Tax Treaties

Tax treaties are typically bilateral agreements in which each country agrees to modify its own tax laws to achieve reciprocal benefits, usually the elimination or reduction of double taxation. This is accomplished through an exclusion from taxation, a special rate on certain types of income and provisions for "competent authority" for procedural redress in cases of double taxation. Tax treaties generally provide for the taxation of industrial and commercial profits only if an enterprise has a "permanent establishment" in the other's country. Special rules are provided for investment income, for personal service income and for defining the source of certain income. Each United States tax treaty also includes a savings clause preserving the right of each country to tax its own citizens, residents and corporations as if the treaty did not exist.

Tax treaties are signed by the executive branch but must be ratified by the Senate. Since tax treaties pertain only to taxes, the House Ways and Means Committee is somewhat jealous of its prerogatives and from time to time there have been vigorous discussions about the role of the House Ways and Means Committee in this area. Fortunately, those discussions tend to drift away as tax policy becomes more clear in a particular area because there is probably no other way of accomplishing internationally tax goals which, in a purely domestic setting, would unquestionably be the province of the House Ways and Means Committee.

This article examines some current treaty issues, United States and foreign country goals and why it is that the United States has fewer tax treaties for almost any other developed nation in the free world.

The first question is what will the United States get by a tax treaty. When should the United States be willing to modify its internal tax law pursuant to a treaty? It does not take much to appreciate the fact that if the United States offers a foreign government the same treatment that the Internal Revenue Code gives them the discussions have no purpose in going forward. If there are no concessions, there will be no treaty. The central question then, when thinking about tax treaties, is what will the United States get that makes it worthwhile to change domestic tax rules.

Obviously, there are a number of identifiable benefits. Treaties are basically intended to and do resolve problems of double taxation. The United States does make an effort at solving that problem through the unilateral mechanism of the foreign tax credit, but there are limits on what can be done unilaterally. There are limits on how conflicting source rules can be rationalized; on how to characterize income; and on the allocation of expenses and the right to deductions. Tax treaties, on the other hand, provide certainty in determining the tax consequences of investments made in foreign jurisdictions. Interestingly enough the tax authorities are major gainers in the tax treaty area because they acquire substantially greater access to information concerning the activities of taxpayers. This is one of the most useful tools the

Internal Revenue Service or United Kingdom Inland Revenue or any other tax collecting agency has in order to combat what is commonly called "international tax evasion."

Tax treaties also encourage discussions at government levels with respect to tax systems and to some degree tend to promote harmonization of tax systems. Obviously they do not go very far in that direction, but they do occasionally round off some of the rough edges.

The model for tax treaties is that promulgated by the Organization for Economic Cooperation and Development (OECD) and last revised about fifteen years ago. Two years ago the United States published its own model treaty which set out the kind of treaty it wanted to negotiate.* Over the last several years, the United States has done more to involve the public in the treaty negotiating process. If the United States has very few treaties compared with other developed countries it has even fewer treaties with developing countries than do other developed countries. As a matter of fact in the last eighteen years, we have added only three treaties with developing countries: Iceland, Korea, and Trinidad and Tobago.

One reason for this phenomenon is rigidity on the part of the United States in trying to negotiate treaties. A tax treaty is the end result of a process of negotiation, a process of give and take. It is next to impossible to carry out that process in an arena of two hundred million people. There is nothing secret, but for every advantage the United States gets, in theory it has to give something else up. Another reason is our treaty ratification process. A treaty is a package which one takes or leaves as the end product of negotiations. Certain provisions are bound to be disagreeable, but when one side pulls out one piece the other side then wants to pull another piece out, and the negotiated agreement can easily come unraveled. Thus when the Senate, as part of the treaty ratification process in effect opens negotiations again as a condition to ratification, it is frequently resented.

Most treaty partners resent having played their hand and then having the United States Senate come along and say: "Well we don't like what the stakes were so we're going to change the rules a little bit." That is a serious problem which, as a practical matter at least, seems unique to the United States.

If these are the major problems in the tax treaty area, the major goal of tax treaties is the avoidance of double taxation. The United States is one of three countries that taxes its citizens on their worldwide income on the basis of citizenship. (Liberia and the Philippines are the other two.) The citizenship concept of United States taxation which the United States uses (and has always used) is something that is frequently difficult for other countries to understand. The United States unilateral foreign tax credit solves the problem in some areas but not in others. For example, the foreign tax credit provisions do not apply to foreign taxes on United States source income. It is perfectly natural for the foreign country in which an American citizen resides

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to tax him on his worldwide income. Unfortunately for him, some of that income may be United States source income. It may be dividends or interest from the United States. He may have worked part of the year in the United States, thereby converting part of his salary into United States source income. If he is a resident of that foreign country he pays a full foreign tax on his worldwide income, but he also owes worldwide taxes to the United States, and since part of the foreign tax that he paid is on United States source income, it is not creditable.

The next question is which country should give a credit in this situation. Should normal statutory rules be adjusted for the benefit of the Americans that live in the United Kingdom or whatever country we are negotiating with? Typically, the United States presses the foreign country to give the credit, so that the United States revenue is greater. Sometimes they win, sometimes they do not. But that is a good example of a problem in our own internal law that does result in double taxation in dealing with the normal situation of taxation on the basis of residence.

Another problem area involves the allocation rules. We have an Internal Revenue Code Section 482 which gives the tax authorities the ability to adjust the income and deductions between commonly controlled business entities so that each business entity is taxed on its fair share of the overall profit. The concept is applicable not only in the domestic context but also in the foreign versus domestic context. The United States Internal Revenue Service is then not the only taxing authority. Assume that the United States comes along and says this domestic company has charged too little for the services it provided its foreign subsidiary. The domestic company's income should go up. If nothing happens to the income of the foreign subsidiary (which is paying tax in its local country) then the sum of the taxable incomes of the two companies exceeds 100 percent of the income. That gets into the competent authority procedure designed for the taxpayer in the example above. He has the right under the competent authority provisions to begin a government to government discussion of how to resolve his double tax problem which both countries would undoubtedly recognize to exist. Of course both fault the other side. That is quite often the end result of competent authority proceedings: the problem does not get solved. One of the difficulties is that often, as above, there may be no "right" way of doing it. From our point of view the parent may not have charged enough because our law tends to stress the value of services provided by parent companies. From the point of view of the foreign government, however, it may well be perfectly rational to conclude that the charges the parent made initially to the foreign subsidiary were correct. So it is possible that there is no right and easily applied standard by which one ought to make the adjustment. Resolution of the difference then gets down to be kind of a horsetrade. Unfortunately, all too frequently, the Internal Revenue Service is reluctant to exercise that sort of horsetrading judgment. Consequently, the competent authority mechanism has not worked as well as it could and should.

One of the major goals of tax administrators is exchange of information. It is very difficult for foreign countries to generate the kind of information the United States government can generate. Their interest in exchange of information initially is much less than hours, but they are usually surprised when they see what information can be generated. Then they become very interested in receiving that information.

Perhaps the treaty with the Soviet Union was a good example. They really didn't care very much about the exchange of information, and so it was treated lightly in the treaty. The exchange of information works on two levels. One is automatic. When the United States gets an IRS Form 1099 or certificates for reduced withholding tax it automatically forwards a copy to the country of residence of the payee. Some of these payees were in Russia, and the Russian Government was surprised to see this material pour in because they had not expected to have many payees there.

The other kind of exchange of information is not automatic but, rather, is on a request basis. It is fair to say that the Internal Revenue Service is committed to helping foreign jurisdictions collect their taxes and, if it gets a specific request about a specific taxpayer, the Internal Revenue Service will exercise its statutory power under Internal Revenue Code Section 7602 to issue a summons to obtain the information for transmission back to the foreign country, as long as the IRS is satisfied that the foreign country does not intend to pass it on to a third country. The IRS does make an effort to make sure that the confidentiality will be observed. That is about the only effort they make. They do not investigate the reasonableness of the request. They are simply messengers in that regard. There have been suggestions that, since exchange of information is so important to tax administrators, perhaps we should have separate agreements dealing with exchange of information. But the United States Treasury has always opposed that, probably because they felt that the foreign country had more to gain than the United States on the information exchange, and that should be a trading point in the tax treaty negotiations.

There is considerable controversy today as to what is a creditable foreign tax. One way of solving that problem in specific cases is to provide in the treaty that a particular tax will be creditable. That was done in the United Kingdom treaty which makes their Petroleum Revenue Tax a creditable tax, with certain limitations. It was Treasury's view, or at least the Internal Revenue Service's view, that the Petroleum Revenue Tax was not a creditable tax under Section 901. However, this is not a general solution to the creditability problem because there are few treaties, and it is difficult to develop negotiating standards of what taxes should be made creditable and what not and when Section 901, the general tax credit provision, dictates a different result. Another matter which has come up periodically, and has really surfaced in public view only with respect to the United Kingdom treaty, is state taxation of foreign businesses. Every treaty has a nondiscrimination clause which prohibits the federal government and the states from discriminating against foreign businesses in their taxes. But until California and, then, Alaska extended their unitary tax concept to include foreign income, foreign countries did not make any loud protests to the Treasury. The unitary system basically says the business is a whole and, using certain factors, we determine how much of the business is attributable to California by applying a fraction to the entire worldwide income of the business. That makes some economic assumptions which many countries do not think are valid. It assumes, for example, that the cost of labor in California is as related to the profits as the cost of labor in Nigeria. Similarly, it assumes that the value of property in California bears the same relation to the profits as does the value of property in Turkey. One can argue about those assumptions. A number of representations were made to the Treasury and United Kingdom was successful in persuading the Treasury to include in the treaty a provision which, in effect, prohibited state taxation on a unitary basis: the infamous Article 9(4). It has been rejected by the United States Senate, but it certainly is a valid goal for foreign governments. That is one thing a foreign government would want to see to protect its nationals and its companies. So the last has not been heard of this issue although it may be the end of the Treasury agreement on this point.

So far the discussion has been fairly general and applicable to both developed and developing countries. There are a number of special problems developed countries have with developing countries, which can be ascribed to differences in perception. The reason the United States has such a poor developing country treaty network is our refusal either to see the validity of the other side or our inability to persuade the developing countries to see the validity of ours. All that can be said is that every other developed country has seen the validity of the developing country side on at least some points. First, consider service income, technical services income and managerial services income. The United States makes a distinction between royalty income on the one hand and personal service income, technical services and managerial services income on the other. Many developing countries do not see any difference at all. They treat the source of service income as being the place where the payor of the services is located. Thus, if a United States construction company does an engineering design for a plant to be constructed in Saudi Arabia, the Saudis will say the source of that profit is Saudi Arabia even though all the design work was done in the United States. The way the United States looks at it, that service income has its source where the services are performed, the United States. Consequently, if Saudi Arabia taxes that income, we are not going to give any credit for that Saudi tax (assuming it is a creditable tax) because we will say that is not a tax on foreign income but, rather, a tax on United States income.

Since the foreign country generally does not know the costs associated with producing that service, that design or those managerial services, it is much easier for them simply to tax it the way they do royalties, dividends and interest on a gross basis. So typically you will see a gross tax on service income. It will be much less than the rate on business income because it is on gross. The United States position has always been that those are really business profits industrial or commercial profits, and they ought not to be subject to tax by a foreign country if the taxpayer does not have a permanent establishment there and, further, that such a tax is not a creditable tax because it does not allow the deduction of the business expenses associated with earning the income. However, the United States has not made much headway with foreign countries on this point.

Another area of difference is in the definition of permanent establishment. The developing countries tend to push much harder for an expansive definition of the term "permanent establishment." You have to have a permanent establishment in order to make business profits subject to tax in that foreign country. Obviously, the more you expand the concept of permanent establishment, the more income the foreign country can tax. Since developing countries have few businesses in the United States, and we have many in developing countries, we are much more interested in a narrow definition of permanent establishment. It would reduce the amount of foreign tax and, therefore, the amount of foreign tax credit, if one looks at it strictly on a revenue basis. The developing countries have been fairly successful in getting their ideas across because, looking at the new United Kingdom treaty, the definition of what is a permanent establishment, with particular regard to the offshore industry, is a very expansive concept.

Shipping income is an area which in the past has presented more problems than it will in the future. Traditionally treaties have provisions essentially exempting shipping companies from tax. Developing countries do not have much in the way of shipping income. So they are not too happy about that. One can anticipate more flexibility on the part of the United States as the Congress begins to think shipping income ought to be taxed differently. The Treasury may lean more towards the thinking of the developing countries.

Another area which seems pretty straightforward but is not is the nondiscrimination clause. The United States always insists in including in treaties clauses that say the other country will not discriminate against Americans. Actually, the language is not quite that blunt. It provides that the foreign country will not tax Americans differently from locals. Many developing countries object on the grounds that they cannot control what their states or local municipalities do. Many say, in effect, that since they discriminate against foreigners in many other ways why tie their hands in this area? This is not simply a Third World attitude. Canada and Australia take exactly the same position. What we see as the principle of nondiscrimination is not always accepted by everybody as something that is desirable. Developing countries want to have the right to discriminate against foreign investment. They are not really picking out Americans versus the British; they just want to have the right to do something to the foreign investor that they do not do domestically, and the nondiscrimination clause restricts that ability.

Then comes the biggest problem: tax sparing credits. A foreign country wants to encourage hotels or wants to encourage manufacturing companies so it might give a limited tax holiday to businesses to establish hotels or manufacturing companies there. The way the United States credit works, that company would get a credit only for foreign taxes paid. But it is not going to pay any foreign taxes, so it gets no credit against its United States tax. The foreign government sees that the net effect has been to shift revenue from their treasury to ours. The foreign investor (i.e., our domestic investor) has not benefited at all. He has no tax incentive to go into the foreign country.

At one time in the 1950s the Treasury did negotiate a couple of tax sparing clauses in treaties under which we would give a foreign tax credit based not only on the taxes paid but on the taxes that would have been paid had the tax sparing provision not been in existence. For example, if the rates in the United States and the foreign country were both 50 percent and the profit was 100 percent, that nominal tax in the foreign country would have been 50 percent and the United States would give a 50 percent credit so there is no United States tax due. The company pays no tax and the foreign country has accomplished just what it wanted. It has got the foreign company to come in because it has a tax free status. The Senate rejected that approach vigorously and the Treasury has never tried it again.

As countries get more sophisticated and begin to understand our system (and the United States does a little better job explaining it) they begin to see some interesting things. One, for example, is the way our foreign tax credit works. Dividends that are paid are always assumed to be on a last-in-first-out basis. Thus, the last earnings are the ones that come back first. If the company has a ten year tax holiday, and does not pay dividends until 15 years have gone by, it is probably going to be paying dividends out of earnings that were subject to the foreign tax because the tax holiday has ended. There are a number of developing countries that have expressed more interest in talking to the United States about tax treaties, even though tax sparing is not there. Moreover, the Treasury has tried to get developing countries to shift from tax sparing to other tax incentives like an investment tax credit. The Treasury thinks the credit approach is better for the foreign country. It is very difficult for the United States to tell a foreign country "we know what is best for you" and make it believable.

The last area of tax treaty discussion has to do with the treaty problems with integrated tax systems. The United States has the classical system of taxation. Corporations are taxed; shareholders are taxed although there really is no connection between the two. In the integrated system essentially there is a recognition that there is major double taxation, and the shareholder gets a credit against his tax on dividends for some or all of the taxes that the corporation pays. That sounds pretty good until you think of it in a foreign tax credit context. If a shareholder of the United Kingdom company (assuming the United Kingdom has an integrated tax) had to pay United Kingdom