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## Extraterritorial Effects of Canadian Tax Laws

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Section can do, taking a problem in one discipline of the law and comparing it with another, from the international point of view. I think Mr. Joelson's remarks were very educational for those in the tax area.

Our final speaker is William J. Caveney who is going to give us an idea of how Canada, our neighbor to the North, deals with some of the same issues we have been talking about today. In the printed proceedings we will also include the prepared remarks of Bruce Verchere.

### **Remarks by William J. Caveney**

#### *Extraterritorial Effects of Canadian Tax Laws*

The comment was made earlier about the dialogue and interaction between "the North and the South." Somehow in Canada, they think of the United States as being one of those countries of the South.

Dave Foster had spoken on the topic of exporting U.S. tax policy. To some extent, there has also been an exporting of U.S. tax concepts. I don't believe that the U.S. Treasury is collecting any royalties on this, but we have exported to Canada the foreign personal holding company concept, or at least a mechanism which functions like subpart F that was discussed earlier. The Canadian term is "Foreign Accrual Property Income." Don't try to understand the words in the statutory term. They mean very little, intrinsically, even in Canada.

Essentially, FAPI can be analogized to the passive income that is constructively taxed to a U.S. parent company from one of its controlled foreign corporations. Canada picked up control rules that are very close to the ones used by the United States. There is a current constructive dividend of this type of income, similar to U.S. rules, and there is even a later tax-free repatriation, somewhat like the U.S. treatment of previously-taxed income. This relatively new legislation was first fully effective for 1976, so there is not a lot of guidance as to how it will be applied by the Department of National Revenue.

Canada also adopted new foreign trust rules, and here they showed us the way for the 1976 Tax Reform Act, since this legislation was passed in early 1975. The foreign trust rules in Canada are similar to the ones adopted in the United States, using the grantor trust concept. I am not going to talk about the specifics here, but it demonstrates that countries which are as close as we are in "economic approach" do often appropriate relatively interesting and complex pieces of legislation.

There is no other subpart F type concept in Canadian taxation. In fact, there is generally a tax-free repatriation to Canada from foreign subsidiaries. Before 1976, this tax-free repatriation was granted as a matter of general tax policy—statutorily. But as of 1976, the law began to require a subsidiary to be

incorporated in, and operate in, a "treaty country." This sounds pretty harsh, but that latter term is pretty broadly defined. In fact, the Canadian tax regulations include thirty-eight "treaty" countries, since they have extended this protection to countries with whom Canada is presently *negotiating* treaties, quite a few of whom do not have existing treaties with Canada.

This tax-free repatriation approach of the Canadian tax law is very attractive for a U.S. company, in terms of making investments in other foreign countries through a Canadian subsidiary. And I should mention that the list of countries with Canadian treaties includes Spain, Singapore, Ireland and various other countries that have tax holidays and export industry incentives, which are certainly wiped out if there is a repatriation policy directly to a U.S. parent company.

This change in the law to require a treaty before "tax sparing" is granted by Canada, as well as the increase at the same time in the statutory withholding on dividends paid out of Canada from 15 percent to 25 percent, were both justified in Canada at the time as "encouraging" other countries to negotiate treaties with Canada. They felt that the 30 percent withholding tax is one of the main treaty bargaining points that the United States used. That is, everybody started out with 30 percent, and always ended up, by treaty, with 15 percent or less. So Canada decided to try 25 percent and negotiate back to 15 percent. In fact, all of the treaties negotiated since Canada initially proposed this change four years ago have established dividend withholding at the 15 percent rate.

Even in the absence of a treaty, a dividend from what is called an active business company, as opposed to the passive income company we spoke about earlier, is only going to be taxed in Canada at the time of repatriation. So even if there is not a tax sparing when it is received, there is no anticipatory taxation of that foreign subsidiary's undistributed earnings. Furthermore, to the extent that the foreign subsidiary has both good income that is generated in a treaty country and "bad income" (i.e., generated in a non-treaty country), the Canadian parent company can elect to have the good income treated as being the first-distributed, and thereby tax-free in Canada. Therefore, you do not really have to pay Canadian tax on dividends unless you have a subsidiary which has only business income in a non-treaty country. In that situation, you have the same barrier to repatriating as you presently have in the United States.

As a result of this exemption approach to the taxation of a foreign subsidiary's operation, there has not really been much study done in Canada on a comprehensive foreign tax credit system. Canada has not adopted the U.S. method of taxation whereby on a dividend we treat the U.S. parent as if it earned the underlying income directly. This is called the "gross-up" method. Canada has a very detailed mechanical rule which brings about substantially

the same result. That is, your foreign source income is going to be taxed at 46 percent, if it is the type of income that is subject to the standard Canadian federal rate, even though you do not go through the same mechanics as in the United States.

Canada also has a very strict per-country approach. In fact, it is a "per-affiliate" approach, to use a term. If you have three separate operations in the same country, you cannot mix them for foreign tax credit purposes. This leads to a lot of foreign holding companies coming out of Canada in order to try to end up with, at least, the per-affiliate approach being overridden.

There is only one comprehensive article on the Canadian foreign tax credit system that I have seen, and it has not been published in the United States. It is in the Canadian Tax Foundation's *Proceedings* for 1976. Early in 1978 I will try to arrange to have a speaker come to New York in order to present a paper on this system, because it is becoming of more interest now that Canada is more aggressively taxing foreign source income.

I want to mention one other topic that was brought up earlier—the imputation and integration proposals that are being discussed here in the United States. Canada has had such a system since 1972, but it has not been a very strong imputation. It has only treated the shareholder as if the corporation had paid income tax at the 25 percent rate. The June, 1977 Budget has proposed an increase in the imputation rate to 33½ percent, regardless of the actual current corporate tax liability. I won't go into the mechanics, but I want to make a point of importance to today's group to illustrate how the imputation system can affect international tax. This change in the imputation rate, which is quite favorable to the shareholder in Canada, will effectively increase the Canadian tax rate on investment income earned by a *wholly-owned* Canadian subsidiary of a U.S. parent company. And the rate increase is fairly substantial—from 34 percent to 41 percent. This rate increase is clearly not the intent. Rather, it is the side-effect of beneficially changing the imputation system for individual shareholders in Canada. Therefore, an imputation system presents problems that really have to be worked out in a treaty, because in the "non-treaty" situation a backlash from domestic law change leaves little recourse to non-residents.

Canada has considered other things in the new Budget that were quite extraterritorial in their application. One, which was eliminated when the March Budget was revised in June, was a provision treating a sale of one subsidiary to another subsidiary, when they are related parties, as a dividend by the purchaser to the common owner. The Canadian Finance Department was approached on this matter, based on the fact that there was no Canadian tax avoidance possible if the subsidiary to be sold were a foreign company, i.e., a non-Canadian company. Therefore, in the revised Budget in June, the original

language was amended. It now will apply only when it is one *Canadian* company purchasing another related *Canadian* company. They have dropped any impact on the intercompany sales of "third country" corporations.

I mentioned earlier during Dick Pugh's speech about the since-expired discriminatory *preference* that Canada had for the fast depreciation write-off on manufacturing and processing. I would say that there is only one major continuing preference in the Canadian law now (other than the split tax rate for Canadian-controlled "small business" corporations) and that is a five percent withholding rate reduction on dividends by a corporation which has a "degree of Canadian ownership." To put it into practical terms, Exxon and General Motors are taxed differently on dividends from their Canadian subsidiaries because only Exxon qualifies for the lower withholding provision. Interestingly, Ford Motor Company, because it owns less than 100 percent, but more than 75 percent, qualifies for neither lower withholding nor the refundable dividend tax discussed earlier.

### **Prepared Remarks by Bruce Verchere**

#### *Extraterritorial Effects of Canadian Tax Law*

##### **A. CANADIAN TAXATION OF FOREIGN SOURCE INCOME**

With respect to passive or investment type income, Canada has adopted rules similar to the U.S. subpart F and/or foreign personal holding company concepts. As a result, where five or fewer Canadian taxpayers control a foreign corporation, such taxpayers are taxed, on a current attribution basis, on their aliquot share of the foreign corporation's passive or investment income.

So far as foreign trusts are concerned, the question will arise of whether the trust has received property from a Canadian resident who is related to any of the Canadian beneficiaries. Beginning in 1976, where a trust has received property from such a Canadian resident, the trust itself would be notionally designated a resident of Canada, if it is a discretionary trust, with any unliquidated tax liability of the trust becoming a liability of any Canadian beneficiary, but then chargeable against actual distributions received from such trusts. Where the trust is of the non-discretionary variety, an attribution system would apply if the Canadian beneficiary has at least a 10 percent interest in the trust.

With respect to business operations carried on abroad by Canadians, the 1972 changes move us closer to the U.S. approach, but with at least one significant difference. Although Canadian individuals and corporations were and remain subject to immediate taxation on direct foreign branch operations, Cana-

dian corporations (but not Canadian individuals) can generally repatriate tax-free business profits earned by foreign corporations, provided their interest in the foreign operating corporation is at least 10 percent. The essence of the regime is to divide the countries of the world between those with which Canada has income tax treaty relations and those with which it does not.

Dividends out of active business profits distributed by corporations resident in and operating in treaty countries qualify for tax-free status when received by Canadian corporations. Dividends derived from non-treaty country operations are taxable when received in Canada. All dividends are taxable when received by Canadian individuals.

Where business profits are repatriated by way of dividend payments from non-treaty countries, the system seeks to provide a full credit for foreign corporate and withholding taxes. The mechanics of the system differ substantially from the U.S. counterpart in that a Canadian corporation does not gross-up the dividend to the pre-tax profit of the foreign corporation and then claim a credit of the foreign taxes suffered or paid against the domestic rate. The same effect is achieved by including only the gross amount of the dividend (before withholding taxes) in income and then deducting in computing taxable income certain amounts in respect of the foreign taxes paid as will yield a Canadian income tax which when added to the foreign taxes amounts to roughly the standard Canadian corporate tax rate.

Unlike the U.S. system, this regime envisages neither a country-by-country nor worldwide basis for taking tax credits, but rather comprises a foreign affiliate by a foreign affiliate limitation. However, a worldwide basis can be achieved by utilizing intermediate foreign holding companies.

I should point out that a foreign holding company permits full use of one of the more favorable features of our system, namely, that where foreign affiliates have earnings in both treaty and non-treaty jurisdictions, or where such earnings are passed to a holding company, dividends therefrom are deemed to be derived first from the treaty or exempt earnings, and only to the extent the pool of exempt earnings has been exhausted are dividends considered to be out of taxable surpluses.

In summary, therefore, the Canadian regime with respect to taxation of foreign active business operations is to permit treaty country profits to be repatriated by Canadian corporate shareholders on a tax-free basis. By judicious use of foreign holding companies, taxable earnings derived from non-treaty country operations can remain free from Canadian taxation until all treaty country profits have been repatriated. To the extent dividends are considered to be derived from taxable (non-treaty country) surpluses, underlying foreign taxes can be averaged so as to provide optimum use of the foreign tax credit.

## B. CANADIAN TAXATION OF NON-RESIDENTS

The Canadian system is basically similar to that in the U.S. in that non-residents (but in our case including Canadian citizens living abroad) will be taxed at graduated rates only on employment or business profits earned directly in Canada, and flat-rate withholding taxes apply to most forms of passive payments received by nonresidents (including Canadian citizens) from Canadian sources. Unlike your rules, we do not seek to tax Canadian citizens residing abroad any differently than other nonresidents of Canada.

The major difference between our two systems is in the manner of taxing nonresidents in respect of capital gains. Under our rules, the key factor in determining such liability is the nature and location of the property rather than the source or place of the gain. In general terms, Canadian real estate, shares of private Canadian corporations and interests in Canadian resident trusts will be taxable when disposed of by a nonresident regardless of where the sale takes place. On the other hand, nonresidents can realize capital gains in Canada without a liability to Canadian tax where the property is, for example, Canadian public securities or foreign-based assets.

An interesting feature of the extra-territorial reach of our tax system arises in respect of the Canadian capital gain regime. In particular, Canada deems incoming residents to acquire all of their capital property at the time they enter Canada in order that future Canadian tax will only be levied on gains realized after taking up Canadian residence. On the other hand, departing residents are deemed to have disposed of their non-Canadian situated assets immediately prior to giving up Canadian residence.

## C. EXPORTING OF CANADIAN TAX AND OTHER FISCAL POLICY

It cannot be said that the Canadian tax system exports Canadian tax or other fiscal policy in the sense of the U.S. DISC, WHTC, Anti-Bribery or Anti-Arab Boycott tax legislation. I can, however, tell you that steps are being taken to bring pressure to bear on Canadian legislators to enact Anti-Arab Boycott measures.

One of the few tax measures which may be considered properly to come within the concept of exporting Canadian fiscal policy is one with which many of you are undoubtedly familiar—namely, the manner in which the Canadian communications industry and, in particular, magazine publishing and border television broadcasting, is being fostered at the expense of their U.S. counterparts (and in particular *Time Magazine* and *Reader's Digest*) by virtue of measures whereby Canadian advertisers cannot deduct for purposes of computing Canadian income tax, cost of media advertising with certain U.S. publications or broadcasters.

**D. ENFORCING CANADIAN TAX LAWS WHERE INFORMATION OR TAXPAYER IS OVERSEAS**

Although the Parliament of Canada can enact tax legislation with extra-territorial effect, Canada's power to enforce its legislation or collect its taxes is generally limited to its territory.

Exceptions to this rule are —

1. Production of documents located outside Canada may be ordered by the federal court on pain of seizure of Canadian property of the person ordered to produce the documents.
2. The double tax conventions generally provide for Canada to obtain documents and other information under the jurisdiction of our treaty partners. In this respect, it is noteworthy that Canada and the United States a few weeks ago announced a joint audit program. One of the objectives of this program is to enable the Canadian and United States fiscal authorities to obtain a better view of efforts which may have or appear to have the effect of shifting profits to tax havens.

The general rule is that Canada cannot obtain the extradition of persons who have committed crimes against the Canadian revenue. However, it would seem at least arguable that Canada could, subject to local laws, extradite a person from Commonwealth countries, which includes the Bahamas, for certain particularly serious tax crimes.

**QUESTION:** Do you think that any substantive change was intended when the foreign account question was expanded to two questions between 1974 and 1976, covering both foreign bank and securities accounts as well as foreign trusts, and do you think U.S. beneficiaries of foreign trusts are required to answer either or both of these questions in the affirmative?

**JOSEPH GUTTENTAG:** There formerly was one question on the 1040 as well as on the corporate returns and partnership returns which required the taxpayer to state whether he had any financial interest in or control over a foreign bank or security account. If the answer was in the affirmative, then there had to be a form 4683 filed to give certain information concerning the accounts. In 1975, the Commissioner removed the question entirely and in 1976 reinstated the question, on individual as well as on corporate, partnership and trust returns. There was a second question added asking for taxpayers to state whether or not they were grantors of, or transferors to, a foreign trust. To complement the changes in the language of the second question, there was some additional information that was required on form 4683. A beneficiary of a foreign trust would not necessarily be a person who contributed to the trust or created the trust, but would likely be a person who had a financial interest in a foreign bank account and, therefore, would be required to answer affirmately.



QUESTION: To what extent and by what means will the United States support U.S. taxpayers seeking the enforcement of U.S. tax laws, particularly U.S. taxpayer treaty rights under those nondiscrimination provisions of U.S. tax treaties?

JOSEPH GUTTENTAG: Any U.S. person who feels that he has been denied the benefits of a U.S. tax treaty by the other country has the right to ask the competent authority as designated in the treaty, usually the designee of the Secretary of the Treasury or the Minister of Finance, for assistance. The treaties provide that the representatives, the competent authorities of each of the countries, will consult with each other and attempt to resolve any questions raised by taxpayers who indicate that they have been denied rights under the treaties. The competent authority procedures set forth in a recent revenue procedure issued by the Internal Revenue Service describes the method by which the U.S. taxpayers should seek that relief. That Revenue Procedure is REV. PROC. 77-16.

QUESTION: With regard to the recent *Field* decision concerning the possibility of violating foreign bank secrecy laws by foreign bankers traveling in this country, what effect do you see on the conduct of international banking and financial transactions by U.S. citizens or residents?

JOSEPH GUTTENTAG: Well, if the question means do you think that U.S. citizens are more likely to go to a foreign country to meet their foreign bankers, rather than their coming here, I think that is true. Foreign bankers have—and I am serious—expressed concern about traveling to the United States and subjecting themselves to a summons of the type served on Mr. Field. Mr. Field had the advantage of having been served with a summons before a grand jury proceeding in which there would be some secrecy, but that would not mean he would not be requested to testify at a public trial, or some other foreign banker could not be requested to testify in a trial.

Now, strangely enough, or not so strangely, as I said, the court in the *Field* case misinterpreted the Cayman Island law because Cayman Island law only applied as then existed in the Cayman Islands. Mr. Field was not subjecting himself to criminal prosecution in the Cayman Islands when he testified or was asked to testify before a U.S. grand jury. However, subsequent to that time, Cayman Islands changed its law to make it apply anywhere in the world with respect to Cayman Islands Bank secrecy. This poses a problem, not just for Cayman Islands bank officials, but for U.S. lawyers, for example, who have information the disclosure of which would violate Cayman Islands law. They are clearly subject to U.S. jurisdiction and it is unlikely that they would be able to defend successfully against being required to testify (leaving aside the

lawyer-client privilege). We now have the situation where Cayman Island bankers are loath to come to the United States, and U.S. lawyers and other advisors who have information which they might disclose concerning Cayman Islands banking transactions should be careful to avoid going to the Cayman Islands.

QUESTION: In the case of a treaty which provides for exchanges of information, if the United States volunteers information to a foreign taxing authority, would that violate section 6103 of the Internal Revenue Code?

JOSEPH GUTTENTAG: That section, basically, is a strict provision against making tax return information public. It does have an exception for treaties, and I am not sure I fully understand the question. Treaties provide for routine exchanges of information, but I do not think that the disclosure is voluntary. But why doesn't Dave Foster comment on that.

DAVID FOSTER: The Code provision (section 6103) says that everything on your tax return and other tax return information is to be kept secret. It does provide an exception for exchanges of information by the competent authority of the United States to the other competent authority under the terms and provisions of a treaty. Now, maybe the question was alluding to the fact that the IRS is now going to have to be extremely careful when it gives information to a treaty country to make sure that the information is being given pursuant to the terms and conditions of the tax treaty. In the past, I think we have been a little sloppy. We have been interpreting the treaties just about as if they all contained the same language on exchange of information. I think the competent authority of the United States had better have his lawyer carefully review the treaty and be able to give him an opinion that the information which he is furnishing is within the provision of section 6103(k), because it is within the terms and conditions of the treaty. I hope that answers the question.

SCOTT CRAMPTON (Former Assistant Attorney General, U.S. Department of Justice): Turning back to the *Field* case, I think the group might be interested in knowing that *Field* was over here soliciting business, in effect, for the bank and I think a large part of the holding in that case is that you can't come over here and do business in this country and say: "Well I am sorry, I don't want to agree with your tax laws," any more than you can say: "I don't want to follow your traffic laws."

JOSEPH GUTTENTAG: If I created the impression I thought the decision in the *Field* case was wrong, I misstated my position. Furthermore I don't think the decision was necessarily even novel, I think there is a long list of precedents for the decision involving Swiss, German, and Panamanian economic security laws. I did intend to indicate that we should weigh all the considerations carefully in

requiring a person to violate a foreign law. One factor to take into account would be that he was here engaged on commercial activities to try to make a dollar.

ROBERT COLE: Joe, if you have to go, thank you very much, and the rest of us will hold on for another fifteen or twenty minutes, as long as there is interest. I might make a comment on the last point which raises the constitutional relationship between treaties and statutes. Sometimes, we tend to lose sight of the fact that treaties and statutes have equal status in the constitutional scheme of things. Even though a statute might prohibit exchanging certain information, a later treaty would clearly take precedence. A later statute will override a treaty if that is the intent, but such an intent must be clearly stated. The only reason you would need a provision in a later statute, like section 6103, about exchanges of information pursuant to then existing treaties is if there might be some uncertainty as to whether it was intended to override existing treaties.

WILLIAM CAVENEY: Bob, I would like to make an observation from the Canadian standpoint. Each Canadian treaty is in existence only because of its implementing statute. Parliament can, by simply passing a statute which repeals the implementing statute, specifically abrogate a treaty; now sometimes, that is done with due notice, where there are such termination provisions in the treaty. Canada has unilaterally used this once against the United States to eliminate the former "direct investor" withholding rate on dividends of five percent. In 1961, the withholding was increased to 15 percent by simply passing an Act of Parliament, but that was within the Treaty provision that Canada was allowed to do this without notice. Thus, there is a vast difference as to where a treaty stands in Canada, versus the U.S. approach as the "supreme law of the land."

ROBERT COLE: Thank you. Dick Pugh has a question.

RICHARD PUGH: This question reads: "In negotiating with a country with respect to a forfeitary income tax, which elements are necessary, usual or advisable to qualify the amount paid pursuant to that arrangement as an income tax for U.S. tax purposes? For example, is a letter to the authority specifying the tax calculation desirable, is a tax ruling from those authorities desirable, are tax receipts desirable, and so forth?"

This problem arises in a variety of contexts. I think the most frequent case is where a U.S. company wants to set up a headquarter branch office or a sales coordination office in a location such as Paris or Brussels, and the question arises as to what French or Belgian income taxes this branch office will be subject. Quite frequently, the Belgian and French tax authorities are willing to recognize that it is very difficult to determine the true income tax liability of an entity that has essentially only expenses, namely, the costs of carrying out the

headquarter managerial functions or the costs of carrying out the sales coordination functions. Recognizing the difficulty of determining the true income that is attributable to that kind of activity, and assuming that it is not activity that would be exempt under the definition of a permanent establishment as set forth in an applicable tax treaty, the situation is frequently resolved by going to tax authorities and saying, "Look, the expenses of this office are likely to be \$300,000 a year, and we would like to have you rule that for French income tax purposes this entity will be deemed to have taxable income in France equal to some percentage of its expenses, perhaps 10 percent of the expenses." That hypothetical income becomes the base for determining the French corporate income tax. That is referred to as negotiating a forfeitary tax arrangement. It is kind of a "*taxe forfaitaire*." The question is: Will this kind of payment qualify as an income tax for purposes of the U.S. foreign tax credit? It is a problem worth some thought. I think it is desirable for the taxpayer to have an exchange of letters with the fiscal authorities of the country concerned and it is desirable, I think, to emphasize that what is being determined is the income tax base. The income tax base, however, will be expressed as a percentage of expenses, but this is simply an alternative to making an actual calculation of what income and what deductions are attributable to that headquarter branch. So you normally end with an exchange of letters that constitutes a ruling, but I think it is important how you articulate the forfeitary tax arrangement in that correspondence. It is also desirable to obtain tax receipts so that they can be presented for purposes of claiming the credit. It is a little hard to generalize, but I think the important thing to remember is that in determining whether a foreign tax payment is going to be considered an income tax for U.S. purposes, the first requirement is that it will be a tax based on income under our concepts. So, to the extent that you can, you ought to emphasize that what is being determined here is net income for purposes of the foreign income tax system. Beyond that you want to avoid any suggestion that the tax is a voluntary tax, but that normally is not a problem in the context of these arrangements.

ROBERT COLE: Dick, we have a follow-up question to that. In determining whether a foreign tax is creditable for U.S. tax purposes, what limits do you believe the United States should impose with respect to a foreign country's rules for determining a person's income that is subject to that country's tax jurisdiction? Or do you believe that the foreign tax credit limitation adequately protects U.S. interests and obviates the need for any limitations?

In other words, the suggestion is being made that the United States should not worry so much about whether the foreign tax is an income tax because we have a foreign tax credit limitation. Do you care to comment on that as a matter of policy rather than as a matter of law?

**RICHARD PUGH:** Well, you do get into the problem of comparing apples and pears. If we start giving income tax credits for taxes that are not imposed on income, I don't think it is a complete answer to say that we have a limitation on the amount of foreign tax credit that can be taken for foreign taxes. Let me add further comment on the section 904 limitation on the foreign tax credit. There are many distortions that can arise in calculating the section 904 limitation. For example, there is the problem that arises in determining the numerator of the limitation fraction. You know the numerator of that limitation fraction is taxable income from foreign sources. Well, that concept has both a quantitative and a geographic aspect. The geographic aspect presents an interesting problem when you get differences in source-of-income rules as applied in the United States and the foreign country concerned.

Just to take an illustration in which this arises frequently, when a U.S. accounting firm or a U.S. engineering firm or a U.S. law firm renders services for a client in some of the Latin American countries, such as Chile and Brazil, if the services are rendered in the United States, they are considered, under the U.S. source-of-income rule, to give rise exclusively to U.S.-source income. However, under the laws of Chile and Brazil, the source of income is determined by the location of the consumer of services, so that when the U.S. engineering firm sends a bill to the Chilean client for services rendered in New York, the Chileans impose a heavy withholding tax on the fee. That is the situation where disparities in characterization of the source of income really creates a problem because the numerator of the fraction, if you look at that income alone, is zero. So, under the limitation, there is absolutely no foreign tax credit available at all. Disparities with respect to the source-of-income rules can result in serious instances of double taxation. Our tax treaties have begun to move into this area, but there is still a great deal more that can be done.

**ROBERT COLE:** Thank you, Dick. I personally believe in the concept of using tax treaties to deal with these sorts of problems. And the Treasury is to be commended for using the U.K. treaty, as it turns out, to make clearly creditable a tax the credibility of which has been questioned. I think it is a good precedent and that is why it is so important for the U.K. treaty to be approved by the Senate, which incidentally is in doubt at the moment.

**RICHARD PUGH:** I guess there are a number of other examples, aren't there, in the treaties of non-income taxes that are rendered creditable by treaty provisions.

**ROBERT COLE:** Can you think of any?

**RICHARD PUGH:** Well, for example, there is a French tax on the transfer of securities that is rendered creditable under the treaty although it would not be an income tax under our standards.

**WILLIAM CAVENEY:** I would like to make one point going the other way. We don't have a treaty in force with Brazil, since it was one of the "investment credit" treaties that the U.S. Senate "reserved on" in the late 1960's. However, most of the Brazilian treaties specifically state that one of their taxes, which is a withholding tax, is not a tax to which the treaty shall apply. It is so written in order that this tax will not be covered by the dividend withholding rate reduction from 25 percent to 15 percent, and the language in the Treaty with Japan directly states it in this manner. But this "supplementary tax" is not by treaty called a tax, so you could get into the same question there as to whether that graduated tax on distributions in excess of a percentage of paid-in and reinvested capital would be treated as an income tax, or whether it is some sort of penalty for taking the money out of a country, in lieu of an exchange control fee. The IRS held, and I think properly so, in Rev. Rul. 68-310 that the tax is a section 901 tax borne by the parent company. Hopefully, our new treaty (presently in negotiation) will use more precise language than the Brazilian-Japanese Treaty.

**DAVID FOSTER:** I would like to comment further on the question of to what extent a foreign tax should be similar to U.S. concepts in order to be creditable as an income tax. I would like to point out that it is possible to read our laws requiring something very close to a mirror image, so that a foreign income tax is not creditable unless it is very close to what the U.S. income tax would be. If you read it in that way, you have the U.S. law as having the effect of shaping the tax laws of foreign countries. They would tend to have the same deductions, the same useful lives on equipment, the same rates, to the extent that the United States is an economic power which is significant to the economy of another country. In fact, our law is having some effect in Indonesia at the moment as well as Saudi Arabia in the past and it has problems in Canada. This is to just name a few of the specific places where foreign countries have devised tax systems specifically in order to make their taxes creditable in the United States.

**QUESTION:** In negotiating a treaty to avoid double taxation, please explain to what extent the government positions and negotiations are 1) consistent with the stated purpose of such treaty to avoid double taxation of U.S. taxpayers, or 2) negotiated on behalf of the IRS in its role as tax collector?

**DAVID FOSTER:** Preambles of our treaties normally say that there are two purposes, to avoid double taxation and to prevent fiscal evasion. The normal standard policy is that we will not enter into a treaty unless we make very substantial progress in achieving both of those goals. Now there are certain cases where we don't achieve 100 percent the avoidance of double taxation and we will, nevertheless, enter into a treaty, and there are other cases where we do not

have the provisions that we would like to prevent fiscal evasion and we will, nevertheless, enter into the treaty. It is a judgment question on how far we will go. There have been some suggestions recently that we should make some progress in negotiating treaties with certain countries, where the treaties only relate to the prevention of fiscal evasion. That may happen at some time. We have been talking in particular with respect to the Bahamas. Of course they don't have a tax system, so with that particular country there is no double taxation to avoid. But it is possible we may move in that area.

ROBERT COLE: Dave, I would like to point out at this point, and ask for your comments, that one of the problems with a treaty is that we have to do reciprocally what we want the other country to do for us. If we want information from countries which are less meticulous in due process than ours, we have the dilemma of wanting information from them and being reluctant to give them information.

DAVID FOSTER: This is certainly true. The language always makes me a little nervous. We always try to draft the language in extremely mandatory terms. It is "information *shall* be exchanged" not "*may* be exchanged" although we do put in some hedges and in practice we don't give the information to other countries if we have reason to believe they are going to misuse it. But there isn't any explicit exception for that. There is also a certain amount of reciprocity. If we ask them for information and they don't give it to us, then we don't cooperate very much when they ask us for information.

To go on with this question, it asks me to justify the U.S. position that U.S. tax law should take precedence over the treaty purpose, if the United States tax collections would be reduced by the treaty. I believe this is referring to the saving clause. We save our right to tax our residents and citizens, but not other residents of the treaty country. In the case of a U.S. citizen resident in the other treaty country, the attempt is made to save the right for the U.S. to tax, but to either have the United States give credit for the foreign tax on that income if it exists, or to have the foreign country give credit for the U.S. tax on that income. Now sometimes, we have trouble reaching an agreement on that question. We both think that the other country ought to credit the tax and then the question is what do you do? We can give up. They can give up. We can split the difference. Sometimes we end up that the taxpayer is paying double tax on that particular item. Sometimes that is deliberate and sometimes we make a mistake. But it is not a conscious treaty policy. It is not true that tax collections are the important issue and we don't care about double taxation. We care about both issues, but if we were willing to give in to the other country's demands in order to avoid double taxation, then no country would ever give in to us or would ever be reasonable.

The second aspect to the second question is "why are the tax treaty negotiations in the hands of the revenue agency, the IRS, and not the State Department?"

Well, they aren't in the hands of the IRS. They are in the hands of the main Treasury Department, the Office of the Assistant Secretary for Tax Policy. The IRS just provides technical assistance. And the State Department is involved to a large extent as to questions like what the title should be, who should sign the treaty, what the definition of the United States should be. But in general, the reason why the State Department is not involved to any greater degree than that, is that they have no expertise.

I am asked the status of tax treaty negotiations with Canada, Germany, and the Netherlands Antilles. I have spent seven weeks negotiating with Canada, which is the longest record that I know of. There was a preceding week before I was involved. Last week was the last week of negotiations. We are making an attempt to completely revise and restate the treaty and at the moment the draft is the most comprehensive and detailed draft that we have every had with any country, which is fairly logical since we have a great deal of ties with Canada. It is easier to cross the border with Canada than with any other country. And items like trucks and railroads go across the border, so there are additional problems not present in other treaties. We have been stalled, however, for some time, on the basic issue of how to reduce the discrimination caused by the integration of their corporate and shareholder tax systems. Under their law, the Canadian investor in a Canadian company does better than a U.S. investor in a Canadian company. The United States would like to try to put them closer to a par. We cannot come to an agreement. So I don't know what is going to happen with the treaty.

With respect to Germany, the problem again is corporate integration. They went from a split rate tax system with a lower rate of tax on distributed earnings to complete integration under which distributed earnings will pay no corporate tax. All the corporate tax which they would pay, would be given as a credit to the shareholder but not to U.S. and other foreign shareholders. We are deadlocked on that issue. We cannot come to an agreement, and I don't know what is going to happen to stop that. Last week there was a legislative move that might help in this regard. Congressman Rostenkowski introduced a bill which would amend section 896 of the Internal Revenue Code to impose retaliatory taxes on foreign countries which integrated their tax systems in such a way as to discriminate against United States investors when no treaty accommodation can be made. It is also possible that if President Carter proposes that we should integrate our system and we do integrate in fact, that would give us some treaty leverage as well.

Now the third treaty I was asked about is the Netherlands Antilles. There is



nothing going on with respect to Antilles at this moment. The Netherlands Antilles Treaty is a cause of periodic concern at Treasury. It is a very favorable treaty. Probably something should be done about it, but I don't know when and if anything ever will be.

I am asked about the *Zenith* case and countervailing duties. The U.S. statutes require that the Treasury impose a countervailing duty on imported items whenever the exporting country provides a bounty or grant (that is a statutory term) with respect to its exportation. The Treasury Department has taken the position throughout the eighty-year history of the statute that countervailing duties are not due if border tax adjustments are made with respect to indirect taxes. The Customs Court held earlier this year that countervailing duties were required to be imposed to offset certain domestic commodity taxes rebated by the Japanese Government to Japan's exporters of television sets, radios, tape recorders, and other electronics products. It was a petition brought by Zenith. This decision, if upheld on appeal and extended to its logical limits, would start a trade war. It would mean imposition of countervailing duties against the rebate of value-added taxes by the Common Market countries and the reciprocal principle would allow foreign countries to impose countervailing duties against the non-imposition of state sales taxes on U.S. exports. Two weeks ago, the U.S. Court of Customs and Patent Appeals overturned the Customs Court decision. The U.S. position continues to be that the countervailing duties should not be imposed. This is an interesting situation, another example where a U.S. statute has a very direct and intended effect on the tax structure of other nations. It is intended to shape their rebate policy.

**QUESTION:** What are the policy reasons for the original U.S. policy not to tax interests on U.S. bank deposits of foreigners, and what are the countervailing considerations that give rise to the change to subject such interest income to such U.S. tax in the future?

**DAVID FOSTER:** Well, there is a basic question about whether we should have withholding on interest payments from the United States at all and the previous Administration took the position that we should not. We do, in general, have withholding, but there are exceptions. Probably the principal exception is the foreign bank account exception. I think that the reason for this is a very practical one. If we have withholding taxes, foreigners won't put any deposits in the United States. But they do in fact have very substantial deposits in the United States and we have for some time had this exemption. If we were to repeal it, there would be substantial withdrawals of fund because there are other places in the world where people can deposit funds without withholding taxes. There wasn't a change to make it subject to tax. In fact, it went the other

way. The Tax Reform Act of 1976 made the exemption permanent. It had been scheduled to expire at the end of last year.

**QUESTION:** Does the Treasury expect to use the technical explanation approach to build a legislative history in future treaties as it did in the U.K. treaty situation?

**DAVID FOSTER:** Yes. Years ago, the Treasury Department issued regulations under treaties. We stopped doing that maybe ten to twelve years ago, and started, a few years ago, issuing technical explanations instead. The reason was that it was possible to get technical explanations out, whereas the regulations just never got published. They were put on the bottom of the pile of important things to do, and they never got done. We have done it not just in the U.K. case, but we have been doing it for at least a dozen treaties in recent years. The thing that was unique about the United Kingdom was that we published the United Kingdom technical explanation prior to the hearings and then we published a proposed change and then we changed it. I don't know whether that will ever happen again. We published it because there was a delay in Senate consideration and we had it ready and there was tremendous pressure from the public to get it. If a similar situation happens again, I guess we will publish it again. We changed it because we made a mistake.

**QUESTION:** Do you believe Congress will be receptive to the use of tax policy to meet, to an appropriate extent, the demands of the Third World, for example, to encourage transfers of technology by U.S. multinationals to LDCs? There is a precedent with a very mild provision in the U.S. treaty with Trinidad and the Senate Foreign Relations Committee reserved on that one; there was a lack of receptivity to that.

**RICHARD PUGH:** That was at a time when the tide was flowing strongly against permitting any sort of tax incentives to foreign investment. The climate may have changed somewhat now and, as I indicated before, it does seem to me to make sense at least for us to take a new look at just what our foreign economic policy objectives are for these developing countries and if we want to encourage private capital and technology to move in that direction. It may well be that we ought to take a new look at the possibility of a variety of tax incentives that might help to achieve that result.

**ROBERT COLE:** One of the things that is being considered by the Section of International Law is a request to the Foreign Relations Committee to hold hearings on the model treaty and treaty policy generally in advance of any particular treaty.

Ladies and Gentlemen, it is 5:30 P.M. We will now adjourn the meeting. Thank you very much.

