May 24, 1983
JCX-13-83

PREPARED STATEMENT OF
RICHARD A. GORDON, DEPUTY CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, AND PATRICK OGLESBY, LEGISLATION ATTORNEY, JOINT COMMITTEE ON TAXATION, BEFORE THE COMMITTEE ON FOREIGN RELATIONS, UNITED STATES SENATE, ON THE PROPOSED TAX TREATIES WITH AUSTRALIA, THE PEOPLE'S REPUBLIC OF CHINA, AND NEW ZEALAND, SCHEDULED FOR A HEARING MAY 24, 1983

It is our pleasure to appear before you to provide staff assistance on the tax treaties and protocol that are currently under consideration by your Committee. Our staff has prepared separate pamphlets on each of the treaties before you; these pamphlets give an article by article description of each treaty and generally indicate those provisions which differ significantly from those normally found in U.S. tax treaties. The summaries of each of these pamphlets highlight the provisions of the proposed treaties which present significant policy issues.

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 are, for the most part, noncontroversial. There are, however, a few controversial provisions.

In light of the materials already 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.

While the Committee may want to consider the option of recommending a reservation or an understanding on a particular provision of the treaty, it is more likely that the provisions are not sufficiently troublesome to require serious consideration of such a recommendation. Instead, 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.

I. BACKGROUND

Most of the 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 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 the country, but it may also encourage other countries not to lower their rates as

---

[1] United States negotiators start from the United States model income 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 may also serve as guides.

much as they otherwise would.

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 full-fledged income tax 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 are also possible if a treaty relationship is established.

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

II. THE TREATIES WITH AUSTRALIA AND NEW ZEALAND

The treaties with Australia and New Zealand are general income tax treaties that are generally consistent with other U.S. tax treaties. Because they are similar in many respects, and present many of the same issues, we will discuss them together.

Importance of Ratification

The treaties with Australia and New Zealand deal with a number of issues that have arisen over the years. The present treaty with Australia is 30 years old and that with New Zealand is 35 years old. They no longer adequately address the economic relationships between those countries and the United States.

The proposed treaties provide a number of significant improvements over the existing treaties. The Australian treaty would reduce the rate of withholding tax on Australian source royalties from as much as 51 percent of gross to a maximum of 10 percent. The New Zealand treaty would reduce the withholding tax rate on New Zealand source dividends from 30 percent to 15 percent; it would reduce the rate on New Zealand source interest from 15 percent to 10 percent. In addition, the proposed treaties generally prohibit future legislation in Australia or New Zealand that would discriminate against U. S. taxpayers.

If the Committee decides to recommend that the Senate advise and consent to the ratification of these treaties, or either of them, quick action would benefit many U.S.

taxpayers. The Australian treaty's reduction of withholding tax on royalty income begins for payments made on or after the first day of the second month following the exchange of instruments of ratification. If the treaty with New Zealand enters into force before April 1, 1984 (which would require Senate approval substantially in advance of that date) the reduction from 30 percent to 15 percent of New Zealand withholding taxes on dividends derived by U.S. persons would apply retroactively to amounts paid on or after April 1, 1982.

The treaties do, however, raise some issues, discussed below.

Leasing of Containers

The proposed treaties differ from most U.S. tax treaties in not providing a reciprocal exemption of the income of container leasing companies as shipping income. Instead they permit the country of source to tax the income from the rental of containers as royalty income at a rate of 10 percent of gross. The current treaties do not limit the tax on royalties at source. U.S. companies may take the position that under the existing treaties in certain circumstances they are not subject to Australian or New Zealand tax.

While these provisions are included in the treaties at the request of Australia and New Zealand, the provisions are reciprocal. That is, the treaties make it clear that activities of Australian and New Zealand companies may be taxed by the United States. As a practical matter, however, any burden of this provision will fall primarily on U.S. companies leasing containers in Australia or New Zealand.

U.S. container leasing companies object to these provisions. They point out that a gross withholding tax can exceed net income. In addition, they note the administrative problems of determining the place of use of containers that lessees are free to use wherever they wish. They note also that shipping companies who lease containers in international traffic as an incidental part of their business would not be subject to the tax, while competing container leasing companies that do not engage in shipping would be subject to the tax. Accordingly, such companies would have a competitive advantage over pure leasing companies.
In addition, the leasing companies are particularly concerned that these provisions may serve as precedents for other treaties.

The extent, if any, to which the imposition of Australian and New Zealand tax on the U.S. container lessors would increase their aggregate worldwide (i.e., combined U.S.

and foreign) tax liability is not clear. These U.S. container lessors would generally be eligible for a U.S. foreign tax credit for any foreign taxes they might pay. With no other changes, a full U.S. foreign tax credit would mean that their aggregate worldwide tax payments would not be increased at all by the imposition of the foreign tax because for each dollar of foreign tax paid, there would be a corresponding dollar reduction in their U.S. tax. In other words, the U.S. Treasury, not the U.S. companies, would bear the cost of the concession in that situation. However, a lessor would not get the benefit from the foreign tax credit to the extent that it is continuously in an excess foreign tax credit position.

Even if the leasing companies are able to get a full dollar-for-dollar reduction of their U.S. tax as the result of the foreign tax credit, they might lose the benefits of any U.S. investment tax credits they are presently claiming because the foreign tax credit for the foreign taxes would reduce the U.S. tax against which they are presently claiming the investment tax credit. (The investment tax credit is generally limited to 85 percent of the taxpayer's U.S. tax liability after reduction by the foreign tax credit.) They would not, of course, be able to use any resulting excess U.S. investment tax credit against their foreign tax liability.

For example, if a leasing company was not taxable in Australia and was subject to U.S. taxes (before investment tax credits) of $200, its maximum allowable U.S. investment tax credit would be $170 (85 percent of $200). If, however, it had that amount of credits, its net U.S. taxes would be $30. If it paid Australian taxes of $100 and those Australian taxes were fully creditable against its U.S. taxes, its U.S. tax liability (before investment tax credit) would be $100 and its maximum allowable investment tax credit would be $85. Its net U.S. tax would be reduced to $15, but its total taxes paid to both the United States and Australia would be increased to $115. Even though Australian taxes are fully creditable, the taxpayer's overall liability is increased by $85 because of the decrease in the investment tax credit limitation. This extra liability is paid entirely to Australia and an additional $15 is shifted from the U.S. to the Australian Treasury.

If the Committee believes that the concerns raised by the container leasing companies are important enough to warrant action, it would appear that it has at least three options. First, it could recommend rejection of the treaties. It is not clear that rejection would solve the problems of the companies, however. The companies' tax treatment under the current treaties is unclear; they may gain more protection under the proposed treaties than they have under the current treaties. Second, the Committee could

recommend reservations providing exemptions for container leasing income. Australia and New Zealand might refuse to accept those reservations, however. In that case, the treaties would not enter into force. Third, the Committee could approve the treaties while indicating its view in the Committee report that future treaties should exempt container leasing income.

Natural Resource Exploration or Exploitation Activities

A second issue in both the Australian and New Zealand treaties is the treatment of mineral exploration and exploitation activities as a permanent establishment giving the country where the activity is conducted the right to tax income in cases where it would not under the U. S. model.

Under the proposed Australian treaty, a country may (on a reciprocal basis) tax income from the use of an installation, drilling rig or ship in that country to dredge or in connection with exploration for or exploitation of natural resources of the sea-bed and subsoil only if the use in that country is for at least 6 months in any 24 month period. Under the proposed treaty with New Zealand, a country may tax income from carrying on activities in connection with exploration for or exploitation of natural resources there only if an enterprise carries on those activities in that country for at least 6 months in any 12 month period. Under the U.S. model treaty, the activities must last for more than 12 months. Some recent treaties, including those with Jamaica, Norway, and the United Kingdom, have deviated from the model provision.

Some U.S. independent drilling companies object to these provisions. Like the container leasing companies, they argue that it is inappropriate for one industry to be denied a treaty benefit they have traditionally enjoyed under U.S. treaties. In addition, the companies argue that these provisions may serve as precedents for other treaties.

As was the case with containers, the extent, if any, to which the imposition of Australian and New Zealand tax on the U.S. drilling contractors would increase their aggregate worldwide (i.e., combined U.S. and foreign) tax liability is not clear. These U.S. contractors would generally be eligible for a U.S. foreign tax credit for any foreign taxes they might pay. With no other changes, a full U.S. foreign tax credit would mean that their aggregate worldwide tax payments would not be increased at all by the imposition of the foreign tax because for each dollar of foreign tax paid, there would be a corresponding dollar reduction in their U.S. tax. In other words, the U.S. Treasury, not the U.S. contractors, would bear the cost of the concession in that situation. However, a contractor would not get the benefit from the foreign tax credit to the extent that it is

continuously in an excess foreign tax credit position.

However, even if the drilling contractors are able to get a full dollar-for-dollar reduction of their U.S. tax as the result of the foreign tax credit, they--like the container leasing companies--might lose the benefits of U.S. investment tax credits they are presently claiming because the foreign tax credit for the foreign taxes would reduce the U.S. tax against which they are presently claiming the investment tax credit.

As was the case with container leasing income, if the Committee believes that the concerns raised by the drilling contractors are important enough to warrant action, it could consider a number of courses of action. It could recommend rejection of the treaties; it could recommend reservations for drilling income, or it could approve the treaties while indicating its view in the Committee report that future treaties should contain broader protection for mineral exploration. The problems with the first two courses of action are the same as those discussed for container lessors.

New Zealand's Customs Duty on Film Rents

The proposed treaty does not deal with the New Zealand "customs duty" imposed on films brought into New Zealand, which is based on the rent that New Zealand residents pay for them. The treaty with Australia presents no similar problem. We understand that some U.S. companies have argued that the treaty should cover this tax, because it operates like an income tax imposed on the gross amount of royalty income. Unlike income taxes, customs duties are not generally covered by income tax treaties and are not covered by any U.S. income tax treaty. Similarly, our internal mechanism for avoiding international double taxation, the foreign tax credit provisions of the Internal Revenue Code, does not apply to customs duties. To require coverage of customs duties in an income tax treaties would represent a significant departure from past practices.

Congressional access

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.

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 the 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.

Treaties contain a provision that limits access to information received by the United States and the treaty partner under the 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 attempts to audit the IRS administration of mutual agreement cases which may involve significant revenue. Treasury has indicated that they are attempting to work out the problem for existing treaties. The Senate, in its resolutions of ratification of tax treaties in 1981, included an understanding that appropriate Congressional access was available.

The treaties with Australia and New Zealand, however, do not specifically mention Congressional access or access for persons or authorities involved in the oversight of the administration of taxes. The Treasury Department has indicated that during its negotiations with Australia and New Zealand, it raised the issue of Congressional and GAO access and oversight with the treaty partner in each case, and that both countries agreed to permit access to Congress and the GAO. They also have indicated that in their view such access is available.

If there is any doubt that the appropriate Committees of Congress would be prevented from exercising their proper oversight function, then we would urge an understanding similar to those in the 1981 treaties. We do not, however, believe that course is necessary. This Committee indicated in 1981 its view that the standard treaty language ensures appropriate Congressional access. We strongly concur in that view. Furthermore, the Treasury Department has indicated that other countries agree that existing treaties and these treaties allow appropriate Congressional access.

Nondiscrimination

The U.S. model income tax treaty contains a broad nondiscrimination provision that 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 U.S. income tax treaties contain comprehensive nondiscrimination provisions similar to that of the U.S. model. The nondiscrimination provisions of treaties with

Australia and New Zealand, at the insistence of those countries, do not apply to laws in effect on the date of their signature--August 6, 1982, in the case of Australia, and July 23, 1982, in the case of New Zealand. The Treasury Department has indicated that, in its view, no provision of the laws of Australia or New Zealand would violate the standard nondiscrimination provision of the U.S. model treaty.

These provisions raise the issue whether it is appropriate to enter into any treaty that does not contain the broadest possible nondiscrimination treatment. There seems to be unanimity that it is proper to seek complete nondiscriminatory coverage. Realistically, however, the United States may have to accept a limited nondiscrimination provision as part of a broad income tax treaty. In these cases, the treaties accept the U.S. model position for future laws. In addition, these articles are the broadest agreed to by Australia or New Zealand. Also, these articles must be measured against the existing treaties which contain no nondiscrimination provisions.

Because these provisions appear substantially similar to the U.S. model, the Committee need not consider a reservation. The Committee could recommend ratification of the proposed treaties but with a clear statement in its report to the Senate of its support of broad nondiscrimination.

Investment in U.S. Real Property

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to United States tax unless the gain is effectively connected with the conduct of a United States 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 (FIRPTA), as amended, a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a United States real property interest as if the gain was effectively connected with a trade or business conducted in the United States.

Although certain income tax treaties presented to this Committee in 1981 would have overriden FIRPTA neither the Australian or New Zealand treaties would do so.

Conclusion

As discussed above, among the very significant benefits provided to United States taxpayers under the

pending treaties are reductions in withholding rates on certain investment income, nondiscrimination treatment, and a more modern treaty generally.

In some cases, a particular taxpayer or industry may receive better treatment under the present treaty than under the proposed treaties or may receive better treatment under the U.S. model treaty than under the proposed treaties. Since a treaty is essentially a compromise between two countries with competing interests that result is not unexpected. The central issue is whether the final agreement represents a bargain which is sufficiently favorable overall to the United States that it should be ratified.

In a number of instances, the proposed treaties with Australia and New Zealand do not conform to the U.S. model treaty. They provide for relatively high rates of source country withholding taxes and they provide permanent establishment rules that permit taxation of enterprises in cases where the U.S. model treaty would not. In addition, their nondiscrimination provisions do not apply to existing rules.

On the one hand, it might be argued that the United States should not make significant concessions to a developed country. On the other hand, these concessions should be viewed in the context of an overall agreement that benefits a broad range of U.S. taxpayers and the United States.

On balance, we tend to believe that the proposed treaties with Australia and New Zealand are satisfactory. Although they are not perfect, they represent improvements over the existing treaties. They may represent bargains as good as we may realistically expect our negotiators to obtain.

III. THE AGREEMENT WITH THE PEOPLE'S REPUBLIC OF CHINA

The Treasury Department is in the process of negotiating a comprehensive income tax agreement with the People's Republic of China. It concluded the proposed agreement with the People's Republic of China covering the taxation of shipping and aircraft income because of the importance of transportation to the expansion of trade and other economic relations between the two countries.

The proposed agreement with the People's Republic of China would be the first tax treaty entered into by the United States covering only one industry, in this case the shipping, airline and container leasing industry. Accordingly, it represents an expansion of the tax treaty process. Such a treaty might remove the incentive for a country to enter into a general income tax treaty with the United States which might benefit a wider range of U.S.

taxpayers. Furthermore, it is not clear that a proliferation of limited treaties would be administrable, or would be the best way to use the resources devoted to the tax treaty program.

The issue for the Committee is whether such a limited treaty is appropriate. If not, the Committee may recommend rejection of the treaty and may consider requesting the Treasury Department to expedite its negotiation of a more comprehensive treaty. Alternatively, the Committee may approve the treaty while instructing the Treasury Department to seek broader treaties in the future.