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Evolution of U.S. Treaties to Avoid Double Taxation of Income - Part II

Mitchell B. Carroll

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Other countries represented at the League of Nations meetings in London in 1927 and Geneva in 1928 and 1929 had become parties to some 18 bilateral agreements for the avoidance of double taxation. If the United States followed their example it could shift a part of the burden of relief granted by the credit for foreign taxes to the other Contracting State. If the latter granted by treaty an exemption from, or a reduction of, tax on income derived from sources in its territory by United States taxpayers, the resulting tax on exempted income or the excess of the United States tax over the allowable credit for a reduced tax would accrue as revenue to the Treasury.

Dr. T. S. Adams, then Economic Adviser to the Treasury Department, was interested in the possibility of concluding treaties, but he was concerned over the fact that while under the Constitution revenue legislation had to originate in the House of Representatives, a tax treaty could be concluded by and with the advice and consent of the Senate only. Hence, Dr. Adams thought it would be advisable to obtain legislation which would be passed by the House as well as the Senate, and would authorize the President to negotiate tax treaties along prescribed lines.[1]

Purport of HR 10165

The bill drafted to accomplish this purpose, which was numbered HR 10165, provided for the exemption, on condition of reciprocity, of an alien resident or a corporation organized in a foreign country on all except certain categories of income from sources in the United States.

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* Part I appeared in Volume II, No. 4 of The International Lawyer (1968).

[1] Dr. Adams asked the writer to draft a one page bill for this purpose. Under-secretary of the Treasury, Mr. Ogden L. Mills telephoned the Secretary of Commerce, Mr. Robert P. Lamont to arrange the writer's transfer to the Treasury where the writer would serve as a Special Attorney to handle international tax matters in the office of the Secretary, and prepare this bill. The writer's starting point was Draft Convention No. 1(b) adopted at the 1928 Geneva Meeting of Government Experts, described in Part I, which the writer had modelled on the provisions for reciprocal exemption of shipping profits in the revenue act (then Secs. 212(b) and 231(b); presently Secs. 872(b) (1) and 833 (1), I.R.C.).

These categories were briefly:

(a) Income from any business or profession allocable to a permanent establishment in its territory;
(b) Compensation for personal services performed therein;
(c) Income from real property located therein, including rentals or royalties therefrom, gains from the sale thereof, and interest on obligations (other than obligations of a corporation) secured by such property.[2]

Accordingly, the United States would exempt from tax at the source in its territory other items of income derived by a nonresident alien or foreign corporation, such as:

(1) dividends paid by a domestic company;
(2) interest paid on obligations of resident debtors;
(3) royalties paid for the use of patents, copyrights, and the like.

The bill was supported at a hearing before a subcommittee of the Committee on Ways and Means but was not approved. However, the attitude of the Chairman, Mr. John Nance Garner, convinced Dr. Adams that enabling legislation was unnecessary.

In any event, this draft legislation has been reflected more or less in the twenty-one general tax treaties in force. The goal of reciprocal exemption has been almost reached in those which reduce to only 5% the rate withheld from dividends paid by subsidiaries to nonresident parent corporations, and attained where interest and royalties have been exempted at source.

Events Leading to the First Tax Treaty with France

A foreign corporation with a branch in France had been subjected[3] to the tax that was withheld from dividends paid by French companies, but on the same proportion of dividends distributed at its head office abroad as its assets in France bore to total assets. In the 1920's the Boston Blacking Company of Massachusetts, in order to obviate the accounting adjustments necessitated by devaluations of the franc, had exchanged the assets of its branch in Paris for registered shares in a newly formed French company. This tax was presumably no longer due except when the French company distributed dividends. Nevertheless, the Bureau de l'Enregistrement, which administered the levy, served a

[2] Legislative History of United States Tax Conventions, Vol. 1, pp. 13-63 (1962).
[3] Under Art. 3 of the Decree of December 6, 1872.

"sommation" on the American corporation to pay the tax. The company contested the assessment but the fisc was upheld by the Tribunal de la Seine.

The United States company appealed to the Court of Cassation. Encouraged by the decision of the lower Court, the Bureau enquired into the relations between various French companies and their respective foreign parent corporations, which were for the most part in the United Kingdom, the Netherlands, Belgium, Germany, Switzerland or in the United States. Claims were made against a number of our largest corporations. The assessment against one of them was based on the assertion that the French subsidiary was "its emanation pure and simple." Another company objected strenuously, and in order to establish a basis for bargaining, the fisc obtained from Moody's the figures of its distributions over the previous 30 years and computed thereon the tax and penalties. The total of the claims was enormous. The American Embassy in Paris forwarded protests to the Department of State [4] in Washington.

When former Senator Walter Evans Edge was leaving Washington in the autumn of 1929 to serve as Ambassador to France, an official in the State Department asked the writer to brief him on the situation. Early in 1930 the claims were mounting so high and the protests were becoming so bitter that Ambassador Edge cabled to the Department of State to send Carroll [5] or other officials to Paris in order to endeavor to persuade the French officials to desist.

At initial conferences in the Palais du Louvre, in May 1930, the Minister of the Budget, Mr. Germain Martin and French officials refused to settle the matter unilaterally. They insisted on negotiating a bilateral treaty with reciprocal concessions, which would set a precedent to invoke vis à vis other interested governments.

Negotiations were suspended in September, 1930, because of the French request for a reduction of our custom duties on wines. After a change in the French Cabinet, the Treaty was signed on April 27, 1932. The United States Senate gave its advice and consent and the President promptly ratified on July 25, 1932; but France delayed.

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[4] The official in charge of the "French desk" in turn asked assistance from me as Chief of the Section of European Law and Taxes, Bureau of Foreign and Domestic Commerce.

[5] In the meantime Undersecretary Ogden L. Mills had arranged the writer's transfer to the Treasury where the writer was serving as a special attorney handling international tax matters in the office of the Secretary.

Prevention of Extraterritorial Tax in 1932 French Treaty

In the case of a United States corporation with a subsidiary in France, the treaty provided that, subject to the company's rights of appeal to the French courts, any amount of income proved by the five to have been diverted to the parent would be included in taxable profits of the French subsidiary and also treated as a dividend subject to the tax on income from securities (Art. VI).

In the case of a branch, the French fisc could add back to the income of such permanent establishment any profit that had been diverted. It would subject the entire amount of profit to the French tax on industrial and commercial profits, and then assume that ¾ was distributed as a dividend subject to the tax on income from securities. This proportion was a compromise reflecting the amount that companies usually did distribute (Art. V).

The American corporation could elect the treaty régime by itself where it had a branch (Art. V), or jointly with its French subsidiary (Art. VI). These two articles were continued in the Convention of 1939 which superseded the 1932 Convention, as Articles 15 and 16 respectively,[6] but the election requirement was abandoned.

The most recent Treaty with France, signed July 28, 1967, was awaiting action by the Senate Committee on Foreign Relations on January 1, 1968, and will be discussed herein because, if ratified, it is expected to serve as a guide for future treaties with developed countries.

Article 16 of the 1939 Convention on subsidiaries is now considered

[6] Art. 3 of the Decree of Dec. 6, 1872 evidently became Art. 109-2 of the General Code of Taxes but was modified by Article 39-II of Decree No. 48-1986 of December 9, 1948 to remove foreign companies merely holding portfolio or controlling investment interests in French companies from its scope. As thus modified to apply solely to foreign companies engaged in business in France, it was further amended by Art. 45-1 of Law No. 65.566 of July 12, 1965 and replaced by Art. 7(1) of that law. This Art. 7(1) apparently supersedes the treaty régime because it states that profits realized in France by foreign companies are deemed to be distributed, for each taxable year, to shareholders which do not have their fiscal domicile in France. The profit mentioned in the foregoing provision is the total income, after deduction of the tax on companies. Par. 2 adds that the retention of tax at the source (at the rate of 25 percent) must be paid to the Treasury within the time prescribed for filing its return. Par. 3 authorizes the company to request that this retention be made the object of a new liquidation to the extent that the amounts to which the retention has been applied exceed the total amount of the effective distribution. The excess collected is refunded.

to be inapplicable,[7] and is not reproduced in the new treaty. However, Article 13 (2)(a), which superseded Article 15 of the 1939 Treaty, says that a United States corporation which maintains a permanent establishment in France shall remain subject therein to the withholding tax in accordance with the provisions of French internal law; the base on which such tax is to be levied will be reduced by ⅓ and the rate of tax is limited to 15 percent.[8]

Retaliation Against Discriminatory and Extraterritorial Taxes

After completing a tax survey for the League of Nations around the world (See Part I), the writer returned in the autumn of 1933 to New York and was asked by a group of members of the United States Council of the International Chamber of Commerce to appear before the Committee on Ways and Means to urge reinstatement of the credit for foreign taxes which was to be repealed in a pending tax bill; it was saved.

Incidentally Congress enacted the retaliatory provision now found in Sec. 891, I.R.C. which declares that whenever the President finds that under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, he may so proclaim. In that case, the rates of tax on each citizen or corporation of that foreign country will be doubled, subject to a maximum of 80 per cent, on the income of each such foreign taxpayer from United States sources. When this provision was brought to the attention of the French authorities, the Treaty was promptly ratified on April 8, 1935, and entered in force January 1, 1936.[9]

[7] Article 16 is not reproduced in the Treaty of 1967 because it is no longer necessary in view of the enactment of Art. 34-II of Decree No. 48-1986 (see footnote 6 above).

[8] In other words the effective rate of the tax is 15% × ⅔ × .50 or 5 percent. When added to the corporation tax of 50%, this makes an effective rate on a company with a branch of 55% as compared with the effective rate of 52.5% on the distributed income of a subsidiary (50% plus 100-50 or 50% × 5%). No explanation is given for this discrimination of 2½ percentage points against a United States corporation with a branch in France.

Nevertheless, Art. 24, entitled "nondiscrimination" states that par. (2) (which provides that a permanent establishment will not be less favorably taxed than a resident) shall not prevent the application of Art. 13 on Branch Profits nor prevent the United States from imposing a comparable tax burden on the income of a permanent establishment maintained by a resident of France in the United States.

[9] For citations of Conventions concluded by the United States concerning taxes on income and property see Annex I.

United States Waives Extraterritorial Tax on Interest and Dividends

About a decade after the United States had prevailed on France to forego extraterritorial taxation, Canadians who were negotiating the 1942 Treaty with the United States objected to the latter's taxation of interest and dividends paid by Canadian corporations (under provisions presently designated as Sec. 861(a)(1)(B) and (a)(2)(B), I.R.C.). They contended that such taxation was extraterritorial and outside the jurisdiction of the United States. Hence, Article XII(1) of the 1942 Treaty exempts from United States tax dividends and interest paid by a corporation organized in Canada to a recipient other than a citizen, or resident of, or a corporation organized in the United States, who was taxable in any case on income received from a Canadian company. Although Canada had no such tax it agreed to a reciprocal restriction of its power to tax.[10]

In 1945 the United States agreed with the United Kingdom to waive the extraterritorial application of its tax on dividends and interest paid by a British corporation, except where the recipient is a United States citizen, resident or corporation (Art. XV). This fixed the pattern for a number of treaties.[11]

The United States for the seventeenth time renounced this extraterritorial taxation when at the end of 1967 it ratified the Convention with Trinidad and Tobago signed December 22, 1966. Article 3(4) categorically declares that dividends paid by a corporation of one of the Contracting States to a person other than a resident or corporation of the other State (and in the case of a dividend paid by a Trinidad and Tobago corporation, to a person other than a citizen of the United States) shall be exempt from tax by this Contracting State.[12] The Senate approved this Treaty on November 2, 1967 and it was brought into force on December 19, 1967 while the Convention with France, signed July 28, 1967 was awaiting consideration by the Committee on Foreign Relations.

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[10] Art. XII, 1 and 2 of the Convention of 1942, as amended by the Supplementary Convention of 1950.

[11] Essentially similar provisions are found in the Treaty with the Netherlands of 1948, Art. XII; New Zealand 1948 (Art. XII(1); the 1948 treaty with Belgium, amended in 1965 (Art. VIII B(2)); Ireland 1949 (Art. XV(1)); Norway 1949 as amended in 1958 (Art. VI-A); Greece 1950 (Art. IX); Switzerland 1951 (Art. XIV(1)); Finland 1952 (Art. XII(1)); Australia 1953 (Art. VI); Germany 1954 (Art. XIV(1)); Italy 1955 (Art. XIV(1)); Austria 1956 (Art. XIV); Pakistan 1957 (Art. VII(1)); and Luxembourg 1962 (Art. X).

[12] S. Ex. F., 90th 1st, p. 7.

In short the first two treaties with France impliedly renounce, and, later, seventeen treaties expressly terminate, the right of this country to levy tax on dividends and interest extraterritorially. Furthermore, in 1934 Congress enacted the provision now found in Section 891 of the Internal Revenue Code, authorizing the President to retaliate if a foreign government subjected United States citizens or corporations to such taxation. Hence the provisions in Articles 9(4)(b) and 13(1)(a) of the 1967 Treaty with France, whereby the United States may tax dividends distributed in France by a French company to French citizens, residents, and corporations,[13] would appear to be an anacronism, to say the least.

Dividend Tax Rates Reduced at Source

While adopting Treaty articles to prevent the extraterritorial taxation of dividends, the United States also prevailed upon other Contracting States to lower the level of the combined effective rate of taxes imposed on income distributed by a local subsidiary to a United States corporation. The purpose was to make the effective foreign rate on such income less than the United States corporate rate, which was the limit on the credit for foreign taxes (Secs. 901, 902, and 904, I.R.C.)

When Swedish officials were negotiating the 1939 Convention, they wanted to reduce the United States rate to 5 percent, as was foreseen for contiguous countries in the legislative amendments of 1936. This reduction had been granted in that year by Treaty to Canada. However, the United States would not go below 10 percent in the case of a non-contiguous country such as Sweden (Art. VII).

The French did not follow the example of the Swedes in their 1939 Convention. It was not until 1956, in Article 6A of the Supplementary Convention, that France agreed to a ceiling of 15 percent on the rate applicable at source to dividends as well as interest. In the Canadian Convention of 1942, a ceiling of 15 percent was placed on the tax withheld from dividends paid by a corporation in one country

[13] Art. 9(4)(b) says in substance that dividends paid by a French company shall be treated as dividends from sources within the United States if such corporation had a permanent establishment in the United States and more than 80 percent of its gross income was taxable to such permanent establishment during a prescribed three-year period. Art. 13(1)(a) declares in substance that dividends paid by a French corporation to a French citizen, resident, or corporation shall be taxable at the rates of 15 or 5 percent according to the case if the French corporation had a permanent establishment in the United States deriving said amount or income.

to an individual resident or a corporation organized in the other. It was reduced to a rate not in excess of 5 percent for dividends from a subsidiary corporation. In either case the enjoyment of the indicated rate was subject to the condition that the recipient was not engaged in trade or business and had no office or place of business in the country of source (Art. XI(1)&(2).

The Supplementary Convention with Canada of 1950 replaced the latter condition by that of not having a "permanent establishment." The 1956 treaty stipulated a ceiling of not more than 5 percent for dividends received from a subsidiary under certain conditions.[14] After a 3-year period a Contracting State could terminate either rate, and Canada terminated the 5 percent rate as of December 20, 1960. The United States promptly cancelled its rate of 5 percent, leaving applicable the 15 percent rate in all cases.[15]

The Supplementary Protocol with the United Kingdom of 1966 places a reciprocal limitation of 15 percent provided the holding that gives rise to the dividends is not effectively connected with a permanent establishment in the country where the dividends are paid (Art. V(5)).

In 1948 the Netherlands at first waived its tax on dividends in order to attract investments by United States corporations in Dutch companies (Art. VII). However, in 1965 it fixed the rate at a maximum of 15 percent for portfolio investments in shares, and not over 5 percent

[14] These conditions were that during the whole of the taxable year of the payer corporation at least 51 percent of the voting stock was beneficially owned by the recipient corporation, either alone or in association with not more than 3 other corporations of the same State, each of which owned at least 10 percent of the voting stock of the payer corporation. Another proviso was that not more than one-fourth of the gross income of the payer corporation (other than a corporation the chief business of which is the making of loans) is derived from interest and dividends from corporations other than its own subsidiary corporations. A final condition was that the relationship was not maintained primarily to enjoy the reduced rate.

[15] As nonresidents of Canada could form a Canadian corporation to hold shares in United States corporations which would be entitled to a reduction in the United States withholding rate from 30 to 15 percent and escape tax in Canada by qualifying as a nonresident through having its central management and control outside of Canada, the United States and Canada signed a Supplementary Convention on Oct. 25, 1966 which deprives such a corporation of the reduced rate. This Convention adds to Art. XI a new paragraph which in substance provides that the limitation of the withholding rate to 15 percent will not apply in respect of income derived from sources in the United States and paid to a corporation organized in Canada if said corporation is not subject to tax in Canada on such income because it is not a resident of Canada for the purposes of its income tax. This prevents residents of third countries from using Canadian companies as a device to avoid American taxes.

for investments in, briefly stated, an at least 25 percent-owned subsidiary which derives mainly operating income.[16] This rate reduction presupposed that the shares held by the recipient are not effectively connected with a permanent establishment in the State of source.

These limitations for the tax withheld from dividends at 15 percent in general and at 5 percent for those distributed by subsidiaries were adopted in numerous subsequent conventions, such as that with Denmark, 1948 (Art. VI);[17] New Zealand, 1948 (Art. V); Belgium, 1965 (Art. VIII A); Norway, 1959 (Art. VI A);[18] Switzerland, 1951 (Art. VI); Finland, 1952 (Art. VI).

Ireland in 1959 (Art. VI) copied the treaty with the United Kingdom, Greece in 1950 omitted an Article on dividends because of the unusual structure of its income tax. Australia in 1955 lowered its dividend tax rate to 15 percent to bring the combined effective rate on distributed income down to the United States level (Art. VII).

The Supplementary Protocol with Japan, of August 14, 1962, introduced rates of 15 percent in general and, if the recipient is a corporation, a rate not exceeding 10 percent if the 50 percent of stock ownership and 25 percent of gross income tests are met (Art. VI A).

In the same year Germany agreed to reduce its withholding rate of

[16] More specifically, the 5 percent rate is applicable if during the paying corporation's taxable year which precedes the dividend and the whole of the prior taxable year (if any) the recipient is a corporation owner of at least 25 percent of the voting stock of the paying corporation either alone or together with another corporation of the same State, each of which owns at least 10 percent of the voting stock, and if not more than 25 percent of the gross income of the paying corporation, for the prior year, consisted of interest and dividends (other than interest derived in the conduct of a banking, insurance, or financing business and dividends or interest received from subsidiary corporations, 50 percent or more of the voting stock of which was owned by the paying corporation at the time such dividends or interest were received).

[17] The conditions for the 5 percent rate were: if (a) the shareholder controls directly or indirectly at least 95 percent of the voting power in the payer corporation, and (b) the payer corporation derives not more than 25 percent of its gross income in dividends and interest, from other than its own subsidiary corporations. Furthermore, the reduction to 5 percent shall not apply, if the relationship of the two corporations has been arranged or maintained primarily to secure the reduced rate (Art. VI(3)).

[18] This was subject to the conditions that the recipient is not engaged in trade or business through a permanent establishment in Norway, and provided the United States corporation alone or in association with not more than 3 other United States corporations owns more than 50 percent of the voting stock of the payer corporation. Each of these must own at least 10 percent of the gross income of the Norwegian company during the immediately preceding taxable year was derived from interest and dividends other than such items received from its subsidiary corporations.

25 percent to a rate not in excess of 15 percent, if a United States corporation not having a permanent establishment in Germany owned at least 10 percent of the voting stock of the German company (Art. VII). The German tax on the corporation itself had split rates of 51 percent on undistributed income and 15 percent on distributed income. In addition to the latter rate the treaty provided for the reduced withholding rate of 15 percent. Some American corporations found it advantageous if their German subsidiary distributed all available income, and they would then reinvest in the subsidiary the excess over taxes.

German companies objected that this gave a discriminatory advantage to United States corporations. In the Protocol of 1965 the German government agreed to a reciprocal withholding rate of 15 percent (Art. VI) but sought to prevent the United States corporation from taking advantage of the low combined rate of corporation tax and withholding tax on distributed income as compared with the 51 percent rate on undistributed income. In the case of a United States corporation owning at least 10 percent of the voting stock of the German company, the treaty accomplished this by increasing the rate to 25 percent on the portion of a dividend that is deemed to be reinvested, e.g. amounts transferred by a United States company in excess of 7.5 percent of the dividends.

The Treaty with Italy of 1955 provided for the reduction to 15 percent in general and to 5 percent for dividends from a subsidiary (Art. VII). The Austrian Treaty of 1956 stipulated ceilings of half the statutory rate in general and of 5 percent in the case of a subsidiary, provided in either case that the 95 percent ownership and 25 percent gross income tests were met (Art. VII). This set the example for Luxembourg in 1962.[19]

Pakistan, in 1957, agreed in Article VI to reduce the rate of Pakistan supertax on dividends by 1 anna in the rupee (16 annas=1 rupee) subject to 3 conditions.[20]

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[19] Conditions in the Luxembourg Treaty are that 50 percent of the voting stock is owned by the recipient corporation alone or with not more than 3 other corporations of the same State, each of which must own at least 10 percent of the voting stock. In addition, not more than 25 percent of the gross income of the payer corporation may consist of dividends and interest other than such items from its own subsidiaries (Art. IX).

[20] These conditions are: (1) the United States corporation has no permanent establishment in Pakistan, (2) is a public company as defined by the law of Pakistan; and (3) owns more than 50 percent of the voting stock of a company resident in Pakistan and engaged in an industrial undertaking prescribed in Sec. 15B of the income tax act.

The 1967 Convention with France provides that the withholding rate is to be 15 percent in general, and not more than 5 percent if (a) the recipient corporation owns at least 10 percent of the voting stock of the payer corporation, and (b) generally speaking not more than 25 percent of the gross income of the payer corporation consists of interest or dividends from corporations other than its own 50 percent-owned subsidiaries. The shares must not be effectively connected with a local permanent establishment.

In contrast to the provisions in the Trinidad and Tobago Treaty, infra, which applies the same rate of 5 percent to dividends and branch profits,[21] the French Treaty discriminates against branches by applying 15 percent to their profits.

Countries Exempting from, or Reducing, Tax on Outgoing Interest

The Four Economists (Sec. Part I) would be gratified to see how consistently countries desiring American capital have waived in tax treaties their tax withheld at source on interest in recognition of the fact that such a tax is tantamount to imposing a cusoms duty on the importation of foreign capital. The United Kingdom in 1945 and other countries in later years wanted in their treaties with the United States to remove any tax obstruction to obtaining loans in the New York money market.

This subject was not considered in the 1932 Convention with France. The Swedish government actually set the pattern in 1939 by providing that interest on bonds, notes or loans would be taxable only

[21] Another condition is that more than 25 percent of the gross income of the paying corporation for such prior taxable year (if any) consist of interest and dividends (other than interest derived in the conduct of a banking, insurance or financing business, and dividends or interest received from subsidiary corporations of which the paying corporation owns 50 percent or more of the voting stock at the time the dividends or interest were received). S. Ex. F., 90th, 1st, pp. 3, 4.

The 1966 Convention with Trinidad and Tobago contains in Art. 3 a reduction in its withholding tax of 30 percent to 25 percent of the gross amount of dividend distributed, or to 5 percent if during the part of the paying corporation's taxable year preceding the payment of the dividend and the whole of the prior year (if any) the recipient corporation owned at least 10 percent of the voting stock of the paying corporation.

In addition to its corporation tax of 44%, Trinidad and Tobago imposes (under its Finance Act of 1966) a tax of 30 percent on profits (after payment of the corporation tax) derived by a local permanent establishment unless such profits are invested within Trinidad and Tobago. Subject to prescribed conditions, the Convention will have the effect of reducing this "branch profits tax" to 5 percent (Art. 3(5).

in the country where the individual creditor resides, or the corporate creditor was organized, except that if the country of the debtor did levy a tax at source, it could continue to do so. This meant that the United States could withhold tax even if Sweden collected no tax at source. However, in 1963 the two countries adopted the principle of foregoing tax at source, regardless of the existence of a withholding rate, as long as the creditor had no permanent establishment in the State from which the interest was derived.

Canada, in the Treaty of 1942, continued to apply its withholding rate of 15 percent and the United States reduced its tax to that level. These commitments were to be effective as long as the creditor had no permanent establishment in the State of the borrower (Art. XI).

In 1945 the United Kingdom was willing to agree, in a reciprocal article, to give up entirely its tax at source on interest as long as the creditor was not engaged in trade or business in its territory. Apparently on the theory that control would permit abuse, the exemption was barred if a creditor corporation controlled, directly or indirectly, more than 50 percent of the entire voting power of the debtor corporation (Art. VII). Ireland followed this example (Conv. 1949, Art. VII).

In 1948 the Netherlands followed the British example of exempting interest at source subject to the same conditions (Art. VIII). This Article was amended in 1965 by freeing the interest at source as long as the indebtedness was not effectively connected with a permanent establishment, and to the extent it represented fair and reasonable consideration for the loan.

As regards Denmark, interest is reciprocally exempt, subject only to the condition that the nonresident creditor has no permanent establishment in the country of source (Conv. 1948, Art. VII). The same is true in regard to Norway (Conv. 1949, Art. VI); Finland (1952, Art. VII), and Luxembourg (1962, Art. VIII).

Greece, in a reciprocal provision, exempts interest paid by a Greek debtor to a United States resident under the additional proviso that the rate does not exceed 9 percent per annum (Conv. 1950, Art. VII). It also forbids the exemption if such interest is paid by a Greek corporation to a United States corporation which controls, directly or indirectly, more than 50 percent of the entire voting power of the paying corporation.

The German Treaty of 1954, as amended in 1965, exempts interest at source provided the creditor in the other State has no permanent establishment in the former State with which the interest is effectively

connected. The exemption is applicable only to the extent the rate conforms to that which would prevail between unrelated persons (Art. VII).

The Treaty with Austria provides for reciprocal exemption of a reasonable consideration on indebtedness, and in the absence of a permanent establishment (Art. VII).

No article on this subject is found in the Treaties with the Union of South Africa, New Zealand, Australia, Italy and Pakistan.

A few countries withhold a rate which they feel is low enough not to impede the inflow of capital, provided the creditor has no permanent establishment in their territory. Thus Belgium withholds reciprocally 15 percent (Art. VIII(A) of 1948 Conv. as added by 1952 Conv.); Switzerland in its Treaty of 1951 withholds its coupon tax of 5 percent, provided the creditor is not a Swiss citizen (Art. VII); in its Treaty of 1962, Japan reduced the maximum rate to 10 percent, provided the creditor has no establishment in Japan. But it then provided the interest is not attributable to its trade, business or assets, or that the transaction is not of a kind normally effected by such establishment (Art. VI).

The 1967 Treaty with France reduces reciprocally the withholding rate from 15 to 10 percent (Art. 10), assuming that the indebtedness is not effectively connected with a permanent establishment in the State of source. A permanent establishment which bears interest will constitute its source.

Copyright and Patent Royalties Generally Exempted at Source

During the negotiation of the Treaty between France and the United States in the summer of 1930, French officials listened to the complaints of resident authors over being taxed in the United States on copyright royalties from American publishers. They insisted that the United States should grant an exemption from its tax.

The exemption adopted in the 1932 Convention (Art. 7) covered royalties for the use of copyrights and also patents, secret processes, and formulae, trademarks and similar rights. However, in the 1967 French Convention (Art. 11), the exemption was continued only for copyright royalties, and was replaced by a 5 percent withholding rate on royalties paid for the use of patents and other industrial property.

Canada kept in its 1942 Convention the right to withhold its nonresidents' tax, which may not exceed 15 percent, provided the recipient has no permanent establishment in Canada (Art. 11). However, in its

1951 Convention, the withholding of tax from copyright royalties was waived with a similar proviso (Art. XIIIC). When the United Kingdom signed the Convention of 1945, that country anticipated such a great need of American technology to modernize its industries that it granted an exemption from the United Kingdom standard rate of income tax ordinarily deducted at source, provided the nonresident recipient was not engaged in trade or business in its territory (Art. VIII). Ireland in 1949 followed Britain's example (Art. IX).

Later a certain United States corporation wanted to open a sales branch in the United Kingdom that was in no way connected with an existing license agreement between this corporation and a British company. Nevertheless, the corporation would lose its exemption from the British tax on royalties. The collection of this tax would incidentally deprive the United States Treasury of its revenue because of the offsetting credit. Hence the Treasury negotiated a Protocol which prevented the application of the force of attraction doctrine if the royalties were not directly associated with the business carried on through the permanent establishment (Supplementary Protocol of 1956, Art. I).

The Treaty with New Zealand of 1948 permits in Article VII the resident of one country deriving royalties of any type to elect to be subject to tax for any taxable year on a net basis as if engaged in trade or business through a permanent establishment in the country of the licensee.

Reciprocal exemption at source for copyright and patent royalties was provided for in the 1948 Conventions with Denmark (Art. VIII), Netherlands (Art. IX), and Belgium (Art. IX), and all prescribe the condition of not having a permanent establishment. The convention with the Netherlands adds to the more or less standard listing of copyrights, patents, designs, etc., also those derived for the use of industrial, commercial or scientific equipment (Art. IX).

In 1949, Norway signed a Convention which emulates its predecessors in Article VII but adds a clause to permit the respective authorities to deny the deduction of the royalty or any part thereof which they do not consider to be reasonable consideration for the right to use the property in question.

In 1950 Greece (Art. VII) followed suit as did Switzerland (Art. VIII) in 1951. In 1952 Finland adopted a similar exemption for copyright royalties (Art. VIII). Australia in 1953, like South Africa, omitted patent royalties but exempted at source copyright royalties (other than for films) (Art. X). In 1954 Japan limited its withholding

tax to 15 percent for patent as well as copyright royalties under essentially similar conditions, but in 1962 agreed to reduce the rate to 10 percent.

The Italian Treaty (Art. VIII) contains the standard provisions exempting, from the national tax, royalties on copyrights, patents, etcetera, but this exemption does not cover the additional percentages levied for the benefit of the province, commune and other local entities.

Austria in 1956 combined most of previously utilized terms in Article VIII of its Treaty. Pakistan in 1957 wanted technology as well as culture, and granted exemption with a protective clause.

In the 1962 Luxembourg Treaty, Article VII covers not only royalties, rentals and similar payments for (a) copyrights, artistic or scientific works, patents, designs, plans, secret processes and formulas, trade-marks, motion picture films, films or tapes for radio or television broadcasting or other like property or rights, but also for (b) industrial, commercial or scientific equipment and also "knowledge, experience, skill, or know-how."

Also in the Treaty with Germany, Article VIII on royalties contains refinements inspired by the OECD Draft. This Article first declares that royalties derived by a natural person resident in, or a company of, one Contracting Party shall be exempt from tax by the other. In the definition of a royalty, after the word "skill" there is inserted in parenthesis the word "know-how," and at the end there is added gains derived from the alienation of any right or property.

Paragraph 4 contains the qualification that the exemption will *not* apply if the recipient of the royalty has a permanent establishment in the country of source with which the right or property giving rise to the royalties is *effectively connected.* Otherwise the royalty is exempt at source. This qualification signifies the abandonment of the "force of attraction" doctrine. The last clause in Article VIII excludes from the exemption any part of the royalty which exceeds the amount that would be agreed upon by independent parties.

In the case of the Netherlands, Article VII of the Supplementary Convention of December 30, 1965, amended Article IX of the existing Convention and made it substantially similar to the above described Article in the Convention with Germany. The same is true of Article VIII of the 1966 Supplementary Protocol with the United Kingdom.

The Convention with France of July 28, 1967, continues in Article 11 to exempt copyright royalties but introduces a withholding tax not in excess of 5 percent for royalties paid for the use of all kinds

of industrial property or rights and adds those paid for "knowledge, experience, or skill (know-how)." [22]

France is said to have departed from the precedent established in 1932 because today French companies are paying to United States licensors a much greater total sum of royalties than the amount that flows to that country. Hence, it wanted to retrieve part of the outflow by collecting at least a nominal amount of tax revenue. This was expected to help its balance of payments. Nevertheless, the great majority of countries favor the rule of reciprocal exemption at source for patent as well as copyright royalties, which was advocated by the London Model Convention of 1946 and the Paris Model of 1963.

Business Income Exempt Unless Allocable to a Permanent Establishment

As domestic corporations operate abroad through foreign subsidiaries more frequently than through branches, the foregoing treaty provisions on royalties, interest, and dividends take care of most situations. There is also a general clause, regarding allocation as between a parent and a subsidiary corporation, originally based on Section 45 of the revenue act in force in 1932 when the first treaty with France was signed.[23]

When the technical experts of the League of Nations began discussions which led to the Model Conventions of 1927 and 1928, they agreed that an enterprise should of course be taxable in its home country and should not become taxable in another if it merely made sales therein through independent commission agents or brokers. However, if it set up a permanent representation in another country through an individual or firm, or opened therein an office, or acquired a plant of some kind then they concluded that it should become taxable therein. The firm would ordinarily be exempt in its home country on such profits earned and taxed abroad.

The dividing line between doing business with and doing business within a country was traced in the commentary on Article 5 of Draft

[22] Par. 4(b) adds gains derived from the sale or exchange of any such right or property, if payment of the amounts realized on such sale or exchange is contingent, in whole or in part, on the productivity, use or disposition of the right or property. If the amounts derived are not so contingent, the profit will be taxed as a capital gain under Article 12. Par. 5 bans the exemption if the recipient has in the State of source a permanent establishment with which the right or property involved is effectively connected. Article 11 ends with clause 7 to maintain tax liability at the rate imposed by law for any part of the royalty which exceeds the amount that would be agreed to by independent persons.

[23] presently Sec. 482, I.R.C.

Convention 1(a) adopted at the 1928 meeting of Government Experts.[24]

Included within the 1932 Convention with France (Protocol Par. 3(a)) was list of the establishments that give rise to taxation and also added to the definition a clause which provided in substance that carrying on business through a local agent who has a general authority to negotiate and conclude contracts for the account of the nonresident enterprise is considered as having a permanent establishment. The 1939 Convention with France added to the definition in the Protocol III(a) the maintenance of a stock of merchandise from which the employee or agent regularly fills orders which he receives.

When the Swedish representatives were negotiating the 1939 Convention in Washington, they requested, on behalf of their exporters of wood pulp, exclusion from the definition of the term "permanent establishment" of the casual or temporary use of storage facilities (Protocol, Par. 16). In the Supplementary Convention of Oct. 22, 1963, the 1939 definition was replaced by one based on the composite OECD definition which *inter alia* excluded this item.

The 1950 Treaty with Canada added to the 1942 definition (Protocol, par. 3(f)), the use in one State of substantial equipment or machinery at any time in any taxable year by an enterprise of the other State. The Canadian tax authorities wanted this addition in order to tax American construction enterprises on earnings from short jobs North of the border.

The 1948 Treaty with New Zealand removes from the definition a fixed place of business exclusively for the purchase of goods or merchandise (Art. II(1)(0)).[25]

The Convention with Switzerland adds to the standard terms a clause to the effect that the maintenance of a warehouse for convenience of delivery and not for purposes of display shall not of itself constitute a permanent establishment, even though offers of purchase have been obtained by an agent of the enterprise in that territory and transmitted by him to the enterprise for acceptance (Art. II(i)(c)).

The Treaty with Australia of 1953 introduces a "pastoral prop-

[24] Document C.562. M.178. II. Report of the General Meeting of Government Experts on Double Taxation and Tax Evasion, p. 12. See Part I.

[25] The 1945 Treaty with the United Kingdom (Art. II(i)(1) and the 1948 Treaties with Denmark (Art. II(i)(e)) and Belgium (Art. II(1)(f)) contain the more or less standard definition that was used prior to the OECD Draft. The same is true of Art. II(1)(1) of that with Greece, 1950, and Art. II(1)(c) of that with Finland, 1952.

erty," but excludes a fixed place of business for the purchase of goods, and an agent other than one who habitually exercises a general authority to conclude contracts or regularly fills orders out of a stock of goods (Art. II(1)(o)).

The Treaty with Japan, 1954, which otherwise is standard, has a novel provision to the effect that a United States enterprise will be deemed to have a permanent establishment in Japan if it has had there for more than twelve months a construction, installation or assembly project. The same is true if it carries on supervisory activities in Japan for more than twelve months in connection with one of the listed projects located therein (Art. II(1)(c)). This was supposed to reach a large United States corporation which maintained in Tokyo a staff of engineers and officers to supervise the installation of heavy equipment sold to a Japanese company. The definition of the term permanent establishment in the OECD Draft was followed in the 1962 Treaty with Luxembourg, the 1965 Protocol with Germany (Art. II(1)(c), and the Supplementary Convention with the Netherlands, 1965 (Art. II(1)(a)).

On the contrary, the British negotiators of the 1966 Supplementary Protocol with the United States apparently were satisfied with the definition in the 1945 Convention (Art. II(1)(1)). The 1967 Convention with France follows almost verbatim the model of the OECD.

Concept of Industrial or Commercial Profits and Allocation Principles

The basic concept of taxing only the industrial and commercial profits of an enterprise of one State that are allocable to a permanent establishment in the other State is found in all of the Conventions.[26]

As representatives of both France and the United States had collaborated in preparing the League of Nations model conventions of 1933 and 1935 on the allocation of taxable income they naturally put the substance into the text of the 1939 Convention. Hence, Article 3 of this Convention followed the League 1935 model by excluding

[26] Conventions with Sweden, 1939, Art. II; Canada of 1942, Art. III, 1; United Kingdom of 1945, Art. III(1) and (2); Union of South Africa, 1946, Art. VI(1); New Zealand, 1948, Art. III(2) and (3); Denmark, 1948, Art. III(1) and (3); Belgium, 1948, Arts. III and IV; Norway, 1949, Art. III(1) and (3); Ireland, 1949, Art. III(1) and (3); Greece, 1950, Art. III(1) and (2); Switzerland, 1951, Art. III(1) and (3); Ireland, 1952, Art. III(1) and (3); Australia, 1953, Art. III(1) and (4); Japan, 1959, Art. III(1) and (3); Germany 1954, Art. III(1) and (2); Italy, 1955, Art. III(1) and (3); Austria, 1956, Art. III(1) and (3); Pakistan, 1957, Art. III(1) and (3); and Luxembourg, 1962, Art. 2.

from the term "industrial and commercial profits" certain items that are definitely allocable to a particular source and are covered by specific articles of the Convention. They are:

(a) income from real property (Art. 2).
(b) income from mortgages, etc. (Art. 6A Conv. of 1956).
(c) dividends from shares (Art. 6A, ditto).
(d) Rentals from leasing personal property, royalties for the use of patents, copyrights, etc. (Art. 7).
(e) Capital gains (Art. 11).

These items will be taxed separately (as in France) or together (as in the United States) with industrial and commercial profits in accordance with the laws of the Contracting States (Art. 3, last par.).

Since 1932, our treaties on income taxes have consistently used the term "industrial and commercial profits" and frequently have replaced the conjunctive "and" by the disjunctive "or."

The principal Canadian official engaged in the negotiation of the Treaty of 1942, Hon. C. Fraser Elliott, K. C., Deputy Minister of Internal Revenue for Taxation, had participated with the writer in the work of the League of Nations Fiscal Committee. Accordingly, Article II of that Treaty defines the term industrial and commercial profits in the manner of the League Draft of 1935.

The United Kingdom Convention of 1945, as amended in 1966, says in Article III(5) that the term "industrial or commercial profits" means income derived from the active conduct of a trade or business, including income from furnishing services of personnel, but does not include items specifically covered in other Articles. Such items are dividends, interest and royalties, unless the holding or indebtedness, or right or property is effectively connected with the permanent establishment. However, the Convention does not set forth any rules as to procedure in allocating income.

The Convention with the Union of South Africa of 1946 follows in Articles II(1), V and VI faithfully the provisions in the League Model. New Zealand adopts in its Treaty of 1948 (Art. III(6)) the general principles, but authorizes the tax officials to redetermine the taxable income by the exercise of "discretion" or the making of an "estimate."

General principles were considered adequate in the Treaties with Denmark 1948 (Art. III), and the Netherlands 1948 (Art. III, as amended in 1965). Italy 1955 (Art. III) and Austria 1956 (Art. III).

The Treaty with Belgium borrows extensively from the League draft (Art. II(g), Arts. III and IV).[27]

Australia in 1953 (Art. IIA) defined the term as including profits of an industrial or commercial enterprise, but excluding the obvious items, and, in regard to allocation, it envisages recourse to discretion or an estimate (Art. III).

In the Treaty with Japan of 1954 (as amended in 1962), Article II 1(1) defines industrial or commercial profits as including manufacturing, mercantile, agricultural, fishing, mining, financial and insurance profits, but excludes the usual items covered by specific articles. The Treaty with Germany of 1954, as amended by the Protocol of 1965, contains a similar definition (Art. III(5)).

On the other hand, the Convention with Pakistan, 1957, in Article II(1)(1) excludes the usual items plus fees for the management, control or supervision of the trade, business or other activity of another enterprise or remuneration for labor or personal services, or income from the operation of ships.

The Treaty with Luxembourg of 1962 (Art. III) was based on the OECD model. The commentary (1963 Report, p. 88) frankly states that it was not found necessary to define the term "profits," which includes all income derived in carrying on enterprise—which corresponds to the use of the term in the tax laws of most member states.

On the contrary, the 1967 Convention with France contains a very inclusive definition of the term "industrial or commercial profits" in Article 6(5) that bespeaks the change in character of the French company tax which superseded for corporations the French schedular tax on industrial and commercial profits and brings in even excluded items if they are *effectively connected* with a local permanent establishment.

As regards allocation, the French Treaty of 1967 merely states the principle of allocating to the local permanent establishment the industrial or commercial profits that would be *attributable* to it if such permanent establishment were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment (Art. 6(2)).

[27] No definition is found in the Conventions with New Zealand, 1948; Denmark, 1948; Belgium, 1948; Norway, 1949; Greece, 1950, Switzerland, 1951; and Finland, 1952.

Exclusion of Profits from Purchasing

In the 1920's and 30's attempts were made from time to time to subject a nonresident to tax on a presumed profit attributable to the act of purchasing, but progressively it was acknowledged that a so-called purchasing profit was usually fortuitous and was impossible to measure. Nevertheless some less developed countries still try to reach a foreign company which buys and exports locally produced goods, especially if they are processed and packed before shipment, and sells them at an establishment in its home country.

Except for the Conventions with Austria and Pakistan, which said nothing on the subject, all the conventions categorically proscribed treating as a permanent establishment a mere office to purchase goods for export, or attributing any profit to the mere act of purchasing.[28]

Deduction for General Overhead Expense Wherever Incurred

General overhead, executive, or administrative expense wherever incurred which is allocable to the permanent establishment is expressly deductible from the gross income allocable thereto in all the Conventions except those with Sweden, the Union of South Africa and Pakistan.[29]

Allocation of Profits Between Related Corporations

The new Treaty of July 28, 1967, authorizes France to tax profits "actually distributed" by a French subsidiary to a United States parent corporation. (This Article 9(2) evidently relates back to Article 16 of the 1939 Convention and to Article VI of the 1932 Convention). The essence of this Article was that if France could prove in court that, as the result of fixing prices or charges that would not be made in dealings between independent enterprises, profits had been diverted

[28] No profits are attributable to mere purchasing of goods or merchandise by a permanent establishment in the Convention with Sweden of 1939, Art. II; Canada of 1942, Art. I; United Kingdom of 1945, Art. III(4); Union of South Africa, 1946, Art. V(2); New Zealand, 1948, Art. III(4); Denmark, 1948, Art. III(2); Belgium, 1948, Art. III(2); Norway, 1949 Art. III(2); Ireland, 1949, Art. III(4); Greece, 1950, Art. III(3); Switzerland, 1951, Art. III(2); Finland, 1952, Art. III(2); Australia, 1953, Art. III(6); Japan, 1954, Art. III(2); Germany, 1954, Art. III(4); Italy, 1955, Art. III(2); and Luxembourg, 1962, Art. III(4).

[29] Canada, 1942, Art. 1; United Kingdom, 1945, Art. III(3) as amended; New Zealand, 1948, Art. III(5); Belgium, 1948, Art. IV(4); Switzerland, 1951, Art. III(4); Finland, 1952, Art. III(2); Australia, 1953, Art. III(3); Japan, 1954, Art. III(4); Germany, 1954, Art. III(3); Italy, 1955, Art. III(5); Austria, 1956, Art. III(3); and Luxembourg, 1962, Art. III(3).

from a French subsidiary to an American corporation, it could add back such diverted profits and subject them first to tax on industrial and commercial profits and then to the tax on income from securities.

The language in Article IV of the 1932 Convention was modelled on the Section 45 of the United States Revenue Act, presently Section 482 I.R.C. This provision in Article IV for bilateral application in a treaty seemed to be so superior to the unilateral application of Section 45 of the United States law in allocating income as between the United States and a foreign country that it was reworded in Article III of the Convention with Sweden of 1939 to serve as a general rule which could be applied also in subsequent treaties. After stating that the amounts proved in court to have been diverted could be incorporated in the taxable profits of the local enterprise, the Article authorized rectifications of the pertinent accounts.

Article IV of the 1942 Convention with Canada embodies the principle taken from Article III of the Swedish Convention and deals specifically with the rectification of accounts on an arm's length basis. It served as a model in subsequent Conventions.[30]

Income from Shipping and Air Transport Reciprocally Exempted

From the beginning of the work on drafting a model Convention for the avoidance of double taxation, invited representatives of the International Chamber of Commerce insisted that a shipping enterprise should be taxed only in the country where its head office was located and not also in the other countries where the ships docked to embark or disembark passengers or freight. This tax regime was called the reciprocal exemption of shipping profits. It was recognized as an exception to the basic principle of taxing a foreign enterprise on business income allocable to a local permanent establishment.[31]

[30] Nothing significant is added by the Treaty with the United Kingdom of 1945 (Art. IV); the Union of South Africa of 1946 (Art. VII); the Netherlands of 1948 as amended in 1965; Convention with Denmark of 1948 (Art. IV); New Zealand of 1948 (Art. IV); the Belgium of 1948 (Art. V); the Norwegians of 1949 (Art. IV); the Greeks of 1950, the Swiss of 1951 and the Finns of 1952. In 1953 the Australians followed the pattern of New Zealand by envisaging recourse to discretion or an estimate. Others returned to a short form of Art. IV, namely Japan and Germany in 1954; Italy in 1955; Austria in 1956; Pakistan in 1957 and Luxembourg in 1962. The new French Treaty of 1967 remained essentially the same as before.

[31] Thus the last paragraph of Art. 3(b) of Draft Convention No. 1(b) adopted in 1928 (22) declares that income from maritime shipping and air navigation shall be taxable only in the State in which the real center of management is situated.

Charles Lindberg had just flown the "Spirit of St. Louis" from the United States to Paris in 1927, and the point was made in Geneva in 1928 that the same principle should be applied to companies that were expected to engage in transportation by air.[32]

As the writer was one of the many who had welcomed Lindberg when he arrived in Paris, the writer urged during the negotiation of our first treaty with France in 1930 that we provide in Article III that income which an enterprise of one of the Contracting States derives from the operation of aircraft registered in such State and engaged in transportation between the two States is taxable only in the former State.[33]

The Convention with Sweden of March 1939 envisages the exemption, on condition of reciprocity, of income from the operation of both ships and aircraft registered in the other Contracting State.[34]

Canada and the United States adopted this régime in the Treaty of 1942 (Art. V)[35] and extended it in 1956 to cover the operation of motor vehicles as a common carrier or a contract carrier.

The United Kingdom and the United States agreed in 1945 to reciprocal exemption of income from the operation of ships and aircraft and stipulated that the Treaty Article superseded an executive agreement resulting from an exchange of notes (Art. VI). These Articles set the pattern for numerous subsequent Treaties.[36]

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[32] League of Nations Document No. C.562. M.178. 1928. II. Report of the General Meeting of Government Experts on Double Taxation and Tax Evasion, Art. 2(B) at 16.

[33] No reference was made to shipping enterprises because they were covered by an exchange of notes dated June 11 and July 8, 1927, called an executive agreement based on the offer of exemption for shipping income in the revenue act. The provision now reads in substance: Earnings derived from the operation of ships documented or aircraft registered under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States. These provisions are now found in Secs. 872(b)(1) and (2) and 883(1) and (2) I.R.C.

[34] However, the first paragraph of Art. 6 stipulated that the shipping enterprises would continue to benefit from reciprocal exemption in accordance with an executive agreement contained in an exchange of notes of June 11 and July 8, 1927.

[35] Art. V stated it would not affect the executive agreement for reciprocal exemption of shipping profits constituted by the exchange of notes of August 2 and September 17, 1928.

[36] The 1948 Treaties with the Netherlands, Art. VI; Denmark, Art. V; New Zealand, Art. V; and Belgium, Art. VII. Similar provisions are embodied in the Art. V of each of the 1949 treaties with Norway and Ireland; of the 1950 Treaty with Greece; the 1951 Treaty with Switzerland; the 1952 Treaty with Finland; as well as the 1953 Treaty with Australia.

A variation is found in the 1954 Treaty with Japan, Article V stating that the exemption applies for income derived by an enterprise of one State from the operation of ships or aircraft registered in such State or (b) in a third country which exempts (A) such enterprise and (B) an enterprise of the other Contracting State, from its tax on earnings derived from the operation of ships or aircraft.

The 1954 Convention with Germany (Art. V) the 1955 Treaty with Italy (Art. V) and the 1956 Treaty with Austria (Art. V) are equally terse. Pakistan falls into line only for aircraft in Article V of the Treaty of 1957. Landlocked Luxembourg agrees to reciprocal exemption for both ships and aircraft in the Convention of 1962 (Art. V).

The 1967 Convention with France provides categorically in Article 7 that regardless of the provisions of Article 6 on industrial or commercial profits, income derived by a resident of one Contracting State from the operation international traffic of ships or aircraft registered in that State shall be taxable only therein.

Income from Real Property and Mining Royalties

The general principle applied in Europe, at least for schedular taxes, is that rentals for property, mining royalties and the like are taxable only in the country where such property is situated. Even though the Treaty with Sweden (Art. V) and other treaties say that income from real property is taxable *only* in the country where the property is located, the so-called "saving clause," *infra,* nevertheless saves the liability to the Federal income tax of the United States citizen, or resident alien, or a domestic corporation in respect of all items of income taxable under its revenue laws. Double taxation is avoided by means of the credit allowable under Sec. 901 I.R.C. (REV. RUL. 59-56, 1959-I C B 737).

After the coming into force of the Revenue Act of 1936, income from real property derived by a nonresident was subject to tax by withholding the rate of 10 percent from the gross income.[37] Nonresident

[37] The application of the withholding rate was conditioned on the recipient of the income not being engaged in trade or business and not having an office or place of business within the United States. Subsequently the latter clause was dropped. With the amendments in the Foreign Investors Tax Act of November 13, 1966, the foreign taxpayers may elect to treat income derived from real property as effectively connected with the conduct of a United States trade or business and accordingly pay the federal income tax on the basis of net income instead of gross income (Secs. 871(a) and 882(d) I.R.C.).

aliens who owned and leased to other persons houses, apartments, or office buildings objected to the fact that they could not deduct operating expenses and pay tax on net income unless they were recognized as being engaged in trade or business or having an office or place of business in the United States.

In order to remedy this situation the United States agreed in its 1945 Treaty with the United Kingdom that the resident of the United Kingdom could elect, in lieu of bearing the agreed withholding rate of 15 percent, to be subject to the United States tax as if such resident were engaged in trade or business in the United States (Art. IX). This was amended in 1966 by inserting after "United States tax" the phrase 'on such income on a net basis.' "

Article IX in the 1945 Treaty with the United Kingdom served as an example for 1946 amendment to the French Treaty (Art. 7) the Protocol with the Union of South Africa (Par. III), the 1949 Treaty with Ireland (Art. IX) and the 1950 Supplementary Convention with Canada (Art. XIII(A)).[38]

The Treaty with Denmark of 1948 (Art. IX) provided reciprocally that taxpayers may elect to pay tax on a net basis and set a trend for a series of treaties.[39] The subject is omitted in the Treaty with Pakistan of 1957. The last word on the subject is found in Article 5 of the 1967 Treaty with France, which echoes the traditional principle of taxing income where the real property or natural resources are situated, and includes gains from the sale or exchange of such property or right giving rise to such royalties. A final paragraph entitles the nonresident recipient to elect to be taxed on the basis of net income as if engaged in business.

Earnings of Temporary Business Visitors Exempted

Tax treaties benefit business intercourse between the Contracting States by exempting the employee who is normally resident, paid, and taxed in one State from tax on amounts earned while present in the other State for a limited period—in most cases not more than

[38] The taxpayer resident in the United States deriving such income from Canada is to be treated no less favorably than what is provided in the Canadian Income Tax Act (Sec. 99).

[39] The 1948 Treaty with New Zealand, (Art. VII); Supplementary Protocol of 1965 with Belgium, (Art. IX(1); and the Treaty with Norway of 1949 (Art. VIII). Greece, Treaty of 1950 (Art. VIII); likewise the Treaties with Switzerland of 1951, (Art. IX(2); Finland of 1952 (Art. IX) Australia of 1953 (Art. XI); in 1954 with Japan (Art. VIII) and Germany, 1956 (Art. IX) and Luxembourg of 1962 (Art. VI); and the Netherlands (Art. X) as amended in 1965.

six months in the aggregate during the taxable year. Starting with the 1939 Convention with Sweden, the other Contracting State exempted earned income of the United States employee, who ordinarily is resident and taxed in the United States, if he is present therein for less than 183 days in the aggregate during the taxable year (except 3 States which limit the exempt period to 180 days, i.e. Denmark (Art. XI), Japan (Art. IX), and Luxembourg (Art. XII)).

Generally countries in this group place no ceiling on the amount exempted for the indicated period, except four which have a ceiling of $10,000, i.e. Finland (Art. XI), Greece (Art. X), Norway (Art. X), and Switzerland (Art. X).[40]

Exemptions for Business Apprentices, Professors, etc.

Allowances vary somewhat from treaty to treaty but one may cite as an example the 1967 Treaty with France which contains in Article 17, headed teachers, and Article 18, headed students and trainees, the latest version of the types of allowances. France, for example, grants an exemption to an individual who is a resident of the United States, at the beginning of his visit to France and is temporarily present therein for the primary purpose of (1) studying at an accredited educational institution, (2) securing training to practice a profession, or (3) studying or doing research as the recipient of a grant of any kind from a governmental, religious, charitable, scientific, literary or educational organization.

The exempt amounts include the gift or grant, and income from personal services not in excess of $2,000 or the equivalent in francs. The benefits of the exemption extend for the length of time reasonably required to effectuate the purpose of the visit, but in no event shall an individual have the benefits of Articles 17 and 18 for more than a total of 5 taxable years.

[40] The Contracting States which have 183 days and no ceiling are Australia (Art. IX); Austria (Art. X); Belgium (Art. XI); Canada (Art. VII); France (Art. 14); Germany (Art. X); Ireland (Art. XI); Netherlands (Art. XVI); New Zealand (Art. IX); Pakistan (Art. X); Switzerland (Art. X); South Africa (Art. II), and the United Kingdom (Art. XI).

Italy (Art. XI) limits the exemption to an aggregate period of 90 days if the employee is paid in the State of residence but otherwise the compensation may not exceed $2,000.

In addition to Sweden certain States limit the exempt amount paid during a period of 90 days by a local employer to $3,000 i.e., Austria, (Art. X); Belgium, (Art. XI), Denmark, (Art. XI); Germany (Art. X), and Japan (Art. IX). Canada allows in this case an exemption for a salary not exceeding $5,000 (Art. VII).

Private Pensions and Annuities

In the balancing of concessions as between the country of the source of the income, and that of the fiscal domicile of the taxpayer, the negotiators of the 1932 Convention with France took from the 1928 models the provisions allocating two minor items to the latter jurisdiction, namely private pensions and life annuities (Art. IX). This clause appears throughout the subsequent Conventions with that country, the latest of 1967 stipulating that pensions and similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State (Art. 19(1)).[41] This rule covers also annuities and alimony (Art. 19(2)). On the contrary, this Convention allots to the paying State the right to tax social security payments (whether representing employee or employer contributions or accretions thereto) (Art. 20).

Remuneration for Government Services and Public Pensions

The 1932 Convention with France followed the 1928 Models in providing that only the government which pays remuneration for labor or personal services by its officials in the other Contracting State and pensions will have the right to tax such remuneration or pensions (Art. VII). This is an extension of the principle of "diplomatic immunity" from tax in the other State to which the official is accredited.

This principle is repeated consistently in all the Conventions.[42]

Capital Gains from Sale of Securities Exempt at Source

The development of international tax law received an impetus from the attempts of the United States in the early 1930's to tax the nonresident on gains from the sale of stocks, securities and commodities on exchanges in New York and elsewhere in the United States.

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[41] Essentially similar provisions are found in the other Treaties as follows: Sweden, 1939, Art. X(2); Netherlands, 1948, Art. XV(2); Denmark, 1948, Art. X(2); Belgium, 1948, Art. X(2); Norway, 1948, Art. XI(1); Ireland, 1948, Art. XI; Greece, 1950, Art. 11(2); Switzerland, 1951, Art. VII; Japan, 1954, Art. X(2); Germany, 1954, Art. XI; Italy, 1955, Art. X(2); Austria, 1956, Art. XI(2); Pakistan, 1947, Art. IX, and Luxemborug, 1962, Art. XI(2).

[42] The same rule is found in the Treaty with Sweden, 1939, Art. X; with Canada, 1942, Art. VI; as amended in 1950; the United Kingdom, 1945, Art. X; the Union of South Africa, 1946, Art. VIII; the Netherlands, Art. V(1) as amended in 1965; Denmark, 1948, (Art. X(1); New Zealand, 1948, Art. X; Belgium, 1948, Art. X; Norway, 1949, Art. XI; Ireland, 1949, Art. X; Greece, 1950, Art. XI; Switzerland, 1941, Art. XI(1); and Finland, 1951, Art. XI; Japan, 1954, Austria, 1956, Art. XI; Pakistan, 1957, Art. IX; and Luxembourg, 1962, Art. XI.

After the signing in 1932 of the first Tax Convention with France, attorneys invoked the exemption in Article 1 of the profits of a French enterprise which did not have a permanent establishment in the United States as a reason for not taxing gains realized on a stock or commodity exchange. However, the Treasury representatives replied that gains from the sale of securities or commodities were not industrial and commercial profits referred to in the Treaty.

Likewise they would not yield to the argument that out of reciprocity the United States should forbear from pursuing nonresidents because the foreign countries in which they resided did not endeavor to tax such gains realized by United States citizens not resident in their territories. Selling orders were shifted to the exchanges of Toronto, London, or other cities abroad. The Treasury was losing revenues not only from income taxes on gains but also on commissions of brokers, and stamp taxes on transactions on the domestic exchanges.

Recognizing the futility of the then existing method of trying to tax nonresidents at the regular progressive rates on the basis of a return, Undersecretary Mills in 1930 asked the writer (while the writer was serving as special attorney in the Secretary's office handling international tax matters) to work out a solution. The writer suggested that the United States should follow the example of other leading countries and exempt nonresidents on gains from the sale of stocks, securities or commodities. The more or less theoretical loss of revenue could be recouped by withholding a tax with a flat rate at source from dividends, interest, rents, and royalties and other recurring income. The nonresident alien or foreign corporation engaged in trade or business in the United States would file a return of income from sources therein and pay tax at the regular rates.

The adoption of these provisions in the Revenue Act of 1936 led to the introduction into tax treaties of the condition that the nonresident would enjoy the benefit of an exemption from the United States tax on capital gains, or, from the withholding rate for royalties of interest, or of a reduction in the rate withheld from dividends, only if he was *not* engaged in trade or business through a permanent establishment in the United States. If the nonresident had a permanent establishment in the United States he had to file a return and pay tax at progressive rates on the basis of net income from all sources in the United States.

Treasury officials invented the term 'force of attraction doctrine' to describe the attribution of such items of income to the permanent

establishment, with the consequent loss of the treaty benefit of a reduced rate or exemption at its source for a particular item of income.

In the 1939 Treaty with Sweden the Treasury agreed to Article IX, providing for the reciprocal exemption at source of gains from "the sale or exchange of capital assets." Such gains would be exempt in one State if derived by a resident or corporation of the other not having a permanent establishment in the former. Article 11 of the 1939 Convention with France was substantially the same. The Swedish text was followed in numerous treaties.[43]

The 1965 Protocol with the Netherlands amends Article XI to exempt reciprocally gains from the sale of capital assets not effectively connected with a local permanent establishment and provided the recipient is not a resident of the Netherlands who is present in the United States for a period of 183 days or more during the taxable year, and the asset alienated was not held for six months.

In the 1967 Treaty with France, Article 12 begins by stating the principle that a resident of one of the Contracting States is taxable only in that State on gains from the sale or exchange of capital assets and then lists exceptions, to wit:

(a) gain from the sale of real property located in the other State or of shares in a real property cooperative or corporation principally holding such property;
(b) the property is effectively connected with a permanent establishment in the other State;
(c) the recipient individual maintains a fixed base therein with which the property sold is effectively connected; and
(d) the recipient individual is present in the other State for periods exceeding 183 days in the aggregate. In all such exceptional cases the gains shall be included in business profits under Article 6.

Saving Clause—Credit for Foreign Taxes

The United States has consistently retained jurisdiction in its law and expressly in numerous tax treaties over the entire taxable income of

[43] Treaty with Canada, 1942 (Art. VIII); Treaty with the United Kingdom, 1945 (Art. XIV), as amended in 1966 to apply the "effectively connected" test; Treaties with Denmark, 1948 (Art. XII); Norway, 1949 (Art. IX); Ireland, 1949 (Art. XIV); Switzerland, 1951 (Art. IX); Germany, 1954 (Art. IX(A) as introduced in Protocol of 1965); Austria, 1956 (Art. IX); and Luxembourg, 1962 (Art. VI).

its citizens, residents, and corporations. Thus Article XIV, as amended in 1963, of the Convention with Sweden embodies for the United States the "saving clause" in order to override certain articles saying that income would be taxable only at its source in Sweden. Examples include provisions stating that an American enterprise's industrial and commercial profits allocable to a permanent establishment in Sweden would be taxable there and "exempt from taxation in the United States" (Art. II); and that income derived from real property in Sweden "shall be taxable only in the Contracting State in which the real property is situated" (Art. V).

In order to obviate the double taxation, resulting from the superimposition of the United States tax, Article XIV then provides for the allowance of a credit for the Swedish tax against the United States tax, as is presently granted in Sections 901-906 I.R.C. For its part Sweden excludes from a resident recipient's tax basis income from a permanent establishment or realty that is taxed in the United States (Art. XIV). However, this Article allows against the Swedish tax a credit for United States tax on other income such as that withheld from dividends.

The 1967 Treaty with France similarly provides for exempting certain income taxable in the United States and grants a credit for tax on other items (Art. 23).

The 1942 Treaty with Canada, as amended in 1950, contains in Article XVII the saving clause only for the benefit of the United States and in Article XV a credit provision for each party. Article XIII of the 1945 Convention with the United Kingdom is similar in this regard but embodies a special provision. The British standard rate of income tax was levied on the profit of a company but was deemed to have been passed on to the shareholder by deduction at source from the dividend. It was regarded by the United States Supreme Court as a tax paid by the company, Biddle v. Commissioner, 302 U.S. 573. Article XIII(1) permits the United States shareholder to take, as a credit, the appropriate amount of United Kingdom income tax paid on the dividend if he includes in his gross income for the purposes of the United States tax the amount of such United Kingdom tax. The company tax has replaced the income tax as the corporate levy, but the income tax is withheld from any dividend paid from net after-tax corporate earnings. The old treaty "special credit" still applies to dividends paid before April 6, 1966.

Article XIII of the British Treaty as drafted in 1945 evidently served as a model for the credit provisions in Article XV of the 1953 Treaty with Australia.

In its 1951 Treaty with Switzerland, under Article XV, the United States applies the saving clause and the credit. Switzerland excludes from its tax base income taxed in the United States otherwise than by a reduced rate, but it may take the excluded income into account in determining the rate of its tax applicable to taxable income. Of the 1954 treaties presently in effect, Japan adopts the counterpart of the United States credit while Germany excludes from the tax on its residents income from realty and permanent establishments and also dividends paid by a U.S. subsidiary company. A credit is allowed for the reduced United States tax rate on dividends received with respect to portfolio investments.

Pakistan in 1957 allowed in Article XV a credit for taxes spared to encourage investments (Sec. 15B of its law of 1922). This provision expired and the Senate adopted a reservation deleting this credit provision.

Saving-clause and credit provisions are found in a number of subsequent treaties.[44] All these instances reflect the influence of the United States.

Taxes on Property

Sweden has taxes on property as well as on income, and Article XIII in the 1939 Convention deals with the former category of taxes.

The inclusion of the Article restricting taxes on property in Article 19(A) in the 1939 French Convention, as amended by the Supplementary Protocol signed May 17, 1948, was due to the fact that France applied its patente tax (droit de patente) on banks, whether foreign or domestic, on the basis of certain empirical factors, one of them being the amount of its capital. A large New York bank with a branch in Paris was being subjected to tax on the basis of its entire capital although only a relatively small part was used in its operations in France.

At the writer's instance, France was induced to accept the principle that a United States banking corporation should be taxable only on so much of its capital as was allocable to its permanent establishment in France, (Art. 19A) but, as the provision in French law was repealed, the Article was omitted in the Treaty of 1967.

Numerous treaties have no Article concerning taxes on property, possibly because the other Contracting State had no such taxes or, if

[44] Denmark, 1948 (Art. XV); Norway, 1948 (Art. XIV); Finland, 1952 (Art. XV); Greece, 1953 (Art. XIV); Italy, 1955 (Art. XV but Italy limits the credit for dividends to 8 percent) and Luxembourg, 1962.

it did, United States taxpayers had not asked the Treasury to limit its application in the Treaty.[45]

Germany's property tax (Vermogensteuer) was listed in Article 1 of the Convention of 1954. The Protocol of 1965 (Art. XIV(A)) subjects real property and assets effectively connected with a permanent establishment to tax where such property or establishment is located. Property pertaining to the operation of ships and aircraft is exempt in the State other than that in which the enterprise has its fiscal domicile; and all other elements of capital are exempt in the State other than that in which the owner is resident.

Luxembourg, in its Treaty of 1962, agrees to exclude, generally speaking, in the case of residents or corporations having their seat in Luxembourg, from its wealth and other taxes, property situated in the United States (Art. XVI(2)).

Protection Against Discrimination

When contesting the application of the French tax on dividends distributed by American corporations with subsidiaries in France, one of the arguments was that this levy was discriminatory as compared with the taxation of French parent companies. This had led to the enactment in the Revenue Act of 1934 of the provision authorizing retaliatory taxation now found in Section 891, I.R.C.

The Canadian Treaty of 1942 contains in Paragraph 11 a prohibition, conditioned on reciprocity, against subjecting United States citizens residing in Canada to more burdensome taxes than those levied on citizens of Canada.

The 1945 Convention with the United Kingdom (in reciprocal Art. XXI(1)-(4) assures the same protection also to permanent establishments, and to corporations the capital of which is wholly owned by one or more nationals or corporations of the other Contracting Party. The word "taxes" covers all kinds—levies and whether national, federal, state, provincial or municipal.

Essentially similar Articles are found in other Treaties.[46]

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[45] Treaties with Canada, United Kingdom, Union of South Africa, Netherlands, Denmark, New Zealand, Norway, Ireland, Greece, Switzerland, Finland, Australia, Japan, Italy, and Austria.

[46] The Union of South Africa Treaty of 1946 (Art. III); the Netherlands of 1948, (Art. XXV(2)-(5)); Denmark, 1948 (Art. XVI), and Belgium, 1948 (Art. XX); Ireland of 1959 (Art. XXI). The same is true of Art. XVI(3), Greece, 1950 (Art. XVI(3)), Switzerland, 1951 (Art. XVIII(3)), Pakistan, 1957 (Art.

The 1967 Treaty with France in Article 24 headed "non-discrimination," declares in a reciprocal paragraph (1) that a citizen of one State (e.g. the U.S.) who is a resident of the other (e.g. France) shall not be subjected in that other to more burdensome taxes than is a citizen of the other State (France) resident therein. Under Paragraph 2 if a resident of the United States has in France a permanent establishment, France may not levy thereon taxation less favorable than on a resident of France carrying on the same activities. However, this would not obligate France to grant to residents of the United States any personal allowances, reliefs and reductions for taxation purposes an account of civil status or family responsibilities which it grants to its own residents.

This Paragraph 2 against discrimination is not to be construed to prevent the application of Article 13 (Branch Profits) which subjects a local permanent establishment of a United States corporation to tax at 15 percent (in contrast to the 5 percent rate on dividends) on two-thirds of its profit after deduction of the profits tax of 50 percent. Discrimination is condoned by stating that the United States is not prevented from imposing a comparable tax burden on a permanent establishment maintained by a resident of France in the United States.

The protection against discrimination is also assured in Paragraph 3 in the case of a corporation in France owned by one or more residents of the United States as compared with a French corporation owned by one or more residents of France and engaged in the same type of activities.

Advantages Granted by Law Preserved by Treaty

The Protocol to the 1939 Convention (Par. VI) with France forbids construing any provision in the Convention so as to restrict in any manner any exemption, deduction, credit, allowance, or other advantage accorded by the laws of a Contracting State in determining its tax (Protocol, Par. VI). Almost identical language is found in the other Conventions.[47]

XVII); and Luxembourg, Art. XX(3). The clause was omitted in the Treaty with New Zealand, Norway, Australia, Japan, Germany and Italy.

[47] Convention with Sweden, (Protocol, Par. 9); Convention with Canada, 1942 (Protocol, Par. 10); Netherlands, 1948, Art. XXV; Denmark, 1948, Art. XXI(2); New Zealand, 1948, Art. XIX; Norway, 1949, Art. XX; Greece, 1950, Art. XVI; Switzerland 1951, Art. XVIII(2); Finland, 1952, Art. XXI(2); Australia, 1953, Art. XX; Japan, 1954, Art. XIX(2); Germany, 1954, Art. XVIII(3); Italy, 1955, Art. XIX(3); and Austria, Art. XVIII(2). This clause is omitted in the Convention with Sweden, 1939; United Kingdom, 1945; Union of South Africa, 1946; Ireland, 1949; Pakistan, 1957; and Luxembourg, 1962.

Administrative Cooperation to Assure Relief

One of the great advantages in tax treaties from the viewpoint of the taxpayer is that the competent authorities of the two Contracting Parties may communicate directly in order to settle a tax dispute in accordance with the principles of the Convention instead of having to proceed through diplomatic channels.

Thus the 1939 Convention with Sweden set the pattern for administrative cooperation by providing in Article XX that where the taxpayer shows proof that the action of the revenue authorities of the Contracting States has subjected him to double taxation in respect of any of the taxes to which the Convention relates, he is entitled to lodge a claim. An individual would appeal to the competent authority of the State of which he is a citizen or resident. A corporate claimant would appeal to the appropriate officials of the State in which it was organized. If the said officials accept the claim, they are to seek to arrive at an agreement with the competent authority of the other State to avoid the double taxation.

An identical provision was incorporated in Article 25 of the Convention with France signed a few months later, and was replaced by substantially similar provisions in Article 14 of the Convention of 1946. During the years since 1939, Article XX of the Swedish Convention has served as a model for articles in one after another of the bilateral Conventions.[48]

The Protocol with Germany of September 17, 1965 amends Article XVII of the 1954 Treaty which contains the traditional language by adding in Paragraph 1 auxiliary provisions. Paragraph 2 authorizes the competent authorities to communicate with each other directly to implement the provisions of the present Convention. They are to agree as quickly as possible on any question about the interpretation or application of the Convention, or its relationship to Conventions between one of the Contracting States and any other State.

Paragraph 3 authorizes the competent authorities to consult in order to agree:

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[48] *See* Art. XVI in the Treaty with Canada of 1942; Art. XIII of the Convention with the Union of South Africa, 1946; the Netherlands, 1948, Art. XXIV; Belgium, 1948, Art. XX; New Zealand, 1948, Art. XVIII; Belgium, 1948, Art. XIX; Norway, 1949, Art. XIX; Greece, 1940, Art. XVII; Australia, 1953, Art. XVII; Japan, 1954, Art. XVIII; Italy, 1955, Art. XVI; Austria, 1956, Art. XVII; Pakistan, Art. XVI(2); and Luxembourg, 1962, Art. XIX. No provision in this subject is found in the Treaty with Ireland which was copied after the Treaty with the United Kingdom before it contained such a provision.

(a) to the same attribution of industrial or commercial profits to an enterprise of one Contracting State and to its permanent establishment in the other;
(b) to the same allocation of profits between related enterprises (as provided in Art. 14); or
(c) to the same determination of the source of particular items of income.

If the authorities reach an agreement, taxes will be imposed accordingly and a refund or credit of taxes will be allowed.

The foregoing provisions are followed closely by the Netherlands in the Supplementary Convention of December 30, 1965 (amending Article XXIV of the Treaty of 1948) and by the United Kingdom in the Supplementary Protocol of March 17, 1966 amending Article XX(A) of the 1945 Convention.

Prevention of Tax Evasion

From the beginning of the studies under the segis of the League of Nations, financial as well as fiscal authorities have been interested in preventing the flight of capital from taxation, as well as the prevention of tax avoidance or evasion.

The technical experts who met in London in 1927, and the governmental experts who convened in Geneva in 1928 framed drafted Conventions on the prevention of fiscal evasion which were synthesized in the Mexico and London Model Conventions (See Part I).

In the Conventions with Sweden and France of 1939 the Treasury officials worked out detailed provisions on exchange of information and even mutual assistance in the collection of taxes. Article XV of the Swedish treaty assures reciprocally the exchange of information which the respective authorities have at their disposal or are in a position to obtain under their own law that may be of use to the authorities of the other State in assessing taxes. They will also lend each other assistance in the service of documents in connection therewith. The information will be supplied "in the ordinary course" or "on demand."

Information to be supplied in the ordinary course by the United States, for example, includes the names and addresses of residents within Sweden deriving, from United States sources, dividends, interest, royalties, and other fixed or determinable annual or periodical income, showing the amount of such income with respect to each addressee.

For their part, the Swedish authorities undertake to forward similar information to the United States Treasury as soon as practicable after the close of each calendar year.

Each State undertakes (Art. XVII) in the case of citizens or corporations of the *other* State (but not with regard to its own *citizens or corporations*) to lend assistance and support in the collection of taxes covered by the Convention, together with interest, costs, and additions to the taxes and fines not being of a penal character.

One State will even enforce finally determined claims of the other and collect the tax in accordance with its own procedure, but does not have to enforce executory measures which are not in its own law. Pending final determination of its claims, one State may request the other to take such measures of conservancy as are authorized by its laws. Particulars in concrete cases concerning the liability of its own citizens or corporations may be obtained by one State through diplomatic channels from the other State, with regard to the taxes to which the Convention relates, and consideration will even be given to requests concerning other cases.

Safeguards in relation to all the foregoing for the taxpayer are specified in Article XIX, which provides that a State receiving a request is not obliged:

(a) to carry out administrative measures at variance with the regulations and practice of either Contracting State: or
(b) to supply particulars which are not procurable under the laws of either State: or
(c) to contravene public policy or reveal a business, industrial or trade secret or practice.

Documents or information transmitted to a State shall not be disclosed to any person except to the extent permitted under its laws (Protocol, Par. 11).

Essentially similar provisions were inserted in the 1939 Convention with France (Arts. 20-24), and were replaced by the Convention of 1946 (Arts. 8-15), regarding estate taxes as well as income taxes. However, taxpayers protested strongly against clauses which required the United States to supply France with assistance in collecting taxes from United States citizens. In response to the opposition expressed at a Hearing before the Senate Committee on Foreign Relations a Supplementary Protocol of May 17, 1948, was adopted which added a Paragraph 5 to Article 12 declaring categorically that the *assistance in collecting taxes*

shall not be accorded with respect to citizens, corporations or other entities of the State to which application is made nor with respect to estates of such citizens.

The 1942 Treaty with Canada contains in Articles XIX, XX and XXI, provisions which provide only for the exchange of information automatically and upon request. They are essentially similar to those in the Treaties with Sweden and France. The commitment was reduced to a single Article XX in the 1945 Convention with the United Kingdom; it assures the exchange of information necessary for the carrying out of the Treaty provisions or for the prevention of fraud or the administration of statutory provisions against legal avoidance of the taxes mentioned in the Treaty. The safeguards are that information so exchanged will be treated as secret but may be disclosed to persons (including a court or administrative body) concerned with the assessment, collection, enforcement or prosecution in respect of taxes covered by the Treaty. No information will be exchanged which would disclose any trade, business, industrial or professional secret or trade process. This served as a model for the Irish Treaty.[49]

A new clause was introduced in Article XVII of the Treaty with New Zealand regarding collection assistance which stipulates that each State may collect such tax imposed by the other as will insure that the exemption or reduced rate of tax granted under the Convention by such other government will not be enjoyed by persons not entitled to such benefits. This was intended to prevent a person living in a third State from arranging with a nominee resident in one Contracting State to receive income entitled to the reduced rate or exemption granted by the other Contracting State. The foregoing comprises the basic elements found in subsequent treaties.[50]

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[49] The substance of the foregoing, including collection of taxes is found in the Convention with the Union of South Africa of 1946 (Arts. XIV, XV and XVI); the Netherlands, 1948 (Arts. XXI to XXIII); Denmark, 1948 (Arts. XVII, XVIII, and XIX).

[50] This new Article was incorporated along with Articles on exchange of information in the 1948 Convention with Belgium (Arts. XV-XVII), the 1949 Convention with Norway (Arts. XV-XVIII), and the 1952 Convention with Finland (Arts. XVII and XVIII). A standard pattern is followed in the 1950 Treaty with Greece (Arts. XVIII-XX) and the 1951 Convention with Switzerland (Art. XVI). Australia agrees only to exchange of information (Conv. of 1953, Art. XVIII). Japan in its 1954 Treaty (Art. XVII) and Luxembourg in its 1962 Convention (Art. XVIII) adds the New Zealand clause to the exchange of information provision. Germany envisages only exchange of information (Treaty of 1954 as amended in 1965, Art. 14) as do Italy, 1955, (Art. XVII); Austria, 1956 (Art. XVI); and Pakistan, 1957 (Art. XVI(1)).

Extending Convention to Territorial Possession

The 1932 Treaty with France envisaged only "France metropolitaine," and that of 1939 still defined the term "France," when used in a geographic sense, to indicate continental France, exclusive of Algeria and the Colonies. Despite amendments in other respects, this continued until the Treaty of July 28, 1967, which authorizes its extension, either in its entirety or with any necessary modifications, to the overseas Territories of the French Republic which impose taxes substantially similar in character to those to which the Convention applies.

The State Department's letter of submittal to the President declares that the geographical coverage is extended to "Metropolitan France and the "Overseas Departments"—namely, Guadeloupe, Cuyane, Martinique and Reunion, and it may be extended to French overseas territories.

Under Article XXI of the Convention with the United Kingdom of 1945, as replaced by the Supplementary Protocol of 1954, the United Kingdom may have the operation of the Convention extended in whole or in part to all or any of its territories for whose international relations it is responsible, which impose taxes substantially similar in character to those which are the subject of the Convention.

Accordingly, the British Government requested that the Treaty be extended to the overseas territories listed *infra* and the United States Senate gave its advice and consent to ratification on July 9, 1958. For the United States tax, the extension was effective on and after January 1, 1959, for all the taxes on income of the listed jurisdictions. The 20 jurisdictions, then called "territories," were Aden, Antigua, Barbados, British Honduras, *Cyprus, Dominica, Falkland Islands, Gambia, Grenada, *Jamaica, Montserrat, *Nigeria (Federation of) **Rhodesia and Nyasaland (Federation of), St. Christopher, Nevis and Anguilla, St. Lucia, St. Vincent, *Sierra Leone, *Trinidad and Tobago, and the Virgin Islands.

All those marked with an asterisk are no longer British territories, but are independent countries and have assumed all international obligations of the United Kingdom, including those under the income tax Convention with the United States. Trinidad and Tobago terminated its adherence to the Treaty with the United Kingdom but is in the process of negotiating a separate treaty. A temporary Convention between it and the United States was signed December 22, 1966, and was brought into force December 19, 1967. The treaty is to remain in effect through 1968 when a general convention is expected to have been concluded. It re-

duces to 5 percent the tax which is withheld from dividends and applied to branch profits on top of the profit tax.

Cyprus denounced the agreement with the United States as of January 1, 1968.

Under international law treaties in force with a country from which a new nation is born are inherited by the new nation until renegotiated or cancelled. The Treaty with Rhodesia and Nyasaland is now considered as extending to the independent nations of Malawi and Zambia, but Southern Rhodesia is still classified as a British territory.

The income tax Convention with Belgium, signed October 28, 1948 and modified by Supplemental Conventions signed September 9, 1952, and August 22, 1957 was extended, as modified, to the Belgian Congo and to the Ruanda-Urundi Trust Territory, for which instruments of ratification were exchanged on July 1, 1959. These have become independent countries, known respectively as Kinshasa (Congo), Rwanda, and Burundi, but are still bound by the Convention of 1948, as modified by the supplementary conventions of 1952 and 1957.

A third Convention in this category is the Convention with the Netherlands signed April 29, 1948, which was extended to the Netherlands Antilles, by virtue of a Protocol of June 15, 1955, and amending Protocols of October 23, 1963, and December 30, 1965.

The Protocol with the Netherlands, signed October 23, 1963, modifying and supplementing the extension to the Netherlands Antilles of the 1948 Convention with the Netherlands, was intended to do away with benefits resulting from the liberal tax law of the Antilles. Under the 1948 Convention Antillian corporations were entitled to a reduction in rate to 15 percent for dividends and to exemption of interest and royalties received from United States sources. The Protocol provides for an increase in 1967 to 30 percent in the United States rate on dividends, interest and royalties paid to existing Antillian investment companies (Report of the Department of State, November 19, 1963, CCH Tax Treaties #5856A).[51]

[51] This Protocol is intended to rectify a situation where individuals residing in countries which do not have tax conventions with the United States were forming investment companies in the Netherlands Antilles to hold their United States investments and to collect on their behalf dividends, interest, and royalties. This advantage was not contemplated when the tax Convention with the Netherlands was extended to the Netherlands Antilles in 1955. The increase in the United States withholding rate by the Protocol of 1963 to 30 percent on dividends, interest and royalties subjects them to the same rate as that imposed on such types of income paid to investment companies incorporated in a country which does not have a tax treaty with the United States. It treats in effect Antillan

Miscellaneous Taxes

Generally the first Article of a tax Convention with a particular country shows that it relates only to taxes on income, but in some cases it applies also to taxes on property or capital. The Treaty with France of 1956 was extended to apply to documentary taxes on sales or transfers of shares or certificates of stock or bonds, and the French tax on Stock Exchange transactions (Art. 1(a)&(b). Accordingly, Article 13(A) of that Convention prevents double taxation of orders taken in France and then executed in the United States. It was reproduced in the 1967 Convention as Article 22(5).

Elimination of Turnover Tax on Patent Royalties

French officials were opposed to including in an income tax Convention provisions concerning the application of a turnover tax (tax on receipts from the rendition of services) to royalties paid by French licensees to American licensors. As the turnover tax was on the receipts from commercial transactions and not from professional activities, corporations contended that they should be exempt from this French tax because as inventors they were not engaged in commercial but in professional activities; furthermore, as this tax was based on royalties (actually income), it should be treated as an income tax from which the 1939 Convention granted an exemption (Art. 7).

Discussions between officials of the two governments took place from July 25 through August 4, 1955, in conjunction with the negotiation of a supplementary income tax Convention signed June 22, 1956. The United States delegation stated that an agreement on this question (as well as on the application of this turnover tax to motion picture royalties) was deemed by the United States government to be an essential prerequisite to the submission to the United States Senate of the Supplement that was being negotiated to the Franco-American Tax Convention.

The two delegations agreed on a "Proces-Verbal" which was embodied in a memorandum submitted by the Department of State on

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holding companies (Art. XV) i.e. by excluding them from the benefits of the Convention. The Netherlands Antilles limits its tax to 3 percent on dividends, interest, and royalty income of so-called Netherlands holding companies, in lieu of the 30-percent rate otherwise applicable. Furthermore, under the present Convention (Art. XII) the United States exempts interest and dividends paid by a N.A. corporation to residents of third countries; which in many cases does not collect tax thereon. Report of July 27, 1964, Senate Committee on Foreign Relations, CCH Tax Treaties #5856B.

June 29, 1956, to the President, who forwarded it with the Convention to the Senate Committee on Foreign Relations (S. Ex. J. 845h, 2d). The Convention was ratified.

A letter of July 28, 1967, addressed by Ambassador Charles E. Bohlen to His Excellency Hervé Alphand, Ambassador of France, Secretary General of the Ministry of Foreign Affairs, Paris, states that: "It is understood that the notes, minutes and arrangements relating to income taxes which were entered into between the French government and the United States government in connection with the prior tax Conventions and their Protocols are considered abrogated; including in particular those of 1955 relating to American motion picture companies." Such companies now are to be taxed in accordance "with French law and the rules laid down by the Convention." The abrogation "would not entail any important tax consequences."

Foreign Investors in the U.S.A. Benefited by Reciprocal Concessions

An investor or enterprise of a country belonging to the "Inner Six" (EEC), or the "Outer Seven" (EFTA-except Portugal, which has not yet signed a treaty with the United States), or any other government which has concluded a tax treaty with this country, can enjoy reciprocal exemptions, rate reductions, limitations on jurisdiction, and facilities for settling tax disputes, and other treaty advantages previously described from the viewpoint of the American taxpayer. If more advantageous concessions were made by the United States in the Foreign Investors Tax Act of November 13, 1966. They also can be invoked.

If provisions in older treaties would deprive residents in the other Contracting State of an exemption from United States tax on interest or royalties, or a reduced rate for dividends, because of their having a permanent establishment in the United States, the 1966 Act would override the treaty and protect the exemption or reduced rate, unless the item of income, or property or right involved, was *effectively connected* with the local permanent establishment. In that case, the item of income would be included in the nonresident's income taxable at the ordinary rate.

With a few exceptions, the United States exempts from its withholding rate interest on bonds or other obligations of resident debtors paid to creditors in any of the other Contracting States. The exceptions are creditors resident in Belgium, Canada and France, who are subject to withholding of 15 percent (the 1967 Treaty with France would reduce

the rate to 10 percent), in Japan in which case 10 percent is withheld, and Switzerland, in which case the rate withheld is 5 percent. Because of the absence of a treaty clause, residents of Australia, Italy, Pakistan and South Africa are not entitled to any reduction in the 30 percent rate.

Patent and Copyright royalties are reciprocally exempted, unless *effectively connected* with a permanent establishment in the United States, except for withholding 15 percent from nonresident licensors of patents to licensees in Canada and 10 percent from those in Japan. Australia and Canada exempt at source only copyright royalties. Both categories paid by United States licensees to French nationals have been exempt since 1932, but if the 1967 treaty is ratified copyright royalties will remain untaxed at source, but 5 percent will be withheld from patent royalties. Either category of royalties flowing to residents of New Zealand or South Africa is taxable at 30 percent.

As regards dividends paid by United States corporations, most of the other Contracting States have agreed to a withholding rate of 15 percent in general and of 5 percent for dividends paid by a subsidiary which meets certain conditions. (This will include France if the 1967 treaty is ratified.) The United States withholds 10 percent from dividends paid by a local subsidiary to its Japanese parent. One should read, *supra,* the conditions for applying the reduced rates in the various treaties.

If the nonresident buys real estate in the United States, he will be subject to having tax withheld at 30 percent from his gross rentals, unless he elects under the treaty or the Foreign Investors Tax Act of 1966 to pay tax on net income (new sec. 871 (d)IRC).

Another advantage assured by the treaties which is more generous than that allowed in the Code is the exemption for the business representative who is normally resident, employed, remunerated, and taxed in the other Contracting State and spends less than six months in the aggregate during the taxable year in the United States.

In short, general tax treaties concluded by the United States with 21 foreign countries stipulate from the viewpoint of residents of the other Contracting States the same benefits of international tax law as those provided for U.S. citizens and corporations. Encouragement of foreign-owned investments and enterprises in the United States are expected to provide a counterpoise for American-owned investments in the interested foreign countries. The treaty should provide the international ground rules of taxation that would be conducive to profitable relationships.

Present Status of U.S.A. Treaties

As of January 1, 1968, the United States has in force general income tax conventions with 21 countries—Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Pakistan, South Africa, Sweden, Switzerland, and the United Kingdom. A "mini-treaty" with Trinidad and Tobago, which is to continue in effect through 1968, raises the number of conventions in force to 22.

The Treaty with Belgium applies to 3 former territories that have become independent—Burundi, Congo (Kinshasa) and Rwanda. That with the Netherlands applies with respect to the Netherlands Antilles.

The Treaty with the United Kingdom was extended to Southern Rhodesia, which is still treated as a territory, and to 5 former British territories which have become independent states, namely, Gambia, Jamaica, Nigeria, Sierra Leone, and Zambia. Cyprus terminated its adherence to this convention as of January 1, 1968.

The United States has estate tax treaties in force with 12 countries—Australia, Canada, Finland, France, Greece, Ireland, Italy, Japan, Norway, South Africa, Switzerland and the United Kingdom. Gift taxes are covered in treaties with Australia and Japan.

Treaties signed but not in force include (a) income-tax Conventions with Brazil, France (which treaty will replace all previous Conventions on this subject), Israel, the Philippines, and Thailand, and (b) estate-tax Conventions with Belgium and Greece (For citations of the foregoing see Annex I.).

Conventions with India, Israel and the United Arab Republic were transmitted to the Senate in 1961 for advice and consent to ratification, but were withdrawn in 1964 at the request of the Executive. They would have allowed a credit against the United States tax for "taxes spared" by the other Contracting Party, (i.e. taxes waived to attract investments). These conventions were withdrawn from the Senate after the Treasury developed a new policy, which was reflected in the 7 percent investment credit (i.e. a credit against the U.S. tax in respect of amounts invested in the subsidiary to buy equipment) in the Treaty with Thailand, and in a renegotiated Convention with Israel. However, the former was rejected by the Senate after a hearing in August, 1965, and presumably the same objections prevail in regard to the Treaty with Israel. The Treasury tried to meet some of these objections in the Treaty with Brazil, which contained a revised text of the 7 percent investment credit

but certain Committee Members were antipathetic at a hearing in October, 1967, and it is said that further consideration in the foreseeable future is unlikely in view of the policy of mandatory restraints on foreign investments introduced by the President on January 1, 1968, in Executive Order 11387. However, all the 22 existing treaties continue in effect.

They are significant and important to U.S. citizens and corporations, especially as in a classified list of international agreements on taxation, now or previously in force, the United Nations has recorded some 526 [52] income and fortune taxes. They show the evolution of international tax law as embodied in bilateral agreements between sovereign States. Because of their many variations from the standard texts described in Part I, they reflect what famed Professor Giuffre De Lapradelle of the University of Paris Law School said about international law-which also describes international tax law, namely, that it is "in a state of perpetual 'becoming' " (dans un état de devenir perpetuel).

[52] The classified list of international tax agreements contained in Volume III, Supplement 3, of the World Guide to International Tax Agreements, as of October, 1967, shows 526 general agreements on income and fortune taxes, 119 on death duties and gift taxes, 77 on sea and air Transport, and numerous others on particular categories of taxes.