TAX CONVENTIONS WITH BRAZIL, CANADA, AND TRINIDAD AND TOBAGO

HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

NINETIETH CONGRESS

FIRST SESSION

ON

EXECUTIVE J, 90TH CONGRESS, FIRST SESSION
TAX CONVENTION WITH BRAZIL

EXECUTIVE B, 90TH CONGRESS, FIRST SESSION
SUPPLEMENTARY INCOME-TAX CONVENTION WITH CANADA

EXECUTIVE F, 90TH CONGRESS, FIRST SESSION
INCOME-TAX CONVENTION WITH TRINIDAD AND TOBAGO

OCTOBER 5, 1967

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TAX CONVENTIONS WITH BRAZIL, CANADA, AND TRINIDAD AND TOBAGO

THURSDAY, OCTOBER 5, 1967

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 4221, New Senate Office Building, Senator J. W. Fulbright (chairman) presiding.

Present: Senators Fulbright, Sparkman, Morse, Gore, and Pell.

The CHAIRMAN. The committee will come to order.

The committee is meeting this morning to receive testimony on the income tax conventions with Brazil, Trinidad and Tobago and the supplementary income tax convention with Canada.

Our first witness is Assistant Secretary of the Treasury, Stanley Surrey.

Mr. Surrey, will you please proceed, sir?

STATEMENT OF HON. STANLEY S. SURREY, ASSISTANT SECRETARY OF THE TREASURY; ACCOMPANIED BY JACK B. KUBISCH, BRAZIL COUNTRY DIRECTOR, DEPARTMENT OF STATE

Mr. SURREY. Yes, Mr. Chairman. I have with me Mr. Kubisch from the State Department, who is in charge of Brazilian affairs for the State Department.

I have a general statement, Mr. Chairman, on three matters before you, and in addition a technical statement with respect to the Brazilian treaty. If it is all right with you, rather than read the general statement, I would like to talk about these matters and file the statement for the record.

The CHAIRMAN. File both statements for the record and then summarize them for the committee, if you will. That will be fine.

(The prepared statement of Mr. Surrey follows. The technical memorandum referred to appears in the appendix.)

STATEMENT BY HON. STANLEY S. SURREY, ASSISTANT SECRETARY OF THE TREASURY

Mr. Chairman, Members of the Committee, I am pleased to appear before your Committee this morning to discuss three tax treaties—with Brazil, with Canada, and with Trinidad and Tobago—that are pending before the Committee. I hope that your Committee will be able to take prompt action on these conventions because the problems they seek to meet are urgently in need of this action.

The proposed conventions with Canada and with Trinidad and Tobago are limited in scope. I should like to discuss them first and then turn to the convention with Brazil, which involves the whole range of international tax relationships generally covered by our income tax conventions with other countries.

CANADA

The proposed convention with Canada would modify the existing Canadian treaty by denying the reduced rate of U.S. withholding tax that exists under that treaty to certain Canadian corporations which are nothing more than conduits for investment in the United States by persons who are not residents of Canada and who would not otherwise be entitled to the benefits of the tax treaty. They are persons whom the tax treaty with Canada was not intended to benefit.

The existing tax treaty between Canada and the United States provides that investment income flowing from the United States to Canadian residents and corporations shall be subject to U.S. withholding tax at the rate of 15 percent instead of our statutory rate of 30 percent. The treaty defines a Canadian corporation to include corporations that have received their charter under the laws of Canada. Canadian corporations are normally subject to Canadian tax on their income at the rate of 50 percent. However, there is a group of Canadian corporations which are tax-free in Canada because they are not considered to be resident in Canada, but which nevertheless fall within the definition of a Canadian corporation for purposes of the treaty. These are corporations which derive all their income from sources outside Canada and are managed and controlled outside Canada. As a result, individuals resident in, say, Latin America or Asia, that is in countries with which we do not have tax treaties, have been able to use such Canadian corporations as a vehicle for the purpose of making their investments in the United States, with the result that they derive their investment income from the United States subject only to the 15 percent U.S. withholding tax, rather than the statutory 30 percent withholding tax, and pay no additional tax to Canada, or even, perhaps, to their own country.

The existence of this loophole was called to the attention of the Canadian Government several years ago, and legislation was enacted in Canada which eliminated the tax-exempt status accorded such nonresident companies. However, the legislation applied only to newly created Canadian corporations. Pre-existing Canadian corporations continued to retain their tax-exempt status in Canada. At about the same time that the Canadian Government adopted its legislation, the income tax treaty between the United States and the Netherlands, as it applied to the Netherlands Antilles, was modified to eliminate a similar loophole for foreign investors arising out of the interaction of that tax treaty and the Antilles tax laws. This elimination of the tax advantages that accrued to Antilles investment companies placed a premium on Canadian tax-exempt corporations. Since the use of new Canadian corporations could not be created for this purpose, trafficking developed in dormant Canadian corporations created prior to the change in Canadian law.

Neither we nor Canada see any reason to perpetuate the existing state of affairs. The proposed amendment to the existing U.S.-Canadian tax treaty would therefore eliminate the opportunity that exists for this avoidance of U.S. tax by residents of countries with which we do not have tax conventions. This corrective action is accomplished by denying the reduced rate of withholding tax on investment income under the treaty to a corporation whose exemption from tax in Canada is based on the ground that it is regarded as not being resident in Canada.

There are unlikely to be any adverse consequences to either the United States or Canada from this corrective change. We have explored the question whether the change might adversely affect the volume of foreign investment in the United States and have concluded that it would not. Alternative portfolio investment opportunities for residents of countries with which we do not have treaties are limited. On the other hand if we fail to modify the convention in the manner proposed, we are likely to see a proliferation of Canadian companies used for tax avoidance. There are at present U.S. investment companies which find themselves at a disadvantage in competing for business with other firms that operate through Canadian companies of the type I have described, and in order to achieve tax equality they have been seeking out dormant Canadian companies through which to conduct their investment operations. The fact that a modification of our treaty with Canada is pending has restrained some of these companies from initiating such operations. Failure to make the change will remove this restraint.

TRINIDAD AND TOBAGO

The proposed convention with Trinidad and Tobago (for simplicity I shall refer to that country as "Trinidad") is an interim agreement which deals only

with the rate of withholding tax on dividends. Until January 1, 1966 a tax convention of the traditional scope was in effect. It was a legacy from the time when Trinidad was a dependent territory of the United Kingdom and when the tax treaty between the United States and the United Kingdom applied to it. When Trinidad achieved independence that treaty continued in effect as between two sovereign countries. However, in accordance with procedures in the treaty, the Trinidad Government gave notice of its desire to terminate the treaty and this took effect January 1, 1966. At the same time Trinidad requested negotiation of a new treaty which it hoped would be more appropriate to the economic relations between the United States and Trinidad. Negotiations for such a treaty have been under way but have not been concluded.

Termination of the old income tax convention means that the full weight of the Trinidad tax law applies to income generated in that country without any of the moderating effects of a treaty as respects income flowing across international boundaries. The unrestrained application of Trinidad law would impose a heavy burden on American firms operating there, much heavier than that in effect when the treaty applied. As an interim measure, the Trinidad Government has agreed to modify its withholding tax with respect to dividend income while discussions continue on a tax treaty of general application.

Accordingly, the convention before you provides that dividends paid by a corporation of one country to residents in the other country shall be subject to a withholding tax rate of 25 percent rather than the statutory rate of 30 percent which applies in both countries. However, when the dividends are paid to a parent corporation, the withholding tax is reduced to 5 percent. For this purpose, a corporation is regarded as a parent of the dividend-paying corporation if it owns 10 percent or more of the outstanding voting stock of the latter corporation. Trinidad law also imposes the equivalent of the withholding tax on profits earned by a foreign corporation that operates a branch in Trinidad and does not reinvest those profits there. The proposed treaty recognizes the similarity of the two situations and therefore limits the branch tax on distributed earnings to the same 5 percent that would apply to dividends distributed by a Trinidad subsidiary. Both the 5 percent rate of tax and the definition of a parent-subsidiary relationship are to be found in other treaties to which the United States is a party. However, application of the lower rate to branch profits is somewhat unique. Generally those countries with which we now have income tax treaties do not impose a tax on branch profits transferred to the home office just as the United States does not impose such a tax. Accordingly, usually we have not found it necessary to have treaty provisions dealing with such a special tax.

We recommend that you approve the convention with Trinidad to give effect to the reduced rate. The Trinidad Government is also desirous of effectuating this interim arrangement. It is likely that we shall submit to you next year a full-scale convention with Trinidad.

BRAZIL

Turning now to the proposed treaty with Brazil, this agreement for which we are asking your approval will be the 22nd U.S. income tax convention.[1] It is, on the one hand, an extension of our already widespread treaty network, and on the other hand our first tax treaty with a major Latin American country. It incorporates provisions which in our view can constitute the framework for treaties with the other Latin American countries.

Before going into the details of the proposed treaty with Brazil, I should like to develop some overall observations concerning the purpose and objectives of the tax treaty program.

GENERAL PHILOSOPHY OF TAX TREATIES

Our income tax treaties with the industrialized countries date back to 1935 when the first treaty between the United States and France was ratified, clarifying the French and U.S. taxing jurisdiction in cases where a resident of one country derived income from the other. With the increased pace of international economic activity since the end of World War II, many new treaties were concluded and old ones revised to reflect changes in tax legislation and underlying changes in economic conditions. Other industrialized countries of the world have responded in the same way and now participate with each other in an extensive

[1] In addition, nine treaties are now in effect with former colonies of the United Kingdom and Belgium which were covered by the treaties with the United Kingdom and Belgium.

web of treaties. The United States, for example, has entered into tax treaties with virtually every industrialized country.[1]

These treaties set forth rules whereby the contracting states agree on those situations in which the country that is the source of income shall have the prior right to tax and those situations in which it shall refrain from imposing a tax. The contracting states then agree on how the country of which the taxpayer is a resident (or also a citizen in the U.S. case) shall give recognition to the tax levied in the source country, so as to avoid or minimize the double taxation that would otherwise result from the fact that both countries may levy a tax on the same income. In addition, and corollary to these objectives, the treaties seek to perform four other services: (1) to adjust the rates of withholding tax in the source country with the object of avoiding to the extent possible a heavier aggregate tax burden on income which a taxpayer derives from foreign sources than would result if the income originated in his own country; (2) to eliminate wherever appropriate the requirement to file tax returns, and therefore to be conversant with the tax laws, in more than one country; (3) to prevent discriminatory tax treatment on the basis of nationality; and (4) to provide machinery for consultations between the tax officials of the two governments to seek equitable solutions to tax problems that may arise in implementing the treaty.

Returning to the first point I mentioned—that the treaty partners acknowledge the prior right of each state to tax in certain cases and abandon its right in others—I should like to illustrate how important a part of a treaty it may be. Statutory definitions of where income originates frequently vary and unless rules of priority to tax or rules of source of income are established, the result may be unintended double taxation of the same income. Suppose a travel agent in a foreign country X sells seats on a U.S. airline for transportation between points which lie outside that country. Country X may consider the airline to derive income there because the ticket was purchased there. Other countries may consider the airline to have derived the income within their territories because a flight segment originated or terminated there. Total taxable income may thus be more than the profit earned by the airline. Or suppose an architect in the United States draws up plans for a building to be constructed in another country. Does the income paid him for those services arise in the United States where he performed the services or in the foreign country where the plans are put to use? The two countries may have different rules so that both countries would tax the same income without making any allowance for the fact that the other country has levied a tax.

A treaty seeks to establish order on such issues as these by arriving through negotiation at a *set of rules* that is mutually acceptable. This normally involves *concessions by both sides concerning their statutory jurisdiction.* In some cases these rules establish uniform criteria for determining the source of a given item of income. Thus as to the two examples above referred to, our treaties generally provide that only the country of registration may tax revenue from airline transportation, and that the source of personal service income is where the services are rendered. In other cases, the source rules may not be disturbed but the country of source may abandon its tax on income from a given activity even though it has the power to tax under its law. A common treaty provision having this effect is the so-called permanent establishment article. This provides that a country will not tax the industrial or commercial profits of a resident of the other country unless that resident has a permanent place of business within its borders, even though both countries are agreed that the source of at least some of the profits is in the country which gives up its right to tax. The objective of such a provision, among others, is to remove a tax obstacle to early stages of a firm's participation in international trade.

Where the treaty assigns to a country priority to tax because it is the source country, the country where the taxpayer resides then agrees in the treaty either to give its residents a credit against their tax liability for taxes paid on income which the country of source taxes, or to exempt such income from tax. A country may agree by treaty to adopt a credit similar to that which the U.S. provides by statutory law, even though that country's own law may provide less generous relief.

With respect to *withholding tax rates* on investment income paid to nonresidents, we have sought and agreed to reductions in rates in order to come to an

[1] Excluding the U.S.S.R., Spain and Portugal; discussions with the latter two are already well advanced.

aggregate of taxes on foreign income that is as close as possible, consistent with other factors, as the tax on a similar amount of domestic income. Thus, for U.S. firms having subsidiaries or branches in Brazil, the Brazilian 25 percent withholding tax on their dividends or branch profits raises their total Brazilian tax on distributed profits to more than 50 percent, resulting in unused foreign tax credit in the United States on that income. Our statutory withholding rate of 30 percent has the same effect on dividends obtained by foreign residents of those countries with similar investments in the United States. Other problems regarding withholding rates arise from the fact that withholding taxes are applied on the gross amount of income without taking into account costs, personal deductions and the like. Brazil, for example, in most cases imposes its 25 percent withholding tax on the gross amount of income remitted to a nonresident. For U.S. individuals and corporations deriving income from Brazil in situations in which there are expenses involved in earning that income, this will represent a high effective rate of tax if the net amount taxable in the United States because of those expenses is low in relation to the gross payment from Brazil. The Brazilian tax will in such cases be too high to be fully offset by the foreign tax credit in the United States. For example, suppose a U.S. citizen derives rent of $100 from leasing property owned in Brazil and has costs of $50 associated with that income. The Brazilian 25 percent tax on the gross amount means a tax of 50 percent on the net income, which is almost certain to be higher than the recipient's effective rate of U.S. tax. The purpose of the treaty provisions in this area of withholding taxes is to reduce the frequency and size of excess tax burdens of this type through negotiated adjustments in withholding rates.

The treaty objective of *reducing the need to file multiple tax returns* may sound less important than the attempt to avoid the same income being taxed by two countries neither of which accepts the other as the country of source, but it may be no less troublesome in many instances. A U.S. business executive on temporary assignment to a foreign subsidiary can credit against his U.S. income tax the tax paid to the foreign country on income earned for the services he performed there. He does not need a treaty to permit this. But if he is taxable in the foreign country he commonly has to file a return there declaring his taxable income according to the rules employed there. If he is concerned with operations in a region encompassing several countries, the obligation to be familiar with varying tax systems and to submit returns to each is troublesome and costly in terms of time and energy which could be more efficiently employed in other tasks. A similar situation could confront any number of persons whose activities involve international travel. Tax treaties meet this difficulty by exempting from tax in one state the personal service income of working visitors who are self-employed or employed by a resident of the other state, within specified limits of time and remuneration.

The *nondiscrimination provisions* of tax treaties ensure that a U.S. corporation operating in a foreign country through a branch or through a foresign subsidiary will not have those business activities taxed more heavily than are the businesses or corporations of the foreign country, and that an individual U.S. citizen resident in a foreign country will not be taxed more severely than a national of that country in comparable circumstances.

The *administrative provisions* of tax treaties implement their application by providing for consultation on such matters as proper intercorporate pricing, exchanges of information and procedures for hearing taxpayers' grievances.

The need for solutions to these types of international tax problems is unquestionable. Taxes can be an effective barrier restricting the international mobility of capital, labor and skills, a mobility which economically is highly desirable. We have to proceed to achieve such solutions by means of bilateral agreements which conform as closely as possible to the standards considered to represent the most rational international treatment of each type of income-generating transaction.

OECD MODEL TREATY AND DEVELOPING COUNTRIES

Currently, the point of departure for treaties *between industrialized countries* is the "Draft Double Taxation Convention," prepared by the Organization for Economic Cooperation and Development, to which certain improvements have been introduced by the United States and other countries since its adoption. As between an *industrialized country and a developing country*, however, the OECD model treaty needs more substantial alterations. The economic relationship between two such countries is apt to be significantly different from that prevailing between two industrialized countries, and the traditional answers are not always

satisfactory. The income flows between any two industrialized countries may not be exactly in balance, but if their multilateral relationships are taken into account there is a reasonsable mutuality of income flows, so that revenue and balance of payments considerations can take a secondary place to trade objectives, consistency, equity and similar elements that enter into tax treaty discussions. When an industrial country undertakes to enter a tax treaty with a less developed country with much smaller amounts flowing into it. To this large imbalance in income flows must be added the fact that a fundamental objective of all less developed countries is the attraction of foreign capital and skills. Local resources are inadequate to finance a rate of economic development commensurate with their needs.

Most of the substantive provisions of the OECD model tax treaty that have revenue effects require the giving up of tax revenue by the country in which the income is earned or has its source in favor of the country in which the taxpayer resides in order to make the necessary accommodation to desirable international tax relationships. Since the less developed country is usually the country of source, the revenue loss under a standard tax treaty is apt to rest largely on the developing country rather than the industrialized country. To compensate for this revenue loss, developing countries have pressed for concessions by industrialized countries. These concessions take either of two forms: one is to grant to their taxpayers who invest in the developing country tax exemption on profits derived there and remitted home; the other is to grant a so-called "tax-sparing" credit. Under such a credit, the industrialized country allows its investors in a developing country a credit against its tax not only for the tax actually paid to the developing country but also for the taxes that for one reason or another have been waived or reduced by the developing country. We have reviewed over 40 treaties written by other industrialized countries with developing countries and find that, with a few minor exceptions, each treaty contains provisions under which those industrialized countries either exempt their residents on one or more types of income received from the developing country or give their residents a tax-sparing credit for the tax foregone by the developing country.

Our approach to tax treaties with developing countries has differed in some respects from that of other industrialized countries. We have sought—and in general I believe so have the other industrialized countries—first, to minimize the adverse revenue effect of a treaty upon a developing country by limiting our demand for reductions in foreign taxes to the point where those taxes would equal our tax on the income brought into the United States. In other words, we have not sought to increase our revenue at the expense of the revenues of the developing country. We have sought reductions where the taxes of the developing country would act as a deterrent to investment and trade. Conversely, we have discouraged the developing country from seeking reductions of U.S. tax on investment income on the ground that the treaty should not encourage capital flows to the United States when capital is so urgently needed at home.

As to capital flows to the developing country, however, we believe that neither the exemption approach nor the tax-sparing approach is desirable. If we were to grant tax exemption to firms making investments in a developing country, taxpayers engaged in business solely in the United States would regard that as highly inequitable. It would be inconsistent with the principle of tax neutrality as between domestic and foreign economic activity which our foreign tax credit mechanism seeks to maintain. Moreover, a tax-sparing credit would provide the largest tax benefits to investors in countries which have the highest nominal tax rates, and it would promote the repatriation of profits from developing countries instead of encouraging reinvestment of profits in those countries. In contrast to the methods pursued by other industralized countries, therefore, we have included in this treaty with Brazil a provision which would extend our domestic investment credit to investments made by American firms in the treaty country. I shall shortly develop the details of this provision as it is incorporated in the Brazilian treaty. Here I should like to stress that the extension of the investment credit serves to make the treaty reciprocal in character and at the same time is consistent with our own law.

Under our tax law we give our taxpayers a credit against their tax equal to 7 percent of the amount spent on machinery and equipment for use in the United States. What we propose to do by this treaty is to extend this credit to similar investments when made in Brazil. Our existing tax law has established a tax benefit for investment in the United States in machinery and equipment. By the same token, we have made investment in developing countries less attractive

than at home. An extension of this investment credit by treaty will reestablish the tax neutrality that formerly prevailed as between domestic investment and investment in the treaty country. A developing country can view this as a device to facilitate capital movements to its borders, as indeed it is compared with the present situation. We may look upon it as the elimination of a disincentive to investment in the treaty country.

PRINCIPAL FEATURES OF BRAZIL TREATY

I should like to turn now to the substantive provisions of the income tax convention between Brazil and the United States which is now before you for consideration.

Industrial and commercial profits

Under the convention Brazil agrees not to tax the industrial and commercial profits of a firm in the United States (and vice versa) unless the firm derives profits through a permanent establishment within Brazil. The value of this provision to U.S. enterprises is apparent when we consider some of the features of the Brazilian law. One provision makes a U.S. firm that sells goods to Brazil subject to tax there even if the firm has no place of business in Brazil. The firm need merely receive orders from Brazil through an agent there, even though the agent is entirely independent, has no authority to conclude any contracts on behalf of the U.S. firm, and maintains no stock of goods in Brazil from which to fiill orders. Moreover, if the U.S. firm is thus subject to tax in Brazil, it also becomes taxable on all sales made by it to residents of Brazil, including those made without any participation by the Brazilian agent. In the latter case, the American firm is considered to have derived a profit equal to 20 percent of the gross sales price of the goods sold. Brazilian tax applies even though under U.S. law the American firm may be considered not to have derived any income at all from Brazilian sources. If title to the goods purchased by the Brazilian buyer passes in the United States, the income from the sale of those goods is considered to have its source in the United States, and any tax paid by the American firm to Brazil would not be eligible for credit against U.S. tax. These differences in tax rules hinder U.S. trade with Brazil not only by causing double taxation but also by imposing a compliance burden of filing tax returns and understanding the intricacies of a foreign tax system. Such burdens may effectively hamper U.S. exports especially on the part of smaller American business firms and cause financial loss to those unsophisticated in tax matters.

Under the treaty no tax would apply in Brazil unless the U.S. firm has a permanent place of business there through which it conducts its activities. (Article 8). Consequently American firms will be able to solicit business in Brazil through an agent, and may even send their own traveling salesmen to Brazil and not be concerned about the impact of the Brazilian tax law on their sales. The treaty facilitates other activities in Brazil by providing that, even if a U.S. firm has a permanent place of business there, if that place of business is only used for purchasing, the storage of goods, or advertising and research, the firm would not be regarded as having a permanent establishment and would not be taxable by Brazil. Of course these provisions are reciprocal, so that Brazilian firms may also seek to develop markets in the United States without becoming involved in U.S. tax law so long as their activities do not constitute the maintenance of a permanent establishment in the United States.

Under Brazilian law, an American firm that sends its employees to Brazil to install, say, an electric generator or to oversee the installation of factory machinery, or to do an engineering job is considered to be engaged in business in Brazil and is subject to Brazilian tax. Under the treaty, however, Brazilian tax would be eliminated in such cases unless the activities involved are rather extensive. The treaty defines a permanent establishment to exclude a construction, assembly, or installation project unless the project exists for at least six months.

Dividend income and branch profits

Brazil imposes a general tax on total corporate profits at the rate of 30 percent and a 5 percent tax on distributed corporate profits. It also imposes a 25 percent tax on dividends paid to a foreign shareholder. Consequently the total Brazilian tax on the profits earned by a Brazilian subsidiary and distributed to its parent company in the United States amounts to 50.12 percent. This is higher than the tax the United States would levy on the profits received by the parent company. (The U.S. tax on such income is even less than the normal 48 percent for technical

reasons related to the method of determining taxable income when dividends are received from a foreign subsidiary in a developing country.) Consequently, part of the Brazilian tax represents a burden on American firms that they may not be able to offset, through our foreign tax credit provision, against their U.S. tax. To reduce Brazilian tax to a level that would reflect the U.S. corporate rate, Brazil agrees in the treaty to lower its 25 percent withholding tax on dividends to a rate of 20 percent. (Article 12.) A Brazilian branch of a U.S. firm is taxed in Brazil at about the same rate as a subsidiary, and in order to maintain a tax on branch operations comparable to that on a subsidiary, Brazil has also agreed to limit its withholding tax on branch profits transferred to the U.S. home office to 20 percent.

The reduced Brazilian withholding tax on dividends (and branches) will apply only when paid to a U.S. parent company, as defined for purposes of our foreign tax credit, because it is only in these instances that the present Brazilian tax rate produces an unused credit. In portfolio investment situations, as where an individual has an interest in a Brazilian company or where a U.S. corporation owns less than 10 percent of the Brazilian firm, the present Brazilian taxes will not usually generate any excess credits, and the treaty therefore does not lower Brazilian withholding tax rates.

It is of interest to note that this feature of the treaty is not reciprocal. It does not provide a reduction in U.S. withholding tax rates on dividends flowing to Brazilian investors in U.S. corporations. This is attributable, as indicated earlier, to a mutual desire that the treaty should not divert investment from Brazil to the United States. If the United States were to lower its withholding taxes on dividends going to Brazilian residents, it might induce Brazilian capital to flow into American securities, contrary to one of the objectives of the convention, which is to promote capital formation and economic development in Brazil.

Interest and royalties

The supply to foreign users of capital, know-how, patents, and the like, which is valuable to our export program, is now hindered by the high taxes levied by Brazil on interest and royalties. A resident of the United States who derives interest from a Brazilian debtor is subject to a withholding tax in Brazil of 25 percent of the gross amount of interest. If the interest is received by an individual or a firm that is not engaged in the business of lending money, the gross amount of interest received presumably will be generally equivalent to the net return, since there would be little or no cost incurred in making the loan. Consequently, in such cases the U.S. tax on the interest may be as high as or higher than the Brazilian tax. Since the Brazilian tax may be credited against the U.S. tax, it does not constitute any net additional burden on the U.S. lender. The treaty therefore does not disturb the Brazilian withholding tax on interest in such cases.

However, when interest is received from Brazil by a U.S. bank or other financial institution, the net earnings may be a significantly smaller amount than the gross interest received. A financial institution incurs various expenses in doing business, such as the interest it pays to obtain the funds that have been loaned out. These costs must be charged against the gross interest received. Since expenses represent a substantial share of gross income, a 25 percent Brazilian withholding tax on the gross interest represents a much higher percentage of the net income accruing to a financial institution. In all cases where expenses are more than 48 percent of the gross income, the present Brazilian withholding tax rate of 25 percent on gross income exceeds the U.S. tax on the net income and generates an unused foreign tax credit. To minimize the cases where unused credits occur, Brazil has agreed to reduce its withholding tax on interest paid to financial institutions to 15 percent. (Article 13.) At that rate, unused foreign tax credits will not be generated unless expenses exceed 68.7 percent of gross income. In some cases expenses may go as high as 80 percent or 90 percent, so that unused credits will continue to exist.

For similar reasons the Brazilian withholding tax rate on royalties is also reduced to 15 percent. (Article 14.) This provision is reciprocal since royalties are not likely to involve an outflow of capital from Brazil. I should note in passing that the tax treatment of royalties is complicated by the fact that under Brazilian law royalty payments are frequently disallowed as a deduction to the payer. This is true when they are paid by a Brazilian subsidiary to a U.S. parent company. When royalties are disallowed as a deduction, Brazil in effect treats the royalty as a dividend. Hence, the reduction in withholding tax on dividends also acts to bring the Brazilian tax on royalties down to a level where it is less likely to exceed the U.S. tax.

Deduction of expenses

As in some other less developed countries where American firms have subsidiaries and branches, Brazil does not allow as a deduction for Brazilian tax purposes certain expenses which are incurred outside Brazil. This disallowance is contrary to the principles governing the allocation of expenses which have been developed under international standards. For example, the overhead costs of the home office of a U.S. company doing business abroad would normally be allocated among all of the countries in which the company has branch operations. Indeed, such an allocation is required under U.S. law and regulations, and this principle of allocation is recognized in the OECD model treaty. However, under its internal law, Brazil may not allow a deduction to be taken by a U.S. branch in Brazil, in computing its Brazilian tax, for the amount allocated to the branch operations. Under the convention, however, Brazil does agree to allow deductions in computing taxable income for expenses which are reasonably connected with the profits taxed by Brazil, whether incurred within Brazil or outside it. (Article 8(3).)

A similar situation exists in connection with the determination of taxable income from real property. Under Brazilian law, an American would pay tax on the gross rentals received from real property located in Brazil without any allowance for the expenses involved in maintaining and operating the property. However, under the convention Brazil is obliged to compute tax on a net basis as if the property owner were engaged in business in Brazil, so that the expenses will be deductible (Article 15.)

Personal service income

An American engineer or other technician who goes to Brazil for a brief period as a consultant or to perform other services for a Brazilian employer is subject to tax under Brazilian law on the income he earns while there, irrespective of how much he earns or the period of time he has spent there. Tax is imposed at the rate of 25 percent of the gross amount received. Similarly, a Brazilian temporarily employed in the United States by a U.S. company is subject to U.S. tax on the income earned for those services, irrespective of the amount he earns or the period of time he spent here. Under the treaty, both Brazil and the United States adopt the approach of granting an exemption to persons who are present for less than 183 days and earned less than $4,000. (Article 17.)

The treaty also solves a related problem concerned with personal services. Under Brazilian law, an American technician or lawyer who performs services in the United States for a Brazilian client becomes subject to tax in Brazil because he receives payment from the Brazilian firm. Yet the source of those earnings, according to the standards used by most countries, would be here in the United States since the individual actually performed the services here. Therefore, as I indicated earlier, the tax imposed by Brazil in such a case would not be credited against United States tax. To eliminate the problem of double taxation that thus arises in these cases, the treaty provides that personal service income shall be considered to have its source in the country where the services are performed. The result is that Brazil will not tax in those situations where an American law, accounting, management or engineering firm performs services in the United States for Brazilian clients. (Article 5.)

Shipping and aircraft

At present American shipping and airline companies are exempt from Brazilian income tax on the basis of reciprocity, but this can be altered by action on either side. The treaty confirms the existing situation but strengthens the commitment by making the exemption a matter of international agreement. (Article 10.)

Administrative cooperation

At present, there is no basis for administrative cooperation between the tax authorities of Brazil and the United States, and therefore there exists no medium for eliminating double taxation in certain cases or resolving tax controversies involving the two countries even though the amounts may be substantial.

Suppose there are transactions between a parent company in the United States and a subsidiary in Brazil or between two sister companies, one in Brazil and one in the United States, and the prices at which those transactions take place are considered by either country or both to be other than on an arm's length basis. The company which buys a product may be reqired to recompute its taxable prof-

it on the basis of a lower price than that used in recording the transaction originally, and on the basis of which the company selling the product computed its taxable profits. Unless there is a downward adjustment in the seller's taxable profits, both countries will be taxing all or a part of the total profits that should be taxed only in one country. The treaty therefore provides for consultation between the two countries in order to arrive at the same prices for tax computations or the same allocation of income or expenses in transactions between related companies. After such consultation and agreement, the country which is obliged to grant a refund is empowered to do so even though the statute of limitations has expired. The importance of this provision, especially as to exporters, cannot be overemphasized, because the statutes of limitations governing refunds and assessments are frequently different from one country to the other, and tax justice frequently cannot be achieved in cases of the kind I have mentioned. One country may assert a deficiency after the other country has lost its power to make a refund. The treaty would cure this situation. (Article 24.)

Extension of investment credit

These and other principles incorporated in the convention with Brazil are not significantly different from those to be found in the conventions we have with other countries. Nevertheless, when considered in relation to its existing law, the treaty rules are important changes in the Brazilian tax treatment of international transactions. In return for these changes the treaty extends to investment in Brazil the 7 percent tax credit granted under our law to investment in the United States.

A firm in the United States which purchases machinery or equipment for domestic use is allowed a reduction in its tax liability equal to 7 percent of the amount spent on such equipment. There were a number of considerations that justified the adoption of this investment credit for domestic purposes. At the same time, for a variety of reasons, we were not interested in granting an incentive to investment in European plants owned by American firms, and hence the credit was confined to investment within the United States. However, as a result of our preoccupation with our position relative to European countries, we have tipped the scales against investment in developing countries. What we look upon as an appropriate treatment for domestic investment is regarded by develping countries as an obstacle to investment within their borders. It is one coin but observed from different sides.

Extension of the investment credit is a valuable and, realistically, the only instrument for obtaining tax treaties with countries such as Brazil and other Latin American countries, and through such treaties removing the tax obstacles to international trade and investment that result from differences in national tax concepts and the fact that each country administers its taxes independenly of every other country. In a world where international trade and investment are of major importance and are becoming increasingly more so, these obstacles should be eliminated wherever possible. Tax treaties move in that direction, and yet, as I have indicated, the fact that tax treaties involve revenue losses for developing countries can constitute, without some balancing factor, a barrier to such treaties even though in the long run they are of interest to all concerned.

With this in mind, the treaty with Brazil extends the investment credit to investment made by American firms in Brazil. (Article 7.) In all essential respects the credit granted under the treaty would be the same as the credit granted for domestic investment. Variations from our own law have been made to take account of the fact that investment abroad frequently is made through a foreign corporation rather than a foreign branch of a domestic corporation, and to assure that the investment credit is associated with a net increase in the capital of the eligible enterprise in Brazil. Thus, the credit would be granted to an eligible American company whether its activities in Brazil are conducted in branch form or through a Brazilian subsidiary. Under our domestic law, a firm may purchase machinery or equipment out of depreciation reserves, out of borrowed funds or out of new equity contributions, and irrespective of the source of funds it is allowed a credit against its tax liability of 7 percent of the amount thus spent. However, under the treaty approach the credit would not be granted to the U.S. company unless it has made a net addition to the funds available to the enterprise operating in Brazil. Moreover, the new capital added to the venture in Brazil must be committed for a minimum period of five years. If the capital is withdrawn in a shorter period, provision exists for the recapture of the tax credit.

As in the United States, qualified machinery and equipment must have a minimum useful life of eight years for the full credit to be obtained. With respect to

equipment having a useful life of between four and eight years, a partial credit would be granted similar to that allowed under domestic law. To the extent that the net new investment remained in the enterprise in Brazil, replacements of qualified machinery and equipment would also be eligible for the investment credit, just as replacements in the United States qualify for the investment credit.

The treaty credit treats as net new investment amounts in excess of one-half the profits earned each year in Brazil which are reinvested in the business. Reinvestment of one-half the profits of an enterprise is considered a normal reinvestment practice and would not be regarded as a net addition to the capital of the company for purposes of the investment credit. Thus, if 50 percent or less of the profits are retained in Brazil, then no reinvestment is considered to have occurred. But if 60 percent of the profits are reinvested then the excess over half, that is 10 percent, would be considered to be net new investment and qualified equipment purchases, to the extent of the 10 percent, would give rise to an investment credit.

CONCLUSION

There can be no doubt that tax treaties have a beneficial effect in facilitating the movement of goods, services and capital between countries. The efforts of other nations to develop a network of treaties indicate the importance of these international agreements. The support we have received from the business communities engaged in international trade and investment at each stage in the development of our own now extensive network of treaties also attests to their utility. But it is time that we moved further along in our efforts to mitigate the effects of the anarchistic system where, despite the economic interdependence of nations, each country applies its tax system as if it were alone in the world. This is an anachronism that should be eliminated. A major achievement in this process will be the establishment of agreements with the countries of Latin America. And to reach such agreements we are required to make our contribution to accommodation to proper international tax relationships, just as those countries are required to make their contribution to such an accommodation. The Brazilian treaty is the first step in this direction. The treaty is a balanced agreement that can be considered to be of equal worth to both parties, which is the essence of international negotiations and arrangements.

The United States in many ways has indicated that wherever possible it seeks to have private capital, rather than public aid, move to these Latin American countries. The treaty before you is in an effort to remove tax impediments to the participation of American private enterprise in Brazilian economic development. I therefore urge your approval of this treaty with Brazil, so that the United States can thereby make its proper contribution to international tax relationships that will assist in the furtherance of private investment and trade with the Latin American countries.

Mr. SURREY. I will start first with the two protocols, those with Canada and Trinidad and Tobago, because they are short and can be covered quickly.

TAX CONVENTION WITH CANADA

The protocol with Canada is designed to eliminate a defect in the present Canadian-United States treaty. Under the present treaty with Canada we reduce our rates of withholding tax from 30 to 15 percent on investment income flowing to Canada. Canada does the same on income flowing to the United States. That reduction was designed to be a reciprocal benefit for Canadian and United States residents, and normally it would work out that way. Any investment income flowing to Canada would be taxed under the Canadian tax system and the Canadian tax system is roughly comparable to the U.S. tax system, with one major exception. That exception is that if there is a Canadian corporation which receives its income from abroad, outside of Canada, and is owned by non-Canadians, then that corporation is not subject to Canadian tax. Consequently persons who desired to invest in the United States began to invest in the United States through Canadian

corporations, and thereby obtained the benefits of the reduction in the U.S. withholding rate from 30 to 15 percent in our treaty with Canada.

We called this to the attention of Canada. Canada changed the rule insofar as new Canadian corporations were concerned. But it did not change the rule insofar as existing Canadian corporations are concerned.

That meant that people started to buy up existing Canadian corporations, people from outside the United States, and use those as a mechanism to invest in the United States.

Prior to the recent amendment to our treaty with the Dutch, a similar situation had existed in the Netherlands Antilles where holding companies were being formed as a method of investing indirectly in the United States rather than investing directly. People from the Middle East or Latin America were channeling their investments through the Netherlands Antilles into the United States to get the benefit of our Dutch treaty, which was written not to benefit the whole world, but to benefit only Dutch and Netherlands Antilles residents, just as our Canadian treaty is not intended to benefit the whole world, but to benefit only Canadian residents.

CANADIAN CORPORATIONS OWNED BY NON-CANADIANS

When we called this problem to the attention of the Canadians they said the best way to work it out would be to amend the Canadian-United States treaty to say the benefits of the treaty reduction do not go to Canadian corporations which are not fully taxed in Canada. This would exclude the benefit of the treaty to those Canadian corporations which are owned by non-Canadians. That would, in effect, close a loophole in our treaty with Canada. This protocol with Canada does exactly that. It will eliminate this defect in the Canadian treaty and consequently people who invest in the United States will, if they come from treaty countries, get the reduced rates; if they come from non-treaty countries will be subject to our 30 percent rate just as resulted from our change in the Netherlands Antilles treaty which this committee approved several years ago.

This is a matter also of unfair competition because there are a number of American enterprises which are engaged in attracting funds from abroad and they do it through American corporations and they do not like to see their competitors resort to buying up existing Canadian corporations to take advantage of this defect in the treaty.

TAX CONVENTION WITH TRINIDAD-TOBAGO

The second matter before you, the second protocol, is that with Trinidad and Tobago. When Trinidad and Tobago became independent they carried with them our treaty with the United Kingdom. Consequently we ended up with a treaty with Trinidad and Tobago. That treaty fitted the United Kingdom method of tax and the method of tax in Trinidad and Tobago then in effect. But with independence Trinidad has changed its whole tax system and our treaty with them became outmoded. They consequently renounced that treaty several years ago, and it ceased to exist as of January 1966. They asked for renegotiation. We had a similar problem with the United Kingdom

which also changed its tax system and we did renegotiate the United Kingdom tax treaty.

We have had discussions with Trinidad and Tobago about a new treaty, and we are progressing but there are still some problems to be resolved.

In the meantime, Trinidad did not like to be put in the position of having a very heavy tax on foreign investment in Trinidad. They had adopted under their new system a 30-percent withholding tax on income earned in Trinidad by foreign investment whereas up to then they in effect had no withholding tax. That 30-percent withholding tax combined with their basic tax of 44 percent would be too heavy a tax on international activity.

PARENT-SUBSIDIARY RELATIONSHIPS

In this treaty they have reduced the tax from 30 to 5 percent with respect to parent-subsidiary relationships (U.S. parents with Trinidad subsidiaries) and U.S. companies that have branch operations in Trinidad. This is an interim arrangement, in effect, to accommodate their new tax system to an international situation.

The Trinidad Government would very much like this interim arrangement to come into effect. Then we will proceed to work out the negotiation of those aspects of our tax relationship with Trinidad which are less critical than this particular matter of the tax rate on our branches or on our subsidiaries in Trinidad.

TAX TREATY WITH BRAZIL

Now, we come to the treaty with Brazil. This is a full treaty and not a protocol. It is an important matter because it will be our 28th tax treaty, if signed. But more important than that, it would be our first treaty with a major Latin American country and our first treaty with any South American country.

The background is this: Until a few years ago Latin American countries had no international tax relationships with the rest of the world. They had their tax systems and they applied their domestic tax systems without regard to the normal rules of international taxation.

In recent years they have become very interested in developing sounder economic relationships in the tax field and elsewhere with respect to investments from the industrialized world. All of the major countries of Latin America have commenced negotiations with Europe and with Japan to deal with their international tax relationships. They have also asked the United States whether it will join with the other countries in seeing whether a network of treaties can be established between the industrialized countries and the countries of Latin America. Brazil asked the United States to enter into negotiations at the same time that it asked Europe and Japan to enter into negotiations.

We, of course, from over 20 years ago have favored international tax treaties and we have now an international network of tax treaties with practically all of the industrialized countries of the world and with practically all of the European countries. The only two exceptions are Portugal and Spain and we are negotiating treaties with them. But we do not have treaties with Latin America.

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THE OECD MODEL CONVENTION

In our treaties with the industrialized world we have followed the so-called OECD model convention, which is a model that the OECD countries have worked out for the industrialized nations. For example, the treaty with France that came to you just the other day is a complete revision of the French treaty based on this new OECD model.

Most countries of the world have high tax systems. For example, the United States is a very high tax country when viewed from the eyes of the rest of the world because anybody who invests in the United States pays first the 48-percent corporate rate of tax and then we withhold 30 percent on any dividends going from the United States. Consequently anybody who invests in this country and invests in our corporate enterprises in effect pays a tax of about 64 percent. That is a very high tax for international transactions and, consequently, could tend to inhibit investment in this country. The Europeans are in the same position, since they also have high taxes.

In all our industrialized country treaties we have reduced that 30-percent tax. In our treaty with France you will find that the 30-percent tax on dividends has been reduced in certain cases to 5 percent, and the French reciprocally reduced their tax to 5 percent, which was lower than they had ever done before.

APPLICATION OF INCOME TAX IN BRAZIL

In all of these international treaties with industrialized countries, the country of the source of income is the country that says, we will accommodate our tax system to the rest of the world and bring our rates down and our method of taxation down so we do not interfere with international trade and investment. That has been the pattern of all the treaties you have approved with the industrialized countries.

When we turn to the Latin American scene we have the same problem. The Latin American tax rates often are higher than our 48-percent rate, and they have a number of rules which tend to inhibit or overtax our investors or our exporters or our people, our professional people who earn income from these countries. Consequently——

The CHAIRMAN. Are these personal or corporate taxes?

Mr. SURREY. Both.

The CHAIRMAN. Whenever you say taxes, you are speaking of both.

Mr. SURREY. Both.

For example, suppose an American lawyer or an American professional man, an American architect was hired to do a job in Brazil or other Latin American countries, and was paid for that job and he never left the United States. If he had been hired by any of the industrialized countries of the world he would not worry about the foreign tax system. If he did all his work here, he would pay only the U.S. tax.

But if he is hired by a Brazilian company to design a building for them and never leaves the United States he may be subject to Brazilian tax today, which is not the basic international rule. So that he has to concern himself with the Brazilian system although everything he does takes place right here.

The CHAIRMAN. He is also subject to American tax?

Mr. SURREY. He is also subject to American tax.

The CHAIRMAN. In other words, he pays a double tax?

Mr. SURREY. We do give a foreign tax credit, but in this particular case our foreign tax credit would not apply since we would say the income was all earned in the United States and therefore there was no reason for the imposition of the Brazilian tax and he would be subject to taxes by both countries.

Now, these kinds of things don't make sense and these are the things that one irons out in treaty negotiations. This particular matter is ironed out in the treaty with Brazil and Brazil withdraws its tax in this situation where the services are all performed outside of Brazil.

That is an instance of a situation where the personal income tax sometimes applies in Brazil.

Other instances of where Brazil has made accommodations to international tax standards are these—in this fashion I will just summarize a few of the matters in the Brazilian treaty where, in effect, Brazil, like the rest of the Latin American countries, will bring their systems into harmony with the international tax rules applicable to international transactions.

RECOGNITION OF OVERHEAD EXPENSES

In a number of Latin American countries, if our investors or our exporters have branches in these foreign countries, and incur expenses for these branches outside of the foreign country—in other words, there may be overhead expenses which are attributable to the operations in Brazil—these overhead expenses are normally not deductible in the foreign country, although they have to be paid by the branch or the subsidiary corporation in the foreign country. Among most industrialized countries these overhead expenses are deductible. But they tend not to be deductible in Latin American countries, so that there is an excessive rate of tax in those countries because they are taxing more than net income. They are not allowing for the expenses that are incurred by the branch in Brazil or by the subsidiary in Brazil for the services that happen to be performed outside their country. It is an outgrowth of systems that were not molded for international dealings.

In this treaty Brazil does allow a deduction, just as the United States has always allowed a deduction in similar situations for expenses incurred by firms operating in Brazil for activities outside the United States.

REDUCTION IN BRAZILIAN WITHHOLDING TAX

Another major change in this treaty is in the Brazilian withholding tax. Brazil has a withholding tax of 25 percent. That tax, when combined with their internal corporate taxes, comes to more than the U.S. rate of 48 percent, and in many cases, therefore, produces excess foreign tax credits; in other words, produces a rate of tax that is not entirely absorbed by the U.S. foreign tax credit.

We had pointed out to the Latin American countries that " we don't expect you to reduce your withholding taxes to the extent we would ask industrialized countries to do," because we recognize that there are mutual relationships between these industrialized countries that don't exist in Latin American countres. But we also point out to them that rates higher than 48 percent can have an inhibiting effect upon investment. Consequently, we think it is in their interest, if they are in-

terested in attracting private investment, to have their rates of tax not generally higher than the effective U.S. rate.

In this treaty Brazil reduces its 25-percent withholding tax to 20 percent in the case of dividends from Brazil to the United States and in the case of U.S. branch profits earned in Brazil. So that——

Senator GORE. May I ask a question, Mr. Chairman?

The CHAIRMAN. Yes.

EFFECT OF INVESTMENT TAX CREDIT

Senator GORE. Then, as I understand your statement, by this treaty Brazil roughly conforms her taxes of U.S.-owned corporations to an approximation of the U.S. tax?

Mr. SURREY. To an approximation of the U.S. 48-percent rate; that is correct.

Senator GORE. Which means that a U.S. corporation owning a business in Brazil will, by reason of the foreign tax credit, pay no taxes on its profits earned in Brazil to the U.S. Government, and then the other provision of the treaty—the investment credit—would let them take investment credit against profits earned in the United States, thus subsidizing investment in Brazil, which seems to me to make this treaty another part of the foreign aid package.

Mr. SURREY. Well, I would like to comment on that when I come to the investment credit aspect.

Senator GORE. Well, first, before you come to investment credit——

Mr. SURREY. This treaty would, in effect, put the U.S. corporation investing in Brazil in the same situation as a U.S. corporation investing in the United States, because a U.S. corporation investing in the United States pays a 48-percent tax, less the investment credit, and a U.S. corporation investing in Brazil will pay a tax of, roughly, 48 percent to somebody. Now the philosophy of our foreign tax credit, and I suppose the foreign tax credit is the basic aspect upon which the United States has based its international tax relationships, is that we will yield to the country of source to have first claim on the taxpayer if that country of source has a reasonable tax system.

Senator GORE. Yes, I understand that. But the overall effect is that this means that a U.S. corporation doing business in Brazil will pay no taxes to the United States, but will get an investment credit against other profits earned in the United States, in fact, for investment abroad or in Brazil?

Mr. SURREY. Yes, but I say, be in the same position as an investor in the United States.

Senator GORE. Yes. I can understand how the U.S. corporations doing business in Brazil would be tickled pink with this treaty. I can understand how Brazil would want it because it subsidizes U.S. investment in Brazil. But I can't understand how the U.S. Government would want it, since it is a one-way street.

Mr. SURREY. No.

Let me indicate to you, Senator, how the Brazilians would answer you. Brazil in this treaty is making——

The CHAIRMAN. We will have to recess for about 5 or 6 mintes to vote and we will come back.

(Short recess.)

The CHAIRMAN. The committee will come to order.

Mr. Surrey, perhaps you could proceed to make the record. I think the others will be back soon. We unfortunately can't control these meetings of the Senate. They weren't scheduled when we set this meeting, but we had the alternative of either proceeding or to postpone the meeting, so we will do the best we can.

Mr. SURREY. Yes. I will reserve the answer to Senator Gore's question until the Senator returns.

The CHAIRMAN. He will be back in a minute if you can go on to make a record.

Mr. SURREY. I will go to some of the other aspects.

EFFECT OF VALUE ADDED TAX

The CHAIRMAN. I will ask one question before I forget it: You were mentioning the French—the fact that a very large part of their internal tax is raised from the value added tax—what effect does that have on these agreements as to income taxes?

Mr. SURREY. As you point out, these agreements are only as to income taxes.

The CHAIRMAN. Yes.

Mr. SURREY. The French rate of income tax on corporations, which is the paramount form of investment, is high. It is a 50 percent rate of tax.

The CHAIRMAN. On the net return after the value added taxes have been paid?

Mr. SURREY. Have been paid.

The CHAIRMAN. I see.

Mr. SURREY. So the French rate of tax is a high corporate rate of tax, 50 percent, and with their withholding tax which, as I recall, is 25 percent, in a general sense insofar as international transactions are concerned would present the same picture as the United States would present to a Frenchman. Their value-added taxes are largely internal excise taxes in the nature of general sales taxes, and affect basically only their national prices rather than their international prices.

The CHAIRMAN. Except when they forgive the value added tax on exports which is an indirect subsidy for exports, isn't it? That is another matter, but it does have that effect.

Mr. SURREY. That is a difficult matter and I think you will find all shades of opinion as to how that question should be answered.

The CHAIRMAN. Well, proceed. I just wondered how that worked.

Mr. SURREY. I just want to mention a few other aspects of the Brazilian treaty, and I mention them in part because I think we will find similar problems with respect to other Latin American countries. In other words, I think we will find that the situation in Brazil will not differ appreciably from elsewhere.

TAXING EXPORTERS TO BRAZIL

Let's take, for example, a U.S. firm that desires to export to Brazil, and it sells its goods in Brazil through an agent in Brazil who is an independent agent—that is, he is a Brazilian who is just in the importing business—Brazil, under those circumstances, often will tax the U.S. exporter, largely because his goods are being sold in Brazil. In a sense,

one can understand that position, but it is not the international rule that has developed. The international rule that has developed is that in order to facilitate export trade and to facilitate the establishment of commercial contacts a country in which goods are sold will not tax the exporter unless the exporter has what is called a permanent establishment in that country—which means, unless the exporter has, in effect, a business presence of his own in that country, an office, for example, in which he can be said to be conducting business there himself rather than selling into the country through an independent agent. That would be the rule in the United States.

We and the industrialized countries of the world have gone further and said in treaties the tax will not be imposed if the presence of the exporter is no more than a showroom to display goods or an office to do research in marketing in the country, or an office for advertising purposes or the like. That is not sufficient business presence to warrant imposing a tax on the exporter who is just selling into the country.

In this treaty Brazil adapts its tax system to the international rule and says it will not tax our exporters to Brazil unless they have this so-called permanent establishment, which is the rule, as I say, in all other treaty countries. We, in turn, adopt the same rule with respect to Brazilian exports into the United States.

I did mention the reduction in dividends in Brazil from 25 to 20 percent, but I want to point out that the United States does not reduce its 30 percent tax on any Brazilian investment in the United States, for two reasons: One, there isn't much Brazilian investment in the United States and, two, neither Brazil nor the United States, I think, is interested in encouraging Brazilian capital to come to this country, because Brazilian capital can best perform its services to Brazil by being invested in Brazil. So that contrary to the usual pattern of treaties we do not reduce our rates of tax on such investment in the United States.

TAX ON INTEREST ON LOANS FROM U.S. FINANCIAL INSTITUTIONS

Brazil in this treaty reduces its withholding tax of 25 percent to 15 percent in the case of interest on loans from financial institutions in the United States to Brazil. The reason that that is done is that the Brazilian tax of 25 percent is a tax on the gross interest. It is simply a tax of 25 percent on the interest paid by the Brazilian who borrows from the U.S. financial institutions.

We impose a tax on that interest at a rate of 48 percent and superficially it would look as if our tax being 48, is higher than 25 and, therefore, our foreign tax credit would readily absorb the Brazilian tax and, therefore, why are we interested in seeking a reduction in Brazilian tax?

The answer is that our tax of 48 percent on interest earned on a loan to Brazil is a tax on that interest reduced by any expenses incurred in making that loan, which would include the cost of borrowed money in the United States. For many, and as far as we can tell, for nearly all of our financial institutions, the American tax of 48 percent on the net interest earned will be lower than the Brazilian tax of 25 percent on the gross interest. So that our banks that lend to Brazil incur a tax in Brazil which is not absorbed by the U.S. foreign tax

credit. We have pointed that out to Brazil and indicated that their rate of tax on interest is higher than our tax on the interest and it would be to their advantage to reduce that rate of tax. They did reduce the rate of tax on interest going to financial institutions to 15 percent, which will make it roughly comparable as far as we can tell to the normal American tax. In some cases it will still be a higher tax, but on the average it will be about where we are. There is a similar reduction in the case of royalties paid by a Brazilian company to a U.S. company, where their tax is on the gross royalty—25 percent on the gross royalty—and our tax is 48 percent on the net royalty after allocation of U.S. expenses. Therefore, here also the Brazilian reduction brings their tax down to about the level of the U.S. tax.

That is the general pattern we have followed in this treaty in saying to Brazil, "we are not going to ask you for the sort of tax concessions that we would ask of an industrialized country because we recognize that is inadvisable. You need your revenue sources, you have your revenue problems which are acute. We do point out to you that in those cases where your tax is higher than what we are able to credit against the U.S. tax you end up by imposing a burden on the taxpayer which is higher than the burden he would have in the United States." Therefore, when he comes to consider should he enter into this transaction in Brazil at least he has that marginal factor to look at that since he will be paying a higher tax burden than if he confines his transactions to the United States. And it is that marginal factor, which in some cases may be adverse, that the treaty is designed to eliminate in the interest of sounder economic relationships with Latin America.

That has been the pattern in the treaty. In other words, it has been an attempt to say to Brazil "we want to point out to you those marginal areas where your tax system can act as a disincentive to an economic relationship. In some cases, of course, the disincentive will be overcome by other factors. But if you are interested in wanting to know what are the disincentives we point them out to you." That is what was done in this treaty and these are the disincentives the treaty corrects.

U.S. FOREIGN TAX CREDIT

This gets me back to the question Senator Gore asked: Let me first say Brazil looked very carefully at these changes in their system, as Brazil properly should, because it should not give up revenue needlessly, and the United States should not ask a foreign country in a developing situation to give up revenue needlessly. So Brazil said "we are giving up this revenue because we can see that in these marginal situations our taxes can have a disincentive effect." But then they say "what about your tax system? What are you doing to accommodate your tax system to the encouragement of economic relationships with our country?"

Now, we can point out one very basic thing and that is we give a foreign tax credit. In other words, we say to Brazil, "we will let your taxes count first, and we will collect only the balance." We say that to the whole world. We have said it ever since 1918. But we have said it unilaterally without regard to treaties.

It may have been we should have said that on a bilateral basis, but we have not. American investment would not proceed at all without the

foreign tax credit because then, as the Chairman pointed out, two taxes would be imposed and the overall burden of two taxes would be so great that international investment would practically cease. So we do make this major concession to every country in the world, just as other countries make to us, because they also—the industrialized countries—work out foreign tax credits or similar approaches.

But Brazil says "well, that is good and true, but you do that unilaterally and it is no special regard for us. You do that to an industrialized country. But what will you do with respect to the changes and concessions we make?" They go on to say "many of the European countries will by treaty exempt investment in developing countries."

We say "we will not make that sort of concession. We do not think it is proper. We think that if there is any residual tax the United States taxpayer should pay it. We do not want to give our investors in these countries such a favored position over investment at home as to bias our whole tax system."

ENCOURAGEMENT OF U.S. CAPITAL GOODS INVESTMENT

But we then point out that the United States does give an inducement to investment in machinery and equipment in the Untied States of 7 percent. That was a step adopted in 1962 in part, I think, to correct what may have been a bias in our tax system against investment in capital goods, and to encourage that investment in capital goods. That was done in 1962, as a structural part of the U.S. tax system.

Now, it was confined to domestic investments because we were concerned at that time in 1962 about the industrialized countries of the world.

If you will recall in 1962 the U.S. Treasury, the administration, was greatly concerned about the whole outpouring of the investments to Europe, and did not want in any way to use the American tax system to encourage an outpouring of investment to Europe. It thought that European economic conditions were such that investment in Europe should take certainly no more than its natural course without any stimulus from the United States. So the whole focus in 1962 was to encourage capital goods investment in the United States, and not to encourage through a tax system investment in Europe. We did not consider the developing countries of the world.

The Brazilians now say to us "you, in effect, have a disincentive against investments in our country because American firms investing in machinery and equipment in the United States get a 7 percent credit. If that American firm wants to open a branch in Brazil and invest in machinery and equipment it does not get the 7 percent credit." They say "you talk about sounder economic relationships with us, you talk about encouraging American capital to come to Latin America, but when you look at your system you do have a bias against investment in Latin America because of the investment credit."

Then they say to us "if you are not willing to completely exempt investments here, you should eliminate that bias in return for the concessions that we, Brazil, are making."

It seemed to us that that was an appropriate argument. If the United States is to enter into sounder economic relationships with Latin America and we ask these countries to make accommodations in their tax systems to international transactions, then the United States

must look at its approach and recognize that international agreements involve accommodations by both sides and must therefore make its accommodations so that we can enter into a network of treaties with these countries.

EXTENSION OF INVESTMENT TAX CREDIT TO BRAZIL

Now, in this treaty we, therefore, extend the investment credit to Brazil.

We had previous discussions with this committee on this subject, and the Chairman of this committee said in a letter last year to me that, in effect, there was a feeling that if the investment credit is to be extended to developing countries it should be on the same terms as in the United States, and we agreed. Therefore, in this treaty, the investment credit is extended on the same terms as in the United States.

The CHAIRMAN. And it will exist only when it is applicable in the United States?

Mr. SURREY. Yes, Mr. Chairman. There is a provision in the treaty that if it is terminated in the United States, suspended in the United States, changed in the United States, then it shall automatically change in this treaty.

TREATY MAY BE TERMINATED IN THREE YEARS

There is also a provision in this treaty that after—let me say that the treaty is limited to three years in the sense that either country may terminate the entire treaty in three years. Now, I should mention this when Senator Gore is here—when he said, well, the Brazilians would fall all over themselves in saying this was a wonderful treaty because we extended the credit—the Brazilians, as I tried to point out, made changes in this treaty which they naturally want to reexamine and see what the course of conduct is and they therefore preferred that the treaty last only three years.

I was just saying, Senator Gore, before you entered, that the provision in this treaty that it can be terminated in three years at the instance of either government, was not put in at the instance of the United States. We normally, if we put a clause in of that nature at all, put the time at five years. It was put in at the instance of the Brazilian Government because the Brazilian Government was quite concerned about the concessions they were making in this treaty and they wanted an opportunity to examine those changes and think about those changes. We thought that was proper and when they asked for three years we agreed to three years.

Either government may terminate this in three years.

In addition, as I was pointing out to the Chairman when we were talking about the extension of the investment credit, the extension is on the same terms as in the United States, at the suggestion of the Chairman. So that if the credit is suspended or terminated or changed in the United States it automatically is changed in the treaty. Moreover the United States reserves the right even if the treaty continues after three years to terminate the investment credit clause without terminating the entire treaty. So that we could have an independent look at that particular clause. But the Brazilian Government, in turn, if the investment credit were suspended or terminated in the United

States, reserves the right to suspend or terminate the concessions it makes to the United States. Consequently the reduction of the 25 percent withholding tax to 20 percent on dividends, and the 25 percent withholding tax on royalties and interest to 15 percent can be terminated by Brazil if we terminate the investment credit.

PUTTING INVESTMENT ON AN EQUAL BASIS

In negotiating the treaty, I could see no objection to that because it is perfectly understandable from their standpoint. But I mention that to indicate that they are making changes and concessions in this treaty and accommodations to the U.S. taxpayer, and I would say accommodations in an effort to place investment in their country on the same basis as investment in the United States so that they will not impose barriers to our capital or to our exporters. In turn, we will not impose barriers in the interest of economic relationships with them, as part of the very broad interest that the United States has in its economic relationships with the Latin American countries.

Now, let me say that the other countries of the world have recognized this same problem. Brazil has concluded a treaty with Japan; Brazil has concluded a treaty with Sweden. In these treaties, Japan and Sweden make concessions to their investors in Brazil, and I might say they make concessions of a kind which I think are not really in the longrun interest, and which we would not make in our tax system because we think it would be unfair to our investors in the United States. We have, therefore, sought to make our international accommodations with Brazil and with the rest of Latin America by saying that we will remove our disincentive and place investment in their countries on the same basis as investments in the United States insofar as the investment credit is concerned.

FOCUS OF U.S. INVESTMENT TAX CREDIT

Senator GORE. But, Mr. Surrey, when we were urged to pass the investment tax credit we were urged to do so to encourage people to invest in the United States in order to meet foreign competition. Now, you list as a virtue of this bill that we turn around and give this subsidy to investment in Brazil the same as we do here in the United States. Instead of that being a virtue, I would say it would be a severe handicap to the treaty.

Mr. SURREY. I mentioned that earlier, but let me respond in this way: In 1962 when the investment credit was adopted we were focusing on two things. We were focusing, one, on whether the U.S. system as a whole had an inherent impediment, bias or what you will, against investment in capital goods and whether there shouldn't be an encouragement to investment in capital goods, to the modernization of machinery and equipment. That was one thing we were focusing on.

We were also focusing on—and you were one of the principal proponents of that aspect—our capital outflow to Western Europe, and we believed that we should not have a capital outflow to Western Europe motivated by the tax situation. That capital outflow to Western Europe was motivated by tax concessions the United States made in one way or another to investment in Western Europe, tax-haven operations and the like, and also in part motivated by the

fact that European tax rates may have been somewhat lower than U.S. tax rates due to very liberal depreciation allowances and credits. So, in 1962 we were focusing on that and, therefore, we said that we will attempt to withdraw our tax concessions on investments in the industrialized countries and we did, in large part, and I say in great part through your efforts, Senator, and we also brought our corporate system roughly in line with that of Western Europe through the investment credit and depreciation reform. We did not specifically consider the developing countries in this context.

Now, the United States, in all of its programs, has taken special notice of investment in the developing countries and especially Latin America. We have our guidelines for investment in Europe, but we do not apply those guidelines and those voluntary restrictions to investments in Latin America. We have investment guarantees in Latin America and the like. These are national policies with respect to private investment and I suppose they involve saying that there is a broad interest in the United States in economic relationships with these developing countries, and that broad interest at least extends to not having a disincentive to private capital in Latin America.

INVESTMENT TAX CREDIT IS FOREIGN AID

Senator GORE. Well, I understand that, Mr. Surrey. We have foreign aid in several different categories: One, which is direct foreign aid. Two, investment tax credit, investment guarantees. Third, an international loan program. Then more recently we have had the soft loan windows of the Inter-American Development Bank and the Asian Development Bank, and now we have by way of treaty foreign aid subsidizing investment in Brazil. If this treaty is ratified, it is the position of the Administration to conclude such treaties with all Latin American countries. So what we are really considering here is an additional facet of foreign aid by way of treaties.

Mr. SURREY. Well, you say foreign aid. That has a connotation, I think that I would like to put a bit differently. It is saying that the American tax system will not have a disincentive for private investment in Latin America, so that in the marginal cases private investment can make its contribution to the economic relationships and the economic growth of these countries. And also, I would say, so that the United States will remain on a parity with the rest of their world in its economic relationships with these countries.

REPATRIATION OF CAPITAL

Senator GORE. I would like to analyze that for just a moment. Your treaty provides that Brazil will approximate her taxes to that of the United States, which means when we apply the foreign tax credit that U.S. investors in Brazil will pay no tax to the U.S. Government on their profits earned in Brazil. Then Brazil would retain her withholding rate at 20 percent to discourage any repatriation of capital.

Mr. SURREY. No.

Senator GORE. To the United States?

Mr. SURREY. No, I don't think so. The Brazilian tax rate—I am sorry, I didn't make it clear, Senator.

Senator GORE. Yes.

Mr. SURREY. The Brazilian tax rate, approaching 48 percent, is a combination of the domestic Brazilian corporate rate and the withholding rate.

Senator GORE. Withholding, thank you very much.

Mr. SURREY. So it is the combination of both that yield that 48 percent rate, so that on repatriation to the United States there isn't that discouragement of repatriation.

SUBSIDY FOR INVESTMENT IN BRAZIL

Senator GORE. Now, I would be prepared to consider more favorably the granting of investment credit for investment in Brazil if it were confined to the taxes the taxpayer owed on the profits he earned in Brazil. But when you enter into a treaty which provides in essence that taxpayers will pay no taxes to the U.S. Government on their profits earned in Brazil, and then on the other hand give them credit against taxes owed on profits earned in the United States for their investment in Brazil, it adds up to a subsidy for investment in Brazil. If that isn't foreign aid—maybe you don't like the term "foreign aid," but it is aid to Brazil. It is aid to the companies operating in Brazil, if you don't like the words "foreign aid."

FINANCIAL EXTRACTIONS FROM COMPANIES

Mr. SURREY. Here is where I think I put it differently. I think there is in the way you present it, although I don't think you intended to imply it, some implication that these companies somehow are getting benefits that others don't get in the United States. Now, that isn't the case. These companies——

Senator GORE. You fleeth where no one pursueth.

Mr. SURREY. I beg your pardon.

In other words, when one looks at the financial extractions from them by the governments combined, the financial extractions from them do not differ from the financial extractions that exist if they make their investments in the United States. They are paying taxes to governments.

Now, the United States has said—and I think this is the heart of the matter—the United States has said "in our international relationships we recognize a financial extraction by a foreign country as a financial extraction from the taxpayer and we do not exact additional financial extractions from him beyond the American level of 48 percent."

Now, many of our international companies do not pay taxes to the United States. Many of them pay far greater taxes to foreign countries. In some instances our American companies will continue to pay taxes to Brazil greater than in the United States. But even where this is not so the taxpayer himself, the organization, has a financial extraction from him that does not differ from the financial extraction any American taxpayer has.

Brazil is saying "we are interested in attracting private capital; we believe private capital will help to build up our country." They say that to the Japanese, they say it to the Western Europeans and they say it to us: "We look at the combined tax systems of your country and our country, and we see that the financial extractions both of us

are making are greater than the financial extractions that would be made singly. And, therefore, there is that impediment to investment."

Now, they say "what can we do to eliminate that impediment?" And they say "we will draw back our financial extractions, we will draw back the power of our tax system so that we are not exacting a financial extraction greater than you would exact from your companies." And they say in turn to us, "if you are really saying that you are interested in economic relationships between our countries and if you are really interested in joining with us in building up an economic structure, which also is of benefit to the United States through expanded markets and so on, then you should join with us in removing an excess financial extraction. Thus both of us combined can contribute to leaving a financial extraction that is not higher than a company would have if it chose to stay in the United States."

Senator GORE. I think I would go along with you——

Mr. SURREY. That seems to us a fair international approach to a situation where it is in the interest of the United States.

Let me say parenthetically, Senator, if we had a situation in which a foreign country would not say that to the United States, would not make its concessions, we would not extend the investment credit. In other words, I do not say this is automatic, and I think that should be clear. We would not in Latin America extend the credit to a foreign country which in turn is not willing to reduce its financial extractions to the American level.

APPLICATION OF MOST FAVORED NATION CLAUSE

The CHAIRMAN. The principle of the most favored nation clause does not apply to taxes.

Mr. SURREY. It has never applied to tax treaties.

The CHAIRMAN. It never has.

Mr. SURREY. Which is a very important point.

The CHAIRMAN. I hadn't thought of it. What are the limits of the most favored nation clause, or does it apply? I know to some of the things it does, but what are some of the limitations, do you know?

Mr. SURREY. I do not know personally, and I think it may depend upon each particular situation. But I know it does not apply in the tax field and each country makes its own fiscal accommodations, but it makes it with an——

The CHAIRMAN. It applies to tariffs; but is that all it applies to?

Mr. KUBISCH. I believe so.

The CHAIRMAN. Only to tariffs?

Mr. KUBISCH. I am not certain, but I believe so.

The CHAIRMAN. I hadn't thought of it until you mentioned it, but it comes up in regard to tariffs, I know, quite often.

Mr. SURREY. Yes; that is right.

But if Brazil makes a concession to Sweden in a tax treaty, it does not have to make the same concession to us.

The CHAIRMAN. And we do not.

Mr. SURREY. We do not either.

REVENUE EFFECT OF TREATY

The CHAIRMAN. What effect would this treaty have upon the revenues of the U.S. Government?

Mr. SURREY. The revenue aspects of this treaty are quite minor and I think this is a point that I should touch on. I do not want to give the impression that we are talking about vast sums, because we are not.

The CHAIRMAN. What is the amount?

Mr. SURREY. It is our best guess that—for example, last year the revenue effect would be negligible because there was a net outflow of investment from Brazil.

The CHAIRMAN. From Brazil?

Mr. SURREY. 1965; that is right. A net outflow.

The CHAIRMAN. What is the estimated revenue cost——

Mr. SURREY. Of course, that depends on the level of investments, but I would say under $5 million for a current year, as respects our best judgment of investment in Brazil. That is what the investment credit clause would cost. If I had to estimate for all of Latin America, I would say that the cost of extending the investment credit would come to under $15 million for all of Latin America.

The CHAIRMAN. You are speaking now just of investment credit?

Mr. SURREY. That is the only cost we incur.

The CHAIRMAN. There are no other overall effects on our income?

Mr. SURREY. That is correct.

The CHAIRMAN. Tax income?

Mr. SURREY. Basically, that is correct.

AMERICAN INVESTMENT IN BRAZIL

The CHAIRMAN. While we are on that, what is the present level of American investment in Brazil?

Mr. SURREY. In 1965 there was a net outflow of investment from Brazil because of problems in Brazil.

I do not have the final statistics for 1966, but I think it would be estimated for 1966 at around $85 million. We have a billion dollars invested in Brazil.

The CHAIRMAN. Cumulative total?

Mr. SURREY. Cumulative. In the years 1963, 1964, and 1965, the net result was negative. In 1966 it began to turn up, partly because of investment guarantees, partly because of a lot of other factors associated with Brazil, such as currency stabilization. And it was just in 1966 that the Brazilian Government came to the realization that international accommodations would be helpful to it, and it was in 1966 that they sent their tax negotiators to Europe, Japan, and the United States to ask what is there in the international treaty world that will facilitate investment in their country. That started in 1966 which, I think, represented a new attitude on the part of the Brazilians toward foreign investments generally in their country.

Now, similarly there are concessions by the Brazilian Government in this treaty, revenue concessions which are difficult to estimate. Our best estimate is that they would be somewhere in the neighborhood of, I think, $3 to $4 million. In other words, I think they do match our concession, but it is hard to say because and some of the concessions such as that regarding the permanent establishment are nearly impossible to measure. But looking at the treaty as a whole I think it is balanced, and I do want to emphasize that the revenue cost to the United States is very minor. To put it in some perspective, the invest-

ment credit in the United States runs at a level of $2½ billion. Now, we are talking here of an extension of that credit which, I think for Brazil, at least looking ahead, would be under $5 million and looking at all of Latin America, I do not see rising above $15 million, and I see in most cases matched by appropriate revenue concessions on the part of the other governments involved in the interest, as I said, of leaving companies in the same position as they would be in this country.

SUBSIDY FOR U.S. INVESTMENT IN BRAZIL

Senator GORE. But be it $5 million or $50 million it operates as a subsidy from the U.S. Treasury for investment in Brazil.

Mr. SURREY. It operates to extend the benefits of the investment credit to U.S. investment in Brazil.

Senator GORE. You are saying in technical terms what I have said in practical terms.

Mr. SURREY. If you want to say that the subsidy that we now give——

Senator GORE. You can say it a third way if you want to.

Mr. SURREY. If you want to say that a subsidy we give to investment in the United States for good and sufficient reasons, this same benefit would be extended to the U.S. company investing in Brazil.

Senator GORE. Do you have a list of the companies that would share this $5 million?

Mr. SURREY. No, I don't, because that would depend on which companies are going ahead and making investments.

Let me indicate, Senator, that the investment credit is the same for the United States with one exception and that is that the company has to be making a net new investment in Brazil.

Senator GORE. I understand that.

Mr. SURREY. Consequently, a company that withdraws its profits from Brazil under certain conditions does not get the investment credit. I do not have a list because I just don't know which of the companies will be investing in Brazil.

Senator GORE. Thank you, Mr. Chairman.

ANY OPPOSITION TO BRAZILIAN TREATY?

The CHAIRMAN. Mr. Surrey, do you know of any objection from any source to the Brazilian treaty?

Mr. SURREY. I do not know of any objections to the Brazilian treaty in this sense. I think all of the business organizations that I have talked to and discussed this with, believe that the Brazilian treaty should be approved. Now, I think there are some who would have said "why didn't you get more concessions from Brazil." I think there are still aspects of the Brazilian system that we should consider and we have had discussions with Brazil and I believe that there will be improvements in time in the Brazilian system. I also think there are some companies that have some very technical questions with the very minute details of the investment credit, which are inevitable as you go along and which they have asked us to keep in mind when we negotiate with other countries.

The CHAIRMAN. That doesn't mean they are opposed?

Mr. SURREY. I do not know of any business organization or any business that is opposed to the Brazilian treaty. And on the other hand, I think they recognize that the Latin American countries are now, for the first time, being concerned really with private investment in their areas, and they feel that the United States will have to maintain its position in Latin America and that one way of maintaining its position is to have the international tax accommodation which the other countries of Europe are achieving.

The CHAIRMAN. Can you say the same thing about the conventions with Trinidad and Tobago and Canada?

Mr. SURREY. Yes, I know of no objections to that or to Canada.

APPLICATION OF INVESTMENT TAX CREDIT TO EXTRACTIVE INDUSTRIES

The CHAIRMAN. I understand investment tax credit does not apply to extractive industries; is that so?

Mr. SURREY. The investments credit does not apply to the extractive part of extractive industries; that is correct. No American company extracts oil in Brazil as I understand it. There is some mining in Brazil.

The CHAIRMAN. Some iron ore?

Mr. SURREY. Beg your pardon?

The CHAIRMAN. Some iron ore, some minerals?

Mr. SURREY. Yes, iron ore and bauxite.

Senator GORE. I don't know why companies would object because in testimony on this subject last year, Mr. William L. Hearn of United States Steel testified that the 7 percent investment credit for investment abroad was a gift. I don't know why they would object to Santa Claus.

Mr. SURREY. I suppose he would say that the investment credit in the United States would be a gift and United States Steel may have its attitude on the investment credit in the United States. It has helped to modernize United States Steel, however, which I think is helpful to the United States.

The CHAIRMAN. Senator Pell?

Senator PELL. Thank you, Mr. Chairman.

SUPPORT FOR 1962 INVESTMENT TAX CREDIT

I would just like to reinforce Senator Gore's recollection as to the reason we agreed to the 7 percent investment credit in 1962. I know in my part of the country we urged support of it because of the question of foreign competition to upgrade our own industrial plants immediately. That was the main selling point to my people, as I recall, at that time.

Secondly, I must say I have always agreed with the statement that consistency is the mark of the small mind but yours seems very large when I was going through your statements in 1958 opposing any special privileges or provisions to foreign countries, I think in connection with tax treaties.

I think also since you mentioned the letter from our Chairman, Senator Fulbright, it would be advisable, if it is agreeable with the Chairman, to have the entire correspondence included in the record at this point.

Senator MORSE (presiding). The entire correspondence will be included in the record at this point.

(The correspondence referred to above follows:)

TREASURY DEPARTMENT,
Washington, D.C., July 26, 1966.

Hon. J. W. FULBRIGHT,
Chairman, Foreign Relations Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The pending tax convention between the United States and Thailand includes a provision granting United States taxpayers a 7 percent credit for new investment in Thailand. In certain respects this credit mechanism differs from that of the 7 percent credit allowed under the Internal Revenue Code for domestic investment. I understand the question has been raised in your Committee whether these differences might be eliminated so that the treaty credit would produce benefits no greater than those available under the domestic credit.

The usual manner for effecting such a modification would be to include a reservation in the resolution consenting to the ratification of the treaty. The attached draft of such a reservation, to which the Treasury would not object, would fully accomplish this objective.

The revised treaty credit incorporates all of the operative provisions of the domestic credit. The domestic credit applies only to purchases of machinery and equipment for use predominantly in the United States. In effect, the starting point of the revised treaty credit is to extend the domestic credit to purchases of machinery and equipment for use in Thailand. Thus, the treaty credit, like the domestic credit, would be available only with respect to the acquisition of depreciable tangible personal property; the limitations of the domestic credit relating to used property, the useful life of the property, and the amount of tax liability against which the credit may be taken are also incorporated in the treaty credit. In addition, the provisions of the domestic credit relating to a recapture of the credit upon a premature disposition of the property are made applicable under the treaty credit. Some of the minor technical provisions of the domestic credit are not spelled out in the treaty, but are implicit and will be covered in detail in the regulations which the Treasury is authorized to prescribe under paragraph (5) of the attached Article 5.

I might also point out that paragraph (4) contemplates that if modifications are made in the domestic credit or if that credit is suspended or terminated, these changes will automatically apply to the treaty credit.

The balance of Article 5 relates to additional limitations, included in the present article of the pending treaty, which are necessary to insure that the objective of the treaty credit will be accomplished. I would like to emphasize that these provisions merely limit what would otherwise be available under the domestic credit, and in no way extend the benefits of the domestic credit.

The additional limitations are basically threefold. The first limits the credit to those situations where new capital is in fact injected into Thailand. Thus, unlike the case of the domestic credit, an existing Thai business will not be entitled to a credit merely by purchasing new machinery and equipment; instead, the capital used for such purchase initially will have to be new capital rather than funds presently on hand or funds borrowed in Thailand. Second, the credit is available only with respect to machinery and equipment used in a qualified "trade or business." The list of qualified trades or businesses in paragraph (3)(c) of the revision follows the one in the pending treaty, with the exception that certain public utilities have been eliminated. The third limitation is that the credit allowed for any taxable year may not exceed the amount of United States property purchased for use in the Thai business.

If you should have any questions about the attached draft, I would be happy to discuss them with you. The draft has also been discussed in detail with Dr. Woodworth, Chief of Staff, Joint Committee on Internal Revenue Taxation, who is prepared to discuss it with you if you should so desire.

I would appreciate the opportunity to discuss this letter, and other matters relating to the Thailand treaty, with your Committee.

Sincerely yours,

STANLEY S. SURREY,
Assistant Secretary.

84-890—67——3

[Insert to be included at the end of the resolution of ratification of the Thai treaty.]

Subject to the reservation, which is hereby made a part and condition of the resolution of ratification, that Article V be amended to read as follows:

ARTICLE 5

(1) (a) An eligible investor in an eligible corporation shall be allowed as a credit against the U.S. income taxes otherwise payable, an amount equal to 7 percent of his allocable share of the applicable percentage of the eligible property placed in service by the eligible corporation during the corporation's taxable year. The credit shall be allowed in the taxable year of the investor in which or with which such taxable year of the corporation ends. The amount of the credit, however, shall not exceed the lesser of—

(i) 7 percent of the eligible investor's net new investment for his taxable year (as defined in paragraph (3) (f)); or

(ii) the amount of U.S. property acquired by the eligible corporation, during its taxable year in which it placed the eligible property in service or during the preceding taxable year, and attributed to the eligible investor.

(b) Notwithstanding subparagraph (a), the credit allowed for any taxable year shall not exceed—

(i) so much of the liability for U.S. income tax for the taxable year as does not exceed $25,000, plus

(ii) 25 percent of so much of such liability as exceeds $25,000.

For purposes of this subparagraph, such liability shall be computed after all allowable credits other than the credit allowed by section 38 of the U.S. Internal Revenue Code (relating to a credit for domestic investment). If the amount of the credit allowed under subparagraph (a) exceeds the limitation provided in this subparagraph, the unused credit shall be carried forward for a period not in excess of five years.

(2) (a) If, before the close of the useful life of any eligible property which was taken into account in computing the credit in paragraph (1)—

(i) the eligible corporation disposes of such eligible property;

(ii) such property ceases to be eligible property;

(iii) the eligible corporation or the eligible investor ceases to be eligible; or

(iv) the eligible investor disposes of his investment in the eligible corporation,

then the U.S. income tax of the eligible investor shall be increased (or the credit carryover shall be decreased) by an amount equal to the aggregate decrease in credits allowed for all prior years which would have resulted solely from substituting, in the computation of the credit for such years, for such useful life the period beginning with the time such property was placed in service by the eligible corporation and ending with the date of the event specified in this subparagraph.

(b) If an eligible investor withdraws any property from an eligible corporation, the U.S. income taxes otherwise payable by such eligible investor shall be increased (or the credit carryover shall be decreased) by an amount equal to the aggregate decrease in credits allowed for the prior three years which would have resulted solely from substituting, in the computation of the limitation of the credit for such years, the recomputed amount of new investment made by such eligible investor in the eligible corporation in such years. For purposes of this subparagraph, a withdrawal from the eligible corporation by a person related to the eligible investor, or a withdrawal by the eligible investor or a related person from another corporation conducting in Thailand a trade or business similar or related to a trade or business conducted by the eligible corporation may, under regulations prescribed by the Secretary of the Treasury of the United States or his delegate, be considered to be a withdrawal by the eligible investor from the eligible corporation.

(3) For purposes of this Article:

(a) The term "eligible investor" means a resident of the United States or a U.S. corporation which owns, or under regulations prescribed by the Secretary of the Treasury of the United States or his delegate, is a member of a group of U.S. residents or corporations which owns, at least 25 percent of the total combined voting power of the stock of an eligible corporation.

(b) The term "eligible corporation" means a U.S. corporation or a Thai corporation if, for its taxable year, it derives at least 80 percent of its gross in-

come, if any, from, and at least 80 percent of its assets (including assets located outside Thailand) are used or held for use in connection with, one or more of the qualified trades or businesses described in subparagraph (c).

(c) The term "qualified trade or business" means any trade or business actively conducted within Thailand and consisting of—

(i) the manufacture, production or construction of property (not including the extraction, refining, or similar processing of any mineral, ore, oil or gas) or the processing of agricultural or horticultural products or commodities (including but not limited to livestock, poultry, fur-bearing animals or any kind of fish);

(ii) the market of agricultural or horticultural products or commodities (including but not limited to livestock, poultry, fur-bearing animals or any kind of fish);

(iii) the transportation within Thailand of passengers and/or freight;

(iv) the catching or taking of any kind of fish;

(v) the sale of tangible personal property to the general public through one or more retail establishments; or

(vi) the performance of services utilized within Thailand, if the services are industrial, financial, technical, scientific, engineering or architectural in nature or are rendered as an incident of a trade or business of the kind described in (i) through (v), and any payments in consideration of such services are reasonable in amount and are not contingent either in whole or in part on the sales, productivity, or profits of the person for whom these services are performed.

(d) The term "eligible property" means property which is—

(i) "new section 38 property" or "used section 38 property" within the meaning of section 48 of the United States Internal Revenue Code of 1954 (but determined without regard to subsection (a)(2) of such section);

(ii) used exclusively in the active conduct of a qualified trade or business; and

(iii) acquired by the eligible corporation in a taxable year to which this Article applies.

(e) The term "applicable percentage" means the percentage taken into account under section 46(c)(2) of the United States Internal Revenue Code of 1954.

(f) The term "net new investment" for any taxable year means the sum of—

(i) the amount for such taxable year and the nine preceding taxable years (but excluding any taxable year to which this Article is inapplicable) of—

(A) any property transferred to an eligible corporation by an eligible investor as a contribution to capital or in exchange for stock or indebtedness of the eligible corporation, but only to the extent that such property does not represent, directly or indirectly, funds borrowed within Thailand; and

(B) the eligible investor's allocable share of creditable reinvested earnings of the eligible corporation;

(ii) with respect to any eligible property (or the portion thereof) for which the eligible investor received a credit under paragraph (1)(a) which was not recaptured under paragraph (2)(b)—

(A) if such property was used by the eligible corporation for five years or more, the amount of the reserve for depreciation;

(B) if such property was disposed of, the cost of such property less the amount referred to in clause (A),

less the amount of credits allowed to the eligible investor during the nine years preceding the taxable year (determined without regard to paragraphs (1)(b) or (2)) divideded by 7 percent. In the event of a withdrawal of property by the eligible investor, the amount of such withdrawal shall reduce the investment, to the extent thereof, made in the year of withdrawal, the three years preceding the withdrawal, and the year subsequent to the withdrawal.

(g) The term "creditable reinvested earnings" means an amount equal to one-half of the earnings and profits of the eligible corporation for its taxable year, reduced by the amount of any dividends it distributed during such year.

(h) The term "withdrawal" means—

(i) a distribution made by an eligible corporation to the eligible investor which either—

(A) is not out of earnings and profits;

(B) is in excess of 50 percent of the earnings and profits for the year of distribution; or

(C) is in cancellation or redemption of the stock of the eligible corporation; and

(ii) the payment by an eligible corporation of an indebtedness to the eligible investor.

(i) The term "U.S. property" means any tangible property which has been manufactured, constructed, produced, grown, extracted or created in the United States and thereafter continuously used, if at all, only in the United States.

(4) This Article shall not be effective with respect to any taxable year for which section 38 of the United States Internal Revenue Code of 1954 (or any subsequently enacted comparable section of said Code) is not in effect. If the credit provided by said section 38 (or comparable section) is modified, amended, suspended or terminated, the comparable provisions of this Article shall automatically be modified, amended, suspended or terminated upon terms and conditions consistent with those applicable to said credit provided by section 38 (or comparable section).

(5) The Secretary of the Treasury of the United States or his delegate shall prescribe such regulations as may be necessary to effectuate the provisions of this Article, to integrate it with the provisions of the United States Internal Revenue Code, and to further define and determine the terms, conditions, and amounts referred to herein.

AUGUST 9, 1966.

Hon. STANLEY S. SURREY,
Assistant Secretary of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: This will acknowledge your letter of July 26, 1966, enclosing a proposed reservation to the tax treaty with Thailand which is pending before the Committee on Foreign Relations.

As a matter of procedure for the handling of treaties, it seems to me that redrafts as extensive as that which you propose should not be considered in the format of reservations to the treaty. While I would not in any way want to imply that the Senate should not remain free to give its advice and consent to treaties with such amendments, reservations, or understandings as the Senate finds appropriate, I am most reluctant to proceed in this manner in this instance.

It seems to me that the proper procedure would be for the Administration, in the light of its discussions and hearings with the Committee on Foreign Relations, to withdraw the Thai convention, renegotiate the investment credit provision, and re-submit the treaty to the Senate. To follow the course which you suggest means, in effect, that the Senate is being asked to approve a treaty with a reservation drafted by the Administration with only informal assurances that the proposed language would be acceptable to the other side. This injects the Senate too far into the negotiating process and is, I think, somewhat inconsistent with the role assigned to the Senate in providing an independent judgment upon treaties negotiated by the Executive.

I should add, as I am sure you will understand, even an extensive re-drafting of the convention may not meet all objections, and, indeed, definitely would not meet the basic objection which some Members of the Foreign Relations Committee have voiced against extending the benefits of the investment tax credit for investments made outside the United States. As you know, the vote in the Subcommittee was unanimous in favor of a reservation which would have completely eliminated Article 5.

Sincerely yours,

J. W. FULBRIGHT, *Chairman.*

INVESTMENT TAX CREDIT PROVISION IN THAI TREATY

Senator PELL. What this letter really does is to say very firmly that the Senate Foreign Relations Committee rejected the Thailand treaty with the 7 percent investment credit in it, and suggested that you renegotiate it. This was August 9, 1966. Well, in view of that fact, I am wondering why you went ahead and negotiated this treaty with Brazil?

Mr. SURREY. Senator, let me answer the questions in reverse order.

Senator PELL. Right.

Mr. SURREY. The letter from Chairman Fulbright, I think, does not indicate that.

The question had come up in connection with the Thailand treaty, and we think it was a fair observation, that the investment credit in the Thailand treaty was not on the same terms as the investment credit in the United States. I had suggested in a letter to the Chairman that that was a proper objection, and we indicated that that could be met by a reservation which would put it on the same terms. The Chairman said he thought that was a complex way and it was not an appropriate way and that aspect should be renegotiated, first to see if Thailand would agree and then present it in those terms to the committee. The previous action on the treaty was by a subcommittee of this committee, not the full committee.

Now, consequently, we did exactly what the letter said. We explored whether the extension of investment credit could be written on terms similar to its application in the United States and whether that would be acceptable to a foreign country, and that has been done, Senator, in this treaty.

Now, it is acceptable to a foreign country on the condition, of course, that they are free to withdraw their concessions if the United States withdraws its concession. So, consequently, that has been done. You will recall at the time of the Thailand treaty the investment credit was suspended in the United States just about the time that this matter was up for consideration in the Senate Foreign Relations Committee. In that sense, the whole matter became academic on that point and since Senator Fulbright had asked us to see if the clause could be negotiated we recognized that was proper, a proper attitude and we set about seeing if it could and we have found out it could.

DIFFERENCES IN INVESTMENT CREDIT PROVISIONS IN TWO TREATIES

Senator PELL. What is the difference between the investment credit provisions in the Thailand and the Brazilian treaties—the 7 percent investment credit provision as drafted by you in the Brazil treaty as opposed to that in the Thailand treaty?

Mr. SURREY. There are these differences: In the Thailand treaty if the 7 percent investment credit as last year was suspended in the United States, it would have continued in the Thailand treaty for five years. At the end of five years the United States had the right to reexamine that. In the Brazilian treaty if that treaty had been in effect and the investment credit had been suspended as it was last year in the United States, it would have been automatically suspended in the Brazilian treaty.

In addition, the investment credit in Thailand was based upon a credit for investment in Thailand, but not tying down that investment to investment in machinery and equipment. In the Brazilian treaty the credit is only for machinery and equipment which would qualify in the United States. Also, all the other rules of the investment credit, the limitation, for example, that there can be no more than 50 percent of U.S. tax offset are incorporated by reference in the Brazilian treaty. It is tailored, if it is changed in the United States, it is automatically changed in the Brazilian treaty without negotiation. There is an automatic result.

Senator PELL. Then what is being done, as I understand it, is that it is being brought more in line with the American tax credit treatment of American citizens.

Mr. SURREY. I think basically at the suggestion of a number of members of this committee.

Senator PELL. As you know, this is just the reverse of my own view because I feel it should be a little bit different, not 7 percent, but 8 or 6 and I, obviously, have differed with you.

Mr. SURREY. You have that viewpoint; it should be 6 or 8; but others have insisted that it should be no more than 7 and exactly 7.

Senator PELL. I am not saying it should be 8, but I am saying if it is accepted at all it should be, from my viewpoint, no more different from the logic we used in accepting investment credit as we did at the beginning.

Mr. SURREY. Can I go back and answer two observations you made?

Senator PELL. Surely.

TAX-SPARING TYPE TREATIES

Mr. SURREY. One was that of consistency, and without going into whether it is a virtue or defect let me at least explain what may appear to you to be an inconsistency.

The United States had negotiated one or two treaties in the 1950's, which were treaties of the so-called tax-sparing type, which meant, for example, if a foreign country reduced its tax rate, let us say, to zero—let's take a foreign country which has had a 48 percent tax rate, and let's say reduced its rates to zero to attract foreign investment—a tax-sparing treaty would mean in perhaps an extreme situation that the United States in applying its foreign tax credit would say, "Well, you would have paid a foreign tax at 48 percent if it hadn't been reduced; therefore, we will consider you as having paid a rate of 48 percent; therefore, when the United States comes and says we want a tax of you of 48 percent all you have to show is that you didn't pay a 48 percent tax abroad and, therefore, you get a credit, and, therefore, you pay nothing to the United States."

Now, I thought in 1958—when I was asked to comment upon it by this committee in another capacity then—I thought that was extremely unwise because it would, as Senator Gore points out, have been a terrific windfall, and would have—looking at your Rhode Island manufacturers—it would have said that a Rhode Island investor who went to the foreign country would pay taxes to nobody in the world, but a fellow who stayed in Rhode Island would pay 48 percent, and I thought that was dead wrong. We still think it is wrong, and the State Department agrees, and we have not negotiated treaties of that character, although I must say that there is a feeling in the Latin American countries and other countries that tax sparing is an appropriate way. I think it is a misguided view and we are hoping to indicate that to them. Some European countries will negotiate that kind of treaty. We think it is wrong. This present treaty at least says if you are an American company you don't get windfalls by going to Latin America. The company is subject—as I said to Senator Gore—to a financial extraction, and it would be the financial extraction that it would have in this country. So consequently, I think the difference be-

tween those treaties in 1958 and the Brazilian treaty is sharp and crucial, and this administration did not follow through on any of the tax-sparing treaties.

PURPOSE OF 1962 INVESTMENT TAX CREDIT

Let me come back to your first question of the investment tax credit in 1962. It was to help our manufacturers, and it was to help our companies. It was to help them in two ways, basically: One, a lot of investment was going to Europe, some of it, I think, under the pull of lower tax systems in Europe, perhaps not appreciably, but to some extent, and secondly we were getting import competition, very severe import competition, from the industrialized countries of the world who had more modern tax systems than the United States had. That is what our target was. If you look at Secretary Dillon's testimony before the committees, he compared the rates of tax and the rates of depreciation and investment credit between the United States and the industrialized countries of the world. The tables that were given and the comparisons that were given were with the industrialized countries. We said that our tax structure, the weight of our tax structure will not be as heavy with the investment credit as it was up to then and will be more in line with Europe, and I might say our reduction in 1964 was along the same pattern. It brought our rates comparatively in line. We did not, at any stage that I recall, discuss the developing countries.

When all that was over, then the question came up, and it came up in the context of some of the developing countries interested in treaties and in the case like Brazil, what about those countries? They said: "If you ask us for international accommodations, will you remove a barrier to investment in our country?

Now, if France were to ask us to extend the investment credit for investment to France, we would say that is ridiculous. Portugal is negotiating with the United States. We are not extending the investment credit to Portugal.

DEFINITION OF A DEVELOPING NATION

Senator PELL. What is a developing nation?

Mr. SURREY. I think the nations of Latin America are developing nations. We have tried to maintain a consistency of approach here that follows other measures of the United States involving the same distinction. The interest equalization tax does not apply to funds borrowed in the United States by developing countries. We have been following that list so far. The voluntary guideline program also does not apply to developing countries.

Senator MORSE. Mr. Surrey, I am sorry I have to interrupt. We will recess the hearing for that period of time necessary for members of the committee to go to the floor and vote. We will be back shortly.

(Short recess.)

Senator PELL (presiding). The session will resume. As a means of saving time, we might continue with the line of questioning I was pursuing until either Senator Fulbright or Senator Morse returns to preside more officially. But from the viewpoint of the record the session is resumed.

TAX CREDIT ON BRAZILIAN GOODS PRODUCED FOR EXPORT

Pursuing this line of questioning that Mr. Surrey and I were on earlier, at one point we had a discussion two years ago, I think it was in August of 1965, in which I asked whether or not it would be possible to administer the investment tax credit provision whereby those goods that were produced for export to the United States, in competition with our own goods, would be excluded. At that time Mr. Surrey was kind enough to say he thought it could be handled. I think his phrase was, "I think we can, I would like to think about it."

Now that you have had a chance to think about it, I wonder if you think it could be handled or not.

Mr. SURREY. "Handled," meaning mechanically, technically handled?

Senator PELL. Technically, yes.

Mr. SURREY. I think I would have to answer the question that I suppose it could. It would involve tracing of products, and the like, and might involve a good many complexities, but I would suppose it could. But I do not want that to be construed as indicating I in any way would think it, one, wise, or, two, necessary. I think overwhelming American investment in Brazil in manufactured products is for either the Brazilian market or a Latin American market. Many of the companies that I have talked with—and I have been interested in that question myself—and when I have asked "What is your market when you are down there to invest," and they say, "Well, Brazil is an enormous country, a country with such great potential, our market is Brazil, it is an indigenous market," or it is Latin America. The trade statistics and the like will show an almost negligible inflow of manufactured goods from Brazil into the United States and a fortiori from U.S. subsidiaries in Brazil.

So I say, looking at it from that standpoint, and looking at it from the standpoint of our Latin American countries, it would be resented as saying, "Well, yes; you would like to help us but never, never at any possible expense to you."

TREATY NEGOTIATIONS WITH PAKISTAN QUESTIONED

Senator PELL. Is a treaty being contemplated with Pakistan?

Mr. SURREY. No, we have no negotiations with Pakistan. We have a treaty with Pakistan.

Senator PELL. But not with the 7 percent investment credit.

Mr. SURREY. Right; and we have no negotiations with Pakistan.

Senator PELL. There is no discussion with the Pakistanis that may be contemplated.

Mr. SURREY. We have no discussions with Pakistan.

Senator PELL. I understood Pakistan was on the list of countries to be considered for this type of treaty.

Mr. SURREY. No. We have had no discussions with Pakistan. As I say, our discussions now, we are focusing our discussions at the present moment with Latin American countries.

TREATIES CONTEMPLATED WITH OTHER COUNTRIES

Senator PELL. What other countries are you contemplating similar treaties with?

Mr. SURREY. As I say, for the moment we are focusing our attention on the Latin American countries. We had announced publicly negotiations with Jamaica and negotiations with Trinidad in the Caribbean. We have also publicly announced negotiations with Argentina and have held one set of discussions with them, one round, and that has been adjourned for further discussions.

We would be hopeful of discussions with other major Latin American countries where they are presently engaged in conversation with European countries.

Senator PELL. Are you contemplating—

Mr. SURREY. Yes.

Senator PELL. I am sorry, go ahead.

Mr. SURREY. We have had discussion but we have not advanced them appreciably yet with South Korea.

Senator PELL. Are you contemplating a treaty with Israel?

Mr. SURREY. We signed a treaty with Israel. It had the investment credit clause in it which was of the type that was criticized. We have not renegotiated that.

Senator PELL. It is not in force?

Mr. SURREY. It is not in force. We have not renegotiated it as yet. We have not as yet had discussions.

Senator PELL. In other words, the investment credit provision in that treaty was of the kind in the Thailand treaty?

Mr. SURREY. Yes. It was written into that treaty. And following Chairman Fulbright's letter, we have not entered into discussions with them further on that matter.

AGREEMENTS WITH THE 7 PERCENT INVESTMENT CREDIT

Senator PELL. Are there any other countries that you have agreements with as you have with Israel?

Mr. SURREY. Initialed agreements.

Senator PELL. Is this an initialed agreement?

Mr. SURREY. Oh, signed.

Senator PELL. Signed.

Mr. SURREY. We have an agreement with Thailand and Israel, and we have an agreement with the Philippines.

Senator PELL. With this 7 percent investment credit?

Mr. SURREY. No. The Philippine treaty does not have the 7 percent investment credit.

Senator PELL. What countries do you have signed agreements with that contain 7 percent investment credit?

Mr. SURREY. Seven percent?

Senator PELL. Signed agreements.

Mr. SURREY. Thailand and Israel, but of the kind the committee asked us to renegotiate—but we have not renegotiated—and now Brazil.

The treaty with the Philippines does not have the investment credit. The reason is we did not feel that the changes made by the Philippine Government removed all of the impediments that would exist with respect to American investment in the Philippines, and in that situation both Governments felt that this aspect of the treaty should be reserved for future discussions. That treaty is still pending before this committee.

PROBLEM OF AN INVESTMENT TAX CREDIT CLAUSE

Senator PELL. I think that the Chairman's letter is open to interpretation, and since the text is already in the record it would speak for itself. But I must myself read into the record, if I may, this last paragraph from the letter where the Chairman says:

> I should add, as I am sure you will understand, even an extensive redrafting of the convention may not meet all objections, and, indeed, definitely would not meet the basic objection which some Members of the Foreign Relations Committee have voiced against extending the benefits of the investment tax credit for investments made outside the United States. As you know, the vote in the Subcommittee was unanimous in favor of a reservation which would have completely eliminated Article V.

To my mind, the intent of such letter is to wave a signal, which we sought to do as members of the subcommittee, not to go ahead with any more negotiations, including the investment tax credit, until this point is resolved. I realize this is a point of disagreement between us.

Mr. SURREY. Well, as I say, I do not want to speak for the Chairman.

Senator PELL. Right.

Mr. SURREY. I did not read the letter that way. I read the letter as indicating that the point could never be resolved without our bringing to the Senate, to this committee, a treaty that had an investment credit clause of the type that we had said we think should have been entered into in a reservation in the Thailand treaty.

We had suggested there were problems with the Thailand treaty that center around the character of the investment credit clause, and I think there were genuine problems, in other words, what would happen if the investment credit clause were suspended in the United States. I think at the time the Thailand treaty was negotiated that the Treasury had always looked upon the investment credit as a permanent part of the tax structure in the United States. But at the time the Thailand treaty came before your committee, there were discussions of suspending the investment credit in the United States, and, therefore, it raised for the first time that precise issue which we had not focused upon because we had a different view of the investment credit.

Well, that being so, we can see the attitude that the two should be on the same basis so we suggested the reservation in the Thailand treaty. The Chairman said it is inappropriate for us to consider the reservation until we know whether the other countries would consider the investment credit clause under those circumstances.

So the consideration of the matter could not be advanced unless we came back to this committee with a treaty which had an investment credit clause written in the way that we had ourselves suggested and we could say to the committee that other governments will accept it.

Now, I can say two things: This clause does comport with the suggestion we made. Other governments will accept it but conditionally.

In other words, Brazil has said that its concessions are linked to the investment credit, and, consequently, if we were ever to terminate or suspend the credit, they will terminate or suspend their changes. Now, it is in that posture that the matter is brought back, and I really do not see, Senator, how it could be brought back in any other way.

I might say there have been suggestions—there have been conversations as a result of this letter with the Chairman of the committee before these matters were brought back to the committee.

NEGOTIATION OF TREATIES WITH TAX CREDIT PROVISION

Senator PELL. I query how tidy a procedure it is though when it has been more than two years—when was the treaty with Thailand actually signed?

Mr. SURREY. 1965.

Senator PELL. I wonder from your viewpoint as to the orderliness of continuing to negotiate agreements and sign them when you have clear indications of problems up here with ratification.

Mr. SURREY. But, as I stated, Senator, as we understood the letter, and in the course of further discussions, our understanding was also that stated by the Chairman, the only way the matter could be brought to the committee would be through a treaty.

Senator PELL. Why not wait to find out——

Mr. SURREY. We cannot do it until there is a treaty before you.

Senator PELL. I see. In your view, the guinea pig is the present treaty we are considering now.

Mr. SURREY. Yes. The Chairman said he did not want it in the form of a reservation. He said this would inject the committee too far in the negotiating process and, therefore, we should negotiate with another country. The only way I can do that is to negotiate.

Senator PELL. So your thought is to bring the matter to a head. Let us consider the Brazil treaty, and then if it is approved move on from there. On the other hand, if we do not approve it, you will not be able to move on.

Mr. SURREY. Yes, yes; that is correct. Also I want to add one other thing, Senator. That suggestion of the Chairman to see if other countries will agree to this kind of a clause coincided with an interest on the part of Latin American countries, a strong interest exhibited for the first time. In other words, a number of Latin American countries exhibited for the first time the fact that they were beginning to welcome private investment and wanted to bring about the international accommodations necessary. It all coincided at that time, so we thought—and there were discussions about this with the Chairman—it would be appropriate to focus attention on the course of U.S. relationships with Latin America.

Senator PELL. If the Senate takes no action on this treaty with Brazil, would you sign agreements with any more countries?

Mr. SURREY. I would consult with the Chairman and with the committee.

Senator PELL. Prior to signing.

Mr. SURREY. Yes.

I might say, Senator, that the discussions with Argentina were not commenced until this committee was notified of that fact.

Senator PELL. I am fully aware of that. I am just wondering if you were contemplating signing other similar agreements with various governments before the Senate decides what to do about the treaty with Brazil.

Mr. SURREY. No, I would discuss the matter with this committee. I have been attempting, I think, today to underscore the very important aspect of this with respect to the relationship of the United States to Latin America and to indicate how important it is.

Now, this Brazilian treaty was signed in March of this year, so there has not been a lapse of time that followed.

WISDOM OF SIGNING SIMILAR AGREEMENTS QUESTIONED

Senator PELL. But just speaking as one member of the committee, one Senator, I am just wondering what is your view. Do you not think it would be a bit improper to sign an agreement with another nation until this matter has been resolved and the treaty with Brazil ratified or rejected?

Mr. SURREY. No; it would not necessarily be improper, and let me indicate why. Negotiations are difficult matters. You do not do it in one year and at one meeting and get it over with. You have a number of conferences. Ministers change in other countries, people change, attitudes change. There is a sense of rhythm in these matters and a sense of movement, and I am now speaking of the interests of the United States with respect to Latin America.

If you find a government that suddenly says, "We are interested in opening relations with the United States in the tax field," I think it is important for the United States to negotiate with that government and to move ahead and to see what can be done because times may change. Now, this committee always reserves the right to pass its judgment on these treaties.

Senator PELL. But it is embarrassing when a treaty comes up signed. My question though is not about negotiating. I said would you consider it good and proper to sign an agreement with another nation of the same sort prior to either the acceptance or ratification or rejection of this treaty?

Mr. SURREY. As I say, we do not like to be put in that position. We would not want to be, but on the other hand I would say that it may well depend upon the circumstances. For example, you may have another country in a position where it is simultaneously signing a treaty with several European countries and does not want to be put in the position of not signing a treaty with the United States. Let me say for the moment with the exception of Jamaica there is no Latin American treaty which could be signed this year. Does that more specifically answer your question?

Senator PELL. No. I would like the thought of my more learned colleague, Senator Morse, who is a lawyer and more familiar with the constitutional processes than I. The question I was trying to pursue here was whether it would be proper to sign an agreement of the same sort with another country prior to the time that this one had been either ratified or rejected.

My view, speaking as an individual Senator, is that it would not be proper. I hate to say, proper—Mr. Surrey's view is that it would be acceptable if you determine it were in the national interest.

Mr. SURREY. Might I say this, Senator: we have taken a different view of the matter, I think. We think it would be more helpful for this committee, and we have always felt so, to be able to see a full range of treaties with a number of countries so they would be able to see the worldwide impact of this situation. In other words, one reason why we have gone ahead with our negotiations is to get an awareness of the attitude of all these governments, because it is very difficult for the United States to enter into a treaty with one country without an awareness of what all the other countries are going to do. That is why we went ahead with Argentina, to see whether they felt that this was an appropriate approach.

Senator PELL. This is getting into much more of a constitutional discussion, and I had better reread the Constitution, the Federalist Papers, and go over my history. But it does not seem to coincide with my view of the interpretation that the Senate is supposed to give guidance in this area. I think the executive branch ought to wait and find out whether this kind of treaty is going to be ratified or not. We have as much a responsibility in determining the national interest in this regard as does the executive branch.

But this is a question, obviously, of individual interpretation, and it puts us in an embarrassing position as individuals if we have four or five treaties to consider. It is very hard to, say, turn them all down, because it would make it embarrassing for you in the executive branch. This was the thought I wanted to throw out. There are other men here who probably have other ideas.

Mr. SURREY. I hope our discussions are academic.

Senator PELL. I would very much hope so, and, speaking personally, I would think it wrong or improper to sign a treaty with another nation until this matter has been decided. But I am only one man, and as you know, it takes a two-thirds——

Mr. SURREY. I do not know of any treaty we are going to sign tomorrow, so I say in that sense I think it is also academic.

Senator PELL. Right. I just wanted to make that point. I would think so.

DEFINITION OF A DEVELOPING NATION—PORTUGAL, ISRAEL

Now—returning to the discussion we had at the time of the last vote regarding the definition of a developing nation as opposed to a developed nation—would Portugal be to your mind a developed nation? You were talking about Portugal, I think. To my mind it is no more developed than Israel.

Mr. SURREY. We have not extended the investment credit to Portugal.

Senator PELL. But you have to Israel.

Mr. SURREY. We signed a treaty with Israel. Israel is very difficult to classify. It is a country close to the borderline. Israel is a country passing out of the nature of a developing country. It still has some aid assistance from the United States, and it is in that transitional area where it is passing from one type of country with respect to our attitudes to another. Israel is a developing country under the interest equalization tax. Portugal is not. Consequently, with most of the classifications that we have, Israel has retained its character in its process of transition as a developing country. How long that will continue is hard to say, but I would say it is in that process of transition, and when you are in that process of transition, you are on the borderline of these situations.

REEXAMINATION OF INVESTMENT CREDIT CLAUSE

Now, in all of these treaties we have put in a clause that the investment credit can be reexamined independently of the entire treaty to a period of years.

Senator PELL. In other words, in your view, if it passed that line——

Mr. SURREY. That is right.

Senator PELL. It is conceivable that the investment credit would be withdrawn.

Mr. SURREY. That is right. Consequently, under the Israel treaty, the United States, after five years, can terminate the investment credit without having to terminate the whole treaty.

Senator PELL. Would the whole treaty then be acceptable to Israel?

Mr. SURREY. That would be a judgment Israel would have to make.

Senator PELL. It is my understanding from you that none of these treaties would be acceptable without the sweetener of the investment credit.

Mr. SURREY. No, not with the Latin American countries. The Philippines did sign a treaty without the investment credit clause but that is the exception and in our discussions with the Latin American countries I have not found that so. Portugal, I believe, will sign a treaty without the investment credit clause. Spain will, I think. I do not want to venture a judgment on Israel because I have not discussed it again with them and after five years, who knows?

Senator PELL. I recognize, too, the political fact that Israel is a very special country and exercises a very important moral role in the world. But I was thinking of it in economic terms.

Mr. SURREY. I think the question raised on developing countries is a difficult one, and I think up to now fortunately, with maybe one exception, we have been dealing in cases where classifications are easily made.

CONSTITUTIONAL INTENT REGARDING TAX TREATIES

Senator PELL. I would be interested in the thoughts of legal minds as to our discussion on the general question of the intent of the Constitution. It could be interesting to carry it over to fields other than tax treaties, too.

Mr. SURREY. That is quite right. I do want to say that we are in favor of harmonious relationships between the executive branch and the legislative branch and this committee, and I might say we have never taken a step in the negotiation of tax treaties without consultation with the Chairman or the committee.

Senator PELL. Consultation or notification?

Mr. SURREY. Every step in the treaty area is taken with consultation with the Chairman, and information to the committee staff.

Senator PELL. Does consultation mean seeking agreement or does it mean notification?

Mr. SURREY. I do not think we have taken a step in this area—I do not want to speak for the Chairman—but I do not think we have taken a step in the tax treaty area that has been contrary to any advice we have received from the Chairman of this committee.

Senator PELL. Thank you very much.

Mr. SURREY. That is the course I have followed.

Senator PELL. All right. Our colloquy is wound up.

Senator MORSE. Senator Pell, I want to say I was called out in an emergency, and I apologize for being late because I got buttonholed

in an emergency from downtown that I had to take care of. The question you put to me, Senator Pell—I do not duck them, but I want you to know that I am going to supply an answer to your question for the record, after I get to the books, as to what my opinion is, for whatever it may be worth.

Senator PELL. Thank you.

(The following was subsequently furnished for the record:)

Article II, section 2, clause 2 of the Constitution provides that the President "shall have the power, by and with the advice and consent of the Senate, to make treaties, provided two-thirds of the Senators present concur." It does not contain any language which would have the effect of inhibiting the Executive with regard to negotiating, signing, or submitting agreements to the Senate. On the contrary, traditionally the Executive has had a virtual monopoly in the negotiating process. I emphasize the word "negotiating." Accordingly, the question as to whether it would be appropriate for the Executive to sign an agreement similiar to one which is pending in the Senate prior to the time that body either approves or rejects the pending agreement is, in my judgment, discretionary with the Executive.

It should be noted, however, that once a treaty is submitted, the Senate may accept it or reject it, or amend it, or incorporate such reservations, understandings, and interpretations in the resolution of ratification as it deems appropriate. Thus, even though the Senate may not participate in the negotiating process, it is nevertheless in a position to stipulate the conditions under which it will give its advice and consent to ratification of an agreement.

"Advice," of course, is a word which has meaning only with respect to a prospective act, whereas the word "consent" seems more to relate to something that has already been done. One might expect, therefore, that the Executive would be guided in the negotiating process by its successes or failures in obtaining Senate consent in similar cases. As a practical and legal matter, however, the word "advice" does not seem to require that the Executive limit its freedom to conduct negotiations.

MAKING A PUBLIC RECORD

Senator MORSE. Now, Mr. Surrey, I have three or four things I want to take up with you, but first may I say to the other witnesses that Dr. Marcy was not aware of the understanding I reached with the Chairman of the committee before he had to leave.

I had made an arrangement with the Chairman that we would reconvene at 2:30 to hear the other witnesses, for I think it is very important that we make a public record.

I would like to have the other witnesses plan to do what Mr. Surrey did in regard to his testimony: file the statement but summarize it in oral testimony so that they can be available for examination.

It happens to be my judgment—this is very important in the handling of public hearings on important issues—that you do not meet the legal requirements of a public hearing unless you can say that there has been a substantial public hearing. The law does not indicate how many witnesses you need to hear, but you need to hear more than one, in my opinion, and, therefore, I am going to reconvene at 2:30 after we finish our colloquy with Mr. Surrey, to hear Mr. Woodworth, Mr. Wells, Mr. Scott, Mr. Sherfy, and Mr. Danielian.

I think, Mr. Surrey, that I will end up in support of this treaty but my job now is to sit in judgment, at least as a legislative juror, rather

than as an advocate. So I do not sit in advocacy. But once the hearing is over and the committee reaches its decision then I become an advocate when we take the matter to the floor.

SPECIFIC QUESTIONS ABOUT TAX TREATY

In order to save time I would suggest that you comment on the treaty briefly, but then file a supplemental statement. What we are going to have in this record in a very concise form is a statement from you in answer to the following questions: First, what are the advantages in this tax treaty to Brazil, one, two, three, four, and so forth?

We have to be able to say to our colleagues in the committee and on the floor of the Senate and to our constituents why Brazil wants this tax treaty. She is not knowingly negotiating a tax treaty to her disadvantage. What are the advantages to her?

Second, categorical statements enumerating the advantages of the treaty to the United States.

Three, what does the United States give up by way of this treaty, what are the alleged disadvantages, what concessions have we made, what did we agree to that made it desirable for Brazil to accept from the standpoint of our concessions?

Four, what did Brazil give up, what were her concessions?

You always need that in a concise package form because taxpayers understand that kind of a summary.

I would like to have that put into the record. When I get through you may make any brief comment you want, but maybe it would simply be better for you to do it that way in the interest of time. Just give me a memorandum that answers those questions for the record.

PURPOSE OF INVESTMENT TAX CREDIT

Now, I want to go back to the point that Senator Pell made before the vote recess. I think you will find that a good many of us on the committee supported the domestic investment credit, and as one of the few in the Senate, I opposed suspending it during that period of time that it was suspended. I thought it was a great mistake. I did not buy the argument that it was necessary for the reasons that the administration gave, and I happen to believe that in times of danger of inflation you ought to be increasing production, not decreasing it. I was not brought up in the school of economics that taught that you handle inflation by restricting production. I am talking about the producing of goods that, in turn, create wealth. But, as Senator Pell has pointed out, that was the primary reason why, I am sure, most of us voted for it in the first place, which was to strengthen production in our own country, to encourage factories in our own country to produce, to encourage expansion of businesses in our own country.

It is quite different from encouraging expansion of factories in Brazil or any other country.

CRITICISMS OF U.S. TAXPAYERS

So we as politicians have a problem with taxpayers. There is, in my judgment, in this country, considerable feeling among taxpayers that there is a flight of capital out of the United States by way of foreign

investment in American businesses abroad, which take advantage of advantages abroad, including cheap labor or supplies, and cheap raw materials. You often hear out in the political hustings in the open forum period that we are subjected to after our speeches that we are supporting the exportation of jobs, that we ought to stop exporting jobs, and that we ought to be building up American industry at home, not American industry abroad.

Now, I think you have to get into this record some answers to those arguments that a tax credit writeoff in Brazil does not build up any factory in the United States. It is, as Senator Gore said, a form of financial benefit to the American company abroad because they are able to reduce their taxes at home, and it is pretty hard to sell the taxpayer, particularly in the current state of flux in this country—and if you think it is not a state of flux you ought to come with me and try to get some votes. You are talking to men on this committee who, after all, are responsible to the voters, and there are a lot of questions about this tax writeoff that have to be answered. I think I will save time if I mention these other things and then you make whatever oral reply you want to the whole package and then file a supplemental statement.

TAX BENEFITS TO AMERICAN INVESTORS ABROAD

There is a considerable amount of criticism of our foreign assistance program—Senator Gore refers to it as a foreign aid program—but criticism that our encouraging of these American companies to invest abroad not only is a form of flight of capital but it works to the disadvantage of our economic productive power here at home. They ought to be encouraged to expand their businesses here instead of abroad.

I know part of the other side of this coin, but I am trying to give you some idea of the criticisms we have to face, and it results in their not paying taxes here to the amount that they otherwise would pay. It amounts to a tax subsidy.

It was pointed out, however, that the American taxpayer is paying an awful lot to sustain them abroad, because they are not sustained entirely on the basis of their own investment, but also the amount of money that we pour into our whole Foreign Service, our whole diplomatic protection, to maintain our prestige as a nation that protects American property and lives abroad, and as a taxpayer expenditure for a Navy and an Air Force. You know the argument that they are getting abroad what the businessman on main street gets, all the firehouses and the police departments and the city halls, and by way of governmental protection here at home they are getting a similar type of governmental protection abroad, that therefore the Congress has a duty to see to it that, if these American businesses are going to go abroad and they are not going abroad out of charitable purposes, they are going abroad with a legitimate rightful purpose of making profits, and I yield to no one in my defense of that system.

I happen to think that the most important part of our foreign policy really, is our economic program abroad. But that, nevertheless, is the taxpayer's attitude, that there is a growing trend in this country for this Government to support tax escapism, and I can hear some criticisms of this treaty unless we really buttress the record against the charge that this is another attempt on the part of American business

to get some more favoritism from the standpoint of tax benefits abroad.

I think I have said enough in these broad generalities to tell you what I think needs to be put in this record to meet this kind of criticism. You are not going to get this kind of criticism at this table because I do not see the witnesses who have been called to present Mr. John Doe Taxpayer's general criticism of our foreign assistance policy. I am only speaking now for the purpose of helping build the record. I am not speaking as an advocate.

Mr. SURREY. Senator, I appreciate that, because I think your remarks are very helpful in indicating the kind of record we have to build up.

We will submit the memorandum, you say. We will also deal with the observations that you say should be made in this regard. (See p. 48.)

I will just say a few things now and then in passing I will ask Mr. Kubisch of the State Department to indicate the position of his Department.

GENERAL AVAILABILITY OF INVESTMENT CREDIT

We, too, in the Treasury Department are concerned with flights of capital, and I think we have been concerned very much with respect to the industrialized countries of the world to see that the resources of the United States are not pushed abroad to the detriment of this country. We also have been concerned in the Treasury Department with tax escapism. I think we have been—I think the business community will find we have been—rather zealous in protecting the interests of the United States in that regard, and I think in this treaty we have been careful.

As I pointed out to Senator Gore, benefits are not obtained which a taxpayer could not obtain if he invested similarly in the United States and he would not be taxed differentially as compared to the result if he had invested at home. People who would go to Brazil under this treaty to get the investment credit could equally get the investment credit if they stayed at home.

So that brings you to the question of the overall advantages to the United States of American private investment in developing countries, because we are talking here only about developing countries. We would not extend this investment credit to any industrialized country, as I stated in the colloquy with Senator Pell.

ENCOURAGEMENT OF PRIVATE ENTERPRISE IN THE AID PROGRAM

I think perhaps a general criticism of the foreign assistance program made by many is that it is a costly program for the Government and that it would be far less costly if private enterprise were assisting the program and were involved in it. Through this treaty the investment credit does encourage private enterprise to play a role in developing economies and by eliminating a disincentive to go abroad; the treaty at least says that private enterprise can look upon the developing countries of Latin America as appropriate places of investment.

Now, we believe, and the State Department believes, and I think those who have considered the matter believe it is in the best interests of the United States that the Latin American countries develop, and this development will be aided materially both by improvements in the public sector in those countries and by improvements in the private sector, through all of the capital, enterprise, innovation, stimulation, and the like, that private capital brings to those countries, brings to any country. There are great returns for the United States in the development of those countries.

EXPORT MARKETS IN DEVELOPING COUNTRIES

These countries are important export markets for the United States. Our exports to these countries are far in excess of our investment in these countries. I am sure that the business community will say to you that investment in Latin America brings with it in its train exports to Latin America. New markets open up. The goods that are produced there are not specialized goods but goods for new markets. There is still room for American goods.

I think American labor has always favored the aid that the United States can give to developing countries. It looks upon capital invested in developing countries far differently than it looks upon capital invested in other parts of the world.

So that in assisting these countries we are also assisting the United States, which is proper. We have our interests to consider as well as the interests of these other countries.

EFFECT OF INVESTMENT CREDIT EXTENSION

The investment credit was, of course, to strengthen production in our country, but largely to strengthen it as compared with the terrific competition we were having from Europe.

Now, in offering the investment credit to Latin America we are not in any way hurting our country. We are not in any way really discouraging expansion in the United States. What we are saying is that we look at our system, and we see that to Latin America our system appears to present a disincentive on the part of private capital going to their countries. We have no such intention. We do not desire to put a barrier in the way of our capital going to Latin America.

So, consequently, the extension of this credit will not harm us. It will remove what looks to Latin America to be a barrier to investment and which may in a marginal case be a barrier. The capital may not go to Latin American because of that barrier. It may go to Europe. By removing this barrier, we can achieve something that is in the interest of both the United States and the Latin American countries. We will not in any way make our taxpayers any wealthier compared with if they had invested at home. But we will join with Latin American countries in seeing to it that neither of us places a barrier in the way of having private enterprise play its part in joining Government activity, in encouraging the development of the economies of Latin America because both of us are in sound agreement that the development of the economies of Latin America will redound to their benefit and to the benefit of the United States.

I think Mr. Kubisch would like to say a word.

Senator MORSE. Go right ahead. We will keep the record open long enough to receive your memorandum, and I would like to have it printed in the record immediately following the testimony he has just given.

(The information referred to follows:)

ADVANTAGES TO THE UNITED STATES AND TO BRAZIL OF THE PENDING INCOME TAX CONVENTION

(Prepared by the Treasury Department)

MUTUAL ADVANTAGES

1. It is important to recognize at the outset that this convention is mutually advantageous in that there are significant advantages shared by both countries. The convention eliminates tax obstacles to the flow of goods, and the movement of businessmen, technicians and others between the two countries. The results will be beneficial to both Brazil and the United States, since trade is to the advantage of both the importing country and the exporting country.

2. The convention also eliminates tax obstacles to the flow of capital between the United States and Brazil. It will thus help to increase the resources for economic development available to Brazil, but at the same time, as indicated below, it will help to preserve, if not enlarge, the Brazilian market for U.S. exports.

3. Both countries will benefit from a mutual reduction in withholding taxes on royalties flowing from one country to the other in connection with copyrights and patents. Inventors, authors and artists will enjoy an increased return from their output.

4. Another mutual advantage of the treaty is that it establishes a basis for cooperation among the tax authorities of both countries so that tax questions that may arise in each country concerning proper allocations of income and expenses and pricing practices, etc., may be resolved without adverse effects on the taxpayers concerned. It also establishes a channel for the adjustment of what may be unjustifiable administrative practices.

5. The treaty contains mutual assurances of non-discrimination so that nationals of one country resident in the other and companies of one country with branches or subsidiaries in the other will be treated in the same way that nationals and companies of the host country are treated.

6. In considering the advantages to each country, and the concessions, it must be remembered that there are variations in the scope and quantitative importance of the various provisions, just as in any tax convention. The present status of each country's tax system in relation to the internationally accepted standards in this area will also affect the nature of the concessions made. Viewed in the entirety, however, the accommodations made by the two countries are both balanced and mutually reinforcing.

ADVANTAGES TO BRAZIL

1. The principal benefit of the tax treaty from the point of view of Brazil is that it facilitates the attraction of added private investment from the United States. This is to be expected from the extension of the 7 percent investment credit to investment in Brazil, operating in conjunction with the changes made by the convention in the Brazilian tax system as it affects investment from the United States. The existing grant of the 7 percent credit to investment in the United States but not in Brazil makes Brazil a less attractive place for investment than would otherwise be the case. The extension of the investment credit may be regarded as being complementary to the various assistance programs of the Federal Government to Brazil.

2. A second advantage to Brazil is that the treaty facilitates its efforts to enlarge its markets in the United States. Brazilian enterprises will be able to explore and develop markets in the United States without running into complex tax compliance problems. Their exporters will not be subject to U.S. tax in the absence of their establishing a stable business operation—a "permanent establishment'" in the words of the treaty—in the United States.

3. The treaty will facilitate the acquisition by Brazilian technicians and scholars of skills and training in the United States at a lower cost than at

present. This would result from the tax exemption from U.S. tax that would be accorded such persons coming to the United States for specified periods of time and deriving amounts of income within the specified limits. Brazilian teachers would also be encouraged to come to the United States by an exemption granted to them from U.S. tax.

4. Contributions to Brazilian nonprofit institutions will be encouraged under a provision in the treaty that would allow such contributions as a deduction from U.S. income tax in those cases where the Brazilian institution meets the statutory qualifications which apply to a nonprofit institution in the United States. This provision is similar to one found in the income tax convention between Canada and the United States.

ADVANTAGES TO THE UNITED STATES

1. The treaty will help to preserve the trade and market position of U.S. firms in Brazil. Intensive efforts are now under way among other industrialized countries to enter into tax treaties with Brazil (and other Latin American countries) which would give to their business firms the same types of advantages that would accrue to American firms under this convention. If there were to be no treaty between Brazil and the United States, American firms would be at a disadvantage as respects trade and investment with Brazil compared with their counterparts from other industrialized countries, with adverse consequences to the U.S. position in the Brazilian market.

2. Many of the advantages that would accrue to the United States under the income tax convention with Brazil are similar to those that would accrue to Brazil and for the same reasons. Thus, the convention should facilitate exports from the United States. Potential exporters to Brazil who now fail to explore and develop trade opportunities because of the cost, in terms of money, time, and energy, of becoming familiar with Brazilian tax laws and paying Brazilian taxes despite the absence of a business presence, need no longer do so. They need not be concerned about Brazilian taxes until they create a "permanent establishment" in Brazil.

3. United States companies with subsidiaries in Brazil will be able to receive dividends from their subsidiaries subject to reduced Brazilian withholding taxes such that the aggregate of Brazilian corporate and withholding taxes on profits earned there and distributed to the U.S. parent will not exceed the U.S. corporate tax rate of 48 percent. Consequently excess or unusable foreign tax credits will be reduced or eliminated. Similarly, U.S. recipients of royalties from Brazil, and United States financial institutions receiving interest on loans to Brazil, will have the high withholding taxes now levied by Brazil on the interest and royalties (these withholding taxes do not take into account the costs incurred in producing such income) lowered by a reduction in the withholding tax rates to a level which is more nearly equivalent to the U.S. tax on the net income from such transactions. This also will eliminate unused foreign tax credits. Similarly, owners of real property in Brazil will be subject to Brazilian tax on the net income from such property, that is after the deduction of the costs of operating such property, instead of on a gross basis.

4. Costs incurred by American firms operating in Brazil, which now may be disallowed because incurred outside Brazil, would be allowed under the treaty as a deduction for Brazilian tax purposes, thus contributing toward a more equitable tax treatment of the income of such firms.

5. United States engineers, architects, attorneys and others will be able to perform services for Brazilians both in the United States and Brazil (in the latter for limited periods of time and within specified earnings limitations) without becoming subject to the Brazilian tax laws. Teachers from the United States will be able to go to Brazil for periods up to two years and be exempt from tax there, thus making it possible for more teachers to accept teaching opportunities.

U.S. CONCESSIONS

1. A number of the concessions made by the United States are reciprocal in character and have been referred to above. These are present in our standard tax conventions. Thus each country grants reductions in its withholding taxes on royalty payments, exemption from tax on business profits derived in the absence of a permanent establishment, and exemption to visiting businessmen, technicians and teachers for limited periods of time and on limited amounts of income.

2. The United States would make an additional concession in the form of extending the 7 percent investment credit, now given for domestic investment, for new capital used to put machinery and equipment in place in Brazil. This is not a unique concession to the American firms involved, since the investment credit is presently granted to U.S. taxpayers for their domestic investments. However, it brings the Brazilian economy more fully within the orbit of potential areas of investment which American firms consider when making investment decisions. It thus affords Brazil an improved opportunity for obtaining needed capital resources. This provision constitutes from the Brazilian point of view the principal concession made by the United States.

3. The United States agrees to treat contributions to Brazilian charitable institutions meeting the Internal Revenue Code requirements as if they were contributions to U.S. charitable institutions. This would facilitate the participation by American nationals and firms in the financing of socially desirable welfare activities in Brazil. This provision is similar to that now in the income tax convention between Canada and the United States.

CONCESSIONS BY BRAZIL

1. Most of the items which have been listed previously as being advantageous to the United States may also be listed as concessions by Brazil. The principal ones are the reductions in withholding taxes on dividends, interest and royalties flowing to the United States. However, these reductions also mean that the tax costs associated with the flow of capital, patents and know-how to Brazil are reduced, to the benefit of the U.S. taxpayers involved. They thus represent the removal by Brazil of a barrier to such inflows from the United States.

2. Other concessions by Brazil include the giving up of tax on income derived from the sale of goods in Brazil by American firms that have no permanent establishment in Brazil, the elimination of tax on businessmen, technicians and teachers for limited periods of time and on limited amounts of earnings, and the allowance of a deduction for expenses in certain cases where they are not now allowed, such as costs incurred abroad. These changes represent the adoption by Brazil of internationally accepted standard rules for the taxation of foreign nationals and firms and of international business transactions.

3. Finally, Brazil adopts rules concerning the source of income generated by various types of activity which are generally in accord with those that have been adopted by other countries. It thus gives up tax in certain cases on income which is considered under present Brazilian law to be from Brazilian sources but which under the rules of most other countries would be considered to be from sources outside of Brazil.

INVESTMENT IN BRAZIL AND UNITED STATES EXPORTS

Concern is often expressed that U.S. private investment in a foreign country is necessarily accompanied by a decline of production in the United States of goods which would have been exported to the country where the investment is made. Whatever may be the situation with respect to investment in industrialized countries, there is little basis for this concern with respect to the situation in Brazil or in Latin America generally. Also, this consideration is in no way involved with respect to the proposed extension of the investment credit in the treaty with Brazil.

The factors which motivate private investment in less developed countries are many and varied. But one of the major factors involved in such investment decisions is the drive of developing countries to increase their productive capacity and to expand domestic consumption. To promote the growth of domestic productive facilities, these countries usually adopt a protectionist policy for new industries, just as the United States has done in the past. American firms, therefore, may be confronted with a choice of either losing their export market in a given country or of establishing production in that country. If they choose not to produce in the foreign country, the likelihood is that producers from another capital exporting country will do so instead.

While production within the foreign country may cause U.S. exports of the particular product concerned to decline, the important point to keep in mind is that the creation of additional productive facilities in a developing country such as Brazil does not mean a reduction in the total volume of its imports. Developing

countries suffer from a profound shortage of foreign exchange and by increasing the domestic production of goods they free foreign exchange for the purchase of goods which they could not formerly buy. The volume of imports of the less developed countries is determined almost entirely by the amount of foreign exchange available to them to finance the purchase of the goods they need and want. There is a tremendous unsatisfied need for goods throughout the less developed part of the world, and the magnitude of capital flows to these countries in the foreseeable future is such that it could have no adverse effect on the volume of our exports to those countries. On the contrary, the history of our trade relations with developing countries reveals that the higher the level of productive activity in a foreign country, the greater is the volume of trade between it and the United States.

That being the case, it is particularly important that there be U.S. investments in Brazil, so that U.S. companies might share with those of other countries in the rising volume of business which accompanies economic development.

The presence of U.S. companies in Brazil exerts an important influence in generating exports from the United States. Although they supply locally produced goods, they establish a familiarity with U.S. merchandise and merchandising techniques which helps to form consumer preference in Brazil for U.S. goods. The development by U.S. firms of local markets encourages the sales of additional products produced by U.S. parent companies and others. Moreover, in some cases it may not be feasible to export these additional products without the services of the local organization.

It should also be noted that U.S. subsidiaries in these countries are important markets for U.S. goods. The latest available data (for 1964) indicate that 75 percent of net new investment in U.S. subsidiaries in Latin America was matched by purchases of capital equipment from the United States by such affiliates, and total U.S. exports to such subsidiaries were 8 times the amount of such net new investment. The return flow of U.S. imports from such subsidiaries was insignificant in comparison with their purchases from the United States. United States exports to or through manufacturing subsidiaries in Latin America in 1964 totaled $700 million, constrasted with U.S. imports of only $80 million. Sales by such affiliates to third countries represented less than 5 percent of their total sales, thus indicating that their productive facilities were used for consumption in the particular domestic market.

Senator MORSE. You may proceed, Mr. Kubisch.

Mr. KUBISCH. Thank you, Senator. I shall be brief. Some of the questions you have raised go to the heart of certain aspects of our foreign assistance programs, and the costs and benefits of these programs to the people of the United States. I will not try now to go into those inasmuch as I know you have had witnesses here and representatives spoke on them from the Department of State before. Confining my remarks to this particular convention and representing the Department of State, I can say that we are in favor of the treaty and hope very much that the Senate will approve it.

PRIVATE INVESTMENT NEEDED IN BRAZIL

We believe that the treaty is consistent with overall U.S. policy in the hemisphere, with respect to the Alliance for Progress and specifically with respect to our policy with Brazil.

There is no question about the need for private investment to make the Alliance for Progress successful. This was foreseen in the Charter of Punta del Este. At that time—back in 1961—it was foreseen that U.S. public funds would constitute only about 10 percent of the overall cost of attaining the objectives of the Alliance for Progress. Eighty percent of the funds were to come from the countries themselves, and the final 10 percent had to come by means of foreign private investment and from international bodies. So I think here, if we subscribe to

the goals of the Alliance for Progress which is the cornerstone of our policy in the hemisphere—and the Brazilian Government has certainly been moving forward in the last several years in trying to attain those goals—it is very much in the interest of Brazil and the United States that this private form of investment be available to Brazil. It is beyond the public resources of the United States to supply all of the resources needed from abroad to attain the goals, and anything that tends to——

EXPORT OF U.S. PRIVATE INVESTMENT SYSTEM

Senator MORSE. I want to interrupt just long enough to endorse what you have said about what the basis of the Alliance for Progress program was from the standpoint of private investment, for the program really originated in our Subcommitee on Latin American Affairs here in the Senate, of which I happen to have the privilege of serving as chairman. The then Senator from Massachusetts, John Kennedy, was a member of my subcommittee, and seconded the motion, and made a supporting speech, for my idea to have studies done by experts in research foundations and universities in this country. These studies brought forth the recommendations that created the Alliance for Progress program. He took those recommendations to the White House with him and made clear at the time that he was using them as the basis for his initiation of the program. And basic to that program, which both of us said so many times, was the importance of our exporting our system of economic freedom into Latin America.

That does not mean government aid. That means private aid by way of developing in the various countries of Latin American the private enterprise system, in contrast to a government system which is the very foundation of the program. I am so glad that you mentioned it, and I only take this time to reinforce what you have said because we have to have the investments. It is a question of how we are going to have those investments and at the same time protect the legitimate interests of the American taxpayer.

Mr. KUBISCH. Thank you, Senator.

I agree that it is not only the resources themselves that flow when private investments go from the United States to Brazil but in addition a technology goes with them, personnel go with them, and a system and an approach to the development of a society go with them which is very much in the interest of the United States, and I may say in the interest of Brazil as well.

In my view this treaty which is proposed will advance those interests. It is in the enlightened self-interest of Brazil and the United States that we do cooperate in just this fashion in encouraging American investments to go to Brazil. They will help in the development of that country and also help to develop the kind of world that both Brazilians and Americans want to see.

Senator MORSE. Thank you very much.

We will stand in recess until 2:30 when our first witness will be Mr. L. N. Woodworth, Chief of Staff of the Joint Committee on Internal Revenue Taxation.

(Whereupon, at 12:50 p.m., the committee recessed, to reconvene at 2:30 p.m. the same day.)

AFTERNOON SESSION

Senator MORSE. The hearing will come to order.

Our first witness this afternoon will be Mr. L. N. Woodworth, Chief of Staff of the Joint Committee on Internal Revenue Taxation.

We are delighted to have you. It is like having an old friend back with us. You may proceed in your own way, Mr. Woodworth. You are accompanied by whom?

STATEMENT OF LAURENCE N. WOODWORTH, CHIEF OF STAFF, JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, ACCOMPANIED BY DENNIS BEDELL, ATTORNEY

Mr. WOODWORTH. This is Mr. Dennis Bedell, an attorney on the joint committee staff who has specialized in the foreign income area.

Senator MORSE. We are delighted to have you, Mr. Bedell.

Mr. WOODWORTH. I appear, as I am sure you know, because Senator Fulbright has asked me to present an analysis of the proposed treaties.

I would like, if I may, to submit the memoranda that I have for the record.

Senator MORSE. The complete memoranda of the witness will be inserted in the record and he can summarize them in accordance with his own pleasure (see page 62).

SUPPLEMENTARY TAX CONVENTION WITH CANADA

Mr. WOODWORTH. I would like, first of all, to refer to the supplementary income tax convention with Canada. This is fundamentally just a provision to close a loophole.

Canada exempts from its tax Canadian corporations organized before April 1965 which are managed and controlled outside of Canada and owned by foreigners.

We, on the other hand, tax Canadian corporations at 15 percent under the existing Canadian treaty on income that they derive from the United States. The result of this is that non-United States and non-Canadian persons who own these types of corporations I have just described can invest in the United States and pay only the 15 percent tax. It is to close that loophole that this supplementary convention has been entered into.

This supplementary convention would simply provide that the regular U.S. 30 percent withholding rate applies in this type of case.

I see no problems with this convention and I know of no one who has raised any problems with it.

TRINIDAD AND TOBAGO CONVENTION

The convention with Trinidad and Tobago is a temporary one. We first had a treaty with Trinidad and Tobago because it was a United Kingdom possession to which our treaty with the United Kingdom was extended. This status was continued after it became independent but Trinidad and Tobago terminated this as of January 1, 1966. They are, as I understand it, thinking of entering into negotiations for a

permanent treaty. This convention represents merely a temporary one until further work is done in that connection. It provides a 25-percent tax on dividends instead of the 30 percent which would otherwise apply, both in the case of dividends paid by Trinidad and Tobago corporations to U.S. residents and corporations, and vice versa.

In addition, there is a 5-percent tax in those cases where the dividend is paid by a 10 percent owned subsidiary.

The effect of this convention would be very limited as well as temporary. I see no problem with it and I have heard of no problem in connection with it.

BRAZIL TAX TREATY REPRESENTS MAJOR DEPARTURE

There remains the Brazilian convention which, of course, is a full-scale major convention. In general, I should say that this follows the usual tax treaty rules but contains the one feature which represents a departure from the tax treaties that we have entered into in the past. By that I am, of course, referring to the fact that it makes allowance for the investment credit.

I think it is important to note that the effect of this is that the United States would be lowering its own tax on its own citizens or residents or corporations by means of a tax treaty. On occasion this has been done to reconcile differences between tax concepts of the United States and the foreign country—primarily by actions which increased the allowable foreign tax credit. This treaty departs from this occasional practice of the past, however, in that under it the U.S. tax on U.S. persons is reduced directly by allowing a credit for foreign investments which would be eligible for the domestic investment credit if made in this country.

On the other hand, I think it is well to recognize that this treaty, if approved, would be the first broad-scale tax convention we have concluded with a less developed country. There have been a few, one or two, very limited examples of where the United States has entered into tax conventions with a less developed country, but they were not full-scale tax conventions, such as this one would be.

The usual tax convention that we have entered into with a developed country has been designed to eliminate double taxation on both sides. It has been something that was advantageous to both countries because each had investments or business activity in the other country and, therefore, it was important to both countries to straighten out the areas of double taxation, particularly differences in the source of income rules.

TREATY WITH A LESS DEVELOPED COUNTRY

This general proposition is not true, however, in the case of a less developed country, because its volume of business in the United States usually is small, and therefore the usual developed country tax treaty means nothing but the loss of revenue from the standpoint of a less developed country. So, in the past, it has been difficult for the United States to enter into tax treaties with less developed countries.

I think this is one of the principal reasons the Treasury has made provision for the allowance of the investment credit. This, in effect,

provides something that the less developed country wants—in other words, it provides a quid pro quo for concessions made by the less developed country. Of course, accompanying that is the fact that the United States has a general policy of encouraging investments in less developed countries. I think the inclusion of the investment credit in this treaty results from a combination of those two factors.

As I see it, this is the major issue before the committee. This aspect of the treaty is a departure in some respects from what generally has been done in the past. On the other hand, the Treasury reasons that this is necessary if we are to conclude treaties with these countries.

I thought that perhaps what I might do now is to point out what appears to me to be some of the major factors in the tax treaty with Brazil which are favorable to Brazil and some of the major factors which are favorable to the United States. If I understand it, this is what you were asking for this morning.

FACTORS FAVORABLE TO BRAZIL

From the standpoint of Brazil, certainly the most favorable aspect is the allowance of the foreign investment credit. This, of course, is designed to make investment by U.S. persons in Brazil more attractive and should in that regard help in the development of the country.

In addition certain tax rate reductions are provided, which, in a sense, help both Brazil and the business interests in the United States. The rate reductions are made for the most part by Brazil and not by the United States, with the result that the investment climate in Brazil becomes more attractive to U.S. concerns. There are rate reductions in the areas of dividends, interest, and royalties.

EFFECT OF REDUCTION OF DIVIDEND TAX

The withholding tax on dividends at the present time is 25 percent in Brazil. This would be reduced to 20 percent where the dividend is paid to a U.S. corporation which has an ownership interest in the paying Brazilian corporation of 10 percent or more.

Mr. Surrey this morning indicated the reason for this was that although a reduction from 25 to 20 percent may appear modest, it means, when you add up the various taxes which apply in Brazil, that a U.S. concern with a subsidiary there will probably pay no additional tax to the United States and, moreover, will not have an excess foreign tax credit which it cannot use. In other words, the Brazilian tax will just about equal the U.S. rate of tax and will be fully creditable under the foreign tax credit. Because of that there will be no U.S. tax due.

This is true since Brazil has a regular corporate tax rate of 30 percent, plus a 5 percent tax on distributed profits, plus the 20 percent withholding tax that I have just referred to which—when you take into account the fact that they are not imposed on the same base—add up to a tax of 46.8 percent, or slightly less than our corporate tax.

I understand that Brazil has imposed what appears to be an additional corporate tax, but it is not clear to me that this does not replace to some extent an existing tax, and in any event even if it does not, it only would bring the total Brazilian tax rate to very slightly above the U.S. rate.

TAX TREATMENT OF INTEREST

In the case of interest, a much narrower policy is followed than in the case of dividends. Interest is exempt when it is paid to either Government. It is also subject to a 15 percent rate instead of a 25 percent rate when it is paid from a Brazilian source to a bank or other financial institution in the United States. This, however, like the dividend provision, is not a reciprocal arrangement; this is unilateral. In other words, this is a reduction made only by Brazil and not by the United States.

Special rules apply in this case which would deny the reduction in tax on interest in the case of those having permanent establishments in Brazil, but in this case deductions are allowed for expenses related to the interest in the computation of the Brazilian tax. This also improves the tax treatment from the standpoint of the U.S. persons involved.

TAX ON INCOME FROM REAL PROPERTY

In the case of income from real property the treaty provides that this income may be taxed on a net basis. This treatment is advantageous to Americans with investments in Brazil, and it also presents a more attractive investment climate for Brazil, because of the fact that the expenses of earning the income may be deducted in computing the Brazilian tax. In many cases, Brazil would not otherwise allow this treatment.

The United States adopted this kind of rule, with respect to U.S. income earned by foreigners, in the Foreign Investors Tax Act which you passed in 1966, and now under this treaty, Brazil will, in effect, be following that same rule with respect to their tax treatment of income from real property located there.

TAX ON NONMINERAL ROYALTIES

The tax on royalties is also reduced under the treaty in the case of nonmineral royalties, other than royalties from film or related items, from 25 to 15 percent in the case of Brazil and from 30 to 15 percent in the case of the United States. Again this reduction will not apply if the person receiving the royalties has a permanent establishment in the other country. However, in such a case the income will be taxed on a net basis.

The royalty treatment that I have just described to you is a bilateral provision, and the reason for this, I suppose, is the probability that favorable treatment for royalty income derived from the United States from the use of Brazilian technology here will not detract from investments in Brazil.

ADVANTAGES TO THE UNITED STATES

Now, I would like to look at the treaty from the standpoint of the advantages Americans receive. If you are looking at it from the standpoint of the American businessman, he receives the lower rates that I have just referred to. You can also say from the standpoint of the U.S. Government that the treaty is desirable to the extent it furthers our policy of encouraging investments in less developed countries.

PERMANENT ESTABLISHMENT RULE

In addition, however, to these particular points, I think I should indicate that the permanent establishment rule, which is in this treaty, should be particularly desirable to Americans operating in Brazil. In the past Brazil has used very broad rules in deciding how much business activity in Brazil would cause a person to be subject to Brazilian tax. The result of this was that Americans were never quite sure when they were going to be taxed there.

In this treaty the more or less conventional permanent establishment rules have been adopted which will lessen the likelihood of Americans being taxed in these unusual situations where there is only a small amount of business activity carried on in Brazil.

This treaty also contains the generally accepted rules for determining the source of income. Mr. Surrey mentioned this morning an example of where these source rules are advantageous in the case of personal services. You can add a number of other examples to this. By making the source rules more definite and more uniform, double taxation is prevented in a number of areas.

I think it is important also to add that Brazil in the past has been inclined not to allow deductions against income earned from Brazilian sources for expenses incurred outside of Brazil, such as overhead expenses, which are nevertheless in part attributable to the earning of income in Brazil. This has been specifically provided for in the treaty, so that these expenses will be deductible.

I think these points that I have presented to you are the principal advantages of the treaty, first from the standpoint of Brazil, and then from the standpoint of the United States.

TAX ON INCOME OF A BRAZILIAN BRANCH

I might just mention another point or two of importance in the treaty before I get to the investment credit, as such.

Industrial and commercial profits attributable to, and income effectively connected with, a Brazilian branch are treated as income derived from Brazilian sources under the treaty. This in one sense, is a somewhat different rule than we have followed previously. This rule means that Brazil may tax this income, which is the same result that would occur under our other treaties. The rule, however, also means that the United States will treat this income as being from Brazilian sources for purposes of the foreign tax credit—this feature has not been present in prior treaties. This will help the Americans involved, both where they use the per country limitation on the foreign tax credit as well as where the overall limitation is used. In other words, if income attributable to the Brazilian business would otherwise be considered as derived from sources in the United States, to take an extreme example, under this rule it would be treated as derived from Brazilian sources, and the Brazilian taxes on it would be creditable under the foreign tax credit against the U.S. tax on the income.

There are also two other rules that I think should be pointed out. One of these relates to the case of where a U.S. business has a permanent establishment in Brazil, but also derives profits from direct sales by it within Brazil of products which are either the same or similar to those the permanent establishment sells in Brazil. In this type of

a situation Brazil reserves the right to tax the income of the parent organization from these direct sales.

DEDUCTION FOR CHARITABLE CONTRIBUTIONS

The last point that I wanted to mention deals with the deduction for charitable contributions. Under the treaty charitable contributions will be deductible for U.S. tax purposes when paid to a Brazilian charity. This has not been the general rule in the past, although it would have been true under the Thai treaty which was proposed 2 years ago, and it is true under the Canadian treaty already in effect.

I should also point out that the Brazilian charity will have to qualify under the U.S. laws as a charity which is exempt under section 501(c)(3) of the Internal Revenue Code for this treatment to be available.

In actual practice, this deduction may not mean as much as it might seem, however, because it is possible under the law generally for individuals to obtain a charitable contributions deduction where they give the funds to a U.S. charitable organization which, in turn, carries on charitable activity abroad. So in that sense this provision of the treaty probably does not constitute a substantial change.

INVESTMENT CREDIT PROVISION COMPARED TO THAT IN THAI TREATY

Now, I would like to turn to the investment credit. This provision, of course, is not reciprocal. In other words, in this case the investment credit is a reduction made by the United States with respect to investments in Brazil by U.S. taxpayers and not by Brazil with respect to Brazilian investments in the United States. It follows the same general form that was followed in the Thai treaty last year except that it is much narrower in its application. I think the narrower application in large part arose from the discussion before the Foreign Relations subcommittee last year in which I participated.

There is what I call a two phase limitation on the investment credit in this case whereas in the Thai treaty there was a one phase limitation.

The Thai treaty essentially provided that amounts invested by Americans in United States or Thai corporations were eligible for the investment credit if 80 percent of the income and the assets were derived from or connected with a business in Thailand. In addition, the Thai treaty provided the credit was allowed for earnings of these corporations—called eligible corporations—to the extent that more than half of their earnings were reinvested. In other words, the Thai treaty did not actually require the investment of the funds in equipment, plant or facilities. Actually under the Thai treaty, as was pointed out last year before the subcommittee that considered it, funds could have been held in cash by the eligible corporation or could have been used in any other way so long as the corporations in which the investment was made met the two conditions that I have just described.

The Brazilian treaty contains essentially the same restrictions that the Thai treaty did but, in addition, has what I have called the second phase limitation. That is, the funds invested in the Brazilian operation must also be invested by the eligible corporation in assets in the same way as would be true if it were a domestic corporation involved which was seeking the domestic investment credit.

It is rather involved. Let me see if I can restate it this way.

TAX CREDIT PROVISION FOR DOMESTIC INVESTMENT

Senator MORSE. Let me ask you right there, to help you in further explanation. It has been my understanding up until this point that the investment credit that will be enjoyed by American corporations operating in Brazil will be for an investment exactly the same as though the investment were made, plowed back into the corporation in the United States, is that right or wrong?

Mr. WOODWORTH. That is almost right. In addition to having met essentially the same conditions as would be true for a domestic corporation, the new funds—with certain exceptions—also have to be placed into this eligible corporation, the one operating in Brazil. These can't be just existing funds already in the business operating in Brazil, except to the extent I am going to indicate in just a moment.

There are three sources from which the funds that are used to invest in the plant and equipment can come. They can come from new capital placed in the eligible corporation by the American persons owning it. They can come from the reinvested earnings of the eligible corporation—that is, the second half of the earnings. No credit is received for the first half of the earnings if they are reinvested. It is only to the extent more than 50 percent is reinvested that the earnings are taken into account. To the extent of the two sources of funds I have just described the treaty is comparable to the Thai treaty. But the Brazilian treaty also allows depreciation reserves to be invested in property eligible for the investment credit.

So there are those three sources from which the funds can come, which, in turn, then have to be invested in qualified property, which is primarily equipment, although it includes a limited number of types of buildings as well.

EXTENT OF APPLICATION OF INVESTMENT CREDIT PROVISION

Senator MORSE. Let me tarry a bit longer on this, because I need the information. It has been my understanding that the investment credit provision enjoyed by American companies is limited to investment in equipment, in machinery, in productive, creative instruments of the plant and not in these types of property investments that you have just outlined which go beyond equipment. Am I right or wrong in the application of it to U.S. companies?

Mr. WOODWORTH. It does go somewhat beyond equipment. Although the U.S. investment credit is basically limited to investments in equipment.

Senator MORSE. That is what I want to know.

Mr. WOODWORTH. It includes storage facilities.

Senator MORSE. Storage facilities?

Mr. WOODWORTH. Yes, that is correct, and facilities built and developed for a particular use or particular products. A grain elevator, for example, is eligible for the investment credit, and so is railroad track. This is also true of blast furnaces and a limited number of other facilities which you cannot really call equipment.

Senator MORSE. But they are all tangible assets——

Mr. WOODWORTH. Yes.

Senator MORSE. That are necessary to increase the productivity of the plant, as the machinery or equipment operates within the plant, that is true, is it not?

Mr. WOODWORTH. That is true.
Senator MORSE. Under the so-called American system.
Mr. WOODWORTH. Yes.

RESTRICTIVE NATURE OF CREDIT PROVISION IN BRAZIL TREATY

Senator MORSE. Now, in Brazil, would you include in the Brazilian treaty other types of investment, and also explain them in a little greater detail other than equipment or tangible plant facilities that are necessary to operate the plant to increase this production? The major idea I always thought we were seeking to accomplish with the investment credit provision was to encourage American businessmen to enlarge their plants and increase their production. I would be the first to admit that the kind of capital investment that I understand you are talking about, vis-a-vis the Brazilian treaty, has that effect, but it is not included in the American investment credit provision.

Mr. WOODWORTH. The problem is that there is a twofold limitation. The funds for the investment have to come from the capital sources that I referred to, but then, in addition, the funds have to be invested in the type of plant and equipment you have just referred to.

In other words, in this regard, the investment credit in this treaty is more restrictive than the domestic credit, because not only must the investment be made in equipment which under U.S. domestic law is eligible for the credit, but, in addition, the funds used to purchase that equipment must be new capital invested in the Brazilian operation, depreciation reserves, or the second half of reinvested earnings.

Senator MORSE. Isn't the committee going to find itself in a position that if we recommend this treaty, that following its ratification, there will be a large number of American business concerns operating just in our country that will then come forth with a request for additional legislation saying they are not, they are being discriminated against, they are not being given the same tax credit advantage that American concerns operating in Brazil will be getting?

Mr. WOODWORTH. No. I don't believe that would be true, because, with one exception, the limitations with respect to investment in Brazil are at least as severe or restrictive as those for investment in the United States.

The one exception is that in the case of investments in the United States, used property that has been purchased can only be taken into account in any year to the extent of $50,000. This limitation has been omitted in the Brazilian treaty. So it is possible for used equipment to be eligible for the credit without this limitation. I think the reason this was done is because there is a relatively large market for used American equipment in South America.

ADVANTAGES TO PURCHASING USED EQUIPMENT

Senator MORSE. There is not a large import duty on used equipment.

Mr. WOODWORTH. I am not acquainted with the import duty but I know there is a substantial market for used American equipment there.

Senator MORSE. I am not talking in terms of specifics, but I understand that there are various reasons for used equipment. First, it is

cheaper and very usable, and, second, there is an advantageous import duty.

Mr. WOODWORTH. I see your point. I am sure it is true that used equipment is imported in volume because of the duty on new equipment.

RESTRICTIONS ON TYPES OF INVESTMENTS TO BE MADE

I should also point out that under the treaty there is a further restriction in that the investment has to be in one of eight general types of business which are listed in the treaty. For the most part, these are the same as the types of business in which investments could be made in the case of the Thai treaty. But there are some variations and I thought you might be interested in knowing what those variations are.

This treaty would include investments in the refining and smelting businesses. It would also include investments in the business of running a hotel. Neither of these would have qualified under the Thai treaty. The running of the hotel would have qualified under the proposed Israeli convention, but not the Thailand convention.

In addition, there is, what I would call, a catchall category 9, which in one way is expansive and in one way is restrictive. This catchall category provides that, when the competent authorities agree, additional categories of business may be added, or types of business which are listed in the other eight categories, can be withdrawn. So there is this flexibility by which the Brazilian and United States authorities can agree to either expand or contract the types of business which would be eligible for this treatment.

ELIGIBILITY OF GROUPS OF RESIDENTS OWNING STOCKS

One further point I believe I should note here is the fact that the eligible investor, that is, the one making the investments in the Brazilian business, can include not only an individual U.S. resident or a U.S. corporation which owns at least 25 percent of the eligible corporation, but can also include groups of individual residents or individual corporations owning 25 percent or more of the eligible corporation.

This would not have been true under the Thai treaty. I think this provision presents some limited problems because it appears that it makes it possible for a very large group of individuals to receive the benefit of the investment credit even though their individual holdings may be less than one percent. I think it would have been better if this group rule had been restricted to those who have holdings of five percent or more, so as to preclude portfolio investors from becoming eligible for the investment credit.

I did want to call that point to your attention. That completes my remarks.

Senator MORSE. It is a very excellent statement. I speak only for myself, but I think you have performed a valuable service. You have clarified things that needed to be clarified.

Senator Sparkman.

EFFECT ON TREATY OF SUSPENSION OF U.S. DOMESTIC CREDIT

Senator SPARKMAN. Just one or two questions, Mr. Chairman. Suppose our domestic investment tax credit laws are repealed or suspended.

What effect would this have on the investment tax credit provisions in the treaty with Brazil?

Mr. WOODWORTH. I should have mentioned that, Senator Sparkman. I neglected to do so.

The convention specifically provides that if our domestic credit is suspended, modified, or changed in any respect, the suspension, repeal, or modification applies to the credit in the Brazilian treaty. Brazil, however, does reserve the right, should that happen, to reconsider concessions that she has made to the United States in other parts of the treaty. But automatically, the investment credit changes that we make in our laws here would apply to the treaty credit.

Senator MORSE. As was pointed out this morning, Senator Sparkman, as I recall, under the Thai treaty, it would have gone on for five years.

Mr. WOODWORTH. That is correct. The credit in that case would have continued for a minimum of five years even if this domestic credit were repealed.

Senator MORSE. This treaty provides for an immediate suspension.

Mr. WOODWORTH. That is correct. In other words, were we to suspend the domestic credit, as was done last year, this would automatically result in a suspension of the treaty credit.

IS THIS A GOOD TREATY FOR THE UNITED STATES?

Senator SPARKMAN. Let me just ask this general question: Do you believe this is a good treaty for the United States; a good agreement for us to enter into?

Mr. WOODWORTH. First let me say that I am a congressional employee who works for members of the Senate and members of the House who have different points of view on this particular issue.

Senator SPARKMAN. I know, but you are an expert, and we have to answer that question.

Mr. WOODWORTH. I would like to answer the question this way: providing the investment credit for investments abroad is a departure from what the United States has generally done by tax treaty in the past. As I said earlier, there have been situations in the past where by treaty the United States has reduced its taxes on its own citizens, residents, and corporations—however, it has not done so in the manner contemplated by this treaty. If you conclude that it is appropriate to adopt the method of reducing U.S. taxes on U.S. persons embodied in this treaty, then I think the rest of the treaty can be justified. I did note one problem, however, with respect to portfolio investments.

Senator SPARKMAN. Thank you.

Senator MORSE. It is a good answer. Thank you very much.

(The memoranda previously referred to follow:)

SUPPLEMENTARY CONVENTION BETWEEN THE UNITED STATES AND CANADA

(Memorandum prepared by the Staff of the Joint Committee on Internal Revenue Taxation)

The proposed supplementary income tax convention with Canada changes in one respect the Canadian income tax convention of 1942, as modified by the supplementary conventions of 1950 and 1956. The purpose of the proposed supplementary convention is a narrow and limited one, namely, to eliminate an un-

intended benefit which arises from the combined effect of Article XI of the existing convention and the Canadian income tax law.

Article XI(1) of the existing convention provides, in general, a reciprocal reduction to 15 percent in the rate of income tax imposed by one country on income (other than earned income) derived from sources within that country by residents of, or corporations organized under the laws of, the other country. Thus, investment income received from the United States by a corporation organized in Canada is taxed at the rate of 15 percent rather than the statutory U.S. rate of 30 percent which is generally applicable to investment income received by foreign corporations if the income is not effectively connected with the conduct of a business in the United States.

Under the Canadian tax law, a Canadian corporation is not taxed on foreign source income if the corporation is not considered to be a resident of Canada. For corporations organized in Canada before April 27, 1965, Canadian law provides, generally, that the corporation will not be considered a resident of Canada if the corporation is, and was managed and controlled outside of Canada. Corporations organized in Canada after April 26, 1965, are considered residents of Canada no matter where they are managed and controlled.

Inasmuch as the 15 percent reduced rate of tax under Article XI(1) of the existing convention applies to corporations organized in Canada, it is possible for a Canadian corporation to pay the reduced rate of tax to the United States and no tax to Canada on U.S. investment income, if the corporation was organized before April 27, 1965, and is, and was, managed and controlled outside of Canada. The combination of Article XI of the existing convention and the Canadian definition of "resident" has allowed residents of a third country to avoid U.S. taxes on investment income by funneling the income through a Canadian corporation which was not a resident of Canada for Canadian tax purposes.

Income tax conventions are designed to confer tax benefits on residents of the contracting countries, not residents of third countries. The proposed supplementary convention eliminates the use of the tax benefit provided by Article XI(1) of the existing convention by third country residents. This is accomplished by the addition of a paragraph to Article XI which provides, in effect, that the reduced rate of tax will not apply if the recipient of the income is not subject to tax in Canada on the income, because the recipient is not considered a resident of Canada for purposes of its income tax. Thus, the reduced rate of tax will no longer apply where the recipient of investment income from the United States is a Canadian corporation which was organized before April 27, 1965 (all Canadian corporations organized after April 26, 1965, are considered residents of Canada), and which is, and was, managed and controlled outside of Canada.

The proposed supplementary convention provides that the provision which it adds to Article XI of the existing convention will apply to amounts paid on or after January 1, 1967, or the date on which the instruments of ratification are exchanged, whichever is later. Since January 1, 1967, has passed, as a practical matter the new provision will apply to income paid on or after the date on which the instruments of ratification are exchanged.

Income Tax Convention Between the United States and Trinidad and Tobago

(Memorandum prepared by the staff of the Joint Committee on Internal Revenue Taxation)

The proposed income tax convention with Trinidad and Tobago is essentially an interim convention of limited scope. It contains only two substantive articles, one providing a reduced rate of source country withholding tax on dividends, and the other providing a foreign tax credit.

From 1959 to 1965, an income tax convention between the United States and Trinidad and Tobago was in force. The United Kingdom income tax convention of 1945, as modified, was extended to the territory of Trinidad and Tobago as of January 1, 1959, by an exchange of notes under the procedure provided in Article XXII of that convention. In 1962, Trinidad and Tobago became an independent nation and agreed to assume this treaty obligation. Thus, the U.K. convention as extended to Trinidad and Tobago continued in force as if there was a separate income tax convention between the United States and Trinidad and Tobago. In 1965, the Government of Trinidad and Tobago gave notice to the

United States of its intention to terminate the convention and, accordingly, under Article XXIV of the convention, it ceased to have effect as of January 1, 1966.

DIVIDENDS

The primary purpose of the proposed convention is to provide a reduced rate of tax on dividends paid by a corporation of one country to a corporation of the other country with at least a 10 percent ownership interest in the paying corporation. In the absence of a treaty provision, dividends paid by a Trinidad and Tobago corporation to a U.S. corporation would be subject to a 30 percent withholding tax. The same is generally true regarding dividends paid by a U.S. corporation to a Trinidad and Tobago corporation.

The proposed convention provides that the U.S. and Trinidad and Tobago withholding taxes will be reduced to 5 percent in the case of dividends paid by a corporation of one country to a corporation of the other country which has at least a 10 percent ownership interest in the paying corporation (provided that not more than 25 percent of the paying corporation's income is from dividends and interest, other than dividends and interest from subsidiary corporations). The reduced rate will not apply, however, if the corporation receiving the dividend has a permanent establishment in the source country. Thus, dividends paid by a Trinidad and Tobago corporation to a U.S. corporation which has the requisite ownership interest and which does not have a permanent establishment in Trinidad and Tobago will be taxed at a rate of 5 percent rather than the normally applicable 30 percent rate.

The proposed convention also provides that, in other cases, dividends derived by a resident of one country from the other country will be taxed by the source country at a rate of 25 percent rather than the usual 30 percent, provided the person receiving the dividend does not have a permanent establishment in the source country.

The proposed convention further provides that dividends paid by a Trinidad and Tobago corporation to a person other than a citizen, resident, or corporation of the United States will be exempt from U.S. tax. Under U.S. statutory law, a portion of these dividends generally would be subject to a 30 percent U.S. tax if 50 percent or more of the paying corporation's income for the past 3 years was effectively connected with a U.S. business. This provision of the proposed convention also exempts from Trindad and Tobago tax dividends paid by a U.S. corporation to a person other than a resident or a corporation of Trindad and Tobago.

The treatment provided for dividends in the proposed convention accords generally with the approach embodied in most of our income tax conventions and also with the provision contained in the convention with Trindad and Tobago which was treminated. Under that provision, portfolio dividends were taxed at a 15 percent rate, and intercorporate dividends were taxed at a 5 percent rate. The ownership requirement in the case of intercorporate dividends, however, was 95 percent, rather than the 10 percent specified in the proposed convention

The more recent income tax conventions to which the United States is a party embody the effectively connected concept rather than the force of attraction principle. Thus, dividends are taxed at the reduced rate unless the recipient has a permanent establishment in the source country to which the dividends are effectively connected. The proposed convention retains the force of attraction principle and, therefore, the normal 30 percent rate rather than the 25 or 5 percent rate will apply if the recipient has a permanent establishment in the source country, even though the dividends are not effectively connected with the permanent establishment.

The proposed convention also contains a provision regarding the so-called "branch profits" tax imposed by Trinidad and Tobago. Under Trinidad and Tobago law, profits earned by a Trinidad and Tobago permanent establishment of a foreign corporation are subject to the regular 44 percent corporate tax, and also to a 30 percent "branch profits" tax, unless the profits are reinvested in Trinidad and Tobago. Thus, these profits are taxed in the same manner as if they were earned by a subsidiary corporation and then the after-tax profits were paid as a dividend to the parent corporation. The proposed convention provides, in effect, that remittances of profits earned by a Trinidad and Tobago permanent establishment of a U.S. corporation will be taxed in the same manner as intercorporate dividends. Thus, the "branch profits" tax will be reduced from 30 percent to 5 percent.

FOREIGN TAX CREDIT

The proposed convention contains a provision which allows a tax credit for income taxes paid to the other country.

Under the proposed convention, a citizen, resident, or corporation of the United States will be allowed to credit against its U.S. tax the amount of income tax paid to Trinidad and Tobago. Moreover, a U.S. corporation which receives a dividend from a Trinidad and Tobago corporation in which it has at least a 10 percent ownership interest will be allowed a credit for the Trinidad and Tobago tax paid on the corporate profits out of which the dividend is paid, if the U.S. corporation includes the amount of Trinidad and Tobago tax in its gross income. The credit allowed by the United States under the proposed convention is subject to the so-called per country limitation. Of course, if the overall limitation on the foreign tax credit which is provided by the Internal Revenue Code produces a more favorable result, a U.S. taxpayer may use that provision rather than the per country limitation contained in the proposed convention.

The foreign tax credit allowed by the United States under this provision of the proposed convention conforms generally to the foreign tax credit allowed under the Internal Revenue Code (sections 901–906). There is, however, one significant difference regarding the so-called "deemed paid" credit, i.e., the credit allowed to certain U.S. corporations for Trinidad and Tobago taxes paid on the corporate profits out of which a dividend is paid. To receive this credit under the proposed convention, the recipient U.S. corporation must include in its income the amount of Trinidad and Tobago tax for which a deemed paid credit is claimed. In other words, the dividend must be grossed up. Under the Internal Revenue Code however, a dividend does not have to be grossed up in order for the recipient U.S. corporation to claim a deemed paid credit, if the dividend is paid by a less developed country corporation and most Trinidad and Tobago corporations will be considered less developed country corporations. Inasmuch as the computation of the deemed paid tax credit without gross-up under the Internal Revenue Code will generally produce a more favorable result than the grossed-up computation under the proposed convention, it will be to the advantage of U.S. corporations in many cases to use the Code rules in computing the deemed paid credit. Of course, in these cases U.S. corporations may continue to use the Code rules rather than those found in the proposed convention.

Under the proposed convention, Trinidad and Tobago will allow its taxpayers a credit for income taxes paid to the United States. Also, a Trinidad and Tobago corporation which receives a dividend from a U.S. corporation in which it has at least a 10 percent ownership interest will be allowed a credit for the U.S. tax paid on the corporate profits out of which the dividend is paid. In the absence of the proposed convention, this credit would be allowed under Trinidad and Tobago law only where the recipient corporation had at least a 25 percent ownership interest in the paying corporation. The credit allowed by Trinidad and Tobago under the proposed convention is subject to the per country limitation.

The proposed convention also contains the usual savings clause which provides that the United States may continue to tax the income of its citizens, residents, and corporations as if the treaty had not come into effect.

EFFECTIVE DATE

The proposed convention will be effective as of January 1, 1966, and will terminate as of December 31, 1967, unless it is extended pursuant to the procedure provided in the convention. Under this procedure, the United States and Trinidad and Tobago can agree by an exchange of notes prior to December 31 of any year to extend the convention for the following year. There is no limit on the number of extensions which may be agreed to.

This procedure differs from that found in our other income tax conventions in that a convention usually continues in force indefinitely, but can be terminated as of the end of any year by either of the countries giving notice to that effect. In other words, positive action usually must be taken to terminate an income tax convention; otherwise, the convention continues in force. The proposed convention, on the other hand, will terminate unless positive action is taken to keep it in force for the following year.

The difference between the proposed convention and our other income tax conventions in this regard is not an important substantive difference. Moreover, the fact the proposed convention continues only on a yearly basis serves to em-

phasize its interim nature and the anticipation that it will be replaced by a more comprehensive income tax convention between the United States and Trinidad and Tobago.

Proposed Income Tax Convention Between the United States and Brazil

(Memorandum prepared by the staff of the Joint Committee on Internal Revenue Taxation)

The proposed income tax convention with Brazil follows in most respects the general pattern embodied in income tax conventions which the United States has with foreign countries. At the present time, the United States has income tax treaties with most developed countries but with only one less developed country. The proposed convention with Brazil differs in some important respects from the general developed country treaty pattern primarily because the considerations underlying a tax treaty between developed and less developed countries are not the same as the considerations upon which a tax treaty between two developed countries is based. The more important differences from the general pattern are as follows:

The domestic investment credit is extended under certain conditions to investments in Brazil.

Only the Brazilian withholding taxes on dividends and interest paid to U.S. persons are reduced. There is no reduction in the U.S. withholding taxes on these types of income.

A special source rule is provided which treats the profits attributable to a permanent establishment in one country as having their source in that country. Generally, the primary effect of this is to allow U.S. taxpayers a larger tax credit for Brazilian taxes.

A detailed explanation of the proposed convention on an article-by-article basis is presented below.

Article 1. Taxes covered

The proposed convention applies to all Brazilian income taxes covered by the Federal Income Tax law applicable to individuals and to legal persons, except for the tax on activities of minor importance and the excess remittance tax. In the case of the United States, the proposed convention applies to the Federal income tax (including the surtax) with the exception of the improperly accumulated earnings tax imposed by section 531 of the Internal Revenue Code and the personal holding company tax imposed under section 541 of the Code.

The proposed convention also contains the provision generally found in income tax treaties to which the United States is a party to the effect that the convention will also apply to substantially similar taxes which either country may subsequently impose.

Article 2. Definitions

The standard definitions found in most of our treaties are contained in the proposed convention, including the provision that undefined terms are to have the meaning which they have under the applicable tax laws of the country applying the convention.

Article 3. General rules of taxation

The proposed convention contains basic rules regarding the manner in which one country may tax residents or corporations of the other country. These are found in most of our income tax conventions. Thus, one country may tax residents or corporations of the other country only on income from sources within the taxing country. In applying this provision, the source rules provided by the proposed convention are to be used. As noted in Article 5, the source rules contained in the proposed convention differ in some respects from the source rules provided by U.S. law. Each contracting state is to impose its taxes in accordance with the limitations contained in the proposed convention, but is free to tax without regard to the proposed convention any income to which it is not expressly applicable. The proposed convention is not to be interpreted, however, to deny any tax benefit available presently or in the future under the tax laws of the two countries or under any other agreement between the countries.

The usual savings clause is included in the proposed convention. This clause provides that, with certain exceptions, the proposed convention is not to affect

the taxation by a country of its own citizens, residents, or corporations. The important exceptions include the foreign tax credit, the nondiscrimination provision, the foreign investment credit, and the foreign charitable contributions deduction.

Article 4. Relief from double taxation

One of the primary purposes of an income tax convention is to avoid taxation by both countries of the same income. This purpose is usually served either by providing that the taxes paid to one country by a resident or corporation of the other country may be credited against the tax imposed by the resident's country, or by exempting income taxed in one country from tax in the other country.

The proposed convention with Brazil, as do the tax treaties the United States has previously entered into, adopts the tax credit approach and provides rules essentially similar to the foreign tax credit provisions of the Internal Revenue Code (sections 901–906). Thus, the proposed convention provides that a U.S. citizen, resident, or corporation may credit against U.S. tax the appropriate amount of taxes paid to Brazil. Moreover, a U.S. corporation with at least a 10 percent ownership interest in a Brazilian corporation which pays a dividend may obtain a credit for taxes paid to Brazil on the profits out of which the dividend is paid. Although this so-called "deemed paid credit" has been and is available under the Internal Revenue Code, only a few income tax treaties to which the United States is a party specifically provide a deemed paid credit, such as the 1966 protocol with the United Kingdom and the proposed convention with Trinidad and Tobago.

The proposed convention with Brazil provides that the source of income rules contained in the convention are to be applied in determining the credit and also provides a per country limitation on the amount of the credit. Of course, under the general rule that the proposed convention is not to deny any existing tax benefit, if the source of income rules or the overall limitation on the credit provided by the Internal Revenue Code produce a larger credit, a U.S. taxpayer may use the Code rules.

Under the proposed convention, Brazil will allow its residents and corporations a tax credit for taxes paid to the United States in the manner and subject to the conditions of the credit allowed by the United States. In the absence of a treaty provision such as this, Brazil does not allow foreign taxes to be credited against its tax. Therefore, this provision of the proposed convention provides a benefit to Brazilian residents, including U.S. citizens who are residents of Brazil.

Article 5. Source of income

One of the ways by which income tax treaties can eliminate double taxation is to provide rules for determining the source of income. The source of income is important in view of the general rule in treaties that one country may tax residents and corporations of the other country only on income from sources within the taxing country, and also in view of the fact that the limitation in the foreign tax credit provision is based on the source of income. The Internal Revenue Code contains detailed rules for determining whether income is derived from sources within or without the United States. Many foreign countries, however, either do not have source rules as detailed as ours or have different source rules. Therefore, the inclusion of source rules in an income tax convention produces both greater clarity and uniformity.

The proposed convention with Brazil follows the general approach of the more recent treaties to which the United States is a party and provides rules for determining the source of income that conform, in general, to the Internal Revenue Code source rules. There is, however, a minor difference in the source rule relating to nonmineral royalties, and a new rule regarding the source of business profits is included in the proposed convention.

Under the Internal Revenue Code, the source of a royalty paid for the use of property is the country where the property is used. Under Brazilian law, the source of a royalty is the country of residence of the person paying the royalty. The proposed convention combines these two rules so that a royalty paid by a resident or corporation of one country for the use of property in that country is considered to have its source in that country. In situations where the payor of the royalty is a resident or corporation of one country and the property is used in another country, the royalty source rule in the proposed convention will not apply. Instead, Brazil and the United States will each apply their own respective source rules.

The proposed convention provides a unique rule regarding the source of industrial and commercial profits, including passive income which is considered industrial and commercial profits because it is effectively connected with a permanent establishment. Under the Internal Revenue Code and most other treaties to which the United States is a party, industrial and commercial profits of, and income effectively connected with, a permanent establishment or a business may generally be taxed by the country where the permanent establishment or business is located, regardless of the source of income. Instead of using his approach, the proposed convention with Brazil treats industrial and commercial profits of, and income effectively connected with, a permanent establishment as from sources within the country in which the permanent establishment is located. The difference in this regard between the proposed Brazilian convention on the one hand, and other treaties and the Code on the other hand, is primarily a conceptual one. The practical results achieved under the two approaches are basically the same with one exception. Since income attributable to, or effectively connected with, a Brazilian permanent establishment is considered to be from sources within Brazil—even though the income has its source elsewhere under the usual source rules—a foreign tax credit under the per country limitation will be available to a United States taxpayer for Brazilian taxes imposed on this income. In the absence of this special source rule, a credit would not be available for these taxes unless the overall limitation were used, and also would not be available to the extent the Brazilian taxes were imposed on income usually considered to be United States source income.

Article 6. Nondiscrimination

The proposed convention with Brazil follows the general treaty approach by providing that one country cannot discriminate by imposing more burdensome taxes on its residents who are nationals of the other country, or permanent establishments of nationals or corporations of the other country, than it imposes on its own comparable taxpayers.

The extension of the nondiscrimination provision to corporations of one country which are owned by nationals or corporations of the other country that is found in the recent supplementary convention with the Netherlands and supplementary protocol with the United Kingdom is also contained in the proposed Brazilian convention.

Article 7. Investment credit

At the present time the United States has in effect tax conventions with most of the developed nations of the world, while the only less developed country with which the United States has a treaty is Pakistan. The United States also has treaties with Greece and Finland which are sometimes classified as less developed countries. The effecting of a tax treaty between a developed country, such as the United States, and a less developed country, such as Brazil, has always been confronted with the problem of the absence of equivalent reciprocal benefits. Although, as a consequence of a treaty, the revenue of each country is reduced reflecting the benefits obtained by the investors and traders of the other country, similarly, each country has gains for its own investors and traders. However, there are fewer investors and traders in less developed countries with activities in the United States. In addition, the revenue losses involved in standard treaty provisions are likely to be a more significant percentage of the overall revenues of a less developed country. Consequently, less developed countries have been reluctant to enter into tax treaties with the United States unless the standard treaty provisions are altered so as to grant them what they believe to be significant benefits.

In response to this problem, in the past, our treaty negotiations with less developed countries led into the concept of "tax sparing." However, this concept was not accepted with the result that three treaties which contained the tax-sparing concept (India, Israel, and United Arab Republic) were withdrawn. Conventions were then entered into with Thailand and Israel which embodied a new incentive for less developed countries to enter into tax conventions with the United States, the investment credit concept. The proposed convention with Brazil also embodies the investment credit concept. It differs significantly, however, from the provisions found in the proposed Thai and Israeli treaties; substantial changes have been made in the treaty credit to bring it more in line with the domestic investment credit.

At the outset, it should be noted that the domestic investment credit was enacted to stimulate investments in capacity expansion and modernization in the

United States, to aid in the growth of U.S. productivity and output, and to increase the competitiveness of American exports in world markets. It is apparent that these purposes are not served by a credit for investments abroad. Instead the foreign investment credit apparently is designed to provide the same incentive for investment in a particular less developed country as in the United States. Presumably this has the two-fold purpose of encouraging U.S. investments in that country and also providing an inducement to that country to enter into tax treaty with the United States.

The investment credit provided under the proposed convention, while for the most part the same as the domestic credit, nevertheless has some differences from the domestic credit. On the one hand, not only is the treaty credit allowed for investments in a foreign country but it also is available with respect to investments in used section 38 property while the domestic credit is available only with respect to $50,000 of used section 38 property in any one year. On the other hand, the domestic credit is available for any funds used to purchase qualifying section 38 property for use in any trade or business. The foreign investment credit, however, is available only for investments in limited types of trade or businesses and, to the extent earnings of an eligible corporation are used to purchase section 38 property, only the second half of its earnings may be taken into account.

(1) *General pattern of the credit.*—The proposed Brazilian convention allows U.S. taxpayers which qualify as eligible investors an investment credit with respect to property placed in service by an eligible corporation. The allowance of this credit is unilateral. In general, the investment credit provision is patterned after the domestic investment credit, with those modifications which are necessitated by the fact that the person investing in the eligible corporation receives the credit rather than the eligible corporation which invests in equipment and machinery. In essence, the credit involves a two-phase procedure. The first phase concerns the acquisition and placing in service of qualified property by the eligible corporation. The second phase concerns the investment by an eligible investor in an eligible corporation. This procedure differs from the investment credit provision in the proposed Thai convention in that the Thai convention contained only phase two and did not require investment in qualified property.

(2) *Persons allowed the credit.*—The investment credit is allowed to a person (an eligible investor) who is a U.S. resident or corporation which owns—or is a member of a group of United States residents or corporations which owns—at least 25 percent of the voting power of an eligible corporation. In the proposed Thai convention, there was no provision regarding a group qualifying as an eligible investor. In the case of a group holding 25 percent or more of an eligible corporation, there is no floor on the size of the holdings of the members of the group.

(3) *Eligible corporations.*—An eligible corporation is a U.S. or Brazilian corporation which derives at least 80 percent of its gross income from a qualified trade or business and at least 80 percent of whose assets are used, or held for use, in connection with a qualified trade or business. A qualified trade or business must be conducted within Brazil and may consist of the following:

(a) The manufacture or production of personal property (not including the extraction of any mineral, ore, oil, or gas, or any processing which does not involve a substantial transformation thereof, but not excluding smelting or refining).

(b) The catching or taking of fish.

(c) The processing or marketing of agricultural or horticultural products or commodities.

(d) The marketing of goods or merchandise to the general public through one or more retail establishments, unless the business consists primarily of the distribution of goods or merchandise manufactured or produced outside Brazil by a related person.

(e) The operation of hotels and related facilities.

(f) The transportation within Brazil of passengers or freight.

(g) The performance of services incident to a qualified trade or business.

(h) The performance within Brazil of services utilized either within Brazil or within a less developed country if the services are industrial, financial, technical, scientific, engineering, or architectural in nature.

(i) Any other trade or business agreed upon by the competent authorities of both countries.

Unlike the proposed Thai treaty, the proposed Brazilian convention includes smelting or refining as a qualified trade or business. The extractive industries, however, would not, as they did not in the proposed Thai treaty, constitute a qualified business. The provision for the designation of any other trade or business as a qualified trade or business by agreement of the competent authorities, and the exception to the general retail merchandise business, are not found in the proposed Thai treaty. The rights of the competent authorities are also extended to include the right to remove any designated type of business—a provision not contained in the Thai convention.

(4) *Determination of the credit.*—As indicated above, the amount of the credit is determined by a two phase procedure, first at the eligible corporation level and then at the eligible investor level. In the first phase referred to, the amount of the credit is 7 percent of the appropriate amount of qualified property placed in service by the eligible corporation for use exclusively in Brazil in a qualified trade or business. Most of the principles governing the domestic investment credit are applicable in determining the amount of the credit in this phase. Thus, the various requirements relating to placing property in service, useful life of the property, and applicable percentages must be applied. Moreover, the credit will be allowed only for investments by the eligible corporation in section 38 property (as defined in the Internal Revenue Code) with two exceptions: The exclusion of property used outside the United States will not be applicable and the dollar limitations regarding "used section 38 property," which provide generally that only $50,000 of used section 38 property can qualify for the credit in any one year, also will not apply.

A fundamental difference between the investment credit provisions in the proposed Thai treaty and the proposed Brazilian convention in that the proposed Thai convention did not contain the phase one limitation. Under the proposed Thai treaty, the credit was available for investments in qualified trades or businesses, regardless of how the eligible corporation employed its retained earnings or the new investment funds it received. Thus, the credit would have been available under the proposed Thai treaty with respect to investments in land, inventories, securities, and cash. As noted above, the credit provision in the Brazilian convention, by incorporating the Internal Revenue Code rules regarding the credit, restricts the availability of the credit to situations which closely parallel those in which a credit may be obtained under the Code.

(5) *Limitations.*—Under the proposed convention, the credit as determined in the first phase, at the eligible corporation level on the basis of the Internal Revenue Code rules, is then allocated ratably to the eligible investors. The credit which an investor may actually claim is subject to three limitations. First, the credit cannot exceed the amount of United States property acquired by the eligible corporation during the current or preceding year and attributed to the investor. Second, it is limited to 7 percent of the investor's net new investment in the eligible corporation. An eligible investor's new investment consists of—

(a) the property transferred by the investor to the eligible corporation as a capital contribution or in exchange for stock or indebtedness of the corporation,

(b) the investor's allocable share of creditable reinvested earnings of the corporation (one-half the earnings and profits for the taxable year minus the dividends distributed during the year), and

(c) an amount to reflect the depreciation of property placed in service by the eligible corporation for which a credit has previously been allowed.

Transfers of property and creditable reinvested earnings for the current year and the nine preceding years are to be taken into account in determining net new investment. This, in effect, allows a carryover of unused new investments.

This new investment is then reduced by the amount of property withdrawn by the investor from the corporation in the current year, the preceding year, and the three subsequent years. This is the net new investment.

An eligible investor's credit as limited in the manner discussed above is subject to the further limitation contained in the Internal Revenue Code regarding tax liability. The provisions of the Code relating to carryover and carryback of unused credits also are to apply.

Under the proposed Thai treaty, the credit was also limited by the investor's tax liability; however, the limitation was 100 percent of tax liability. The proposed Brazilian convention limits the credit in the same manner as does the Internal Revenue Code. Thus, the credit will not be allowed to exceed 100 percent

of the investor's tax liability up to $25,000 plus 50 percent of the investor's tax liability in excess of $25,000. The proposed Thai treaty did not contain any provision for a carryover and carryback of unused credits.

(6) *Rollover.*—The proposed Thai treaty did not contain the so-called "rollover" aspect of the credit whch is present under the Internal Revenue Code and also is found in the proposed Brazilian convention. The rollover aspect of the credit, which has been referred to above, in essence, means that a credit is available for investments made with funds from a depreciation reserve as distinct from new funds. Thus, under the Code, a corporation can invest in qualified property and receive an investment credit for the investment. At the end of the useful life of the property, the depreciation reserve for the asset will have accumulated to sufficient size to acquire a new asset, and a second investment credit will be available with respect to that asset. The proposed Brazilian convention incorporates the rollover aspect of the domestic credit by providing, in effect, that the depreciation reserve for property on which an investment credit was allowed will be treated as a new investment by the eligible investors and this will support a further credit if the other requirements are satisfied.

(7) *Recapture.*—The proposed Brazilian convention also contains dual provisions relating to the recapture of credits. First, the provisions of the Internal Revenue Code regarding recapture of credits on early dispositions of property for which a credit was allowed will apply. For this purpose, a cessation of eligibility of a corporation will be considered an early disposition of the property. Thus, if a property for which a credit was allowed is disposed of by an eligible corporation before the end of its useful life, the credit will be recomputed on the basis of the period the property was actually used and any excess credit recaptured.

Second, there also will be a recapture of credits if an eligible investor directly or indirectly withdraws his investment from an eligible corporation. In the case of a withdrawal, an investor's net new investment, the basis of one of the limitations on the credit, will be recomputed, and if this reduces the amount of the credit originally allowable, the appropriate amount will be recaptured. If a U.S. investor transfers stock or indebtedness of an eligible corporation to another U.S. resident or corporation, this would normally be considered a withdrawal of investment and subject the credit to possible recapture. However, an agreement may be entered into by the competent authority of the United States and the transferor and transferee investors whereby the transfer will not be considered a withdrawal if the transferee investor agrees that any later withdrawal by him will be treated as a withdrawal which may give rise to a recapture of the initial investment credit. This will allow investments in eligible corporations to be transferred from one U.S. person to another without this being treated as a withdrawal if the parties all agree. At the same time, this preserves the right to recapture the credit upon a subsequent withdrawal.

(8) *Changes in the domestic credit.*—The proposed convention also provides that if the domestic investment credit is modified, amended, suspended, or terminated, the treaty credit is to be modified, amended, suspended or terminated to the extent necessary to keep the treaty credit consistent with the domestic credit. If Brazil considers that a modification or amendment of the domestic credit, and therefore the foreign investment credit, materially and adversely affects the credit, it may treat the modification or amendment as a suspension of the credit which will allow it to terminate the reduced rates provided in the treaty for dividends, interest, and royalties. These provisions reflect the importance to Brazil of the investment credit as an incentive to enter into the proposed convention and to make tax concessions under it.

Article 8. Business profits

The proposed convention contains provisions regarding the taxation of business profits which generally accord with similar provisions found in other treaties to which the United States is a party. Thus, it is provided that the business profits of a resident or corporation of one country will not be taxable by the other country unless the resident or corporation has a permanent establishment in that other country. If the resident or corporation does have a permanent establishment in the other country, then that country may tax the industrial and commercial profits of the resident or corporation which are attributable to the permanent establishment. That country may in certain cases also tax business profits of the resident or corporation having the permanent establishment. It may tax the business profits of this resident or corporation where they are derived

by it from sources within the country from sales of goods or merchandise (or other business transactions) similar to sales made by (or the business of) the permanent establishment. This latter provision is not generally included in our tax conventions, although a similar provision is found in the 1965 protocol with the Federal Republic of Germany and in the 1965 supplementary convention with the Netherlands.

In computing the business profits of a resident or corporation of one country which are subject to tax in the other country, the proposed convention follows the general treaty approach of allowing the deduction of all expenses which are reasonably connected with the business profits taxable in that other country. Under Brazilian law, the deduction for expenses attributable to profits of a Brazilian permanent establishment would frequently be limited to expenses incurred in Brazil. However, the exchange of letters accompanying the proposed convention contains the understanding that the proposed convention will be interpreted by both Brazil and the United States to allow the deduction of expenses wherever those expenses are incurred. This accords with the result reached under most of our treaties.

The definition of industrial and commercial profits in the proposed Brazilian convention follows the approach of our other recent treaties and also of the Internal Revenue Code, as amended by the Foreign Investors Tax Act of 1966, by including in industrial and commercial profits income which is effectively connected with the permanent establishment deriving the profits. The types of effectively connected income so included in industrial and commercial profits are limited to dividends, interest, royalties, and income from real property and natural resources.

Article 9. Definition of permanent establishment

The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, a resident or corporation of one country will not be taxable on his business profits by the other country, unless the profits are attributable to a permanent establishment of the resident or corporation in that country. In other words, the permanent establishment concept defines the degree of economic penetration a resident or corporation of one country may make in the other country without being subject to tax in that country on the business profits arising in that country.

The proposed convention with Brazil follows the general treaty pattern by defining a "permanent establishment" as a fixed place of business through which a trade or business is engaged in, such as an office, factory, mine, etc. Moreover, the proposed convention also follows the approach embodied in our other recent treaties and in the OECD draft convention by modifying this general rule to provide that even though an office or other fixed place of business exists it will not be considered a permanent establishment if it is used for any one or more of the following activities:

(1) The processing by another person, under arrangements or conditions which are, or would be, made by independent persons, of goods or merchandise belonging to the resident or corporation,

(2) The purchase, under arrangements or conditions which are, or would be, made between independent persons, of goods or merchandise.

(3) The storage or delivery of goods belonging to the resident or corporation (this provision does not apply, however, to goods or merchandise held for sale in a store or other sales outlet, or to goods or merchandise purchased and resold in the country by the resident or corporation or by an independent agent on behalf of the resident or corporation),

(4) The collection of information for the resident or corporation,

(5) Advertising, the conduct of scientific research, the display of merchandise, or the supplying of information,

(6) Construction, assembly, or installation projects if the site is used for such purpose for less than 6 months.

The independent persons requirement of the business activities described in paragraphs (1) and (2) is not generally contained in our other treaties, nor are the exceptions to the activity described in paragraph (3). Nevertheless, the activities which may be engaged in without giving rise to a permanent establishment will allow U.S. persons to engage in a number of activities in Brazil without being subject to tax; in the absence of the proposed convention these activities might give rise to Brazilian taxation of various types of business profits, such as on sales of goods in Brazil through an independent agent who secures orders

for the goods. Also, under Brazilian law all income resulting from a construction project is subject to Brazilian tax if a fixed place of business is used for the project at any time. The proposed convention substantially eases the impact of this rule by allowing a site or facility to be used for a construction or assembly project of up to 6 months duration without the income from the project being subject to Brazilian tax.

As in other treaties and in the OECD draft convention, the proposed Brazilian convention provides that even though a resident or corporation of one country does not have a fixed place of business in the other country, nevertheless the resident or corporation will be deemed to have a permanent establishment in the other country, if it has an agent in the other country who regularly exercises a general contracting authority (other than for the purchase of merchandise) or who maintains a stock of merchandise from which he regularly makes deliveries. The proposed convention does not include the rule, which is found in the proposed Thai treaty, that an agent who regularly secures orders will be deemed a permanent establishment.

The normal rule that the use of an independent agent acting in the ordinary course of his business will not be considered a permanent establishment is included in the proposed convention. It does not contain, however, the provision found in the proposed Thai treaty that an agent, even though of independent status, will be considered a permanent establishment if the agent acts exclusively, or almost exclusively, for the resident or corporation.

Article 10. Ships and aircraft

The proposed convention adopts the approach embodied in most other tax treaties to which the United States is a party by providing that income which a resident or corporation of one country derives from the operation in international traffic of ships or aircraft registered in that country will be completely exempt from tax by the other country. The proposed Thai treaty would have only granted a 50 percent exemption in the case of income from the operation of ships.

Article 11. Related persons

Most income tax treaties contain a provision similar to section 482 of the Internal Revenue Code which allows the allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons. The proposed convention includes a provision of this nature.

Article 12. Dividends and branch profits

The proposed convention provides a reduction in the Brazilian withholding tax on dividends from 25 percent to 20 percent in the case of dividends paid by a Brazilian corporation to a U.S. corporation, if the U.S. corporation has owned at least 10 percent of the stock of the Brazilian corporation for that part of the Brazilian corporation's taxable year occurring prior to the payment of the dividend and for the preceding year (provided that not more than 25 percent of the paying corporation's income is from dividends and interest, other than dividends and interest from subsidiary corporations).

The treatment of dividends contained in the proposed convention is less liberal than the treatment provided by most income tax treaties to which the United States is a party in two respects. First, our treaties generally contain a reduction in the source country withholding tax rate on dividends which applies to dividends received by any resident of the other country, not just corporations with a specified ownership interest in the paying corporation. Second, the source country tax rate is generally reduced at least to 15 percent, and to 5 percent in many cases for dividends paid, by subsidiary corporations, rather than the 20 percent rate specified in the proposed Brazilian convention. The reduction in the Brazilian withholding tax to 20 percent is sufficient, however, to make the aggregate of Brazilian taxes paid on distributed corporate profits creditable against the U.S. tax on those profits (30 percent corporate tax plus a 5 percent distributed profits tax on the remaining 70 percent of profits plus a 20 percent withholding tax on the remaining 66.5 percent of profits equals a total tax of 46.8 percent).

The proposed convention is more liberal than most of our income tax treaties in one important respect. Generally, the reduced rate of tax on dividends in the source country is not available if the recipient of the dividend has a permanent establishment in that country and, in the case of our more recent treaties, if the dividend is effectively connected with the permanent establishment. This

rule is not contained in the proposed convention. Thus, the reduced rate will be available regardless of the fact that the recipient of the dividends has a permanent establishment in Brazil and whether or not the dividends are effectively connected with the permanent establishment.

The reduction in a source country tax on dividends provided in the proposed convention is unilateral on the part of Brazil. The U.S. withholding tax on dividends paid by U.S. corporations to Brazilians is not reduced inasmuch as this might cause Brazilian investments to be diverted from Brazil to the United States, and this is contrary to one of the purposes of the proposed convention, namely, the encouragement of investments and economic development in Brazil. Therefore, the United States will continue to impose its tax on dividends derived from the United States by residents and corporations of Brazil at the statutory rates (30 percent in the case of dividends not effectively connected with a U.S. business and the generally applicable rates in the case of dividends which are so effectively connected).

The proposed convention also provides that the so-called "branch profits" tax imposed by Brazil will be reduced from the normal 25 percent to 20 percent. Generally, the earnings of a Brazilian branch of a U.S. corporation are subject to the regular 30 percent corporate tax, the 5 percent distributed profits tax, and also a 25 percent "branch profits" tax on the remaining profits. In other words, these branch profits are basically treated by Brazil in the same manner as intercorporate dividends, and, therefore, the reduction in the Brazilian withholding tax rate on intercorporate dividends is extended to the "branch profits" tax.

A unique feature of the proposed convention is that it allows Brazil to raise the tax rate on dividends and branch profits provided by the convention to the same extent it decreases its general corporate tax rate below 28 percent. (The general corporate tax rate was 28 percent until November 21, 1966, when it was increased to 30 percent). The effect of this provision is to allow Brazil to keep its aggregate tax rate on distributed profits at approximately the level for which the U.S. foreign tax credit will be available.

Article 13. Interest

A number of income tax treaties to which the United States is a party provide that interest derived from sources within one country by a resident or corporation of the other country will either be exempt from, or subject to a reduced rate of, tax in the source country. The proposed Brazilian convention contains a more limited provision. Interest received by the Government, or a wholly owned agency, of the United States or Brazil is exempt from tax by the other country.

The proposed convention also contains a unilateral reduction from 25 percent to 15 percent in the Brazilian tax which is applicable to interest derived from sources in Brazil by a nonresident. This reduction only applies, however, to interest received by a U.S. bank or other financial institution that does not have a permanent establishment in Brazil. This provision does not adopt the effectively connected concept which is contained in our other recent treaties. In other words, the reduced rate of Brazilian tax on interest does not apply if the recipient of the interest has a permanent establishment in Brazil, regardless of whether the interest is effectively connected with the permanent establishment. The proposed convention does provide, however, that where the reduced Brazilian tax rate on interest is not available because the bank or other financial institution has a permanent establishment in Brazil, the interest received by the bank or financial institution will be treated as business profits attributable to the permanent establishment and taxed accordingly. The effect of this provision is to allow interest received by U.S. banks and financial institutions to be taxed in Brazil on a net basis (i.e., after deduction of the expenses attributable to producing the interest). In situations where interest is not effectively connected with the permanent establishment, it would not otherwise be considered as business profits, and, therefore, could be taxed by Brazil on a gross basis.

The proposed convention also contains provisions found in other recent treaties and in the OECD draft convention regarding the definition of interest and the limitation of the application of the interest article, in situations where the payor and the recipient are related, to the amount of interest which would have been agreed upon by the payor and recipient if they were not related.

Article 14. Royalties

Income tax treaties to which the United States is a party generally provide an exemption from tax in the source country for nonmineral royalties paid to

residents or corporations of the other coutry, provided the recipient does not have a permanent establishment in the source country.

The proposed Brazilian convention provides for a reduction of source country tax to 15 percent in the case of nonmineral royalty income if the recipient does not have a permanent establishment in the source country. The reduced rate of 15 percent compares with the normal Brazilian tax rate on royalties paid to nonresidents of 25 percent, and the generally applicable U.S. statutory rate of 30 percent.

This provision of the proposed convention does not adopt the effectively connected concept contained in our other recent treaties. Thus, the reduced rate of source country tax will not apply if the recipient has a permanent establishment in the source country, whether or not the interest is effectively connected with the permanent establishment. As in the case of interest, the proposed convention does provide, however, that in situations where the recipient of a royalty income has a permanent establishment in the source country, the royalty income will be treated as industrial and commercial profits attributable to the permanent establishment and taxed accordingly. This will allow the recipient of the royalties to compute his source country tax on the basis of the net royalties. Normally, a source country tax is fully creditable by the recipient against his tax liability in his country of residence. However, in cases where the recipient of royalty income incurs substantial expenses in producing the royalty income, the application of source country tax rates to the gross amount of the royalty income could result in a substantial tax burden for the recipient, because the source country tax on the gross amount would greatly exceed the residence country tax on the net amount which may be offset by a foreign tax credit. Therefore, providing that, in the absence of a reduced source country tax rate on royalties, the source country tax will be determined on the basis of the net royalties will in some cases substantially lessen the total tax burden imposed on the royalties by the two countries.

The royalty provision of the proposed convention applies to so-called industrial and commercial royalties. It does not, however, cover royalties arising from the use of motion picture films or films or tapes for radio and television broadcasting, as do a number of other income tax treaties to which the United States is a party.

Under Brazilian law, royalties paid by a Brazilian corporation to a related foreign corporation are treated as dividends rather than royalties. Also, royalties in excess of 5 percent of the paying corporation's gross income are treated as dividends. The proposed convention does not affect these provisions of Brazilian law, but does provide, in effect, that royalties which are characterized as dividends will be taxed in accordance with the dvidend provisions of the proposed convention. Also, as in the case of the interest provision, the royalty provision of the proposed convention does not apply to that part of a royalty paid to a related person which is considered excessive.

Article 15. Income from real property

The proposed Brazilian convention follows the approach of most income tax treaties to which the United States is a party and of the Internal Revenue Code, as amended by the Foreign Investors Tax Act of 1966, by providing that a resident or corporation of one country may elect to be taxed on a net basis in the other country on real property income, including gains from the sale or exchange of real property, and on mineral royalties arising from sources in that other country. The effect of this provision is to produce a source country tax on this income which, in most cases, will be fully creditable against the tax on the income in the country of residence of the recipient, which is usually computed on the basis of the net amount of the income.

In the absence of this provision, Brazil would not allow a U.S. person to be taxed on a net basis on Brazilian source income from real property, unless the U.S. person was considered to be engaged in business in Brazil.

Article 16. Investment or holding companies

The proposed convention contains a provision which denies the benefits of the dividends, interest, and royalties articles to a corporation which is entitled in its country of residence to special tax benefits resulting in a substantially lower tax on those types of income than the tax generally imposed on corporate profits by that country, if more than 25 percent of the capital of the corporation is owned by nonresidents of that country. A similar provision is contained in the Luxembourg convention.

The purpose of this provision is to prevent residents of third countries from using a corporation in one treaty country, which is preferentially taxed in that country, to obtain the tax benefits in the other treaty country which the proposed convention provides for dividends, interest, and royalties derived from that other country. This accords with the purpose of an income tax convention between two countries which is to lessen or eliminate the amount of double taxation of income derived from sources within one country by a resident of the other country.

At the present time, neither Brazil nor the United States grants to investment or holding companies the type of tax benefits with respect to dividends, interest, or royalties which would make this provision of the proposed convention applicable. Thus, the provision will have effect only if Brazil or the United States should subsequently enact special tax measures granting preferential tax treatment to dividends, interest and royalties received by an investment or holding company.

Article 17. Income from personal sources

Under the Internal Revenue Code, a nonresident alien is not taxed by the United States on income earned from services performed by him in the United States if—

(1) he is present in the United States for less than 90 days during the taxable year;

(2) his aggregate income from services performed in the United States does not exceed $3,000; and

(3) he performs the services as an employee of a foreign individual, partnership, or corporation which is not engaged in business in the United States, or for a foreign branch maintained by a U.S. citizen, resident, partnership, or company.

Tax conventions to which the United States is a party generally extend the period a nonresident may be present in the host country (usually from 90 to 183 days) and, in effect, eliminate either the $3,000 income limitation or the foreign employer requirement by not taxing nonresident in the host country if either requirement is satisfied.

The proposed Brazilian convention adopts the general treaty approach by extending the 90-day presence requirement to 183 days. The $3,000 requirement is not eliminated, but rather is raised to $4,000. Also, the foreign employer requirement is retained in the case of employment income, but is eliminated for income derived from the performance of services in an independent capacity.

The proposed convention, however, imposes an additional specific dollar limitation on the amount of personal service income which public entertainers (such as actors, athletes, etc.) may receive tax free in the source country. Compensation of these persons in excess of $100 for each day the person is present in the source country is taxed. If a Brazilian public entertainer, however, satisfies the requirements of U.S. statutory law for exemption of personal service income which includes the $3,000 per year limitation, he may avail himself of the statutory exemption and, thus, avoid the $100 per day limitation contained in the proposed convention.

Article 18. Teachers

Most income tax treaties to which the United States is a party provide some exemption from tax in the source country to teachers who are residents of the other country and who are temporarily present in the source country at the invitation of the Government or an educational institution. The purpose of such a provision is to facilitate the interchange of teachers between countries.

The proposed Brazilian convention follows the approach of our more recent conventions which contain more liberal exemption provisions than did earlier conventions. Thus, it is provided that a resident of one country will be exempt from tax in the other country on income from teaching and research for 2 years if he is present in the other country for the purpose of teaching or engaging in research at an accredited educational institution. The exemption, however, does not apply to income from research which is undertaken primarily for the benefit of private persons, rather than in the public interest.

Article 19. Students and trainees

The income tax conventions to which the United States is a party generally provide that students who are residents of one country will be exempt from tax in the other country on certain types of income if they are present in

that country for the purpose of attending school. This exemption is usually limited to gifts from abroad which are used by the student for his maintenance or education. Other U.S. source income received by a foreign person attending school in the United States, such as income from part-time jobs or scholarships from a U.S. exempt organization, would not be entitled to the exemption.

The proposed Brazilian convention contains a provision similar to that embodied in the 1965 supplementary convention with the Netherlands which expands the exemption contained in most of our other tax conventions to encourage a greater exchange of students between the treaty countries. The proposed convention provides that residents of one country who become students in the other country will be completely exempt from tax in the other country on gifts from abroad used for maintenance and study, and on any grant, allowance or award received from a governmental or charitable organization. Also, limited exemptions are provided for personal service income derived from sources within the country in which the individual is studying. In the case of students generally, $2,000 per year of personal service income (such as income from part-time jobs) is exempt from tax in the country in which the individual is a student. The limitation is increased to $5,000 per year if the individual is studying for a profession or a professional specialty. These exemptions (the complete as well as the limited ones) may not be utilized for a period longer than 5 years.

In addition to the exemptions regarding students, the proposed convention follows the approach of our other treaties and provides limited exemptions for personal service income of employees of a resident or corporation of one country who are temporarily present in the other country to acquire technical, professional or business experience ($5,000 per year) and for personal service income of participants in Government sponsored exchange training programs ($10,000 per year).

Article 20. Government salaries

As is the case in other income tax treaties to which the United States is a party, the proposed convention provides that one country will not tax wages, salaries, pensions, or annuities paid by the other country to its nationals for governmental services.

Article 21. Rules applicable to personal income articles

The proposed convention provides that reimbursed travel expenses are exempt from tax under the personal income articles without regard to the maximum amount of the exemptions. The proposed convention also provides that only the benefits of the most favorable personal income article may be claimed by a taxpayer for a year if more than one of those articles is applicable in that year.

Article 22. Deduction for charitable contributions

The Internal Revenue Code allows U.S. taxpayers to deduct as charitable contributions among other things, contributions to organizations formed for religious, charitable, scientific, literary, or educational purposes if the recipient is organized in the United States. No charitable contributions deduction is available to a U.S. taxpayer, however, for contributions to charities organized abroad.

The existing income tax treaty with Canada allows U.S. taxpayers to deduct contributions to Canadian charities. This deduction is subject to two limitations:

(1) The limitation provided by the Internal Revenue Code on the charitable contributions deduction (generally, 30 percent of taxable income in the case of individuals and 5 percent of taxable income in the case of corporations); and

(2) The limitation provided by Canadian law on the deduction for charitable contributions (a specified percentage of income) computed on the basis of the U.S. taxpayer's Canadian source income.

The proposed Brazilian convention contains a charitable contributions deduction provision similar to that found in the Canadian treaty except that it includes only the first limitation discussed above, that related to U.S. law. In other words, there is no limitation determined by applying the percentage limitations under Brazilian law to the U.S. taxpayer's Brazilian source income.

Thus, the proposed convention allows a citizen, resident, or corporation of the United States to deduct contributions to Brazilian charities (subject to the limitations under the Internal Revenue Code otherwise applicable if the contributions were to U.S. charities) if (1) the contributions are used entirely within

Brazil, and (2) the recipient Brazilian organization has qualified as a charitable, etc., organization under section 501(c)(3) of the Internal Revenue Code.

Article 23. Pensions and annuities

The proposed convention adopts the approach embodied in most of our income tax treaties of exempting private pensions and annuities paid to residents of one country from tax in the other country.

Articles 24–28. Administrative provisions

The proposed convention contains the various administrative provisions found in most income tax conventions to which the United States is a party. In general, the proposed convention provides for—

(1) consultation and negotiation between the countries to resolve differences arising in the interpretation and application of the proposed convention and to resolve claims by taxpayers of taxation contrary to the proposed convention;

(2) the exchange between the countries of legal information and of information relating to carrying out the provisions of the proposed convention or to preventing fraud or fiscal evasion with respect to the taxes covered by the proposed convention; and

(3) the countries to assist each other in collecting taxes imposed by the other to the extent necessary to ensure that the benefits provided by the proposed convention are enjoyed only by persons entitled to those benefits.

Article 29. Diplomatic and consular officers

As in the case in the OECD draft convention and in a number of our other income tax treaties, the proposed convention provides that its provisions are not to prejudice any tax privileges which diplomatic or consular officers enjoy under rules of international law or the provisions of special agreements.

Article 30. Effective dates

The proposed convention will become effective generally for taxable years beginning on or after January 1 of the year following the exchange of the instruments of ratification. There are, however, a number of exceptions to this general rule. The rule for determining the source of income derived from the sale of personal property produced in one country and sold in another country will not become effective until Brazil and the United States have established mutually acceptable rules for the implementation of this source rule. The investment credit provision will apply to property placed in service and net new investments made on or after January 1, 1968. The tax benefits extended to dividends and branch profits, interest, and royalties will only apply to amounts paid on or after January 1, 1969.

Senator MORSE. Our next witness is Mr. George C. Wells, vice president of the Union Carbide Corporation.

I want those in attendance to know that my colleague here is not presiding because of his own request. I asked him to preside, but apparently Senator Sparkman plans to leave shortly, and has asked me to carry on. I am not usurping any jurisdiction.

You may proceed, Mr. Wells.

STATEMENT OF GEORGE C. WELLS, VICE PRESIDENT, UNION CARBIDE CORPORATION, NEW YORK, N.Y.

Mr. WELLS. Mr. Chairman, Senator Sparkman, my name is George Wells. I am a vice president of Union Carbide Corporation for international affairs, and I would like to say I certainly appreciate this opportunity of presenting our views on the Brazilian tax treaty.

I have submitted our statement for the record, and I would like to summarize or make a comment or two thereon.

Senator MORSE. Mr. Wells, your statement will be printed in full at this point in the record, and you may summarize it in your own way.

Mr. WELLS. Thank you, sir.

(The prepared statement of Mr. Wells follows:)

STATEMENT OF GEORGE C. WELLS ON THE PROPOSED TAX CONVENTION WITH BRAZIL

My name is George Wells. I am the Vice President of Union Carbide Corporation for International Affairs.

Union Carbide Corporation has interests in a number of companies operating in Latin America, including Brazil. These operations in Brazil encompass 28 plants which make chemicals, plastics, graphite electrodes, batteries, and industrial gases and appliances, and which also distribute many products manufactured by Union Carbide Corporation in this country.

Our Corporation is greatly interested in the consumation of income tax conventions between this country and the countries of Latin America. We consider it both unfortunate and anomalous that there is not today a single such treaty with any of the countries of Latin America, when the United States does have tax conventions with many of the countries of Europe and Asia, Canada, and Australia. These income tax conventions, we believe, prevent tax barriers to trade arising between the contracting countries and tend to eliminate problems which relate to the double taxation of income by both contracting parties.

In the past less developed countries have felt that they would receive little benefit from tax conventions since the flow of income is toward the more developed countries. We, therefore, are most happy with the development of a convention between Brazil and the United States which will benefit both countries. Again, we believe that this convention if approved will encourage better understanding between our two countries in the areas of commerce and investment. Likewise, this treaty with a Latin American country should represent a most important initial step in negotiating similar treaties with all of Latin America. Therefore, it is our earnest hope that this treaty, which represents the results of years of careful and constructive negotiations by the Treasury Department of the United States, will be ratified by the Senate.

We understand that certain details of this treaty have been subject to some criticism as might be expected. In our opinion such details are not of sufficient importance to justify postponement of approval by your Committee of a package which must have involved many mutual concessions by both parties over a long period of time.

An important point of this treaty from the Brazilian viewpoint relates to the 7% investment credit which would be available to U.S. companies to encourage investments in Brazil. This credit corresponds in general to the credit in the Internal Revenue Code which is contributing to the increased industrial development of the United States. We also believe that this credit will contribute to the objectives of the Alliance for Progress and to improving relations on a broad front with our good neighbors in the Americas. To the extent that the private sector is encouraged and enabled to contribute more extensively to the industrial development of countries like Brazil, the less should be the financial burden upon the U.S. government.

The proposed treaty contains significant provisions found in other bilateral treaties, which will reduce and in some cases prevent double taxation of income, and will therefore be of long term mutual advantage. Among these are the provisions for determining source of particular kinds of income, for attributing different kinds of income to the tax jurisdiction of one or the other of the contracting parties, and also for reducing the withholding tax payable on dividends and royalties. The inclusion of the concept of "permanent establishment" for tax purposes is also significant in that income from exports to Brazil would not be taxable there in the absence of a permanent Brazilian establishment on the part of the exporter.

International double taxation can represent a serious impediment to the free-flow of commerce and investments between nations. The problems connected with it have been recognized and dealt with in the many tax treaties which we now have. We believe it is now the time to take the same step with this important country which is the largest and most populous in Latin America.

Mr. WELLS. Union Carbide Corporation has interests in a number of companies operating in Latin America, including Brazil. These operations in Brazil involve 28 plants which make chemicals, plastics, graphite electrodes for the steel industry, dry batteries, and industrial

gases and appliance, and which also distribute many products manufactured by Union Carbide Corporation in this country.

RATIFICATION OF BRAZIL TREATY URGED

We consider it both unfortunate and even anomalous that there is not today a single tax treaty with any of the countries of Latin America, when the United States does have tax conventions with many of the countries of Europe, Asia, Canada, and Australia. These income tax conventions, we believe, prevent tax barriers to trade arising between the contracting countries and tend to eliminate problems which relate to the double taxation of income by both contracting parties.

Further, we believe that this convention, if approved, will encourage better understanding between our two countries in the areas of commerce and investment. Therefore, it is our earnest hope that this treaty which represents the results of a relatively long period of careful and constructive negotiation by the Treasury Department of the United States will be ratified.

INVESTMENT CREDIT OF 7 PERCENT SUPPORTED

We understand that certain details of the treaty have been subject to some criticism, which might be expected. In our opinion, such details are not of sufficient importance to justify postponement of approval by your committee of a package which must have involved many mutual concessions by both parties over a considerable period of time. An important point of this treaty from the Brazilian viewpoint relates to the 7 percent investment credit which would be available to U.S. companies to encourage investments in Brazil. This credit corresponds in general to the credit in the Internal Revenue Code which is contributing to the increased industrial development of the United States. We also believe this credit will contribute likewise to the objectives for the Alliance for Progress and to improving relations on a broad front with our good neighbors in the Americas. To the extent that the private sector is encouraged and enabled to contribute more extensively to the industrial development of countries like Brazil, the less should be the financial burden upon the U.S. Government.

PROVISIONS TO REDUCE DOUBLE TAXATION

The proposed treaty contains significant provisions found in other bilateral treaties, which will reduce and in some cases prevent double taxation of income, and will therefore be of long-term mutual advantage. Among these are the provisions for determining source of particular kinds of income, for attributing different kinds of income to the tax jurisdiction of one or the other of the contracting parties and also for reducing the withholding tax payable on dividends and royalties.

The inclusion of the concept of permanent establishment for tax purposes is also significant in that income from exports to Brazil would not be taxable there in the absence of a permanent Brazilian establishment on the part of the exporter.

International double taxation can represent, we believe, a serious impediment to the free flow of commerce and investments between

nations. The problems connected with it have been recognized and dealt with in the many tax treaties which we now have. We believe it is now the time to take the same step with this important country which is the largest and most populous in Latin America.

Senator MORSE. Could I interrupt at that point for just a moment, Mr. Wells?

Mr. WELLS. Yes, sir.

Senator MORSE. I have spoken to a good many meetings of American businessmen in Latin America, including the various chapters of our American Chambers of Commerce, and if I had to list the five most common complaints that are presented to me at those various meetings, the one that you are mentioning, I think, would be very high on the list and that is this whole matter of double taxation and the inhibition that it really serves for the spread of American investments in Latin America.

EXPORT OF U.S. SYSTEM OF ECONOMIC FREEDOM TO LATIN AMERICA

Now, with that comment, let me put my question to you this way: Would you agree with me that it is really much cheaper from the standpoint of dollars and cents to make it encouraging for American private business to invest in Latin America and do what you heard me say this morning, export our system of economic freedom to Latin America, than to spend American taxpayer dollars by way of direct aid to governments in Latin America for them, in turn, to use the money for development of their economy in accordance with their rights? Do you think that I am very far from wrong? It has been an argument I have used as chairman of the Latin American subcommittee now for some years, that you will save more money from the standpoint of foreign assistance if you can channel it through the exportation of our system of business into Latin America in the private sector than you will if you channel it through direct foreign assistance programs, and government to government. Do you think I am wrong in that evaluation?

Mr. WELLS. Senator, I could not put it any where nearly so aptly from our viewpoint.

WHY AMERICAN CORPORATIONS GO OVERSEAS

Could I, by way of trying to respond to this question, take just a moment to briefly analyze the reasons why and the process by which American corporations like my own go overseas in the first place, and how they do it?

The reason I request the opportunity to do this is and I didn't come down here with any intention of saying this but there were a number of questions raised this morning which indicated to me a fear that incentives toward foreign investment categorically tended to injure us domestically, either in terms of reduced tax revenue or lower employment. In other words, that the export of our system, as you put it, and of investments overseas, tends to export jobs and reduce the revenue of the Government.

Now, the first thing that an American company from the standpoint of evolution does in trying to develop an overseas business is to start

to try to export—generally one of its major product lines for which it thinks there is a market in a certain given area.

It never wishes to or deliberately "talks itself" into making a major investment overseas, because, after all, in most countries the risk is greater and the task of running a manufacturing establishment overseas is far more complicated and difficult and sometimes less profitable, even, than it is in the United States. Therefore, we always start, and I think this is almost without exception, in attempting to promote exports.

Now, from the standpoint of evolution, let's assume we are successful, as many have been, and as the export business grows, we develop a major share of a local market, in our case, let us say, for a major chemical or a major plastic product.

We enjoy this business for a while; and employment goes up in the United States in our plants because of the increase in export business. But the day finally arrives when the market which we are developing has become large enough to economically justify, at least in the minds of competitors, a local manufacturing operation, and very often this is not just an American competitor or a local group, but a Japanese or European competitor.

EFFECT ON U.S. EXPORTS

Now, at that point, we are faced with only two alternatives. We either have to "beat them to the punch" and get a plant in first ourselves, even though we had no idea of doing this in the first place, or we lose the market which we have put a lot of effort and expense into building up, and our exports are lost; we are through; we are out of the market. It is as simple as that.

Most international companies feel that if we fail to invest to protect our market, we are not going to grow overseas. We are not going to build our international business, and then there is no question but what our exports and hence domestic jobs are going to suffer.

But if we do invest, it isn't necessarily the case that exports are going to suffer. In fact, very often, the opposite takes place, because while the export of this single product to be produced locally will obviously be reduced, we have found in our experience that what eventually happens is that the local foreign operation, with the advantage of having the American system of management, production, and so forth, as you pointed out, Senator, exported, forming the nucleus, the basis from which the market for the local product can be developed—from this we have found that many collateral products similar to the local product being produced (but not in sufficient volume in the beginning to justify local manufacturing and which we have not been exporting previously) come into the picture from the export standpoint for the first time. Strangely enough, over the years we have found that while the value of the production from the operations in which we are interested outside the United States has increased subsantially, our exports have also grown substantially at the same time.

INCREASING PURCHASING POWER OF LATIN COUNTRIES

SENATOR MORSE. I am glad I interrupted you to digress, but I think this record ought to contain the viewpoint that you are expressing

and what the Chairman is seeking to elicit from you. We talk a good game here, time and time again, about the importance of our increasing the purchasing power of the masses of the population in these Latin American countries, and that is our objective, one of our objectives.

It is a fine objective. But we are not going to increase their purchasing power unless you increase their manufacturing power, which increases their job opportunities, which, in turn, increases their ability to sell and buy. So just for the record, I think it is so apropos of what you say that I am going to put into the record certain provisions of part III of the Foreign Assistance Act, starting with section 601. I will just read the first sentence and put the rest of that paragraph in. It reads:

FOREIGN ASSISTANCE ACT PROVISIONS

ENCOURAGEMENT OF FREE ENTERPRISE AND PRIVATE PARTICIPATION.—(a) The Congress of the United States recognizes the vital role of free enterprise in achieving rising levels of production and standards of living essential to economic progrss and development.

Mr. Reporter, I want to put the rest of paragraph (a) in the record. (The paragraph referred to follows:)

[From the Foreign Assistance Act of 1961, as amended]

PART III

CHAPTER 1—GENERAL PROVISIONS

SEC. 601. ENCOURAGEMENT OF FREE ENTERPRISE AND PRIVATE PARTICIPATION.—(a) The Congress of the United States recognizes the vital role of free enterprise in achieving rising levels of production and standards of living essential to economic progress and development. Accordingly, it is declared to be the policy of the United States to encourage the efforts of other countries to increase the flow of international trade, to foster private initiative and competition, to encourage the development and use of cooperatives, credit unions, and savings and loan associations, to discourage monopolistic practices, to improve the technical efficiency of their industry, agriculture, and commerce, and to strengthen free labor unions; and to encourage the contribution of United States enterprise toward economic strength of less developed friendly countries, through private trade and investment abroad, private participation in programs carried out under this Act (including the use of private trade channels to the maximum extent practicable in carrying out such programs), and exchange of ideas and technical information on the matters covered by this subsection.

Senator MORSE. Then I turn to paragraph (b) of section 601:

In order to encourage and facilitate participation by private enterprise to the maximum extent practicable in achieving fully the purposes of this act, the President shall—(1) make arrangements to find, and draw the attention of private enterprise to, opportunities for investment and development in less developed friendly countries and areas; * * *"

Our idea is to say to you people in business, "Here are some opportunities down there. You ought to go down and make some investments to carry out this foreign policy of your country."

(2) establish an effective system for obtaining adequate information with respect to the activities of, and opportunities for, nongovernmental participation in the development process, and for utilizing such information in the planning, direction, and execution of programs carried out under this Act, and in the coordination of such programs with the ever-increasing development activities of nongovernmental United States institutions.

(3) accelerate a program of negotiating treaties for commerce and trade, including tax treaties, which shall include provisions to encourage and facilitate

the flow of private investment to, and its equitable treatment in, friendly countries and areas particularly in programs under this Act.

I shall ask, Mr. Reporter, that the rest of section 601 of the act be incorporated in the record at this point.

(The legislation referred to follows:)

[From the Foreign Assistance Act of 1961, as amended]

(b) In order to encourage and facilitate participation by private enterprise to the maximum extent practicable in achieving any of the purposes of this Act, the President shall—

(1) make arrangements to find, and draw the attention of private enterprise to, opportunities for investment and development in less developed friendly countries and areas;

(2) establish an effective system for obtaining adequate information with respect to the activities of, and opportunities for, nongovernmental participation in the development process, and for utilizing such information in the planning, direction, and execution of programs carried out under this Act, and in the coordination of such programs with the ever-increasing developmental activities of nongovernmental United States institutions;

(3) accelerate a program of negotiating treaties for commerce and trade, including tax treaties, which shall include provisions to encourage and facilitate the flow of private investment to, and its equitable treatment in, friendly countries and areas participating in programs under this Act;

(4) seek, consistent with the national interest, compliance by other countries or areas with all treaties for commerce and trade and taxes, and take all reasonable measures under this Act or other authority to secure compliance therewith and to assist United States citizens in obtaining just compensation for losses sustained by them or payments exacted from them as a result of measures taken or imposed by any country or area thereof in violation of any such treaty;

(5) to the maximum extent practicable carry out programs of assistance through private channels and to the extent practicable in conjunction with local private or governmental participation, including loans under the authority of section 201 to any individual, corporation, or other body of persons;

(6) take appropriate steps to discourage nationalization, expropriation, confiscation, seizure of ownership or control of private investment and discriminatory or other actions having the effect thereof, undertaken by countries receiving assistance under this Act, which divert available resources essential to create new wealth, employment, and productivity in those countries and otherwise impair the climate for new private investment essential to the stable economic growth and development of those countries;

(7) utilize wherever practicable the services of United States private enterprise (including, but not limited to, the services of experts and consultants in technical fields such as engineering);

(8) utilize wherever practicable the services of United States private enterprise on a cost-plus incentive fee contract basis to provide the necessary skills to develop and operate a specific project or program of assistance in a less developed friendly country or area in any case in which direct private investment is not readily encouraged, and provide where appropriate for the transfer of equity ownership in such project or program to private investors at the earliest feasible time.

(c) (1) There is hereby established an International Private Investment Advisory Council on Foreign Aid to be composed of such number of leading American business specialists as may be selected, from time to time, by the Administrator of the Agency for International Development for the purpose of carrying out the provisions of this subsection. The members of the Council shall serve at the pleasure of the Administrator, who shall designate one member to serve as Chairman.

(2) It shall be the duty of the Council, at the request of the Administrator, to make recommendations to the Administrator with respect to particular aspects of programs and activities under this Act where private enterprise can play a contributing role and to act as liaison for the Administrator to involve specific private enterprises in such programs and activities.

(3) The members of the Advisory Council shall receive no compensation for their services but shall be entitled to reimbursement in accordance with section 5 of the Administrative Expenses Act of 1946 (5 U.S.C. 73b-2) for travel and other expenses incurred by them in the performance of their functions under this subsection.

(4) The expenses of the Advisory Council shall be paid by the Administrator from funds otherwise available under this Act.

(d) It is the sense of Congress that the Agency for International Development should continue to encourage, to the maximum extent consistent with the national interest, the utilization of engineering and professional services of United States firms (including, but not limited to any corporation, company, partnership, or other association) or by an affiliate of such United States firms in connection with capital projects financed by funds authorized under this Act.

Senator MORSE. Now, there is your governmental policy set forth in the Foreign Assistance Act. All we are dealing with here in this hearing, it seems to me, is a treaty that is designed to implement that objective, and the question before us is whether or not it does it rightly or wrongly, whether or not it has bugs in it or has not. That is the purpose of the hearing.

But, certainly, there is no question about the fact that as long as that act is on the books, that is supposed to be one of the objectives of our foreign assistance program and that is why I thought I ought to take these few minutes to take advantage of you, sir, as a witness, to elicit from you what I happen to know are the objectives of your company and there isn't any doubt about the fact, in my judgment, that the Alliance for Progress program has probably been strengthended more by the investment of American business in Latin America than by anything we have done as a Government.

SEARS, ROEBUCK OPERATIONS IN BRAZIL

I can remember very well when I spoke at São Paulo, Brazil, to the American Chamber of Commerce there, and the businessmen were quite excited about the results of a very bad poll that had come out in Brazil expressing anti American feeling that American business was just skimming off the cream of profits. I cannot walk into a meeting such as that unless I have done a little homework, and Mr. Williams of Sears, Roebuck, as I recall, was chairman and these businessmen were greatly concerned.

I said:

Well, I have a few suggestions to make to you, and I would like to know, Mr. Williams, how many in this Chamber of Commerce audience, to say nothing about Brazilians, know that you have never declared a dividend down here until three years ago, and that was three percent, and last year two and a half. And you haven't made up your mind yet whether you are going to declare one this year, because you plowed back in your operations your earnings, and you not only have thereby increased the productivity of your Sears, Roebuck operations, but who in Brazil knows what else you did with your money, and the libraries that are the beneficiaries, the parks that are the beneficiaries, the child-care programs that are the beneficiaries?

I was loaded for bear, in other words, and he was quite surprised, and I said:

Here I am speaking almost a stone's throw away from your retail plant. How many in this room, to say nothing about Brazilians, know that 85 percent of the goods that you sell in this great Sears, Roebuck retail outlet are made right here in Brazil, which means you have created jobs? Not only that, but you have created job training for a good many Brazilians.

Now that is what I mean when I talk about exporting our system of economic freedom. If anyone thinks that we don't collect great dividends in the long run by increased purchases in the United States, which, in turn, create jobs in the United States, then they have not followed through.

LOOKING AT ENTIRE PROGRAM OF AMERICAN INVESTMENT ABROAD

One of our dangers is to see only a little segment of this problem. We only concentrate on that segment and we don't see the relationship of it to the whole. You have to look at the whole economic program of American investment abroad to see how it carries out the objectives of the act that I have just referred to.

Of course, I don't have to tell you there has to be a policing. Of course, we have those every once in a while who do us a great deal of harm abroad, because they follow business practices and business programs that blacken our eye, but they do it here at home, too, and you have to do some policing here. It is so important that we on this committee keep our sights pretty high as to what the real objectives are, and that is why, with apologies to you, and to Senator Sparkman, I have intervened this much, because I thought it was a pretty good opportunity to link this tax treaty to this act.

Now, if this tax treaty has bugs in it, we will take them out, if they are pointed out to us. But the Foreign Assistance Act itself calls upon us to negotiate tax treaties and when you say all through Latin America we don't have these tax conventions, but we have them in Europe, sure, we are dealing there with developed countries and here with underdeveloped countries. But I happen to think that one of the ways to help speed up the development is to get some equitable, fair, tax treaties that will give business the encouragment that it needs to increase the production of Latin America, to increase the purchasing power, to increase the exports and the imports, and to do something to have us meet on the economic front the problems of Latin America.

If you don't meet them on the economic front, you can't meet them on the political front. I wouldn't worry about the political front in any country if you can first make the people economically free. I am through with my little speech, but you are responsible for it.

Go ahead.

EFFECT OF PRIVATE INVESTMENT ON FOREIGN AID

Mr. WELLS. If I might, Senator, I would just like to supplement a little bit one point which you aptly made and that is the point about the relationship and effect of investments from the private sector with respect to foreign aid by the Government.

To the extent that we are able to do as you say; that is, export the American management system along with our capital investment, which is what we try to do, this tends to upgrade, we think, the whole economic picture as far as business generally in the host country and therefore eventually the standard of living is concerned.

The trouble is that while government funds are necessary, particularly for infrastructure expenditures and that kind of thing, unfortunately direct aid from the government doesn't carry with it the exportation of the American management and production system. It tends to go to local interests who, unfortunately, don't always utilize

it as effectively as it should be, and the United States tends to lose in a degree to the extent that we have to do that.

Now, I believe this Government is committed or if not committed, at least is expending several hundred million dollars a year in connection with the Alliance for Progress and over a period of years figures have been talked of in the order of magnitude of a total cost of $5 billion or more.

To the extent that we can expand investments in the private sector, because most of the businesses in a country like Brazil have to be financed through private capital, and it is difficult to do the job entirely from the government standpoint, to that extent we are, it seems to us, going to reduce the load on the government from the financial standpoint.

Senator MORSE. Is there anything further?

Mr. WELLS. Thank you.

Senator MORSE. Senator Sparkman.

Senator SPARKMAN. No questions. I think it is a very fine statement.

Mr. WELLS. Thank you very much.

Senator MORSE. Thank you very much, Mr. Wells.

Our next witness will be Mr. Robert T. Scott, National Foreign Trade Council, Inc., New York.

Mr. Scott, we are delighted to have you. I have your statement in front of me. I imagine you wish that I incorporate it in the record.

STATEMENT OF ROBERT T. SCOTT, NATIONAL FOREIGN TRADE COUNCIL, INC., NEW YORK, N.Y.

Mr. SCOTT. Yes, I do, Senator.

Senator MORSE. I will incorporate it in the record at this point, and you may summarize it in your own way.

(The statement of Mr. Scott follows:)

CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED STATES OF BRAZIL FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME

The National Foreign Trade Council believes that the United States should move forward in the negotiation of income tax treaties with the developing nations of the world, which will improve the climate for the investment of private capital, implement the aims of the Alliance for Progress and be consistent with the concept of the Latin American Common Market, recently given impetus by the Declaration of the American chiefs of state signed at Punta del Este on April 14th of this year. The proposed treaty with the United States of Brazil is the first income tax treaty with a country in South America and, therefore, the National Foreign Trade Council recommends that the Senate give its advice and consent to ratification.

Although the Council recommends ratification of the treaty with the United States of Brazil as a significant extension of this country's less developed country treaty program, there are certain concepts and provisions therein which should be changed in future treaties concluded with other Latin American countries and in any revision of the Brazil treaty, if maximum incentive is to be given U.S. private investment in South America. The particular provisions which give concern to the Council are:

1. INVESTMENT CREDIT

If the investment incentive is to take the form of an investment credit, Article 7 of the treaty represents a significant improvement over corresponding pro-

visions in Articles 5 and 7 of the Thailand and Israel treaties, respectively. Nonetheless, Article 7 could be improved upon in those instances where there is a significant departure from the principles of the domestic investment credit. Such departures could result in undue restrictions which might tend to inhibit the amount of private investment capital otherwise flowing into such countries as Brazil.

For example, while there are not similar restrictions in the domestic investment credit, item (iv) of paragraph (3)(c) of Article 7 of the Brazil treaty excludes from the term "qualified trade or business" the business of marketing goods or merchandise manufactured outside of the country by related persons. Thus, while it is common for a Brazilian manufacturer who establishes a trademark in Brazil to exploit such mark by the sale of related products produced in other countries, item (iv) would penalize this type of marketing activity by disallowance of the investment credit. Further, wholesaling activities are excluded from the concept of a qualifying trade or business by items (iii) and (iv) of paragraph (3)(c) of the treaty. This would be true even though substantial processing and/or manufacturing of the product were to occur in Brazil. Such restrictions are contrary to both existing business practice, and the basic philosophy of the concept of the Latin American Common Market.

In addition, contrary to the provisions of the domestic investment credit, item (i) of paragraph 3(c) of Article 7 of the treaty excludes the extraction of hard minerals, oil and gas from the definition of a qualified trade or business, therefore excluding any investment therein from the treaty investment credit. We know of no sound economic reasons for such exclusion in the treaty.

However, while the definition of a "qualified trade or business" defined under Article 7(3)(c) is at present restrictive, item (ix) of Article 7(3)(c) does provide that the competent authorities of both contracting states may agree to make appropriate revisions in this definition. This is a significant and desirable provision which we hope will be utilized at the earliest possible opportunity to remedy the above discriminations.

Along the same lines, the domestic investment credit does not contain a definition comparable to that of an "eligible corporation" set forth in Article 7(3)(b) of the Brazil treaty. In defining an "eligible corporation," in terms of an 80 percent of assets and gross income test, Article 7(3)(b) places a premium on the circumstances of how a business is conducted in the treaty country. In many cases, this test could not be met without substantial reorganization by corporations presently operating in Brazil where business activity is also carried on in other South American countries and/or the U.S. A problem could exist here to the extent that under Brazil law such qualifying and non-qualifying activity cannot be severed tax free.

The Council hopes that any such problems could be expeditiously dealt with so as not to inhibit the flow of U.S. private investment to Brazil. We are encouraged in this regard by the letter dated March 13, 1967 from the Brazilian Minister of Finance to the Acting Secretary of Treasury, Senate Executive J, 90th Cong., 1st Sess., 31, which indicates a desire to make future treaty improvements as both countries gain experience in the operation of the treaty and also to reflect any relevant changes in the law of the signatory countries.

2. BUSINESS PROFITS

In arriving at taxable industrial or commercial profits of a permanent establishment, Article 8(3) of the treaty provides for the deduction of all expenses (including executive and general administrative expenses) which would be deductible if the permanent establishment were an independent enterprise and which are reasonably connected with such profits. The letter dated March 13, 1967 from the Acting Secretary of the Treasury of the Minister of the Treasury of Brazil, Senate Executive J, *supra*, 29, 30, states that such expenses incurred outside Brazil will also be deductible. The Council considers this a significant clarification of Brazilian law. However, we would hope that Brazil could be persuaded that similar deductions should be allowed in computing Brazilian taxable income of a Brazilian subsidiary of a U.S. corporation for charges from a U.S. parent or its U.S. affiliates. This is because many U.S. companies operating in Brazil do so by means of locally incorporated subsidiaries.

3. INVESTMENT INCOME

i. In General

The treaty will also improve the investment climate in Brazil to the extent of the reductions obtained in Brazilian withholding tax on investment income.* Apparently, the underlying theory regarding treaty withholding on investment income is that Brazil will attempt to reduce its tax on such income to approximate a supposed U.S. rate of 48 percent which can then be absorbed by the U.S. foreign tax credit. It is thus intended to limit the benefits of such reductions to the U.S. taxpayer and not the U.S. government. See, letter of submittal to the President from the Acting Secretary of State dated April 10, 1967, Senate Executive J, *supra*, 3.

We would, however, like to point out for the record that due to section 922 of the Code, this theory of reducing the foreign withholding rate so that the combined foreign income tax and withholding rates do not exceed 48 percent may be misleading in the case of certain other South American countries. Under section 922, a domestic corporation qualifying as a Western Hemisphere Trade Corporation is taxed at an effective U.S. rate of 34 percent. It is realized that at present, the combined rates of Brazilian income and withholding taxes on profits earned by a U.S. corporation in Brazil exceed 48 percent. However, there is concern that the mere statement of this theory, without qualification, may induce other South American countries to increase their rates up to the supposed U.S. level of 48 percent without consideration of the Western Hemisphere Trade Corporation provisions. It should also be borne in mind that the numerous expenses not deductible under the Brazilian tax law, such as salaries of directors and interest, royalties and service fees paid to the parent make the effective rate of Brazil tax greater than the statutory rate.

Further, the application of Brazil's excess remittance tax and numerous expenses not deductible under Brazilian tax law may make it difficult to limit the rate of Brazilian tax on income flowing to the U.S. to the amount of the U.S. tax on such profits. We would therefore hope that any future treaty revision would include the excess remittance tax as one of the taxes covered by the treaty.

ii. Dividends

If ratified, Article 12 of the treaty will effect a reduction in the combined rates of Brazilian income and withholding tax on dividends and branch profits flowing to the U.S. Nonetheless, as noted above, dividends flowing to the U.S. from Brazil will still be taxed at a rate slightly in excess of 48 percent (not considering the excess remittance tax).

iii. Interest and Royalties

It is hoped that through an early revision, the treaty would provide a general exemption from Brazilian tax on Brazilian source interest and royalties flowing to a U.S. resident or corporation under Articles 13 and 14 of the treaty, respectively. In any event, the reduction in Brazil's withholding rates on interest should apply equally to all U.S. residents and corporations, without restriction as to industry or status in Brazil.

We would also anticipate that such revision would provide for a more effective and complete negation of the force of attraction principle with respect to U.S. investors in Brazil similar to that afforded Brazilian investors in the United States pursuant to section 864(c), added by the Foreign Investors Tax Act of 1966, P.L. 89–809.

Notwithstanding the comments expressed above, the National Foreign Trade Council does not believe that the Senate should delay its advice and consent to the ratification of this proposed income tax treaty between the United States of America and the United States of Brazil.

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*Article 12 of the treaty permits withholding on intercorporate dividends and branch profits at the rate of 20 percent and in stated circumstances permits the rate to go even higher. Under Article 13 of the treaty, only interest received by a government or its agency is exempt from Brazilian tax. Otherwise, a reduced 15 percent rate of withholding on Brazilian source interest will apply, but only to the gross amount of interest received by U.S. banks and then only if such bank does not have a permanent establishment in Brazil. In effect, those U.S. banks operating through a branch in Brazil may not take advantage of this provision. Royalties under Article 14 are taxed at 15 percent of the gross royalty unless the recipient has a permanent establishment in the country of source. In the latter case the regular rates apply regardless of whether the royalty is in fact effectively connected therewith.

Mr. SCOTT. My name is Robert T. Scott. I am director of the tax legal division of the National Foreign Trade Council, and secretary of the tax committee.

At this point, I would like to thank you, Mr. Chairman, for extending an opportunity to the National Foreign Trade Council to appear before you.

RATIFICATION OF BRAZIL TREATY URGED

Our remarks today are addressed solely to the income tax treaty with Brazil.

The National Foreign Trade Council approves the negotiation of tax treaties with developing nations which improve the investment climate, which implement the Alliance for Progress, and are consistent with the concept of the Latin American common market.

Accordingly, we recommend that the Senate give its advice and consent to the ratification of the Brazil treaty.

SUGGESTED IMPROVEMENTS FOR FUTURE TREATIES

Nonetheless, even though this is the first treaty with a South American nation, there are certain concepts which we would hope could be eliminated from future treaties and which might be improved upon at an early date with regard to the Brazil treaty. If I may, Mr. Chairman, I would like to summarize some of these points.

If the investment incentive is to be in the form of an investment credit, then it should be patterned upon the Internal Revenue Code as is article 7 of the Brazil treaty.

However, we feel that article 7 might be improved upon to the extent of those departures from the Internal Revenue Code investment credit.

For example, under the concept of a qualified trade or business set forth in article 7(3)(c) marketing activities would not qualify for credit where the goods were produced by a related entity without Brazil. Similarly, wholesaling activities are excluded under this concept.

The extraction of minerals, oil, and gas, would also be excluded from the treaties but not the code credit. Nonetheless, we feel that item 9 of article 7(3)(c) which is the open end provision, that Mr. Woodworth mentioned before, is a significant and very desirable provision and we hope that it may be used in the near future to remedy these restrictions.

Similarly, the concept of an eligible corporation, as defined in terms of 80 percent of asset and 80 percent of gross income test, may be restrictive to the extent that it would preclude the investment credit from applying to a corporation which has operations in other South American countries, and/or the United States.

Again, the correspondence attached to Senate Executive J indicates the desire on the part of both governments to come to grips with these problems, and we hope that this, too, could be done shortly.

BUSINESS PROFITS

As to business profits, the treaty provides for the deduction of expenses, including administrative expenses which are reasonably connected with such profits. In this regard, we think it very significant that the correspondence attached again to Senate Executive J states

that such expenses encompass home office type expenses which are incurred abroad. This, we think, is a significant clarification of existing Brazilian law. We would only hope that in the future this could be applied also to subsidiaries of U.S. companies operating in Brazil.

REDUCED RATES ON INVESTMENT INCOME

As to the reduced rates of withholding on investment income, we feel that such rates are a definite improvement in the investment climate in Brazil.

We would like, however, to point out for the record that the western hemisphere trade corporation deduction provided under section 922 of the code may be affected to the extent that other South American counrties are induced by this treaty to raise their rates up to the U.S. rate of 48 percent.

We recognize of course, that at present the Brazil rates are over 48 percent. Nonetheless, we would like to make this comment at this time.

INTEREST AND ROYALTIES

As to interest and royalties, we hope that in the future the Brazilian authorities could appreciate the fact that it would be to their advantage to grant an exemption for interest and royalties. But, nonetheless, we still hope that the interest provisions of the present treaty would be broadened to include all taxpayers. At present article 13 is limited to the receipt of interest by U.S. banks, excluding those banks operating through a branch in Brazil.

Finally, we would hope there would be in the future a more complete negation of the force of attraction principle.

Nonetheless, Mr. Chairman, I would like to say in conclusion that, notwithstanding these comments, the National Foreign Trade Council hopes that the Senate will not delay its advice and consent to ratification of the Brazil treaty.

Senator MORSE. I am very glad to have this statement in the record. I need not tell you that both the Treasury and the State Department will undoubtedly take note of it, because they are listening.

Mr. SCOTT. Yes, sir.

Senator MORSE. And they will read it, and I am sure that they will welcome your representations in connection with future treaty negotiations.

Senator Sparkman.

Senator SPARKMAN. No questions. Thank you.

Senator MORSE. Thank you very much.

Mr. SCOTT. Thank you very much.

Senator MORSE. The next witness will be Mr. Raphael Sherfy, special tax counsel for the Manufacturing Chemists' Association, Washington, D.C. We are delighted to have your statement, which is so short. Why don't you just read it?

STATEMENT OF RAPHAEL SHERFY ON BEHALF OF MANUFACTURING CHEMISTS ASSOCIATION, INC., WASHINGTON, D.C.

Mr. SHERFY. I have cut this statement a little bit, because of time problems.

Senator MORSE. I will put the whole statement in the record.

Mr. SHERFY. Put the whole statement in, and I am going to read portions of it and summarize two paragraphs of it.

Senator MORSE. All right.

Mr. SHERFY. My name is Raphael Sherfy, and I am appearing today on behalf of the Manufacturing Chemists' Association in my capacity as special tax counsel for the association.

The Manufacturing Chemists' Association is a nonprofit trade association with 184 U.S. member corporations, large and small, which account for more than 90 percent of the productive capacity of the chemical industry in this country. Many of the members of the association engage extensively in the international operations with activities in all parts of the world. A substantial number of our members engage in business in Latin America, including Brazil.

RATIFICATION OF BRAZIL TREATY RECOMMENDED

The Manufacturing Chemists' Association recommends that the Senate give its advice and consent to the convention between the United States of America and Brazil for the avoidance of double taxation with respect to taxes on income. This convention was signed at Rio de Janeiro on March 13, 1967, and was transmitted to the Senate on April 21, 1967.

We believe it highly desirable that the Brazilian income tax convention be acted upon favorably by your committee and by the Senate. Since less developed countries have believed that there is a lack of reciprocal benefits for them in our standard treaties, it has been exceedingly difficult to consummate an income tax convention with a Latin American country. Therefore, it is extremely encouraging that the Brazilians have concluded a treaty. It is most important to keep in mind that the provisions of the Brazilian treaty may well become the pattern for other Latin American treaties. Thus, we believe that it is essential that this treaty be approved without any reservation.

The Manufacturing Chemists' Association recommends that your committee look with favor upon the provisions embodied in article 7 relating to the 7 percent investment credit given for investment in Brazil. It is understood that this investment credit provision is an important consideration insofar as the Brazilian negotiators are concerned. As you know, in contrast with the Thailand convention, which had been considered by your committee at a prior date, the credit provided in this convention more closely parallels that given by our own Internal Revenue Code.

We also would like especially to commend the adoption of the principle embodied in paragraph 9 of article 5, which, in conjunction with paragraph (1) of article 4, will be quite helpful in eliminating potential double taxation through the allowance of the foreign tax credit as the result of more sensible source rules. This provision more closely integrates the foreign tax credit allowance with the source rules followed by Brazil in taxing profits of permanent establishments operating therein.

TWO SUGGESTIONS TO MAKE

Although we approve the Brazilian treaty, as far as it goes, we would like to call to your attention the two following suggestions

which would improve future treaties with Latin American countries; first, that the "qualified trades or business" encompassed in the investment credit include marketing of goods from related corporations (just as the previous witness suggested on behalf of the National Foreign Trade Council), and, secondly, the deductability of U.S.-incurred expenditures properly allocable to foreign businesses should be extended to royalty receipts from foreign corporations.

Senator MORSE. The previous witness had that specifically in his statement, but he did not read it.

Mr. SHERFY. Yes.

Senator MORSE. But royalties are specifically mentioned in his statement.

Mr. SHERFY. They are generally allowed as proper deductions in developed countries; royalties are usually considered ordinary business deductions.

We recommend the Treasury make a strong effort to get that type provision in the treaty.

Although the Brazilian convention does not cover the two above suggestions, we wish to recommend strongly that the Senate give its advice and consent to the Brazilian convention.

(Mr. Sherfy's prepared statement follows:)

STATEMENT OF RAPHAEL SHERFY, ON BEHALF OF MANUFACTURING CHEMISTS' ASSOCIATION, INC., BEFORE THE COMMITTEE ON FOREIGN RELATIONS, U.S. SENATE, CONCERNING THE INCOME TAX CONVENTION WITH BRAZIL, OCTOBER 5, 1967

Mr. Chairman, my name is Raphael Sherfy and I am appearing today on behalf of the Manufacturing Chemists' Association, Inc. (MCA) in my capacity as Special Tax Counsel for the Association. I am a partner in the law firm of Miller and Chevalier located in Washington, D.C. Prior to entering private law practice in 1959, I was, for seven years, Associate Tax Legislative Counsel in the Treasury Department and during this period was a member of various United States delegations in the negotiation of income tax treaties.

The Manufacturing Chemists Association is a nonprofit trade association with 184 United States member corporations, large and small, which account for more than 90% of the productive capacity of the chemical industry in this country. Many of the members of the Association engage extensively in international operations with activities in all parts of the world. A substantial number of our members engage in business in Latin America, including Brazil.

The Manufacturing Chemists Association recommends that the Senate give its advice and consent to the Convention between the United States and Brazil for the Avoidance of Double Taxation with respect to Taxes on Income. This Convention was signed at Rio de Janeiro on March 13, 1967, and was transmitted to the Senate on April 21, 1967.

Income tax conventions establish a bilateral framework which is very beneficial to United States business carried on in tax treaty countries. The income tax treaties which have already been consummated establish mutual rules under which each contracting state is obliged to operate, and also remove some of the existing tax impediments in the free flow of trade between the two countries stemming from double taxation. Because of these problems, the Manufacturing Chemists Association has endorsed the tax treaty program pursued by the United States.

We believe it highly desirable that the Brazilian Income Tax Convention be acted upon favorably by your Committee and by the Senate. Since less developed countries have believed that there is a lack of reciprocal benefits for them in our standard treaties, it has been exceedingly difficult to consummate an income tax convention with a Latin American country. Therefore, it is extremely encouraging that the Brazilians have concluded a treaty. It is most important to keep in mind that the provisions of the Brazilian treaty may well become the pattern for other Latin American treaties. Thus, we believe that it is essential that this treaty be approved without any reservation.

The Manufacturing Chemists Association recommends that your committee look with favor upon the provisions embodied in Article 7 relating to the 7% investment credit given for investment in Brazil. It is understood that this investment credit provision is an important consideration insofar as the Brazilian negotiators are concerned. As you know, in contrast with the Thailand convention which has been considered by your Committee at a prior date, the credit provided in this Convention more closely parallels that given by our own Internal Revenue Code.

We would like especially to commend the adoption of the principle embodied in paragraph 9 of Article 5, which, in conjunction with paragraph (1) of Article 4, will be quite helpful in eliminating potential double taxation. This provision more closely integrates the foreign tax credit allowance with the source rules followed by Brazil in taxing profits of permanent establishments operating therein.

Although we approve the Brazilian Treaty, as far as it goes, we would like to call to your attention two suggestions which would improve future treaties with Latin American countries.

The investment credit should be extended to all wholesale and retail marketing operations. Under the treaty, the credit is not allowed for any marketing activities other than retail activities where the products sold are not produced by a related person. There is no similar restriction on the domestic investment credit and we are unaware of any reason why such marketing operations should be eliminated from coverage in a tax treaty. Therefore, we recommend that with respect to future treaties in Latin America the 7% credit be accorded marketing activity.

We also believe that it would be desirable for future Latin American treaties to eliminate situations where one country does not allow a deduction for reasonable remittances to affiliated companies in the other country. For example, where reasonable royalties and other expenses are charged the Brazilian subsidiary by the United States parent company, they should be deductible in determining the Brazilian tax.

Although the Brazilian Convention does not include the above two suggested provisions, every effort should be made by our Government to obtain them in future negotiations.

I wish to thank the members of the Committee for the opportunity of presenting the views of the Manufacturing Chemists Association on this important matter.

Senator MORSE. A very helpful statement, Mr. Sherfy.

Senator Sparkman.

Senator SPARKMAN. No questions.

Senator MORSE. Thank you very much.

Our last witness will be Dr. N. R. Danielian, president of the International Economic Policy Association, who has appeared before us on various occasions in the past. We welcome him again, and we will be glad to hear you. I will put your full statement in the record. You may summarize it according to your desires.

STATEMENT OF DR. N. R. DANIELIAN, PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION, WASHINGTON, D.C.

Mr. DANIELIAN. It is a very short one, Mr. Chairman. May I read it? It is only about four pages.

Senator MORSE. Go right ahead; you may read it all.

Mr. DANIELIAN. Mr. Chairman, I appreciate this opportunity to appear before your committee in support of the convention between the United States and Brazil for the prevention of double taxation with respect to taxes on income.

I am not a tax expert, and therefore it will be difficult for me to add to what Mr. Stanley Surrey and what Mr. Raphael Sherfy and others have stated here concerning the technical aspects of the convention.

ECONOMIC BENEFITS OF TREATY

I would like to emphasize the economic benefits from the point of view of Brazil as well as the United States.

As one who has followed developments in economic policy toward Latin America fairly closely since 1959, I can say that there has been great improvement among our neighbors to the south in the understanding of economic forces that bring about lasting and continuing development. In some official circles, of course, there is still persistent belief that economic development requires commitment of public resources, particularly by the U.S. taxpayers, to governmental programs.

However, in the last few years, there has been growing understanding of the development process, and some very salutary actions have been taken by governments to improve the climate for private investment.

This is implicit in the growing number of countries that have signed investment guarantee agreements, as a result of which a very substantial amount of private investments have gone to Latin American countries, and it finds further expression, as a beginning, in this tax convention with Brazil.

It is indeed refreshing to find a bellwether country like Brazil expressing sufficient interest in U.S. investments to allow a reduction in income taxes on dividends, royalties, and other income to U.S. corporations and individuals. This is such a welcome change from the "Yankee go home" refrain one hears so often that we should embrace our Brazilian friends with approbation and affection.

CONTRIBUTION OF U.S. INVESTMENT

In all my travels around the world, I have found it more and more apparent and convincing that the most creative contribution to economic development is provided by U.S. direct investment. This is certainly true in Latin America. In the four-year period, calendar years 1963–66, total U.S. direct investment in manufacturing in Latin American countries has increased by about $1.3 billion. This is noticeable in every country where the traditional brand names of American enterprise appear from Bogotá to Caracas to São Paulo to Buenos Aires, and this contribution is in addition to the wealth producing capacities of these countries.

In roughly the same period, our foreign aid has amounted to $4.8 billion. It is not so easy to identify the contributions of foreign aid to economic growth as that of private investments.

Brazil during that period did not fare as well. Because of the economic climate created by the Goulart regime, direct investments in Brazil did not show an improvement until 1965, but since the signing of the investment guarantee program private investments in Brazil have increased materially year by year.

I make this point because Brazil is a country which, in times of crisis, has been the most cooperative with the United States, with a wealth of resources which can be helped with private investments at little cost to the U.S. Government. Through increased guarantees, as the Congress in its wisdom has provided through the years, and now through the approval of this treaty, eliminating onerous double taxation provisions and giving encouragement to a specific effort by U.S. exporters and investors, we can help Brazil in its developmental effort.

ADVANTAGES OF GIVING INCENTIVES TO PRIVATE INVESTORS

There may be some who think that the 7 percent tax credit may diminish revenues for the U.S. Treasury, but this cannot be proved because no one knows to what alternative uses the potential investor in Brazil would put his capital.

Even if there should be a loss to the U.S. Treasury of $7 out of $100 invested in Brazil, if it can take the place of $100 in some forms of foreign aid, you will have exchanged $7 for $100 of the taxpayers' money, and in the bargain probably obtained a great deal more lasting, constructive economic development in the country.

I do not, therefore, understand the position of those who year by year are willing to vote for foreign aid in superlative figures, but who show less appreciation of the advantages of giving incentives to private investors at much lower costs.

In view of the fact that the 7 percent credit is restricted to that portion of investment which is produced and shipped from the United States and that the rest of the dollar investment has a short payout period, the balance of payments consideration are all in favor of the proposed treaty.

This treaty carries out the policy expressed by the Congress in section 601(b) of the Foreign Assistance Act of 1961, as amended, which recommended a program of treaties to encourage and facilitate the flow of private investment to, and its equitable treatment in, friendly countries and areas participating in programs under this act.

Mr. Chairman, our very friendly and constructive relations with the Government and people of Brazil deserve a quick and affirmative action by the Senate, so that this treaty goes into force, as provided, on January 1, 1968.

I wish to add to this statement, Mr. Chairman, for the record, a letter that was addressed to the Chairman, Senator Fulbright, on May 12, 1967, as a part of the record.

Senator MORSE. That will be received into the record at this point.

(The letter referred to follows:)

INTERNATIONAL ECONOMIC POLICY ASSOCIATION,
Washington, D.C., May 12, 1967.

Hon. J. W. FULBRIGHT,
United States Senate,
Washington, D.C.

DEAR SENATOR FULBRIGHT: I am writing you in support of the Income Tax Convention with Brazil which was submitted recently to the Senate Foreign Relations Committee for approval. We urge you to report the treaty favorably as it contains many provisions favorable to the United States.

As other income tax conventions now in force between the United States and numerous other countries, this one is aimed at eliminating, as far as possible, double taxation and establishing procedures for mutual assistance in the administration of income taxes. It goes further than some other treaties in an effort to meet the policy expressed by the Congress in Section 601(b) of the Foreign Assistance Act of 1961 as amended, which recommended a program of treaties "to encourage and facilitate the flow of private investment to, and its equitable treatment in, friendly countries and areas participating in programs under this Act." Article 7 of this treaty is aimed at achieving that objective. The Brazilian government undertakes in the treaty to reduce the tax on dividends by a Brazilian corporation to a U.S. corporation owning at least 10 percent of the paying corporation as a further step to encourage direct investment in Brazil. She also undertakes to reduce the withholding tax on industrial and artistic royalties. In addition to encouraging direct U.S. investment in Brazil, these measures should have the effect of increasing the return on such investments to the benefit of the investor and, in turn, the U.S. Government.

Our Association is on record in support of a credit for new investment in the less developed countries as the best means of stimulating economic development in the private sector. To the extent that the U.S. Government can encourage greater U.S. investment in the less developed countries, there will be a corresponding lessening of the need for direct foreign assistance. The developing countries will benefit from the management know-how and the transfer of technology which are always attendant to U.S. direct investment abroad. In the long run the United States will benefit also from repatriated income. We therefore support the investment tax credit provision contained in Article 7 of this treaty.

It should be noted that the investment credit may not exceed the amount of U.S. property as defined in Section 1 and Section 3(f) of Article 7, invested by the resident or corporation in the eligible corporation. Qualified property is the same as that which would qualify for the credit granted under the Internal Revenue Code for investment made in the United States and applies only to tangible property produced in the United States. Further, the credit allowed by the Convention will be suspended or modified to the same extent that the domestic credit is suspended or modified.

Furthermore, the amortization of the *dollar* costs of U.S. direct investments in less developed countries is quite rapid. When related exports to such affiliates are added to dividends and royalties, most experts think that within three to five years the dollar outflows in connection with direct investments are completely offset by income repatriations and export receipts. Finally, once the initial, actual dollar outflow has been returned to the United States, the investment remains and continues to add to U.S. external earnings through the repatriation of dividends, royalties and fees and as a catalyst for increased U.S. exports.

In the last analysis this is the greatest strength in the U.S. balance of payments. The 1964 performance of U.S. direct investment abroad, which is the last year for which complete data are available, clearly demonstrates this. Exports to or through foreign affiliates of U.S. firms plus dividends, royalties and fees from U.S. direct investment abroad amounted to $10.8 billion in 1964, or about 30 percent of total U.S. earnings abroad. Such earnings had steadily increased up to 1964.

The record shows that the investment activities of U.S. corporations abroad have been a great asset to both the recipient country—in transmission of skills, technology, productive employment and diversification of industry—and to the U.S. competitive position in world markets which contributes to the plus side of our balance of payments.

In light of this analysis we urge you to report the Brazil treaty favorably and without reservation.

Sincerely yours,

GEORGE O. GRAY, *Consultant.*

FOREIGN AID AND PRIVATE INVESTMENT IN LATIN AMERICA

Mr. DANIELIAN. I wish also to put in the record some tabulations on a comparison of foreign aid and private investments in Latin America generally, and in Brazil in particular.

Senator MORSE. The tabulation will be received in the record at this point.

(The tables referred to are as follows:)

Economic assistance to Latin America by the United States, fiscal years 1960 to 1967 (1967 estimated)

[In millions of U.S. dollars]

AID	3,762
Ex-Im	1,693
Food for Peace	1,236
SPTF[1]	520
Other[2]	1,222
Total	8,433

[1] Social Progress Trust Fund, administrated for United States by IDB.

[2] Includes Peace Corps, contributions to Inter-American Highway, and contributions to the Fund for Special Operations, administered by the IAB ($250,000,000 per year; 1965, 1966, 1967).

Economic assistance to Latin America by international agencies, fiscal years 1960 to 1967 (1967 estimated)

[In millions of U.S. dollars]

IBD [1]	1,538
IBRD	1,893
IDA	108
UNTA [2]	104
UNSF	212
UNICEF [2]	47
IFC	95
EEC	55
Total	4,052

[1] These figures exclude the Social Progress Trust Fund.
[2] For calendar year ended, in fiscal years shown.

Source: "Commitment for Progress—Declaration of the Presidents of America," U.S. State Department Publication 8237 of May 1967.

Economic assistance to Brazil from the United States, fiscal years 1960 to 1966

[In millions of U.S. dollars]

AID	840.8
Ex-Im	218.1
Food for Peace	559.3
SPTF	62.1
Other	13.7
Total	1,694.0

Economic assistance to Brazil from international agencies, fiscal years 1960 to 1966

[In millions of U.S. dollars]

IDB	255.8
IBRD	128.5
UNTA [1]	2.2
UNSF [2]	11.7
UNICEF	5.1
IFC	11.2
UNEFTA [3]	3.6
Total	418.1

[1] U.N. Technical Assistance.
[2] U.N. Special Fund.
[3] U.N. Expanded Program of Technical Assistance.

Source: "Special Report by AID for House Foreign Affairs Committee on U.S. Overseas Loans and Grants and Assistance from International Agencies," Mar. 17, 1967.

U.S. economic assistance (grants and loans) to Latin America

[In millions of U.S. dollars]

Fiscal year:	*Amount*
1963	1,000.1
1964	1,264.4
1965	1,196.3
1966	1,387.7
Total	4,848.5

U.S. economic assistance (grants and loans) to Brazil

[In millions of U.S. dollars]

Fiscal year:	*Amount*
1963	142.5
1964	381.8
1965	273.3
1966	383.6
Total	1,181.2

Source: "Special Report by AID for House Foreign Affairs Committee on U.S. Overseas Loans and Grants and Assistance from International Agencies," March 1967.

U.S. direct investment at end year in Latin America (as of each year)

[In millions of U.S. dollars]

	1963	1964	1965	1966
Manufacturing and other	4,474	4,692	5,243	5,778
Mining and smelting	1,093	1,098	1,114	1,117
Petroleum	3,095	3,142	3,034	2,959
Total	8,662	8,932	9,391	9,854

U.S. direct investment at end year in Brazil (as of each year)

[In millions of U.S. dollars]

	1963	1964	1965	1966
Manufacturing and other	1,042	909	966	1,119
Mining and smelting	30	34	51	58
Petroleum	60	51	57	69
Total	1,132	994	1,074	1,246

Source: Survey of Current Business, September 1965 and September 1967, U.S. Department of Commerce.

PRIVATE INVESTMENTS, EXPORTS AND BALANCE OF PAYMENTS

Mr. DANIELIAN. Finally, in answer to the questions that you put to Mr. Surrey this morning, I would respectfully call your attention to three chapters, chapters 4, 5, and 6, in a book on the balance of payments that our organization sponsored last year which directly relate to the factual questions that you raised with Mr. Surrey, particularly to that phase of the problem relating to the export of jobs and the effect of foreign investments on income to the United States and on the development of industry in other countries, as well as the effect upon our export business.

I think these facts show definitely that as a generality, about 30 percent of our exports of manufactured products are probably related to and carried out by affiliates of U.S. investors abroad.

In one year, 1965, this amounted to almost $6.1 billion which was about a third of the total manufacturing exports of this country.

Again, these facts in these chapters show that in commodity trade between South America and the United States, there is a fair equality in amounts in both directions. It is our investment income that is in surplus, and it is this investment income which, in fact, is returned back to Latin America as foreign aid in the neighborhood of about $1 billion.

So I think a proper understanding of these very important relationships between direct private investments and exports and balance of payments income to the United States is very essential for this country in its effort to adopt a sensible policy toward both investments and trade policy.

Thank you very much.

Senator MORSE. I am very glad to have your statements in the record.

COMMITTEE CONSIDERATION OF TREATY

I would like to have counsel for the committee take note of your reference to those three chapters, so that when we discuss the matter in executive session, we will have a digest of it presented to the committee.

Now, if counsel will give heed to the acting chairman before I close

these public hearings, it is my ruling that we keep the record of these hearings open until 5 p.m. next Monday for receiving any additional material that Mr. Surrey or other witnesses wish to supply for the record, to be closed at 5 p.m. next Monday, and sent to the Government Printing Office, and the whole transcript will then be made available to the members of the committee ready for markup in the Foreign Relations Committee.

I cannot make a statement today as to when that markup will take place, but the acting chairman does want to make very clear for the record that it will be my recommendation to Senator Fulbright that we have this treaty considered within the next two weeks.

Thank you very much. The hearing is closed.

(Whereupon, at 4:00 p.m., the hearing was closed.)

APPENDIX

Technical Memorandum of Treasury Department Concerning United States—Brazil Income Tax Convention

ARTICLE 1. TAXES COVERED

Article 1 designates the taxes of the respective States which are the subject of the convention. Generally, the provisions of the convention concern only the United States Federal income tax, including surtax, imposed by subtitle A of the Interanal Revenue Code (but not including the accumulated earnings tax or the personal holding company tax) and the Brazilian income tax imposed by the Federal Income Tax Law, except the tax on activities of minor importance and the excess remittance tax.

The convention also applies to taxes substantially similar to those taxes specified which are subsequently imposed in addition to, or in place of, the existing income taxes. For purposes of the nondiscrimination provisions of Article 6, however, the convention applies to taxes of every kind which are imposed by the respective States, at the national, state, or local level.

ARTICLE 2. GENERAL DEFINITIONS

This article sets out definitions of certain of the basic terms used in the convention and provides that any undefined term shall, unless the context otherwise requires, have the meaning which it has under the laws of the State imposing the tax.

ARTICLE 3. GENERAL RULES OF TAXATION

The general rules of taxation applicable under the convention are as follows:

(a) A resident or corporation of one of the States will be taxable by the other State only on income derived from sources within that other State and only in accordance with the limitations set forth in the convention. The rules set forth in Article 5 will be applied to determine source of income. The effect of this general rule read together with Article 5 (9), dealing with the source of industrial and commercial profits, is to provide that a resident of one State may be taxed by the other State only on (1) industrial or commercial profits attributable to a permanent establishment located in that other State, and (2) other income from sources within that other State, subject to the limitations of the convention. The jurisdictional rules of the proposed convention are substantially similar to those set forth in section 872(a) of the Code, relating to nonresident alien individuals, and section 882(b), relating to foreign corporations engaged in trade or business in the United States, as amended by the Foreign Investors Tax Act of 1966.

(b) Income from sources within a State to which the provisions of the convention are not expressly applicable will be taxed by such State in accordance with its own law. Thus, for example, because prizes and awards are not expressly covered by the convention, such income will be taxed by the State from which such income is derived in accordance with the internal law of such State.

(c) No provision of the convention will be construed so as to restrict in any manner any exclusion, exemption, deduction, credit, or other allowance presently or subsequently accorded (1) by the laws of one of the States in determining the tax imposed by that State or (2) by any other agreement between the two States. This provision reflects the policy of the United States under all conventions to which it is a party.

(d) With specified exceptions, the United States may tax its citizens, residents, and corporations as if the convention had not come into effect. A clause of this nature is found in most existing United States income tax conventions. The exceptions to the "savings clause" provision are made to preserve benefits which are specifically intended to apply to citizens or Brazilian nationals

residents in the United States, *viz*, relief from double taxation (Article 4), the investment credit (Article 7), and the deduction for charitable contributions (Article 22). The benefits conferred on teachers (Article 18), students and trainees (Article 19), and governmental salaries (Article 20), are also excepted from the "saving clause" but only with respect to individuals who are not citizens of, and do not have immigrants status in, the United States. Corresponding rules apply to the right of Brazil to tax its citizens, residents, and corporations except that Brazil is not obligated to allow an investment credit or a deduction for charitable contributions.

ARTICLE 4. RELIEF FROM DOUBLE TAXATION

This article provides that each State will allow a foreign tax credit for the appropriate amount of taxes paid to the other State.

For purposes of the United States foreign tax credit, the source of income rules set out in Article 5 may be used in lieu of the source rules provided in the Internal Revenue Code. Moreover, even though Article 4 contains a per-country limitation, such provision will not affect the right of a United States taxpayer to elect the overall limitation under section 904(a)(2) of the Internal Revenue Code. See Article 3 (2) of the convention and the accompanying explanation.

A Brazilian resident or corporation will be allowed a credit against Brazilian income tax for the appropriate amount of taxes paid to the United States. For this purpose, such amount will be limited to that portion of the Brazilian tax which net income from sources within the United States bears to the total net income of such residents of corporation subject to Brazilian tax. Moreover, in the case of a Brazilian corporation receiving dividends from a 10 percent or more owned United States corporation, Brazil will also allow an indirect credit for United States taxes paid with respect to the profits out of which such dividends are paid. This provision corresponds generally to section 902 of the Internal Revenue Code. For Brazilian credit purposes, the source rules set out in Article 5 will be applied to determine source of income.

ARTICLE 5. SOURCE OF INCOME

This article sets forth the rules for determining source of income for purposes of Articles 3 (General rules of taxation) and Article 4 (Relief from double taxation).

The following items of income are to be considered from sources within a State:

(1) Dividends paid by a corporation of that State, or by any corporation which had a permanent establishment in that State and derived 85 percent or more of its gross income from sources within that State for the 3-year period preceding declaration of the dividends. Dividends paid by any other corporation are treated as income from sources outside that State. This source rule conforms to United States statutory law except that, under section 861(a)(2)(B) of the Internal Revenue Code, if 50 percent or more of a foreign corporation's gross income is effectively connected with a United States business conducted by such foreign corporation, a pro rata share of such corporation's dividends is treated as from sources within the United States. The treaty rule permits taxation of *all* corporate dividends by a State if the corporation derives 85 percent or more of its income from such State, while the Code requires proration.

(2) Interest paid by that State, including any local government within such State, or by a resident or corporation of such State. Interest paid by any other person will be treated as from sources outside that State. However, interest paid by a resident or corporation of any State with a permanent establishment in another State, directly out of the funds of such permanent establishment on indebtedness incurred for the sole use of, or on banking deposits made with, such permanent establishment will be treated as income from sources within the State where such permanent establishment is located. The rules set forth in the first two sentences of this paragraph correspond generally to the Internal Revenue Code provision dealing with interest (other than interest on deposits with persons carrying on the banking business, except that under section 861(a)(2)(C) of the Internal Revenue Code if 50 percent or more of a foreign corporation's gross income is effectively connected with a United States business conducted by such foreign corporation, a pro rata share of such corporation's interest (not all of such interest as provided by the treaty rule) is treated

as from sources within the United States. The permanent establishment source rule for interest set forth in the third sentence of this paragraph is not contained in the Internal Revenue Code provision.

(3) Royalties paid by a resident or corporation of one State for using or the right to use, in the State, copyrights, artistic or scientific works, patents, designs, plans, secret processes or formulae or information concerning industrial commercial, or scientific knowledge, experience, or skill or trademarks related to any of the foreging items. This rule is of more limited application than the rule set forth in the Internal Revenue Code which relies solely on the place where rights are used ignoring the residence of the payor. The Code rule would control in those cases in which the two tests of the treaty rule were not satisfied.

(4) Income from real property located in the State, including the gain from the sale or exchange of real property, and royalty income from the operation of mines, quarries, or other natural resources located within the State. This rule conforms to the rules set forth in section 861(a) (4) and (5) of the Internal Revenue Code. Interest income from mortgages or bonds secured by real property is not considered income from real property, but see (2) above.

(5) Income from rentals of personal property located within the State. This rule conforms to the rule set forth in section 861(a)(4) of the Internal Revenue Code.

(6) Compensation for personal services performed within the State; income from providing personal services performed within that State; and compensation for personal services performed aboard ship or aircraft operated by a resident or corporation of that State and registered in that State, provided the services are performed by a member of the regular complement of the ship or aircraft. For source purposes, compensation for personal services includes private pensions or annuities paid in respect of such services. The rule set forth in the first clause of this paragraph conforms generally to that set forth in section 861(a)(3) of the Internal Revenue Code. The other rules are not specifically covered by the Code rules and serve to provide certainty in several common types of cases.

(7) Income from the purchase and sale of personal property if such property is sold within that State. This rule conforms to the rule set forth in section 861(a)(6) of the Internal Revenue Code.

(8) Income from the production of personal property to the extent that such property was produced in that State. Income from the sale of such property will be treated as from sources within the State in which the property is sold. These rules conform generally to the rules set forth in section 863(b) of the Internal Revenue Code and the regulations thereunder. It should be noted that, under Article 29(3)(a), this provision of the convention will have effect only after the competent authorities have established mutually acceptable rules for its implementation, and under Article 29(5)(a), such rules may be terminated by either State at any time. However, under Article 29(7) any termination may be prospective only.

(9) Industrial and commercial profits attributable to a permanent establishment situated in that State. Such profits include dividends, interest, royalties, and income from real property which is effectively connected with such permanent establishment. The factors taken into account in determining whether such income is effectively connected will include whether the income is derived from assets used, or held for use, in the conduct of a trade or business by the permanent establishment and whether the activities of the trade or business are a material factor in the realization of the income. In applying these factors, due regard will be given to the manner in which the asset or income is accounted for on the books of the recipient of such income. There is no comparable source rule provision in the Internal Revenue Code.

The source of any item of income to which the convention is not expressly applicable will be determined by each of the States in accordance with its own law.

It should also be noted that the source rules do not extend the benefits of this treaty to persons other than residents or corporations of the two States. Generally, the rules are applicable only to residents or corporations of either State, and, therefore, are not applicable in determining the source of income of residents of other States, although the income of such other residents is of a type referred to in this article.

ARTICLE 6. NONDISCRIMINATION

This article provides that the United States and Brazil will not discriminate in their tax law against their residents who are citizens of the other State nor

against permanent establishments within their jurisdiction owned by nationals or corporations of the other State. This does not prevent either State from imposing whatever tax it desires on citizens of the other State, resident within its border, so long as such residents are taxed in the same manner as citizens of the State imposing the tax. Furthermore, this Article does not require a State which grants personal allowances or deductions only to its residents to grant such allowances or deductions to nonresidents who are nationals of the other State.

A corporation of one State, the stock of which is completely or partly owned by citizens or corporations of the other State, may not be subjected to more burdensome taxes than a corporation owned wholly by citizens or corporations of the former State.

The provisions of this article apply to state and local as well as national taxes.

ARTICLE 7. INVESTMENT CREDIT

The purpose of this article is to encourage investment in Brazil by extending to such investment a credit similar to that allowed for investment in the United States under sections 38 and 46 through 48 of the Internal Revenue Code. The concepts employed in this Article are patterned as closely as possible after the concepts employed in the domestic investment credit except for necessary changes to reflect the fact that the investment will generally be in stock or debt obligations of a corporation which will purchase machinery and equipment rather than directly in such machinery and equipment. The amount and terms of the credit allowed by this article will be governed by the same principles as are applicable to the credit for investment in the United States.

The United States agrees to allow a credit against United States income tax for investment in Brazil by an eligible investor (as defined below) in an ineligible corporation (as defined below). The credit will be allowed in the eligible investor's taxable year in which or with which the eligible corporation's taxable year ends, and will be based on 7 percent of an appropriate amount of qualified property (as defined below) placed in service by the eligible corporation during such corporation's taxable year. Reference is made to an "appropriate" amount because several limitations discussed below together with the ownership interest of the investor must be taken into account in determining the proper amount of qualified property. Moreover, in addition to the limitations discussed below, as is the case under the domestic investment credit, a limitation, determined with reference to the amount of the tax liability of the eligible investor for the taxable year will be imposed on the amount of credit allowed for such taxable year. In the event of insufficient liability in the taxable year in which the eligible investor becomes entitled to credit, a carryback or carryover patterned after the comparable provisions of the domestic investment credit will be provided. See section 46 of the Internal Revenue Code.

Qualified property is "section 38 property" which is used exclusively in Brazil in connection with a qualified trade or business. "Section 38 property" is defined in section 48 of the United States Internal Revenue Code except that, for purposes of this article, section 48(a)(2), relating to the limitation of the credit to property used in the United States, is no applicable. Moreover, for purposes of this article, the limitations applicable to "used section 38 property" will not apply. Generally, qualified property includes tangible depreciable property which is either personal property or is used as an integral part of industrial, transportation, communication, or other similar processes, or as a research or storage facility (but not including a building or its structural components). The amount of the property placed in service for which a credit will be allowed depends upon the useful life of such property. Thus, the percentage of the basis of the property for which a credit will be allowable is 100 percent, 66⅔ percent, or 33⅓ percent where the property has a useful life of 8 years or more, 6 years or more but less than 8 years, or 4 years or more but less than 6 years, respectively. If property is sold before the end of its original estimated useful life, the amount of the credit allowed when such property was placed in service will be recomputed with reference to the actual period the property was used and any excess credit will be recaptured. The recapture rules will also be applied if (a) the eligible corporation placing the property in service ceases to be eligible, (b) the eligible investor ceases to be eligible, or (c) the qualified property ceases to be qualified, and any such cessation will be treated in the same manner as if the corporation disposed of the property before the end of the useful life of the property.

In no event will the credit exceed the lesser of—

(1) 7 percent of the eligible investor's net new investment (as defined below) in the eligible corporation; or

(2) the amount of United States property (as defined below) acquired by the eligible corporation, during such corporation's taxable year in which such corporation placed in service the property for which a credit is allowed, or during the preceding taxable year, and attributed to the eligible investor.

As indicated in an exchange of letters, the concept of "net new investment" represents a running account covering a period of up to 10 years. The account is determined as of the end of the taxable year in which or with which the eligible corporation places qualified property in service, as follows:

(a) the sum for the eligible corporation's taxable year and its 9 preceding taxable years (but excluding any taxable year to which this article is inapplicable) of:

(1) any property transferred to the eligible corporation by the eligible investor as a contribution to capital or in exchange for stock or indebtedness of the eligible corporation, but only to the extent that such property does not represent directly or indirectly, funds borrowed within Brazil;

(2) the eligible investor's allocable share of creditable reinvested earnings (as defined below) of the eligible corporation;

(3) the eligible investor's allocable share of the amount of the reserve for depreciation with respect to the cost of any qualified property with respect to which the eligible investor previously was entitled to a credit; but during the first 5 years of the life of the property only to the extent that, and in the year in which, an amount equal to that reserve is used to purchase qualified property;

(4) in the case of a disposition by the eligible corporation of any qualified property for which the eligible investor was previously entitled to a credit, the eligible investor's allocable share of the undepreciated cost of such property at the time of disposition;

(b) less the amount of the credits allowed to the eligible investor with respect to the eligible corporation during the 9 years preceding the taxable year (determined without regard to any recaptures of the credit) divided by 7 percent.

In the event of a withdrawal, described below, of property by the eligible investor, the amount of such withdrawal shall reduce the new investment, to the extent thereof, made in the year of withdrawal, the 3 years preceding withdrawal, and the year subsequent to the withdrawal. With respect to the 3 years preceding the withdrawal, a recomputation of the credit allowed in those years will be required. The taxes otherwise payable by an eligible investor in the year of withdrawal shall be increased by an amount equal to the aggregate decrease in credits allowed for the prior 3 years which would have resulted solely from subtracting, in the computation of the limitation of the credit for such years, the amount of the eligible investor's net new investment in the eligible corporation in such years.

Creditable reinvested earnings is defined as an amount equal to one-half of the earnings and profits of the eligible corporations for its taxable year, reduced by the amount of any dividends distributed by such corporation during such year.

A withdrawal is defined as (1) a distribution made by an eligible corporation (or by another corporation conducting in Brazil a trade or business similar or related to the trade or business conducted by the eligible corporation) to the eligible investor (or to a related person) which (a) is not a distribution of earnings and profits, (b) is in excess of 50 percent of earnings and profits for the year of distribution, or (c) is in cancellation or redemption of the stock of the eligible corporation; (2) the payment by the eligible corporation of an indebtedness to the eligible investor; and (3) the sale or other disposition by the eligible investor of stock or indebtedness of the eligible corporation. An accompanying exchange of letters provides that a transfer of stock or indebtedness of an eligible corporation to a resident or corporation of the United States will not be considered a withdrawal of property if the transferor, transferee, and competent authority of the United States mutually agree to defer recognition of the withdrawal. Under such circumstances, a later withdrawal by the transferee will be considered a withdrawal by the transferor.

The term "eligible investor" means a resident of the United States or a United States corporation which owns, or is a member of a group of United States resi-

dents or corporations which owns, at least 25 percent of the total combined voting power of the stock of an eligible corporation. The term "eligible corporation" means a United States corporation or a Brazilian corporation if, for its taxable year, such corporation derives at least 80 percent of its gross income, if any, from, and at least 80 percent of its assets (including assets located outside Brazil) are used or held for use in connection with, one or more qualified trades or businesses (as defined below).

The term "qualified trade or business" means, unless otherwise agreed by the competent authorities of the States, any trade or business conducted within Brazil, and consisting of:

(i) the manufacture or production of personal property (not including the extraction of any mineral, ore, oil, or gas, or any processing which does not involve a substantial transformation thereof, but not excluding smelting or refining) or the processing of agricultural or horticultural products or commodities (including but not limited to livestock, poultry, fur-bearing animals, or any kind of fish);

(ii) the catching or taking of any kind of fish;

(iii) the marketing of agricultural or horticultural products or commodities (including but not limited to livestock, poultry, fur-bearing animals, or any kind of fish);

(iv) the marketing of goods and merchandise to the general public through one or more retail establishments, unless the business consists primarily of the distribution of goods or merchandise manufactured or produced outside Brazil by a person who is a related person with respect to the eligible corporation;

(v) the operation of hotels and related facilities;

(vi) the transportation within Brazil of passengers and/or freight;

(vii) the performance of services rendered as an incident of a trade or business described in (i) through (vi); or

(viii) the performance within Brazil of services utilized either within Brazil or within a less developed country if the services are industrial, financial, technical, scientific, engineering, or architectural in nature. The preceding sentence will not apply if the services are performed for any person who is a related person with respect to the eligible corporation and if the payments made in consideration of such services are not reasonable in amount or are contingent either in whole or in part on the sales, productivity, or profits of the person for whom these services are performed; and

(ix) any other trade or business agreed upon by the competent authorities of both contracting States.

The term "United States property" means any tangible property which has been manufactured, constructed, produced, grown, extracted, or created in the United States and thereafter continuously used, if at all only in the United States.

If the domestic investment credit is modified, amended, suspended, or terminated, the comparable provisions of this article will be deemed modified, amended, suspended, or terminated so as to conform the investment credit allowed by this article to the domestic investment credit. The United States will notify Brazil through diplomatic channels of any such change. If Brazil considers that any modification or amendment as a result of this paragraph materially and adversely affects the credit allowed by this article, Brazil may, by giving notice to the United States through diplomatic channels, treat such modification or amendment as a suspension of the credit under Article 29(6)(b) and suspend the reduced rates for dividends, interest, and royalties (Articles 12, 13, and 14). In such a case, Brazil and the United States will consult together. However, at any time prior to such consultation and until such time as a supplementary agreement is reached, the United States may, by notice given to Brazil through diplomatic channels, suspend the application of the investment credit.

The investment credit will be subject to such regulations as are prescribed by the Secretary of the Treasury of the United States or his delegate, after consultation with the competent authority of Brazil, to effectuate the provisions of this article and to further define and determine the terms, conditions, and amounts referred to in this article.

ARTICLE 8. BUSINESS PROFITS

This article corresponds generally to the article dealing with taxation of business profits which is found in other tax conventions to which the United States

is a party. It provides that industrial or commercial profits of a resident or corporation of one State will be exempt from tax in the other State if such resident or corporation does not have a permanent establishment in the latter State. If such resident or corporation does have such a permanent establishment, the latter State may tax all of the commercial or industrial profits which are attributable to such permanent establishment. Profits which are derived from sources within such latter State from sales of goods or merchandise of the same kind as those sold, or from other business transactions of the same kind as those effected, through the permanent establishment, are deemed attributable to the permanent establishment.

In determining the proper attribution of industrial or commercial profits, the permanent establishment is to be treated as an independent entity and considered as realizing the profits which would be realized if the permanent establishment dealt with the resident of which it is a permanent establishment on an arm's length basis. All expenses, including executive and general administrative expenses, wherever incurred will be allowed as deductions by the State in which the permanent establishment is located in computing the tax due to such State, if such expenses would be deductible if the permanent establishment were an independent enterprise and such expenses are reasonably connected with profits attributable to the permanent establishment. An exchange of letters accompanying the proposed convention sets forth the understanding that in accordance with established Brazilian juridical principles, the foregoing language will be interpreted to include all such expenses, whether incurred in Brazil or abroad. Such expenses are those actually incurred, directly connected with the activities of the permanent establishment, and necessary to the production of its taxable income. The understanding is reciprocal in form though the result merely conforms to United States internal law.

The mere purchase of goods or merchandise in a State by the permanent establishment, or by the resident of which it is a permanent establishment, for the account of such resident will not by itself cause attribution of any profit to such permanent establishment. This rule conforms to existing United States statutory law. (See section 862(a)(6) of the Internal Revenue Code.)

The term "industrial or commercial profits" is defined as income derived from activities which constitute the active conduct of a trade or business, including agricultural activities, the furnishing of personal services, the rental of tangible personal property, and insurance activities. The term also includes investment income but only if the right or property giving rise to the income is effectively connected with a permanent establishment. Income received by an individual as compensation for personal services either as an employee or in an independent capacity is not treated as industrial or commercial profits.

ARTICLE 9. DEFINITION OF PERMANENT ESTABLISHMENT

This article defines the term "permanent establishment". The existence of a permanent establishment is, under the terms of the convention, a prerequisite for one State to tax the industrial or commercial profits of a resident or corporation of the other State. The concept is also significant in determining the applicability of other provisions of this convention, such as Articles 12, 13, and 14 dealing with dividends, interest, and royalties, respectively.

The definition of "permanent establishment" is a modernized version of the definition found in most conventions to which the United States is a party. The term "permanent establishment" means "a fixed place of business through which a resident or corporation of one of the Contracting States engages in trade or business". Illustrations of the concept of a fixed place of business include an office; a store or other sales outlet; a workshop; a factory; a warehouse; a mine, quarry, or other place of extraction of natural resources; and a building, construction, or installation site. As a general rule, any fixed facility through which business is conducted will be treated as a permanent establishment unless it falls within one of the specific exceptions described below.

Under the specific exceptions, a permanent establishment does not include sites or facilities used as follows:

(a) for the processing by another person, whether related or unrelated, under arrangements or conditions which are or would be made between independent persons, of goods or merchandise belonging to the resident or corporation;

(b) for the purchase, under arrangements or conditions which are or would be made between independent persons, of goods or merchandise for the account of the resident or corporation;

(c) for the storage and/or delivery of goods belonging to the resident or corporation, other than goods or merchandise;

(i) held for sale by such resident or corporation in a store or other sales outlet; or

(ii) purchased and resold in that Contracting State by the resident or corporation, or by an independent agent or agents for or on behalf of the resident or corporation;

(d) for the collection of information for the resident or corporation;

(e) for advertising, the conduct of scientific research, the display of goods or merchandise, or the supply of information if such activities have a preparatory and auxiliary character in the trade or business of the resident or corporation; or

(f) for construction, assembly, or installation projects if the site or facilities are used for such purpose for less than 6 months.

These exceptions are cumulative and a site or facility used solely for one or all of these purposes generally will not be considered a permanent establishment under the convention.

A person will be considered to have a permanent establishment if he engages in business through an agent who has and regularly exercises authority to conclude contracts in the name of such person unless the agent only exercises such authority to purchase goods or merchandise. In addition, a permanent establishment will be considered to exist if an agent maintains a stock of goods or merchandise belonging to such person from which he regularly makes deliveries. However, these rules will not apply merely because a resident or corporation of one Contracting State uses the services in the other Contracting State of a bona fide broker, general commission agent, forwarding agent, custodian, or other agent of independent status acting in the ordinary course of its business.

Whether a corporation of one State has a permanent establishment in the other State will be determined without regard to any control relationship between such corporation and a corporation organized or engaged in trade or business in the other State. Therefore, United States subsidiary of a Brazilian corporation may be considered an independent agent of such corporation if it otherwise qualifies as an agent of independent status acting in the normal course of its business.

A person of one State will be deemed to have a permanent establishment in the other State if such person provides the services of public entertainers (described in Article 17(4)) in the latter State.

If a resident or corporation of one State maintains a permanent establishment in the other State at any time during the taxable year, the permanent establishment will be considered to have existed for the entire taxable year.

The general effect of this article will be to eliminate some existing uncertainties respecting the application of Brazilian income tax to business activities in that country in the situations described above. This article will also operate to restrict Brazilian taxation of income from certain activities conducted by U.S. citizens, residents and corporations in Brazil.

ARTICLE 10. SHIPPING AND AIR TRANSPORT

This article provides that a resident of one State will be exempt from tax in the other State on income derived from the operation in international traffic of ships or aircraft registered in the former State. A similar provision is found in most conventions to which the United States is a party.

ARTICLE 11. RELATED PERSONS

This provision corresponds in purpose and scope to section 482 of the Internal Revenue Code of 1954 and confirms the power of each government to reallocate income in cases in which a resident of one State is related to a resident of the other State if such related persons impose conditions between themselves which are different from conditions which would be imposed between independent persons.

ARTICLE 12. DIVIDENDS AND BRANCH PROFITS

This article provides that dividends paid by a company which is a resident of one State to a resident or corporation of the other State may be taxed by both

States. However, the rate of withholding tax imposed by Brazil on dividends paid by a Brazilian corporation to a United States corporation will not exceed 20 percent if the recipient corporation owns 10 percent or more of the outstanding voting shares of the paying corporation and, generally, not more than 25 percent of the paying corporation's gross income consists of dividends and interest. The rate of withholding tax imposed by Brazil on profits of a Brazilian branch of a United States corporation is also limited to 20 percent. In the absence of a convention, the Brazilian withholding tax on dividends and branch profits remitted to nonresidents of Brazil is 25 percent.

The reduced rate provision is limited to intercorporate dividends because its purpose is to encourage direct investment in Brazil. Another provision of the convention designed to encourage such direct investment is the investment credit provision (Article 7). The reduced rate is nonreciprocal in form. Thus, the United States remains free to impose its 30 percent withholding tax on dividends paid by United States corporations to Brazilian corporations. This lack of reciprocity is in accordance with the desires of both Brazil and the United States to encourage the formation of local Brazilian capital sources and not to encourage the flow of such capital to the United States.

This article also includes a provision under which Brazil may increase the rate of withholding tax on dividends and branch profits to the same extent as any reduction below 28 percent in the rate of tax applicable generally to business profits of corporations in Brazil.

The term "dividend" is defined in the case of the United States, as any item which under the law of the United States is treated as a distribution out of earnings and profits, and, in the case of Brazil, generally as income from shares including all distributions of profits made by any company or individual enterprise situated in Brazil. The definition employed by Brazil is adopted, in part, from the OECD model convention. However, the OECD draft definition does not include the language relating to distributions by any company or individual enterprise. Under Brazilian law, such distributions of partnerships and single proprietorships are treated as dividends.

Dividends paid by a corporation of one State to a person other than a resident or corporation of the other State are exempt from tax in such other State. However, the exemption does not apply in the following cases: (1) if the recipient of a dividend paid by a Brazilian corporation is a citizen of the United States, even though a nonresident of the United States; (2) if the dividends are treated as income from sources within such other State under Article 5(1)(b); or (3) if the recipient of the dividend has a permanent establishment in such other State and dividends are effectively connected with such permanent establishment. The first exception represents a specific application of the traditional "savings clause" under which the United States reserves the right to tax its citizens as though the convention had not come into effect. See Article 3(3). With respect to the United States, the second and third exceptions represent reservations of the right to tax dividends paid by Brazilian corporations when either the payor or the recipient of the dividends is, to a significant extent, commercially involved in the United States.

It is important to note that the reduced 20 percent rate on dividends received by certain United States corporations from their Brazilian subsidiaries is available without regard to whether such United States corporation has a permanent establishment in Brazil and without regard to whether such dividends are effectively connected with such a permanent establishment.

ARTICLE 13. INTEREST

Under this article, interest derived from sources within one State by a resident or corporation of the other State may be taxed in both States. However, interest derived by a Government of a State, or any agency or instrumentality wholly owned by that Government, will be exempt from tax in the other State. Moreover, the rate of tax on interest derived from sources within Brazil by a bank or financial institution which is a resident or corporation of the United States will not exceed 15 percent of the amount paid. However, if such bank or financial institution has a permanent establishment in Brazil, the 15 percent reduced rate will not apply and the interest of such a recipient may be taxed as industrial and commercial profits attributable to the permanent establishment.

In the absence of a convention, interest derived from sources within Brazil by a nonresident of Brazil would be subject to witholding tax of 25 percent on the gross amount paid. The United States remains free to impose its withhold-

ing tax at the statutory rate of 30 percent on interest derived by residents or corporations of Brazil from sources within the United States except that interest derived by the Government of Brazil is exempt from tax. The lack of reciprocity arises out of the mutual desire of the United States and Brazil to encourage and maintain investment in Brazil.

Interest is defined generally as income from any kind of debt-claim or any income treated as interest under the tax law of the State of source. In cases in which excessive interest is paid by reason of a special relationship between the payor and the recipient, the provisions of the interest article do not apply to the excess part of the payments. Excess interest payments may, in certain cases, be taxed as dividends under Article 12.

Interest paid by a corporation of one State to a person other than a resident or corporation of the other State is exempt from tax in such other State. However, the exemption does not apply in the following cases: (1) if the recipient of interest paid by a Brazilian corporation is a citizen of the United States even though a nonresident of the United States; (2) if the interest is treated as income from sources within the other State under Article 5(2)(b); or (3) if the recipient of the interest has a permanent establishment in the other State and the interest is effectively connected with such permanent establishment. These rules parallel those found in the dividend article and reserve the right of the United States to tax interest paid by Brazilian corporations to United States citizens and interest derived under circumstances in which either the payor or the recipient of the interest is, to a significant extent, commercially involved in the United States.

ARTICLE 14. ROYALTIES

This article provides that the tax imposed by one State on royalties derived from sources within the other State by a resident or corporation of the other State will not exceed 15 percent of the gross amount of such royalties. In cases in which the recipient of royalties has a permanent establishment in the other State, the reduced rate does not apply. Thus, the proposed convention retains the so-called "force of attraction" principle with respect to royalties.

In the absence of a convention, the Brazilian withholding tax on royalties is 25 percent and the United States withholding tax on royalties is 30 percent.

The term "royalties" is defined as including any royalties, rentals, or other amounts paid for specified types of intangible property, including trademarks related to such property, and know-how.

The reduced rate does not apply to natural resource royalties or to rentals for films and similar property. See Article 15 (Income from real property) for rules governing the treatment of natural resource royalties.

If excessive royalties are paid by reason of a special relationship between the payor and recipient, the provisions of the royalties article do not apply to the excess part of such payments. Excess royalty payments may, in certain cases, be taxed as dividends under Article 12.

ARTICLE 15. INCOME FROM REAL PROPERTY

This article provides a net basis election with respect to income from real property. Thus, a resident of one State will be subject to tax in the other State on income from real property and natural resource royalties if the property or natural resource is located in such other State. However, such resident may elect for any taxable year to compute the tax on such income on a net income basis which takes account of expenses relating to the property. The income referred to in this article includes gain from the sale or exchange of real property. A similar provision appears in many conventions to which the United States is a party and in internal U.S. law (see IRC, §§ 871(d) and 882(d)).

ARTICLE 16. INVESTMENT COMPANIES

This article denies the benefits of the dividends, interest and royalties articles to a corporation of one of the States deriving such income from sources within the other State if (1) such corporation is entitled to special tax benefits which result in the tax imposed on such income being substantially less than the tax generally imposed on corporate profits in such State, and (2) 25 percent or more of the capital of the corporation is owned directly or indirectly by persons who are not individual residents of such State or, if residents of Brazil, are citizens of the United States.

The purpose of this article is to deal with a potential abuse which could occur if one of the States provided preferential rates of tax for investment or holding companies. In such a case, residents of third countries could organize a corporation in the State extending the preferential rates for the purposes of making investments in the other State and, but for this article, also obtain reduced rates or exemptions in the source State. At present, neither the United States nor Brazil extends special benefits of the type referred to in this article to investment or holding companies.

ARTICLE 17. INCOME FROM PERSONAL SERVICES

This article provides that an individual resident of one State is exempt from tax by the other State with respect to income from personal services performed in such other State if such person is physically present there for not more than 183 days during the taxable year and such income does not exceed $4,000 or its equivalent in Brazilian cruzeiros.

In the case of employment income which exceeds $4,000 or its equivalent in Brazilian cruzeiros, in addition to the physical presence limitation the individual must be an employee of a resident or corporation of a State other than the State of source (or an employee of a permanent establishment of a resident or corporation of the State of source located outside such State) and the amount must not be deducted in computing the profits of a permanent establishment of the State of source. If, however, such individual's employment income does not exceed $4,000 or its equivalent in Brazilian cruzeiros, such individual need only satisfy the physical presence limitation in order to qualify for the exemption.

Compensation for services performed as a member of the regular complement aboard ships or aircraft operated by a resident or corporation of one State and registered in such State is exempt from tax in the other State. This exception does not limit a State's right to tax its own citizens or residents.

"Income from personal services" includes income from the performance of personal services in an independent capacity and "employment income". Employment income includes income from services performed by officers and directors of corporations. However, income from personal services performed by partners is treated as income from the performance of services in an independent capacity.

The exemption applicable to personal service income is limited in the case of public entertainers, such as musicians, actors, or professional athletes. These persons are taxable if their income from such activities exceeds $100 (or its equivalent in Brazilian cruzeiros) for each day the individual is present within the State.

ARTICLE 18. TEACHERS

This article provides a reciprocal exemption from tax for personal service income of visiting teachers. It applies only if the teacher is invited by the Government, a university or other accredited educational institution to teach or engage in research activities, or both, at a university or other accredited educational institution. The exemption applies only to income received by the visiting teacher as compensation for such teaching or research activities. If the visit exceeds a period of 2 years, this exemption applies only to the income received by the visting teacher before the expiration of such 2-year period. The exemption does not apply to income from research undertaken not in the public interest but primarily for private benefit.

ARTICLE 19. STUDENTS AND TRAINEES

This article provides that a resident of one State visiting the other State for the purpose of studying at a university or other accredited educational institution, securing training for qualification in a profession or professional speciality, or studying or doing research as a recipient of a grant, allowance, or award, is exempt from tax in the host State on:

(1) Gifts from abroad for his maintenance or study;

(2) The grant, allowance, or award; and

(3) Income from personal services performed in the host State not in excess of $2,000 (or its equivalent in Brazilian cruzeiros) for any taxable year. This exemption is increased to $5,000 (or its equivalent in Brazilian cruzeiros) if the student is training for qualification in a profession or professional specialty.

These exemptions continue for such period of time as may be reasonably or customarily required to effectuate the purpose of his visit but in no event for more than 5 taxable years.

Furthermore, a resident of one State, employed by or under contract with a resident or corporation of that State, who visits the other State for a period not in excess of 1 year for the purpose of studying or acquiring technical, professional, or business experience, is exempt from tax in such other State on income from personal services rendered there not in excess of $5,000 (or its equivalent in Brazilian cruzeiros). In order to qualify for the exemption, the visiting individual must study at a university or accredited educational institution in the host State, or receive his experience from a person other than the resident or corporation by which he is employed or under contract (including a 50-percent or more owned subsidiary of such corporation).

A resident of one State who visits the other State for a period not in excess of 1 year as a participant in a program sponsored by the Government of the host State for the primary purpose of training, research, or study shall be exempt from tax in the host State on income not in excess of $10,000 (or its equivalent in Brazilian cruzeiros) received for personal services performed in the host State in respect of such training, research, or study.

ARTICLE 20. GOVERNMENTAL FUNCTIONS

This article exempts from tax in one State any wages, salaries, and similar compensation, and pensions, annuities, or similar benefits paid by, or from public funds of the other State, or a political subdivision thereof, to a national of that other State for services rendered to it or its political subdivisions in the discharge of governmental functions.

ARTICLE 21. RULES APPLICABLE TO PERSONAL SERVICE ARTICLES

This article provides that under Articles 17 through 20 reimbursed travel expenses will be exempt as income from personal services but will not be taken into account in determining whether the maximum income exemptions in Articles 17 and 19 have been exceeded. If an individual qualifies for the benefits of more than one of the provisions of Articles 17 through 20, he may choose the provision most favorable to him but he may not claim the benefits of more than one article in any one taxable year.

ARTICLE 22. DEDUCTIONS FOR CHARITABLE CONTRIBUTIONS

This article provides that a United States citizen, resident, or corporation may deduct for United States tax purposes contributions made to charitable organizations in Brazil if the following conditions are met:

(1) The Brazilian organization has qualified as a nonprofit organization exempt from tax under the income tax laws of Brazil;

(2) The contributions are used entirely within Brazil; and

(3) The Brazilian organization has qualified as a tax-exempt organization under section 501(c)(3) of the Internal Revenue Code.

If these conditions are met, the contribution will be treated as a charitable contribution as defined in section 170(c) and will be deductible subject to the limitations contained in section 170 of the Internal Revenue Code.

ARTICLE 23. PENSIONS AND ANNUITIES

This article provides an exemption from tax in the State of source for private pensions and private life annuities paid to individuals who are residents of the other State. A life annuity is a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration. A pension is a periodic payment made after retirement or death for, or by way of compensation for injuries received in connection with, past employment, and does not include social security type payments.

ARTICLE 24. CONSULTATION

This article provides that the competent authorities of the two States may—

(1) Settle by mutual agreement all questions of interpretation or application of the convention;

(2) Resolve any matter concerning the relation of this convention to any convention concluded by either State with third countries;
(3) Consult regarding the application of the source rules in Article 5 to particular items of income;
(4) Consult in regard to reaching a fair and equitable apportionment of industrial or commercial profits between a resident or corporation of one State and its permanent establishment in the other State; and
(5) Consult concerning the allocation of gross income and deductions between related enterprises as provided in Article 11, and to adopt appropriate procedures for effectuating such apportionment or allocation.

This article also provides that if the competent authorities reach agreement, taxes may be imposed and refund or credit may be allowed in accordance with such agreement. A similar provision has been included in recent supplementary protocols to the conventions with the Netherlands, Germany, and the United Kingdom.

ARTICLE 25. EXCHANGE OF INFORMATION

Article 25 provides for a system of administrative cooperation between the competent authorities of the two States and specifies conditions under which information may be exchanged to facilitate the administration of the convention and to prevent fraud or fiscal evasion of taxes to which the convention relates. This provision is substantially similar to those found in existing tax conventions to which the United States is a party.

ARTICLE 26. ASSISTANCE IN COLLECTION

This article which corresponds to articles in our existing treaties, provides that each State will assist the other in the collection of taxes imposed by such other State to the extent necessary to insure that any exemption or reduced rate of tax granted under the convention by the other State will not be enjoyed by persons not entitled to such benefits. However, neither State is required to take measures at variance with its administrative practice or which would be contrary to its sovereignty, security, or public policy. Nor is either State required to enforce the tax claims of the other or entertain suits on such claims in its courts.

ARTICLE 27. TAXPAYER CLAIMS

Under this provision, where a citizen, resident, or corporation of either State shows proof that the action of the other State's tax authorities has resulted, or will possibly result, in taxation in contravention of the provisions of the convention, such person may present his case to his State's competent authority, who may attempt to come to an agreement with the competent authority of the other State with a view to the avoidance of double taxation.

ARTICLE 28. EXCHANGE OF LEGAL INFORMATION

This article specifically provides that the competent authority of each State shall advise the competent authority of the other State of any addition to or amendment of the tax laws of the State which concern the imposition of taxes which are the subject of this convention.

This article also provides that for the purpose of mutual assistance in development and maintenance of sound fiscal policies and tax administration, the competent authorities may consult together and make mutually acceptable arrangements, including exchanges of personnel, technical memoranda, and studies.

ARTICLE 29. DIPLOMATIC AND CONSULAR OFFICERS

This article preserves the existing fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements.

ARTICLE 30. EFFECTIVE DATES AND RATIFICATION

This article provides that the convention will be ratified and the instruments of ratification exchanged at Washington as soon as possible.

In general the convention will be effective for taxable years beginning on or after January 1 of the year following the date of exchange of instruments of ratification.

Special exceptions to the general effective date are as follows:

(1) The source rule governing income from the sale of personal property produced in one State and sold in the other State (Article 5(8)) will have effect only after the competent authorities of both States have established mutually acceptable rules for the implementation of the rule.

(2) The investment credit provision (Article 7) will have effect with respect to property placed in service and net new investments made on or after January 1, 1968.

(3) The dividends, interest, and royalties articles (Articles 12, 13, and 14) will have effect with respect to amounts paid on or after January 1, 1969.

The convention will continue in effect indefinitely but may be terminated by either of the States at any time after 3 years from the general effective date described above if at least 6 months' prior notice of termination is given through diplomatic channels. In such event, the convention will cease to be effective for taxable years beginning on or after January 1 of the year following the expiration of the 6-month period.

In addition, upon 6 months' prior notice given through diplomatic channels, the following may occur:

(a) Any rules established for the implementation of the source rule discussed at (1) above may be terminated by either State at any time;

(b) The investment credit provision (Article 7) and the deduction for charitable contributions (Article 22) may be terminated by the United States at any time after 3 years from the general effective date of the convention; and

(c) The reduction in rate for dividends and branch profits (Article 12(3) and (4)), the reduction in rate for interest derived by banks or other financial institutions (Articles 13 (3)), and the reduction in rate for royalties (Articles 14 (1)) may be terminated by Brazil at any time after 3 years from the general effective date of the convention.

Further, by notice given by Brazil to the United States through diplomatic channels, the reduced rates discussed in (c) above, may be terminated by Brazil at any time after the date on which the investment credit is terminated pursuant to Article 7 (4) or suspended by Brazil at any time after the date, and for the period, of any suspension of the investment credit provided by Article 7 (4).

Any termination or suspension under the preceding two paragraphs will not prejudice benefits available with respect to transactions entered into prior to such termination.

NATIONAL ASSOCIATION OF MANUFACTURERS,
New York, N.Y., October 9, 1967.

Hon. J. WILLIAM FULBRIGHT,
Chairman, Committee on Foreign Relations,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The National Association of Manufacturers is pleased to present its views to the Committee on Foreign Relations concerning the Proposed Income Tax Convention Between the United States and Brazil.

The NAM is a voluntary organization of industrial and business firms, large and small, with members located in every state, and accounts for the major part of the manufacturing output in the United States. Many of its members are engaged in overseas operations and Brazil is one of the more important countries in which they have interests.

Its Subcommittee on International Taxation has studied the Proposed Income Tax Convention with Brazil and recommends that the Senate ratify it.

We are sympathetic with the problems which confront our negotiators when dealing with representatives of other countries, in this case Brazil, under the attendant circumstances. The principal problem has to do with the duality of tax jurisdiction, the predictable flow of capital, and the predictable flow of income which that capital produces. The United States is the capital exporting country and the developing country, Brazil, wants and needs that capital. We believe that United States investments overseas should be encouraged, particularly in developing countries.

We further believe that the negotiations which have been concluded with the Brazilian authorities are a move in the right direction and will facilitate the achievement of this objective.

The Convention concluded with Brazil may well become a model for future negotiations with other developing countries. This is not to say that every clause of the Brazilian Convention should be repeated in others, for economic and highly technical differences inevitably exist in the relationships with other countries. Accommodation can and will be made for these differences.

The immediate purpose in concluding this Convention was to encourage future investment in Brazil. The product of this investment will be earnings in Brazil. Brazil has the primary jurisdiction to tax this income because it is earned there.

It was the purpose of our negotiators to limit, insofar as possible, the amount of Brazilian tax on this income. The objective of the Brazilian negotiators was to tax this income at high rates, rates which are no less than the U.S. tax rates otherwise applicable to this income were it not for U.S. foreign tax credits.

This is perhaps an inherent flaw in the foreign tax credit mechanism and certainly is an indictment of the present U.S. policy against so-called "tax-sparing". Consequently, the only thing that our negotiators have to bargain with when dealing with the Brazilian tax authorities and those of other developing countries is the investment credit mechanism incorporated in this Convention.

We feel, under these circumstances, that the investment credit principle is appropriate.

Undoubtedly, others have considerable fault to find with specific technical details of this tax convention. We have reviewed them in depth and have concluded, on balance, that they are not sufficient to offset the advantages. In all likelihood, modifications and changes will be made in negotiations in the future as experiences unfold and point to the desirability of changes.

We consequently believe that the Proposed Income Tax Convention Between the United States and Brazil is a good one and should be ratified.

We would appreciate it if this letter could be included in the printed record of your Committee's hearings on this Convention.

Sincerely yours,

DONALD H. GLEASON,
Chairman, Subcommittee on International Taxation,
Committee on Taxation.

UNITED STATES COUNCIL OF THE INTERNATIONAL CHAMBER OF COMMERCE, INC.,
NEW YORK, N.Y., OCTOBER 9, 1967

MEMORANDUM ON THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE UNITED STATES OF BRAZIL FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXATION ON INCOME

The United States Council is the American section of the International Chamber of Commerce, a worldwide association of businessmen committed to expanding trade and production internationally. The Council's membership consists of some 350 U.S. corporations heavily engaged in international operations.

The Committee on Taxation of the United States Council has recently given careful consideration to the Convention between the United States of America and the United States of Brazil for the Avoidance of Double Taxation with Respect to Taxation on Income. As a result of its study, and while recognizing that there are areas which could be improved upon, the Committee on Taxation recommends ratification of this Convention..

The United States Council believes that U.S. private enterprise can and should play a large part in promoting economic activity in the developing countries. We further believe that the investment credit provisions of the United States-Brazil Convention may prove to be a useful and effective means to encourage private investment in Brazil.

Our examination of the Convention has, however, raised a number of interesting questions which we would like to bring to the attention of the Committee. We recognize that in the instance of the United States-Brazil Convention the Senate is called upon to either ratify or reject the Convention which has already been approved by the two governments. While we would obviously like to see the Convention modified to take into account some of the problems raised, we recognize that this is a matter for negotiation between the governments. We would hope that these modifications could be negotiated. More importantly, however, we would hope that the substance of our comments would be taken into account in future treaty negotiations with other less developed countries.

The Investment Credit

The United States-Brazil Convention excludes from the basis of the credit investments for extractive industries, notably oil and mining. Not only is such an exclusion discriminatory against U.S. enterprises engaged in such activities, but more importantly, it will tend to defeat the purpose of the investment credit, which seeks to stimulate through private investment the economies of the less developed countries involved. The argument frequently advanced on behalf of such an exclusion is that since mineral resources can only be developed where they are located, no stimulus is needed to make them more attractive than competing investment opportunities elsewhere.

It is however, unrealistic to assume that the mere existence of mineral resources will automatically attract foreign capital for their development. As in other businesses, there are ventures in mining and other extractive industries on which possible return on investment is marginal and speculative, and a tax incentive (or a tax disincentive as compared to other opportunities for investment) can be decisive in determining whether to take the capital risk.

It is not just a matter of giving the U.S. investors an inducement to investment in mineral resources in a developing country, rather than in her risky investments elsewhere or of other types. If the United States wishes to stimulate the economies of the developing countries, in many cases development of their mineral resources is a necessary first step. It provides foreign capital (from the private sector) before other investment opportunities exist, and it is usually the first and fastest way to generate the wealth needed to promote the economic and social progress which these countries need and which we want to help.

We therefore urge that the Senate expressly recommend to the U.S. Treasury that in future tax conventions which include an investment credit provision, investments in extractive industries be included in the term "qualified trade or business." We are in favor of further negotiations in due course with Brazil (and other developing countries with which Tax Conventions have been negotiated) to remove this exclusion. Because such investment will accelerate their economic growth, we feel certain that the developing countries would welcome this modification.

As a general matter, we recognize that there is an appearance of comity in closely relating the investment credit for foreign investments to the provisions for the investment credits in the U.S. Internal Revenue Code. But the purposes and the objectives sought, are clearly different. Circumstances in the United States may suggest modifications, suspension or termination of the credit for U.S. investments, although circumstances in foreign countries may not change, or may even require, to further our national policy, that stimulation of U.S. investments should be increased. Thus we believe that in tax conventions the 7% rate of the domestic credit should not be considered sacrosanct, and that the various U.S. provisions for recapture and limitations should not be included in tax conventions.

As a matter of fact, the U.S.-Brazil Convention includes investment credit limitations (in addition to those on the extractive industries) not present in the domestic provisions; the reasons for these particular limitations are not apparent to us. Thus the credit is not available for investments in most wholesaleing businesses and rented tangible personal property. Furthermore, a U.S. corporation operating a branch in Brazil cannot avail itself of the credit for branch investments. While business consideration usually dictates use of a Brazilian subsidiary, the investment credit section should not be so limited.

Allocation of Income and Settlement of Disputes

We have been concerned for some time over the apparent failure of tax treaties to which the U.S. is a party to eliminate double taxation in cases where the tax laws or administrative policies of the two contracting countries differ on the treatment of a particular item of income. Thus, for example, Article 8(3) of the Brazil treaty provides that if a U.S. taxpayer has a permanent establishment in Brazil, that country will allow deductions for all direct expenses which would be deductible under its law if the permanent establishment were an independent enterprise. Leaving aside the fact that the treaty gives no relief in cases where a U.S. corporation has a subsidiary in Brazil which is not a permanent establishment, Brazilian law allows only a limited category of expenses to be deducted. This is to be contrasted with a much broader category of expenses which, under Section 482 of our Internal Revenue Code, U.S. corporations would be required to charge to their Brazilian affiliates. Similar conflicts are inherent

in the determination of an arm's length charge required under Section 482 for the sale of goods, the rendition of services or the transfer of intangibles.

Article 21 of the treaty provides for consultation between the Competent Authorities with a view toward the elimination of double taxation. However, because the provision merely states that the authorities may consult together "to endeavor to agree", the interaction of the U.S. Treasury's position on Section 482 and provisions of Brazilian law, such as those referred to above, will result in the failure of the treaty to avoid double taxation in many cases.

The Treasury has indicated that it will make allocations of income and deductions between related parties under Section 482 regardless of whether or not the foreign government is prepared to give recognition under its law to necessary corresponding adjustments. We seriously question this policy in cases, such as Brazil, where the United States has entered into conventions designed to avoid double taxation. It is important to keep in mind that conflicts concerning allocations of income or expenses are basically disagreements between governments over the same tax dollar.

We believe that it is not the taxpayer who should suffer in the event of unresolved disputes. It recommends that in case of such disputes the Treasury allow the U.S. taxpayer to offset against the U.S. tax liability resulting from the allocation, the amount of foreign taxes which have resulted from the refusal of the foreign government to agree to the allocation. Moreover, we recommend that, at least in future treaties, the consultation provisions be strengthened in a manner which will achieve the elimination of double taxation in the event of disputes.

Tax Sparing

We understand that the United States has not looked favorably on the concept of "tax sparing" under which the United States would treat as taxes paid for credit purposes taxes provided by foreign country law but waived or reduced for a stated temporary period. Nevertheless, certain developing countries favor use of this device to improve their business climate for foreign investment and have welcomed its inclusion in treaties with European countries. We suggest the United States consider the use of tax sparing in negotiation of future tax conventions with developing countries.

RALSTON PURINA CO.,
St. Louis, Mo., October 13, 1967.

HON. J. WILLIAM FULBRIGHT,
Chairman, Committee on Foreign Relations,
U.S. Senate, Washington, D.C.

DEAR SENATOR FULBRIGHT: We would like to urge the Foreign Relations Committee to take prompt action in recommending early ratification of the proposed tax convention with Brazil. Of special importance to us, and to United States business in general, is the investment tax credit provision contained in article 7 of the convention. This provision is designed to place private investment in developing countries on a more even footing with private investment in the United States.

The purpose of an investment tax credit is to spur the economy through encouragement of investment in productive facilities. It has proven effective in stimulating domestic capital investment and its purpose in connection with the Brazil treaty is the same. If United States capital is to be assigned to Brazil to increase the latter's productive capacities, tax inducements similar to those offered for domestic investment are necessary. Otherwise, the required capital will remain in the United States in order to take advantage of the tax benefits offered here.

The investment tax credit prescribed in the treaty is modeled after the domestic credit and is applicable under similar conditions. The amount of credit allowable against United States taxes (to a United States resident or corporation owning at least 25% of the voting power of an eligible corporation) is 7% of the cost of qualified machinery and equipment placed in service by the eligible corporation during the taxable year.

In our opinion, the investment tax credit is the best financing device yet conceived to encourage investment of United States capital in underdeveloped areas. Because of the extreme risk involved, the difficulty of financing, and the customary low rate of initial return on investment, business must have some

incentive to assign its capital to these areas rather than to the industrialized nations. Article 7 of the convention provides such an incentive by extending domestic tax advantages to private investment in Brazil.

Brazil has recognized the significance of this provision by agreeing to limit application of its tax rates on income returning to the United States to a level not exceeding the United States tax rates imposed upon such income.

For these reasons we think the tax convention with Brazil reflects sound international tax policy in the encouragement of investment in productive facilities of less developed countries, and should be promptly submitted to the Senate for ratification.

We would appreciate inclusion of this letter in the record of the hearings.

Respectfully yours,

R. HAL DEAN,
President.

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