that is the intended meaning of the provision. It might be useful if Treasury were to submit a statement outlining its views of the scope of the provision.

A number of the pending treaties would give the competent authorities the right to increase amounts specified in currency. The effect is to permit the competent authorities to increase the amounts individuals must earn before they will be subject to tax in the country where services are performed. The treaties do not contain standards for determining when the amounts should be increased, although most do say that economic developments should be taken into account. This is also the first explicit Congressional delegation to the competent authorities (in the case of the United States, in effect, the Assistant IRS Commissioner for Compliance, or his delegate) of the right to set taxing jurisdiction. There is no comparable delegation in the Code. Thus, issues to be considered are whether it is appropriate to delegate this authority to the IRS, and, if so, whether any standards should be articulated by the Senate to provide guidance to the IRS in the exercise of that authority (e.g., any increases in amounts specified in currency in the treaties should be modified only to reflect the impact of inflation).

C. <u>Congressional Oversight of Competent Authority Cases</u>

The mutual agreement procedures are important because many cases that involve double taxation that cannot be resolved through the operative provisions of the treaty are resolved through that procedure. Many of these cases are intercompany pricing cases involving substantial revenue. They are resolved by negotiations between the United States and the foreign competent authorities. The result may be a splitting of substantial revenue between the United States and its treaty partner.

All of the treaties contain a provision that limits access to information received by the United States and the treaty partner under the treaty to persons involved in the assessment or collection of taxes. This provision in existing treaties has been interpreted by the IRS as precluding Congressional access, specifically General Accounting Office access, to mutual agreement case files.
Accordingly, the Congressional Oversight Committees, and the GAO at their request, have been hampered in their recent attempts to audit the IRS administration of mutual agreement cases which may involve significant revenue, Treasury has indicated that this problem will be taken care of in future treaties, and that they are attempting to work our the problem for existing treaties. Most of the instant treaties, however, do not contain language that clearly permits Congressional access. The Canadian treaty does contain language which we understand is intended to

permit continued access to information obtained from Canada. The issue is the extent to which Congressional oversight should be permitted and, if so, whether some change in the treaty language is necessary to accomplish that objective.

If this issue is of significant concern to the committee, the relevant treaties could be approved subject to an understanding that the Congressional Oversight Committees and the GAO will, pursuant to the procedures established in the Internal Revenue Code, have access to the mutual agreement case files where necessary to carry out their oversight functions. Alternatively, this result might be accomplished by a statement in the committee reports that access is intended to be permitted under these provisions.

their oversight functions. Alternatively, this result might be accomplished by a statement in the committee reports that access is intended to be permitted under these provisions.

D. <u>Nondiscrimination</u>

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

(1) <u>Foreign investors in U.S. real estate</u>.--One area of particular concern is whether the nondiscrimination provision overrides the recently enacted legislation which is intended to subject foreign persons to capital gains tax when they sell

United States real property. An argument could be made that the basic structure of that legislation technically violated the nondiscrimination provisions of certain existing U.S. tax treaties. In order to prevent foreign investors from taking the position that this arguable technical conflict relieved them from tax liability under the legislation, the legislation specifically overrode the existing treaties on this point to the extent, if any, that a conflict existed and provided an exclusive remedy under the statute. While this statutory relief provision resolves the possible conflict with respect to existing treaties, the problem can arise under the pending treaties since they will be ratified after the legislation was enacted and thus, to the extent of any conflict, might be held to supersede it. We understand that Treasury takes the position that these treaties do not conflict with the legislation.

We recommend that the committee clearly specify the relationship between the nondiscrimination provisions of the proposed treaties and the real estate legislation. More particularly, we recommend that the committee should take the position that the real estate legislation would not be overriden by the nondiscrimination provisions and that this position should be reflected by approving the treaties subject to an understanding stating that position or by including a statement in the committee report to that effect.

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

We recommend that the committee make clear the relationship of the nondiscrimination provisions of the proposed treaties and the dividends received deduction of the Internal Revenue Code. More particularly, we recommend that the treaties not be interpreted as granting the exclusion and that this interpretation be made clear either in an understanding accompanying the Senate's approval of the treaty or in the report of the committee.

(3) Acquiescence to discriminatory practices.--Another side to the issue of the appropriate level of nondiscrimination is the question of whether the United States should demand a broad based nondiscrimination article, or, alternatively, agree to some exceptions from the nondiscrimination provisions.

The U.S. model nondiscrimination provision generally prohibits the parties to the treaty from discriminating against similarly situated residents of the other country or against their own corporations that are owned by residents of the other country. Most of the treaties contain the model nondiscrimination provision. One major reason for entering into a treaty with a developing country is to obtain nondiscrimination protection.

However, a few of the treaties contain specific provisions which permit discrimination. These are usually inserted into the treaty at the insistence of the developing country. The Philippine Treaty, for example, would permit the Philippines to grant certain tax incentives to Philippine residents but not to U.S. residents. Also, the Philippine Treaty and thus its nondiscrimination provision, does not apply to income from air transport. The airline industry views this as permitting the Philippines to continue discrimination taxation of U.S. airlines. The Jamaican Treaty on its face appears to permit some limited discrimination vis-a-vis U.S. insurance companies.

There seems to be unanimity that it is proper to seek complete nondiscriminatory coverage. Realistically, however, the United States as a developed country may have to permit at least some limited discrimination involving protection of local industry or incentives to residents of the other countries to invest locally if it is to enter into income tax treaties with developing countries. If the committee should decide that nondiscrimination is an overriding policy issue it could reserve on those provisions which permit some discrimination. In the alternative, it might recommend ratification of the present treaties but with a clear statement in its report to the Senate of its view that future treaties not contain discriminatory provisions. Of course, either action might significantly restrict the expansion of the treaty network to include more developing countries.

E. Deductions--Expansion of the Scope of the Treaties

Three of the treaties before the committee, the treaty with Canada and two of the treaties which are the subject of hearings this afternoon (those with Israel and Jamaica) contain provisions which permit U.S. persons to take U.S. tax deductions to which they would not otherwise be entitled. The issue is whether the U.S. taxation of U.S. persons is inherently a matter which should not be resolved through bilateral agreements without specific legislative approval.

Both the Israeli and Canadian treaties contain a provision which, on a reciprocal basis, permits a U.S. person to treat as a charitable contribution a contribution to a charity of the other country. The amounts are limited to a percentage of adjusted gross income from the other country. A similar provision is contained in the existing treaty with Canada. As a general rule, treaties have not given U.S. persons deductions for activities related to the other country. Arguably, the situations with Canada and Israel are unique because of the special relationship with the two countries and the special interest which U.S. residents have in charitable activities in the other country.

Two of the treaties (Jamaica and Canada) contain a provision which permits U.S. persons to deduct the expenses of attending a convention in the other country. Under provisions of the Internal Revenue Code (Code sec. 274(h)) adopted in 1976 and modified in 1980, U.S. taxpayers are generally not allowed deductions for attending business conventions outside the United States, its possessions, Canada, and Mexico unless it is as reasonable to hold the convention outside that North American area as within it. The provision in the Canadian Treaty was negotiated before the legislation which gave the convention deduction for conventions in Canada was enacted at the end of 1980.

The recently negotiated protocol to the pending Jamaican Treaty would expand the North American area exception to the U.S. foreign convention expense rule and would thus permit Americans to deduct expenses of attending a convention in Jamaica.

The issue is whether treaties should be used to allow U.S. persons deductions to which they would not otherwise be entitled. Arguably, this is an appropriate function of treaties in limited cases because it adjusts U.S. rules to take into account the tax relationships between the countries. Also, it is the type of provision for which a significant identifiable concession may be obtained. For example, in the Jamaican protocol in return for the convention deduction the United States obtained the tightest anti-treaty shopping provision in any treaty and also a commitment from Jamaica to enter into negotiation of a criminal mutual assistance treaty.

The committee might want to make a clear statement in its report of its view that deductions should be allowed by treaty only in very limited circumstances.

F. Foreign tax credits

The treaty generally provides for relief of double taxation which is not otherwise eliminated by the other rules of the treaty. The United States generally agrees to relieve double taxation by granting a credit for income taxes paid to the treaty partner. The credit is given subject to the limitations contained in the Internal Revenue Code.

In most cases, the treaties provide that taxes which would be creditable under the Internal Revenue Code in any event are creditable. In that case it is unnecessary for the taxpayer to rely on treaty rules for his credit. In some cases, however, credits are given for taxes that are of questionable creditability under the Code rules but whose economic substance is sufficiently comparable to U.S. notions of what constitutes income tax that it does not require a major departure from applicable Code policy to treat the tax as a creditable tax. These cases often solve otherwise difficult technical problems in trying to determine whether a foreign tax system specifically and absolutely fits within our concept of income tax.

Forced loans.--In a few cases, however, the United States has granted foreign tax credits for taxes that would clearly appear not to be creditable under the Code. An obvious example in the treaties before you is the granting of a credit for forced loans required by Israel and Morocco. In both cases the United States is required to allow a foreign tax credit for loans which U.S. businesses operating in the country are required to make to the Israeli or Moroccan Government.

The provisions provide that a repayment of the loan is treated as a refund of foreign tax to the U.S. business, and thus the taxpayer's creditable foreign taxes would be reduced in the year of repayment. In practical effect, these provisions amount to a loan from the U.S. Government to the Moroccan or Israeli Government, as the case may be, with a taxpayer acting as a middleman. In the case of Israel the loans are being phased out. We understand that Morocco still has a loan provision. These provisions in effect are an indirect form of loan from the U.S. Government through the tax system.

The committee might want to consider reserving on these provisions. Alternatively, in light of the fact that these treaties were signed a number of years ago, the committee may wish to approve the treaties with the provisions but expressing strong concern with similar provisions in the future.

Oil taxes.--Another issue that is raised by at least two of the treaties before the committee is the question of the appropriate limitation on a foreign tax credit granted under the treaty.

As a general rule, the United States permits a foreign tax credit which is limited to U.S. taxes imposed on foreign source income of a U.S. taxpayer. The limitation is a worldwide limitation which is a ratio of the taxpayer's foreign income to worldwide income. Both the Norwegian Protocol and the proposed Canadian Treaty contain a provision which would limit the credit granted under the treaty to U.S. taxes imposed on income from the treaty partner rather than on a worldwide basis. However, the limitation under the treaty only applies if the tax is otherwise noncreditable. If it is creditable under the Code, then the normal foreign tax credit limitations apply.

The treaties are thus getting involved in a long-standing debate over what is an appropriate tax credit, particularly where mineral taxes are an issue. Some have questioned whether the treaty process is the appropriate place to negotiate a different set of rules than the Code imposes. Some might question the policy of determining an income tax to be creditable by treaty where the Treasury regulations throw doubt on that creditability. It might be argued that in order to obtain a fair result for U.S. taxpayers, the United States is forced into concessions it would not otherwise have to make. Some have seriously questioned whether the treaty process is really the forum in which to consider the foreign tax credit issue. It has been argued that the availability of the foreign tax credit to a major U.S. industry should not depend on whether or not the United States has a treaty with a particular country.

G. <u>Third Country Use of Treaties</u>

Tax treaties are generally intended to limit double taxation of residents of one country which arises because of operations or investments of the treaty partner. At times, however, residents of third countries which may not have treaties with the United States may establish a corporation in a treaty country through which they route their investment in the United States and obtain a lower treaty rate. This planning device is known as treaty shopping. This issue was clearly drawn in the case of the proposed treaty with the British Virgin Islands. Under the existing treaty, which is an extension of the 1945 United States-United Kingdom income tax treaty to former British colonies, U.S. source royalties can be paid to BVI investors free of U.S. tax and dividends paid at reduced rates of tax. By special arrangements, interest also can be paid out free of tax. Under the proposed BVI treaty foreigners resident in any country would have been permitted to invest in the U.S. and pay a 15-percent rather than the 30-percent gross statutory rate of tax on that investment. Little, if any, investment affected by the treaty would originate in or be destined for the British Virgin Islands. A similar issue was raised with respect to Cyprus because of its status as a tax haven. Principally on account of this issue, Treasury has requested that the BVI and Cyprus treaties not be considered at this hearing.

The present treaty with Jamaica, as amended by the protocol, contains a very strong anti-treaty shopping provision. In effect, Jamaican companies owned by persons who are not residents of Jamaica would not be entitled to treaty benefits unless they could establish that the company was not established to take advantage of the treaty.

The question of the treaty shopping does not arise solely with respect to tax havens that are small countries. An issue has arisen in connection with the ratification of the Canadian Treaty. Much of the Canadian investment in the United States apparently flows through the Netherlands. This is because under the United States-Netherlands Treaty dividends can be paid to the Netherlands subject to a 5-percent rate of tax rather than the 15-percent rate provided for in the United States-Canadian Treaty. Under the new Canadian-Netherlands Treaty, dividends can be paid in certain cases from Netherlands holding companies in Canada at a zero rate of tax. Accordingly, dividends flowing from the United States through the Netherlands and into Canada can incur a rate of tax of 5 percent rather than 15 percent. Should the proposed United States-Canadian Treaty be ratified, the rate for direct investment dividends between the United States and Canada would be reduced to 10 percent but this will still be 5 percentage points higher than the rate that can be achieved through the Dutch connection. [This issue was also discussed in our statement submitted to the Committee in its hearings on the proposed Canadian treaty.]

For a variety of reasons, it may not be desirable to attempt to resolve all these issues in the context of the pending treaties, some of which have been under consideration for a number of years. However, the committee might want to consider directing the Treasury to review its positions on a number of these issues raised by us and by the Treasury in its testimony.

H. Impact of Treaties on Real Property Legislation

On November 26, 1980, Congress passed the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), which generally subjects foreign persons to U.S. tax on sales of U.S. real estate made after June 18, 1980. Also, foreign persons selling stock in a U.S. corporation having 50 percent or more of its gross asset value comprised of U.S. real property interests will be subject to U.S. taxation. Finally, the distributions (liquidating or nonliquidating) of a U.S. real property interest by a foreign corporation will be subject to tax.

While the provision was effective for dispositions after June 18, 1980, special rules apply to transactions covered by a treaty of the United States. In general, the Code provision overrides treaties but not until January 1, 1985. If a treaty is negotiated and signed before 1985, the old treaty takes precedence over the Code provision for the period set out in the new treaty or an accompanying exchange of notes, but only for a maximum period of 2 years after the new treaty is signed. The legislative history to the Act indicates that the old treaty is given a 2-year grace period in order to permit the Senate adequate time to consider the revised treaty.

The Economic Recovery Tax Act of 1981 amended this provision to make it clear that the 2-year period did not apply if the new treaty was signed before January 1, 1981. In that case, the old treaty would continue to apply until December 31, 1984, or, if earlier, until the new treaty is ratified.

The treaties before the committee generally do not conflict with the 1980 legislation in its most important respects. Also, they retain the right of the United States to impose relevant reporting or withholding requirements. However, a number of the treaties contain at least two provisions which would restrict to some degree the right of the United States to apply its legislation.

First, under the legislation a foreign investor is taxed on his dispositions of a United States real property holding company. A corporation is a United States real property holding company if the fair market value of its United States real property interest equals or exceeds 50 percent of the fair market value of its total assets. During the consideration of the legislation, the decision was made to include United States real property in which the business of the entity is carried on as United States real property for purposes of determining whether or not the corporation meets the 50 percent test. The treaties with Argentina and Canada, however, contain a different rule. For purposes of determining whether an entity's assets consist principally of real property under those treaties, property in which the business of the entity is carried on is not treated as real property. This change would make it possible for a foreign investor to make substantial investments in U.S. real estate used in a business and, assuming the asset mix were managed properly, significant nonbusiness U.S. real estate investments without being subject to the legislation.

Second, under the legislation, a foreigner disposing of an interest in a partnership, trust, or estate will be treated as disposing proportionately of its U.S. real property. Accordingly, a foreign partnership disposing of an interest in a partnership, 35 percent of the assets of which consisted of U.S. real estate, would be taxed on his gain equal to 35 percent of the gain of the disposition. A number of the treaties, however, treat partnerships, trusts, and estates as entities and would only tax the disposition of an interest in those entities by a resident of the treaty partner if more than 50 percent of its assets consisted of U.S. real property interest. This entity characterization of a partnership conflicts with those Code rules that treat partnerships as flow-through entities. The two separate rules will add substantial complexity to an area of the tax law that is already complex.

Most of the treaties before the committee were signed prior to the existing legislation, in fact, most are 2 or more years old. The legislation clearly indicates that it would override existing treaties but not until 1985.

In order to eliminate any uncertainty as to whether the legislation or a particular treaty provision prevails, it is important that the committee take a position on this issue that would make clear the result. This certainty could be provided by the committee recommending that the Senate approve the ratification of the treaties subject to an understanding that the legislation either does or does not prevail as against a conflicting real estate treaty provision. A distinction could be made in the case of the step-up in basis or fresh-start rules in the Canadian treaty because those rules take into account the exemption from tax on real property gains which is found only in that treaty. In that case, the step-up-in-basis rule might apply with the legislation prevailing in all other conflicting provisions.

I. Second withholding tax

Under U.S. law, dividends received by a foreign person from a foreign corporation are U.S. source dividends subject to the 30-percent withholding tax if at least 50 percent of the gross income of the corporation, in the prior 3-year period, was from a U.S. business of the foreign corporation. This provision is intended to preserve the U.S. withholding tax on dividends in those cases in which a foreign, rather than a domestic, corporation is used to do business in the United States. A number of the treaties preserve this tax. However, a number of the treaties provide that the United States may impose its tax on dividends from a foreign corporation to a resident of the treaty partner only if the profits of the corporation equal or exceed 50 percent of its gross income. This comparison of profits to gross income in effect makes the provision inapplicable. It is understood that it was a technical drafting error and not intended.

We recommend that the approval of these treaties be made subject to an understanding that the provision is to be interpreted in a manner similar to the Code.

We will now turn to the specific treaties before you. In light of the materials which have already been made available we will focus on the significance of the individual treaties and briefly mention the issues raised by them if any.

Income Tax Treaty (and Protocol) with Argentina

The proposed treaty is important because if ratified it would be our first treaty with a South American country. This treaty, therefore, could represent an important breakthrough. However, in order to reach agreement, the United States found it necessary to make significant concessions to source basis taxation.

Source basis taxation.--The treaty generally does not provide a reduction in source basis withholding taxes on interest and royalties paid to residents of the other country. In addition, royalties include film rentals, with the result that Argentina can continue to tax film rentals at its current 22.5 percent of the gross payment, or can increase that tax. Generally, the U.S. position (which is rarely achieved) is that these taxes should be eliminated, and many treaties limit the taxes to 10 percent. In the case of interest paid to banks, many U.S. treaties actually achieve a zero rate of tax.

The proposed treaty provides that the countries will limit their withholding tax to 20 percent of the gross amount of dividends paid to residents of the other country, with a special rule in the case of dividends paid by an Argentine company aimed at limiting the combined level of corporate level and dividend withholding tax to 45 percent. Unlike many other U.S. treaties, there is no distinction between portfolio investors and corporate direct investors. In most treaties, the withholding tax on dividends paid to direct investors is lower than the tax imposed on dividends to portfolio investors. Furthermore, the 20 percent rate is higher than generally allowed in U.S. tax treaties which are for the most part with developed countries. In the U.S. model, the rates are limited to 5 percent for direct investors and 15 percent portfolio investors.

The provision dealing with the definition of a permanent establishment is slightly different than many other U.S. treaties, although generally consistent with treaties with developing countries. In general, it provides for a six-month test for building and construction sites to be treated as a permanent establishment rather than the one-year period usually provided.

To some degree, these concessions to source basis taxation reflect Argentina's territorial tax system which relies solely on source basis taxation for revenue; that is, it does not tax any foreign source income. Nevertheless, these concessions could be viewed as precedent by developing countries many of whom, in practice, also rely solely on source basis taxation.

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

Territorial tax system.--This treaty raises several unique issues because Argentina is one of the very few countries that has a strict territorial tax system, and this would be our first treaty with a country having such a tax system. The first issue is whether it is appropriate to forego U.S. tax when, because of the general tax system of the treaty partner, the result will be the total elimination of any tax paid by the foreign investor on that U.S. source income. In the case of this treaty, total elimination can occur in only a few cases.

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

Anti-treaty shopping provision.--This treaty is one of two treaties (the other is the treaty with the Philippines) before the committee that does not contain an anti-treaty shopping provision. Most recent U.S. treaties contain a provision that limits the use of the treaty to corporations controlled by persons who are residents of the treaty partner. These provisions are intended to prevent third country residents from establishing a company in a treaty partner in order to take advantage of reduced withholding rates (i.e., "treaty-shopping"). While withholding rates on interest and royalties are not reduced under this treaty, and while the withholding rate on dividends is relatively high, Argentina's territorial system might raise the potential for other abuses.

While the Article that covers other income might cure some of these problems, the potential for abuse under the treaty, given Argentina's strict territorial system, is unclear. Also, experience has shown that if abuses develop later it is very difficult to negotiate solutions. As indicated above, the Committee might consider certain limitations if it considers this potential sufficiently serious. It must be recognized, of course, that insistence by the United States on anti-abuse provisions might result in the refusal of Argentina to accept the treaty.

Income Tax Treaty with Bangladesh

The proposed treaty is not controversial. It contains developing country concessions similar to those in other treaties before the Committee. In fact, they are not as extensive as some.

One provision that should be brought to the Committee's attention is the shipping and air transport provision. Generally, the U.S. seeks a complete exemption from taxation at source for income from shipping and air transport. The proposed treaty exempts international airline income from tax. It does not, however, exempt shipping income. The U.S. model, and most U.S. treaties, contain a source exemption for both aircraft and shipping. The issue is whether the United States wants to establish the precedent of a treaty without an exemption for shipping income.

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

We are not aware of any opposition to the proposed treaty.

Income Tax Treaty with Egypt

The proposed treaty is similar to recent U.S. income tax treaties and to the U.S. and OECD models. It contains some concessions to source basis taxation in recognition of Egypt's status as a developing country. It contains no major provisions which warrant the special attention of the committee.

The treaty does contain a special provision imposing limitations on taxation of dividends paid by Egyptian corporations to residents of the United States which differ from those ordinarily found in U.S. tax treaties. The differences reflect Egypt's corporate system under which dividends distributed out of the current year's earnings are deductible. The provision is explained more fully in the pamphlet describing the Egyptian treaty under the discussion of the dividend article.

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

Income Tax Treaty (and Protocol) with Israel

The proposed treaty is similar to recent U.S. income tax treaties and to the U.S. and OECD models. It contains some concessions to source basis taxation similar to those contained in a number of the treaties before the Committee. In general, we are not aware of any significant controversy concerning the treaty. However, the treaty does contain a few provisions that are worthy of note, and one, the forced loan provision, that might prove troublesome.

Forced loans.--As in the case of the treaty with Morocco, this treaty would require the United States to treat as income taxes certain loans which a U.S. business operating in Israel is required to make to the Israeli Government. Thus, those U.S. businesses not in an excess foreign tax credit position would be allowed a foreign tax credit for the amount of the loan. However, a repayment of the loan will be treated as a refund of Israeli tax to the U.S. business, and thus the taxpayer's creditable foreign taxes would be reduced in the year of repayment. As a practical matter, this amounts to a loan from the U.S. Government to Israel, with the taxpayer as the middleman. This treatment is accorded only to corporations which become subject to the loan requirements before April 1, 1977, but only if levied for taxable years ending before April 1, 1988. We understand that the Israeli Government no longer requires loans.

If this provision should give rise to concern, the Committee might want to consider recommending approval with a reservation. However, in light of the long period of time that the treaty has been here, and also considering the fact that Israel no longer requires the loans, the Committee might, instead, recommend approval but with an indication that in the future provisions of this type will not be approved. In that event, the committee may consider it appropriate to limit the foreign tax credit to the U.S. tax on Israeli source income.

Dividend.--The dividend rates are not reciprocal in certain tax holiday cases. Dividends on a direct reinvestment in an Israeli corporation subject to a tax holiday are taxed at a 15-percent rate while dividends on a direct investment in either a U.S. corporation or an Isreali corporation not subject to a tax holiday would be taxed at a 12.5 percent rate. Dividends from portfolio investment are taxed at a 25-percent rate, which is high when compared to other treaties before the Committee.

Interest.--The treaty permits a 17.5-percent rate of tax at source on payments to persons other than banks, insurance companies, or governmental units. The rate for payments to financial institutions, which generally have the greatest problems, is 10 percent. The 17.5-percent rate is the highest agreed to by the United States in any treaty and might establish a precedent for negotiations with other countries. However, the Argentine treaty would not limit source basis taxation of interest.

We understand that Treasury would not have agreed to such a high rate without the lower rate for interest paid to financial institutions.

Charitable contributions.--On a reciprocal basis, the protocol to the treaty would permit a U.S. person to deduct as a charitable contribution a contribution to an Israeli charitable organization. In the case of an individual, the amount treated as a contribution (which is subjected to U.S. Code limits) cannot exceed 25 percent of adjusted gross income from Israeli sources (25 percent of taxable income for a corporation). A similar provision is contained in the existing Canadian treaty and the pending revision of that treaty. The issues raised by this provision, and possible actions with regard to it are discussed in more detail in the general section of our testimony.

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

Exchanges of information are a primary purpose for entering into a treaty. Routine information can be useful to the IRS in determining whether U.S. persons receiving income from the treaty partner are reporting all of their taxes.

If the Committee is concerned about the inability of Israel to supply this information it might, in its report to the Senate, express its concern. It could suggest that the Treasury monitor the situation closely to ensure that routine exchanges of information are commenced as Israel's capabilities in this area develop.

Income Tax Treaty (and Proposed Protocol) with Jamaica

The proposed treaty generally follows the U.S. and OECD models, but it contains a number of provisions that very from those models and many U.S. income tax treaties. The treaty itself is not controversial. However, the protocol presents an issue which has generated some controversy.

Less developed country concessions.--A number of these provisions generally reflect U.S. concessions to Jamaica because it is a developing country. For example, the definition of permanent establishment is somewhat broader than that in the U.S. model and many existing U.S. treaties. The principal areas in which the proposed treaty departs from the U.S. model are the inclusion as a permanent establishment of a place of management, a store or sales outlet, construction projects or drilling rigs or ships lasting in the country more than 183 days in a 12-month period (rather than the model 12 months), performing services through personnel for more than 90 days, and the maintenance of substantial equipment for more than 120 consecutive days. Also added is the inclusion in the time period for a construction-type project of connected supervisory services.

Furthermore, the limitations on withholding taxes are higher than those in the model. The tax on direct investment dividends is limited to 10 percent in contrast with the 5 percent in the U.S. model.

The U.S. accumulated earnings tax will not apply to certain income of a Jamaican company derived under Jamaican tax incentive legislation. The tax at source on gross interest is limited to 12.5 percent rather than the zero rate in the U.S. model. Royalties, including movie royalties, may be taxed at 10 percent of gross rather than the zero rate in the U.S. model. The zero tate is rarely obtained. Independent personal service income may be taxed if the person is present in a country for more than 90 days, in contrast to the U.S. model which requires presence for more than 183 days. Both dependent and independent personal service income may be taxed at source if the income exceeds a dollar threshold. The U.S. model does not contain a dollar threshold.

The United States may not impose its so-called second withholding tax on dividends paid by Jamaican corporations earning significant business profits in the United States.

Foreign conventions (Protocol).--One provision which might be controversial is that in the protocol to the treaty which allows U.S. persons a deduction for expenses of attending business conventions in Jamaica.

As was explained in our discussion of the broader issues, under provisions (Code sec. 274(h)) adopted in 1976 and modified in 1980, U.S. taxpayers are generally not allowed deductions for attending business conventions outside the United States, its possessions, Canada and Mexico, unless it is "as reasonable" to hold the convention outside that "North American" area as within it. The recently negotiated protocol to the pending treaty would expand the North American area exception to the U.S. foreign convention expense rules and would thus permit Americans to deduct expenses of attending a convention in Jamaica. This granting of a deduction otherwise denied represents an expansion of the general scope of treaties which ususally seek only to minimize double taxation. It raises the issue of the extent to which we should give U.S. tax benefits to Americans under treaties. This issue is drawn with particular acuteness in the instant situation in view of the fact that only last year Congress considered the question of whether an exemption should be extended to the Caribbean countries and Congress rejected that approach. The Jamaican protocol does contain a significant quid pro quo in the form of the strongest anti-treaty shopping provision in any U.S. income tax treaty and a commitment from Jamaica to negotiate treaties on extradition and mutual legal assistance on criminal matters.

This provision is evidently of concern to certain U.S. interests in the tourism industry because it removes a competitive advantage. Also, placing the provision in this treaty establishes precedent for other negotiations. It might be hard to resist giving the provision to other countries, even European countries, once they too are willing to include anti-treaty shopping rules in the treaties.

If the Committee is sufficiently concerned with the provision, it could, of course, recommend that the treaty be approved and that the protocol be approved with a reservation on the convention point. It is, however, likely that Jamaica would refuse to approve the protocol with a reservation, and it could reject the treaty. Alternatively, the Committee might want to recommend approval of the treaty and protocol but with a recommendation that the Treasury not negotiate such provisions in the future, or with guidelines to the Treasury as to the cases where such a conversion would be appropriate.

Anti-treaty shopping provision (Protocol).--The proposed protocol to the proposed treaty contains the broadest anti-treaty shopping provision found in any U.S. income tax treaty. In effect, Jamaican companies owned by persons who are not residents of Jamaica will not be entitled to treaty benefits unless they can establish that the company was not established to take advantage of the treaty. This type of provision would appear appropriate when dealing with a smaller country that is or has the potential to become an offshore banking center or tax haven.

Some concern has been expressed that inclusion of this provision will encourage other countries to put similar provisions in their treaties, and that this will foreclose opportunities to lower taxes on international transactions. On the other hand, others take the view that limiting treaty shopping will encourage more countries to enter into treaties directly with the United States.

Also, as discussed above, countries such as Canada will be more willing to make concessions to the United States if their companies cannot, by routing their U.S. investments through countries such as the Netherlands, avoid the high rates which Canada insists on imposing on U.S. investors under the U.S.-Canada tax treaty.

Income Tax Treaty with Malta

The proposed treaty with Malta contains no major provisions which warrant special attention of the Committee. The proposed treaty is in virtually every respect similar to recent U.S. income tax treaties and the model income tax treaties of the United States and the OECD. It does contain some developing country concessions similar to those contained in other treaties before the Committee.

The treaty does contain a provision designed to give U.S. shareholders of Maltese corporations the benefit of Malta's integrated corporate tax system.

Income Tax Treaty with Morocco

The proposed treaty is similar to recent U.S. income tax treaties and to the U.S. and OECD models. Because it was negotiated a number of years ago, it differs somewhat in form from more recent treaties and the current models. The proposed treaty does contain some developing country concessions similar to those in other treaties before the Committee. It has only one special provision which warrants the attention of the Committee.

Forced loans.--As discussed in our statement on foreign tax credit issues, the proposed treaty contains a provision that is similar to the provision contained in the Israeli treaty and would require the United States to allow a foreign tax credit for loans which U.S. businesses operating in Morocco are required to make to the Moroccan government. Like the Israeli provision, this forced loan rule can be viewed as a loan from the U.S. government to Morocco, with the taxpayer as the intermediary. While similar to the provisions contained in the proposed treaty with Israel, it will have a more significant impact here because the forced loans are still required by Morocco. Also, the Moroccon treaty contains a per country limitation on the foreign tax credit, and accordingly, the loan can only offset U.S. tax on Moroccon income.

As suggested above, the Committee may wish to consider whether this provision is appropriate in an income tax treaty. As an alternative to a blanket reservation on this provision, this provision could be subject to a "sunset" similar to that contained in the Israeli provision. Also, the Committee may wish to consider whether it would be appropriate to allow the credit for Moroccan forced loans, if approved (with or without a sunset), only against U.S. tax on Moroccan income.

Protocol to Income Tax Treaty with Norway

The proposed protocol to the existing income tax treaty with Norway deals with issues which arose since that treaty came into force. The timing of the ratification of the protocol is important because the provisions of the protocol dealing with the foreign tax credit for Norwegian offshore Petroleum Taxes will apply retroactively to the six years preceding the year in which the instruments of ratification are exchanged. Accordingly, if the protocol is ratified this year, the credit provisions will apply for 1975 and thereafter. If it is delayed it will not apply to 1975.

Petroleum Tax Act.--In 1975, Norway introduced a tax on petroleum-related activities on the Norwegian continental shelf (PTA). The main feature of this Act was the addition to the generally applicable corporate tax of an additional tax of 25 (now 35) percent of the taxpayer's income computed under Norwegian law. The details of this law are described in the pamphlet (pp. 4-6). The protocol would amend the existing treaty to treat this tax and the other generally applicable Norwegian corporate taxes as creditable taxes for U.S. foreign tax credit purposes.

No determination has been made by the U.S. Treasury or Internal Revenue Service concerning the creditability or noncreditability of Norway's national or municipal income taxes or the Special Tax as such under the PTA. Questions such as whether the Special Tax is a creditable income tax under general U.S. Internal Revenue Code concepts or whether it is a substantially similar tax to those creditable taxes enumerated in paragraph (1)(b) of Article 1 of the present treaty or whether the national and municipal taxes as modified and applied under the PTA remain creditable under Article 23 have not been resolved administratively or judicially. However, under the Treasury's proposed and temporary foreign tax credit regulations, as presently drafted, it would appear that at least certain of these taxes would not be creditable. The protocol provides that these taxes are creditable, subject to the limitations contained in the proposed protocol.

In addition to the general rules found in tax treaties, the proposed protocol would permit the taxes covered by the PTA to offset only U.S. taxes on Norwegian oil and gas income. A limited carryback and carryforward of taxes not used in the current year is also provided for. A similar provision is contained in the third protocol to the U.S.-United Kingdom treaty. There was a threatened reservation on the provision in that treaty making the U.S. Petroleum Revenue Tax creditable. In response, a per-country limitation was inserted in the treaty.

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

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

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

Income Tax Treaty with the Philippines

The proposed treaty with the Philippines contains a few provisions that may be controversial. The treaty is generally similar in form to recent U.S. income tax treaties and to the U.S. and OECD models, but with significant adjustments to source basis taxation in recognition of the status of the Philippines as a developing country. The proposed treaty was the subject of hearings held by this Committee on July 19 and 20, 1977. Because of opposition from the airline industry, the treaty was never reported.

There are four matters contained in the treaty which we would like to discuss.

Shipping and air transport income.--This is the first U.S. tax treaty which does not provide for the reciprocal exemption of shipping and air transport profits. In the case of air transport profits, the treaty contains no restrictions whatsoever on either country's right to tax income from sources within that country which is earned by residents of the other country. In the case of shipping profits, the treaty limits the tax which may be imposed by either country to 1.5 percent of gross revenues derived from that country (this tax rate limitation on both countries is to be reduced in the event that the Philippines concludes a tax treaty with a third country under which a lower tax rate limitation is established).

The airline industry continues to object vigorously to this failure to provide a reciprocal exemption for airline profits and to other features of the convention.

The airline industry has argued that the United States should not depart from prior treaty policy and accept a provision which permits the other country to tax shipping and aircraft operating income. The tax paid in the Philippines either reduces U.S. tax revenues (to the extent the Philippine tax can be credited by a particular taxpayer against U.S. income tax) or represents an increased cost to U.S. companies doing business in the Philippines (to the extent the U.S. companies have no U.S. tax liability or have excess foreign tax credits without regard to the Philippine tax). In addition, it is argued that other developing countries would rely on this provision as a precedent in attempting to negotiate tax treaties with the United States which do not provide the reciprocal exemption to shipping and air transport income. Nonetheless, at least with respect to shipping income, there has been increasing interest in recent years in moving away from a system of exemptions and the Philippine treaty is consistent with that position.

Perhaps more important than the fact that the treaty does not provide for the complete exemption of shipping and air transport income is that the treaty permits discrimination in the Philippine tax treatment of U.S. companies and their Philippine competitors. The potential for discrimination is different in the case of shippers and airlines.

First, while the Philippines imposes on U.S. airlines a tax equal to 2.5 percent of their gross revenues from Philippine sources plus a corporate franchise tax of 2 percent of the same amount, the Philippine Airlines (PAL) is exempt from that 2.5 percent tax but instead pays a tax of 2 percent on its worldwide gross revenues. At one time there was some dispute as to the actual difference in the Philippine tax burden imposed on income derived by PAL and that imposed on the U.S. airlines on their income from operating into and out of the Philippines. Whatever the differential, it appears that there is discrimination, and it is permitted to continue under the treaty.

It should be noted that the treaty leaves open the option for the U.S. Government to retaliate against this discrimination by increasing the U.S. income tax on Philippine corporations under the antidiscrimination provisions of the Internal Revenue Code (sec. 896). However, given the limited contacts which Philippine aircraft operators have with the United States, it is doubtful that this retaliation would have much impact.

The airlines now may be willing to accept a compromise that treats airline income like shipping income so that it would be taxed at 60 percent of the normally applicable rate, and that makes it clear that certain ticketing activities of independent Philippine agents of U.S. airlines will not result in the Philippines taxing the U.S. airlines as if they earned income through an office in the Philippines. The airline industry would not be completely satisfied, but they have indicated that they would not oppose a treaty containing these provisions. The Philippines have apparently agreed to a similar provision with Japan. The industry most likely will, however, continue to oppose the treaty until the provision is added.

If the committee decides that the failure to provide for the exemption of air transport income presents sufficiently troublesome problems, it could recommend that the treaty be rejected. However, rejection of the treaty will not by itself end the taxation by the Philippines of U.S. airlines.

If the committee decides that the potential for discrimination by the Philippines against U.S. airlines is sufficiently troublesome, it could recommend the adoption of the treaty subject to a reservation on the Shipping and Air Transport provision (Article 9) to the extent it permits this discrimination. It must be emphasized, however, that the Philippines may refuse to ratify the treaty subject to such a reservation.

Alternatively, the committee could recommend that ratification be delayed pending negotiation of a protocol resolving the airline issue.

Another alternative is to recommend ratification of the treaty, but with a recommendation to the Treasury to negotiate relief similar to that contained in the Philippine-Japanese treaty. It is possible that the Philippines might accept such a reservation. If this approach is taken, the committee might also reserve on the termination article and provide that the treaty will terminate within a specified period if a solution has not been achieved.

If the committee does not want to take any of the above actions because it feels that the treaty is sufficiently important that it should be ratified notwithstanding any problems presented by the Shipping and Air Transport provisions, the committee may wish to include a statement in its recommendations emphasizing its concern and strongly urging the Treasury to resist similar provisions in future treaties.

U.S. real estate.--The proposed treaty prevents the United States from taxing a Philippine resident on his income from the sale or other disposition of an interest in a U.S. entity that owned U.S. real estate. As in the case of several other treaties negotiated before the adoption of the 1980 legislation taxing foreign investors in U.S. real property, this provision would, if not limited, override that legislation. It would appear advisable to limit this provision so that it does not override that legislation.

Royalty income.--The withholding tax rates established under the treaty with respect to royalties are not strictly reciprocal. As discussed more fully in the pamphlet describing this treaty, the limitation of the withholding tax imposed by the United States is 15 percent of the gross amount of the royalty. The withholding tax on royalties imposed by the Philippines may not exceed 25 percent except that royalties paid by a corporation registered with the Philippines Board of Investments and engaging in preferred areas of activity are limited to 15 percent. However, these Philippines withholding rates are to be reduced in any case where the Philippines reduces its rates to a lower level in a treaty with a third country.

Reciprocity in withholding rates is one of the basic policies of U.S. treaty negotiation. However, in this case, given the variable withholding rates established for the Philippines and the probability that a substantial part of U.S. corporate investments in the Philippines will be subject to the lower 15 percent rate, this provision would seem to raise no serious problems.

Anti-treaty shopping provision.--Of the income tax treaties before the committee, only this one and the treaty with Argentina do not contain a holding or investment company provision intended to limit the use of the treaty by residents of third countries. Almost all of our recent treaties have that provision. It is not clear why it was not included in this treaty.

Even if no abuse is possible at the present time, possibilities may develop later. It has proved difficult to renegotiate treaties to curb abuses.

The committee could recommend that ratification be delayed pending negotiation of an anti-abuse provision. In the alternative, it could recommend ratification with an understanding that the Treasury will negotiate an anti-treaty shopping provision. As support for the Treasury, the committee could recommend a "sunset" reservation under which the treaty will terminate within a specified period if an anti-treaty shopping provision is not agreed to. Another alternative would be to approve the treaty subject to a reservation or understanding imposing an appropriate anti-abuse provision.

Estate and Gift Tax Treaty with the Federal Republic of Germany

The proposed estate and gift tax treaty with Germany is intended to limit double taxation of estate and gifts of domiciliaries of the two countries. The treaty is similar in concept to recently ratified treaties with France and the United Kingdom. The treaty generally follows the U.S. model estate and gift tax treaty.

The treaty does not contain any special provision which warrants the attention of the Committee. The treaty is explained in the pamphlet which has been made available to the committee and its staff.